Tax-Advantaged Savings Accounts: Overview and Policy Considerations

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SUMMARY

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Congress has created a variety of tax-advantaged savings accounts to encourage taxpayers to save for certain expenses. These accounts are some of the largest benefits administered through the United States' tax code. The first tax-advantaged savings accounts enacted were pensions and retirement accounts such as 401(k)s, 403(b)s, and Individual Retirement Accounts (IRAs), which remain the most widely held and well-funded tax-advantaged accounts. Households can also save in tax-advantaged accounts for costs related to a relative's education or disability-related expenses using 529 plans, Coverdell accounts, or Achieving a Better Life Experience (ABLE) accounts. Taxpayers with high-deductible health insurance plans can also save in tax-free accounts to pay for out-of-pocket health care costs using Health Savings Accounts (HSAs).

Impact on Saving

Despite the popularity of these accounts, evidence of their effectiveness at encouraging saving is mixed. Many studies suggest that these accounts encourage little to no saving that would not have otherwise occurred in their absence. However, limitations complicate these analyses. Other research indicates that tax-advantaged accounts encourage saving, but not because of the tax advantage they provide. Rather, this research highlights that other "nontax" features of these accounts that make saving simpler—such as automatic enrollment—may encourage saving more effectively than the tax advantage does.

Budgetary Impact

Tax-advantaged accounts cost the federal government revenue it would otherwise collect. Absent a reduction in spending or increase in revenue elsewhere, they will increase the budget deficit (or reduce any surplus). The revenue impact of these accounts may vary over time. Accounts that defer taxation on contributions and gains (e.g., traditional retirement accounts) reduce revenue in the short run. Over time, when households withdraw these funds and pay taxes on their withdrawals, the federal government may recoup some of this lost revenue. Accounts that exempt gains and withdrawals from taxation (e.g., Roth retirement accounts, 529 plans, ABLE accounts) will not reduce revenues in the short term, but will over time. State and local governments that model their income taxes on the federal code may also offer tax advantages on these accounts and therefore experience similar temporal changes in revenues.

Distribution of Benefits by Household Income

Higher-earning households are more likely to both own tax-advantaged savings accounts and have larger balances in those accounts. Unlike lower-income households, who often need to spend a larger share of their income to pay for necessities, higher earners are more likely to have disposable income to save. Tax deductions and exemptions are also worth more in dollar terms to individuals in higher tax brackets than lower ones. However, savers withdraw and contribute to tax-advantaged accounts over time, and the lifetime tax benefit of a tax advantage can depend on factors besides just the saver's marginal tax rate in the year they receive a tax advantage. In addition, tax-advantaged accounts are often only one component of a broader collection of social benefits aimed at a particular issue such as retirement or higher education financing. Some argue that measuring the regressivity of tax-advantaged accounts in isolation obscures the progressivity of the larger collection of benefits serving a given population. These and other factors could influence whether policymakers decide to alter existing tax-advantaged accounts or create new ones to address additional policy issues.

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Introduction

Lawmakers often use tax incentives to encourage or subsidize certain behaviors. For example, Congress has tried to encourage households to save for particular expenses by letting them open designated tax-advantaged savings accounts that qualify for special federal tax benefits. These accounts reduce the tax liability that savers incur on their savings, and thus are a way for Congress to subsidize the expenses.

The oldest class of tax-advantaged savings accounts are retirement accounts. Today, these include Individual Retirement Accounts (IRAs) and a variety of employer-sponsored retirement accounts, including those commonly known as 401(k)s, 403(b)s, and 457(b)s.[1] In 2019, 50.5% of households held retirement accounts. Of those with an account, the median value was $65,000, while the average value was $255,200.[2] Savers can also open tax-advantaged accounts to save for a family member's education or disability-related expenses, and some can open accounts to cover out-of-pocket health care costs.

By limiting the use of these accounts to a particular activity such as higher education or retirement, policymakers may hope these accounts encourage households to save for activities that the policymakers view as socially beneficial. Encouraging saving may enable more people to participate in the activity. Policymakers may also want to make participation more affordable for all, including those who would have participated even without the benefit.

Further, increased saving may benefit the economy overall if new savings are invested in activities that spur economic growth. Businesses may respond to savers buying stocks, bonds, or other assets by investing more in their own capacity to produce goods and services. If tax-advantaged accounts encourage new saving, they could encourage economic growth and innovation. However, if the revenue loss from the savings incentives increases the deficit, these programs could reduce national savings.[3]

Moreover, these tax advantages reduce the present value of current and future tax revenue, and they typically benefit households with greater income and wealth more than they typically benefit others. To evaluate the efficacy of these provisions and compare them to other policy options, policymakers could measure the extent to which these programs generate new savings at different income and wealth levels against their cost in foregone revenue.

The Tax Treatment of Savings

One way to understand the various tax benefits of tax-advantaged accounts is to compare them to the tax treatment of taxable accounts. Unless otherwise specified by law, a savings account would generally be considered a taxable account.

[1] The popular names for these accounts are in reference to the sections of the Internal Revenue Code that authorize them.

[2] Neil Bhutta et al., "Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin, *Board of Governors of the Federal Reserve System*, vol. 106, no. 5, p. 16, September 2020.

[3] Jonathan Huntley, *The Long Run Effects of Federal Budget Deficits on National Saving and Private Domestic Investment*, Congressional Budget Office, Working Paper 2014-02, February 2014.

Taxable Savings

If a saving or investment account has no explicit tax advantages (it is a taxable account), savers will have to contribute to the account with income that would be subject to the income tax already. The federal government will also tax any income the account generates over time. The timing and tax rate on gains depends on how the taxpayer invested their savings.

Short-term capital gains (those from assets held for less than a year) are subject to the normal (or "ordinary") income tax rates, as are many dividends and interest earned from savings accounts and bonds. For example, the interest earned on a standard savings account is subject to the same tax rates as those that apply to earned income, such as wages and salaries. Households pay income tax on the earnings of these accounts and investments every year when they file their income tax returns.

Other earnings from savings—such as qualified dividends and long-term capital gains—are either exempt from taxation or subject to lower or preferential tax rates. Additionally, the government generally does not tax these assets until the year the underlying asset is sold. This process can defer taxation until years after the investor first bought the asset.[4] Capital gains on assets that a decedent (i.e., deceased person) bequeaths to an heir are never subject to capital gains taxation.[5] Additionally, interest on state and local government bonds is not subject to federal tax.

Taxpayers who earn net investment income and have modified adjusted gross income above a threshold of $200,000 ($250,000 for married taxpayers filing jointly) typically pay an additional 3.8% net investment income tax (NIIT) on that income. The NIIT applies whether the investment income is subject to the income tax rates or the lower capital gains tax rates.[6]

Tax Advantages on Savings

There are two general forms of tax-advantaged savings accounts in the United States (see **Table 1**):

- **Pre-tax accounts** (also known as "tax-deferred" accounts) exempt *contributions* from taxation, typically by letting savers deduct or exclude the value of contributions from their income when calculating their income tax—while taxing *withdrawals* as ordinary income. Taxation on all contributions and earnings is deferred until the saver withdraws the funds. "Traditional" Individual Retirement Accounts (IRAs) and defined contribution (DC) employer-sponsored retirement plans (such as 401(k) accounts) are examples of pre-tax accounts. Note that with pre-tax accounts, all gains are taxed as ordinary income in the year the saver withdraws funds, unlike taxable accounts, in which different kinds of gains are taxed at different times and rates. Inherited pre-tax accounts are subject to tax by the recipient, although this tax is paid over time depending on the relationship to the deceased.
- In contrast, **after-tax accounts** (also known as "tax-exempt" accounts) do not allow a deduction or exclusion for *contributions*, but exempt *withdrawals* from taxation. Money entering these accounts is taxed as income, but any growth is not taxed at all. "Roth" retirement accounts, qualified tuition college savings

[4] See CRS Report R47113, *Capital Gains Taxes: An Overview of the Issues*, by Jane G. Gravelle.

[5] See CRS In Focus IF11812, *Tax Treatment of Capital Gains at Death*, by Jane G. Gravelle.

[6] See CRS In Focus IF11820, *The 3.8% Net Investment Income Tax: Overview, Data, and Policy Options*, by Mark P. Keightley.

plans (also known as "529 plans"), Coverdell education accounts, and Achieving a Better Life Experience (ABLE) accounts are all examples of after-tax accounts.[7]

There are two noteworthy exceptions to this classification. First, Health Savings Accounts (HSAs) offer both deductible contributions and tax-free withdrawals for qualified expenses, giving them the tax advantage of both a front-loaded and back-loaded account. Second, while the federal government normally subjects cash-like employment benefits to the payroll taxes, these taxes do not apply to employer contributions to employer-sponsored savings accounts (such as 401(k)s and HSAs).[8]

Table 1. Tax Benefits of Selected Savings Accounts

Account Type	Contributions	Growth
Taxable Accounts	Taxable	Taxable. Rate and timing dependent on nature of the growth (simple interest, capital gain, dividend, etc.)
Traditional retirement accounts	Individual and employer contributions not taxable	All withdrawals (including contributions and growth) taxable
Roth retirement accounts	Taxable	Not taxable
529 plans	Taxable	Not taxable
Coverdell accounts	Taxable	Not taxable
ABLE accounts	Taxable	Not taxable
HSAs	Individual and employer contributions not taxable	Not taxable

Notes: This table assumes that contributions and withdrawals qualify for the tax benefit that the account offers. "Growth" includes both returns on saving that the federal government would otherwise tax annually—such as simple interest—and returns the government would tax when the saver realized the gains, such as capital gains and qualified dividends. Note that savers can make nondeductible contributions to traditional retirement accounts. While savers pay taxes on contributions and withdrawals, the savings can grow tax-free in the account until withdrawal, unlike taxable accounts that tax some returns annually. Emergency savings linked to defined contribution pension plans will become after-tax starting in 2024. Contributions to these emergency savings accounts will be taxable, but growth will not.

The government can exempt income from taxation in one of two ways. First, it can **exclude** the income from taxation, in which case taxpayers do not need to report the income when they file their taxes. Second, it can require the taxpayer to report the income, but then let them **deduct** the income from their taxable income. These two forms of benefits are economically equivalent.

After-tax accounts benefit savers by excluding gains from taxation. Pre-tax accounts also benefit the saver, even though the government will eventually tax the contribution when the saver withdraws funds from the account. As **Figure 1** demonstrates, taxpayers who contribute to pre-tax accounts can make larger initial contributions because they do not need to pay taxes on the income they contribute. Even if both accounts grow at the same rate, the additional assets in the

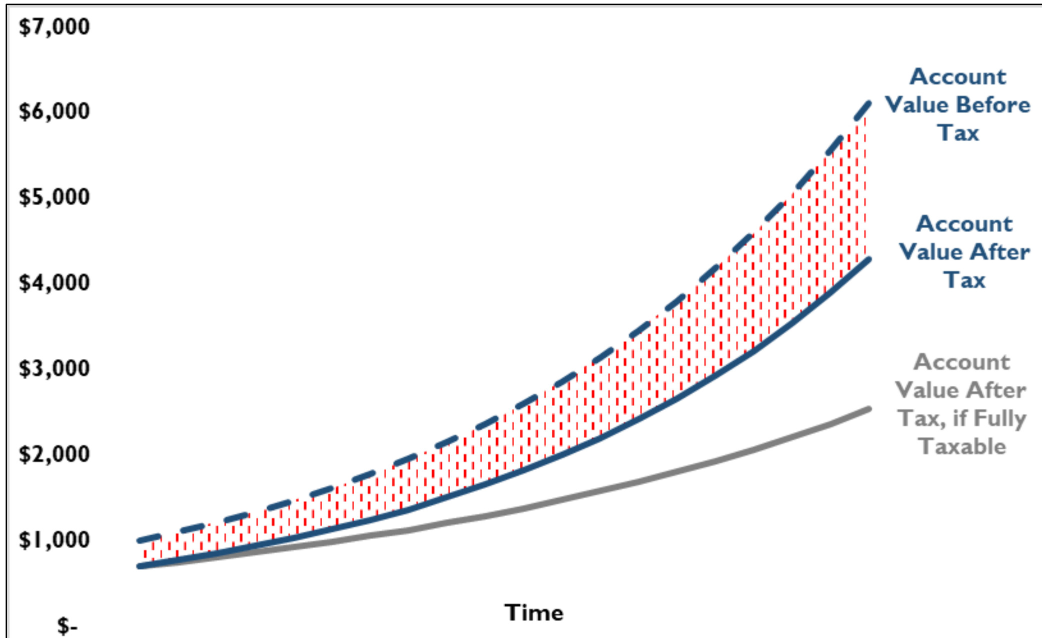
[7] See **Table 3** for more details on these accounts.

[8] See CRS Report R47062, *Payroll Taxes: An Overview of Taxes Imposed and Past Payroll Tax Relief*, by Anthony A. Cilluffo and Molly F. Sherlock.

pre-tax account (represented by the dashed blue line) compound over time. Even after the assets face taxation upon withdrawal (represented by the solid blue line), the additional gains make it more valuable than a similar investment in a taxable account (represented by the grey line).

Figure 1. Benefit of a Pre-Tax Account

Deferring taxation lets a larger pool of assets grow, which benefits the saver.



Notes: The example shows a hypothetical $1,000 that grows by 10% in each of 20 periods and faces a 30% tax rate. Assumes that the federal government taxes growth in the taxable account annually; if taxes on some gains would be deferred, such as those on long-term capital gains, the distinction between the taxable and deferred accounts would be smaller. "Deferred, After Tax" refers to the value of the investment if the saver withdrew it and paid taxes on the withdrawal.

Equivalence of Pre-Tax and After-Tax Accounts to the Taxpayer

While pre-tax and after-tax accounts appear to offer different tax benefits, they provide the same benefit to the taxpayer, provided several conditions are met. These assumptions include that taxpayers face the same marginal income tax rate both when they contribute to the account and when they withdraw from it;[9] that the investments are identical; and that the contributors to the pre-tax account save the tax benefit they receive for contributing to the account, rather than using it to increase their consumption. **Table 2** illustrates the equivalence of the final cash value of withdrawals from these accounts.

Table 2. Equivalence of Pre- and After-Tax Accounts

	Pre-Tax Account	After-Tax Account
Pre-Tax Contribution	$1,000	$1,000
Tax on Contribution (20% rate)	$0	$200
Contribution, After Tax	$1,000	$800

[9] See CRS Report R44787, *Statutory, Average, and Effective Marginal Tax Rates in the Federal Individual Income Tax: Background and Analysis*, by Molly F. Sherlock.

	Pre-Tax Account	After-Tax Account
Future Balance (assume 50% growth)	$2,000	$1,600
Tax on Withdrawal (20% rate)	$400	$0
Amount to Spend	$1,600	$1,600

Notes: This estimate assumes that the taxpayers would contribute the same amount of pre-tax income to either account. However, if taxpayers who save in pre-tax accounts choose to consume some or all of their tax benefit in the short-term rather than save it, this equivalence will not hold. Equivalence also will not hold if the taxpayers would be subject to a different marginal tax rate.

The equivalence does not hold when taxpayers pay a different marginal tax rate in one period than they do in another. In such cases, a taxpayer would receive a larger benefit if they choose to pay the tax when they have a lower marginal tax rate. Since the federal income tax code is progressive, savers whose incomes vary over time would typically prefer to pay tax when their taxable income is relatively low.[10]

Even in cases when tax rates are the same, this equivalence does not apply to government revenue. In the example presented in **Table 2**, the government receives $400 in revenue from a pre-tax account in the future, but only $200 from the after-tax account today. For the government to wait to receive the larger amount of revenue, it must incur debt (or reduce its surplus, enabling it to pay off less outstanding debt). The cost of servicing that debt would offset some of the benefit of the higher tax revenue.

The Saver's Credit

Some contributions to certain tax-advantaged accounts also qualify for the Saver's Credit. The Saver's Credit is a nonrefundable tax credit that is worth as much as 50% of the first $2,000 an individual contributes to retirement accounts. Through 2025, contributions to ABLE accounts also qualify.

The credit is means tested. In 2023, only taxpayers with an adjusted gross income (AGI) of $21,750 or less ($43,500 for married taxpayers filing jointly) can claim the full credit. Savers earning more than $36,500 ($73,000 for married filing jointly) do not qualify for the credit at all.[11] The credit's rate falls immediately when a filer's AGI exceeds certain thresholds, creating "benefit cliffs," meaning the value of the credit can fall by more than the increase in one's income.

The fact that the Saver's Credit is nonrefundable means many low-income taxpayers—who often have little or no income tax liability—cannot claim its full value despite qualifying otherwise. Perhaps as a result, take-up of the credit is low. Only 6.1% of taxpayers claimed the credit in 2019, including 15.5% of households earning between $25,000 and $50,000 but just 0.01% of taxpayers with AGI below $10,000.[12]

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[10] For more on equivalence, see CRS Report RL34397, *Traditional and Roth Individual Retirement Accounts (IRAs): A Primer*, by Elizabeth A. Myers. The time value of money could matter from the government's perspective in this calculation. However, the government will still receive greater present-value revenues under the pre-tax system than the after-tax one as long as the rate of return on the accounts exceeds government's borrowing costs.

[11] See CRS Report RL30110, *Federal Individual Income Tax Terms: An Explanation*, by Mark P. Keightley and Brendan McDermott.

[12] For more on the Saver's Credit, see CRS In Focus IF11159, *The Retirement Savings Contribution Credit*, by Molly F. Sherlock.

The SECURE 2.0 Act of 2022 (passed as Division T of P.L. 117-328, the Consolidated Appropriations Act, 2023), signed into law on December 29, 2022, replaced the Saver's Credit with a federal "Saver's Match" starting in 2027. Savers who earn below $20,500 ($41,000 for married savers filing jointly) will qualify for a 50% federal match on up to $2,000 in retirement savings. This income threshold will be indexed to inflation thereafter. Those who earn up to $15,000 more than this threshold ($30,000 for married filing jointly) will qualify for a reduced match. Unlike the Saver's Credit, the federal government will deposit the Saver's Match directly into the saver's retirement account. This structure is unrelated to a saver's tax liability, meaning the lowest-income savers will qualify for the full benefit, unlike the nonrefundable Saver's Credit.

Limitations on Qualified Contributions and Withdrawals

The benefits of tax-advantaged savings accounts can encourage some savers to use these accounts to save for purposes besides the ones for which policymakers originally intended. To prevent or discourage this, policymakers often place limits on contributions or withdrawals from tax-advantaged accounts**.**

For example, the law may limit contributions to accounts. To prevent savers from circumventing taxes on excessively large sums of money, many accounts limit the total value of annual contributions. Additionally, savers whose income exceeds a maximum level may be ineligible to claim a tax benefit from these accounts, or even contribute to them at all. For example, individuals whose modified adjusted gross income equals or exceeds $153,000 ($228,000 for married couples filing jointly) cannot contribute to Roth IRAs in 2023.

Some savers circumvent these limits. For example, account holders are allowed to "roll over" assets in one account into another, provided they pay appropriate taxes and fees on such transactions. Roth IRAs have income limits that preclude high-income households from contributing directly. However, in a procedure informally known as a "backdoor" Roth IRA, high-income households sidestep those income limits by contributing to a traditional IRA, and then rolling those assets into a Roth IRA.[13]

Additionally, taxpayers may need to pay a penalty on withdrawals used for purposes besides the account's intended use.[14] Savers who use distributions from the account for anything besides those permitted by law typically have to pay income taxes on the earnings portion of the withdrawal, and often must pay a penalty tax as well.

Verifying that taxpayers spent tax-advantaged savings on qualified expenses can be difficult. Some restrictions—such as the requirement that savers reach a certain age before making qualified withdrawals from retirement accounts—are relatively easy for the IRS to verify. Yet others can prove challenging. For example, the firms that administer 529 higher education savings accounts inform the government of how much money savers withdrew from the funds. However, unless the IRS audits a taxpayer or account manager, the agency cannot generally verify that savers spent the withdrawn funds as they claimed they did.

[13] See CRS In Focus IF11963, *Rollovers and Conversions to Roth IRAs and Designated Roth Accounts: Proposed Changes in Budget Reconciliation*, by Elizabeth A. Myers.

[14] See CRS In Focus IF11369, *Early Withdrawals from Individual Retirement Accounts (IRAs) and 401(k) Plans*, by Elizabeth A. Myers. Congress has relaxed such rules for certain accounts at times to let savers access funds during emergencies, such as natural disasters or the COVID pandemic.

Description of Major Tax-Advantaged Accounts

Table 3 details the six major tax-advantaged savings accounts in the United States today, as well as new emergency savings accounts that taxpayers will be able to open starting in 2024. The table does not include Flexible Spending Accounts, which are tax-advantaged accounts employers create that employees can use to buy benefits such as health insurance. Since any unused funds are typically forfeited to the employer, these accounts are somewhat different from tax-exempt accounts owned by individuals. Accordingly, this report does not address them.

Table 3. Description of Tax-Advantaged Accounts

Name	Eligible Contributions	Eligible Withdrawals	Tax Treatment	Penalties	Deficit Impact, FY2023
Traditional and Designated Roth Accounts within employer-sponsored plans.	These plans vary in design. The following parameters apply to 401(k)s. In 2023, combined employee contributions to traditional and Roth plans capped at $22,500 or the employee's wages, whichever are lower. Taxpayers age 50 and older may contribute up to $30,000 ($22,500 plus $7,500 in catch-up contributions). The sum of employee and employer contributions capped at $66,000 ($73,500 for taxpayers 50 and older).	Penalty-free after age 59½. Plans may allow in-service withdrawals (for employees who meet certain age and tenure requirements) or withdrawals on account of financial hardship. Withdrawals are subject to penalty unless account owner meets an exception specified in 26 U.S.C. §72(t). For traditional: minimum distributions required to begin at a specified age (varies depending on date of birth). Current workers can typically delay these distributions for their current employer's plan until retirement.	For traditional: Employer contributions excluded, employee contributions excluded from taxable income, withdrawals taxed as income. For Roth: Employee contributions not included in taxable income, withdrawals untaxed. Employer contributions exempt from payroll taxes.	Non-qualified withdrawals: taxed as income, plus 10%. Unless corrected, excess contributions are taxed as income in the year they are contributed, and again in the year they are withdrawn. Amounts that beneficiaries fail to withdraw under the minimum distribution requirements are subject to a 25% penalty.	$223.7 billion

Name	Eligible Contributions	Eligible Withdrawals	Tax Treatment	Penalties	Deficit Impact, FY2023
Traditional and Roth IRAs	Contributions are capped at $6,500 or the contributor's compensation, whichever is lower. Taxpayers over age 50 can contribute an additional $1,000. Contributions to traditional IRAs may be deductible depending on income and workplace pension coverage. Taxpayers covered by a retirement plan at work with modified adjusted gross income (MAGI) of $73,000 - $83,000 ($116,000-$136,000 for married couples filing jointly) may take a partial deduction; no deduction is permitted for taxpayers with MAGI of $83,000 or more ($136,000 or more for married couples filing jointly). Deductibility of traditional IRA contributions does not phase out for taxpayers who are not covered by a workplace retirement plan, except for married filing jointly taxpayers with a spouse who is covered by a workplace plan with MAGI between $218,000 and $228,000. No deduction is permitted for MFJ taxpayers with MAGI of $228,000 or more. For Roth, the contribution limit falls for those with MAGI of $138,000-$153,000 ($218,000-$228,000 for married couples filing jointly) before phasing out completely.	Withdrawals may be made at any time and for any reason. Penalty-free after age 59½, if the saver becomes totally and permanently disabled, or if the saver withdraws funds for a reason that qualifies for a penalty exception. For traditional: minimum distributions required to begin at a specified age (varies depending on date of birth).	For traditional: contributions may be deductible depending on income and workplace pension coverage, withdrawals taxed as income. For Roth: Contributions not deductible, qualified distributions untaxed.	Excess contributions are taxed at 6% per year for each year the excess amounts remain in the IRA.. Ineligible withdrawal: non-contribution amount taxed as income, plus 10%. Penalty waived for certain expenses, including qualified spending on a first home, out-of-pocket medical expenses, higher education expenses, and birth/adoption expenses.	$38.9 billion

Name	Eligible Contributions	Eligible Withdrawals	Tax Treatment	Penalties	Deficit Impact, FY2023
HSAs	Individuals must be enrolled in a high-deductible health insurance plans (HDHP) and not have disqualifying coverage. The HDHP must have a deductible of at least $1,500 ($3,000 for family coverage) and annual out-of-pocket expenses for covered benefits must be below $7,500 ($15,000 for family coverage). The HDHP may only cover specified benefits before the owner meets their deductible. Contributions capped at $3,850 ($7,750 for family coverage). Individuals age 55 and older may make $1,000 in catch-up contributions.	Must be spent on qualified out-of-pocket medical expenses to avoid penalties.	Employer contributions excluded, individual contributions deductible and withdrawals untaxed. Employer contributions are exempt from the payroll taxes.	Excess contribution: 6% annually until remedied. Ineligible withdrawal: taxed as income, plus 20%. The 20% penalty is waived in cases of disability or death, and for those aged 65 and over.	$11.5 billion
ABLE Accounts	Contributions from the beneficiary are capped at the lower of AGI and the federal poverty level. Contributions from others are subject to the gift tax. The first $17,000 an individual gives to another is exempt from consideration towards the gift tax. Beneficiaries may only have one ABLE account in their name. Beneficiaries must have attained blindness or disability before the age of 26. Starting in 2026, that age limit will rise to 46.	Must be spent on qualified disability-related expenses to avoid penalties.	Contributions not deductible, withdrawals untaxed.	Ineligible contribution: 6% annually. Ineligible withdrawal: non-contribution amount is taxed as income, plus 10%.	JCT estimated the FY2022-2026 cost was below $50 million
Qualified tuition programs (also known as 529 Plans)	Contributions are subject to the gift tax. The first $17,000 an individual gives to another is exempt from consideration towards the gift tax. States set their own limits on the maximum aggregate amounts savers may contribute to a given 529 plan account.	Must be spent on qualified higher education expenses to avoid penalties. Through 2025, beneficiaries can spend up to $10,000 on primary/secondary school expenses and $10,000 repaying student loans.	Contributions not deductible, withdrawals untaxed.	Ineligible withdrawal: non-contribution amount is taxed as income, typically plus a 10% penalty.	$3.6 billion

Name	Eligible Contributions	Eligible Withdrawals	Tax Treatment	Penalties	Deficit Impact, FY2023
Coverdell Plans (also known as "Education IRAs")	Capped at $2,000 per beneficiary. Also capped at $2,000 per contributor for any one beneficiary. The cap is lower for contributors with MAGI of $95,000-$110,000 ($190,000-$220,000 if married filing jointly), and those earning above these thresholds may not contribute.	Beneficiary must spend withdrawals on qualified primary, secondary, or higher education expenses to avoid penalties. Student loan payments do not qualify, but rollovers into 529 plans do.	Contributions not deductible, withdrawals untaxed.	Ineligible contribution: 6% annually. Ineligible withdrawal: non-contribution amount is taxed as income, typically plus a 10% penalty.	$200 million
Emergency Saving Accounts *(The federal government will begin recognizing these accounts in 2024.)*	*Employers who sponsor defined contribution retirement savings plans will be allowed to create tax-advantaged emergency savings accounts for their employees.* *The total savings in the account attributable to the savers' contributions will not be allowed to exceed the lesser of $2,500 or any other limit set by the employer. Highly compensated employees will not be allowed to contribute to these accounts.* *Employers will be allowed to match employee contributions and automatically contribute up to 3% of each employees' compensation to the accounts.*	*Savers will be able to make up to 4 withdrawals per year without incurring fees. Savers will not need to justify their withdrawals or demonstrate that they spent their withdrawals on expenses related to any particular emergency.*	*Contributions not deductible, withdrawals untaxed.*	*Ineligible contribution: if possible, the contribution is made to the employer-sponsored retirement account instead of the emergency saving account. If not, the plan must reject the contribution.* *Ineligible withdrawal: Not applicable, since savers do not need to justify withdrawals.*	*N/A*

Source: CRS analysis of the Internal Revenue Code and IRS publications; CRS Committee Print CP10005 (2022); Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2022-2026," JCX-22-22, (Washington, DC: December 22, 2022); CRS Report RL34397, *Traditional and Roth Individual Retirement Accounts (IRAs): A Primer*, by Elizabeth A. Myers; CRS Report R47152, *Private-Sector Defined Contribution Pension Plans: An Introduction*, by John J. Topoleski and Elizabeth A. Myers; CRS Report R45277, *Health Savings Accounts (HSAs)*, by Ryan J. Rosso; CRS Report R41967, *Higher Education Tax Benefits: Brief Overview and Budgetary Effects*, by Margot L. Crandall-Hollick and Brendan McDermott.

Notes: Limitations are those that apply in 2023 and may not be exhaustive. The revenue estimate for IRAs includes Keogh plans for self-employed workers. Keogh plans can be defined contribution or defined benefit, although most are defined contribution. JCT's revenue estimates do not account for changes in tax law since August 16, 2022. These estimates are based on the Congressional Budget Office's March 2022 revenue baseline and JCT's own projections of the gross income, deductions, and expenditures of individuals and corporations.

Impact on Saving

Despite the expansion of tax-advantaged accounts in recent decades, economists have yet to reach a consensus as to whether tax-advantaged accounts encourage households to consume less (and therefore, save more) of their income than they otherwise would.

There are several reasons that these accounts may or may not encourage greater private or national saving. First, tax advantages raise the return that a saver can expect from saving a certain amount of money. The expectation that tax advantages will encourage saving relies on the assumption that increasing the return to saving will make households more willing to sacrifice current spending to achieve greater returns in the future. Economists call this incentive the "substitution effect."

However, higher returns also mean households can achieve greater future balances without saving more. Households may then decide that they do not need to save as much to achieve their saving goals, such as for retirement. Economists call this the "income effect."

If the income effect overpowers the substitution effect, then tax-advantaged savings accounts could encourage households to save less rather than more. For example, suppose a household without access to a tax-advantaged account would have saved enough to have the same disposable income in retirement as they do while working. If they then had access to a taxable account, they would receive greater gains, and would have a higher income in retirement than they do today. To smooth out their disposable income across their lifetime, the family would respond by saving less and spending more at present.

Even if tax-advantaged savings do encourage more *private* saving, they may not increase total saving in the national economy. Tax-advantaged accounts can increase the amount of savings an account holder has in two ways. First, the tax benefit itself can increase the value of the account holder's savings. Second, the incentive could make saving more lucrative, and encourage the account holder to save a larger share of their income to access the tax benefit. In the first case, the taxpayer's level of saving rises, but the government's saving falls by the amount of the tax benefit. Tax benefits reduce federal revenues, which the government can finance by borrowing, raising other taxes, or reducing spending. Government borrowing naturally increases the federal debt, so it

How Do Contribution Limits Affect Saving?

Policymakers might try to stop households from saving excessively large amounts of income tax free by capping annual contributions to accounts that are eligible for the tax benefit. However, doing so also eliminates the savings incentive that tax-advantaged accounts may otherwise offer.

For example, suppose a household would save $30,000 per year without any tax advantage, and the federal government capped contributions to a tax-advantaged account at $20,000. The household would save the $20,000 in a tax-advantaged account and save their remaining $10,000 in a taxable account.

Since the rate of return on savings above $20,000 would not change, the family would have no incentive to save more than they otherwise planned to. However, since they know they will receive a tax advantage on the first $20,000 they saved, they may decide they do not need to save all of the remaining $10,000 to reach their saving goal.

In this case, the savers would have no *substitution effect* encouraging them to save more, but would still have an *income effect* discouraging them from doing so.

represents a reduction in *public* savings, which would offset some of the increase in private saving.[15]

If tax-advantaged accounts do not stimulate more household saving, they would neither increase productive investment in the economy nor encourage more people to participate in the activity that savers can use the account for. In such case, the tax windfall that the accounts provide would still make that intended purpose more affordable for savers with tax-advantaged accounts.

Capping annual or lifetime contributions may make accounts more prone to providing a windfall benefit instead of encouraging new saving. Tax-advantaged accounts create no incentive for households who want to raise their saving rate above what the cap permits to do so. However, they would receive a federal subsidy for all of their tax-advantaged saving below the cap.[16] In 2018, approximately 50.7% of taxpayers contributing to traditional IRAs contributed the maximum, as did 33.9% of taxpayers contributing to Roth IRAs and 8.5% of individuals making elective deferrals to employer-sponsored DC plans.[17]

Research on the Impact of Tax Benefits of Tax-Advantaged Accounts on Savings

Nearly all academic research on whether tax advantages stimulate saving has focused on retirement accounts. Early research on the topic found little evidence that households newly eligible for tax-advantaged retirement accounts shifted existing savings into those accounts, suggesting the accounts did encourage people to save more.

Determining whether tax-advantaged savings accounts encourage account holders to save more than they otherwise would is difficult for a number of reasons.[18] For example, those who prefer to save more of their income may be more likely to open accounts, meaning that the fact that account holders save more than non-holders is insufficient to determine whether the accounts are encouraging the saving. Even looking at the same savers before and after they become eligible for a tax-advantaged account may still fail to isolate the effect of eligibility if that change coincides with other important changes in law, personal finances, or other factors. The preponderance of later research that attempted to account for these and other limitations in the early studies found that tax advantages had little to no effect on national savings.

Early Work

Carroll and Summers (1987) observed that a sudden rise in the personal savings rate in Canada relative to that of the United States coincided with Canada's expansion of tax-advantaged

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[15] Jane Gravelle, , "Do Individual Retirement Accounts Increase Savings?" *Journal of Economic Perspectives*, vol. 5, no. 2 (Spring 1991), pp. 133-148.

[16] See Leonard Burman, Joseph Cordes, and Larry Ozanne, "IRAs and National Savings," *National Tax Journal*, vol. 43, no. 3 (September 1990), pp. 259-283.

[17] See CRS Insight IN11722, *Data on Contributions to Individual Retirement Accounts (IRAs)*, by Elizabeth A. Myers and John J. Topoleski; and CRS Insight IN11721, *Data on Retirement Contributions to Defined Contribution (DC) Plans*, by John J. Topoleski and Elizabeth A. Myers.

[18] The following literature reviews explain these and other critiques of the literature in more detail. James M. Poterba, Steven F. Venti, and David A. Wise, "Personal Retirement Saving Programs and Asset Accumulation: Reconciling the Evidence" in *Frontiers in the Economics of Aging*, ed. David A. Wise (Cambridge, MA: The National Bureau of Economic Research, 1998), pp. 23-124; Eric M. Engen, William G. Gale, and John Karl Scholtz, "The Illusory Effects of Saving Incentives on Saving," *Journal of Economic Perspectives*, vol. 10, no. 4 (Fall 1996), pp. 113-138.

accounts in the early 1970s. Contributions to Canadian tax-advantaged accounts could explain at most half of the rise in the Canadian savings rate.[19]

Feenberg and Skinner (1989) found that from 1980 to 1984, households that opened IRAs actually saved more in other assets after opening their accounts than before. These results suggest that the savers were not financing their IRAs with existing saving, but rather with new savings.[20] The study did not control for whether savers who open IRAs do so because they prefer to save more regardless of any tax advantage, which is a common limitation in the literature.

Competing Research and Methodology

From the mid-1980s through the early 2000s, two groups of authors studied the expansion of IRAs and 401(k)s in the 1980s, but reached different conclusions about their impact on savings. Poterba, Venti, and Wise conducted a series of studies that found that tax-advantaged retirement accounts did increase saving.[21] In contrast, Engen, Gale, and Scholtz typically found that they did not.[22]

Debates in the literature included how best to account for differences in individuals' preferred level of saving, how and whether they controlled for income and wealth levels, the relevance of external events, and the quality of the datasets themselves. Additionally, while early papers only asked whether account holders saved less in other financial assets such as stocks and bonds, later papers also considered whether people would fund retirement accounts by contributing less to pensions or investing less in their home's equity.[23]

Poterba, Venti, and Wise (1998) found that the financial assets of IRA contributors grew much more quickly after becoming eligible for IRAs than before. The authors interpreted this finding as evidence that IRAs encouraged these households to save more than they otherwise would. Meanwhile, Engen and Gale (2000) found that contributing to 401(k)s did not coincide with significant increases in total wealth for any income group besides the lowest earners, who held the smallest share of 401(k) savings. They also found some evidence that those who contributed to 401(k)s invested less in their homes. This finding suggests savers were substituting 401(k) savings for home equity.

Later Findings

Subsequent research tended to show that tax-advantaged retirement accounts do not encourage people to save more. For example, Pence (2001) found that households newly eligible for 401(k) plans did not increase their average overall savings by more than other households at any income level, perhaps in part because they invested less in their home.[24] Attanasio and DeLeire (2002)

[19] Chris Carroll and Lawrence H. Summers, "Why Have Private Savings Rates in the United States and Canada Diverged?" *Journal of Monetary Economics*, vol. 20, issue 2 (September 1987), pp. 249-279.

[20] Daniel Feenberg and Jonathan Skinner, "Sources of IRA Saving," *Tax Policy and the Economy*, vol. 3 (1989), pp. 25-46.

[21] For a discussion of these works, see Poterba, Venti, and Wise (1998).

[22] For a discussion of the works of Engen, Gale, and Scholtz, see Eric M. Engen and William G. Gale. "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," NBER Working Paper 8032, *National Bureau of Economic Research*, December 2000.

[23] Households may fund retirement accounts with savings they would otherwise invest in their home by either taking our larger mortgages, delaying paying down their mortgage, or buying less expensive property.

[24] Karen Pence , "401(k)s and Household Saving: New Evidence from the Survey of Consumer Finances," *Federal Reserve Board of Governors*, December 2001.

showed that individuals who opened IRAs did not cut their spending by any more than existing IRA contributors on average.[25] Benjamin (2003) found that only a quarter of 401(k) contributions represented new saving.[26]

An exception is Gelber (2011), who found little difference in the growth of non-401(k) savings between workers who have always been eligible for 401(k) plans and those who had just become eligible after working for a period of time. These findings suggest that 401(k) plans encouraged new saving. 401(k) eligibility may have even made younger and highly educated households more familiar with saving vehicles, and therefore encouraged additional IRA savings. However, the author notes that variability in the data limit the strength of these results.[27] Few researchers have studied this topic in the United States in recent years.

Effect of Other Features of Tax-Advantaged Accounts on Savings

Findings from Behavioral Economics

While the research is mixed on whether the tax benefits from tax-advantaged accounts encourage saving, studies in the field of behavioral economics—which uses psychological findings to study how cognitive biases cause people to deviate from the consistent, rational decisions assumed in conventional economic theory—show that other features of these accounts may induce additional saving.

One study on the power of suggestion, Madrian and Shea (2001), found that workers at a major company hired after it automatically enrolled staff in a 401(k) were 50% more likely to participate than those hired before. Workers also responded strongly to the account's default settings. Almost two-thirds of new workers participated in the plan, contributed the default amount, and used the default asset allocation, compared to 1% of pre-existing workers. Those pre-existing workers actually became more likely to use the default asset allocation even though it did not apply to them, possibly because they thought their employer endorsed that allocation.[28] The fact that workers responded strongly to these changes when they always could have opted in or contributed in this way suggests that inertia may have motivated their decisions to save.

Later research by Chetty et al. (2014) extended this finding to show that savers respond more to behavioral effects than tax advantages, specifically.[29] This paper examined how people saved after a series of changes to Danish retirement policy. After the Danish government weakened the tax-advantage for retirement accounts, savers contributed less, but they offset 99% of that decrease by saving more elsewhere. However, workers who switched to jobs that automatically contributed an additional percentage point to retirement accounts actually increased their savings by 0.8 percentage points. This finding held even for workers who suffered a mass layoff, meaning a preference for saving was unlikely to drive their decision to move to a firm with a better match. The authors interpreted these findings as suggesting that most account holders are "passive"

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[25] Orazio P. Attanasio and Thomas DeLeire, "The Effect of Individual Retirement Accounts on Household Consumption and National Saving," *The Economic Journal*, vol. 112, no. 481 (July 2002), pp. 504-538.

[26] Daniel J. Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Economics*, vol. 87 (2003), pp. 1259-1290.

[27] Alexander M. Gelber, "How do 401(k)s Affect Saving? Evidence from Changes in 401(k) Eligibility," *American Economic Journal: Economic Policy*, vol. 3, no. 4 (November 2011), pp. 103-122.

[28] Brigitte C. Madrigan and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *The Quarterly Journal of Economics*, vol. 116, no. 4 (November 2001), pp. 1149-1187.

[29] Raj Chetty et al., "Active vs. Passive Decisions and Crowd-Out in Retirement Savings Accounts," *The Quarterly Journal of Economics*, vol. 129, no. 3 (August 2014), pp. 1141-1220.

savers who respond more to the expectations set by the default saving rate than they do to the return on investment.

One could attribute these strong behavioral responses to some of the requirements employers must meet to offer tax-advantaged retirement accounts. Employers may choose to offer tax-advantaged accounts to recruit and retain employees. Once they do, they then provide matches to encourage enough employees to participate that the plan meets requirements meant to prevent discrimination in favor of highly compensated employees. Without the tax advantage that these accounts offer, it is possible that fewer employers would offer them, precluding any behavioral responses from encouraging saving.

Short vs. Long-Term Saving

Another non-tax factor that could determine whether tax-advantaged savings accounts encourage new saving is the time over which households can save in them. Savings held only briefly may not have much time to grow. Further, short-term swings in the prices of assets may make the value of a tax-advantaged account that taxpayers expect to need soon more volatile.

As a result, the value of a tax advantage may depend, in part, on how long savers typically hold the accounts. This, in turn, will depend on the purpose of the saving the government created the advantage to incentivize. While workers often save for retirement or their child's higher education over the course of decades, tax-advantaged accounts would likely prove less valuable to those saving for shorter times. Savers may not find the risk of investing worth the potential rewards for costs they anticipate will occur in the short- to medium-term. This may be among the reasons that savers only invested 9% of their holdings in HSAs—which they can use for short-term out-of-pocket medical costs—in assets other than cash in 2020.[30]

Government Revenue

Subsidizing saving through tax-advantaged accounts reduces federal tax revenue. In 2022, the Joint Committee on Taxation (JCT) estimated that tax-advantaged savings accounts cost the federal government approximately $280 billion in revenues in FY2023 (see **Table 3**, above).[31] Ninety-five percent of that cost was attributable to retirement accounts.[32] If not paired with spending reductions or alternative tax increases, these lost revenues increase the federal deficit.

Pre-tax benefits reduce income tax receipts immediately, although the government will eventually tax distributions (possibly at different rates) from those accounts. The revenue loss from after-tax savings accounts, meanwhile, occurs whenever the government would have taxed the gains on the

[30] Paul Fronstein, *Trends in Health Savings Account Balances, Contributions, Distributions, and Investments and the Impact of COVID-19*, Employee Benefit Research Institute, Issue Brief No. 538, September 15, 2021.

[31] Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2022-2026," JCX-22-22, (Washington, DC: December 22, 2022). JCT's estimates use a cash-flow accounting method, meaning they account for revenues raised in a given year, but not costs or revenues the government will incur in the future. JCT estimates the cost of tax expenditures by modeling the effect of eliminating each expenditure individually if taxpayers could then respond by claiming other expenditures. Since taxpayers who lose access to one form of tax-advantaged account may choose another, JCT's estimate likely understates the fiscal cost of tax-advantaged accounts. Note also that the expiration of many income tax provisions of P.L. 115-97 at the end of calendar year 2025 will likely raise the cost of these expenditures in subsequent years.

[32] Generally, these figures includes defined contribution plans and Keogh plans for self-employed workers. Keogh plans can be defined benefit or defined contribution plans. However, most are defined contribution.

savings, which could be many years later in the case of long-term capital gains. As a result, the revenue loss associated with these accounts occurs later than for pre-tax accounts.

Fiscally, this timing difference can affect the cost of financing these accounts. Pre-tax accounts require the government to cover the revenue shortfall sooner than after-tax accounts. It can do so by either cutting spending, raising other taxes, borrowing, or a mix of the three. Borrowing requires the government to pay interest on that debt in the future. Since pre-tax accounts cost the government more revenue in the short-term, they can also require it to incur more short-term interest costs than after-tax accounts do. Additionally, more of the revenue losses associated with after-tax accounts may occur outside the 10-year budget window JCT uses to score the cost of tax law changes.[33] This later loss of revenue might make after-tax accounts more politically palatable than deferred accounts.

Feldstein (1995) argued that holdings in tax-advantaged savings accounts could stimulate investment—and therefore economic growth—that raises corporate tax revenue. As savings increased, businesses could sell more stocks and bonds, and use the proceeds to invest in expanding production. The profits businesses made on new production would be taxed. Assuming that half of IRA contributions represent new economic investment, he estimated that this revenue could more than compensate for lost income-tax revenue in the long run.[34] However, critics, such as Engen, Gale, and Scholtz (1996) and Ruggeri and Fougère (1997) countered that Feldstein relied on unreasonable assumptions.[35]

Tax-advantaged accounts can lower state and local governments' revenue as well. Forty-one states have state income taxes, and many have laws or policies that automatically conform definitions or structures in their tax code to the federal code.[36] As a result, many states automatically provide the same tax benefits to tax-advantaged accounts as the federal government. Federal expansions of tax-advantaged savings accounts would reduce those state and local governments' revenues, absent a change in state law.

Distribution of Tax Benefit by Income

High-income taxpayers hold the vast majority of balances in most tax-advantaged savings accounts. The Tax Policy Center estimated that the highest earning fifth of households received 47% of the present value of the current and future tax benefit of tax-advantaged retirement accounts in 2020.[37] That share would rise to 56% of the benefit if Congress were to permanently extend the temporary tax rate reductions passed as part of P.L. 115-97, the law popularly known

[33] While the Congressional Budget Office estimates the future cost of spending programs, JCT typically estimates the changes to revenue associated with tax policy changes. See Joint Committee on Taxation, "Revenue Estimating," https://www.jct.gov/operations/revenue-estimating/. Accessed November 8, 2022

[34] Martin Feldstein, "The Effects of Tax-Based Saving Incentives on Government Revenue and National Saving," *Quarterly Journal of Economics*, vol. 110, no. 2 (May 1995), pp. 475–494.

[35] Engen, Gale, and Scholtz (1996); Guiseppe Ruggeri and Maxime Fougère, "The Effect of Tax-Based Savings Incentives on Government Revenue," *Fiscal Studies*, vol. 18, no. 2 (1997), pp. 143-159.

[36] Even if states do not conform their definitions to the federal tax code's automatically, they may choose to do so whenever federal lawmakers create, alter, or eliminate a tax-advantaged account to simplify taxpayers' experience.

[37] Tax Policy Center, "Table T20-1039: Eliminate Deductions for New Contributions to Retirement Savings Plans," May 7, 2020, https://www.taxpolicycenter.org/model-estimates/tax-incentives-retirement-savings-may-2020/t20-0139-eliminate-deductions-new.

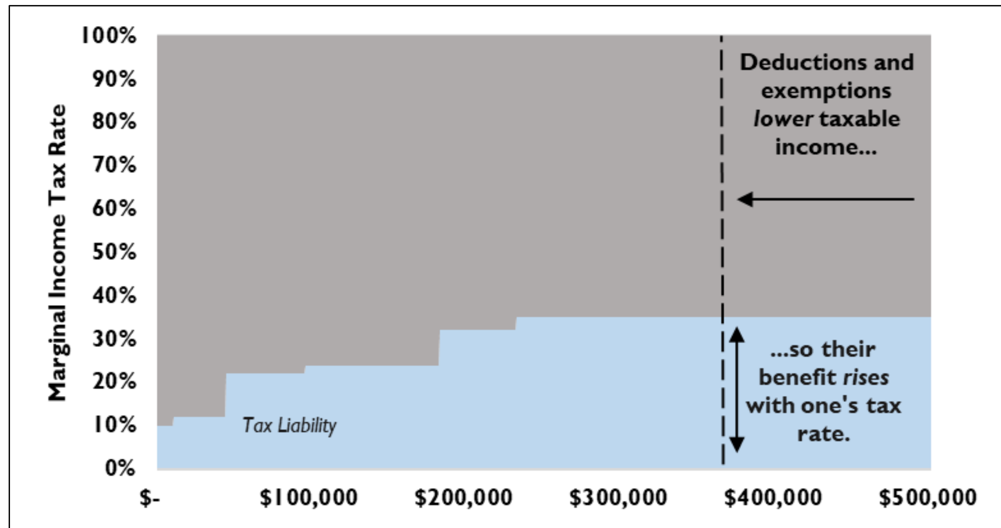
as the Tax Cuts and Jobs Act (TCJA). Under the TCJA, the reduced marginal tax rates are scheduled to expire after 2025.[38]

Education accounts are similarly concentrated among high-income families. While just 0.3% of the lowest-earning half of households had 529 plans in 2013, 16% of households in the highest-earning 5% did, and they typically held over 3.6 times as much in those accounts.[39]

Higher-income households typically save a larger share (and hence dollar amount) of their income than lower-income households do, enabling them to take advantage of these accounts.[40] Additionally, higher-income people generally have greater access and participation rates for tax-advantaged savings accounts compared to lower-income people. For example**,** a larger share of full-time and high-earning employees work for employers who sponsor 401(k) accounts than part-time and lower-earning employees do.[41]

The tax code also naturally makes tax-advantaged saving more attractive for high-income households than others. The benefit of a tax deduction or exemption depends in part on the marginal tax rate that a saver would otherwise pay on their gains or contributions (**Figure 2**). Since the income tax code is progressive, marginal rates rise with income. As a result, high-income people often benefit more from excluding some savings or gains from taxable income than lower-income people do.

Figure 2. Tax Deductions and Exemptions are Often Regressive



Notes: Based on 2023 marginal income tax rates for a single filer. Since the Social Security payroll tax only applies to income up to a taxable maximum threshold ($160,200 in 2023), it is regressive. Tax exemptions that lower income subject to the Social Security payroll tax therefore have some offsetting progressivity.

[38] Tax Policy Center, "Table T20-1038: Eliminate Deductions for New Contributions to Retirement Savings Plans. Baseline: Current Law with TCJA Permanently Extended," May 7, 2020, https://www.taxpolicycenter.org/model-estimates/tax-incentives-retirement-savings-may-2020/t20-0138-eliminate-deductions-new.

[39] Simona Hannon et al., "Saving for College and Section 529 Plans," *Fed Notes*, Washington: Board of Governors of the Federal Reserve System, February 3, 2016.

[40] Bhutta et al., "Changes in U.S. Family Finances from 2016 to 2019," p. 13.

[41] See Bureau of Labor Statistics, March 2022 National Compensation Survey (NCS), September 2022, https://www.bls.gov/ncs/ebs/benefits/2022/home.htm.

For example, suppose two people both claim a tax deduction of $1,000. One person is subject to a marginal income tax rate of 24 percent, while the other pays a lower marginal income tax rate of 12 percent. Both people could reduce the amount of income subject to the income tax by $1,000. However, that reduction would save the person who is subject to the 24 percent marginal rate $240, while it would save the other person $120.[42] Low earners might value an additional dollar of benefit more than higher earners do, as they are more likely to need the benefit to pay for expenses that are more essential.

People often hold savings in tax-advantaged accounts over multiple tax years, which complicates this analysis in two ways. First, taxpayers may not face the same marginal tax rate when they contribute to an account and when they realize gains on it. Those who contribute to pre-tax accounts can receive a larger benefit if they pay higher marginal tax rates when they contribute to their account and claim their deduction than when they withdraw their savings and have to pay tax. Savers with after-tax accounts benefit most from the opposite: paying a lower marginal tax rate when they contribute and paying taxes at a higher rate when they withdraw.

Second, most tax-advantaged accounts exempt from taxation either qualified contributions or withdrawals, but still tax the other (as discussed above, HSAs do not tax either). Even when savers pay the same marginal tax rate both when they contribute and when they withdraw, the taxation that the savings face will partially counteract the regressivity of the tax advantage.

For example, savers with high lifelong marginal tax rates who contribute to pre-tax accounts receive a larger initial deduction or exemption than savers with low marginal tax rate, but pay a higher tax rate on their withdrawals.[43] Compared to similar investments in a taxable account, savers with high lifelong marginal tax rates can effectively make larger initial contributions than savers with low rates.[44] Similarly, while savers facing high marginal tax rates pay more tax on their initial contributions to after-tax accounts than other savers do, they also receive a larger tax benefit when they withdraw their savings. So long as the investment experiences growth, savers with high lifelong marginal tax rates should always receive a larger benefit (in percentage terms) from a tax advantage than those with low lifelong marginal rates.

Some have argued that measuring the distributional impact of these accounts in isolation—rather than in conjunction with other benefits—is misleading. They argue this is because an entire system of government benefits can be progressive even if one component, such as a tax-advantaged account, is regressive.[45]

Accounts aimed at narrower portions of the population may prove less regressive than others. For example, individuals who meet the disability criteria for an ABLE account have difficulty performing certain actions or activities, such as working. The exemption of ABLE account assets from means tests for other social benefits may compel some to open them for reasons besides the tax benefit. If so, these alternative incentives may overpower the forces that typically make tax-advantaged accounts regressive.

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[42] See Congressional Budget Office, *The Distribution of Major Tax Expenditures in 2019*, October 2021.

[43] In addition to assuming taxpayers face the same marginal tax rate throughout their lives, these examples assume that savers in tax-deferred accounts save their entire tax benefit. If they choose to consume some of their tax deferral upon contribution, their initial contribution would be smaller than presented here. Since less initial savings would grow, the equivalence between tax-deferred and tax-exempt accounts would not hold, and the advantage that high marginal tax rate savers have over low marginal tax rate savers would be smaller.

[44] Peter Brady, "How America Supports Retirement: What Do Tax Rates Have to Do with the Benefits of Tax Deferral? Less Than You Think," *Investment Company Institute*, February 24, 2016.

[45] For example, see Peter Brady, *How America Supports Retirement: Challenging the Conventional Wisdom on Who Benefits* (Investment Company Institute, 2016).

Recent Proposals for Reform

In recent years, lawmakers have put forth several proposals to either expand the coverage of tax-advantaged accounts or make the tax benefit they provide more progressive. These reforms include changing their tax treatment, either by converting them to direct spending programs or tax credits; augmenting them with additional tax credits; changing their limitations; or letting employers contribute to more accounts tax-free. Some have also proposed creating new tax-advantaged savings accounts in the hopes of encouraging saving for additional purposes.

Change the Tax Benefit

Some have proposed replacing certain tax-advantaged accounts with direct spending or tax credits. While the value of a deduction depends on the marginal tax rate a taxpayer would otherwise pay on the deducted income, direct spending and refundable tax credits give all qualified claimants the same financial benefit.[46] For example, President Obama proposed phasing out the federal tax advantage for 529 plans and Coverdell plans, and using the resulting revenue to increase spending on a tax credit for higher education expenses.[47] Additionally, lawmakers have suggested creating new direct spending programs that match contributions to 529 plans, similar to the benefit that the Saver's Match will provide some savers contributing to retirement accounts starting in 2027.[48]

Alter or Expand Employer Contributions

Another commonly proposed reform is to alter the treatment or nature of employer contributions. Employers can typically deduct employee compensation, including contributions to tax-advantaged retirement accounts and HSAs, from their own taxable income, even when the federal government does not consider that compensation part of the employee's taxable income. Lawmakers could let employers contribute to tax-advantaged accounts besides employer-sponsored retirement accounts and HSAs. Some have proposed letting employers contribute to 529 or ABLE accounts directly.[49] Others have suggested letting employers contribute to ABLE accounts in lieu of retirement accounts, which would allow disabled people to save more without losing access to means-tested benefits.[50]

Change Limitations

Some have suggested loosening limits on contributing to and withdrawing from tax-advantaged accounts. These proposals include changing the legal thresholds or reducing the penalties associated with unqualified contributions or withdrawals.[51] However, others involve changing the structure of the limitations, and their nature depends on the account in question.

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[46] "Nonrefundable" credits lower a taxpayer's income tax burden to zero, but no further, so their exact value depends on a household's tax burden.

[47] Office of the Press Secretary, "FACT SHEET: A Simpler, Fairer Tax Code That Responsibly Invests in Middle Class Families," *The White House*, January 17, 2015, https://obamawhitehouse.archives.gov/the-press-office/2015/01/17/fact-sheet-simpler-fairer-tax-code-responsibly-invests-middle-class-fami.

[48] For example, S. 1173, the Earn to Learn Act (117th Congress).

[49] For example, H.R. 529, the 529 and ABLE Account Improvement Act of 2017 (115th Congress).

[50] For example, H.R. 4672, the ABLE Employment Flexibility Act (117th Congress).

[51] For example, H.R. 725, the Personalized Care Act of 2021, and H.R. 9160, the Healthcare Freedom Act of 2022

Retirement Accounts

The Build Back Better Act, an earlier version of P.L. 117-169, would have prohibited high-income households from contributing to IRAs if such contribution would cause the account's value to exceed $10 million.[52] Doing so would have generated more tax revenue from high-income taxpayers. The bill also would have increased required minimum distributions from large retirement accounts for high-income savers.[53] These provisions were removed from the bill before final passage.

Health Savings Accounts

Lawmakers have proposed expanding eligibility for HSAs by making all taxpayers eligible to open them, not just those who also own high-deductible health insurance plans. Others have suggested parents should be able to open HSAs for their children to use once they reach the age of 18 and are no longer a dependent.[54]

There have also been proposals to let savers spend their HSA funds without penalty on a wider scope of medical expenses, such as spending on home care expenses or adult diapers.[55] Additionally, some have proposed prohibiting HSAs from covering costs related to certain types of abortions.[56]

Create New Tax-Advantaged Accounts

Just as existing tax-advantaged accounts are meant to encourage saving for specific purposes, some have proposed creating new accounts to encourage saving for other costs. For example, some have proposed creating new after-tax accounts that households could use to save for childcare expenses, parental leave expenses, or down payments on a first home.[57]

Other proposals involve creating tax-advantaged accounts for children, which the beneficiaries could use for specific purposes once they reached adulthood. Typically, these purposes include wealth-building activities such as obtaining a higher education or making long-term investments. They may also include starting a business or buying a home. In some proposals, parents would

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(117th Congress).

[52] The text of the Build Back Better Act that included the changes described in this paragraph is available at https://docs.house.gov/meetings/BU/BU00/20210925/114090/BILLS-117pih-BuildBackBetterAct.pdf.

[53] See CRS Report R46923, *Tax Provisions in the "Build Back Better Act:" The House Ways and Means Committee's Legislative Recommendations*, coordinated by Molly F. Sherlock.

[54] For example, H.R. 6507, the Child Health Savings Account Act of 2022 (117th Congress).

[55] For home care, see H.R. 2898, the Homecare for Seniors Act. For diapers, see H.R. 7585, the Health Equity and Accountability Act of 2022, and H.R. 259, the End Diaper Need Act of 2021.

[56] For limiting abortion expenses, see H.R. 6471, the Protecting Life in Health Savings Accounts Act. For expanding contraception expenses, see H.R. 8428, the Allowing Greater Access to Safe and Effective Contraception Act.

[57] For childcare, see Donald J. Trump for President Campaign, "Fact Sheet: Donald Trump's New Child Care Plan." September 13, 2016, https://web.archive.org/web/20170308122458/https://www.donaldjtrump.com/press-releases/fact-sheet-donald-j.-trumps-new-child-care-plan. For parental leave, see S. 247, the Working Families Flexibility Act of 2021. For down payments on a home, see H.R. 1360, the American Dream Down Payment Act of 2021. All of these bills were introduced in the 117th Congress. Some states already offer tax-advantaged accounts for first-time homebuyers. The benefits only apply to state income taxes. See Sarah O'Brien, "More states are creating tax-advantaged savings accounts just for first-time home buyers," *CNBC*, May 22, 2018.

contribute funds to the accounts, while in others, the government itself would contribute to the account.[58]

Letting taxpayers use savings in existing accounts for additional purposes without penalty could be equivalent to creating new accounts. For example, lawmakers have proposed letting savers use funds in 529 plans and Coverdell plans to pay for industry-recognized job-training credentials or a wider range of expenses related to elementary and secondary education.[59]

Conclusion

Tax-advantaged savings accounts are a prominent mechanism for social benefits in the United States. They are among the largest forms of household wealth and may influence how households prepare for retirement, health care costs, education expenses, and disability expenses.

Supporters argue these accounts induce households to save more for important expenses, stimulate economic investment, and subsidize the cost of retirement, higher education, health care, and other major expenses. Yet the evidence that these accounts actually encourage new saving, as opposed to rewarding households for doing what they would have done anyway, is mixed. Studies generally find that other features associated with the accounts encourage saving more strongly.

The substantial tax benefits that these accounts offer accrue disproportionately to higher-income households. Savers with high taxable income both own a larger share of the assets held in these accounts and benefit more from the reduction in taxable income these accounts offer. However, some counter that measuring these accounts separate from other progressive benefit systems is misleading. These findings may be of interest to policymakers interested in whether tax-advantaged savings accounts are achieving their goals or whether to use this policy design to structure a new social benefit.

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[58] See S. 2206, the Young American Savers Act of 2021, and S. 222, the American Opportunity Accounts Act (117th Congress).

[59] Proposals in the 117th Congress to make job training eligible include H.R. 2691, H.R. 2171, S. 905, H.R. 8128, and H.R. 1242. S. 4023, the Lifelong Learning and Training Account Act of 2021, would create new accounts for the same purpose.

Proposals in the 117th Congress to expand eligible withdrawals for elementary and secondary education include H.R. 605, H.R. 7269, S. 4265, S. 1757, and S. 8913. Additionally, H.R. 625 would make certain costs regarding homeschooling for military children eligible expenses for 529 plans, and H.R. 499 would create a new tax-advantaged account specifically for military education expenses.

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