

Child Savings Accounts Are Not the Best Way to Help Low-Income Families Save

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Child Savings Accounts and Other Tax-Advantaged Accounts Benefiting American Children

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Chairman Wyden, Ranking Member Crapo, and members of the US Senate Committee on Finance, I thank you for the opportunity to testify today. My name is Veronique de Rugy, and I hold the George Gibbs Chair at the Mercatus Center at George Mason University, where I study tax and fiscal policy, the federal budget process, and the implications of government spending for economic growth.

Finding ways to help children from low-income families become economically self-sufficient is a worthy goal. And creating inroads to make sure everyone saves is one way to ensure that low-income children are well positioned for the future. But asset limits, deposit restrictions, and investment options on newly proposed savings programs would affect participation and outcomes, especially for low-income participants, in the same ways existing savings options do. Indeed, there are already plenty of savings options in the US, but many of them discourage savings due to their complex rules, tax penalties for early withdrawals, or limitations on qualified uses.

Policymakers should fix these savings disincentives, the biggest being our debt and our tax code. Policymakers should also consider enacting a more comprehensive savings program, such as the Universal Savings Accounts (USAs) program. USAs would allow workers to save in one simple account from which they could withdraw without penalty for any expected (college, childcare, or retirement, for example) or unexpected (major car repair or emergency medical expense) event throughout their lifetime. USAs have successfully increased savings among low-income earners in the United Kingdom, South Africa, and Canada.¹

What comes next in my testimony is (1) a brief discussion of the limitations of the proposed Child Savings Account (CSA) model and (2) suggestions for better pathways to higher rates of savings for Americans.

¹ Adam N. Michel, "Universal Savings Accounts Can Help All Americans Build Savings" (Heritage Foundation Backgrounder No. 3370, Washington, DC, December 4, 2018).

1. The Limitations of Child Savings Accounts

There are two primary limitations to the proposed Child Savings Account model worth noting: (1) this model is simply shifting wealth around at a high cost, and (2) the proposed plan limits what the CSA may be used for, namely, post-secondary education and training, a small business, a first home, or retirement security. While all these investments are worth saving for, the CSA's lack of flexibility may prevent low-income families from using their savings for what they might need in the future.

1. Societal wealth would not increase

First, the proposal to establish CSAs—government-contributed investment accounts for some children—faces several economic and philosophical objections to moving existing assets from one group to another. The government would purchase financial assets (through the 529 platform), likely from selling government bonds to older and higher-income households. The program will also likely require future tax hikes to pay for the ensuing debt accumulation. In other words, such a program would not create new savings per se since it would generate “savings” in one place with money from reduced savings in another. In that sense it would be different from a 401(k). In the best-case scenario, it would merely constitute a redistribution of existing wealth from current asset holders to children, and a redistribution across time. However, a review of the literature on the effects of government spending on the economy reveals that the multiplier is often well below one, meaning that the best-case scenario is unlikely.

On the plus side, the government-contributed assets would be held in private-market investments, thereby avoiding direct government ownership and emulating the ownership society. That is a better idea than investing the assets in treasuries or having the government itself invest and hold the assets.

Second, this plan is presented as a wealth-building proposal by which most of the money can be withdrawn when the child turns 18. A child can use the money for expenses other than college; if they do use it for college, however, it would be an expensive way to fund college, since the government already spends elsewhere in the higher-education system, allegedly to help low-income students.

2. Complex regulations and penalties on early withdrawal could create disincentives to save

One of the greatest concerns of low-income earners has traditionally been access to liquidity, and convoluted savings rules and penalties for early withdrawals only restrict liquidity. Research from the Internal Revenue Service demonstrates that low-income earners are 31 percent more likely to take a net-taxable withdrawal when they experience an income shock.² The Urban Institute found similar results: people with limited education, low income, and few assets tend to withdraw from their retirement accounts more frequently over a two-year period than those with higher education and income.³

The same Urban Institute study indicates that 40 percent of those withdrawals are linked to either adverse events such as job loss or poor health, or investment events such as buying a home. Ten percent

² Robert Argento, Victoria L. Bryant, and John Sabelhaus, “Early Withdrawals from Retirement Accounts during the Great Recession,” IRS, November 2013.

³ Barbara A. Butrica, Sheila R. Zedlewski, and Philip Issa, “Understanding Early Withdrawals from Retirement Accounts” (Discussion Paper 10-02, The Urban Institute, Washington, DC, May 2010).

of the withdrawals were for necessary expenses during a job change. The study concludes that withdrawals from retirement savings accounts are more common when families experience a change in employment, the birth of a child, or starting college.⁴ Of these, only starting college could be a qualified withdrawal from a Child Savings Account, and that is only if families withdrew for tuition payments, not for other costs related to attending college.

Withdrawing from savings to cover rent after a job loss or to cover an unexpected hospital visit should not be penalized. Putting many restrictions on the use of the funds may dissuade parents from adding money to the account.

2. Better Ways to Encourage Savings

Encouraging savings, especially for low-income Americans, is a worthy exercise. But there are better ways to do it.

1. Government debt crowds out savings

While proponents may tout the CSA as boosting asset accumulation for future generations, the program faces an inherent contradiction given the US government's current fiscal position of running sustained budget deficits and accumulating debt. As Harvard University economist Robert Barro highlighted in his seminal work on debt neutrality, increasing public dissaving through deficit spending can offset and crowd out private saving.⁵ The size of the debt accumulation's impact on savings is debated by economists, but it is not zero and it may also be quite large.⁶

The federal government has run deficits for decades, causing public debt levels to rise from around 30 percent of GDP in the 1970s to nearly 100 percent today. Debt has a share of GDP that is heading to 166 percent within 30 years assuming relatively low interest rates, prosperity, and a return of inflation to the Fed target. The government cannot readily boost national savings and wealth accumulation while continuing to dissave at high rates.

Rather than creating a new spending program, many economists argue that placing the federal budget on a sustainable long-run path should be the foremost priority for increasing national savings. Reducing the projected debt-to-GDP ratio could help restore incentives for higher household savings rates. Economic research has established that the best way to do that is to implement fiscal adjustments that mostly focus on cutting spending rather than raising taxes.⁷ Fiscal-adjustment packages that feature

⁴ Butrica, Zedlewski, and Issa, "Understanding Early Withdrawals."

⁵ R. J. Barro, "Are Government Bonds Net Wealth?," *Journal of Political Economy* 82, no. 6 (1974): 1095-117.

⁶ D. W. Elmendorf and N. G. Mankiw, "Government Debt," in *Handbook of Macroeconomics*, ed. J. B. Taylor and M. Woodford (Elsevier), 5: 1615-69). A. De Serres and F. Pelgrin, "The Decline in Private Saving Rates in the 1990s in OECD Countries: How Much Can Be Explained by Non-wealth Determinants?" (OECD Economics Department Working Papers No. 344, OECD Publishing, Paris, 2003), 117-53; L. De Mello, P. M. Kongsrud, and R. Price, "Saving Behavior and the Effectiveness of Fiscal Policy" (OECD Economics Department Working Papers No. 397, OECD Publishing, Paris, 2003).

⁷ A. Alesina, and R. Perotti, "Fiscal Expansions and Fiscal Adjustments in OECD Countries" (NBER Working Paper No. 5214, National Bureau of Economic Research, Cambridge, MA, August 1995); J. Guajardo, D. Leigh, and A. Pescatori, "Expansionary Austerity? International Evidence," *Journal of the European Economic Association* 12, no. 4 (2014): 949-68; A. Alesina, C. Favero, and F. Giavazzi, *Austerity: When It Works and When It Doesn't*, (Princeton, NJ: Princeton University Press, 2019); Ö. Jordà and A. M. Taylor, "The Time for Austerity: Estimating the Average Treatment Effect of Fiscal Policy," *The Economic Journal* 126, no. 590 (February 2016); 219-55.

smaller spending reductions and larger tax increases are unsuccessful at reducing the debt-to-GDP ratio. This finding is not controversial among economists who have studied the issue.

Another important finding is that fiscal adjustments based only on tax hikes are deleterious to both short- and long-term growth. However, fiscal adjustments based on appropriate spending cuts promote long-term economic growth. This matters since the preponderance of studies suggest higher economic growth generally leads to higher savings rates, especially over longer time horizons.

In summary, persistently large public dissaving poses a fundamental economic challenge to policies aimed at boosting private savings and wealth.

2. Create Universal Savings Accounts

Short of putting the US on a fiscally sustainable path, there are other solutions Congress could pursue. While there are some dissenting views, the weight of evidence indicates the current system of double taxation of income—first taxing earned income, then taxing the returns from saving—creates considerable disincentives to save relative to a benchmark of taxing consumption only. Tax reform to integrate corporate and personal taxation is often proposed to mitigate these effects.

Instead of fixing the tax code, we have created tax-deferred saving accounts, such as 401(k)s and IRAs, meant to alleviate some of that double taxation. Federal law currently provides several such tax-preferred savings vehicles, each with varying rules and limitations: some are for retirement, some are for education and disability, some for health and dependent care, and some for emergencies.⁸

Unfortunately, as mentioned earlier, the rules and restrictions on withdrawals for each of these accounts likely create disincentives to save for low-income workers or parents who are worried about not being able to use their savings in case of an emergency.

A better alternative would be for Congress to streamline these accounts into one universal tax-preferred savings vehicle. The introduction of Universal Savings Accounts would take what is good about specialized savings accounts such as 529 plans and apply it to all Americans, incentivizing them to save. In simple terms, USAs make lower tax rates on savings more accessible to a greater number of people for a greater number of reasons. One study by Harvard economist Daniel Benjamin found that nearly 50 percent of 401(k) balances were new private savings.⁹ This is a generous estimate, but even the most modest estimates, like the one by the Brookings Institution,¹⁰ still demonstrate that absent income tax penalties, retirement savings have compounding returns.

USAs have the potential to increase savings for all groups, not just those saving for retirement. With fewer rules and more opportunities, USAs can encourage new populations to save. But people with the lowest income brackets may see the most benefit. After USAs were implemented in the UK and Canada, moderate-income earners were the most responsive. In both countries, low- and moderate-income

⁸ Alex Durante, William McBride, and Garrett Watson, “Dwindling Savings and Increasing Financial Stress Highlights Need for Tax Reforms,” *Tax Foundation* (blog), November 9, 2023.

⁹ D. Benjamin, “Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification,” *Journal of Public Economics* 87 (2003).

¹⁰ Eric M. Engen et al., “Do Saving Incentives Work?,” *Brookings Papers on Economic Activity* 1994, no. 1 (1994).

savers represent over 50 percent of USA holders.¹¹ As the Cato Institute’s Chris Edwards and Ryan Bourne found, in 2016 in the UK, 52 percent of USA holders earned less than £20,000—around \$26,000.¹² Furthermore, in the UK, low-income savers earning between £9,500 and £20,000 (about \$12,000 and \$26,000, respectively) utilizing USAs reported a 23 percent increase in savings that would not have been saved or invested absent the USA.¹³

There is great potential for USAs to help our lowest income earners begin saving for whatever life may bring.

Conclusion

With the expiration of the Tax Cuts and Jobs Act at the end of next year, there is an opportunity for policymakers to simplify the tax system and create pathways to savings and building financial security for all Americans. Universal Savings Accounts are a preferable method for boosting savings and ensuring that American families are financially equipped for whatever life may bring.

¹¹ OECD, *Encouraging Savings through Tax-Preferred Accounts* (OECD Tax Policy Studies, No. 15, OECD Publishing, Paris, 2007).

¹² Ryan Bourne and Chris Edwards, “Tax Reform and Savings: Lessons from Canada and the United Kingdom” (CATO Institute, Tax and Budget Bulletin No. 77, May 1, 2017).

¹³ OECD, *Encouraging Savings through Tax-Preferred Accounts*.