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The Case for the Savings-Exempt Income Tax

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Introduction

It is a great pleasure to participate in this bipartisan session on tax policy sponsored by Sam Nunn and Pete Domenici, two men that we all respect so highly.

This meeting deals with the missing link in the budget debate. Until now proposals to reduce the deficit have focused on either cutting spending or raising taxes. There is a third and constructive alternative — improving the way that the tax system functions. And that is what the two senators are proposing.

The Economic Case

In this time of huge budget deficits and high unemployment, the attractiveness of the Nunn-Domenici tax plan is that it raises revenue with far less damage to the economy than the existing tax system and it will do this while generating the same amount of revenue.

As a result, this means that, over the years, we will see a faster growing economy. The ultimate benefits will be threefold: (1) more people at work, (2) lower federal outlays for unemployment payments, etc., and (3) more income to the Treasury from a growing tax base with no future change in tax rates.

How do we achieve all these good things? Not by tinkering with the details of the Internal Revenue Code. Instead, we must overhaul the present federal income tax so that it exempts savings, which is the seedcorn for economic expansion. No, we are not advocating a new tax, such as a VAT. What I will describe is a sea change in the existing income tax structure.

For individual and family taxpayers, the proposal is very straightforward. Continue reporting your income. But, on a new schedule, list all of your saving during the year. Deduct saving from income and you pay tax only on the remainder. Basically, the senators are

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proposing a progressive-rate tax on income minus saving. Anybody who remembers their freshman course in economics will recognize that income minus saving equals consumption.

To state the matter a little differently, the idea is to tax income when it is spent instead of when it is received. You can also call it a consumed-income tax. These are all accurate synonyms.

But don't jump to the wrong conclusion. This is not a regressive sales tax. Each taxpayer will still use a rate table to figure the amount of tax. Therefore, the rate structure can be as progressive or proportional as Congress wants to make it.

Exempting saving from the income tax encourages thrift and enterprise, which means a stronger economy. *Saving* sounds so esoteric until you stop to think about it. So many references to saving go on to add the phrase "for the future." Of course, we save for the future. The importance of saving is that it reflects how much we care about the future — of ourselves, our families, and our country. The money to invest in a more productive and competitive economy — with a higher rate of job formation — that money comes fundamentally from our saving.

Under the Nunn-Domenici tax plan, the economic incentives are improved. The basic way to cut your tax — legally — will be to save more. In contrast, to minimize your current income tax liability, you have to earn less, which reduces the incentives to work, save, and invest.

Among the major industrialized nations, there is a clear and positive correlation between the share of GDP going to investment and the rate of economic growth. This is not a transitory or fleeting relationship. The close fit between investment and growth shows up in the data for the past three decades. Unfortunately, the United States has much lower rates of saving and business investment than our economic competitors.

The motivation for saving is basic. We save for vacation, for our children's education, for that proverbial rainy day. But that money doesn't sit idle. It works for us by being invested in stocks, bonds, and bank accounts — which provide interest or dividends — and in homes that provide us shelter. In the process of saving and investing, we generate the forces that create more production of goods and services, more employment, and a higher living standard. More capital formation will also enhance our competitiveness in an increasingly global marketplace. All this is why encouraging saving and investment is so important.

"It's Regressive"

One of the key reasons a general consumption-oriented tax has not been adopted in the United States is that most of the debate has focused on a very different kind of tax, a value-added tax, which is a sophisticated sales tax.

Let us explore the major criticisms of exempting saving and taxing consumed income. We will see that the negatives only pertain to the "bottom up" VAT and not to a "top down" tax on income minus saving.

The first reaction by many people to a savings-exempt income tax is that it is unfair because it is regressive. Supposedly the poorer people pay a larger share of their income than richer taxpayers. The VAT *is* regressive. That regressivity can only be reduced by making it more complicated.

However, the savings-exempt income tax is not regressive at all. Like the existing income tax, each taxpayer faces a rate table and — as already mentioned — that table can be made progressive or proportional. Under a revenue-neutral shift from the traditional income tax, the average taxpayer experiences no change in tax burden. However, above-average savers pay less than they do now and below-average savers pay more.

"It's Inflationary"

A second argument is that taxes focusing on consumption are inflationary. That is true for sales taxes such as a VAT, which show up directly in the prices of the products we buy.

However, the proposed tax would not be inflationary because it is levied on taxpayers and not on the goods and services we buy.

"It's an Administrative Burden"

The critics note correctly that the enactment of a value-added tax would require setting up a new tax-collection system and new recordkeeping on the part of taxpayers. Overhead costs would rise in both the public and the private sectors.

In contrast, a savings-exempt income tax relies on the existing IRS tax collection system. From the viewpoint of the taxpayer, the current bookkeeping and requirements will be reduced. Existing restrictions will be eliminated on Individual Retirement Accounts, Keogh accounts, and other specialized investment vehicles. *All* saving will be exempt from the new tax.

To a typical taxpayer, the change proposed here is essentially the equivalent of adopting a universal but simplified IRA — and using an amended rate table. Each of us would decide how much to save and in what form we should save.

All sorts of benefits will result. Take the current tax treatment of housing. Currently, the bigger your down payment — and thus the lower your interest payments — the smaller your tax break. But why should tax policy discourage investing in your home? Under our approach, your principal payments would be fully deductible. After all, building equity — in a home or a business — is a form of saving and investment.

Business Taxation

The Domenici-Nunn proposal also includes a reform of the corporate income tax by developing a counterpart to the individual savings-exempt income tax. It is a business "cash flow" tax to replace the corporate income tax. It also takes the place of the income tax on unincorporated business.

There is no need to fuss with depreciation allowances, estimates of an asset's useful life, or similar complications. The senators are talking about a low tax rate (about 10 percent) on corporations, partnerships, and proprietorships. To encourage investment, an immediate writeoff is given for capital investment. Such a simpler business tax system will particularly encourage small business.

An immediate writeoff of business capital investment is not exactly a radical or brand new idea. I remember presenting a statistical analysis of the issue the first time I testified before a congressional committee — that was the Joint Economic Committee a mere 35 years ago.

Conclusions

By providing a powerful incentive to saving and investment, the Nunn-Domenici proposal will generate important budgetary and economic benefits. Moreover, it does not require setting up an additional collection system. Nor is it regressive or inflationary. It puts the fiscal burden on what people take from society — when they spend their income — rather than taxing directly what the people contribute by working and saving.

The combination of a savings-exempt personal income tax and a companion business cash-flow tax will initially be revenue neutral compared to the income tax system that it displaces. However, over the years, it will generate more revenue for the U.S. Treasury. That is so because it encourages more saving to finance additional investments in a growing economy. This is one of the few pain-free ways of reducing the federal budget deficit!

On the positive side, a stronger economy will do more than generate more revenue. A more rapidly growing economy will require fewer food stamps and less need for unemployment benefits or for other expenditures such as welfare. A stronger economy generates a double whammy: a lower budget deficit and a higher level of employment. That's the basic motivation for the Nunn-Domenici tax proposal. Boiled down to its fundamentals, a tax system that assures a stronger flow of saving and investment demonstrates a proper concern for our future.

A final point. It takes time for a new idea to percolate. After all, in the nineteenth century, classical economist John Stuart Mill advocated the exemption of saving as part of a just income system. In the 1940s, American economist Irving Fisher argued that the existing income tax involves double taxation of saving and thus discourages enterprise. That's why we're delighted at this turnout today. *You're* the percolators.