Written by Veronique de Rugy on November 2, 2017

Tax Reform Should Encourage More Saving, Not Less

Republicans want tax reform, but their refusal to cut spending forces them to look into all sorts of revenue raisers. Some are good, such as eliminating the deductions for state and local taxes. Others are counterproductive, such as the threat to significantly decrease the tax deduction on 401(k) accounts, potentially reducing the overall levels of savings for the millions of Americans using them.

Instead, they should keep the deduction intact, hence encouraging savings — and in addition create universal savings accounts. There are rumors that they are considering such a move.

First, let me complain about the no-good proposal to reduce the 401(k) tax deduction from $18,500 to $2,400 and expand Roth individual retirement accounts in their place.

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I like Roth IRAs; don't get me wrong. Like 401(k) accounts, they are a good way to avoid double taxation of income that is saved. A Roth IRA allows you to save after-tax income and withdraw the income from that savings tax-free in retirement. A 401(k) allows you to save tax-free today but will tax you tomorrow when you consume the income from your savings.

Because there are no upfront tax savings with a Roth IRA, people tend to save and consume in a fairly neutral manner.

By contrast, 401(k) plans tilt people toward saving for retirement by allowing them to reduce their tax bills now. To experts who worry that Americans don't save enough, these accounts are important because they increase savings for 62 million users. Reducing the deduction, they fear, could lead to a reduction in savings.

And yes, 401(k) plans mostly benefit middle- and upper-middle-class savers. But these taxpayers will also bear much of the burden from inevitable policy changes to address the insolvency of Social Security when the trust funds eventually dry out.

This potential move is annoying for another reason: It has nothing to do with improving retirement savings and everything to do with Republicans' search for revenue. That's what happens when you give up entirely on spending cuts as a way to pay for tax reform.

In this case, the tax writers are resorting to a budget gimmick that would not raise overall revenue but instead shift the tax collection from tomorrow to today. In other words, revenue collection might increase today but would shrink tomorrow — as would our retirement security.

Instead, they should leave 401(k) deductions untouched and go a step further to supercharge savings with the creation of universal savings accounts. The good news is that House Ways and Means Committee Chairman Kevin Brady recently suggested to Politico that his committee could do just that.

Chris Edwards of the Cato Institute has been calling for the creation of USAs since 2002, and for good reason. Their hugely successful implementation in Britain and Canada has increased financial security and flexibility for millions of average families.

USAs are similar to Roth IRAs in that people contribute after-tax income. After that, all earnings and withdrawals are completely tax-free.

But the beauty of USAs is that they are for all types of savings, not just retirement savings. Savers are taxed once, and then they can put money away without arbitrary restrictions based on what it's for and when they may use it.

No more having to wait until retirement to use your money, so if you had an emergency, you could take out money without a penalty. No more having multiple accounts for multiple purposes and multiple filing requirements. No more having to justify every single dollar you spend from your kid's 529 account to show the IRS that those college books are indeed a legitimate use of the money you saved. The privacy benefit alone is huge.

USAs, in addition to 401(k) accounts, would add to personal financial security. And more savings would help the economy, because when people save, they expand the amount of credit available for companies and innovators to start or expand businesses. Thus, savings are a powerful source of economic growth.

There is one potential risk with Roth IRAs and USAs: Future governments may change the rules on us down the road when they are even more desperate for revenue than they are now. They could, for example, renege on their promises of tax-free withdrawals and start double-taxing Roth IRAs and USAs. This is another reason to preserve 401(k) accounts.

Apart from that, here is to hoping that Kevin Brady will listen to Chris Edwards.

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