Statement

of

Adam N. Michel, Ph.D.

Director of Tax Policy Studies
Cato Institute

before the

Senate Finance Committee

May 21, 2024

Less Government, More Savings

Cato Institute • 1000 Massachusetts Ave., N.W. • Washington, D.C. 20001 • (202) 842-0200
Fax: (202) 842-3490 • www.cato.org

Chairman Wyden, Ranking Member Crapo, and Members of the Committee: Thank you for inviting me to testify today.[1]

Saving is an important foundation for economic growth, personal well-being, and intergenerational support. When economists and policymakers determine that an activity, like saving, is important, the impulse is to encourage more of it. Today, I will urge you to first address the places where the government makes it harder for individuals to save.

The tax code is a major impediment to savers. The income tax double and triple-taxes investment income, discouraging Americans from putting money away for their kids, their retirement, or their dream of opening a business. The trillions of dollars the federal government spends on social welfare programs each year also undermines incentives to save, crowding out personal savings for government promises.

Thankfully, the tax code has many features, such as qualified investment accounts and lower capital gains taxes, that reduce some of the built-in disincentives to save. However, more work must be done to simplify and equalize the tax code's treatment of savers.

Instead of subsidizing personal savings, Congress should simply get out of the way. You could start by ensuring the 2017 tax cuts are made permanent so American families and businesses can have the certainty they need to plan and save for the future. Further reforms to the tax code, such as universal savings accounts (USAs) and lower income and capital gains taxes, would remove additional disincentives to save. Tax cuts that are paired with cuts to spending programs that crowd out personal wealth would be most effective at allowing Americans to save for their own priorities.

Following pandemic-era stay-at-home orders and massive government financial support, Americans accumulated $2.1 trillion in excess savings (savings above the previous trend). As of March 2024, that excess savings has been spent, and Americans are drawing down other assets as savings rates are again historically low, solidifying a half-century decline.[2] Checks from the government fueled more inflation than wealth building. Getting government policy out of the way is a better way to reverse the decline in American's savings.

The Tax Code Double Taxes Savers

Traditional income tax systems encourage consumption over saving by assessing multiple layers of tax on interest and investment returns.

Wages are first taxed by income and payroll taxes. Individuals then choose to spend or save their after-tax income. Saved income is delayed consumption, saved to be spent in the future—in retirement, for a down payment on a home, to start a business, or to pay for

[1] The views I express in this testimony are my own and should not be construed as representing any official position of the Cato Institute.
[2] Hamza Abdelrahman and Luiz Edgard Oliveira, "Pandemic Savings Are Gone: What's Next for U.S. Consumers?" Federal Reserve Bank of San Francisco blog, May 3, 2024.

education. A saver's earned interest income or investment returns are what the market pays to delay spending.

Under the income tax system, the increased value of investments is often taxed again as interest, capital gains, dividends, and transfers at death by the estate tax. The corporate income tax adds another layer of tax on income earned from corporate equity investments. Taxing investment returns reduces the market incentives to save by lowering the payment to delay consumption. Proposals to tax unrealized capital gains through mark-to-market taxes and wealth taxes would further increase effective tax rates on saving.[3]

Saving and Investment are Key to Growth

The level of investment is one of the three main components driving long-run economic growth: capital investment, paired with labor (workers), and technological innovation. When businesses invest in capital, such as machinery, buildings, and factories, the economy can be more productive, generating more goods and services using the same quantity of labor. Since personal saving is an important component of overall investment, additional personal savings will lead to a larger capital stock and economy.

A tax base that equally taxes income from labor and capital creates the smallest economic distortions. Such a tax is commonly referred to as a consumption tax.[4] When the income tax system lowers the after-tax return to savings, more income is consumed immediately, and entrepreneurs have fewer resources to invest in future technologies, expand their businesses, and raise wages. The US tax system mitigates the worst of these effects through lower capital gains and corporate income tax rates, as well as tax-advantaged savings accounts, but additional reforms are needed.

Qualified Accounts Reduce the Double Tax

One way the tax code reduces the income tax systems' built-in bias against saving is through qualified savings accounts, such as employer-administered 401(k) retirement accounts, Individual Retirement Accounts (IRAs), and 529 Plan education savings accounts. Qualified savings accounts remove capital gains and dividends taxes from investment returns, although the corporate income tax still reduces the investment return. In the accounts, savers can purchase a wide range of stocks, bonds, mutual funds, and exchange-traded funds, although rules vary.

Qualified accounts allow taxpayers to contribute tax-deferred income (traditional accounts) or after-tax income (Roth accounts). Contributions to traditional savings accounts are deducted from taxable income so that income taxes are not due when the contribution is

---

[3] Chris Edwards, "Taxing Wealth and Capital Income," Cato Institute Tax and Budget Bulletin No. 85, August 1, 2019; and Nicole Kaeding, "Structural Questions Abound With New Mark-to-Market Tax Proposal," National Taxpayers Union Foundation Policy Paper, December 18, 2019.

[4] N. Gregory Mankiw, Matthew Charles Weinzierl, and Danny Yagan, "Optimal Taxation in Theory and Practice," *Journal of Economic Perspectives*, Vol. 23, No. 4 (2009), pp. 147–174; and Alan J. Auerbach, "The Choice Between Income and Consumption Taxes: A Primer," NBER Working Paper No. 12307, June 2006.

made. For Roth accounts that receive after-tax contributions, no tax is due at withdrawal. If the contribution and withdrawal are made while the taxpayer is in the same tax bracket, the effective tax rate on an investment in Roth and traditional savings accounts is identical.

Table 1 shows an illustrative example. Tom and Dan are both 30 years old, in the 24 percent income tax bracket, and want to save $5,000 this year. Tom deposits $5,000 directly into his traditional 401(k) and receives a corresponding income tax deduction, saving him $1,200 in taxes this year. Dan also saved $5,000 of pre-tax income this year but did not deposit it in a qualified savings account and paid $1,200 of income tax on his saved income. If Dan and Tom both earn the same 7 percent rate of return for 30 years, Tom will pay about $9,800 in taxes when he withdraws the savings, leaving him with $31,000. Dan only pays $4,600 in capital gains taxes when he sells his assets, but because his original seed money was smaller, he is left with $26,400 in after-tax savings ($4,700 less than Tom). Tom's marginal effective tax rate is 24 percent, and Dan's is 35 percent.[5]

Table 1

Qualified accounts lower taxes on saving

	Tom (Traditional qualified account)	Dan (Savings outside qualified account)
Pre-tax contribution	$5,000	$5,000
Income tax paid on contribution	$0	$1,200
Value of account, year 1	$5,000	$3,800
Value of account, year 30	$40,831	$31,031
Income tax paid on withdrawal	$9,799	$4,655
After-tax value of savings	**$31,031**	**$26,377**

Source: author's calculations.

Note: Calculations are based on an income tax rate of 24 percent, capital gains rate of 15 percent, and a 7 percent continuously compounded rate of return for 30 years. This is a simplified example that does not account for discounting taxes in different time periods and other timing complications.

Without qualified accounts, the income tax system increases the tax rate on Dan's savings, discouraging him from setting money aside for the future. All else being equal, Dan will save less for retirement than Tom, and the broader economy will be poorer due to Dan's missing

[5] This example builds on a similar work in, Adam N. Michel, "Universal Savings Accounts Can Help All Americans Build Savings," Heritage Foundation Backgrounder no. 3370, December 4, 2018.

contribution to the capital stock. Without protections from investment taxes, the same is true for other types of savings.

Congress has created qualified accounts for several types of savings:

- Retirement: Employer-sponsored 401(k) accounts, IRAs, and about ten other types of accounts for special circumstances.
- Education: 529 Plans and Coverdell education savings accounts.
- Disability: ABLE 529.
- Health care: Health Savings Accounts (HSAs). In addition to the protection from capital gains and dividend taxes, HSAs are fully exempt from income tax and payroll tax when distributions are for qualified health expenses—sometimes called a triple tax advantage.

Universal Savings Accounts

The existing qualified accounts shield taxpayers from double taxation, but they also come with income and contribution limits, age restrictions, employer requirements, required minimum distributions, and restrictions on what and when the savings can be spent. These rules are enforced with additional tax penalties and regulatory hurdles designed to increase the cost of accessing the savings for non-qualified expenses. The complexity of this existing system and penalties for mistakes discourage uptake, especially among young and low-income savers for whom liquidity is most important. The restrictions also act as an implicit subsidy for savings spent on targeted activities, such as education and retirement.

To fix this problem, Congress could create a universal savings account that would function similarly to retirement accounts—income saved in the account would only be taxed once—but without restrictions on who can contribute, when funds can be spent, or on what they can be spent. Similar accounts have been set up in Canada, the United Kingdom, and South Africa, where they are wildly popular, have increased personal savings, and are used by people at every income level.[6] In 2020, 40 percent of Canadian households contributed to a Canadian tax-free savings account (TFSA)—almost 60 percent own a TFSA—and 51 percent of TFSA account holders earned less than Canadian $50,000 (about US $37,000).[7]

A similar reform proposed in President George W. Bush's fiscal year 2005 budget would have simplified the existing retirement system and created a universal savings account, called a lifetime savings account, that would have "allow[ed] an individual to earn a tax-free return on deposit amounts and withdraw the funds as needed without paying further taxes

---

[6] Ryan Bourne and Chris Edwards, "Tax Reform and Savings: Lessons from Canada and the United Kingdom," Cato Institute Tax and Budget Bulletin No. 77, May 1, 2017.
[7] "Table 1C: TFSA Holders by Total Income Class," Government of Canada, Canada Revenue Agency, last revised January 17, 2022.

and without facing a withdrawal penalty."[8] A small (annual limit of $2,500) universal savings account passed the House of Representatives in 2018 as part of the Family Savings Act.[9] The annual contribution limit should be at least $10,000 to ensure the accounts can serve the majority of Americans' saving needs and could be opened as custodial accounts for children to encourage saving in early life.

Not Everyone Needs to Save More

The appropriate savings rate varies significantly among individuals and changes over the course of their lives. To the extent that government savings programs go beyond removing disincentives to save, they could make some people worse off. For example, default auto-enrollment features and matching incentives may prompt some individuals to save more than is optimal for lifetime financial needs. This over-saving can reduce the resources available for current consumption or lead to higher debt levels as individuals attempt to maintain their lifestyles.

For instance, Andrew Biggs highlights the potential pitfalls of automatic enrollment in state-level retirement saving programs. He questions whether lower-income individuals—the target of the reforms—actually need to save more for retirement, whether state-run auto-IRA plans actually increase net household savings, and whether such plans improve the financial well-being of the poor, especially when accounting for interactions with means-tested government transfer programs. Biggs concludes that "the answer to all three questions may be 'no,'" suggesting that savings incentives could leave some people worse off.[10]

Supporting this view, a study of the federal government's Thrift Savings Plans found that automatic enrollment of federal employees with less than a high school education led to increased borrowing, likely to compensate for lower take-home pay.[11] A similar dynamic could result from existing policies, such as the savers credit, and proposed policies, such as the saver match in 401Kids. Artificially induced savings that incur additional tax penalties when accessed for non-approved spending further reduce individual economic security and wealth building.

Government Crowds Out Private Wealth

---

[8] "Promoting Prosperity, Expanding Opportunity," in *Budget of the United States Government, Fiscal Year 2005* (Washington: U.S. Government Publishing Office), p. 33.
[9] Family Savings Act of 2018, US House of Representatives, 115th Congress, (H.R. 6757).
[10] Andrew G. Biggs, "How Hard Should We Push the Poor to Save for Retirement?" AEI Economics Working Paper, Updated October 2017; and Andrew G. Biggs, "How Much Should the Poor Save for Retirement? Data and Simulations on Retirement Income Adequacy Among Low-Earning Households," Presentation at "Remaking Retirement? Debt in an Aging Economy." Sponsored by the Pension Research Council/Boettner Center for Pensions and Retirement Research, May 2, 2019.
[11] John Beshears, et al., "Borrowing to Save? The Impact of Automatic Enrollment on Debt," *The Journal of Finance* Vol. LXXVII, No. 1 (2022).

Beyond the direct effects of the income tax system on personal savings, social welfare spending can also displace individuals' incentive to save.

Social Security likely crowds out the most private savings. Early work from Martin Feldstein in the 1970s, corroborated and refined by subsequent research, shows that each dollar of promised Social Security benefits can reduce private savings by as much as 50 percent.[12] Jagadeesh Gokhale, Laurence Kotlikoff, and John Sabelhaus find that increased Social Security and Medicare benefits are significant factors explaining the multi-decade decline in the US savings rate (which declined from an average of 12 percent in the 1970s to 6 percent in years before the pandemic).[13] The lost private savings and resulting smaller capital stock have likely placed significant downward pressure on the size of the US economy.[14]

In addition to Social Security and Medicare, many other welfare programs similarly reduce the incentive for Americans to save for their own needs. The taxes necessary to finance these programs also reduce the funds available to save. Chris Edwards and Ryan Bourne review evidence showing that by crowding out private savings, and thus wealth accumulation, welfare spending increases wealth inequality.[15] It does this by reducing the wealth of the lowest-income Americans who rely most on the government alternative to private savings.

Neutral, Pro-growth Tax Code is Important for Saving

Policymakers should work to remove existing government barriers to saving and investment before considering new subsidies or transfer programs. In addition to reforming and reducing spending programs that crowd out wealth accumulation, Congress should build on the successes of the 2017 Tax Cuts and Jobs Act (TCJA) by making it permanent before the 2026 expiration and pursuing additional reforms.

The TCJA cut individual and corporate tax rates, made it easier for millions of Americans to pay their taxes, simplified family benefits, and overhauled the international tax system, among many other reforms. As a result, the law increased the share of taxes paid by higher-income taxpayers and successfully boosted economic growth, investment, and wages.[16]

Tax cuts can boost savings in two ways. First, allowing individuals to keep more of their earnings gives them additional resources to save and a greater incentive to invest in human capital, from which they can keep more of the returns. Second, individuals will save more

---

[12] Congressional Budget Office, "Social Security and Private Savings: A Review of the Empirical Evidence," CBO Memorandum, July 1998.
[13] Jagadeesh Gokhale, et al., "Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis," NBER Working Paper No. w5571, May 1996.
[14] Andrew G. Biggs, "Social Security and Private Savings — Causes and Effects," AEIdeas, September 17, 2009.
[15] Chris Edwards and Ryan Bourne, "Exploring Wealth Inequality," Cato Institute Policy Analysis No. 881, November 5, 2019.
[16] Adam N. Michel, "Protecting American Families from Higher Taxes," Testimony, Committee on the Budget, United States Senate, May 17, 2023.

and consume less if the tax cut increases the after-tax investment return by cutting capital gains, dividends, estate, or business taxes. The 2017 tax cuts worked through both channels, cutting taxes for individuals and reducing the after-tax cost of capital by cutting the corporate income tax and allowing full investment deductions (full expensing).

Due to the structure of the 2017 tax cuts, the most economically powerful incentives were for increased business investment, which can be financed by domestic and foreign savings. Additional investment is the primary channel through which the economy benefited from the tax cuts, as businesses raised wages, added jobs, and produced more goods and services. Kyle Pomerleau and Donald Schneider find that in the years immediately after 2017, "real GDP, consumption, business investment, and payrolls grew more rapidly than expected."[17] Gabriel Chodorow-Reich and coauthors report similar results. Using variations in how the 2017 tax reform impacted different corporations, they found that the tax cut "caused domestic investment of firms with the mean tax change to increase by roughly 20% relative to firms experiencing no tax change."[18] Similarly, disposable personal income, personal savings, and mortgage delinquency rates all improved significantly for individuals in 2018 and 2019.

The most pro-growth tax changes must be permanent. Individuals and businesses are always planning for the future and almost always, taxes play a key role in their decisions. Thus, temporary tax changes have little effect on long-term planning, savings decisions, or economic growth. Making the TCJA permanent and continuing to cut tax rates by reducing government spending and broadening the tax base would support families, individual savings, and economic growth. With automatic tax increases hanging over the economy, it is harder for individuals and businesses to save, plan, and invest.

[17] Kyle Pomerleau and Donald Schneider, "Making the Tax Cuts and Jobs Act Permanent: Two Revenue-Neutral, Pro-Growth Options for Tax Reform," American Enterprise Institute Report, updated April 8, 2024.
[18] Gabriel Chodorow-Reich et al., "Tax Policy and Investment in a Global Economy," NBER Working Paper No. 32180, March 2024.