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The Universal Savings Credit

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Introduction and summary

The financial crisis of 2007 to 2009 took a tremendous toll on household wealth and shattered the sense of financial security for millions of American families. American households lost more than $20 trillion in wealth (in 2012 dollars) in the Great Recession, and households still had $10 trillion less in wealth at the end of 2012 than they had before the crisis.[1] This massive wealth decline contributed to a widespread loss of economic security, particularly among lower-income and moderate-income families, single women, and communities of color.

This economic insecurity can have long-ranging adverse effects on U.S. economic growth as American families:

- Invest less in new businesses, which slows productivity growth and innovation

- Save less for large long-term expenses such as retirement and their children's college tuitions, which leads to less-stable financing for capital investments

- Become less likely than they would with more wealth to switch jobs and careers when better opportunities arise, which slows employees' productivity

The bottom line: Economic insecurity from decimated household wealth today could potentially reverberate through our nation's economy for a long time through slower growth, fewer jobs, and lower living standards. Helping households rebuild their wealth should therefore be a top policy priority.

The federal government already uses the tax code to incentivize people to save, typically through tax advantages for particular forms of savings. Employers and employees can often deduct their contributions to retirement savings vehicles, such as 401(k) plans, from their taxable income, and the capital gains in retirement savings plans are not subject to taxation until people withdraw the money. The federal government loses income tax revenue that it otherwise would have received while people save and then recuperates some of the lost tax revenue

when people withdraw money for retirement and then pay income taxes. The underlying idea is that these tax advantages encourage more people to save more money for retirement than they otherwise would have. Similar incentives exist for people to save for health care and their children's education, but retirement savings incentives are by far the most prevalent and largest tax savings incentives that the federal government offers.

Yet a closer look at the tax incentives for retirement savings as well as other similar incentives for health care savings and educational savings suggests that the current system suffers from two key inefficiencies:

- **Upside-down tax incentives:** Tax deductions carry a greater value for people with a high marginal tax rate than for people with a lower marginal tax rate. A person whose last dollars earned fall into the top income tax bracket, for instance, faces a marginal tax rate of 39.6 percent. That is, each dollar of a tax-advantaged contribution to a retirement savings account reduces the taxes that this person owes to the federal government by 39.6 cents. A lower-income earner with a marginal tax rate of 10 percent, however, reduces the money they owe to the federal government by only 10 cents for every dollar that they contribute to retirement savings. The value of the tax incentive is upside down, as it is almost four times larger for high-income earners—who arguably do not need much help to save—than it is for lower- and moderate-income earners, who typically have a hard time saving.

- **Savings complexities:** Employers and employees can choose from a wide range of retirement savings vehicles. There are defined-benefit pensions and defined-contribution savings plans, the latter of which come in a whole host of flavors—401(k)s, 403(b)s, SIMPLEs, SEPs, IRAs, and Roth IRAs, just to name a few. Moreover, all of these retirement savings plans come with their own rules of who can save with them, how much money people can save, and when the tax advantages occur—during the contribution phase, during the investment phase, or during the withdrawal phase. This complexity often stands in the way of people taking full advantage of all of the tax incentives available to them.

Because of these two inefficiencies, the federal government is not getting as much additional savings as it ideally could from the foregone tax revenue. More efficiently designed savings incentives, however, would generate more bang for the buck, as people would save more than is currently the case for every dollar in tax incentives.

We propose to vastly simplify existing savings incentives by turning all existing deductions into one single tax credit—the Universal Savings Credit. With this credit, people would receive a flat percent of their contributions to a predetermined savings account, regardless of their income and how much money they owe in federal income taxes. People can use the savings that they accumulate with the Universal Savings Credit for a wide range of purposes, such as paying for health care or education, putting a down payment on a first residence, starting or expanding a business, an economic emergency such as unemployment, and retirement.

We also envision only one set of rules for contributing money, investing money, and withdrawing money that will govern savings for these purposes, as discussed further below.

Our goal is to end the current system of upside-down savings incentives and to streamline savings incentives to make it easier for people to understand what they can save, how much they can save, and when they can withdraw their money. Lower-income households, who need more help in saving, will get more help from the new tax incentives than from the existing ones, and everybody will find it easier to understand tax incentives. The result of these changes should be more-efficient savings incentives and thus more saving.

More savings are good not only for individuals but also for the economy as a whole. Building wealth more quickly increases economic security. People will have more money available for short-term emergencies and for longer-term goals such as buying a house, starting a business, and sending their children to college. Greater short-term and long-term economic security should translate into faster economic growth, as people can better handle changes in the economy. More economic security will allow people to take a longer-term view and better plan for possible economic changes such as sending children to college, starting a business, and switching jobs and careers.