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CAN CAPITAL TAX POLICY BE FAIR? STIMULATING SAVINGS THROUGH DIFFERENTIATED TAX RATES

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Americans do not save enough.[1] This proposition commands rare assent among legislators and academics who agree on little else. Economic growth requires investment, which in turn requires savings. The American savings rate, never high, dropped precipitously during the 1980s,[2] and our present anemic savings rate endangers our future economic prosperity. The savings rate did not decline from lack of attention. Policy analysts and editorialists warn regularly of the consequences of inadequate savings. Their fears are echoed on the floor of Congress:[3] The national savings rate is a frequent subject of congressional hearings;[4] the Internal Revenue Code contains a complex system of subsidies intended to encourage

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1 This statement has been articulated since the late 1970s. Joan Courtless, *Trends in Savings*, 4 FAMILY ECON. REV. 15 (Dec. 1991) (arguing that Americans save considerably less than Western Europeans and Japanese, and their savings rate has declined significantly since 1970. U.S. personal savings rates: 1970-74, 8.5%; 1975-79, 7.5%; 1980-84, 6.6%; 1985, 5.1%); Martin Feldstein, *Does the United States Save Too Little?*, 67 AM. ECON. ASS'N 116 (concluding that the United States would benefit if Americans would save more); Burton Malkiel, *The Capital Formation Problem in the United States*, 34 J. OF FIN. 291 (May 1979) (stating that in the late 1970s, fear of continued inflation, increased business regulation, weak capital structures, and increased risk premiums together led to insufficient investment and savings in the United States).

2 In 1980, the personal savings rate was 7.9% of personal income; in 1991 it was 5.3%. *See Economic Report of the President*, WEEKLY COMP. PRES. DOC. 1334 (Feb. 1992).

3 *See, e.g.*, 125 CONG. REC. S229-32 (1979) (statement of Sen. McClure) (introducing a bill designed to stimulate waning U.S. savings); 125 CONG. REC. S5,068-69 (1979) (statement of Sen. Pressler) (endorsing tax incentives to increase savings); 125 CONG. REC. S18,119 (1979) (statement of Rep. Crane) (expressing need for increased personal savings in the U.S.); 126 CONG. REC. S1,270-71 (1980) (statement of Sen. Roth) (identifying increased savings as critical to economic growth); 126 CONG. REC. H1,323-24 (1980) (statement of Rep. Brown) (identifying savings as essential for economic growth); 136 CONG. REC. S781-83 (daily ed. Feb. 6, 1990) (statement of Sen. Murkowski) (advocating reforms focused at increasing the U.S. personal savings rate); 138 CONG. REC. E2220-22 (daily ed. July 22, 1992) (statement of Reps. Schulze & Jenkins) (introducing a bill designed to assist with and stimulate U.S. savings).

4 *See, e.g., Savings Incentives: Hearing Before Subcommittee on Savings, Pensions, and Investment Policy of the Senate Committee on Finance*, 97th Cong., 1st Sess. (1981).

Americans to save; and new proposals to stimulate savings are constantly offered.

But consensus that our savings rate is a problem has produced no consensus about a solution. On the contrary, the savings rate crisis has created a major political conflict. Legislators and academics argue over the merits of two different approaches to increasing the savings rate: cuts in the tax rate on capital gains and deductions for various special retirement savings vehicles.[5] Former President Bush, for example, frequently advocated capital gains cuts, invariably meeting with vehement resistance from many Democrats.[6] The two sides differ, above all else, in the degree of concern each expresses over the distributional effects of various schemes. Those whose primary goal is to stimulate savings favor lower capital gains rates for the unrealized appreciation on capital assets.[7] Opponents of capital gains rates argue that affluent taxpayers, who save proportionally more, would receive a disproportionate amount of the benefits from these special rates.[8]

To ensure that the benefits of tax cuts are fairly distributed, some capital gain opponents propose providing deductions for contributions to various specially designed savings accounts. These proposed accounts resemble the Individual Retirement Accounts (IRAs) now available in limited form.[9] However, the use of a deduction would exacerbate the distributive problems inherent in any savings subsidy because a deduction provides a larger subsidy to high-bracket taxpayers. To offset this problem, the proposed accounts would be subject to ceilings on the amount that could be deducted. Other opponents of capital gains would retain the current system of subsidies to employer pensions, especially nonelective ones, primarily because they believe that the nondiscrimination rules governing

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5 Capital gains cuts and retirement savings subsidies are essentially the only general capital tax cuts under consideration. Other capital incentives in the Code or under consideration would target specific classes of capital, such as investment tax credits or accelerated cost recovery (ACRS) for tangible capital. This Article focuses on general capital incentives, although many of its arguments also apply to more specific subsidies.

6 *See, e.g.*, Ian K. Louden, *Bush Challenges Democrats on Capital Gains*, 53 TAX NOTES 772 (1991).

7 *See, e.g.*, Catherine Hubbard, *Capital Gains a Key Element of New Bush Budget*, 53 TAX NOTES 1096 (1991); Rep. Newt Gingrich, *Capital-Gains Cut is Vital*, USA TODAY, Dec. 3, 1991, at 12A; Jude Wanniski, *Blame Bush for the Recession*, N.Y. TIMES, Nov. 12, 1991, at A25.

8 Tim Gray, *Give Us that New-Time Religion: The 'Super IRA'*, 51 TAX NOTES 806, 806 (1991) (stating that debates in Senate Finance Committee deal with question of whether affluent tax-payers save more); Editorial, N.Y. TIMES, Sept. 22, 1989, at A34; Editorial, N.Y. TIMES, May 15, 1986, at A26; *This Capital Gains Tax Is No Economic Solution*, USA TODAY, Dec. 3, 1991, at 12A.

9 Gray, *supra* note 8, at 806. *Tax Reform Is Worth Your IRA*, N.Y. TIMES, May 15, 1986, at A26 (arguing that the biggest beneficiaries of IRAs are the wealthy because they have more to save).

such plans guarantee an equitable distribution of the savings subsidy.

In this Article, I argue that neither IRAs in their current form, nor employer pensions, nor a capital gains cut, can provide a fair or cost-effective stimulus to savings. Instead, a system of differential tax rates on labor and capital would be superior to any proposal currently under consideration. This two-rate system could have two primary advantages. First, it could impose not only a different rate, but a different degree of progressivity, on labor and capital. Second, it could encourage savings in a distributionally fair way by cutting capital tax rates more dramatically for the less affluent than for the more affluent.

A system of differentiated rates, though, may not entirely satisfy the advocates of IRAs and pensions, since IRAs and pensions advance paternalistic as well as distributive goals. To address paternalistic concerns, I suggest instituting a differential-rate IRA. Bills providing for differential rates on capital and labor have occasionally been introduced in Congress, but have met with surprisingly little interest. Part I examines how ability-to-pay theory, long used in tax policy analysis, creates a presumption that a single rate of tax be imposed on both labor and capital. This presumption tends to limit proposals for savings incentives to either capital gains cuts or restricted deductions like IRAs and pensions. The ability-to-pay approach, I suggest, is less satisfactory than its principal alternative, welfare economics, both as an analysis of fairness and as a guide to determining efficiency. Unlike ability-to-pay theory, welfare economics suggests that a fair and efficient tax system may impose different rates on labor and capital.

Part II examines IRAs. In particular, it proposes a modified version of IRAs that can accommodate paternalistic concerns while making use of differentiated rates. IRAs, once universally available, are presently permitted only to a few taxpayers. However, they have great political appeal, and frequent attempts are made to reintroduce them on a broad scale. Unfortunately, IRAs depend on the use of a deduction with all its associated distributive problems. Consequently, all past and pending IRA legislation has imposed strict ceilings on contributions. From an economic point of view, IRAs that consist of deductions with ceilings are greatly inferior to a system of differentiated rates. Yet the economic case for differentiated rates may not satisfy those who support IRAs—at least for some taxpayers—subject to the imposition of ceilings. Economic theory assumes that individuals save rationally for their retirement, and if this assumption is accepted, differentiated rates solve the distributive problems of deductions. But economists may misread Congres-

sional concern for the less affluent when they interpret this concern as wholly distributive. Congress worries about the distributive effects of savings policy, but it also seems to believe that the middle class and the poor are in need of greater paternalistic solicitude than the well-to-do. Even these paternalistic concerns, though, can be better met by differentiated rates than by conventional IRAs. The paternalist's rate structure will differ from the economist's to the extent that a paternalist would advocate more steeply progressive rates to correct for the greater likelihood that the less affluent will fail to save optimally. This rate structure can be reinforced by designing differential-rate IRAs that employ various strategies to restrict liquidity and encourage contributions.

Part III examines the system of employer pensions, currently the largest retirement savings program. Employer pensions, like IRAs, are subsidized through deductions. Congress has attempted to remedy the distributive consequences of deductions by using the so-called nondiscrimination rules. From an economic perspective, though, I suggest that the present system of employer pensions and nondiscrimination rules makes little sense and is far inferior to a system of differentiated rates. However, employers are likely to resist the substitution of differential-rate IRAs for the present system of employer pensions. One possible political compromise would retain the use of employer pensions, but replace the current deductions, subject to nondiscrimination rules, with a system of differential rates.

Part IV explores the preferential rate for capital gains and argues that it is vastly inferior to a system of differentiated rates as a means of encouraging savings. I suggest that the persistent appeal of the capital gains rate as a reform measure results only from the authority of its use in previous years, which gives it an advantage over untried differential rates in defeating the presumption of uniform taxes.

I

TWO APPROACHES TO CAPITAL TAXATION

The current Internal Revenue Code imposes, in general, a uniform nominal rate of tax on income from various sources.[10] In this respect, the Code accords with the ability-to-pay approach to analyzing tax problems. This theory frames the basic issue in tax policy as whether a given item should be included in the tax base. In so doing, the ability-to-pay theory forecloses the possibility of imposing a

10 I.R.C. §§ 61, 63 (1968). A minor exception existed between 1969 and the early 1980s, when capital and wage income were generally subject to a single rate schedule but a higher top rate applied only to capital income.

systematically different rate on different types of income. As a result, legislators seeking to subsidize savings by varying the effective rate of tax on capital have two avenues open to them. They may propose excluding capital from taxation through a deduction, yielding an effective capital tax rate of zero.[11] Alternatively, they may advocate capital gains rates, a device which, though seldom defended by ability-to-pay theorists, at least has the authority of history on its side.

This Part explains the origins of the presumption of the uniform tax in ability-to-pay theory. It then suggests welfare economics as an alternative and preferable theory that allows for the possibility of differential rates.

A. Ability-To-Pay Theory and The Uniform Tax on Capital and Labor

Since its inception, the American income tax has been levied at a single rate on both capital and labor income. The present tax system is as much the product of practical politics as of academic theory. Still, in the patchwork of the Code there is an underlying presumption of uniformity in the taxation of income from various sources. That presumption generally reflects the perspective of the most popular approach to tax equity, ability-to-pay theory.

Ability-to-pay theory has many of the same roots as its principal alternative, welfare economics. Both ability-to-pay theory and welfare economics regard the basic goal of tax policy as the balancing of fairness to individuals against social and administrative costs and benefits. But only ability-to-pay theorists, not welfare economists, proceed by asking whether the goals of equity and efficiency would be served by the inclusion of various items in the tax base. This method produces a tendency to think in terms of deductions and exclusions rather than credits and special rates.[12] This tendency has its roots in the ability-to-pay approach to fairness and efficiency.

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11 Capital subsidies that specifically target certain kinds of capital, such as ACRS or the exemption for state and local bonds, also make use of deductions. The two general capital subsidies that are implemented through a deduction are IRAs and pensions.

12 This approach is implicit in virtually every major piece of scholarship on the personal tax. *See* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972); Boris I. Bittker, *A "Comprehensive Tax Base" As a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why they Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831 (1979); Alvin C. Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980).

1. *Equity*

Ability-to-pay theory and economics differ in their starting points. While economics begins with a descriptive theory of behavior, ability to pay theory begins with a concept of fairness. This concept of fairness requires that the tax burden be apportioned according to the ability of individuals to pay.[13] Stated in this general form, the ability-to-pay principle may seem so obvious as to require no defense. However, the theory has been interpreted to imply two specific principles that are more controversial than the general form. First, similar burdens must be imposed on taxpayers in similar positions—horizontal equity. Second, higher burdens must be imposed on taxpayers in better positions—vertical equity.[14] On closer inspection, these principles contain a fairly controversial position on a key question of equity. Both horizontal and vertical equity assume that the relative pre-tax distribution of income is fair. In other words, tax equity principles assume that the tax system should preserve the relative ordering of incomes.[15] Both principles, though, leave open the possibility that the absolute distribution may be in need of some compression through progressive rates.[16]

If all income came from a single source and was put to a single use, then the only issue in tax would be deciding the proper degree of progressivity. In fact, income has many sources and many uses. Consequently, tax policy must address the question of what the proper tax base should be. Since no one disputes that the tax base should include labor income, the most important issue in this determination is whether the tax base should include capital income. Most ability-to-pay theorists believe that both vertical and horizontal tax equity would be served by taxing the most comprehensive tax base possible.[17] The most accepted comprehensive base is Haig-Simons income, which consists of the individual's consumption plus

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13 *See, e.g.*, Richard A. Musgrave, *In Defense of An Income Concept*, 81 HARV. L. REV. 44, 45-46 (1967).

14 *Id.* at 45.

15 Edwin R. A. Seligman, *The Theory of Progressive Taxation*, 8 POL. SCI. Q. 220, 222 (1893); Warren, *supra* note 12, at 1097. For a criticism of this aspect of traditional tax doctrine, see Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989).

16 ANTHONY B. ATKINSON & JOSEPH E. STIGLITZ, LECTURES ON PUBLIC ECONOMICS 29 (1980). If the average rates are consistent with income, the tax system is proportional, and if they fall, it is regressive.

Many ability-to-pay theorists determine the ideal degree of progressivity with reference to the principle of equal sacrifice. This principle requires that all individuals make equal proportionate sacrifices of well-being. If the marginal value of money declines as income rises, the equal sacrifice principal is generally thought to imply a progressive rate structure; that is, taxpayers with higher incomes face higher average tax rates.

17 *See, e.g.*, Walter J. Blum, *Federal Income Tax Reform—Twenty Questions*, 41 TAXES 672, 674, 682 (1963).

the net accretion to his net worth.[18] In general, a tax on consumption plus accretion turns out to be identical to a tax on wage income plus capital income,[19] and a tax on the Haig-Simons income is generally referred to as an income tax.

The equity arguments for the Haig-Simons tax base rest on an interpretation of the ability-to-pay concept. The Haig-Simons view of ability-to-pay treats income as valuable in itself as a way of commanding resources. That income may serve as a means to some more fundamental end, like happiness, is not critical. Haig-Simons theorists thus view all income as evidence of ability to pay and include it in the tax base, regardless of whether that income is used to purchase consumption.[20] Thus, capital income, like wage income, should be included in the measurement of capacity. Excluding it would violate principles of both vertical and horizontal equity.[21] The case for the Haig-Simons comprehensive income tax base therefore provides an argument against any savings subsidy at all.

The Haig-Simons framework was for many years the only theoretical approach used by ability-to-pay analysts. In a highly influential 1974 article, William Andrews argued for rejecting the Haig-

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18 HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938). *See generally* Bittker, *supra* note 12, at 925.

19 *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1123-28 (1974). For some qualifications to this, see Alvin C. Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931, 938-41 (1975).

20 This principle has other implications for the definition of the ideal tax base. For example, the Haig-Simons approach assumes that income is the only factor that influences well-being. Sometimes the use of income rather than utility as a tax base is defended as part of a general rejection of utilitarianism. Simons seems to reject utilitarianism on egalitarian grounds; Warren, on anti-egalitarian grounds. SIMONS, *supra* note 18, at 12-15; Warren, *supra* note 12, at 1096-97. Another reason given for rejecting utility as a base is the administrative infeasibility of other measures. SIMONS, *supra* note 18, at 52-54; Warren, *supra* note 12, at 1096. However, an argument for importing utility considerations in a piecemeal fashion, for example, the medical deduction, can be found in Andrews, *supra* note 12, at 331-43. Although they reject utility as an underlying concept, advocates of an income base sometimes seem to regard income as an intermediate concept, not a fundamental one. Most feel that since total income indicates the ease with which the individual provides for himself, "faculty" or ability to earn is the true underlying issue. EDWIN R. A. SELIGMAN, PROGRESSIVE TAXATION IN THEORY AND PRACTICE 291-92 (2d ed. rev. 1908). The exclusion of unexercised ability is defended partly on administrative grounds, although one scholar has suggested that the taxing ability is undesirable on the grounds that doing so represents an objectionable invasion of individual freedom. Kelman, *supra* note 12, at 835-44; *see also* Warren, *supra* note 12, at 1114; Alan Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370, 381-82 (1979) (citing administrative problems and restraints on freedom as reasons to eliminate earning capacity from taxation).

21 *See, e.g.*, SIMONS, *supra* note 18, at 95-100; Warren, *supra* note 12, at 1090-92.

Simons framework in favor of a consumption tax.[22] Andrews and others since have suggested that a consumption tax would be more horizontally equitable than even an ideal pure accretion tax.[23] In adopting the principle of horizontal equity, this argument implicitly endorsed certain aspects of the basic equity framework of comprehensive tax base analysis, notably the privileged status of the pretax distribution of income. However, the horizontal equity analysis itself rests on strikingly different premises from those underlying the case for a comprehensive income tax. The advocates of a consumption tax argue that capital taxes are horizontally inequitable because two taxpayers with income of the same pre-tax net present value will have incomes of different post-tax net present value if their incomes are received at different times, or if they have different tastes for the timing of consumption.[24] By focusing on consumption rather than income, the argument for a consumption tax moves towards a utility based conception of ability-to-pay,[25] and rejects the control-over-resources approach implicit in comprehensive tax base analysis.

The horizontal equity argument for a consumption tax suggests that capital income need not be taxed at the same rate as labor income. Yet it implies more than this about the proper tax treatment of capital. Specifically, it suggests that capital should be wholly excluded from the tax base, for only in this way can the system preserve pretax relative positions. This implication supports the tax system's use of deductions to subsidize savings.

Consumption tax proponents emphasize horizontal equity arguments, but they also defend their proposal as vertically equitable. Consumption tax opponents, however, argue that excluding capital from the tax base would impede attempts to attain vertical equity. Since the more affluent save a higher proportion of their income, excluding capital from the tax base would tend to favor them. Defenders of a consumption tax respond that, like an income tax, consumption taxes can be imposed at progressive rates.

Although this is undeniably true, income and consumption tax proponents disagree about what constitutes comparable progressiv-

22 Andrews, *supra* note 19, at 1113. Although Andrews regarded the horizontal equity argument as subsidiary to his main point, it has received more attention in subsequent literature than the administrative argument.

23 *Id.* at 1165-77.

24 Irving Fisher first made this argument. IRVING FISHER, THE NATURE OF CAPITAL AND INCOME 249-53 (1906); *see also* Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 967-68 (1992); Warren, *supra* note 19, at 934-38. The most telling objection to this argument is that all taxes discriminate against someone: Wage taxes against workers, capital taxes against savers. Andrews, *supra* note 19, at 1169. For other objections, see Gunn, *supra* note 20, at 382-86; Mark G Kelman, *Time Preference and Tax Equity*, 35 STAN. L. REV. 649 (1983); Fried, *supra*; Warren, *supra* note 12, at 1094-1121.

25 *See infra* part B.

ity, because the progressivity of an income tax is not straightforwardly comparable to that of a consumption tax. With a single rate of tax on both capital and labor, the definition of progressivity is simple. A tax system is progressive if marginal rates rise with income. For example, income up to $30,000 might be taxed at 10%, and income over $30,000 might be taxed at a marginal rate of 20%. But if capital is excluded from the tax base, should the concept of progressivity be defined with respect to total income, or labor income only? A separate progressive tax on each source might fail to be progressive with respect to income as a whole. For example, suppose that the progressive rate structure described above applies only to labor income. An individual with $50,000 in labor income would pay taxes of $30,000(.1) + $20,000(.2) = $7,000, for an effective rate of 14% on income. An individual with $30,000 in each capital and labor income would pay ($30,000)(.1) + ($30,000)(0) = $3,000, for an effective rate of 5% on all income. Still, the appearance of regressivity may be illusory. If fairness dictates that capital be wholly excluded from the tax base, a definition of progressivity based on income makes little sense.[26]

Consumption tax theory and comprehensive income tax theory, then, have an important common feature: in both, the decision whether to tax capital is equivalent to a determination of the proper tax base. Thus, only two tax rates on capital are possible: the same rate as on wages, if capital is included in the tax base, or a rate of zero, if it is not. If, as comprehensive tax base theory suggests, capital income should be included in the tax base, it should be wholly subject to taxation; if, as consumption tax proponents argue, capital does not belong in the tax base, all capital income should be exempt from taxation.

2. *Efficiency Arguments*

Ability-to-pay theorists regard equity analysis as fundamental, but advocates of a consumption tax and of a comprehensive tax base both rely on efficiency as well as equity arguments. Yet, like the ability-to-pay arguments from equity principles, these efficiency arguments lead to the conclusion that capital should be either wholly taxed or wholly excluded from the tax base.

Andrews and other advocates of the consumption tax have argued that the complete exclusion of capital would be efficient. They have suggested that the efficiency advantages of a consumption tax would be primarily administrative. Most of the truly intractable difficulties in the Code, Andrews argued, were the result of the impos-

26 *Cf.* NICHOLAS KALDOR, AN EXPENDITURE TAX 23 (1955).

sibility of implementing a true accretion tax on capital. Consequently, the taxation of capital is inherently arbitrary and capricious, and exempting capital entirely would be less distortionary, more administratively efficient, and more fair.[27] This line of reasoning implies that capital should be wholly excluded from the tax base. A lower tax rate would leave intact all the administrative problems associated with the tax.

On the other hand, comprehensive income tax base proponents believe that efficiency requires the full taxation of capital income. One efficiency argument for full taxation is substantive: markets work well without interference, and the most efficient tax would interfere least with market efficiency by treating all transactions uniformly. A comprehensive income base, with few exclusions or deductions, achieves this uniformity.[28]

Not all comprehensive tax base theorists accept the substantive efficiency argument. The more popular efficiency arguments for a comprehensive base have been procedural. These comprehensive tax theorists argue that market interference, when necessary, should be accomplished through direct expenditures rather than through so-called tax expenditures. Tax expenditures are adjustments to gross income that are defended on grounds unrelated to tax policy. These tax adjustments are, in effect, subsidies that could be implemented by direct expenditures, but are instead enacted through the tax code.[29] Comprehensive tax base proponents argue that use of the tax system has at least two important faults.[30] First, it often results in a haphazard pattern of implementation quite different from what would have resulted under a system of direct expenditures. Second, use of the tax system hides expenditures from political scrutiny because such expenditures are protected from the procedural rules governing the normal budgetary process.

Perhaps the most important example of haphazardness is the implementation of most tax expenditures, including the system of retirement incentives, through deductions. Comprehensive tax theorists are correct in thinking that using a deduction for a tax expenditure produces a structure that is undesirably different from what

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27 Andrews, *supra* note 19, at 1123-65.

28 *See, e.g.*, Blum, *supra* note 17, at 674. For an excellent and highly critical analysis of this argument, see Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973 (1986).

29 STANLEY S. SURREY, PATHWAYS TO TAX REFORM vii (1973).

30 SURREY, *supra* note 29, at 174; Paul R. McDaniel & Stanley S. Surrey, *Tax Expenditures: How to Identify Them; How to Control Them*, 15 TAX NOTES 595 (1982); Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352, 359-64 (1970). For a skeptical view of the idea of tax expenditures, see Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969).

would have resulted from a pattern of direct expenditures. The fundamental problem lies in the fact that the value of a deduction increases with the tax bracket of the taxpayer, so that the use of deductions produces a subsidy rate that increases with income. Even if the total number of subsidies taken were the same across income classes, this inverse relation between subsidy and income would be inconsistent with principles of vertical equity. The inverted structure of the deduction subsidy seems even more unfortunate in the context of savings because, like most tax theorists, Congress believes that high income taxpayers save proportionally more than other taxpayers.

As we will see, the use of a deduction has given rise to a complex set of rules intended to undo the deduction's distributive effect. This regressive subsidy could be avoided by use of a credit. Credits differ in an important way from deductions. While the value of a deduction depends on the tax bracket of the taxpayer, the value of a credit may be the same for all taxpayers or may be designed to vary according to criteria other than the recipient's tax bracket. Despite this advantage, Congress has been slow to switch from deductions to credits. Unfortunately, academic tax analysts have not exerted much effort in encouraging them to do so. Although most opponents of tax expenditures concede that a properly designed tax expenditure, such as credit, could be an acceptable policy tool, they are skeptical about whether political problems associated with tax expenditures are actually surmountable.[31]

Indeed, the problem of ill-designed subsidy measures may be related to the problem of political expedience. Perhaps the use of deductions as a subsidy mechanism is simply an unreflective transposition of tax base reasoning to tax expenditures.[32] Yet the use of deductions may be an attempt to disgnise tax expenditures from political scrutiny. Comprehensive tax theorists regard many of these provisions, especially the retirement savings deductions, as obvious tax expenditures.[33] They are even listed as such in the tax expenditure budget. But, as tax expenditure theorists are eager to point out, legislators are simple folk who may be misled into thinking that a given deduction is justified by the definition of the tax

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31 The procedural attack on tax expenditures has a certain paradoxical quality. As in the case of deductions, the haphazardness of tax expenditures often results from the desire to disguise the expenditure as a part of the definition of income. Stigmatizing tax expenditures provides another motive for such efforts at disguise and inhibits the rational redesign of these deductions.

32 Surrey, *supra* note 30, at 720.

33 *Id.* at 711.

base, rather than as a tax expenditure.[34] Still, even a Congressman can see that a tax credit is always a tax expenditure. Similarly, a differential rate, such as that provided to capital gains, invariably indicates a tax preference.[35]

Many comprehensive tax base theorists thus dismiss the retirement savings provisions as inherently ill-advised tax expenditures. A few tax policy theorists have allowed for the possibility that a tax expenditure to encourage retirement savings might be justified. However, they express doubt about whether vertical equity can be achieved through these deductions.

With a comprehensive tax base framework, then, savings subsidies cannot be justified except as a tax expenditure. Partly because of the campaign against them by comprehensive tax base theorists, tax expenditures tend to be implemented through deductions. Recent developments in tax theory have provided a different argument for exempting capital from taxation, but have not changed the basic analytic framework of the comprehensive tax base. Indeed, these developments provide an even stronger argument for the use of a deduction.

B. The Welfare Economics Approach to Capital Taxation

The ability-to-pay theory of tax policy arises from a specific conception of fairness: taxation according to one's ability to pay. This leads naturally to tax policy that proceeds by asking whether various items should be included or excluded from the measurement of taxable capacity. Even when modified to incorporate certain efficiency considerations, this approach lacks a central ingredient of a complete analysis of efficiency: namely, a theory of how people respond to incentives.

Such a theory of individual behavior is provided by economics. The ability-to-pay approach was developed by economists, but did not fully integrate the insights of descriptive economics. Descriptive economics suggests that restricted deductions chosen by Congress to advance its distributional aims are a poor policy tool. From an economic perspective, a system of differentiated taxes on capital and labor would accomplish Congressional goals more efficiently. However, such a system is hard to reconcile with ability-to-pay views of fairness. But economic theory has, in recent years, suggested a different and more persuasive approach to equity. From the viewpoint of economic theory, differential taxes may be fair as well as efficient.

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34 SURREY, *supra* note 29, at 98 (credits "lack the protective coloration possessed by those tax expenditures using the exclusion or, perhaps more so, the deduction device.").

35 *Id.* at 100.

1. *The Economic Approach to Behavior*

The economic analysis of individual behavior assumes that individuals choose rationally among the available consumption items to maximize the utility they derive from their consumption, as limited by their income. If the individual behaves rationally, the consumption choices he makes will maximize his well-being. This analysis of individual behavior applies to savings in that consumption in one period is a different good from consumption in another. For present purposes, an individual's life may be thought to consist of two periods, his working-life period and his retirement period. An individual's decision to save is thus a decision to allocate consumption between two periods. This is analogous to a decision to allocate consumption within a single period between goods such as food and housing. The rate at which the individual discounts future consumption is called his rate of time preference. Similarly, the individual's decision to supply labor results from a decision to allocate time between leisure and the consumption goods that wages buy.

The economic approach to the taxation of capital proceeds along entirely different lines from the approach used by ability-to-pay theorists. Ability-to-pay analysis begins by asking what belongs in the tax base or how taxable income should be defined. The tax base is determined by comparisons between the efficiency and equity of various tax treatments of individuals with different incomes. In contrast, economic analysis places no significance on the definition of taxable income. Consequently, unlike the ability-to-pay approach, the economic approach does not assume that capital must be taxed at the same rate as wage income or not at all. Instead, both capital income and wage income may be taxed at any rates the government chooses.

The economic model of individual behavior can be used to analyze the fairness and efficiency losses from various tax systems. In practice, economists and others who use the rational choice approach have tended to emphasize efficiency concerns over concerns about retirement security or distribution,[36] partly because the economic analysis of equity is less developed than the analysis of efficiency. Still, economic analysis can suggest some approaches to

36 Gray, *supra* note 8, at 806 (quoting Federal Reserve Chairman Alan Greenspan's response to a question about whether middle class taxpayers would use IRAs: "I wouldn't be overly concerned about where the savings occur[s] because what we're trying to do is raise savings and to build capital investment and create jobs for everyone in the economy."); *see also* Bennett Minton, *Congress Postpones Consideration of Big-Ticket "Growth Package"*, 53 TAX NOTES 999 (1991) (testimony of Jack Kemp, Secretary, Dep't of Housing and Urban Development).

problems of equity that may be more satisfactory than the ability-to-pay approach.

2. *Efficiency*

The word "efficiency," in its strictest sense, means Pareto-efficiency. A policy is Pareto-efficient if no change can make someone better off without making someone else worse off. Policy *A* is Pareto-superior to policy *B* if *A* makes someone better off without making anyone else worse off. However, Pareto-efficiency does not preclude some very inequitable distributions, such as one person owning everything. In order to examine Pareto-efficiency, I will evade the problem of distributive fairness by assuming that all individuals have identical tastes and endowments, so that any tax policy will affect all equally. Both wage taxes and interest taxes will have adverse efficiency effects by discouraging the productive activities on which they are imposed, work and savings. The size of these losses will depend on the responsiveness, or elasticity, of labor and capital to taxes. The higher the elasticity, the greater the loss.

Diagrams 1(a) and 1(b) illustrate some hypothetical markets for factors like labor or capital. Both diagrams show the same factor demand, labeled *D*. The lines labeled *S* (no tax) represent the supply of a given factor in the absence of taxes. This line is flatter in Diagram 1(a), representing a higher degree of elasticity. The lines labeled *S* (tax) indicate the supply curve under a tax needed to produce a given amount of revenue. That revenue is indicated by the striped box, which is by construction the same size in both diagrams. The dotted area represents the deadweight loss triangle, or the efficiency loss resulting from the tax. This area is larger in Diagram 1(a) because supply is more elastic.

The tax in Diagram 1(b), on the less elastically supplied factor, is clearly more efficient. However, even for such inelastically supplied factors, the deadweight loss rises proportionally faster than the tax rates. Thus, the efficient tax structure will combine a relatively high tax on the less elastically supplied factor with a relatively low tax on the more elastically supplied factor.[37] Consequently, the

37 A complete account of the optimal tax system considers the full range of possible taxes that the government may levy. These include lump-sum taxes and indirect or commodity taxes. Since a lump-sum tax does not depend on the level of any particular activity, it does not distort any behavior. In the absence of distributive concerns, the nondistortionary properties of a lump-sum tax make it ideal. However, distributive concerns make lump-sum taxes impracticable. Some individuals have a higher earnings capacity than others, and most agree that these individuals should be taxed at higher rates. This earnings capacity cannot be directly observed and thus lump-sum taxes cannot be practically made progressive. Ruling out lump-sum taxes is equivalent to stipulating that the consumption of leisure cannot be taxed. With these assumptions, a system of uniform taxes is not desirable. Rather, in a short term context, a system of differential

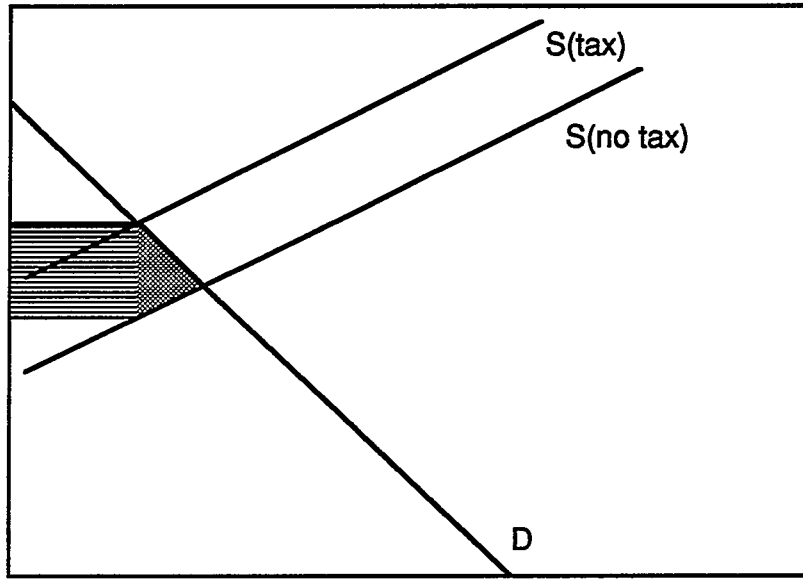

Diagram 1(a)

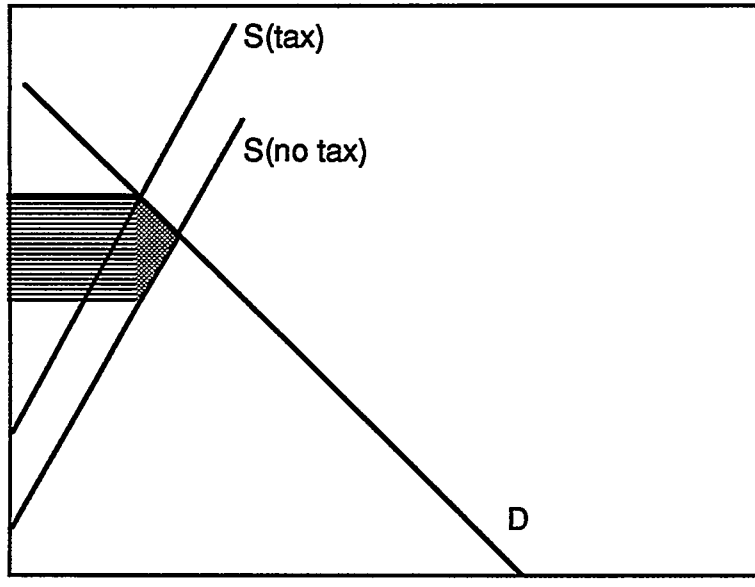

Diagram 1(b)

efficient share of taxes that capital and labor should bear will be an empirical question.

But there are special theoretical reasons why capital taxes may be less desirable than labor taxes. The previous analysis rests on the standard assumptions of economics. These assumptions imply that self-interested individual decisions in a competitive market will lead to socially ideal results without government intervention. This principle holds in many circumstances for labor markets.

Savings, however, is an important exception to the rule that individual rationality leads to socially ideal results. Even without taxes, savings may fall below the socially optimal point. This shortage of savings results from a simple externality referred to as the overlapping generations problem. Savings affects the welfare of future generations, but those generations play no role in determining today's savings. This suggests that national savings may be too low to protect the interests of future generations.[38] Indeed, this reasoning suggests that capital should not only be free from tax but actively subsidized as well. Not only may savings be too low in principle but many economists have concluded that the U.S. savings rate is in fact too low.[39] Capital, then, should probably be taxed at lower rates than labor.

The economic analysis so far assumes that although different rates may be imposed on capital and labor, each factor is to be taxed at a flat rate rather than through progressive or regressive rates. The assumption of a flat rate may seem to be a natural corollary of the assumption that all individuals are identical. Varying rate structures are usually thought to redistribute income between individuals of different income levels. With identical individuals, though, a va-

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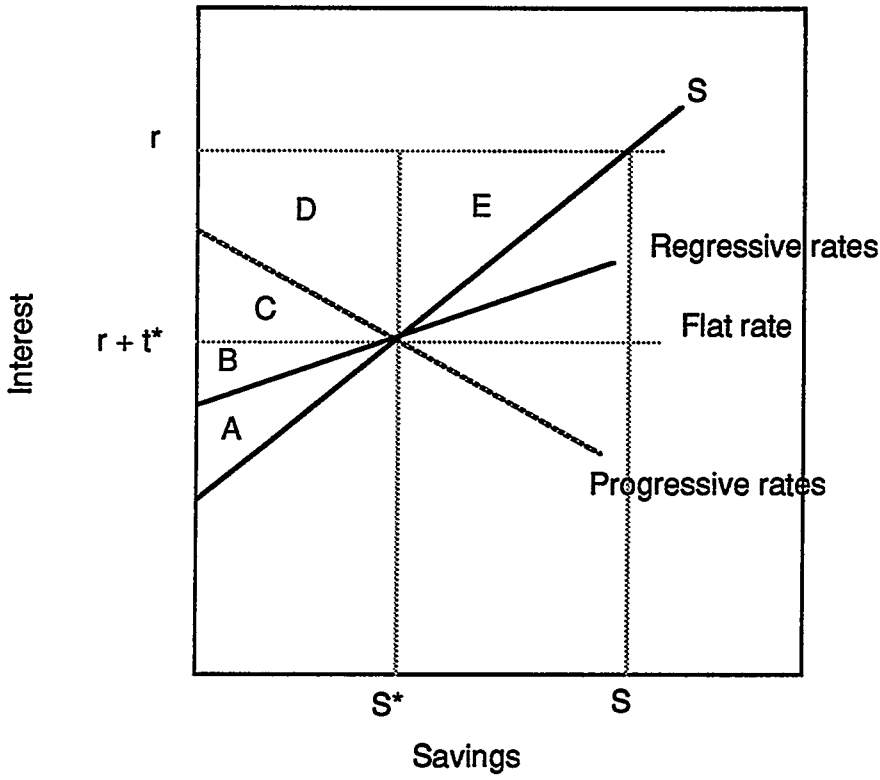
taxes on different consumption goods would be optimal. This is shown in a simple partial equilibrium setting, like that given in the text accompanying this footnote, from ATKINSON & STIGLITZ, *supra* note 16, at 367-70. A comprehensive analysis is provided in the classic F.P. Ramsey, *A Contribution to the Theory of Taxation*, 37 ECON. J. 47 (1927). In particular, an efficient tax system will produce proportionate movement along the compensated demand for all goods. *Id.*; ATKINSON & STIGLITZ, *supra* note 16, at 373. This point can be extended to savings through the analogy between consumption in different periods and consumption of different goods in a single period. This point, made briefly in the original Ramsey article, *supra* at 59, has been extensively developed regarding savings in the public finance literature. *See, e.g.*, Martin Browning & John Burbidge, *Consumption and Income Taxation*, 42 OXFORD ECON. PAPERS 281 (1990). *See generally* ATKINSON & STIGLITZ, *supra* note 16, at 442-51.

38 *See, e.g.*, Peter A. Diamond, *National Debt in a Neoclassical Growth Model*, 55 AM. ECON. REV. 1126 (1965); Lars-Gunnar Svensson & Jörgen W. Weibull, *Constrained Pareto-Optimal Taxation of Labour and Capital Incomes*, 34 J. PUB. ECON. 355, 361 (1987). *See generally* ATKINSON & STIGLITZ, *supra* note 16, at 442-51.

39 *See, e.g.*, Michael J. Boskin, *Theoretical and Empirical Issues in the Measurement, Evaluation, and Interpretation of Postwar U.S. Saving*, *in* SAVINGS AND CAPITAL FORMATION 11, 23-27 (F. Gerard Adams & Susan M. Wachter eds., 1986).

rying rate structure may serve the purpose of efficiency. This argument is illustrated in Diagram 2. Consider the situation of a single individual, whose supply of savings is illustrated by the line labelled *S*.



In the absence of taxes, the market rate of interest, r, would determine the individual's savings, which is S. With a single rate tax, t^* ($t^* < 0$), the individual saves S^*, which gives rise to a consumer surplus of area $A+B$ and government revenues in the amount of area $C+D$. A progressive rate schedule imposes lower tax rates on initial units of savings and higher rates on later units. The progressive rates illustrated impose the same marginal tax t^* at S^* as the flat rate, but with the progressive tax schedule, they cause taxpayer surplus to rise to area $A+B+C$ while they cause government revenues to drop to area D. At the extreme, a progressive schedule could impose rates of zero until reaching the marginal unit S^*, at which point a rate of t^* would be imposed. As a result, consumers would receive a surplus of area $A+B+C+D$, and government revenues would be virtually eliminated.

The government could raise more revenue without increasing distortionary marginal taxes by taxing marginal increments of savings at decreasing, regressive rates. The first units of savings give

rise to the highest levels of consumer surplus, and therefore, can be subjected to higher levels of taxation. Thus, it makes the most sense to impose the largest taxes on the first dollars of savings.

A perfectly tailored schedule follows the supply curve, leaving the market equilibrium unchanged while extracting all taxpayer surplus. This tax structure is analogous to the price discrimination practiced by a monopolist. A purely price-discriminating schedule would leave the market equilibrium of S unchanged, while yielding government revenues of area $A+B+C+D+E$. An imperfect price-discriminating schedule, illustrated by the line labelled "regressive rates," provides the marginal rate t^* at S^*, leaving the equilibrium as S^*. This results in a consumer surplus of area A and government revenues of area $B+C+D$. An alternative schedule would provide perfectly price-discriminating tax rates up until S^*, but impose higher rates above that point, leaving savings at S^*, eliminating consumer surplus, and providing government revenues of area $A+B+C+D$.

3. *Equity*

If all individuals are identical, a system of differentiated regressive taxes for capital and labor will not only be efficient but also fair. The preceding part assumed that all individuals are identical. Identical individuals benefit equally under efficiency gains and suffer equally under efficiency losses. This assumption obviates the need for explicit consideration of equity; under this assumption, efficient schedules are equitable. The fact that the optimal schedule may be regressive is unproblematic.

Where individuals are not identical a policy that benefits one individual may hurt another. The analysis of equity is less developed than that of efficiency, and economists have reached no consensus about how to make trade-offs between the gains of one person and the losses of another.[40] No distributive principle com-

[40] The central obstacle in equity analysis is that most plausible equitable principles require interpersonal comparisons of utility, which in turn require cardinal measurements of utility. Cardinal measurement is highly problematic and can be avoided by using descriptive utility theory. Some economists argue that the the problem of cardinal measurement is insuperable, and therefore economics has little to say about equity. Among those economists willing to employ the cardinal utility measurement, two basic approaches are utilized: (1) a version of the equal sacrifice principle framed in terms of equal utility sacrifice and the social welfare function; (2) a mathematical implementation of the utilitarian calculus, which calculates the maximization of total social well-being. An analysis of optimal taxation asks which combination of taxes best balances distributional effects and efficiency effects in order to maximize social welfare. This approach differs fundamentally from equal sacrifice theory in that no special emphasis is placed on the pretax distribution of income, nor does it assume that the relative distribution of income is fair.

mands as much support among economists as horizontal and vertical equity do among ability-to-pay theorists. Still, the absence of an accepted equity principle does not prevent welfare economists from providing useful economic analysis. All possible economic theories of equity suggest that taxes need not be uniform. The reason is simple: Pareto-efficiency is a precondition to all economic ideas of fairness, and Pareto-efficiency may require differential tax rates. To see this, consider how the individual whose factor supplies are described by Diagram 1 would prefer to be taxed. This person would be least burdened by a non-uniform tax, and would therefore prefer such a tax, regardless of any differences between himself and other taxpayers. Thus, regardless of that person's preferences, there would be no reason to view uniform taxes as more fair.

4. *Progressivity*

The proper degree of rate progressivity in a theoretically satisfactory equity analysis would be a by-product of a general process like maximizing a social welfare function. However, economists have yet to produce a theoretically satisfactory account of equity. In practice, equity analysis has proceeded informally, searching for a degree of progressivity that feels appealing. This common sense approach to equity is perfectly adequate to analyze individual differences in income as long as all individuals save the same proportions of their incomes. To see how Congress could move from a system of uniform rates on capital and labor to a system of differentiated rates of the same degree of progressivity, consider the following example. Assume all income is taxed at a proportional rate of 20%. There are two groups of workers with different incomes who both receive 10% of their income from capital. Affluent workers earn $50,000 a year and have $5,000 in income from capital; less affluent workers earn $20,000 a year and have $2,000 in capital income. Affluent taxpayers pay total taxes of $\$55,000(.2) = \$11,000$, and less affluent taxpayers pay total taxes of $\$22,000(.2)=\$4,400$. Both groups have an effective tax rate of 20%.

Now suppose that Congress wishes to retain the proportionality of the system as a whole while cutting capital taxes. Suppose that it attempts to do this by cutting capital taxes to 10% while maintaining leaving wage taxes at 20%. If, as assumed, all income classes save the same fraction of their income, the proportionality of the tax system is preserved. Affluent individuals pay $(\$50,000)(.2)+(\$5,000)(.1)=\$10,500$, for an effective rate of 19%. Less affluent individuals would pay $(\$20,000)(.2)+(\$2,000)(.1)=\$4,200$, for an identical effective rate of 19%.

Although this common-sense approach to fairness has much to recommend it, this approach becomes complicated if different income classes save at different rates. If all individuals, rich and poor, save the same proportion of their income, then uniform reductions in capital taxes will not affect the progressivity of the system as a whole. The congressional assumption that the rich save more is shared by many economists[41] and social thinkers,[42] and has empirical support from both economists[43] and psychologists.[44] The studies do not provide conclusive evidence of the most controversial

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41 The belief that savings increases more than proportionately with income was expressed by many neoclassical capital theorists. *See, e.g.*, IRVING FISHER, THE THEORY OF INTEREST 72-73 (1930); EUGEN V. BÖHM-BAWERK, THE POSITIVE THEORY OF CAPITAL 275-76, 314 (William Smart trans., 1891). Later neoclassicals were apt to make assumptions about utility functions that eliminated any association between savings and income. There are, however, a few who have explored the relation between the two. Shlomo Maital & Sharona Maital, *Time Preference, Delay of Gratification, and the Intergenerational Transmission of Economic Inequality: A Behavioral Theory of Income Distribution*, *in* ESSAYS IN LABOR MARKET ANALYSIS 179 (Orley C. Ashenfelter & Wallace E. Oates eds., 1977); Luigi L. Pasinetti, *Rate of Profit and Income Distribution in Relation to the Rate of Economic Growth*, 29 REV. ECON. STUD. 267 (1962).

42 Many social theorists have argued that the tendency to save more is simply one corollary of the theory that an individual's future-orientedness increases with class. *See, e.g.*, EDWARD C. BANFIELD, THE UNHEAVENLY CITY REVISITED 52-76 (1974).

43 Studies by economists uniformly confirm that time preference is lower among higher income individuals. The most comprehensive study, using household consumption data, found—depending on the exact assumptions employed—that discount rates for the poorest 5% of families were between 3.5% and 5% higher than for the wealthiest 5%. Emily C. Lawrance, *Poverty and the Rate of Time Preference: Evidence from Panel Data*, 99 J. POL. ECON. 54, 66-69 (1991). A few other computation methods produced even larger discrepancies, but were not statistically significant. Similar results have been obtained in studies of appliance purchases, Jerry A. Hausman, *Individual Discount Rates and the Purchase and Utilization of Energy-Using Durables*, 10 BELL J. ECON. 33 (1979), as well as in studies using survey evidence, M. Kurz et al., *The Experimental Horizon and the Rate of Time Preference for the Seattle and Denver Income Maintenance Experiments: A Preliminary Study*, Research Memorandum 21, Center for the Study of Welfare Policy, Stanford Research Institute (November 1973); J. Paul Leigh, *Accounting for Tastes: Correlates of Risk and Time Preferences*, 9 J. POST-KEYNESIAN ECON. 17 (1986).

44 A large body of literature by experimental psychologists supports the view that the willingness to delay gratification is correlated with income. Most of these studies provided laboratory subjects with the choice between an earlier, smaller reward and a later, larger reward. However, these psychological studies do not clearly confirm the theories that explain greater delay through class factors. Many sociologists and political thinkers have suggested that the tendency among the more affluent to delay gratification is connected to a longer time horizon. *See, e.g.*, BANFIELD, *supra* note 42, at 52-76. Several laboratory studies confirm the view that the length of an individual's subjective time horizon is positively related to class. Lawrence L. LeShan, *Time Orientation and Social Class*, 47 J. ABNORMAL & SOC. PSYCHOL. 589 (1952); Angela O'Rand & Robert Ellis, *Social Class and Social Time Perspective*, 53 SOC. FORCES 53 (1974). However, it appears that the ability to delay gratification is related to the accuracy of the individual's time perception and not to the length of his time horizon. Walter Mischel & Ralph Metzner, *Preference For Delayed Reward as a Function of Age, Intelligence, and Length of Delay Interval*, 64 J. ABNORMAL & SOC. PSYCHOL. 425 (1962). One study found, somewhat ambignously, that while accuracy of time perception was more important than length of time horizon, preoccupation with future events might be predictive of the tendency to delay. Stephen L. Klineberg,

aspect of the relationship between income class and time preference: Do differences in time preferences result from fundamentally different tastes or are they simply manifestations of a given taste structure at different income levels?[45]

The possibility that different income classes save at different rates introduces some complications into the design of the rate structure. A tax that was progressive, proportional, or regressive with respect to each income source separately might have a different distributive effect on income as a whole. Suppose that total income were subject to this proportional rate structure, but income classes were to differ in their propensities to save. Under this scenario, preserving a given degree of progressivity with respect to income requires steeper cuts on capital taxes for less affluent workers. For example, suppose that less affluent workers now earn $20,000 a year and still have $2,000 in capital income and affluent workers still earn $40,000 a year but have $15,000, not $5,000, in capital income. The income of the two groups is the same as in the previous example, but the income of the affluent now contains proportionately more capital income when compared with the less affluent workers. If capital taxes are, as in the previous example, cut to 10% for everyone, affluent taxpayers pay *$40,000(.2) + $15,000(.1) = $9,500* in taxes, for an effective tax rate of 17%. Less affluent taxpayers pay, as before, *($20,000).2 + ($2,000).1 = $4,200,* again for an effective rate of 19%. In this example, the capital tax cut has made the tax system regressive with respect to income, even though the tax rate on each factor taken separately is proportional. Yet the tax system cannot obviously be called regressive since, in the economic framework, income is not self-evidently the proper basis for welfare comparisons. In any utility based approach, comparisons based on income will, at best, approximate the proper comparison based on utility. For example, two people with equal endowments of energy and ability may have the same utility levels but different money in-

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Future Time Perspective and the Preference for Delayed Reward, 8 J. PERSONALITY AND SOC. PSYCHOL. 253 (1968).

45 Differences in savings behavior might result from two distinct causes. First, all individuals might have basically identical utility functions and attitudes towards savings, but those attitudes might uniformly depend on income level. Alternatively, rich people and poor people might have fundamentally different tastes, causing each group to behave differently even if sudden fate were to reverse their fortunes. Although these taste differences might not respond to short term income shifts, they also might reflect long-term, intergenerational differences in income distribution. Some observers acknowledge the role of time preference as both a cause and effect of income differences. BANFIELD, *supra* note 42, at 55-57; BÖHM-BAWERK, *supra* note 41, at 275, 314; FISHER, *supra* note 41, at 333-38. Some emphasize the role of time preference as a cause, JOHN RAE, THE SOCIOLOGICAL THEORY OF CAPITAL 218-36 (Charles W. Mixter ed., 1905); Maital & Maital, *supra* note 41, at 179. Others have interpreted differences in time preference as an effect. ELLIOT LIEBOW, TALLY'S CORNER 223 (1967).

comes. The difference in income results from different tastes: one may prefer leisure goods while the other may prefer consumption goods. Thus, at best, an income-based definition of progressivity is a proxy for a utility-based system.[46]

The preceding example reveals that the income-based definition of progressivity has serious limitations. Nevertheless the argument for income progressivity has a powerful emotional appeal.[47] Without a theoretically satisfactory analysis of equity, popular sentiment deserves considerable weight. I will assume that progressivity is properly measured with respect to income as a whole.

It would seem, then, that an ideal system would have a separate schedule of rates for capital and labor, imposing more steeply progressive rates on capital.[48] This system would, however, have one important disadvantage: high-income taxpayers as well as low-income ones would receive the benefits of the low marginal rates on the first few units of savings. As illustrated in Diagram 2, this consequence of progressive rates reverses the efficient rate structure, which is regressive. The inefficiency of low taxes on inframarginal savings suggests that a single rate structure on capital income may not be the ideal policy choice.

An alternative to a single progressive structure for capital income would provide rates on capital income that varied with the level of wage income. The simplest means of achieving this alternative would impose a flat rate on capital income based on wage in-

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46 *See, e.g.*, Richard Goode, *The Superiority of the Income Tax, in* WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 49-52 (Joseph A. Pechman ed., 1980). Comparisons based on utility become exceedingly difficult to make when diverse tastes are involved. *See, e.g.*, Martin Feldstein, *On the Theory of Tax Reform*, 6 J. PUB. ECON. 77. *See generally* ATKINSON & STIGLITZ, *supra* note 16, at 261.

47 Warren, *supra* note 12, at 1090-93.

48 One issue that arises in a system of differentiated rates is the treatment of human capital. This is a problem in diverse situations, such as the deductibility of education expenses, tax liability compensation awards, and so on. The policy issues raised by human capital are distinct from those raised by other savings. One possibility is that human capital income should be subject to a regime entirely separate from other capital income. The present system treats human capital income neither consistently as capital income nor consistently as wage income. *See generally* Paul B. Stephan III, *Federal Income Taxation and Human Capital*, 70 VA. L. REV. 1357 (1984). The adoption of differentiated rates, however, would cause at least one new problem. Under the present tax code, when a corporation makes a payment to a shareholder/employee the characterization of the payment determines its taxability. If the payment is characterized as a dividend, it is taxable at the corporate and individual levels; however, if it constitutes a wage payment, the corporation may deduct it. Under a system of differentiated rates, distinguishing between wage and capital payments is also a problem for entities not subject to a double tax, such as *S* corporations, partnerships, and sole proprietorships. This problem also arises when a yield-exemption consumption tax is used. A cash flow consumption tax only partly avoids the problem, because it places additional siguificance on the already difficult task of labeling certain expenditures, such as education expenses, as consumption or human capital investments.

come. For example, with a 20% tax on wage income, taxpayers with up to $10,000 in wage income might pay no taxes on capital; taxpayers with $10,000 to $50,000 in wage income might pay 10%; and taxpayers with above $50,000 in wage income might pay 20%. But this system might result in income regressivity: A person with $20,000 in capital income would pay fewer taxes than an individual with $20,000 in labor income A more ambitious income-differentiated schedule would provide rates that were progressive *between* income classes, but regressive *within* classes. For example, such a schedule might provide:

Total Income:	Capital Income:			
	1st $5000	2nd $5000	3rd $5000	Over $15,000
Below $20,000	20%	0	5% credit	20% credit
Between $20 and $40,000	50%	20%	0	10% credit
Over $40,000	60%	40%	10%	0

The desirability of this approach depends upon many factors, such as the elasticity of labor supply, the government's information about inframarginal behavior, and the degree of similarity in the savings habits of members within each wage group. Differences in savings habits within groups can produce one especially troubling problem. An individual with low wage income might have unusually large capital income, and thus substantial total income. The hybrid system suggested would treat such atypical individuals too leniently. The possibility of income regressivity cannot be eliminated in any system of differential progressive taxes, but can only be minimized for any particular distribution of income.

The ideal tax system, then, might even provide schedules for capital income and wage income, with lower and more progressive rates for capital income. Such a system might even provide a separate capital tax schedule for different wage groups. The late 1970s and early 1980s saw a brief flurry of interest in such proposals.[49] These proposals never received serious attention, though, perhaps

49 125 CONG. REC. 229 (1979) (Statement of Sen. McClure). The Savings Act of 1979 would have provided a 50% tax credit on savings to all taxpayers, and would have achieved progressivity by requiring a threshold savings amount based on a percentage of income that would increase with household income. The Savings Expansion Act of 1980, 126 CONG. REC. 1270 (1980), introduced by Sen. Roth and sponsored in the House by Reps. Brown and Rousselot, would have imposed a single rate schedule separately on capital and labor income. 126 CONG. REC. 1531 (1980). Another bill introduced by Rep. Rousselot and sponsored in the Senate by Senator Schmitt, would have exempted 25% of each dollar of savings income from tax. 126 CONG. REC. 1323 (1980). This bill would have provided different progressive tax rates for capital and income, with lower rates on capital. *See also* 127 CONG. REC. 485 (1981) (report on tax incentives without deficits and implementing plans that will stimulate savings, which Martin Feldstein proposed).

because the massive tax overhaul of 1986 represented such a complete triumph of comprehensive tax base theory. Congress' loss of interest in differentiated progressive rates is unfortunate, for as the following suggests, such schedules would be more effective in balancing equity and efficiency than either capital taxes or the current system of ceilings and nondiscrimination rules.

II
INDIVIDUAL RETIREMENT ACCOUNTS

Since the early 1970s, the Code has contained provisions for IRAs.[50] IRAs were once available to all, but since 1986 they have been restricted to individuals not covered by employer pensions.[51] IRAs, however, are politically popular, and bills to revive them in some form are regularly introduced in Congress.[52]

The current tax system reveals a presumption that all items included in the tax base are subject to taxes of the same rate, and both the IRAs now in place as well as those proposed make use of deductions. In particular, IRAs provide a deduction for contributions and for the appreciation of this principal, though both are taxable upon retirement. The resulting use of deductions, however, creates distributive problems because deductions are inevitably worth more to higher income taxpayers. A deduction reduces the taxpayer's gross income by the deductible amount and, thus, provides a benefit equal to the tax on that deductible amount. This tax benefit is obviously higher for those in higher tax brackets. Thus, an unrestricted IRA would magnify the discrepancy between the savings rates of more affluent taxpayers and less affluent taxpayers.

All current and proposed IRAs make use of ceilings. Ceilings, as this part suggests, do not and cannot fully reverse the effects of a

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50 I.R.C. § 219 (West Supp. 1992).

51 I.R.C. § 219(g) (West Supp. 1992).

52 Some bills would simply reintroduce IRAs. H.R. 1290, 102d Cong., 1st Sess. (1991); H.R. 205, 102d Cong., 1st Sess. (1991). Others would provide IRA-like accounts with fewer withdrawal restrictions. For example, the Bush administration has proposed a Family Savings Account that would, with certain income restrictions, permit tax free accumulation on up to $2500 in annual contributions. H.R. 3972, 101st Cong., 2d Sess. § 202 (1990). Both the Bush administration proposal and a proposal by Senator Lloyd Bentsen would permit tax-free transfer to certain other investments. H.R. 3972, 101st Cong., 2d Sess. § 201 (1990); (housing; administration proposal); S. 612, 102d Cong., 1st Sess., § 101 (1991) (Sen. Bentsen's proposal presenting tax-free transfer and housing and education). The Bush proposal was also limited to families with incomes of less than $120,000 per year. *Id.* at § 292(c)(3). Modified IRA proposals that would permit similar withdrawals include H.R. 960, 102 Cong., 1st Sess. § 301 (1991); H.R. 1074, 102 Cong., 1st Sess. (1991); H.R. 1291 102 Cong., 1st Sess. (1991); H.R. 1406, 102 Cong., 1st Sess. (1991); H.R. 1731, 102 Cong., 1st Sess. (1991); H.R. 2340, 102 Cong., 1st Sess. (1991); H.R. 2478, 102 Cong., 1st Sess. (1991); S. 381, 102 Cong., 1st Sess. § 301 (1991) (same as H.960).

deduction, and are distributively inferior to differentiated rates. A pure system of differentiated rates is advisable only if individuals save rationally. If some people need paternalistic help in saving, differentiated rates might be combined with IRAs to restrict withdrawals and encourage contributions.

A. Economic Perspectives on IRAs

IRAs have always been subject to ceilings,[53] and no recent proposals would dispense with them.[54] A ceiling limits the benefit that any taxpayer can receive from a deduction. The ceiling thus ensures that the potential total tax benefit that any taxpayer can receive is a declining fraction of income as income rises. The use of ceilings to achieve progressivity has been advocated by those tax policy theorists who are willing to consider sullying the tax base with tax expenditures.

Some deductions magnify the tendency of the rich to save proportionally more. The use of ceilings to compensate for this regressive tendency, however, makes little sense from an economic point of view. Ceilings have no effect on the behavior of any individual who is above the ceiling. Such an individual simply receives a lump sum transfer in return for doing something that he would have done without the subsidy. Since individuals above the ceiling are likely to be more affluent, a deduction with a ceiling produces an extremely unfortunate combination of effects. The deduction provides a transfer to the affluent while the ceiling removes any incentive for them to save. Indeed, critics of IRAs have argued that they provide no new savings, but merely a shifting of assets.[55] Various tax provisions and proposals have reduced the regressive effect of deductions by providing a credit, but these provisions and proposals have undermined their own potential to stimulate savings by imposing a ceiling.[56]

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53 I.R.C. § 219(b)(1)(A) (West Supp. 1992).

54 *See* Stephan, *supra* note 48.

55 R. Glenn Hubbard, *Do IRAs and Keoghs Increase Savings?*, 37 NAT'L TAX J. 43 (1984); Gale & Scholz, IRAs and Household Savings (July 16, 1990) (unpublished manuscript, on file with author).

56 *See, e.g.*, Crude Oil Windfall Profit Tax Act of 1980 § 404, I.R.C. § 116 (repealed 1986); Economic Recovery Tax Act of 1981 § 301, I.R.C.§ 128 (repealed 1990). An ingenious proposal by Senator Bradley would have avoided this problem by providing a credit, with an annual ceiling, for net savings. 127 CONG. REC. 12,824-26 (1981). Such a credit would be efficient, but seems somewhat inequitable. A frugal low bracket taxpayer who, prior to passage of the proposal, had put aside a nest egg of $20,000, would not receive a tax benefit unless he added to this year's savings, while a high bracket profligate would receive a credit for the first $2000 of savings he put away after the bill's passage.

A deduction with a ceiling, then, has no marginal effect above the ceiling on savings. A system of differentiated rates would avoid this problem. The ideal differentiated rates would be regressive with respect to capital income within classes but progressive with respect to income across classes. Such a structure would reduce the transfer to the well-to-do while creating marginal incentives to save. Differential rates that are not regressive with income classes will provide a greater transfer to the well-to-do, but will at least create a marginal income to save.[57]

B. A Paternalistic Perspective

The economic theory of rational behavior has proven to be a useful tool for analyzing and predicting individual behavior. Yet economic assumptions seem less than wholly applicable to the activity of savings for retirement. Even an efficient and fair system of differentiated rates would only partially blunt the tendency of the rich to save proportionally more than the poor. This fact is of little interest to economists, who defer completely to individual tastes. Economic theory places only formal restrictions on preferences, and does not purport to pass judgement on individual tastes: Rocky and Resnais, Twinkies and tiramisu are as one in the utility calculus. Forcing the middle class to save at the same rate as the rich is no more warranted than forcing them to watch "Last Year at Marienbad."

But the differential savings rates of the poor seem of great consequence to legislators, and some neoclassicals are plainly uncomfortable with the conclusion that all savings choices are equally sensible.[58] Recent empirical evidence has suggested that individual choices do not always conform to economic assumptions.[59] Ration-

57 *See supra* notes 27-49 and accompanying text.

58 *See, e.g.*, A.C. PIGOU, THE ECONOMICS OF WELFARE 24-30 (1960). *See also* BÖHM-BAWERK, *supra* note 41, at 253-59; Martin Feldstein, *The Optimal Level of Social Security*, Q. J. ECON. 303 (1985); F. P. Ramsey, *A Mathematical Theory of Savings*, 38 ECON. J. 543, 541 (1928); ROY F. HARROD, TOWARDS A DYNAMIC ECONOMICS 40 (1948).

59 In general, a set of individual choices can be the result of preference maximization if and only if, when choosing between bundle *A* and bundle *B* on different occasions, the consumer consistently chooses the same one. If the consumer sometimes chooses *A* and sometimes *B*, his choices are said to be inconsistent. In the intertemporal setting, the existence of inconsistency justifies paternalism. *See* George Ainslie, *Specious Reward: A Behavioral Theory of Impulsiveness and Self-control*, 82 PSYCHOL. BULL. 463-96 (1975) (animals); George Ainslie & Vanda Haendel, *The Motives of the Will*, *in* ETIOLOGIC ASPECTS OF DRUG AND ALCOHOL ABUSE 119 (Edward Gottheil et al. eds., 1983); Uri Benzion et al., *Discount Rates Inferred from Decisions: An Experimental Study*, 35 MGMT. SCI. 270 (1989); A. W. Logue, *Research on Self-Control: An Integrating Framework*, 11 BEHAV. AND BRAIN SCI. 665 (1988) (animals); Andrew Millar & Douglas J. Navarick, *Self-control and Choice in Humans: Effects of Video Game Playing as a Positive Reinforcer*, 15 LEARNING AND MOTIVATION 361 (1984); Douglas J. Navarick, *Negative Reinforcement and Choice in Humans*,

ality may fail in several different ways. First, the individual may have preferences that change solely because of the passage of time.[60] The resulting behavior roughly corresponds to impatience.[61] Second, the individual may have preferences that change solely with the proximity of various items of consumption. Such behavior might be called impulsiveness.[62] An impatient or impulsive individual may fail to maximize his own welfare. That individual's welfare may be improved by paternalistic intervention.

The objectives of paternalistic policy are quite different from those of policy based on the assumption of rationality. The tools, however, may be the same. Differential rates may successfully correct impatience, for the behavior of an impatient individual is much

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13 LEARNING AND MOTIVATION 361 (1982) (discussing negative noise reinforcement with adults); Jay U. Solnick et al., *An Experimental Analysis of Impulsivity and Impulse Control in Humans*, 11 LEARNING AND MOTIVATION 61 (1980) (same); Richard Thaler, *Some Empirical Evidence on Dynamic Inconsistency*, 8 ECON. LETTERS 201 (1981).

60 For example, suppose that on Fehruary 1, an individual will receive $100. On January 1, a month earlier, the individual is required to contribute the money to an IRA or to spend it on dinner in an elegant restaurant. On January 1, the individual will choose to contribute the funds to an IRA, yet given the same choice on February 1, he would have chosen the dinner. This behavior, which violates economic theory, may result from a computational error. That is, in discounting the future pleasure from the IRA and the meal, he makes a computational mistake that reverses his choices although his choices would have remained the same had he calculated correctly. Time-inconsistent preferences were first analyzed in R.H. Strotz, *Myopia and Inconsistency in Dynamic Utility Maximization*, 23 REV. ECON. STUD. 165 (1957).

61 In the previous example, the individual's preferences between the dinner and the IRA reverse as the prospect of the dinner grows closer and it becomes more tempting. Experimental studies strongly suggest that at least some inconsistency results from impatience. Such studies have shown that individuals sometimes make precommitments, that is, they deliberately reduce the choices that will be available to them in the future. *See, e.g.*, Howard Rachlin & Leonard Green, *Commitment, Choice and Self-control*, 17 J. EXPERIMENTAL ANALYSIS OF BEHAV. 15 (1972). An agent who fears his preferences may change has an incentive to precommit, while one who is imperfectly rational has no motive to restrict his future options.

62 Continuing with the earlier example, suppose that the individual is asked on February 1 to make the choice between a good meal and an IRA contribution in two different situations: sitting in a bank and sitting in a restaurant. Even an individual who chooses the IRA contribution if seated in the bank may choose the meal when he is actually sitting in the restaurant. Impulsiveness is related to both individual and situational variables. The crucial situational variables are those that focus attention on or distract it from the object of temptation. These so-called attentional factors may be part of the externally determined situation, Walter Mischel, *Cognitive and Additional Mechanisms in Delay of Gratification*, 21 J. PERSONALITY AND SOC. PSYCHOL. 204-18 (1972), but they may also be part of self-initiated, self-control schemes. For example, subjects confronted with the immediate temptation of a reward in front of their eyes may distract their own attention through daydreams and fantasies. Marcia C. Rodriguez et al., *Cognitive Person Variables in the Delay of Gratification of Older Children at Risk*, 57 J. PERSONALITY AND SOC. PSYCHOL. 358 (1989). Therefore, thoughts that distract attention from both the immediate and the deferred reward will increase the capacity to delay. However, factors that focus attention on the abstract, non-arousing characteristics of the reward can facilitate delay. Walter Mischel & Nancy Baker, *Cognitive Appraisals and Transformations in Delay Behavior*, 31 J. PERSONALITY AND SOC. PSYCHOL. 254 (1975).

like that of the neoclassical consumer. He chooses consumption levels at which marginal costs and benefits are equaled, and he adjusts these levels in response to price changes, such as those induced by a direct tax subsidy. However, if individuals are impatient, the ideal rate difference between capital income and labor income should be greater, and perhaps more progressive,[63] than if individuals are rational. With impatient individuals, the differential rates should not only serve a distributive function but should also compensate for the high discount rate.

A concern about impulsiveness explains why Congress might prefer IRAs to an unrestricted differential rate structure. Impulsiveness may be unaffected by differential rates since the response of impulsive individuals depends on factors other than the monetary value of the incentives. In particular, impulsive individuals are influenced by situational factors, such as liquidity. An incentive to save may be ineffective if it does not restrict the impulsive individual's access to liquid assets, such as money in a bank account. Impulsive individuals are by definition overly sensitive to situational influences. Thus, relatively abstract rewards, such as a higher return created by differential rate, may seem insignificant compared to the more vivid pleasures of an imminent good meal.[64]

Current IRAs partially compensate for impulsiveness by restricting the holder's ability to withdraw funds. The ability of IRAs to correct impulsiveness, though, could be strengthened by techniques that might be called precommitment and distraction. A precommitment strategy might, for example, require a taxpayer to commit to transfer a certain amount each week into an IRA or other account from which withdrawal is not permitted. In distraction techniques, the individual's attention is diverted from the object of temptation. Experimental psychology confirms the common-sense observation that removing temptation tends to increase self-control. Thus, a payroll savings plan that automatically deposits funds to a

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63 No direct evidence exists linking inconsistency to income, although some studies indirectly suggest a link. Situational inconsistency seems to be connected to certain individual variables. Of particular importance is IQ. *See* Rodriguez et al., *supra* note 62, at 365. *See also* Mischel & Metzner, *supra* note 44, at 161. IQ also seems to be related to knowledge of distraction techniques, although it plays a role independent of such knowledge. Rodriguez et al., *supra* note 62. The connection between IQ and inconsistency provides indirect evidence of a link between income and inconsistency. Whatever performance intelligence tests measures, high scores on such tests are strongly correlated to wages. Thus, savings rates and wage income have a common correlate.

64 Gene Steuerle, *Super IRAs Wrong Cure for Sickly Savings Rate*, 51 TAX NOTES 923 (1991) ("Through pension plans, employers often set aside siguificant amounts for employees who otherwise might never save for themselves. The expansion of IRA-type options eventually weakens the incentives and demand for employer-based plans."). Even voluntary employer plans offer the advantages of precommitment. 132 CONG. REC. 4857 (1986) (remarks of Stuart Brahs).

savings account might increase savings, even if the plan permitted individuals to withdraw freely money from the savings account. Money in a savings account, unlike money in a checking account, does not constantly remind the individual of his spending power. Employer pension plans provide such precommitment and distraction arrangements automatically. At present, financial institutions administering IRAs often do not employ these devices, but there is no reason why they could not.

III
EMPLOYER PENSIONS

Current tax policy toward savings favors employer pensions, especially pensions that do not allow workers to choose their own contribution levels.[65] This preference stems in part from paternalistic concerns.[66] Neither conventional IRAs nor elective employer plans seem wholly adequate to remedy the problems of impatience and impulsiveness. Moreover, employer plans provide more opportunities than IRAs for countering the distributive problems created by the use of deductions. In particular, the Code seeks to redistribute through the so-called nondiscrimination rules. In this Part I argue that a system of pension plans would inevitably meet both paternalistic and distributive goals less effectively than would a system of modified IRAs using differentiated rates.

Part III.A. argues that as long as a deduction is used as the basic subsidy mechanism, no regulatory structure can achieve ideal coverage levels. Part III.B. argues that even a system of differentiated rates will be difficult to adminster using employer pension plans. However, if political pressures prevent Congress from abandoning employer pensions, then these pensions should at least use em-

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65 Employer pensions can be of several types, each subject to a separate regulatory regime. Employee participation in these plans is often nonelective. Other plans rely on voluntary employee contributions either to supplement the main nonelective plan, or through a separate "cash-or-deferred-arrangement" (CODA). I.R.C. § 401(k) (West Supp. 1992). The ceiling on allowable annual contributions for CODAs is $7000. I.R.C. § 402(g)(1) (West Supp. 1992). Voluntary contributions to basic plans are further disadvantaged by tbe fact that they must be made from after-tax income, so that only the appreciation accumulates tax free. For nonelective plans, contributions to a defined contribution plan generally cannot exceed the lesser of $30,000 or 25% of the participant's compensation or until a pension annuity of $90,000 per year is reached. I.R.C. § 415(c) (West Supp. 1992). A defined benefit plan cannot provide benefits greater than the lesser of $90,000 or 100% of the individual's average salary for his three highest paid years. I.R.C. § 415(b) (West Supp. 1992). By combining defined contribution and defined benefit plans, an individual can generally accrue more pension wealth than by using either alone, although it is not possible to deduct the full amounts permitted by either type of plan alone. I.R.C. § 415(e) (West Supp. 1992).

66 Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. CHI. L. REV. 1275 (1991).

ployer-based differentiated rates. These differentiated rates would have to be modified to take into account various complications created by the use of employers.

A. The Nondiscrimination Rules

Like the tax subsidy to IRAs, the tax subsidy to employer pensions has as its central feature a deduction. Like the IRA subsidy, the pension subsidy provides a tax deduction to contributions and appreciation while it taxes withdrawals at retirement. Employer pensions, though, are subject to a set of regulations that do not apply to IRAs. In an attempt to undo the inverted distributive effects of deductions, Congress has granted tax-favored status only to those pension plans that meet the so-called nondiscrimination rules. These rules, however, fail to compensate for the use of a deduction and seldom produce socially desirable coverage levels.

The nondiscrimination rules for nonelective plans[67] have two basic components. The first, the uniform benefit rules component, restricts the variations in benefits payable to covered workers, thus creating a presumption that benefits bear a proportional relation to compensation.[68] The second component of the nondiscrimination rules, the coverage rules, restricts the firm's freedom to exclude workers from coverage. The coverage rules are an attempt to rectify problems created by the use of a deduction as a basic tax subsidy mechanism. These rules condition receipt of the subsidy on coverage of those whom the firm might have no incentive to cover. I will refer to this approach to distributing the subsidy as a conditional subsidy rule. Unfortunately, even the best possible conditional subsidy will fail to produce the desired distributional effects. The basic problem is the use of a deduction to dole out the subsidy. The total value of deductions is not systematically related to the amount needed to induce the desired level of coverage. Consequently, no

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67 Historically most pension plans have provided nonelective benefits. Although voluntary contributions to employer plans are disfavored relative to nonelective plans, they are more generously subsidized than IRAs. Congress apparently believes that the disadvantages of voluntarism are partly offset by the fact that even voluntary contributions to employer plans can be governed by the nondiscrimination rules. *See, e.g.*, 132 CONG. REC. 4858 (1986) (remarks of Stuart Brahs). In nonelective employer-sponsored pension plans, the nondiscrimination requirement can be imposed directly; covered employees are not permitted to choose between wages and pension contributions, and must meet guidelines specifying the proportions of less-compensated to highly compensated employees covered. Voluntary contributions, though, are under the control of the employee. Since the employee's use of the plan is not entirely under the employer's control, implementing the nondiscrimination rules is more difficult. Such plans must meet after-the-fact nondiscrimination tests, that is, the actual percent deferred must not be biased towards highly compensated employees.

68 I.R.C. § 401(a)(5)(B) (West Supp. 1992).

conditional subsidy can induce full coverage in some cases or prevent excess subsidies in others.

Consider what the best possible conditional subsidy rule would look like. Under the system of deductions, if the firm chooses to cover some highly compensated workers, it will receive more than the socially optimal subsidy rate. Conversely, it will receive less than the optimal rate if it chooses to cover less highly compensated workers. A conditional subsidy rule requires the firm to cover some of the less compensated workers in returu for receiving the subsidy for covering the more compensated workers. The firm should be required to cover those extra workers whom it would cover under a system of differential rates, so long as it is not required to incur costs in excess of the tax benefits received.

The ideal rule can be examined through some simplifying assumptions. Suppose that the firm employs a given number of highly compensated workers, *hc,* and a given number of non-highly compensated workers, *nhc.* All members of each group earn the same wage and all workers wish to save the same proportion of their income. However, the deduction subsidy is in excess of the level needed to produce optimal coverage for highly compensated workers and insufficient to induce optimal coverage for nonhighly-compensated workers. The loss on each non-highly compensated workers is *L,* and the surplus on each highly compensated worker is *S.*

To guarantee maximum coverage, the ideal conditional subsidy rule would compare the total benefit from covering highly compensated workers, $hc(S)$, with the loss from covering all non-highly compensated workers, $nhc(L)$. If $hc(S) > nhc(L)$, then the firm should be required to cover all non-highly compensated workers. Suppose nhc^* is the number of non-highly compensated workers that the firm is required to cover, and hc^* is the number of highly compensated workers that the firm chooses to cover. If $hc(S) < nhc(L)$, then the firm should be required to cover the number of non-highly compensated workers nhc^* such that the total loss on these workers equals the total surplus from high income workers.

$$(1)\quad hc(S) = nhc^*(L)$$

Rearranging (1), the number of non-highly compensated workers covered must be the lesser of all non-highly compensated workers, or

$$(2)\quad nhc^* = hc(S/L)$$

Suppose, for example, that the excess tax subsidy that Firms *A* and *B* receive from providing the optimal pensions for each high income worker is $6,000, while each firm would need $2,000 in excess tax

subsidy to induce it to provide optimal pension coverage to each non-highly compensated worker. Thus, the subsidy available for each highly compensated worker could finance the pensions of three[69] non-highly compensated workers. Suppose that Firm *A* has 500 highly compensated workers and 1000 non-highly compensated workers. The subsidy to the highly compensated workers can finance 1500 pensions for non-highly compensated workers.[70]

Since Firm *A* only has 1000 non-highly compensated workers, it surely should not be required to cover 1500 non-highly compensated workers. So the ideal rules thus stipulate that the firm must cover the lesser of all its non-highly compensated or the amount specified in equation (1). Firm *A* can then be required to cover all 1000 non-highly compensated workers as a condition of receiving the subsidy for its highly compensated workers.

Suppose, in contrast to Firm *A*, Firm *B* has 250 highly compensated workers and 1000 non-highly compensated workers. For Firm *B*, the excess subsidy to highly compensated workers can only finance pensions for 750 non-highly compensated income workers, less than the total number of non-highly compensated workers.[71] Firm *B* will simply choose not to provide a qualified plan if, in return for a tax deduction for all highly compensated workers, it must provide a pension for all non-highly compensated workers. If Firm *B* is required to cover fewer workers, the government will fail to extract the maximum value from the subsidy dollar.[72]

Even the best possible conditional subsidy rule cannot repair the damage from a deduction based subsidy. Some workers in Firm *B* are not covered, even though it would be socially optimal to do so. If required to provide coverage at the optimal point, firms such as *B*,

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69 *$6000/$2000.*

70 *hc(S/L) = 500(3) = 1500.*

71 *hc(S/L) = 250(3) = 750.*

72 The analysis in this Part assumes a given number of workers at various wage levels. A complete analysis would take into account the fact that employers may respond to the nondiscrimination rules by reducing their demand for less highly compensated workers. *See* Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790, 805-14 (1988). While Bankman's analysis accounts for the conditional subsidy aspect of the nondiscrimination rules, this Article ignores potential labor demand effects. The two analyses are complementary. A peculiar correlation exists between firm size and benefits, even without the conditional subsidy rule. *Id.* at 821-25. It does not allow for the possibility of some transfer between worker groups, as occurs with a conditional subsidy rule. Bankman correctly criticizes the belief that "a free lunch" is implicit in the nondiscrimination rules. *Id.* at 805. Nevertheless, the conditional subsidy nevertheless does cause some transfer to occur. This surplus is ordinarily kept by the firm, although it could be distributed to employees. Note, however, that under the assumption of perfect rationality, any distribution to workers should be a pure cash grant, since workers can be trusted to make their own savings decisions. Whether the surplus is kept by the firm or redistributed to workers, it must be financed by other distortionary taxes and, thus, it is inefficient.

with a large number of non-highly compensated employees, will simply not provide a plan. The ideal rule, therefore, must be subject to the provision that the firm will not lose money. Conversely, firms such as *A*, with large numbers of highly compensated employees, may be able to cover all their non-highly compensated employees without absorbing all the excess benefits paid to highly compensated employees. Only by coincidence will all non-highly compensated employees be covered without excess subsidy. Some critics of the present system have proposed lower ceilings on subsidies to highly compensated workers. Lower ceilings, though, will reduce the size of the surplus, regardless of the size of the deficit that must be covered.

The ideal rule states that the firm should cover the socially optimal number of workers subject to a break-even constraint. Such a rule must be stated in terms of the relative number of workers in each group who should be covered. Depending on the estimates of costs and wage offsets, the ideal rule might require firms to cover, for example, 1.2 less highly compensated workers for each more highly compensated, or 1, or .6. Ideal conditioned subsidy rules fail to achieve universal coverage, but they extract the maximum coverage given an imperfect subsidy—if the deduction provides the firm with an incentive to cover at least some workers, then the firm would cover those workers and any surplus would be used to cover additional workers.

The current non-discrimination rules fail to meet even this limited goal. The basic coverage rule requires that the percentage of non-highly compensated employees covered be a specified proportion K of the highly compensated employees[73] covered.[74] Thus:

$$(3)\quad nhc^*/nhc = (hc^*/hc)K$$

Rearranging (3), the required number of non-highly compensated workers who must be covered is

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73 I.R.C. § 414(a) defines a highly compensated employee according to three separate criteria: absolute salary, relative salary, and control over the corporation. A highly compensated employee is one who in the preceding year: (a) was at any time a 5% owner of employer; or (b) received an indexed salary of more than $75,000; or (c) received an indexed salary of over $50,000 and was in the top 20% of salaries within firm; or (d) was an officer who received compensation exceeding 50% of the maximum annual benefit under I.R.C. § 415 (c)(1)(A).

74 Specifically, the number of less highly compensated workers that must be covered is equal to 70% of the highly compensated workers covered. I.R.C. § 410(b)(1). The primary concern is whether the conditional subsidy rule should be framed in terms of the relative number of workers covered or the relative proportion of workers covered. Estimating the appropriate relationship presents a difficult empirical question for either a numerical or a proportional rule. Permanent part time employees and employees covered by a collective bargaining agreement are also excluded from the minimum participation and coverage tests. I.R.C. §§ 401(a)(26)(B)(i), 410(b)(3)(A).

$$(4)\ nhc^* = (hc^*)K(nhc/hc)$$

If the required proportion K is the cost ratio S/L, this equation becomes the correct equation (2) multiplied by the ratio of non-highly compensated workers to highly compensated workers:

$$(5)\ nhc^* = hc^*(S/L)(nhc/hc)$$

Only when the ratio nhc/hc is one-to-one will the rule be optimal.[75] For firms with high proportions of low-income workers, the ratio is higher than one-to-one, and equation (2) imposes too high a burden. As a result, these firms fail to provide plans at all. When the *nhc/hc* ratio is lower than one-to-one, firms can satisfy the rule while leaving some non-highly compensated workers uncovered. These firms thus receive a net surplus from covering highly compensated workers.[76]

The ideal rule, then, should be stated in terms of the relative number of low-income workers covered, rather than in terms of the absolute number. Of course, to implement this principle perfectly requires a great deal of information. The above example assumed that the government had perfect information about the total loss from covering non-highly compensated workers and the surplus benefits of covering highly compensated workers. This, in turn, required information about the costs of covering the two classes of workers, the wage offset that various workers will take, and the number of workers of each class. In practice, though, only the number of workers at each income level is known with certainty; costs and wage offsets must be estimated. These estimates introduce two problems: (1) a reliable estimate may be difficult to make, and (2) actual numbers may differ between firms, thus making it difficult to formulate a uniform rule.[77]

Any rule stated in relative rather than absolute terms will be an improvement over the present situation. But any non-discrimination rules can correct only imperfectly because of the present upside-down system of subsidies. Ceilings are likewise an ineffective tool for undoing the distributional effects of upside down subsidies.

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75 A *nhc/hc* ratio of one-to-one yields the optimal equation (2) because $K=S/L$. With a different K, the value of *nhc/hc* that will produce equation (2) will be different, but the basic problem will remain: For firms above this level of *nhc/hc*, equation (5) will present too high an obligation, and for firms below this level it will present too low an obligation.

76 Commentators have noted the difficulties in designing a fully optimal nondiscrimination rule. These commentators, however, have advocated either an end to the nondiscrimination rules, the imposition of mandatory plans, or both. *See* Bruce Wolk, *Non-Discrimination in Contributions or Benefits: The New Regulations*, 25 GA. L. REV. 71, 73-74, 88-90 (1990). No commentator has questioned the basic structure of the subsidy.

77 Nevertheless, cost and wage offsets are likely to be well-connected with income, reducing variations between firms.

If consumers are rational, then, a system of differential rates would be vastly superior to the present system. The possibility of imperfect rationality suggests that a system of modified IRAs should be used in conjunction with differential rates. Even with imperfect rationality though, employer pensions would serve no purpose at all.[78]

B. Differentiated Subsidies Administered Through Employers

If Congress could write on a clean slate, it would have no reason to use employer pensions to promote retirement security. But the system of employer pensions is now entrenched, and employers would, no doubt, vigorously oppose any attempt to replace it with IRAs. Congress might continue to use employer pensions while substituting differentiated rates for the present regime of deductions, subject to nondiscrimination rules. This approach, though, would have problems that a differential rate IRA would avoid. These special problems could be reduced, but not eliminated, by manipulating the rate structure. Still, differential-rate employer pensions are superior to the present system, and may be the best arrangement that is politically feasible.

1. *Labor-Management Motives for Pensions*

The previous Part assumed that, absent government intervention, the level of employer pensions was determined by worker demand for savings, the same force that determined IRA contributions. But though worker demand surely contributes to

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78 The conclusion that pensions would serve no purpose whatsoever may be qualified by the possibility that an individual's propensity to save is susceptible to influences from environmental and social factors. *See generally* Albert Bandura & Walter Mischel, *Modification of Self-Imposed Delay to Reward through Exposure to Live and Symbolic Models*, 2 J. PERSONALITY AND SOC. PSYCHOL. 698 (1965) (reporting that subjects who observe models engaged in delay will tend to imitate that delay); Walter Mischel, *Father-Absence and Delay of Gratification: Cross-Cultural Comparisons*, 63 J. ABNORMAL AND SOC. PSYCHOL. 116 (1961) (indicating that cultural factors play an important role in gratification delay); Walter Mischel et al., *Cognitive and Attentional Mechanisms in Delay of Gratification*, 10 J. PERSONALITY AND SOC. PSYCHOL. 381 (1972) (concluding that subjects instructed to engage in self-distraction strategies are more able to delay gratification than others). Thus, employer pensions may serve an educational function by encouraging delay. To ensure that they meet the nondiscrimination rules, employers often encourage employee participation in voluntary plans through informational meetings, and other events. Some have interpreted the fact that pension wealth does not seem to offset private savings as evidence that pensions function as an educational device by providing information about retirement savings plans. *See, e.g.*, PHILIP CAGAN, THE EFFECT OF PENSION PLANS ON AGGREGATE SAVING 5-6, 53-54 (National Bureau of Economic Research Occasional Paper 95, 1965). Others have suggested that the possibility of success raises aspirations. *See, e.g.*, GEORGE KATONA, PRIVATE PENSIONS AND INDIVIDUAL SAVINGS 4-6, 73-75 (1965). Finally, many feel that financial institutions' advertising of IRAs has also increased savings. Gray, *supra* note 8, at 807.

pensions, employers have their own reasons for providing pensions, and the conflict between employer objectives and savings policy complicates the design of the proper rate structure.

Pensions are valuable to employers because they can be incorporated easily into a long term employment contract. Firms may sometimes wish to enter into long-term labor contracts, as opposed to short-term, or spot-market contracts, in order to screen or reduce turnover. In a spot-market labor contract, the marginal product of each period's labor is equal to the wage that the worker receives for that period. In a long-term contract, the total value of the worker's labor for all periods must equal the total value of wage payments, but this relationship need not hold for any given period. Reducing turnover and screening workers both require long-term contracts, in which an employee is paid less than his individual marginal product in the early years of employment and more than his individual marginal product in later years. Pensions, obviously, provide a convenient way to defer compensation.

Current pension policy tries to free ride on a firm's use of pensions to manage its work force. The government permits firms to impose vesting periods on pensions.[79] These vesting periods increase the pensions' value in screening and discouraging turnover. The firm is willing to pay for the value of this labor management device, thus reducing the government's cost of providing pensions. Yet this free ride complicates the use of employer pensions as a tool to subsidize savings.

The use of pensions to screen workers tends to exacerbate class differences in savings propensities. Firms may wish to screen for several kinds of problems, but all are typically associated with higher wage jobs. In general, more highly paid jobs involve more discretion, and employee performance is likely to be more difficult to monitor directly. In higher wage jobs, pensions may be used to reduce shirking by providing an interval of low-wage time in which shirkers can be detected and discharged. A deferred bonus may also be used to screen well matched and poorly matched workers. Even the most talented and diligent worker may be ill-suited to a particular job, yet this may not be apparent until after a substantial period of employment. During the early years of employment, all workers can be paid a wage equal to the marginal product of a poorly matched worker, and well-matched workers can eventually be re-

79 Under the old ERISA rule, 29 U.S.C. § 1053(a)(2) (amended 1986), pensions were permitted to have ten-year cliff vesting or fifteen-year graded vesting. (A pension with cliff vesting is totally forfeitable until it vests). Current law permits five-year cliff vesting or seven-year graded vesting. Slightly more lenient rules apply to multi-employer plans.

warded with a wage bonus.[80] The employer's need to determine how well the worker suits his job is presumably highest in jobs that require special skills. These skills are, in turn, likely to be reflected in the worker's wage.

Firms can also use pensions to reduce worker turnover. Firms invest money in training workers. Training that can be transferred between firms is sometimes referred to as general human capital. Firms can usually force workers to bear the cost of this investment by reducing their wages, since the worker can always sell the resulting skills to another firm. In contrast, training that cannot be transferred between firms is sometimes referred to as specific human capital. Firms must generally bear the cost of this investment, since workers would lose their investment if they were fired. Firms, therefore, are potentially at the mercy of employees who quit before the firm's investment in them is recouped. Pension vesting schedules can be structured to discourage turnover by imposing large pension forfeitures on early departure. Thus, unvested pension wealth should reduce turnover.[81] Typically, jobs that require a great deal of firm-specific training are skilled and highly paid. Thus, the use of pensions to protect investments in firm-specific human capital directs pensions to high income workers.[82]

The present system attempts to exploit the firm's desire to provide pensions for its own labor management purposes. Because the firm benefits from the pension, it is willing to contribute to the cost of providing the pension. But this contribution is obtained at a price. Firm contributions are targeted to high-income employees,

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80 Although screening has not received as much attention in the pension literature as the human capital theory, *see infra* note 81 and accompanying text, the relationship between the two emerges in the literature exploring the connection between screening and wage deferral. *See, e.g.*, Milton Harris & Bengt Holmstrom, *A Theory of Wage Dynamics*, 49 REV. ECON. STUD. 315 (1982); Boyan Jovanovic, *Job Matching and the Theory of Turnover*, 87 J. POL. ECON. 972 (1979).

81 GARY S. BECKER, HUMAN CAPITAL 34-35 (2d ed. 1975); Edward P. Lazear & Robert L. Moore, *Pensions and Turnover*, *in* PENSIONS IN THE U.S. ECONOMY 163 (Zvi Bodie et al. eds., 1988); Douglas A. Wolf & Frank Levy, *Pension Coverage, Pension Vesting, and the Distribution of Job Tenures*, *in* RETIREMENT AND ECONOMIC BEHAVIOR 23 (Harry J. Aaron & Gary Burtless eds., 1984).

82 Even if firms had no labor management motive for supplying pensions, pension coverage patterns would reflect more than differences in individual worker demand for pensions. Instituting a pension plan requires substantial fixed costs, and once a plan is instituted it may be cost effective for an employer to include otherwise uncovered employees. Fixed costs also seem to be associated with assuming pension obligations towards an individual employee: pension records, for example, must be maintained long after the employee has left the company, and the firm has continuing legal obligations to the employee in the event of plan termination or bankruptcy. Employees, however, derive utility only from the level of benefits paid and only these benefits will therefore be accepted to offset wages. Employers may therefore be reluctant to incur these fixed costs unless a threshold benefit level is reached.

adding to the problems caused by the higher savings propensities of the affluent. A more steeply progressive tax rate structure is needed to induce firms to provide pensions to low income workers.

The government's reliance on firm contributions not only skews pension coverage toward the affluent, but also diminishes the value of the pension promise. Because vesting periods make the pension more valuable to the firm, the firm is willing to underwrite a higher proportion of pension costs. But the vesting periods substantially reduce worker security. Full and immediate vesting would increase the value of a pension to the workers but decrease the value to the firm. If firms were required to provide pensions with full and immediate vesting, they would reduce their pension contribution. To restore contributions to their previous level, an increased subsidy would be required, yet the cost of this subsidy might well be justified by the benefits of greater retirement security.

2. *Small Firms*

The implementation of differential rates through employers is further complicated, not only by the use of pensions as labor management devices, but also by the special problems faced by small firms. Small firms, often unsophisticated or uncertain about their prospects, may be reluctant to enter into long term financial obligations like pension plans. Even without the regulatory provisions of the Code, small firms would be less likely to provide pensions.

Yet many aspects of the current tax subsidy actually aggravate the problems faced by small firms. Many of these provisions are responses to the use of deductions to subsidize pensions. The top-heavy provisions of the Code, for example, impose tougher requirements on plans that direct a siguificant proportion of their benefits to individuals with control of the corporation's affairs,[83] regardless of whether these plans meet the income-based nondiscrimination rules.[84] Congress presumably believes that devices to evade the

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83 A top-heavy plan is defined as one in which 60% of benefits go to key employees. These plans must meet three additional requirements. First, they must provide specified minimum contributions for plan participants who are not key employees. These contributions must equal the lesser of a 3% defined contribution or the percent given to key employees. Second, they must vest more rapidly than ordinary plans. Third, there are special limitations on contributions.

84 The definitions of "key employee" and of "highly compensated employee" include elements of both control and compensation. The definition of key employee focuses on control, while that of highly compensated employee focuses on salary. A key employee is defined as: (1) an officer with compensation exceeding 50% of the dollar limit for defined benefit plans; (2) an employee with (a) at least 1/2% interest in the firm and one of the ten largest interests in the firm and (b) annual compensation in excess of defined contribution limits (currently $30,000); (3) a 5% owner of employer; (4) a 1% owner of employer having annual compensation in excess of $150,000. An individual

nondiscrimination rules are not always easily detected, but that one sign of such evasion is the receipt of disproportionate benefits by those in control. The top-heavy rules, however, fall hardest on small businesses.[85] As a firm grows in size, the number of control group employees grows at a slower rate than the number of total employees. Thus, a small firm's pension plan will generally cover a higher proportion of employees who can be characterized as having control. The need for top-heavy rules and the corresponding burden on small business could be eliminated with a system of differential subsidies. Differential rates would create a direct incentive to cover low-income workers. No supplementary rules would be needed. The subsidy for any worker would be designed only to meet the costs of covering that worker, not to cross-subsidize other workers.

Small firms are also burdened by various requirements imposed on affiliated businesses run by owner-employees. The definition of owner-employees includes only sole proprietors or partners.[86] Sole proprietorships and partnerships are typically smaller than corporations, and thus, the owner-employee rules apply primarily to small businesses. Affiliated enterprises run by owner-employees are subject to especially stringent non-discrimination rules. Affiliated employers must, in general, meet the nondiscrimination rules jointly; otherwise, a firm could evade the nondiscrimination rules by creating shell companies and segregating in one of them workers whom it did not wish to cover.[87] An exception is provided for such employers who operate separate lines of business; such employers are permitted to apply the minimum coverage rules of I.R.C. § 410(b) to each line of business.[88] This separate line of business exception, however, is of limited use to owner-employees: Owner-employees may not be covered by a plan unless employees of any other trade or business they own are covered by a comparable plan.[89] Presumably, the chances of manipulation by shifting workers are thought to be greater in an unincorporated business, unfettered by the business constraints of shareholders. Again, the use of differential rates would obviate the need for this rule and its burden on small busi-

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with a high salary hut no control might be highly compensated but not a key employee, while an individual with control but low salary may be a key employee but not highly compensated. I.R.C. § 416.

85 *See, e.g.*, Robert E. Helm & Brian P. Goldstein, *Pension/Reform Simplification—An Urgent Need: Practical Proposals from the Front Lines*, 25 GA. L. REV. 91, 95-96 (1990) (urging repeal of top-heavy rules).

86 I.R.C. § 401(c)(3).

87 I.R.C. § 414(b).

88 The plan must nevertheless satisfy nondiscrimination requirements, apparently on an employee-wide basis. I.R.C. § 410(b)(5).

89 I.R.C. § 401(d)(2); Treas. Reg. § 1.401-12(l)(1).

ness because the incentive to shift employees disappears when no cross-subsidy is used.

Small businesses are also burdened by the minimum participation rules. A plan must benefit at least the lesser of 50 employees or 40% of all employees.[90] Obviously, this requirement can more easily be met by larger firms since 50 employees may be a small percentage of a large firm's work force. This bias is increased further by the interaction of the minimum participation rules with the special provisions for multiple plans. Multiple plans can help workers as well as employers since the same type of plan may not be best for all employees. Highly compensated workers might want a defined contribution plan, while less highly compensated workers might want a defined benefit plan. Recognizing this, the nondiscrimination rules permit an employer to aggregate two plans with different formula types as long as the two together meet the uniformity rules.[91] Multiple plans can also be used to exchange uniform benefits for broader coverage.[92] To prevent excessive division, each component plan must separately meet participation requirements; that is, each must have 50 employees or 40% of the work force. This rule reduces regulatory costs for the administrative agency. Benefits of different types are not easy to compare, and large numbers of small plans create an unmanageable burden for the agency.[93] Yet the brunt of this rule plainly falls harder on smaller firms. Differential rates would eliminate the need for participation rules by obviating the need for nondiscrimination rules.

Yet other rules burden small firms simply by their complexity.[94] The rules permitting integration with Social Security, for example,

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90 I.R.C. § 401(a)(26).

91 I.R.C. § 410(b)(6)(B) permits employers to designate two or more plans as a single plan for purposes of the nondiscrimination rules.

92 An employer may provide non-uniform benefits if they satisfy either of two regimes. First, it may provide two plans, each of which separately meets the ratio-percent rule on its own. Alternatively, the firm may make use of the average benefit rule, I.R.C. §§ 410(b)(1)(C), 410(b)(2). The average benefit test provides a way of getting "credit" for a pension provided in one plan as a method for determining whether other plans meet nondiscrimination rules. The average benefit of all non-highly compensated employees, whether or not included in any plan, must be at least 70% of the average benefit of all highly compensated employees. Within a given plan, benefits must meet the proportionality rule. The average benefits test requires the plan to meet nondiscrimination requirements, usually through a safe harbor rule. In any case, each plan must meet the minimum participation rules separately, which should be easier for larger employers.

93 Separate benefit structures are usually treated as separate plans. I.R.C. § 401(a)(26)(I). Some have argued that the minimum participation rules are dispensable. Helm & Goldstein, *supra* note 85, at 95-96.

94 *See generally* Helm & Goldstein, *supra* note 85, at 91 (argning for the simplification of pension rules by repeal of various provisions of the I.R.C.).

partly lighten the uniformity requirement.[95] These integration rules are fiendishly complicated, and thus small firms have difficulty taking advantage of them. Differential rates would remove this burden by making the nondiscrimination rules unnecessary.

Other burdens on small firms are inherent in the use of employer plans and cannot be eliminated through use of differential rates. Reporting and disclosure requirements, for example, impose a burden of compliance that falls more heavily on smaller firms. These burdens are, to some extent, addressed by the special provisions for simplified employee pensions, or SEPs.[96] Recent proposals have attempted to further lighten the administrative burden on small businesses.[97] But although SEP rules eliminate the administrative burden of the nondiscrimination scheme, they do nothing to address the basic defect of the upside-down tax subsidy. Since essentially all employees must be covered, firms with a high proportion of non-highly compensated workers receive lower subsidies than those with a more highly paid work force.

IV
CAPITAL GAINS RATES

The tax code has long imposed a single nominal tax rate on income. From 1922 until 1986, the Code contained one important exception to this principle: long-term gain on capital assets, capital

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95 I.R.C. §§ 401(a)(5)(C); 401(*l*). Social Security taxes provide marginal rates that are uniform up to a ceiling, then drop to zero. Social Security benefits more or less track marginal rates, and the idea behind integration is that pensions and Social Security should increase proportionally, so that higher income people should have more pensions.

96 SEPs permit employers to make an IRA contribution in the name of each employee, subject not to the IRA limits but to the more generous qualified plan limits. These SEP contributions must not discriminate, must generally be uniform, and must be made on behalf of each employee over age 21 who has worked three to five years and has received at least $300 in compensation. Employers may exclude those who are ineligible for a qualified plan. I.R.C. § 408(k).

97 In introducing one such proposal, Representative La Falce said:

> [A] growing number of U.S. workers do not have access to pensions. . . . Much of the problem, in my view, is caused by the incredibly complex reporting requirements under existing pension laws. Meeting these requirements is hard enough for any employer, but it becomes prohibitively burdensome and expensive for small businesses.

137 Cong. Rec. E1695 (daily ed. May 9, 1991). Other proposals to lighten the burden on small businesses have recently been made. S. 318, 102d Cong., 1st Sess. (1991); *see also* S.2901 101st Cong. 1st Sess. (1990). The Bush administration intended to introduce its own such legislation. Ellis Rosenthal, *Administration's Pension Proposal Seen as Somewhat "POWER-less"; JCT Rates Super-IRA as Big Drain*, 51 TAX NOTES 549 (1991); *Bush Unveils Proposal to Expand, Simplify Nation's Pension System*, BNA PENS. & BEN. DAILY, May 1, 1991, at 17; *see also* Ellis Rosanthal, *Pension Simplification: Similar Messages, Different Approaches,*, 52 TAX NOTES 7 (1991) (outlining congressional proposals to simplify pension rules).

gain, was taxed at a lower rate than other, ordinary income. Many legislators and policy analysts have proposed reinstating preferential capital gains rates to stimulate savings.[98] Capital gains rates, however, were not designed to encourage savings. They are, in fact, a poor tool for encouraging savings. Moreover, general capital cuts can be specifically designed to increase savings and are vastly superior to capital gains rates as an instrument of savings policy.

The special treatment of capital gains never provided a general tax cut for capital, since the current income from capital investments was not accorded capital gains treatment. For example, interest on a bank account is, from an economic perspective, the return to capital, but such interest was taxed at ordinary rates. Capital gains treatment was granted only for capital income that occurred in the form of appreciation.[99] For example, a parcel of land might increase in value independent of any current rental services. This appreciation remains unrealized until a cash flow is produced. At the time of realization, typically through a sale, preferential capital gains rates would have applied only to these deferred gains.

The capital gains preference has one potential advantage over deduction-based subsidies: It can be designed as a set of progressive rates. But the capital gains preference has distributive drawbacks of its own. The regressive incidence of capital cuts stems in part from the higher saving rate of the rich. The rich and poor differ not only in the rate at which they save but in the assets in which they invest. Small savers are far more likely than large investors to put their money in income-producing assets such as savings accounts.[100] Therefore, a capital subsidy limited to capital gains may be more regressive than a general capital subsidy.

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98 A small sample of such proposals includes H.R. 369, 102d Cong., 1st Sess. (1991); H.R. 960, 1020 Cong., 1st Sess. (1991); H.R. 1194, 102d Cong., 1st Sess. (1991) (small business stock); H.R. 1721, 102d Cong., 1st Sess. (1991); H.R. 2703, 102d Cong., 1st Sess. (1991); H.R. 2873, 102d Cong., 1st Sess. (1991); H.R. 2958, 102d Cong., 1st Sess. (1991); H.R. 3128, 102d Cong., 1st Sess. (1991); H.R. 3514, 102d Cong., 1st Sess. (1991); H.R. 3652, 102d Cong., 1st Sess. (1991); H.R. 3859, 102d Cong., 1st Sess. (1991); H.R. 3875, 102d Cong., 1st Sess. (1991); H.R. 3925, 102d Cong., 1st Sess. (1991); H.R. 3970, 102d Cong., 1st Sess. (1991).

99 *See, e.g.*, MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION § 17.01 (5th ed., 1988).

100 Defenders of capital gains often point out that most taxpayers who realize capital gains are middle class. Charles E. Walker & Mark A. Bloomfield, *The Case for the Restoration of the Capital Gains Differential*, 43 TAX NOTES, 1019-23 (1989). Opponents counter that distribution by dollar value is heavily skewed to wealthier taxpayers. Gerald E. Auten & Joseph J. Cordes, *Cutting Capital Gains Taxes*, J. ECON PERSP. Winter 1991, at 181, 186-89. The Congressional Budget Office has estimated that under the Bush adminsistration's most recent proposal to cut capital gains, 95% of the benefits would go to families in the top quintile of income. COMMITTEE ON WAYS AND MEANS, 101st Cong., 2d Sess., TAX PROGRESSIVITY AND INCOME DISTRIBUTION 55 (Comm. Print 1974).

Preferential capital gains treatment may be an inefficient capital subsidy, as well as an unfair one. Capital gains rates were not initially justified as a means of subsidizing capital. Instead, it was intended to relieve some problems associated with the nontaxation of unrealized gains. One such problem arises from a progressive rate structure: The sudden recognition of many years' accumulated gain may push a taxpayer into a tax bracket higher than would have applied during any year in which the appreciation occurred. This is referred to as the problem of "bunching."[101] A second problem occurs during inflationary periods when the apparent gain on many assets is largely nominal. A third problem caused by the realization requirement involves an inefficiency rather than an inequity: by deferring the tax on any given year's appreciation, the exemption of unrealized gains reduces the overall tax rates on capital. The fact that deferring gain reduces total tax liability may cause a taxpayer to retain assets longer than efficiency dictates. This is called the lock-in effect.

The problems of bunching and lock-in were for many years the most commonly mentioned reasons for granting preferential treatment to capital gains. Both problems would be solved by an accretion tax that taxed gain as it occurred.[102] The equivalent of an accretion tax could be attained by calculating the tax due in the year of sale so as to reflect the time value of money.[103] Such a system of cumulative tax reporting could easily be indexed to inflation, thus solving the third problem addressed by capital gains rates.

Neither accretion taxation nor cumulative reporting, though, has ever been seriously considered. Instead, the capital gains rules provided a 60% deduction for the gains on capital assets held for longer than six months. Capital gains treatment clearly reduced the lock-in effect and relieved the effects of inflation and bunching, but it addressed all three problems in a far from systematic way. A taxpayer received capital gains treatment even if he consumed rather than reinvested the income he realized, and so presented a weakened case for relief from lock-in. Similarly, a taxpayer received the benefits of capital gains rates even if he had been in the top marginal rates in all applicable years, and thus needed no relief from bunching. Moreover, the inequities of bunching were compensated for—sometimes in part, sometimes in whole, and sometimes more

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101 *See generally* James W. Wetzler, *Capital Gains and Losses*, *in* COMPREHENSIVE INCOME TAXATION 115, 130-32 (Joseph A. Pechman ed., 1977).

102 *See, e.g.*, *id.* at 120-22; MARTIN DAVID, ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION 183-91 (1968). Another solution to bunching is proration of capital gains rates. *Id.* at 183-91.

103 *See, e.g.*, DAVID, *supra* note 102, at 183-91; WILLIAM VICKREY, AGENDA FOR A PROGRESSIVE TAXATION 172-95 (1947); Wetzler, *supra* note 101, at 120-22, 137-40.

than in whole—by the advantages of deferral.[104] Likewise, the size of any paper gains created by inflation depend on the magnitude of the inflation and the length of the holding period, neither of which were taken into account by the capital gains rate. Again, these gains might be offset by the value of deferral, depending on the relative magnitude of the real interest rate, the inflation rate, and the tax rate.

Capital gains rates, then, serve imperfectly their intended objectives of relieving bunching, lock-in, and the effects of inflation. Not surprisingly, capital gains rates are no better at advancing the goal for which they are now proposed, increasing investment.[105] The key defect of capital gains as a savings subsidy is that capital gains rates, by their nature, are targeted towards investments that produce long-term appreciation rather than current income. Yet investments that produce current interest income, like savings accounts, contribute just as much to national savings as those that produce long-term appreciation, like real estate. Since savings accounts seem at least as socially valuable as real estate, no rational savings policy should be restricted to the rather oddly defined class of assets that produce unrealized appreciation.[106]

Proponents of capital gains rates might defend them as a reward not merely for savings, but for certain kinds of savings such as venture capital investments. Yet a capital gains rate seems a poor method of encouraging risk taking. The capital gains preference applies to investments that are not risky, and fails to alleviate the primary tax burden on risk-taking, limits on the deductibility of losses.[107]

Capital gains proponents also argue that savings policies should focus on long-term savings. This argnment takes two different forms. One version maintains that those who withdraw their savings to use as consumption deserve no special break. But that argnment simply supports a consumption tax, rather than special treatment for capital gains. A preference for capital gains is, at once, too narrow and too broad to achieve the goal of encouraging savings that are long-term in this sense. An individual who reinvests the interest on his savings account should, based on consumption tax principles, not be taxed, yet he would not receive the benefits of capital gains treatment. Conversely, an individual who liquidates a long-term holding to finance current consumption would receive preferential

104 Wetzler, *supra* note 101, at 130-32.

105 Walker & Bloomfield, *supra* note 100, at 1019, 1020-22.

106 Auten & Cordes, *supra* note 100, at 189-90.

107 *Id.* at 190-91; Wetzler, *supra* note 101, at 147-49.

capital gains treatment, although according to consumption tax principles, he should be fully taxed.

A second version of the argument that tax relief should be targeted towards long-term investments is based on the claim that American investors, especially when compared with their European and Japanese counterparts, have an overly short time horizon. This argument suggests that American investors place too much weight on quarterly reports and are too willing to move on to a new investment at the first sign of trouble. But this restlessness, in fact, has little to do with capital formation—a society with a high savings rate might still contain restless investors. The twin problems of low savings and restlessness are not necessarily amenable to a single solution. Most households can be expected to save, but only a small fraction of investors can be expected to take a long-term interest in the companies whose shares they own.[108] A policy to encourage long-term active investment will almost inevitably fail to reach the many passive investors who merely contribute capital. Tax policy is well-suited to broad based objectives like stimulating capital investment, but less suited to more specific objectives. If transient investment is indeed a problem, corporate law policy would provide a more finely tailored solution than tax policy. For example, companies might be encouraged to adopt, as some already have, voting rules that depend on the period for which an investor has held his shares.

Capital gains cuts, then, are effective neither in correcting the realization requirement nor in encouraging capital formation. An ideal system of capital taxes would solve both problems by combining differentiated rates with an accretion tax, although accretion taxation may be infeasible, leaving unresolved the problems associated with a realization requirement. Capital gains rates, however, are a poor antidote to the realization requirement, and a system of differentiated taxes without capital gains provisions would be a second best approach. Under this system, assets like bank accounts would still be taxed more heavily than land, since the tax on gain would not be deferred. Still, they would receive some tax relief through lower general rates on capital which they would not receive under a capital gains cut.

The argument for a capital gains cut, then, is quite weak. Indeed, the defense of capital gains cuts has an *ad hoc* quality. Capital

108 Henry T.C. Hu, *Risk, Time and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 306-13 (1990) (arguing that U.S. corporations and investors engage in short term capital investor behavior because they are risk averse and they are pressured by their financial advisors to participate in such short term investments as takeovers, leveraged buyouts, and high level debt financing).

gains proponents conspicuously do not defend these cuts against the alternative of general capital cuts, but only against the alternative of uniform rates. The focus on capital gains cuts as a savings incentive, therefore, seems to rest only on historical grounds. The presumption of uniform rates is so strong that the weight of precedent seems necessary to overcome it. In this case, however, precedent is a poor guide to policy, and advocates of broad-based savings cuts would do well to give up the crutch of past practice and attack the presumption of uniformity directly by advocating more general cuts in capital gains tax rates.[109]

CONCLUSION

Concern about the low American savings rates has become almost universal in American public life. Our present system of savings incentives is an ad hoc mix of employer pensions and IRAs. Both pensions and IRAs are seriously flawed in their desigu. Both fail to reconcile the two central objectives of savings policy: stimulating growth through investment while not undermining the basic progressivity of the tax system.

But while new proposals to stimulate savings are routinely offered, they are just as routinely defeated. The lack of an agreed on policy to meet this common goal seems puzzling. On closer inspection, however, the lack of consensus results from a failure of imagination in policy design. Those who want sweeping cuts are committed to supporting capital gains rates, an inefficient tool with serious distributional disadvantages. Those who are concerned with distributive equity advocate restricted deductions, which are even clumsier devices than capital gains cuts.

The need to stimulate savings in a distributionally fair way can be met by abandoning the venerable presumption that income tax should be imposed at a single uniform rate. A separate schedule of rates for capital and labor income could provide incentives to save without sacrificing progressivity.

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109 A few bills have proposed reducing taxes on at least some interest income. H.R. 1733, 102d Cong., 1st Sess. (1991) (certain common investment funds); H.R. 2706, 102d Cong., 1st Sess. (1991) (partial exclusion of dividends and interest received by individuals); H.R. 3925, 102d Cong., 1st Sess. (1991).