Tax Policy and Saving

By Rudolph G. Penner

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Penner concludes that tax deductions that target specific types of saving likely increase national wealth. But, turning to tax reform, Penner notes that revenue-neutral reform moving more toward a consumption-type system would have a net positive effect on savings and avoid further debate over specific incentives. To address concerns of progressivity, a consumption-type system could be designed that is almost distributionally neutral except for its effect on a few high-income individuals, says Penner.

Economists have provided valuable insights into human behavior, and as a result, are pretty good at policy analysis. They are not very good at explaining savings, however. Perhaps that is because there is much that is irrational in saving behavior and economists are not good at irrationality. Whether irrational or not, we know that within each income group there are inveterate savers and inveterate spenders, and that may be important in trying to figure out how tax policy affects saving behavior.

Why do we care? Personal saving, as conventionally measured, has fallen dramatically. But it must be admitted that we are having a good time.

Saving increases a nation's wealth by financing physical investments and by reducing liabilities to foreigners. Today's high consumption implies that we are sacrificing relatively less to transfer wealth to future generations than our ancestors sacrificed for us. Moralists would say that doesn't seem quite right.

But there are other reasons for the tax code to treat savings leniently. People with a store of wealth are much less likely to need public assistance in retirement, for education, or to cover health costs. In other words, increasing wealth can reduce the number of free riders. It is also thought that if wage earners are encouraged to become capitalists, they will provide more political support for the free-market policies that economists love so dearly. Last, there is an important equity argument. Thomas Hobbes argued 400 years ago that it is fairer to tax people on what they extract from the economy in the form of consumption than on what they contribute as measured by income.

Our complex ''income'' tax code blends consumption and income taxation in a highly confusing and inefficient manner. There are many specific tax incentives for saving for retirement, health costs, and education and there are lower tax rates on capital gains and dividends, while corporate capital is still taxed heavily.

Those who advocate tax cuts for saving to increase national wealth have to jump a high hurdle. They must argue not only that private saving will increase, but that it will increase sufficiently to more than cover the revenue loss to the Treasury. Other arguments for tax incentives for saving make it less important for national wealth to increase, but the arguments lose much of their appeal if the effect on private saving is miniscule.

The effectiveness of specific incentives for retirement saving has been extensively studied and the results are an embarrassment to the economics profession. One can find studies that say private saving increases far more than the revenue loss to the Treasury, a little bit more, and considerably less. A major problem is that the effects of those incentives are theoretically ambiguous, even if people are completely rational. A tax cut on the return to retirement saving increases the reward for waiting until retirement to consume, but it also provides an increase in after-tax income that allows more future consumption even if one saves a bit less. Consequently, the net effect on current saving can be positive or negative. The issue is further complicated because people with wealth can shift fully taxable assets into a tax-favored retirement account and they do not have to increase saving at all to enjoy a tax break. Some may even borrow in a tax-favored manner (for example, using home equity loans) to invest in a tax-favored account.

There are two types of tax-favored accounts — the traditional IRA type that allows tax deductions for deposits but taxes withdrawals, and the Roth type that does not allow deductions for deposits but allows investment earnings to be free of tax. The Roth approach is greatly favored by the congressional budget process. Congress budgets with a limited time horizon, usually five years. The revenue losses associated with the Roth approach accrue slowly as assets accumulate and most of the revenue loss occurs after five years and is therefore ignored. In contrast, tax deductions associated with the traditional approach cause an immediate revenue loss

while tax revenue from withdrawals mainly accrues on the other side of Congress's budget horizon.

If Treasury borrows to cover the costs of tax deductions under the traditional approach, Treasury earns a profit if the taxpayer earns a rate of return in excess of the interest rate on Treasury securities. Treasury does not profit from excess returns to a Roth account. Whether Treasury has a right to profit from excess returns can be disputed philosophically, much as the nation is now debating how to tax the "excess" profits of oil companies.

It is clear that people are not hyperrational when it comes to making deposits in tax-favored retirement accounts. They tend to wait until the last minute, at tax return filing time, to make a deposit rather than enjoying the tax advantage of making a portion of their eligible deposit early in the tax year. I suspect that this irrationality enhances the positive saving effect of the traditional IRA approach because the tax advantage is very apparent at the last minute. After money is deposited, the saving is locked away; it cannot be withdrawn early without a tax penalty. That could provide another enhancement to saving by people with limited assets. That effect would apply to both types of account. At the other end of life, the Roth approach may favor more saving. Traditional IRAs must be drawn down after age 70½, and if the owner wants to save the proceeds, a portion may have to be put into a taxable account, thus reducing the saving incentive. A Roth account can be allowed to continue to accumulate tax-free. It could also be that having cash on hand because of forced withdrawals from a traditional IRA may irrationally favor consumption.

Although the associated revenue loss is not fully counted, the Roth approach has one advantage. It is much simpler, especially when it comes to estate planning. One does not have to worry about strategizing over how fast the accounts will have to be drawn down by one's heirs.

In conclusion, I lean toward the view that targeted tax deductions do increase national wealth, partly because of irrationalities in behavior. It is not an easy argument to make because personal saving has fallen steadily while tax incentives have become more generous. But who knows how far saving would have fallen in their absence?

So far, I have concentrated on the effects of tax cuts that target different types of saving. The arguments change radically if one considers significant tax reforms that ease the tax burden on saving and investment while providing the same total revenue in a distributionally neutral manner. Recently, President Bush's tax panel described such a reform as one of two options.

With a revenue-neutral reform that moves the system more toward consumption taxation, one does not have to worry about any negative effect on tax revenue or the budget deficit. Any increase in private saving will provide a net gain in the nation's wealth. One also has to worry less about the theoretical ambiguity that afflicts the analysis of policies that both increase the reward for saving and increase after-tax income. In the first instance, a revenue-neutral reform will leave after-tax incomes the same on average. One is left solely with increasing the reward for saving. Theoretically, the effect should be unambiguously positive unless there is something peculiar about the effect of changes in income among the reform's winners and losers.

I suspect that there is something peculiar about the differing effect on winners and losers, but it is something that would enhance the positive effects on saving. I noted above that there are large differences in the propensity to save among households within every income group. A distributionally neutral tax reform that favors saving will cut taxes on those inclined to save while increasing taxes on inherent spendthrifts. One would expect the former to save a disproportionate share of their tax cut while the latter is forced to cut consumption, primarily because there is little saving to cut.

A comprehensive reform also allows us to escape a confusion bedeviling the debate over specific saving incentives. If the tax burden on all saving is cut while the rest of the tax structure is not changed, the rich are favored because they save more on average. Those favoring more progressivity may oppose the incentives on those grounds alone when a more sensible approach would separate debates about progressivity from debates about the relative tax burden on saving versus consumption. While it may be hard to imagine a consumption-type tax that burdens Bill Gates as much as the current system, one can construct a consumption-type system that is almost distributionally neutral except for the effect on the very few super-rich.

One can also easily construct a reform that uses the savings that we have more efficiently by giving the market more say and the tax system less say in how saving is allocated among uses. That could increase productivity as much as a significant increase in saving. With all it has going for it conceptually, it is a shame that comprehensive reform is so unpopular politically.