How Will Additional Savings Incentives in Federal Tax Policy Affect State Revenue Growth?

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Summary

Washington policy makers find themselves involved in a debate over the future of the federal tax system at the same time as they are embroiled in a sharply partisan struggle over the future structure of Social Security, indeed of retirement programs generally. Many observers of the first debate may have overlooked how likely resolution of Social Security's future will affect federal income taxes. Indeed, it is nearly as likely that legislation to create long-term solvency in Social Security will alter the federal tax base fundamentally as it is that Congress will do so through fundamental tax reform.

How might this happen? Because the demographic underpinnings of Social Security are beginning to lean against the long-term financial stability of the program, reformers have advanced changes that include slowdowns in the rate of benefit growth for upper-income workers and personal retirement accounts for all covered employees. Personal retirement accounts that have average, real work-life rates of return above the inflation-adjusted U.S. Treasury bond rate might reduce the unfunded liabilities of Social Security, thus adding to national savings. Savings would further be enhanced if Congress allowed upper income taxpayers to set aside enough additional tax advantaged savings to "compensate" these workers for lower, future benefits from Social Security.

Members of Congress are right to keep their focus on the entire retirement portfolio. By doing so, they are slowly capturing the benefits of heightened economic efficiency that flows from reducing taxes on savings, and thus investment. Indeed, significant interest is building in an idea called Universal Savings and Investment Accounts. These accounts operate like Roth IRAs and could be used to consolidate all of the other tax-based savings programs under one "roof." Some analysts think that USIA accounts would be sufficiently attractive that revenues received from taxpayers for converting their IRA-like accounts to a USIA account might pay for transition to this new savings vehicle.

State and local governments will, of course, closely follow what Congress does to advance savings generally and retirement savings particularly. The current tax code discourages savings through the multiple layers of taxation applied to labor and capital income and the cumulative effect of the tax wedge on savings over time. Thinning or reducing these layers of taxation promotes economic growth, and few factors are as important to state and local revenue change as the pace of economic activity.

States that use all or part of the federal tax base might see that base shrink in the short run, unless Congress adopts a transition plan similar to that advanced by advocates of unified savings accounts (like the USIA). However, revenue planners in state and local governments should be encouraged by Washington's interest in developing a simpler, pro-savings, pro-growth tax system and retirement policies that focus much more than in the past on retirement savings. This direction promises a better economic future for state and local economies than one tied to a tax system that discourages savings and to a retirement program so under funded that significant tax increases and debt financing are all but certainly in its future.