Saving for Social Capital

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social capital project

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INTRODUCTION

Relationships produce benefits for us every day—emotional fulfillment, practical information, rules to live by, and the like. In this sense, the “social capital” we possess is much like the financial capital that we own. Savings and investments, like relationships, also produce benefits, allowing us to mitigate economic risks, giving us shelter from the elements, and increasing our future capacity to afford necessities. Financial capital, in fact, underpins social capital. Savings allow us to form and expand families and to surround ourselves with neighbors and institutions that enrich our lives. Savings make homeownership possible, which invests us more deeply in the community. Savings sustain many institutions of civil society, from clubs to schools to churches.

Unfortunately, under current tax policy, saving and asset-building are disadvantaged relative to spending, with the exception of certain government-approved savings goals. What is more, the savings vehicles that promote those goals largely fail to benefit lower-income and working-class Americans, in part due to the many rules and restrictions on their use.1

Universal savings accounts (USAs) may provide a solution: USAs generally exempt either contributions or distributions from taxation, rebalancing tax policy so that saving is on equal footing with spending.2 Unlike traditional tax-neutral savings vehicles, USAs allow saving for all goals, not just government-approved ones.

USAs may help Americans be more financially independent while also fostering greater voluntary mutual aid. As we noted in a previous Social Capital Project report, lower- and middle-income Americans tend to give to different kinds of charities than upper-income Americans (who benefit more from existing savings vehicles), and a greater share of their donations go toward poverty alleviation.3 As a result, the social capital benefits of USAs are likely to be significant. This report will outline important characteristics of USAs and propose reforms that make the most of their associated benefits.

EXISTING SAVINGS ACCOUNTS AND THEIR LIMITATIONS

When people choose between immediately consuming their income or saving it, they will often require an incentive to save, both because the appeal of consumption is strong and because inflation will often make their income less valuable in the future. Earnings on saved income are the incentive to defer consumption. Savings are then invested by others in productive ways that make economies richer.

Current consumption is taxed only once at the federal level, but in general, future consumption (in the form of savings and investment) is taxed twice—first on the dollars funding savings and again on the earnings from it. The double taxation of savings makes consumption relatively more appealing, which reduces investment and thereby economic growth in the future. A tax on social capital—a
head tax, say, on each relationship—would produce less investment in social capital, with costs to individuals and society as a whole. So, too, does a tax on savings reduce the benefits of financial capital to individuals and the economy.

The exception to this tax policy bias in favor of current consumption involves a variety of savings accounts. However, each has a particular purpose, complete with eligibility standards, withdrawal penalties for non-designated purposes, age limits, time limits, and other restrictions. Table 1 provides a list of the most common types of savings accounts.

Table 1. Current Savings Accounts in the Tax Code

<table>
<thead>
<tr>
<th>Retirement</th>
<th>Expected Term Length</th>
<th>Contributions or Distributions</th>
<th>Income Eligibility Limit</th>
<th>Age Limit</th>
<th>Contributions of Earned Income Only</th>
<th>Time Limit</th>
<th>Penalty for Ineligible Use or Early Withdrawal</th>
<th>2020 Contribution Limits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defined Benefit Plan (Pensions)</td>
<td>Long</td>
<td>Distributions</td>
<td>No</td>
<td>Yes; 62¹</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>N/A</td>
</tr>
<tr>
<td>Defined Contribution Plan (401(k), 403(b),...)</td>
<td>Long</td>
<td>Distributions</td>
<td>No</td>
<td>Yes; 59½²</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>$19,500</td>
</tr>
<tr>
<td>Traditional IRA</td>
<td>Long</td>
<td>Distributions</td>
<td>No³</td>
<td>Yes; 59½³</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>$6,000</td>
</tr>
<tr>
<td>Roth IRA</td>
<td>Long</td>
<td>Contributions</td>
<td>Yes</td>
<td>Yes; 59½³</td>
<td>Yes</td>
<td>Yes³</td>
<td>Yes</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Education and Disability</th>
<th>Expected Term Length</th>
<th>Contributions or Distributions</th>
<th>Income Eligibility Limit</th>
<th>Age Limit</th>
<th>Contributions of Earned Income Only</th>
<th>Time Limit</th>
<th>Penalty for Ineligible Use or Early Withdrawal</th>
<th>2020 Contribution Limits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualified Tuition Plan (529s)</td>
<td>Short-Medium</td>
<td>Contributions</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>$15,000⁶</td>
</tr>
<tr>
<td>Coverdell ESAs</td>
<td>Short-Medium</td>
<td>Contributions</td>
<td>Yes</td>
<td>Yes⁷</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>$2,000</td>
</tr>
<tr>
<td>ABLE Account⁸</td>
<td>Varies</td>
<td>Contributions</td>
<td>No</td>
<td>No⁹</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>$15,000⁶</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Health and Dependent Care</th>
<th>Expected Term Length</th>
<th>Contributions or Distributions</th>
<th>Income Eligibility Limit</th>
<th>Age Limit</th>
<th>Contributions of Earned Income Only</th>
<th>Time Limit</th>
<th>Penalty for Ineligible Use or Early Withdrawal</th>
<th>2020 Contribution Limits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent Care Flexible Spending Account</td>
<td>Short; “use or lose”</td>
<td>Neither</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes¹⁰</td>
<td>N/A¹¹</td>
<td>$5,000</td>
</tr>
<tr>
<td>Health Flexible Spending Account</td>
<td>Short; “use or lose”</td>
<td>Neither</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes¹⁰</td>
<td>N/A¹¹</td>
<td>$2,750</td>
</tr>
<tr>
<td>Health Savings Account¹²</td>
<td>Varies</td>
<td>Neither¹³</td>
<td>No</td>
<td>No¹⁴</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>$3,550 self-only; $7,100 family</td>
</tr>
</tbody>
</table>
1. IRS definition of "earned income" varies according to the type of account.
2. Some accounts allow additional "catch-up" contributions for those age 50 and older. Some plans, such as SIMPLE 401(k)s, have lower contribution limits.
3. Age limits for retirement plans specify the earliest access without IRS penalty in usual circumstances. There may be separation-from-service or other consideration. In addition, retirement funds cannot be kept in tax-deferred retirement accounts indefinitely; with the exception of Roth IRAs, there are required minimum distributions by age 70½ for those who turn 70 by July 1, 2019, or by age 72 for those who turn 70 after that date.
4. No income eligibility limit to contribute, but the tax deductibility depends on income.
5. Cannot withdraw earnings within five years of the first contribution without penalty.
6. Overall contribution limits may vary by state, but $15,000 is the federal limit, above which the gift tax applies.
7. Account must be established before beneficiary turns 18 and balance must be used before beneficiary turns 30.
8. ABLE accounts are intended to help with disability-related expenses, but as section 529A plans, they allow rollovers from 529 plans.
9. Qualifying disability must occur or have occurred before age 26.
10. Must use within eligible expense period or lose the funds.
11. Funds are plan administered and must be approved for payments and reimbursements.
12. Excludes Archer and Medicare Advantage Medical Savings Accounts.
13. Qualified distributions are tax free. Unless age 65 or older (or disabled), non-qualified HSA distributions are subject to a penalty.

The requirements for saving within these accounts are elaborate and often excessive. For education-related savings accounts, like 529s, earnings must be used by or on behalf of the beneficiary for qualified education expenses associated with an eligible educational institution. Contributions to health savings accounts (HSAs) are allowable only if the account-holder is enrolled in a high-deductible health plan, which may not be universally available or work for every individual or family situation. Not all employers offer retirement plans, and if they do, they may not extend the benefit to all positions. Taxpayers must have specific types of taxable income to contribute to an Individual Retirement Account (IRA).

Additionally, qualifying distributions and exceptions to penalties are highly specific to the particular savings account; for example, 401(k)s and their equivalents can have different rules from one employer to the next.

Claiming an exception can be risky, and individuals can incur a penalty if they do not meet the established threshold for claiming an exception. For example, if a filer takes an early distribution in order to cover medical costs, but incorrectly estimates adjusted gross income, or the distribution is too large relative to the medical cost, she will still have to pay a partial or full penalty on the excess. The penalty is a tax on the distribution in addition to the income tax on distributions, if applicable.

It is not clear why the government should make saving so complicated, or favor specific savings goals over others. Saving for a rainy day, a new home, or a new baby are no less meritorious than the existing reasons currently favored. As the American Enterprise Institute’s Alan Viard notes,

We have an array of complicated rules to measure and tax the income from saving and another array of complicated rules to remove the tax.
from dozens of types of savings that Congress has singled out for favorable treatment. Meanwhile, the large portion of national saving done outside tax-neutral accounts faces the income tax’s saving penalty, impeding economic growth.\(^8\)

The many restrictions and excessive complexity of current savings accounts create barriers to saving and reduce their use, especially among families who have fewer resources.

Furthermore, the existing system of separate, government-favored goals including retirement, health, dependent care, and education effectively penalizes account holders for saving for the wrong goal. If an individual diligently saved in an HSA, for example, only to realize that those savings would be better vested in a 529 for her child’s education, that savings is not transferable. Plans change; unfortunately, the allowable uses of assets in savings accounts do not.

### UNIVERSAL SAVINGS ACCOUNTS AND THEIR BENEFITS

Universal savings accounts (USAs) could allow earnings on after-tax contributions to accumulate tax-free, as they do in Roth IRAs.\(^9\) This feature would restore tax neutrality by taxing savings only once. Unlike other savings accounts in the tax code, USAs would promote saving for any purpose over any time horizon without penalties, restrictions, or paperwork to justify saving to the federal government.

In addition to offering impartiality and flexibility, universal savings accounts would increase the accessibility of savings opportunities.

USAs would be accessible by design. Unlike some savings accounts, such as health flexible spending accounts or pensions, USAs would be portable—not tied to a single employer. Additionally, USAs would provide an alternative savings vehicle for those who do not have access to employment-based health and retirement savings accounts. Unlike current saving accounts, there would be no barriers to opening a USA. Nor would there be restrictions on the use of savings from USAs, making them especially accessible to low- and middle-income Americans vulnerable to negative income shocks.

In the United Kingdom (UK) and Canada, taxpayers across the income distribution broadly participate in universal savings accounts. Individual Savings Accounts (ISAs) were created in the UK specifically to induce greater savings among low- and moderate-income groups.\(^10\) Over 2016 and 2017, 71 percent of ISA holders had less than $38,000 in annual income (in US dollars).\(^11\) Similarly, 56 percent of the participants in Canada’s Tax-Free Savings Accounts (TFSAs) had less than $37,000 in annual income in 2017.\(^12\) Over half of Canadian taxpayers in the top fifth of post-tax income and over 20 percent of those in the bottom fifth hold a TFSA (Figure 1).\(^13\)
In contrast, while Americans in the top income quintile are about as likely to have an IRA as Canadians in the top quintile are to have a TFSA (and more likely to have a 401(k) or Thrift Savings Plan), Americans in the bottom two quintiles are only half as likely to be IRA holders as their Canadian counterparts are to have TFSAs (Figure 1). Nevertheless, research reinforces what the Canadian data demonstrate—that the poor do have the capacity to save.27

**USAs AND SOCIAL CAPITAL**

In addition to the key features listed above, USAs also have the potential to expand access to valuable social capital. Savings self-evidently make it more affordable to start and to expand a family. By promoting economic stability, savings is likely to benefit family stability. And more savings is likely to translate into greater charitable giving, which would be expected to strengthen civil society.14

Further, there are strong reasons to think savings increases the value of social capital in various other ways. While the research examining this question is not well-developed, there is a modest literature consistent with the idea that financial capital produces more valuable social capital.15
Most of this evidence focuses on homeownership, which is a key rationale for saving and itself involves saving (via building up home equity). Compared with renting, homeownership is associated with greater residential stability.16 Would-be movers who own their home must either sell it or rent it out, which makes moving more difficult than for renters. Homeownership is also associated with greater access to neighborhood amenities, including neighborhood safety.17

If families who own their homes tend to live in more desirable neighborhoods and to remain in them longer, the value of the social capital available to them is likely to be greater than is the case for renters. One reason that valuable neighborhood social capital may be promoted by homeownership is that owners are more likely than renters to maintain and invest in their property, which can result in more attractive and aesthetically pleasing neighborhoods.18

Being invested in one’s neighborhood—even out of purely selfish concerns about home values—also may lead to greater civic engagement. Homeownership is associated with greater participation in local organizations and greater voting at the local level.19 One study found that more savings in 1968 was associated with slightly higher “connectedness” in 1972, as measured by an index of survey items to do with relationships to relatives, neighbors, and organizations.20

Savings may also increase the value of social capital to which children have access. Homeownership can provide access to better schools, and the residential stability that homeownership promotes minimizes school changes, which have been found to worsen academic outcomes.21 Not only homeownership, but saving generally appears to increase access to higher-quality neighborhoods: families with higher non-housing wealth are more likely to live in neighborhoods with high rates of homeownership.22 If homeownership increases civic engagement, that can make parents more networked than they otherwise might be, which can benefit their children.23

Assets may alter parenting by reducing stress and changing aspirations for children.24 Homeownership appears to accelerate marriage and to reduce divorce.25 By serving as a sort of collateral in the event of a failed marriage, joint homeownership between spouses can encourage not only marriage and marital stability, but greater child investment that may come from one spouse investing less in their own career.26

CREATING UNIVERSAL SAVINGS ACCOUNTS

The accumulation of financial capital, then, has many benefits, one of which is the accumulation of valuable social capital. Universal savings accounts would promote such capital accumulation.28 The remainder of this report outlines how USAs could be developed from current savings accounts in the tax code.29

USAs would be funded from after-tax contributions, but the earnings on those contributions would never be taxed. This arrangement would ensure there is no
guesswork regarding taxes deferred upfront or taxes owed on withdrawals. Subject to the annual limits described below, contributions to USAs would be allowable for everyone without regard to their income, and they could be made from unearned income. Owners of USAs could withdraw earnings tax-free and penalty-free at any time for any purpose, and they would never be required to make withdrawals. All adults at least 18 years old would be eligible to contribute to an account.

Financial institutions sponsoring USAs could be expected to develop a range of options for those wanting to participate. They might include plans oriented toward particular savings goals, such as college or retirement, or different age groups. There would be plans for people with different levels of risk tolerance and other portfolio preferences. Sponsors might feature plans that gradually invest more conservatively over a pre-specified period for those who intend to withdraw savings at a known time.

With the creation of USAs, policymakers would sunset Roth IRAs, ABLE accounts, Coverdell ESAs, and 529 accounts, all of which feature post-tax contributions and tax-free accumulation of earnings. All amounts in these accounts could be rolled over into a USA at any time. In addition, amounts could be rolled over from defined contribution plans such as 401(k)s and from traditional IRAs, subject to income taxation first.

Apart from rollovers, USAs would be subject to an annual contribution limit initially equal to $35,000 less the total contributions to defined contribution plans and traditional IRAs. In the event someone had access to a 401(k) and maxed out her contributions to it ($19,500), that would leave $15,500 available to contribute to a USA. That is slightly higher than the current annual contribution limit to a 529 or ABLE account. Someone contributing the maximum amount to a traditional IRA ($6,000) but with no 401(k) contributions would be able to contribute up to $29,000 to a USA. Like the availability of rollovers from defined contribution plans and traditional IRAs, this policy might encourage a longer-term shift from plans where the distributions are taxed (and penalized for non-approved uses) to USAs, which could ultimately simplify the savings-related provisions of the tax code further.

Any adult could contribute to anyone else's USA. These contributions would count toward the beneficiary’s annual contribution limit, and contributions to others' accounts would be subject to the gift tax if applicable. Parents would not be able to transfer unlimited amounts to their grown-child’s USA for college expenses, but they could still pay for those expenses out of their own USA. (Parental payments of tuition are not subject to the gift tax.)

Beneficiaries of safety net programs generally are subject to restrictive limits on the assets they may hold (often around $2,000), in order to prevent fraud and protect benefits for those who need them. But these asset tests may discourage upward mobility and efforts to escape cyclical poverty and dependence on welfare. Studies suggest these limits discourage beneficiaries from saving, and limited savings can make it harder for poor families to deal with emergencies, such as an expensive car repair, or child care in the face of unpredictable work schedules.
CONCLUSION

Social capital is often created and deepened using a currency that is not denominated in dollars—relying instead on the essential resources of trust, empathy, solidarity, and fellow-feeling. However, while not strictly necessary for building social capital, money can greatly facilitate it. Whether it is used to start a family, to surround children with supportive neighbors, or to shore up institutions of civil society, savings promotes social capital.

The tax code should not be a vehicle for policymakers to incentivize their preferred behaviors at the expense of others. It should not be used to promote social goals. Many people would agree that social capital is important, but that does not justify subsidizing it through tax breaks.

However, the tax code’s imbalanced treatment of spending and saving actually discourages saving. By putting a thumb on the scale in favor of spending, current tax policy thereby poses a barrier to social capital investment. Universal savings accounts would help rectify this bias. Relative to the jumble of existing savings accounts available in the tax code, USAs would also make savings more accessible, impartial, flexible, and portable.39

Most importantly, USAs would assist families as they pursue their own savings goals throughout life, and they would finance the creation and deepening of valuable relationships and institutions throughout American society. They would promote charitable giving to help Americans in need, and they would help lower-income Americans help themselves.

More consumption means less investment—in social capital no less than in financial capital. Many Americans may prefer consumption over investment, and that is their own business. The problem is that tax policy penalizes investment. And social capital deepening—with all its benefits for individuals and society—suffers as a consequence.
ENDNOTES


9. Alternatively, a USA could tax distributions from accounts funded by pre-tax dollars, as happens in more traditional retirement accounts, but for simplicity’s sake, the Roth-style account is preferred and is more commonly used for USAs internationally. Technically, because capital gains and dividends within USAs from corporate stock ownership reflect profits after corporate income taxes, some USA earnings would be indirectly taxed at the federal level.


For comparative purposes, Canadians had a 2017 median personal income just over $26,000 USD: [https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1110023901](https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1110023901).

13. The median amount held by TFSA holders in the bottom two quintiles was about $4,000 and $7,500, respectively, while the top quintile held a median of nearly $15,000 in TFSA accounts. Statistics Canada. Table 11-10-0057-01 Survey of Financial Security (SFS), assets and debts by after-tax income quintile, Canada, provinces and selected census metropolitan areas (CMAs). [https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1110005701](https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1110005701).


21. Gautam N. Yadama and Michael Sherraden, “Effect of Assets on Attitudes and Behaviors: Advance Test of a Social Policy Proposal,” Social Work Research 20 (1996):3-11. However, they also reported that more connectedness in the earlier year was associated with slightly higher savings in the latter year. Higher 1968 home values were also associated with slightly higher connectedness later, but the relationship was too small to rule out chance.


24. Haurin, Parcel, and Haurin.


28. While some suggest that USAs would simply provide a tax advantage for savings that would happen anyway, the Heritage Foundation’s Adam Michel notes that in both the UK and Canada, savings increased in tax-neutral accounts among USA holders rather than crowding out retirement savings, with nearly a quarter increase in savings among low-income savers in the UK. Michel, Adam. “Universal Savings Accounts Can Help All Americans Build Savings.” The Heritage Foundation. Accessed March 12, 2020, https://www.heritage.org/taxes/report/universal-savings-accounts-can-help-all-americans-build-savings.


30. Earned income generally refers to income from participating in a business or trade. Many account holders may not have earned income in a given year, but may have the resources to contribute otherwise. In Canada, earned income is not a requirement to contribute to a TFSA, but contributions are not tax-deductible. Canada Revenue Agency. “Government of Canada.” Canada.ca. Government of Canada, December 4, 2019. https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4466/tax-free-savings-account-tfsa-guide-individuals.html. Nonetheless, Chris Edwards and Ernest Christian correctly point out that contributions would have to be in cash, such that “current savers would have to sell securities and pay tax before they could deposit existing funds into a USA.” https://www.cato.org/sites/cato.org/files/pubs/pdf/tbb-0211-11.pdf.
31. Unlike in traditional investment and savings accounts, where business like day trading may be a common taxable event, day trading in USAs should be discouraged and counted as business income, subject to tax. The Canadian Revenue Agency has offered some clarification of what it considers to be business activity within TFSAs, which would be subject to tax on the profits. Jamie Golombek, “Stop using your TFSA to frequently trade stocks — the CRA may see it as taxable business income,” Financial Post, June 23, 2017, https://business.financialpost.com/personal-finance/stop-using-your-tfsa-to-frequently-trade-stocks-the-cra-may-see-it-as-business-income.

32. However, some states offer tax deductibility for 529 contributions.

33. While some might advocate sun-setting defined contribution plans and traditional IRAs too, many Americans might prefer to retain these accounts. They might believe they will be in lower tax brackets when older than when they are younger, or they might fear that the federal government could institute taxes on USA earnings in the future.

34. The limit should be increased to account for inflation each year and for the annual increase in 401(k) contribution limits.

35. The higher contribution limit arguably would eliminate the need for “catch up” contributions for older savers.

36. The elimination of 529 accounts would not affect the treatment of parental college savings for purposes of financial aid calculations.

