CBO MEMORANDUM

ESTIMATES FOR A PROTOTYPE SAVING-EXEMPT INCOME TAX

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CONGRESSIONAL BUDGET OFFICE

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This Congressional Budget Office (CBO) memorandum, prepared at the request of Senator Pete V. Domenici, Ranking Minority Member of the Senate Committee on the Budget, calculates illustrative tax rate schedules for a saving-exempt income tax (SEIT).

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SUMMARY AND INTRODUCTION

At the request of Senator Domenici, the Congressional Budget Office (CBO) has calculated tax rate schedules for a prototype saving-exempt income tax (SEIT) that meet a prescribed set of revenue and distributional requirements. Senators Domenici and Nunn have proposed a SEIT as a replacement for the current individual and corporate income taxes. The SEIT would be collected partly from businesses and partly from individuals and families. The SEIT's business tax would be levied on cash flow--the difference between business sales and business purchases. All business purchases would be immediately deductible, including investment in plant, equipment, and inventory. The SEIT's tax on individuals and families would resemble the current individual income tax, but would not tax the income that taxpayers save until it is withdrawn from savings and spent for consumption. Because the SEIT would not tax income that taxpayers save and businesses invest, it would not lower the return on saving, as an income tax does. As a result, taxpayers would have an incentive to save more than they do under the current income tax.

The SEIT would incorporate a refundable credit for all of the Social Security payroll tax paid by employers and for some portion of the payroll tax paid by employees. (The credit for employees would phase out for higher-income taxpayers.) Total revenues from the SEIT would equal total revenues from individual and corporate income taxes, plus the revenues needed to pay for the Social Security payroll tax credit. Social Security payroll taxes would

continue to be collected and deposited in the Social Security trust funds just as they are now.

Estimates for the Prototype SEIT

CBO has calculated tax rate schedules for a prototype SEIT. CBO used a prototype because many of the details of the actual proposal are still being formulated. Although the general features of the prototype should closely resemble those of the Domenici-Nunn proposal, some of the details will probably differ.

For the tax rate schedules calculated by CBO, the prototype SEIT would replace the individual and corporate income taxes (after the changes in the Omnibus Budget Reconciliation Act of 1993 are fully phased in) without changing:

- The total amount of federal tax revenue;

- The distribution of the federal tax burden among income quintiles of the population; and

- The share of federal taxes collected from businesses.

Because the SEIT does not tax savings, knowing how much families save is a crucial element of the tax schedule calculations. Existing data yield inconsistent estimates of the amount saved by families with different incomes. Because this inconsistency is unresolved, CBO has used two different approaches to measure household saving. The first approach measures annual saving as the difference between a family's income and expenditures during the year (residual saving). The second approach measures annual saving as the change in a family's net worth during the year (net worth saving). Although these two measures are equivalent by definition and should yield the same results, the actual measures, using the same sample of families, differ substantially. Each measure of saving yields a different estimate of the tax rate schedules that meet the objectives of revenue and distributional neutrality for the prototype SEIT.

The prototype tax for individuals maintains most of the features of the current individual income tax. The prototype has a standard deduction and personal exemptions, although the amounts are higher than those of the current individual income tax. Itemized deductions are limited to medical expenditures in excess of 7.5 percent of income, state and local income tax payments, and charitable contributions. (Mortgage interest payments can be

deducted regardless of whether the taxpayer itemizes or takes the standard deduction.) The prototype has a refundable earned income credit that is larger than that of the current income tax, and a new refundable credit for Social Security payroll taxes.

The prototype employs four tax brackets that start at the same levels of taxable income as the first four tax brackets of the current individual income tax. (The SEIT's definition of taxable income, however, is not identical to that of the current individual income tax.) Tax rates for the four tax brackets depend on which measure of saving is used and on assumptions about the distribution of current-law taxes. Using assumptions consistent with a more progressive distribution of income taxes under current law, tax rates for a distributionally neutral SEIT range from 16 percent in the lowest tax bracket to 55 percent in the highest bracket when saving is measured by the residual approach, and from 13 percent to 41 percent when saving is measured by the net worth approach. Using assumptions consistent with a somewhat less progressive distribution of current taxes reduces the top tax rate for a distributionally neutral SEIT to 49 percent when saving is measured by the residual method and to 36 percent when saving is measured by the net worth approach.

The prototype SEIT for businesses is levied on business cash flow and has a single tax rate of 7.1 percent.

Limitations on Distributional Neutrality

Based on CBO's distributional method, the estimated tax rate schedules give the prototype SEIT the requisite properties of revenue and distributional neutrality. These properties, however, apply only within the context of this analysis. Official estimates for a fully specified SEIT may differ depending upon how saving is measured and how "distributional neutrality" is defined in that analysis.

Even in the context of the present analysis, distributional neutrality is achieved only for certain groupings of the population. Although the estimated tax rate schedules under the SEIT maintain the same distribution of the tax burden among income quintiles as current law, they do not necessarily maintain the same distribution for narrower income categories. For example, even though the tax burden for the entire top income quintile would be unchanged by the prototype SEIT, the burden on some families within the top quintile could be higher or lower than under current law if those families save a smaller or larger share of their income than others in the same income quintile. If

saving rates increase with income within a quintile, then the most well-to-do families in the quintile will receive a tax reduction that is entirely financed by a tax increase on the other families in it.

The estimated tax rate schedules also do not maintain the tax burden on specific subgroups of the population. For example, the annual tax burden on larger families might go up under the SEIT because larger families typically spend more and save less than smaller families with the same income. The annual tax burden on the young and the old also might rise under the SEIT because these people tend to save less of their incomes than other families. The young save less because they expect their income to rise in the future, and the old save less because they can draw upon past saving.

Higher tax burdens for larger families and the young and old reflect the time perspective for distributional neutrality that is used here. In the current analysis, tax burdens are measured in relation to annual income, but annual income may be a poor reflection of a person's lifetime economic status. Incomes may fluctuate from year to year for workers who are prone to temporary unemployment, the self-employed, or people who receive a large share of their income from returns on investments. Incomes usually vary systematically over people's lifetimes, increasing as they move into their peak earning years and declining in retirement. Measuring tax burdens over a

taxpayer's entire lifetime would eliminate differences caused by transitory and life-cycle variations in income and saving.

HOW THE SEIT WORKS

The SEIT is a two-part tax, collected partly at the business and partly at the individual level. The business-level tax is levied at a flat rate, and the individual-level tax is levied under a rate schedule graduated to make the overall burden of the SEIT progressive.

Both parts of the SEIT tax consumption, but in different ways. The business-level tax taxes the difference between the value of a business's domestic sales and the value of its purchases from other businesses (including its purchases of plant, equipment, and inventory). The individual-level tax taxes the difference between a family's income and its saving. In total, the difference between the domestic sales and purchases of businesses and the difference between the income and net saving of individuals and families both approximate the value of consumption.

How the Business-Level Tax Works

To compute its tax base under a SEIT, a business would typically take the value of its business receipts from domestic sales (which, by definition, exclude exports sales, income from overseas operations, and financial income) and subtract its purchases from other businesses. Purchases of imported goods also would be subtracted, assuming that the imports had been taxed at the border.

To compute its tax liability, a business would multiply its tax base by the business tax rate. The business would then take a tax credit equal to the employer's portion of the payroll tax payments for its employees. (For the self-employed, the business tax credit would equal half of their self-employment payroll taxes.) If the business's tax liability was negative, it would receive a refund.

The SEIT's business-level tax would not allow businesses to deduct employee compensation (including purchases of health insurance for employees and their families), state and local tax payments, interest and dividend payments, or the depreciation of plant and equipment. The SEIT's transition rules, however, would probably allow businesses to deduct a portion of the remaining tax basis of most business assets each year until the basis was fully recovered. New investments in plant and equipment, of course, would be fully

deducted as "business purchases" at the time of purchase, making subsequent deductions for depreciation unnecessary.

The business-level tax would be levied on most but not all businesses. The SEIT, for example, might not require small businesses to pay the tax. Moreover, it would not treat state and local governments and nonprofit organizations as businesses unless they were actively engaged in business activities. Although financial institutions would pay tax, their tax base would be computed differently than for other businesses in order to include all financial income.

How the Individual-Level Tax Works

The individual-level tax under the SEIT has most of the characteristics of current individual income tax. It differs, however, in five important ways. First, saving would be fully deducted from income, and money withdrawn from savings and spent would be fully included in income. Second, interest payments on loans generally would be deductible, regardless of whether the taxpayer itemized deductions or not, and regardless of whether a loan was a mortgage or not. Third, income received from business activities would be recognized and measured on a cash basis. Fourth, capital gains and losses would not be

explicitly recognized as income. Fifth, a tax credit would be available to lower-income taxpayers for the employee's portion of the payroll tax.

Under the SEIT for individuals, income that was saved would not be subject to tax until it was withdrawn from savings and spent on consumption. Transactions that increase saving would include deposits to bank accounts, purchases of financial and investment assets, payments of life insurance premiums, cash contributions to businesses, home purchases (including major home improvements), and loan repayments. Each of these transactions has a counterpart that reduces saving. Thus, for example, saving is reduced when a taxpayer withdraws funds from a bank account, takes out a new loan, or sells a home. Unless the proceeds from such a transaction are "resaved," the amount on which the taxpayer must pay tax increases. Although all withdrawals from savings are taxed, transition rules for the individual-level SEIT probably would allow some relief for holders of savings at the time the tax was put into effect.

All taxpayers would be able to deduct interest payments fully, not just those who itemized their deductions. The full deductibility ensures that the measurement of consumption for tax purposes is not affected by the way a taxpayer pays for it. For example, if a taxpayer borrows to finance consumption, the amount borrowed is taxed at the time of consumption. The tax paid

on the borrowing is the same as the tax that would have been paid if the taxpayer had paid for the consumption out of current income. Because the consumption financed by the loan has already been taxed, the future income needed to service the loan (both interest expense and debt repayment) should be tax-free. To accomplish this, interest payments as well as loan repayments are fully deductible under the individual-level SEIT.

Home purchases and home improvements would be a form of saving under the individual-level SEIT and thus deductible from the tax base. Money withdrawn from savings or realized from the sale of a previous home would be included in the tax base, as would the proceeds from a mortgage or home-equity loan. Thus, a home purchase would have no net effect on the tax base in the year of purchase if financed by a withdrawal from savings, the sale of a previous home, or borrowing.

Mortgage repayments and the interest on mortgage loans would be deductible from the tax base in the year that those payments are made.

The annual return on an investment in a home is the flow of "housing services" from owner-occupied housing, which are equivalent to the amount a homeowner would pay in rent to obtain the same housing services. Consistent

with the current individual income tax, the implicit consumption of housing services from owner-occupied housing would not be included in the tax base.

The measurement of income from business activities under the SEIT is consistent with the treatment of net saving. Thus, if the income earned by a business is not distributed to the owner, in effect, the business has saved the income on behalf of the owner. Therefore, the tax treatment should be the same as that when the income is distributed and the owner reinvests it in the business. The cash flow treatment of business income accomplishes this.

Although the proceeds from the sale of capital assets are included in income under the SEIT, no tax is due on the sale if all of the proceeds are reinvested. The unrestricted "rollover" treatment of asset sales under the SEIT eliminates the "lock-in" effect of the current income tax on asset holdings.

Taxpayers would receive a refundable tax credit under the individual-level SEIT for their payment of the employees' portion of the payroll tax. The credit would be phased out for higher-income taxpayers.

Most of the other features of the individual-level SEIT resemble those of the current individual income tax. The SEIT retains personal exemptions,

the standard deduction, some itemized deductions, and graduated tax rate schedules similar to those under the income tax. It also has an earned income tax credit (EITC) for low-income taxpayers.

THE SEIT PROTOTYPE

Because details on the Domenici-Nunn proposal are still being formulated, CBO was asked to base its analysis on a SEIT prototype. The prototype avoids special rules as much as possible, even when fairness or the ability to administer the tax will inevitably require some.

The Business-Level Tax Prototype

Because the tax base for the business-level tax closely approximates the tax base for a value-added tax (VAT), CBO simulated the business-level SEIT using a single-rate, broad-based VAT as the prototype. The base of the business-level tax includes all domestic sales by businesses to nonbusinesses. Because religious and charitable organizations and state and local governments are not considered businesses, their purchases of goods and services from businesses (but not their payments to employees) are included in the tax base along with purchases made by consumers from businesses. Purchases of newly

constructed owner-occupied housing also are included in the tax base along with purchases of durable goods, nondurable goods, and services by consumers.

In general, goods and services that are purchased by employers for the benefit of their employees are included in the tax base of the prototype. Thus, for example, the expense of providing health insurance for employees and their families is included.

The Individual-Level Tax Prototype

CBO modified the current individual income tax and used it as the prototype for the SEIT's individual-level tax. Gross income (before adjustments) under the SEIT is the same as gross income (before adjustments) under the current income tax, except that the SEIT's gross income excludes capital gains and losses. Thus, gross income is defined in the following way for the prototype:

Gross income	=	Wages and salaries
	+	Interest income (excluding interest on state and local government obligations)
	+	Dividend income
	+	Tax refunds

+	Alimony received less alimony paid
+	Business income or loss (Schedules C and F)
+	Rents, royalties, and partnership income or loss
+	Taxable pensions and annuities (determined by the current income tax rules)
+	Taxable Social Security benefits (determined by the current income tax rules)
+	Unemployment compensation.

The prototype adjusts gross income to include some of the fringe benefits that taxpayers receive from their employers that are not treated as income under the current income tax. This adjustment is limited to including in gross income the value of employer-provided health insurance. No adjustment is made to include gifts and inheritances that taxpayers receive from relatives and acquaintances.

The prototype adjusts gross income to exclude the interest expense on all loans. The interest adjustment is determined as follows:

Interest adjustment	=	Interest paid on mortgages
	+	Interest paid on auto and student loans
	+	Interest paid on other installment loans

income tax. (Taxpayers are allowed to deduct mortgage interest payments, however, whether they itemize or not.)

Itemized deductions	=	Unreimbursed medical expenses in excess of 7.5 percent of gross income
	+	State and local income tax payments
	+	Charitable contributions.

MEASURING FAMILY SAVING

The key difference between the individual-level SEIT and the current individual income tax is that all saving is excluded from the tax base of the SEIT. Because the SEIT does not tax the income that families save, the variation in family saving rates by family income changes the tax base for the SEIT in relation to the tax base under current law. The larger the share of income saved by higher-income families as compared with that saved by lower-income families, the flatter is the SEIT tax base in relation to current law, and the more steeply graduated the SEIT's individual tax rates need to be to maintain the same level of taxes by income quintile.

To estimate the tax base for the SEIT, we must know how much families save. Because families need not report saving in order to calculate their taxes under current law, data from individual income tax records are insufficient to

simulate the SEIT. Data from household surveys provide some measure of family saving, but are incomplete and inconsistent.

Because existing data yield inconsistent results, CBO estimated the annual amounts saved by families in two ways using household data from the Consumer Expenditure Survey.[1] The "residual" approach measures annual saving as the difference between a family's income during the year and its consumption expenditures, tax payments, and other outlays over the same period. The "net worth" approach measures annual saving as the change in a family's net worth during the year. Although these two measures are equivalent by definition and given consistent data should yield the same results, the actual outcomes differ substantially.

The measured saving rate varies much more by income under the residual approach than it does under the net worth approach. Saving rates for high-income families are much higher, as are borrowing (dissaving) rates for low-income families, using the residual approach. In order to achieve the same degree of measured tax progressivity, the tax rate schedule for the SEIT's individual-level tax must be more graduated when the saving adjustment under

1. The two measures of saving are compared in John Sabelhaus, "What is the Distributional Burden of Taxing Consumption?" *National Tax Journal*, vol. XLVI, no. 3 (September 1993); and Barry Bosworth, Gary Burtless, and John Sabelhaus, "The Decline in Household Saving: Evidence From Household Surveys," *Brookings Papers on Economic Activity*, no. 1 (1991).

the tax is determined using the residual approach rather than the net worth approach.

SIMULATION RESULTS

The simulated prototype SEIT was designed to yield as much revenue as taxes on individual and corporate income in 1994 under the fully phased in provisions of the Omnibus Budget Reconciliation Act of 1993 (OBRA-93), and to replace the revenues lost through the payroll tax credit. Combined corporate and individual income tax liabilities, including the refundable portion of the earned income tax credit, are projected to be about $650 billion at 1994 levels under the law after OBRA-93 is fully in place. Total Social Security payroll tax liabilities are expected to be about $425 billion in 1994.

The Distribution of Current Income Taxes

The target for distributional neutrality depends on assumptions about the distribution of current federal income taxes. CBO uses two assumptions about the incidence of the corporate income tax: the first assumes that the entire tax falls on income from capital, and the second assumes that half of the tax falls on income from capital and half falls on labor income. CBO divides families

into five groups by income and measures the ratio of taxes paid to before-tax income--the effective tax rate--for each income quintile.

Assuming that the entire burden of the corporate tax falls on income from capital, combined federal individual and corporate income tax rates ranged from -5.7 percent in the lowest income quintile to 19.7 percent in the highest quintile (see Table 1).[2] The effective rate for the lowest income quintile is negative because of the refundable EITC. Assuming that corporate taxes are somewhat less progressive, with half of the burden falling on capital and the other half falling on labor income, combined effective income tax rates range from -5.0 in the lowest income quintile to 19.1 percent in the highest quintile.

Business-Level Tax

The estimated tax base for the business-level tax is about $4.6 trillion in 1994. A tax rate of 7.1 percent would yield approximately $330 billion in revenues, the amount needed to replace current income taxes on corporate and noncorporate businesses and to provide a tax credit for the employer portion of Social Security payroll taxes.

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2. These are projected rates for 1994, assuming full implementation of the OBRA-93 changes in the earned income credit.

TABLE 1. COMBINED EFFECTIVE INDIVIDUAL AND CORPORATE INCOME TAX RATES WITH ALTERNATIVE ALLOCATIONS OF THE CORPORATE INCOME TAX, BY INCOME QUINTILE (In percent)

	Income Quintile				
	Lowest	Second	Middle	Fourth	Highest
Corporate Tax Allocated All to Capital	-5.7	3.2	7.4	10.1	19.7
Corporate Tax Allocated Equally to Capital and Labor	-5.0	3.9	8.1	10.9	19.1

SOURCE: Congressional Budget Office.

Individual-Level Tax

The graduated rate structure of the prototype SEIT for individuals employs separate schedules for single, married, and head-of-household filers (see Table 2). Each has four tax brackets that start at the same level of taxable income as the first four tax brackets under the current individual income tax, although taxable income under the SEIT is not the same as taxable income under current law. The personal exemption amount under the prototype SEIT is twice that under the current individual income tax, and the standard deduction is 50 percent higher than the deduction under current law. The prototype SEIT has an EITC similar to that under current law, but with higher maximum credits, and a new refundable credit for the employee-paid portion Social Security payroll taxes. The payroll tax credit is reduced if income exceeds the standard deduction and is fully phased out if income equals or exceeds $25,000.

TABLE 2. TAX BRACKETS, PERSONAL EXEMPTION, AND STANDARD DEDUCTION FOR THE PROTOTYPE SAVING-EXEMPT INCOME TAX (In dollars)

	Single	Married	Head of Household
Start of Second Tax Bracket	22,750	38,000	30,500
Start of Third Tax Bracket	55,150	91,850	78,700
Start of Fourth Tax Bracket	115,000	140,000	127,500
Personal Exemption	4,900	4,900	4,900
Standard Deduction	5,700	9,525	8,400

SOURCE: Congressional Budget Office.

The estimated schedule of tax rates for the prototype SEIT depends on the method used to measure family saving and on the assumption used to allocate corporate income taxes under current law. Assuming that current corporate income taxes are borne entirely by capital income (the more progressive allocation), the estimated tax rates for a distributionally neutral SEIT range from 16 percent in the bottom bracket to 55 percent in the highest bracket using the residual saving approach, which shows a greater variation in saving rates among income groups, and from 13 percent in the bottom bracket to 41 percent in the top bracket using the net worth saving approach (see Table 3). Under the assumption that labor income bears half of the burden of

TABLE 3.	TAX RATES FOR THE PROTOTYPE SAVING-EXEMPT INCOME TAX FOR INDIVIDUALS (In percent)

		Saving-Exempt Income Tax			
		More Progressive Allocation of Current Income Taxes		Less Progressive Allocation of Current Income Taxes	
	Current Income Tax	Residual Measure of Saving	Net Worth Measure of Saving	Residual Measure of Saving	Net Worth Measure of Saving
First bracket	15	16	13	16	14
Second bracket	28	38	28	38	28
Third bracket	31	49	38.5	49	36
Fourth bracket	36	55	41	49	36
Fifth bracket[a]	39.6	55	41	49	36

SOURCE: Congressional Budget Office.

a. Taxable income in excess of $250,000 is taxed at a 39.6 percent rate under current law.

the current corporate income tax (the less progressive allocation), estimated tax rates for a distributionally neutral SEIT are less graduated. The estimated tax rate in the highest tax bracket is 49 percent using the residual saving approach and 36 percent using the net worth approach.

The earned income credit in the prototype SEIT is similar to the current-law credit but with higher credit rates. The size of the credit in the prototype depends on the method used to measure saving. The total EITC was twice as large as the current-law credit for the residual saving base, and 30 percent higher than the current credit for the net worth base. The total amount of the new payroll tax credit was $10 billion, the same in both

simulations, offsetting less than 5 percent of the total amount of Social Security payroll taxes paid by employees.

LIMITATIONS

The preceding tax rate schedules meet the objectives of revenue and distributional neutrality for the prototype SEIT. Those properties depend on the particulars of the current analysis regarding such factors as the range over which distributional neutrality is measured (in this case family income quintiles) and what data are used to estimate family saving. Official estimates for a fully specified SEIT proposal may be based on different assumptions or data and thus may show that the tax rate schedules estimated here are not revenue or distributionally neutral in a different context. Official estimates may also differ if family economic status or tax burdens are measured differently than in the current analysis.

Measuring Tax Burdens on an Annual Basis

The estimated tax rate schedules for the prototype individual-level SEIT are sensitive to the measure of the economic status of families. To estimate the distributional burden of taxes for this analysis, CBO measured incomes and tax

burdens of families on an annual basis.[3] Family income includes wages and salaries, self-employment income, rental income, interest and dividends, realized capital gains, and pensions and government transfer payments received in cash. Family income also includes income attributable to the family that was paid toward the corporate income tax and the employer-paid portion of the payroll tax during the year. Family income excludes unrealized capital gains, employer contributions to pension funds, employer-provided fringe benefits, and government transfers received in kind.

This measure of economic status is closely related to the amount of taxable income under the current income tax. If CBO used a different measure of economic status that was less closely related to taxable income under the current income tax and more closely related to taxable income under the SEIT, "distributional neutrality" could be achieved with less graduated rate schedules in the prototype SEIT for individuals. If CBO measured a family's economic status using a proxy for lifetime income rather than by its annual realized income, the current income tax would look less progressive and the estimated tax rate schedules of the SEIT would need to be less graduated to maintain distributional neutrality.

3. In order to adjust family income for differences in family size, the income of each family is divided by an amount representing the poverty threshold for a family of its size. Consequently, a family of four needs about twice the income of a single person to achieve the same level of economic status because the poverty threshold for a family of four is approximately twice that of a single individual.

Allocating Tax Burdens to Families

In this analysis, CBO allocated annual tax payments to families based on assumptions about who bears the burden of each tax. Although some federal taxes are paid by businesses, the economic burden of all taxes falls on people. Taxes may reduce a family's income directly or reduce the purchasing power of its income by causing prices to rise. Economists speak of these effects as the incidence of a tax. To a limited extent, the estimated tax rate schedules of the SEIT depend on the incidence of all taxes that are being changed.

In allocating tax payments to families, this analysis makes the following assumptions about the incidence of specific taxes:

- The burden of the current payroll tax--including both the employer's and the employee's share--falls on employees. The allocation assumes that the burden of the employer's share lowers wages in the long run. Employees gain the benefit of the payroll tax credit under the SEIT's business tax.

- The burden of the current individual income tax and the SEIT individual-level tax falls on the families who directly pay the tax.

- The burden of the current corporate income tax falls entirely on families with realized capital income--the sum of net rents, net interest, dividends, and realized capital gains--or half on families with realized capital income and half on families with income from wages and salaries. The first allocation assumes that the size of the domestic capital stock is not sensitive to the after-tax rate of return on investment. The second allocation assumes that it is quite sensitive to the rate of return on investment.

- The burden of the SEIT's business tax component (before the payroll tax credit and before any tax relief for existing business assets during the transition) falls on consumers. Because it is assumed that the burden of the business tax will show up in higher prices for consumer purchases, no burden is allocated to purchases made by consumers with transfer payments that are indexed for inflation.

Measuring Tax Burdens Only When Taxes Are Paid

The estimated tax rate schedules for the SEIT prototype also depend on how the tax on income that families save is measured. Because this analysis only

counts the burden of taxes that are paid during the year, income that families save under the SEIT bears no tax burden. In effect, income that is saved is treated as if it were exempt from tax, even though the tax on that income is only deferred until the savings are withdrawn and used for consumption. If savings are withdrawn and spent almost immediately, the tax burden on income that is saved is almost the same as under the current income tax. If savings are held indefinitely, income that is saved is effectively tax-exempt.

Because the amount of saving is related to income, distributional neutrality could be achieved with less graduated rates under the SEIT if some tax burden were imputed to the realized income that families save. To measure and discount the eventual tax on such income properly, however, the timing of consumption out of savings would have to be determined.