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Piggy-Bank Nation
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In the 2004 Budget, President Bush proposed a simplification and expansion of saving incentives. Instead of choosing among a bewildering array of narrowly focused saving incentives, individuals could save much larger amounts in a Lifetime Saving Account -- usable for any purpose -- and a Retirement Saving Account -- for retirement. Assuming the president renews his call for the proposals in his State of the Union address tonight, as seems likely, they will stimulate broader debates over tax reform and Social Security reform.

While the Lifetime Saving Account (LSA) offers substantial simplification benefits, it also offers a vehicle to save more easily for a downpayment on a home, children's education, or for medical expenses. With no withdrawal penalties, the account's greater liquidity will encourage individuals to save, particularly moderate- income households worried about tying up funds for a long period of time. Like the president's proposal to eliminate investor-level taxes on dividends, the LSA lays claim to the idea that income should be taxed only once. Indeed, given the generous contribution limits, most households could avail themselves of a consumption tax akin to the Flat Tax. They would pay taxes once when they earned wages or business income, but not again on returns to saving. This is an important step toward fundamental tax reform, particularly if the administration continues its recognition of the costs of double taxation of corporate income.

As is often the case with a push toward tax reform, opponents will argue that the proposals will generate little new saving, and merely reward saving done anyway, often by affluent households. Indeed, studies of what portion of contributions to current saving incentives -- principally IRAs -- are new saving are not conclusive.

But studies estimating what fraction of a dollar contributed to an IRA is new saving are asking only part of the question. To assess the impact on capital formation, one should compare the present value of additional private capital formation to the present value of lost tax revenue. Jonathan Skinner of Dartmouth College and I estimated that with even 25 cents of each dollar contribution as new saving, IRA contributions generate $2.21 of new capital per dollar of net revenue cost. If, as suggested by Harvard economist Martin Feldstein, one includes corporate income tax revenue from the higher capital stock made possible by the saving incentives, the ratio rises to $4.84 of net capital per dollar of new revenue cost. If each dollar of contributions contains 40 cents of new saving and one incorporates higher corporate income tax receipts, the savings incentives are actually self-financing.

The expanded savings incentives proposed by President Bush are likely to generate more substantial gains in capital accumulation per dollar of net revenue cost. By simplifying the current patchwork quilt of savings incentives, the Bush plan would increase participation. By significantly increasing contribution limits, a greater share of contributions should consist of new saving -- especially over time.

But even these promising calculations don't answer the bigger question. The higher capital stock from saving incentives is not manna from heaven; rather, it is the consequence of households consuming less today to have more resources later, say in retirement. Why should we do this?

It is true that there are substantial efficiency costs of capital income taxation, and saving incentives reduce these costs. But one could more simply exempt all or part of all capital income from taxation, as President Bush did with his proposal to eliminate investor-level taxes on dividends. The Lifetime

Savings Account, with its high contribution limits, would already do so for most households. But the question of the Retirement Savings Account (RSA) remains.

The usefulness of this account can be seen in the context of Social Security reform. Any successful reform that restores Social Security's long-term financial footing is likely to reduce average replacement rates (benefits relative to average wages) for young workers and future generations (I am ruling out the doubling of payroll tax rates required to finance the program in the future without such a change.). Accordingly, private saving will likely need to play a larger role. The administration's proposal would provide a significant vehicle for accomplishing this. The proposal would also mesh well with Social Security Personal Accounts, into which a portion of an individuals Social Security payroll taxes could be deposited. One could also further subsidize account deposits of lower-income individuals.

The administration's proposals for new and improved saving incentives make good sense for simplification. This alone would be a good reason to champion them. But they offer bold bridges to tax reform and Social Security reform as well. This makes them worth fighting for.

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