



Top Billing In Any Tax Reform Plan Must Go To Saving And Investment

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By Ernest S, Christian

Let's hope President Bush's Tax Reform Advisory Panel recommends the historic step of pairing up the dynamic duo of tax reform — tax relief for personal savings and first-year expensing for business investment in capital equipment.

Here are the reasons: First, taking the double tax off savings gives people a fair chance to save for investment as well as retirement. Next, they have a greater reason to save because first-year expensing stimulates businesses to install more productive capital equipment and, when they do, rates of return on investment improve. And these dynamic tax reforms can be self-financing within the 10-year budget window, even under the restrictive "static economy" way that Congress measures the revenue cost of tax relief for saving and investment.

To start, everyone would have the option of setting up a tax-free universal savings and investment account (USIA). It would function like a combination brokerage and savings account into which the owner could deposit a portion of each year's after-tax income. No tax deduction would be allowed for savings deposited into the account, but because the account would be funded solely with after-tax money, all earnings on investments inside the account and all withdrawals from the account would be free of additional federal income tax.

Basically, that's all there is to it. For illustrative purposes, let's assume that in the beginning annual deposits are limited to a fixed percentage of the saver's taxable compensation income for the year, must remain in the account for at least one year, and can be made only in money, not in stocks or securities already owned outside the account.

Because no upfront deduction is allowed, the static revenue cost of USIAs for future savings starts off quite small but builds up over time as interest, dividends and other gains on after-tax principal are received in the accounts.

Conversely, because first-year expensing is front-loaded compared to depreciation, the static revenue cost starts out large but declines over time.

As an estimate, the revenue cost of first-year expensing for capital equipment should be less than \$600 billion over 10 years and "starter kit" USIAs for future savings might add as much as another \$50 billion to \$100 billion, depending on how strictly deposits were limited at the outset.

Even limited USIAs would be a great boon to future savers, especially young Americans just starting out on the road to acquiring assets. These accounts would fall far short of eliminating double taxation of all personal savings and investment. Fortunately, there is a salutary way to pay for first-year expensing and for full-fledged USIAs that include all future savings as well as a big chunk of existing savings.

The revenues will come from a voluntary one-time toll charge on people who already own stocks and securities, who want their portfolios to be free of double tax in the future, and who are willing to pay for it.

Right now, Americans have \$5 trillion to \$6 trillion invested in 401(k) and other similar tax-deferred accounts over which they have substantial control. When they withdraw money from these accounts in the future, they will have to pay income taxes on the accumulated earnings inside the account and on the previously untaxed principal.

Substantial tax revenues can be raised by letting those savers pay tax now in exchange for shifting savings into a USIA and not having to pay a greater tax in the future.

Many individuals also own stocks and other financial assets that are outside any tax-deferred account. People would be willing to pay a voluntary toll-charge tax as the price of shifting investments into a USIA for the future.

Extrapolating from Federal Reserve data, the amount of financial assets potentially involved is huge — starting off with \$16 trillion in market-traded securities, savings accounts and money market deposits.

In addition to accelerating the payment of taxes that would otherwise be payable in the future, the option of putting existing financial assets in a USIA might trigger the payment of toll-charge taxes on some substantial portion of the “locked in” gains on highly appreciated stocks that are not likely to be sold in the foreseeable future. Toll charges on these assets would be “new revenues,” and the amount could be large during a multiyear transition to the USIA system.

Longer term, additional revenues could come from a decision to phase out the tax deduction for the interest paid by businesses to USIAs and other similar tax-free recipients. Overall, even on a static basis, there will be plenty of revenue to pay for the transition to first-year expensing and a full-fledged USIA system.

The key to making any savings initiative work (whether it be USIA or “personal accounts” under Social Security) is to increase the rate of return on the investment of those savings in productive assets in the U.S.

The cheapest, most immediate and powerful way of doing that is first-year expensing. It makes U.S. investments attractive to U.S.-origin savings and to foreign-origin savings. That is good, but given the choice, U.S. capital is preferable.

When a capital investment is made in the U.S. and produces \$100 of U.S.-source net income, our economy gets the return to labor (\$81) because the resulting new jobs are in the U.S. If the investment is paid for by U.S.-origin savings, our economy also gets the return to capital (\$19).

The dynamic combination of higher rates of return, more investment in the U.S. and more U.S.-origin savings with which to pay for it ought to produce long-term GDP growth rates substantially in excess of the historical average of 3%.

Insofar as the Treasury Department's tax collections are concerned — and just as the marker outside the Treasury Building reads — tax reform would truly have “struck the rock of the public fisc and caused great fountains of revenue to spew forth.”

More important, standards of living in America would increase enormously — and many more people than ever would experience that special kind of freedom that comes from being an owner.

Ernest Christian is a former Treasury tax official who is director of the Center For Strategic Tax Reform in Washington, D.C. His e-mail address is: ernest@cstr.org.