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Lipstick, Light Beer, and Backloaded Savings Accounts

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LIPSTICK, LIGHT BEER, AND BACK-LOADED SAVINGS ACCOUNTS

*Karen C. Burke**

*Grayson M.P. McCouch***

"We'd like to see as many advertisements for lifetime savings accounts as we do for lipstick and light beer."¹

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¹ Michael Kranish, *Life Insurers Fighting Major Bush Initiative*, BOSTON GLOBE, Jan. 20, 2005, at C1 (quoting Pamela Olson, former Treasury Assistant Secretary for Tax Policy).

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I. INTRODUCTION

In recent years the Bush Administration has repeatedly advanced proposals to expand opportunities for tax-preferred saving beyond the targeted subsidies allowed under current law. Specifically, the Administration envisions three new types of accounts — a Lifetime Savings Account (LSA), a Retirement Savings Account (RSA), and an Employer Retirement Savings Account (ERSA) — that would profoundly alter the treatment of tax-preferred savings.² Although these proposals are ostensibly intended to simplify the law by consolidating numerous existing categories of tax-preferred accounts, they also depart sharply from the traditional approach of targeted tax incentives aimed at encouraging saving for retirement or other specific purposes. In contrast to existing special-purpose savings vehicles, funds in an LSA could be withdrawn at any time without penalty and used for any purpose, including retirement, education, health care, or other personal needs. In addition, RSAs would increase contribution limits and lift restrictions on access to tax-preferred individual retirement savings for high-income earners who are already covered by a retirement plan. Similarly, ERSAs would significantly relax existing restrictions on employer-sponsored

² See U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2006 REVENUE PROPOSALS 5–15 (2005) [hereinafter FY 2006 Revenue Proposals]; U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2005 REVENUE PROPOSALS 7–17 (2004) [hereinafter FY 2005 Revenue Proposals]; U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS 118–27 (2003) [hereinafter FY 2004 Revenue Proposals]; see also REPORT OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 107–21 (2005).

retirement plans. Taken together, the new accounts would exempt increasing amounts of capital income from taxation and eventually shift a corresponding share of the tax burden onto labor income.

The existing federal income tax is widely viewed as a hybrid system with significant consumption-type traits, including the cash-flow treatment of retirement savings.³ In contrast, the Administration's proposals adopt a yield-exempt model which requires that contributions to an account be made with after-tax dollars but allows the entire account balance (including investment returns) to be withdrawn tax-free. While the two models of consumption taxation may be theoretically equivalent in present value terms under certain stylized assumptions,⁴ they lead to markedly different results as a practical matter.⁵ In the long term, the yield-exempt savings accounts promoted by the Administration are likely to generate enormous revenue losses, exacerbate inequalities of income and wealth, and potentially undermine broad-based coverage under employer-sponsored retirement plans.⁶ Moreover, by removing substantial amounts of savings from the tax base without addressing the more difficult issue of interest expense, the Administration's proposals are likely to impede efforts to achieve fundamental tax reform.⁷

This article offers a critical assessment of the Administration's savings proposals. Part II traces the expansion of individual retirement accounts during the last thirty years, and probes the limits

³ See generally William D. Andrews & David F. Bradford, *Savings Incentives in a Hybrid Income Tax*, in UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 269 (Henry J. Aaron et al. eds., 1988).

⁴ See DAVID F. BRADFORD AND THE U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 110–11 (2d ed. 1984) [hereinafter BLUEPRINTS].

⁵ The contemporary debate over consumption taxation focuses primarily on a cash-flow model. See William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Joseph Bankman & Barbara H. Fried, *Winners and Losers in the Shift to a Consumption Tax*, 86 GEO. L.J. 539 (1998); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979); Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807 (2005). Some proposals, however, appear to contemplate a yield-exempt model. See David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599 (2000) (discussing various proposals).

⁶ See Alan J. Auerbach et al., *Reassessing the Fiscal Gap: The Role of Tax-Deferred Saving*, 100 TAX NOTES 567 (July 28, 2003); Leonard E. Burman et al., *The Administration's Savings Proposals: Preliminary Analysis*, 98 TAX NOTES 1423 (Mar. 3, 2003).

⁷ See William G. Gale & Peter R. Orszag, *An Economic Assessment of Tax Policy in the Bush Administration, 2001-2004*, 45 B.C. L. REV. 1157 (2004).

of the present value equivalence between cash-flow and yield-exempt treatment. Part III discusses the evolution of the Administration's proposals in response to pressure from various business constituencies, including the financial services and life insurance industries as well as pension lobbying groups. Part IV evaluates the Administration's proposals as tax expenditures under the existing income tax system, focusing on distributional and budgetary implications. Part V considers the proposals as a step in the direction of a pure consumption tax system and argues that the yield-exempt treatment of individual savings accounts runs counter to a well-designed consumption tax. The article concludes that the Administration's proposals reflect a dangerous blend of fiscal recklessness, political opportunism, and misguided retirement policy.

II. TAX-PREFERRED RETIREMENT SAVING

Individual retirement accounts (IRAs) have emerged as a principal vehicle for holding retirement savings. Today, they account for nearly one quarter of all retirement wealth.⁸ The growth of IRAs is closely linked to the rise of defined contribution plans, especially 401(k) plans which allow voluntary pre-tax employee contributions, and the corresponding shift away from defined benefit plans.⁹ Indeed, IRAs could never have achieved their current prominence without the massive accumulation of retirement savings in 401(k)s that can be rolled over tax-free to IRAs when employees retire or change

⁸ In 2001, IRAs accounted for \$2.4 trillion (22.4%) of \$10.69 trillion total retirement savings, including both private-sector and public-sector assets. Craig Copeland, *IRA Assets and Characteristics of IRA Owners*, 23 EBRI NOTES 1, 3-4 (2002).

⁹ Since the 1980s, the number of participants in defined contribution plans has risen steadily, while the number of participants in defined benefit plans has declined sharply, and by 2000 the value of assets held in defined contribution plans exceeded the value of assets held in defined benefit plans. See STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EMPLOYER-SPONSORED DEFINED CONTRIBUTION PLANS AND OTHER RETIREMENT ARRANGEMENTS, at 31-38 (2002) (Joint Comm. Print 2002). Roughly half of all private-sector workers participate in employment-based plans, a figure that has remained remarkably constant since 1975. See STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EMPLOYER-SPONSORED DEFINED BENEFIT PLANS, at 28 (2002) (Joint Comm. Print 2002); CONGRESSIONAL BUDGET OFFICE, UTILIZATION OF TAX INCENTIVES FOR RETIREMENT SAVING 4-5 (2003) (crediting 401(k)s with "[a]ll of the growth in defined-contribution plans" since 1975).

employers.¹⁰ With the rise of IRAs and 401(k)s, individual employees are increasingly exposed to the risks as well as the rewards of investing their own retirement funds.¹¹ Moreover, moderate- and upper-income individuals may have been emboldened through early experience with IRAs to take an active role in managing their retirement assets, thus paving the way for the 401(k) revolution.¹² Defined contribution plans and IRAs have fostered a widespread view of retirement savings accounts essentially as tax-subsidized all-purpose investment vehicles for accumulating and transferring wealth.¹³

A. *Evolution of IRAs*

IRAs were originally created by the Employee Retirement Income Security Act of 1974 (ERISA) to stimulate tax-deferred retirement saving by individuals who were not covered by an employer-sponsored qualified plan.¹⁴ IRAs are technically distinct from qualified employer plans, although they provide similar tax deferral benefits. Contributions to a traditional IRA are deductible, investment earnings accumulate tax free, and the individual owner is not taxed until amounts are actually distributed.¹⁵ In 1981 Congress

¹⁰ See I.R.C. § 402(c) (allowing tax-free rollover); ALICIA H. MUNNELL & ANNIKA SUNDÉN, *COMING UP SHORT: THE CHALLENGE OF 401(K) PLANS* 33 (2004) (noting that most IRA assets are attributable to rollovers from 401(k)s).

¹¹ A growing body of evidence, however, suggests that “most employees have neither the training, the interest, nor the desire to become competent money managers.” Richard L. Kaplan, *Enron, Pension Policy, and Social Security Privatization*, 46 ARIZ. L. REV. 53, 83–85 (2004); see also MUNNELL & SUNDÉN, *supra* note 10, at 123 (noting that “most participants are not sophisticated investors”).

¹² Over half of all households with pension coverage rely exclusively on 401(k)s and similar plans to supplement Social Security. See MUNNELL & SUNDÉN, *supra* note 10, at 1; *id.* at 2 (“It has become a 401(k) world.”); see also Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 454 (2004) (describing the emergence of the “defined contribution society” as “a quiet, largely unheralded revolution” with fundamental consequences for tax and social policy).

¹³ See John H. Langbein, *Social Security and the Private Pension System*, in *IN SEARCH OF RETIREMENT SECURITY: THE CHANGING MIX OF SOCIAL INSURANCE, EMPLOYEE BENEFITS, AND INDIVIDUAL RESPONSIBILITY* 109, 113 (Teresa Ghilarducci et al. eds., 2005) (noting that the “term ‘pension plan’ is increasingly a misnomer for defined contribution plans” which function as “multipurpose savings, investment, and wealth transmission vehicles” for the well-to-do).

¹⁴ See Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2002, 88 Stat. 829, 958-64 (codified, as amended, in I.R.C. §§ 219, 408).

¹⁵ I.R.C. §§ 219(a), 408(e)(1), (d). The annual deductible amount is subject to

lifted the ban on IRAs for individuals covered by qualified employer plans,¹⁶ but this experiment with unlimited access to IRAs ended in 1986 when Congress imposed new income-based restrictions on IRAs for individuals covered by qualified employer plans.¹⁷

The 1986 restrictions on IRAs were prompted by several factors. Perhaps most importantly, unlimited access to IRAs proved to be unexpectedly expensive in terms of lost revenue.¹⁸ To maintain revenue neutrality while slashing top income tax rates, it became necessary to cut back on revenue losses from IRAs and other costly tax incentives.¹⁹ The new restrictions also reflected a concern that the 1981 expansion of IRAs was excessively generous to high-income taxpayers covered by qualified employer plans.²⁰ From 1981 until 1986, when IRAs were universally available, the overall participation rate remained relatively low, with the vast majority of contributions concentrated among high-income taxpayers who received the greatest benefits from the tax incentive.²¹ Unsurprisingly, the tax incentive drew a much weaker response from low- and moderate-income taxpayers who faced lower marginal tax rates and more pressing needs for current income.²²

relatively strict limits, but an individual may make additional nondeductible contributions. I.R.C. § 408(o). Nondeductible contributions result in deferral of tax on the investment earnings and thus reduce the effective rate of tax. See JANE G. GRAVELLE, CONGRESSIONAL RESEARCH SERVICE, INDIVIDUAL RETIREMENT ACCOUNTS (IRAs): ISSUES, PROPOSED EXPANSION, AND RETIREMENT SAVINGS ACCOUNTS (RSAs) 3 n.1 (2000).

¹⁶ Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 311(a), 95 Stat. 172, 274 (amending I.R.C. § 219).

¹⁷ I.R.C. § 219(g), added by Tax Reform Act of 1986, Pub. L. No. 99-514, § 1101(a)(1), 100 Stat. 2085, 2411 (disallowing deductible IRAs for “active participants” in qualified employer plans with income above specified levels).

¹⁸ The revenue loss from the 1981 expansion of IRAs was six times greater than originally estimated. See Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851, 896 (1987).

¹⁹ See *id.* at 897; *id.* at 898 n.188 (“The requirement of revenue neutrality in the 1986 legislation caused the direct linkage of tax rates and tax expenditures in the retirement savings context.”)

²⁰ See S. REP. NO. 99-313, at 5 (1986) (describing tax treatment of IRAs as “unnecessarily generous for individuals who participate in other tax-favored retirement arrangements”).

²¹ In 1986, only 15% of all tax returns reported IRA contributions, but 54% of taxpayers in the top 10% of the income distribution and 70% of taxpayers in the top 1% made contributions. The top one-third of individual tax returns accounted for 82% of IRA deductions. See GRAVELLE, *supra* note 15, at 9.

²² In 1986, only 2% of taxpayers in the bottom third of the income distribution

Congress was also concerned with the limited success of IRAs in stimulating new private saving. During the early 1980s, universal access to IRAs combined with aggressive marketing by financial institutions apparently induced many individuals to shift assets to IRAs from other vehicles,²³ but these contributions failed to generate a significant net increase in private saving. To stimulate new private saving, it would be necessary to curtail consumption that would otherwise have occurred. While the effect of 401(k)s and IRAs on overall saving remains uncertain,²⁴ the general consensus is that these arrangements may encourage some new saving by low- and moderate-income earners who have few assets to shift, but they have little or no positive effect on net saving by high-income earners.²⁵ In effect, IRAs represent a subsidy for new deposits rather than new saving.²⁶ Since high-income earners may be expected to respond to the tax incentive by shifting existing assets or diverting assets that they would have saved in any event, rather than by reducing consumption, the net

and 9% in the middle third made contributions. *See id.* The response to IRAs suggests that the tax incentive is “unlikely to influence many low or moderate earners.” Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It “Still” Viable as a Means of Increasing Retirement Income? Should It Continue?*, 49 TAX L. REV. 1, 13 (1993).

²³ *See* Graetz, *supra* note 18, at 898.

²⁴ There is substantial literature addressing the impact of IRAs and 401(k)s on private and national saving. A few studies find that 45% or more of all IRA contributions represent new saving, but most others conclude that the net addition to saving is significantly smaller or even nonexistent; the findings concerning 401(k) contributions are similar. *See* Auerbach et al., *supra* note 6, at 580–81 (reviewing literature on IRAs and 401(k)s); JANE G. GRAVELLE & MAXIM SHVEDOV, CONGRESSIONAL RESEARCH SERVICE, PROPOSED SAVINGS ACCOUNTS: ECONOMIC AND BUDGETARY EFFECTS 10–12 (2005) (discussing the debate over IRAs and noting that “there was no overall increase in the savings rate during the period that IRAs were universally available, despite large contributions to IRAs”); *see also* Orazio P. Attanasio & Thomas DeLeire, *The Effect of Individual Retirement Accounts on Household Consumption and National Saving*, 112 ECON. J. 504, 507 (2002) (finding that increase in IRA contributions from 1982 to 1986 “was primarily financed from reshuffled assets and saving that would have been done anyway and was not new saving”); William G. Gale & John Karl Scholz, *IRAs and Household Saving*, 84 AM. ECON. REV. 1233, 1253 (1994) (concluding that “increasing IRA contribution limits between 1983 and 1986 would have resulted in little if any net increase in national saving”).

²⁵ *See* MUNNELL & SUNDÉN, *supra* note 10, at 141 (discussing 401(k)s).

²⁶ In 2003, tax expenditures for retirement savings for the first time exceeded total personal saving, which has declined dramatically since the early 1980s. *See* Elizabeth Bell et al., *Retirement Saving Incentives and Personal Saving*, 105 TAX NOTES 1689 (Dec. 20, 2004).

result may be a tax shelter that loses revenue without increasing overall private saving.

Despite the restrictions imposed in 1986, IRA proponents repeatedly pressed for looser eligibility requirements and contribution limits.²⁷ Initially, these demands were frustrated by the congressional budget enforcement rules, which required revenue offsets for new tax incentives.²⁸ As the budget outlook improved during the following decade, however, Congress embraced the opportunity to relax the eligibility requirements for deductible IRAs and create new exceptions permitting penalty-free withdrawals for nonretirement purposes.²⁹ More importantly, in 1997 Congress authorized a new type of individual account, known as the Roth IRA, which became available to all employees subject to lenient income-based restrictions.³⁰

In general, a Roth IRA is a mirror image of a traditional IRA: no deduction is allowed for contributions to a Roth IRA, investment earnings accumulate tax-free, and qualified distributions are nontaxable.³¹ Because contributions generate no upfront deduction, Roth IRAs are often described as “back-loaded” to distinguish them from traditional or “front-loaded” IRAs. In cash-flow budgetary terms, Roth IRAs defer revenue losses until future years when owners

²⁷ See GRAVELLE, *supra* note 15, at 14–16 (describing proposals to expand IRAs).

²⁸ See generally ALLEN SCHICK, *THE FEDERAL BUDGET: POLITICS, POLICY, PROCESS* 48–73 (rev. ed. 2000) (discussing budget enforcement rules).

²⁹ See Health Insurance Portability and Accountability Act, Pub. L. 104-191, § 361(a), 110 Stat. 1936, 2071 (1996) (amending I.R.C. § 72(t) to allow penalty-free withdrawals for medical expenses); Small Business Job Protection Act of 1996, Pub. L. 104-188, § 1427(a), (b), 110 Stat. 1755, 1802 (amending spousal IRA provisions of I.R.C. § 219(c)); Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §§ 203(a), (b), 301(a), (b) and 303(a), (b), 111 Stat. 788, 809, 824, 825, 829 (amending eligibility requirements of I.R.C. § 219(g) and amending I.R.C. § 72(t) to allow penalty-free withdrawals for higher education expenses and first-time home purchases).

³⁰ See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 302(a), 111 Stat. 788, 825 (codified, as amended, at I.R.C. § 408A). The Roth IRA bears the name of its principal sponsor, the late Senator William Roth of Delaware. The maximum contribution that can be made to a Roth IRA is phased out for single individuals with adjusted gross income between \$95,000 and \$110,000 and for married couples with adjusted gross income between \$150,000 and \$160,000. See I.R.C. § 408A(c)(3)(A) and (C).

³¹ See I.R.C. § 408A(c)(1) and (d). In general, once five years have elapsed since the initial funding of a Roth IRA, distributions are nontaxable if made on or after the date the owner reaches age 59½ or dies or becomes disabled. I.R.C. § 408A(d)(2)(A). Nontaxable distributions are also allowed for first-time home purchases. *Id.*

withdraw their accumulated account balances tax-free. The revenue effects of front-loaded and back-loaded accounts may be equivalent in present value terms, but the budget rules generally require that Congress take account of the cash-flow effects of tax expenditures only over a five-year budget window.³² This timing gimmick permitted Roth IRA proponents to minimize the short-term budget costs and avoid taking the inevitable long-term revenue shortfalls into account.³³ The back-loaded approach has also spawned an array of tax-preferred special purpose savings accounts that encourage individuals to set aside funds to meet the costs of medical care and higher education.³⁴ Recent proposals to expand the Roth IRA model still further may portend fundamental changes in the structure of the federal tax system.

B. Cash-Flow and Yield-Exempt Models

The consumption tax literature includes extensive discussions of two alternative models of a consumption tax: the immediate-

³² The 1997 provisions introducing Roth IRAs and relaxing eligibility requirements for traditional IRAs were originally estimated to cost \$1.8 billion in lost revenue over a five-year period and \$20.2 billion over a ten-year period. See STAFF OF JOINT COMM. ON TAXATION, ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT ON THE REVENUE PROVISIONS OF H.R. 2154, THE TAXPAYER RELIEF ACT OF 1997 2 (Joint Comm. Print 1997).

³³ Commentators were quick to point out the budget gimmickry of the Roth IRA provisions. See Daniel Halperin, *I Want A Roth IRA for Xmas*, 81 TAX NOTES 1567, 1567 (Dec. 21, 1998) ("The Roth IRA is the antithesis of sensible tax and budget policy.... The main purpose... was to hide the budget cost."); Gene Steuerle, *Be Wary of Economic Proclamations on Back-loaded IRAs*, 76 TAX NOTES 1775, 1775 (Sept. 29, 1997) ("Almost everyone recognizes that [Roth IRAs] were enacted partly because of perverse budget accounting that does not take into account long-term effects on the deficit."); see also EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER 50 (2002) ("Because Roth-style plans collect taxes now and forswear them later, present members of Congress prefer them to postpaid consumption tax models, where the tax is collected on someone else's watch.").

³⁴ See I.R.C. §§ 220 (medical savings accounts, added in 1996), 529 (qualified tuition plans, added in 1996) and 530 (education savings accounts, added in 1997). Contributions to a medical savings account are deductible, investment earnings are tax-exempt, and distributions are tax-free if used to pay qualifying medical expenses. Thus, medical savings accounts replicate the favorable tax treatment of employer-provided health care. Cf. I.R.C. § 223 (health savings accounts, added in 2003). For discussions of Roth IRAs and their role in spawning newer special purpose savings accounts, see McCaffery, *supra* note 5, at 902-03; Zelinsky, *supra* note 12, at 490-99.

deduction (cash-flow) model and the yield-exempt model.³⁵ A cash-flow consumption tax resembles a front-loaded traditional IRA: the cost of all investments is immediately deductible, and tax is deferred until assets are withdrawn for consumption. In contrast, a yield-exempt consumption tax resembles a back-loaded Roth IRA: no upfront deduction is allowed, but all investment returns are tax-free. It is well established that, under specified assumptions, the two models produce identical after-tax outcomes in present value terms.³⁶ However, this theoretical equivalence cannot be accepted without important qualifications.

The theoretical equivalence between cash-flow and yield-exempt treatment rests on several profoundly unrealistic assumptions.³⁷ Most importantly, the equivalence assumes a uniform, invariable rate of tax. If tax rates are progressive or vary over time, the equivalence is destroyed.³⁸ In the case of retirement savings, the assumption of a constant tax rate is especially problematic because the lengthy accumulation period increases the likelihood of intervening rate changes. Moreover, income that is deferred until after retirement is often taxed at lower marginal rates than during peak earning years. Depending on their particular circumstances and expectations concerning future tax rates, individuals may have *ex ante* reasons to prefer either cash-flow or yield-exempt treatment. Nevertheless, much of the consumption tax literature assumes a flat rate structure and thus ignores significant differences between the two models when rates are progressive or fluctuate over time.

The cash-flow and yield-exempt models also differ in their treatment of certain investment returns in excess of the normal rate of return (i.e., *inframarginal* returns).³⁹ The cash-flow model treats the

³⁵ See, e.g., BLUEPRINTS, *supra* note 4, at 101–03, 110–18 (relying on equivalence to specify rules for implementing alternative forms of consumption tax); Graetz, *supra* note 5, at 1598–611.

³⁶ See Andrews, *supra* note 5, at 1126; Graetz, *supra* note 5, at 1598; Alvin C. Warren, Jr., *The Timing of Taxes*, 39 NAT'L TAX J. 499, 499–500 (1986).

³⁷ See Graetz, *supra* note 5, at 1602–04 (discussing “unrealistic conditions” for equivalence); Steuerle, *supra* note 33, at 1775 (noting that economists demonstrate equivalence using “simple equations that, while mathematically correct, fail to reflect reality”).

³⁸ See Graetz, *supra* note 5, at 1602.

³⁹ The return on an investment is *inframarginal* “if one cannot invest additional cash at the same rate.” Weisbach, *supra* note 5, at 605. Recent academic analysis has focused on the treatment of various components of capital income under an income tax compared to a consumption tax. The literature emphasizes that the principal economic difference between the two types of taxes is that a consumption tax, unlike

government as a co-venturer entitled to a ratable share of any inframarginal returns, while the yield-exempt model exempts both normal and inframarginal returns.⁴⁰ An investor who receives an immediate deduction under the cash-flow model cannot fully “gross up” the investment by the amount of the resulting tax savings.⁴¹ In effect, the government is entitled to a ratable share (equal to the tax rate) of any inframarginal investment, and the investor’s share is limited to the balance of the inframarginal investment.⁴² In contrast, under the yield-exempt model, any inframarginal returns belong entirely to the investor. Thus, the cash-flow and yield-exempt models are not equivalent where speculative investment opportunities are limited or yields vary according to the magnitude of the investment.⁴³

an income tax, exempts the risk-free return to capital, which historically has been quite low. See Daniel N. Shaviro, *Replacing the Income Tax With a Progressive Consumption Tax*, 103 TAX NOTES 91, 101 (Apr. 5, 2004); see also *id.* at 100 n.38 (citing extensive literature). A further insight is that, under specified assumptions, neither an income tax nor a consumption tax reaches marginal returns to risk because individuals can adjust their portfolios to offset the effect of the tax on risky returns. See Joseph Bankman & Barbara H. Fried, *supra* note 5, at 542–44; see also David A. Weisbach, *The (Non) Taxation of Risk*, 58 TAX L. REV. 1, 8 (2004) (noting that, under an income tax, taxing gains and deducting losses “reduces the variance in outcomes from taking a bet,” but that individuals can restore the pretax variance simply by increasing the size of the bet). See generally Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax* (U. Chi. John M. Olin L. & Econ. Working Paper No. 251, 2005).

⁴⁰ See McCaffery, *supra* note 5, at 826–27 (explaining that only postpaid consumption tax reaches “windfall” returns). Unlike a yield-exempt consumption tax that explicitly exempts all returns to capital, both an accretion-type income tax and a cash-flow consumption tax reach inframarginal returns as well as any wages masquerading as returns to capital. See Weisbach, *supra* note 5, at 608–09 (noting that there may be “large differences” between yield exempt and cash-flow consumption taxes to the extent it is difficult to “adequately police the border between wages and capital”).

⁴¹ By hypothesis, any tax savings must be invested at a lower rate than the inframarginal return on the original investment. See Weisbach, *supra* note 5, at 605–06.

⁴² See Graetz, *supra* note 5, at 1603 (noting that, under the cash-flow model, the government “invests a percentage equal to the taxpayer’s marginal tax rate in each venture”); see also Weisbach, *supra* note 5, at 606 n.11.

⁴³ This occurs, for example, when the tax savings from deducting the cost of an investment cannot be invested at the same rate of return as the original investment. The equivalence between the cash-flow and yield-exempt models depends crucially on the assumption that individuals can costlessly gross up investments without diminishing the marginal rate of return. See Shaviro, *supra* note 39, at 99.

When the conditions for equivalence hold, both traditional IRAs and Roth IRAs exempt the yield on the owner's after-tax investment. For example, assume that an individual in a 30% marginal tax bracket has \$100 of earnings that can be invested in either type of account. If the individual places the entire \$100 in a traditional IRA and claims a deduction for the contribution, the government in effect becomes a co-venturer with a 30% share in the investment. If the account doubles in value to \$200, the entire balance is subject to tax when withdrawn from the account.⁴⁴ After paying tax of \$60 on the distribution ($30\% \times \200), the individual is left with \$140 of after-tax retirement savings. Alternatively, if the individual chooses a Roth IRA, the \$100 of earnings are subject to an immediate tax of \$30, leaving an initial contribution of \$70. If the account doubles in value, the entire amount may be withdrawn tax-free, again leaving the taxpayer with \$140 of after-tax retirement savings. The initial contribution to the Roth IRA is made with after-tax dollars and is therefore less than the equivalent pre-tax contribution to the traditional IRA.

In this example, allowing a deduction for the full amount of the initial pre-tax contribution to a traditional IRA (\$100) is equivalent to imposing a tax on the contribution and exempting the yield on the amount remaining after tax (\$70).⁴⁵ The arrangement could be recast as a joint venture in which the individual initially invests \$70 and the government invests \$30, and both contributions double in value. The end result is the same as if the government collected an immediate tax of \$30 and invested that amount at a rate of return equal to the yield on the traditional IRA. Assuming a uniform, invariable tax rate, the only difference is whether the government collects \$30 of tax upfront or \$60 of tax upon withdrawal. The difference is merely one of timing; the immediate and deferred taxes are equivalent in present value terms.⁴⁶ The individual who makes an after-tax contribution to a Roth IRA may be viewed as having "prepaid" the tax that would otherwise be due upon withdrawal of the account balance. Thus, the yield-exempt and cash-flow models of taxing consumption are often referred to, respectively, as the prepaid and postpaid models.⁴⁷

⁴⁴ Assuming a 7.2% pre-tax rate of return, the investment will double in value in approximately ten years.

⁴⁵ See Andrews, *supra* note 5, at 1126; Graetz, *supra* note 5, at 1598.

⁴⁶ Under the cash-flow model, the amount of the deferred tax (\$60) is identical to the compounded value of the individual's original tax savings (\$30).

⁴⁷ See BLUEPRINTS, *supra* note 4, at 110–11; McCaffery, *supra* note 5, at 811.

The present value equivalence does not hold if the tax rate changes during the interval between contribution and withdrawal.⁴⁸ In general, a traditional IRA performs better than a Roth IRA if the tax rate is higher at the time contributions are made than when withdrawals occur.⁴⁹ In the above example, assume that the tax rate falls from 30% to 10% by the time the individual withdraws the balance of the traditional IRA. The tax on the \$200 withdrawal amounts to only \$20 (rather than \$60), leaving the individual with after-tax retirement savings of \$180, or \$40 more than if she chose a Roth IRA. The result would be reversed if the tax rate rose to 50% by the time of withdrawal, because the tax on the \$200 withdrawal would amount to \$100, leaving the individual with only \$100 after tax, or \$40 less than if she had chosen a Roth IRA.

In the case of a Roth IRA, changes in the tax rate after the time of contribution are irrelevant because the effective tax rate on earnings from a Roth IRA is always zero.⁵⁰ In contrast, the effective rate of tax on a traditional IRA is zero only if the tax rate remains unchanged from the time of contribution until withdrawal. If the applicable tax rate on withdrawal is lower (or higher) than at the time of contribution, the effective tax rate on the traditional IRA is negative (or positive).⁵¹ A negative effective tax rate implies that the individual receives a tax reduction windfall because she can withdraw funds at a lower tax rate than the rate prevailing at the time of contribution. Many individuals who made contributions to traditional IRAs before 1986 received just such a windfall when they subsequently withdrew their account balances after a drop in the applicable tax rate.⁵²

⁴⁸ See GRAVELLE, *supra* note 15, at 3 (noting that the tax treatment of front-loaded and back-loaded accounts may differ “if tax rates vary over time, if the dollar ceilings are the same, and if premature withdrawals are made”).

⁴⁹ Even if the tax rate declines between contribution and withdrawal, a back-loaded account may nevertheless be preferable to a front-loaded account due to other factors. See Leonard E. Burman et al., *The Taxation of Retirement Saving: Choosing Between Front-Loaded and Back-Loaded Options*, 54 NAT’L TAX J. 689, 690 (2001). For example, if nominal contribution limits are identical, a back-loaded account is more generous than a front-loaded account. See *infra* notes 53–56 and accompanying text.

⁵⁰ See Burman et al., *supra* note 49, at 690.

⁵¹ See *id.* (defining effective tax rate as “the accrual rate of taxation on a nondeductible investment that would yield the same end-of-horizon asset balance as the IRA does”); GRAVELLE, *supra* note 15, at 3–4.

⁵² See Burman et al., *supra* note 49, at 690–91 (finding a negative average effective tax rate on IRA contributions made in 1982 and withdrawn in 1995 due to

When the nominal contribution limits for a traditional IRA and a Roth IRA are identical, the Roth IRA shelters a larger investment.⁵³ For example, assume that the nominal contribution limit for both accounts is \$5,000. For an individual in a 30% marginal tax bracket, the \$5,000 pre-tax investment in the traditional IRA is equivalent to a \$3,500 after-tax investment in the Roth IRA. If both investments double, the individual will be left with \$7,000 in the traditional IRA (\$10,000 less \$3,000 tax⁵⁴) and \$7,000 in the Roth IRA (assuming a \$3,500 after-tax contribution). In effect, the government is entitled to 30% of the investment in the traditional IRA, reflecting the built-in tax liability, and the individual is entitled to the remaining 70%. Thus, the individual is better off contributing \$5,000 (the nominal limit) after tax to the Roth IRA, since she is not forced to share any portion of the tax-exempt return with the government.⁵⁵ To preserve parity between the two accounts, the contribution limit for the Roth IRA would have to be only 70% (100% less the individual's 30% marginal tax rate) of the contribution limit for the traditional IRA.⁵⁶

The back-loaded or yield-exempt approach imposes similar tax burdens on individuals with similar ex ante opportunities in present value terms but ignores enormous variations in actual investment outcomes.⁵⁷ For example, assume that two individuals in the same tax bracket contribute \$1,000 after tax to their respective Roth IRAs and pursue different investment strategies. One account performs well and increases in value to \$5,000 at the time of withdrawal; the other

reduction in overall tax rates during this period).

⁵³ For an individual with a marginal tax rate of 30%, a back-loaded account shelters the entire amount of the contribution but a front-loaded account shelters only 70% of the account. In effect, the remaining 30% of the account belongs to the government due to the built-in liability for tax on withdrawal. Thus, if tax rates remain constant over time, the back-loaded account is generally preferable. *See id.* at 693.

⁵⁴ The \$3,000 tax represents the doubling of the government's investment of \$1,500 (reflecting the built-in tax liability at the time of contribution).

⁵⁵ In the traditional IRA, the government's 30% share displaces \$1,500 of tax savings which must be invested outside the account at an after-tax rate of return.

⁵⁶ Since the relative size of the equivalent Roth IRA varies according to the individual's marginal tax rate, a Roth IRA provides a disproportionately large tax benefit for higher-income earners who contribute the maximum amount. *See GRAVELLE, supra* note 15, at 4. For example, for an individual in a 50% marginal tax bracket, a \$5,000 investment in a Roth IRA is equivalent to a \$10,000 investment in a traditional IRA.

⁵⁷ *See* Gene Steuerle, *Back-Loaded IRAs: Head Taxes Replace Income and Consumption Taxes*, 77 TAX NOTES 109, 109 (Oct. 6, 1997) (noting that "individuals with vastly different amounts of success will pay similar or the same amount of tax").

declines to \$500. Although both individuals made identical contributions and paid the same amount of tax, one enjoys \$5,000 of prepaid consumption while the other ends up with only \$500. Thus, under the back-loaded approach, the effective tax rate on realized income and actual consumption is lower for lucky investors than for unlucky ones.⁵⁸

In contrast, the front-loaded or cash-flow approach defers taxation until amounts are actually consumed, thereby mitigating after-tax disparities between lucky and unlucky investors.⁵⁹ Such an ex post perspective is consistent with traditional notions of ability to pay, which would apportion the tax burden according to relative standards of living.⁶⁰ Thus, a cash-flow approach reflecting ex post outcomes may be viewed as fairer than a yield-exempt approach based on ex ante expectations. Moreover, to the extent that progressivity remains desirable as a matter of tax policy, the cash-flow approach can readily accommodate a graduated rate structure, while the yield-exempt approach generally assumes a single flat rate of tax.⁶¹

⁵⁸ See BLUEPRINTS, *supra* note 4, at 115–16 (noting that a “lucky investor . . . would incur no additional tax liability on the extra future consumption out of any positive payoff” while “unlucky investors will have prepaid a tax on expected returns and will then obtain no deduction for the losses they incur”); Steuerle, *supra* note 57, at 110 (noting that successful investors pay lower rates of tax on both income and consumption, and concluding that back-loaded IRAs “resemble more of a ‘head’ tax than a traditional income or consumption tax”).

⁵⁹ See Graetz, *supra* note 5, at 1602; cf. Weisbach, *supra* note 39, at 29 (“Perhaps the intuition about taxing winners more than losers is related to inframarginal returns.”).

⁶⁰ See Graetz, *supra* note 5, at 1600–01 (describing the ex ante approach as a “radical departure” from traditional notions of horizontal and vertical equity, and concluding that “once an expenditure tax with progressive rates is chosen the tax must be imposed with regard to actual, not expected, consumption”); Alvin C. Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081, 1098 (1980) (positing that “fairness in taxation should depend on outcomes, not expectations”).

⁶¹ See Andrews, *supra* note 5, at 1174–75 (noting that in a cash-flow consumption tax, rates and personal exemptions can be adjusted to achieve the desired degree of progressivity); McCaffery, *supra* note 5, at 812 (“A progressive postpaid consumption tax emerges as the fairest and least arbitrary of all comprehensive tax systems, precisely because it chooses to make its decisions about the appropriate level of progressivity at the right time.”); *id.* at 817 (arguing that “a prepaid consumption tax . . . falling exclusively on wages, jeopardizes America’s historic commitment to at least moderate progression in the distribution of tax burdens”).

In sum, the theoretical equivalence between the cash-flow and yield-exempt models rests on unrealistic assumptions that are unlikely to be met in the real world.⁶² Indeed, the theoretical equivalence masks potentially significant differences in the practical implications of the two models. In assessing recent proposals for expanding tax-preferred savings accounts, it is important to bear in mind that a choice between the cash-flow and yield-exempt approaches may have serious long-term budgetary consequences, and may also affect the distribution of financial risks and rewards among investors.

III. THE ADMINISTRATION'S SAVINGS PROPOSALS

Expanded access to tax-preferred private savings accounts has featured prominently in the Administration's recent annual budget proposals.⁶³ The Administration's proposals would introduce a new Lifetime Savings Account (LSA) available to all individuals, regardless of age or income, and would replace both traditional and Roth IRAs with a so-called Retirement Savings Account (RSA). In addition, 401(k)s and similar employer-sponsored plans would be consolidated in an Employer Retirement Savings Account (ERSA).⁶⁴

A. LSAs and RSAs

The LSA marks a significant departure from the conventional

⁶² See William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947, 953 (1975) (noting that the equivalence depends on specified conditions, and suggesting that its "chief interest lies in the way in which the conditions are not met").

⁶³ See FY 2006 Revenue Proposals, *supra* note 2, at 5–15; FY 2005 Revenue Proposals, *supra* note 2, at 7–17; FY 2004 Revenue Proposals, *supra* note 2, at 118–27.

⁶⁴ The proposals would redesignate existing 401(k)s and thrift plans as ERSAs. Other types of defined contribution plans, including 403(b) and 457 plans, would also be eligible for redesignation as ERSAs. Alternatively, such plans could continue in their current form but would not be allowed to receive any new contributions. ERSAs would be taxed in the same manner, with respect to contributions and distributions, as the plans they replaced. Thus, depending on the design of the particular plan, an ERSA might be either front-loaded or back-loaded. Employees would be allowed to make elective contributions up to the current limit for 401(k) plans (\$15,000 in 2006), and total annual contributions to an ERSA (including employer and employee contributions) for an employee would be limited, as under current law, to the lesser of 100% of the employee's compensation or \$42,000 (indexed for inflation). See FY 2006 Revenue Proposals, *supra* note 2, at 13–14. The proposals would also generally relax the nondiscrimination rules of current law. See *id.* at 14–15; see also *infra* notes 97–98 and accompanying text.

approach of targeted tax incentives aimed at promoting saving for specific purposes such as higher education, medical care and retirement security. In contrast to existing special-purpose vehicles, the funds in an LSA could be withdrawn by the owner at any time for any purpose, without penalties or restrictions.⁶⁵ The RSA would resemble an LSA, except that withdrawals made prior to age 58, death, or disability would be subject to a penalty.⁶⁶ Both types of accounts would permit after-tax contributions of up to \$5,000 per year.⁶⁷ By contributing \$20,000 to an LSA and \$10,000 to an RSA, a married couple with two children could set aside up to \$30,000 each year in the combined accounts.⁶⁸

Under the proposals, LSAs and RSAs would be available to all individuals. Unlike traditional and Roth IRAs, the new accounts would not be subject to eligibility restrictions based on age, income, or qualified plan coverage.⁶⁹ Both LSAs and RSAs would follow the back-loaded Roth IRA model of taxation: contributions would be nondeductible, investment earnings would be tax-exempt, and withdrawals would generally be tax-free. To encourage consolidation of existing accounts, Roth IRAs would be redesignated as RSAs,⁷⁰ and

⁶⁵ See FY 2006 Revenue Proposals, *supra* note 2, at 9.

⁶⁶ Early distributions from an RSA would be treated the same as nonqualified distributions from a Roth IRA, i.e., includible in gross income and subject to a 10% penalty tax only to the extent they exceeded amounts previously contributed. See *id.* at 8–9; cf. I.R.C. §§ 72(t), 408A(a), (d).

⁶⁷ The \$5,000 annual contribution limit would apply to all LSAs held in an individual's name, rather than to each individual contributor. Thus, individuals could contribute up to \$5,000 each year to their own LSAs as well as LSAs held in the name of other individuals, but total contributions to an LSA held in the name of any individual would be limited to \$5,000 per year. See FY 2006 Revenue Proposals, *supra* note 2, at 9. In the case of an RSA, the maximum annual contribution limit for an individual would be \$5,000 (or the individual's earned income, if less); a married couple could contribute up to \$10,000 (or the couple's combined earned income, if less). See *id.* at 8–9. The \$5,000 contribution limit was reduced from \$7,500 as originally proposed. See FY 2004 Revenue Proposals, *supra* note 2, at 119–20.

⁶⁸ Assuming annual contributions of \$30,000 and a 6% pre-tax annual rate of return, the combined accounts would grow to nearly \$400,000 over a ten-year period.

⁶⁹ Cf. I.R.C. §§ 219(b)–(g) (restricting deductible contributions to traditional IRAs based on income, age, and qualified plan coverage), 408A(c)(3) (prohibiting contributions to Roth IRAs for individuals or married couples with adjusted gross income above specified amounts).

⁷⁰ The income-based restrictions applicable to Roth IRA conversions under current law would not apply. See FY 2006 Revenue Proposals, *supra* note 2, at 9; cf. I.R.C. § 408A(c)(3)(B)(i) (prohibiting conversion for individuals with adjusted gross income over \$100,000).

traditional IRAs would be convertible to RSAs at the owner's option.⁷¹ No new contributions to traditional IRAs would be permitted.⁷² Converting a traditional IRA to an RSA would be especially attractive for high-income individuals, despite the income tax toll charge, because the new back-loaded account would shelter a larger investment than the original front-loaded account and would also avoid mandatory distributions during the owner's life.⁷³

The Administration claims that its proposals will encourage saving and simplify the tax law by allowing existing accounts to be consolidated into new accounts.⁷⁴ There is reason for skepticism on both counts. Any increase in net private saving is likely to be small, as well as highly concentrated among high-income individuals and costly in terms of long-term revenue loss.⁷⁵ Furthermore, the promised benefits of simplification remain elusive. Instead of streamlining the existing panoply of special-purpose, tax-preferred savings vehicles, the new back-loaded accounts may merely add to their number.⁷⁶

⁷¹ Upon conversion, the balance in a traditional IRA (less any basis attributable to nondeductible contributions) would be subject to income tax. See FY 2006 Revenue Proposals, *supra* note 2, at 9. Amounts converted from a traditional IRA (or a front-loaded ERSA) to an RSA would be subject to a five-year holding period. Distributions attributable to a conversion, if made before the end of the five-year period (or before age 58, or death or disability, if earlier) would be subject to a 10% penalty tax. See *id.* (providing ordering rules).

⁷² New traditional IRAs could nevertheless be established to accommodate rollovers from front-loaded qualified employer plans. See *id.* at 9.

⁷³ See *id.* at 8. The absence of mandatory distributions during the owner's life mimics the treatment of Roth IRAs under current law. After the owner's death, an RSA would presumably be subject to the same required minimum distribution rules as a Roth IRA. Cf. I.R.C. §§ 401(a)(9), 408(a)(6), 408A(a), (c)(5) (requiring minimum distributions during owner's life and after death, but exempting Roth IRAs during owner's life).

⁷⁴ See FY 2006 Revenue Proposals, *supra* note 2, at 7 (noting the "complexity and redundancy" caused by the "plethora of individual savings accounts, each subject to different rules regarding eligibility, contributions, tax treatment, and withdrawal").

⁷⁵ See *infra* notes 139–52 and 171–78 and accompanying text.

⁷⁶ Amounts currently held in section 529 qualified tuition plans and Coverdell education savings accounts could be converted tax-free to LSAs, subject to certain limitations. See FY 2006 Revenue Proposals, *supra* note 2, at 9–10. Under the proposal, section 529 plans would continue to exist but could be offered in the form of an LSA, subject to the annual LSA contribution limit (but free of the additional reporting requirements for section 529 plans and the income tax and penalties on distributions for noneducational purposes). See *id.* at 10. While some financial advisers have expressed concern that LSAs might drive out these types of savings, others see no reason why LSAs cannot "live side by side" with section 529 plans. See Dorothy Hinchcliff, *Bush Tax Proposals Would Affect College Saving*, FIN. ADVISOR,

Currently, the benefits of section 529 plans and Coverdell education savings accounts tend to be concentrated in a group with relatively high levels of income, education, wealth, and savings.⁷⁷ Wealthy individuals could escape the restrictions on distributions from an existing section 529 plan for noneducational purposes by transferring up to \$50,000 from the plan to an LSA and then using other funds to replenish the balance in the section 529 plan.⁷⁸

The Administration's proposals would expand access to back-loaded accounts and prohibit further contributions to traditional IRAs, but would not put an end to front-loaded accounts. The value of assets held in front-loaded and back-loaded accounts cannot be compared directly because the former, unlike the latter, must be discounted to reflect a built-in liability for the tax on future distributions.⁷⁹ Although back-loaded accounts may make it easier for individuals to keep track of their progress toward a specific savings target, the new ERSAs would continue to be front-loaded unless the plan permitted employees to elect back-loaded treatment.⁸⁰ Accordingly, employees would still have to choose between front-loaded and back-loaded accounts as the preferred investment vehicle for their retirement savings. If simplification were a central goal, it could be achieved by consolidating existing vehicles in a new front-loaded account without expanding access to back-loaded accounts. Nevertheless, the Administration's preference for back-loaded accounts appears to rest on the same "budget-driven tax policy" that gave rise to Roth IRAs.⁸¹

Apr. 2004, at 85, 86.

⁷⁷ See Susan Dynarski, *Who Benefits from the Education Saving Incentives? Income, Educational Expectations and the Value of the 529 and Coverdell*, 57 NAT'L TAX J. 359, 365 (2004). Each state imposes its own lifetime limit on contributions that can be made to a section 529 plan in the name of a beneficiary. See *id.* at 361 (noting lifetime limits ranging from \$182,000 to \$305,000).

⁷⁸ See STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2006 BUDGET PROPOSAL 17 (Joint Comm. Print 2005).

⁷⁹ Estimating the present value of assets in a front-loaded account is complicated by several factors, including uncertainty concerning the length of the accumulation period and potential future tax rate changes. See generally James M. Poterba, *Valuing Assets in Retirement Saving Accounts*, 57 NAT'L TAX J. 489 (2004) (comparing the value of retirement assets held in tax-deferred accounts and fully taxable accounts).

⁸⁰ Beginning in 2006, 401(k) and similar plans may allow employees to elect Roth-type treatment. See I.R.C. § 402A. ERSAs would similarly allow a choice between front-loaded and back-loaded treatment. See *supra* note 64.

⁸¹ See Steuerle, *supra* note 57, at 110 (describing back-loaded IRAs as "the by-

B. Interest Groups

The Administration's savings proposals represent a major policy initiative with potentially far-reaching ramifications.⁸² Nevertheless, in 2003 when the proposals initially appeared as part of the budget proposals, the Bush Administration displayed an uncharacteristic lack of focus and cohesion. Senior Administration officials complained that they had been "blindsided,"⁸³ and faulted former Treasury Secretary Paul O'Neill for having failed to consult adequately in developing the proposals,⁸⁴ although a senior Treasury official insisted privately that the proposals had been "fully vetted and considered" within the Administration.⁸⁵ The savings proposals met with resistance from some of the Administration's allies in Congress who preferred to move forward with broad pension reform.⁸⁶ Moreover, it quickly became apparent that the Administration had failed to reconcile the diverse interests of several crucial business constituencies — mutual funds, life insurance companies, and qualified plan sponsors — that stood to gain or lose if the proposals were enacted.

From the outset, the financial services sector enthusiastically supported the savings proposals, perceiving that management of the new accounts would generate a bonanza of new business for

product of the bad application of a bad theory to budget-driven tax policy").

⁸² Glenn Hubbard, an architect of the proposals and former chairman of the Council of Economic Advisers, characterized them as "radical, the biggest expansion of savings incentives on record." Jonathan Weisman, *Treasury Renews Campaign for Tax-Free Savings Accounts*, WASH. POST, Dec. 6, 2003, at E01.

⁸³ *Id.* (describing reaction of White House Chief of Staff Andrew Card and Budget Director Mitchell Daniels). Budget Director Daniels admitted that he "didn't . . . realize how fundamental a difference those proposals, if fully acted on, would be." Jonathan Weisman, *Anti-Tax Crusaders Work for Big Shift*, WASH. POST, June 14, 2003, at A01.

⁸⁴ See Jim VandeHei, *GOP Not Backing Savings Changes*, WASH. POST, Feb. 7, 2003, at A01 (reporting that Administration officials were "laying the blame" on O'Neill for developing the proposals "in secret"); Weisman, *supra* note 83, at A01 (quoting Budget Director Daniels as stating that "pure tax policy tended to be sort of left at Treasury" and was not coordinated with the White House).

⁸⁵ Weisman, *supra* note 83, at A01; *cf. id.* (reporting that Budget Director Daniels attributed inclusion of the proposal in the budget to a "policy hitch").

⁸⁶ See VandeHei, *supra* note 84, at A01 (noting concerns of Republican Congressional leaders that the proposals were "sprung on Republicans with no forewarning," and would interfere with bipartisan efforts to increase contribution limits for traditional IRAs and 401(k)s).

investment advisors.⁸⁷ As one observer noted, “[i]nvestment advisors, particularly those with wealthy clients, will benefit because over time, they will have more money to manage.”⁸⁸ In contrast, the life insurance industry opposed the proposals, fearing that the new accounts would undercut the existing market for tax-deferred annuities and similar products. Frank Keating, president of the American Council of Life Insurers and former governor of Oklahoma, derided LSAs as “a spending account, not a savings account,” and warned that such accounts could reduce net savings and divert funds from 401(k) plans.⁸⁹ The Administration appears to have been caught off guard by the controversy over its proposals,⁹⁰ and has reportedly considered adding new tax incentives for life insurance products in an attempt to placate the life insurance industry.⁹¹

Pension lobbying groups also expressed concern that the proposed new accounts posed a threat to the viability of 401(k)s and similar qualified employer plans. Because LSAs (and RSAs) would offer employers (and highly-compensated employees) an escape from the nondiscrimination rules and other burdens of maintaining a 401(k) plan, they would erode the relative tax advantages of 401(k)s and weaken existing incentives for employers to maintain such plans. The proposals originally specified a contribution limit of \$7,500 per account, which would have allowed a married couple with two children to contribute up to \$45,000 each year. At this level, many

⁸⁷ See, e.g., Matthew P. Fink, *Plan Meets People's Needs*, USA TODAY, Feb. 5, 2003, at 12A (statement of ICI President Matthew Fink praising proposals as “combin[ing] bold innovations with much-needed simplification”); see also Weisman, *supra* note 82, at E01 (quoting securities industry representative’s characterization of proposals as “a big priority”).

⁸⁸ Joel Bruckenstein, *Behind the New Savings Plans*, FIN. ADVISOR, Apr. 2003, at 73.

⁸⁹ Kranish, *supra* note 1, at C5 (quoting Keating).

⁹⁰ Elizabeth Varley, vice president of the Securities Industry Association, noted that the Administration seemed unprepared for opposition to the proposals and was slow to respond. According to Varley, “[t]here was a very strong lobbying push by [the life insurance] industry to ensure that the LSAs did not get a lot of support from anybody other than Treasury.” *Id.* at C5 (quoting Varley).

⁹¹ See Weisman, *supra* note 82, at E01. Upon leaving her post as Assistant Secretary for Tax Policy at the Treasury, where she was widely recognized as a principal architect of the Administration’s savings proposals, Pamela Olson returned to private law practice and was promptly retained by the life insurance industry as a consultant on the opposite side of the controversy. See Kranish, *supra* note 1, at C1 (noting that in “classic Washington fashion, the plan’s architect has been hired by the plan’s opponent”); *id.* at C5 (quoting Olson’s comment that “[t]here are lots of strange things that happen in Washington”).

business owners might prefer to save individually through LSAs and RSAs instead of sponsoring their own qualified plans.⁹² Moreover, many employees would be tempted to shift their savings into LSAs, which would allow them to withdraw funds at any time for any purpose without the early withdrawal penalties or mandatory distribution rules applicable to 401(k)s. Thus, the pension lobbying groups viewed the proposals as undermining the linkage between tax incentives and broad-based retirement security that lies at the heart of the existing 401(k) system.⁹³ Not surprisingly, they advocated providing new tax incentives for the existing pension system rather than “inventing a flawed new one.”⁹⁴

⁹² See Aaron Bernstein, *Bush's Retirement Rx is Bad Medicine*, BUS. WK. ONLINE, Feb. 19, 2003, http://www.businessweek.com/careers/content/feb2003/ca20030218_8886_ca030.htm (noting that companies and experts fear the new plans would result in less saving for retirement because they “would remove many of the incentives small-business owners now have to set up 401(k)s or other nontaxable savings plans for their employees. Even large employers might wind up abandoning 401(k)-type plans in favor of the proposed new ones, leading many employees to stop saving for retirement.”); see also Bruckenstein, *supra* note 88, at 74 (noting that employers might prefer to pay regular bonuses to allow employees to fund their own individual accounts in lieu of an employer-sponsored plan).

⁹³ According to the Profit Sharing/401k Council of America (PSCA), which represents a broad range of qualified employer plan sponsors,

[t]he proposed changes significantly erode the tax code incentives that encourage employers to accept the fiduciary obligation and expense that come with offering a retirement plan. . . . The current approach links the availability of tax benefits for decision makers and better off workers with the retirement savings of lower paid employees. This linkage requires that employers incentivize lower paid workers to save for retirement by using expensive matching contributions as well as conducting aggressive educational campaigns.

Press Release, PSCA, *President's Proposals Will Reduce the Appeal of Employer Plans*, Feb. 5, 2003, <http://www.psc.org/press/p2003/feb5.html> (quoting PSCA president David Wray). As a spokesperson for a pension lobbying group for large businesses observed, employers were “worried about undercutting our current retirement system.” Bernstein, *supra* note 92 (quoting ERISA Industry Committee vice president Janice Gregory).

⁹⁴ See Bernstein, *supra* note 92 (“[A] growing chorus of experts say that goal [of improving pension coverage] might be better served by directing the proposed new tax cuts into the current system, instead of inventing a flawed new one.”). The proposals represented a “bittersweet victory” for employer groups that had lobbied for relaxing the nondiscrimination rules and providing “more tax breaks for employer-sponsored savings plans.” Theo Francis & Ellen E. Schultz, *Retirement Savings Proposal Has Small but Significant Changes*, WALL ST. J., Feb. 4, 2003, at A8 (reporting reaction of PSCA vice president Ed Ferrigno).

The Administration worked closely with the pension lobbying groups to allay their concerns and enlist support for the savings proposals.⁹⁵ One prominent industry group, the American Society of Pension Professionals and Actuaries (ASPPA), formally withdrew its opposition when the Administration announced a modified set of proposals that included reduced contribution limits for LSAs and RSAs and relaxed nondiscrimination rules for ERSAs.⁹⁶ Specifically, the ERSA proposals included a design-based safe harbor that would generally allow lower levels of matching contributions for non-highly-compensated employees than the existing 401(k) safe harbor.⁹⁷ The ERSA proposals also included a more lenient nondiscrimination test for non-safe-harbor plans, allowing increased contributions for highly-compensated employees relative to non-highly-compensated employees.⁹⁸ The concessions made by the Administration led

⁹⁵ See Weisman, *supra* note 82, at E01 (noting efforts of Treasury officials to “revive the proposal and make it more palatable politically”).

⁹⁶ The Administration’s fiscal year 2005 proposals reduced the annual contribution limit for LSAs and RSAs from \$7,500 to \$5,000, and also abandoned several features of the original proposals relating to qualified defined contribution plans (e.g., modifying the minimum coverage requirements, repealing the top-heavy rules, eliminating permitted disparity and cross-testing, and specifying a uniform definition of compensation), in response to pressure from the pension lobbying groups. See Press Release, ASPPA, Administration Announces Revised Savings Proposals – Changes Made to Address ASPPA’s Concerns, Feb. 2, 2004, <http://www.aspa.org/archivepages/gac/2004/2004-02-02-savingsproposals.htm> (noting that “many of the revisions to the proposals were made in response to the concerns raised by ASPPA”); FY 2005 Revenue Proposals, *supra* note 2, at 10, 16–17; STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2004 BUDGET PROPOSAL 235–37 (Joint Comm. Print 2003) (describing original proposals).

⁹⁷ The proposed safe harbor would be satisfied, for example, if an employer matched 50% of employee contributions up to the first 6% of compensation. See FY 2005 Revenue Proposals, *supra* note 2, at 17. In contrast, the most lenient design-based safe harbor under current law requires that the employer match 100% of employee contributions up to the first 3% of compensation and 50% between 3% and 5% of compensation. I.R.C. § 401(k)(12)(B). Thus, if an employee contributed 6% of compensation, the required matching contribution would drop from 4% of compensation under current law (100% on the first 3% and 50% on the next 2%) to 3% of compensation (50% of 6%). Moreover, the proposals would allow a small employer (with no more than ten employees) to fund an ERSA by making contributions to a custodial account if the contributions satisfied the safe harbor, thereby offering relief from ERISA’s reporting and fiduciary rules. See FY 2005 Revenue Proposals, *supra* note 2, at 16.

⁹⁸ The proposals would modify the nondiscrimination test for 401(k) and similar plans to allow an average contribution percentage for highly-compensated employees

ASPPA to endorse the revised proposals, based on its view that they no longer posed a threat to coverage under qualified employer plans.⁹⁹

The revised ERSA proposals thus offered significant inducements in the form of reduced costs for employers sponsoring qualified plans.¹⁰⁰ The willingness of the pension lobbying groups to embrace the revised proposals might be viewed either as a sign of successful bargaining on behalf of employers or as a symptom of a deeper tension between the “carrot” of tax incentives and the “stick” of plan regulation in the existing pension system.¹⁰¹ Relaxing the nondiscrimination rules might encourage employers to expand qualified plan coverage, even if the plans provide fewer benefits for low- and moderate-income employees.¹⁰² However, the advent of LSAs and RSAs would most likely increase the perceived burden of the existing nondiscrimination rules and perhaps make employers more reluctant to shoulder the costs of maintaining qualified plans.¹⁰³

of up to twice the average contribution percentage for non-highly-compensated employees if the latter percentage did not exceed 6%. If the average contribution percentage for non-highly-compensated employees exceeded 6%, no discrimination test would apply. For example, the proposals would allow highly-compensated employees to contribute 10% of compensation if non-highly-compensated employees contributed at least 5% of compensation (in contrast to current law, which would require that non-highly-compensated employees contribute at least 8% of compensation). See FY 2005 Revenue Proposals, *supra* note 2, at 16; I.R.C. § 401(k)(3)(A). In addition, the actual deferral percentage (ADP) and actual contribution percentage (ACP) tests under current law would be repealed. See FY 2005 Revenue Proposals, *supra* note 2, at 16.

⁹⁹ See Press Release, ASPPA, *supra* note 96.

¹⁰⁰ See Francis & Schultz, *supra* note 94, at A8 (noting that proposed changes in nondiscrimination tests would allow employers to “keep the tax advantages of offering a retirement plan to their workers, while spending less on them”).

¹⁰¹ See Halperin, *supra* note 22, at 6–7 (describing pension policy in terms of carrot and stick metaphor).

¹⁰² See Press Release, ASPPA, *supra* note 96 (arguing that the effect of the ERSA proposals “would be directed most significantly at small businesses where the need to expand retirement plan coverage (in the majority of cases it does not exist at all) is most acute”); Robert L. Clark et al., *Effects of Nondiscrimination Rules on Pension Participation*, in PRIVATE PENSIONS AND PUBLIC POLICIES 259, 259–60 (William G. Gale et al. eds., 2004) (suggesting that more relaxed nondiscrimination rules would increase pension coverage and improve benefits for workers at all income levels); cf. William G. Gale & Peter R. Orszag, *Whither Pensions? A Brief Analysis of Portman-Cardin III*, 99 TAX NOTES 573, 573 n.4 (Apr. 28, 2003) (noting lack of empirical support for claims that higher limits and less regulation will expand coverage or provide meaningful benefits to low- and moderate-income workers).

¹⁰³ See Burman et al., *supra* note 6, at 1443; *id.* at 1439 (“The weaker nondiscrimination rules are likely to reduce the prevalence of employer matches, thus

Without a robust set of nondiscrimination rules, the tax subsidy may fail to achieve the goal of ensuring broad coverage for low- and moderate-income employees.

C. Interaction with Retirement Policy

The generous tax incentives for qualified plans have traditionally been justified as a means of encouraging employers to provide retirement benefits for rank-and-file employees who may undervalue such benefits.¹⁰⁴ In recent years, however, Congress has increasingly embraced a policy of encouraging additional contributions to qualified plans by high-income employees, while at the same time relaxing regulatory requirements aimed at ensuring participation by low- and moderate-income employees.¹⁰⁵ This trend continued in 2001 when Congress raised the contribution limits for 401(k)s and IRAs.¹⁰⁶ Proponents argue that higher contribution limits will encourage employers to establish plans if they themselves can benefit and that “more plans mean more retirement savings for the rank and file.”¹⁰⁷

reducing worker participation even where a firm continues to offer a pension.”). The availability of “safe harbor” 401(k) plans may create a perverse disincentive for participation by non-highly-compensated employees because the nondiscrimination test can be satisfied merely by offering a match (even if no employee accepts the offer). See Daniel I. Halperin & Alicia H. Munnell, *Ensuring Retirement Income for All Workers, in THE EVOLVING PENSION SYSTEM: TRENDS, EFFECTS, AND PROPOSALS FOR REFORM* 155, 168 (William G. Gale et al. eds., 2005) (noting that with the safe harbor in place, “the employer has nothing to gain from educating reluctant savers and encouraging them to participate, since the employer’s costs increase when employees choose to participate”).

¹⁰⁴ See ALICIA H. MUNNELL, *THE ECONOMICS OF PRIVATE PENSIONS* 51 (1982) (“The rationale for the favorable treatment of qualified plans, then, seems to be that these tax incentives will induce higher-paid employees to save through a mechanism that will also benefit the rank and file.”).

¹⁰⁵ See Norman P. Stein & Patricia E. Dilley, *Leverage, Linkage, and Leakage: Problems With the Private Pension System and How They Should Inform the Social Security Reform Debate*, 58 WASH. & LEE L. REV. 1369, 1389 (2001) (“Congress has moved in the direction of higher subsidies for the highly paid and of less regulation – sweetening the carrot and softening the stick.”).

¹⁰⁶ See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, §§ 601(a), 616(a), 115 Stat. 38, 94, 102 (amending I.R.C. §§ 219(b) and 404(a)(3)). The 2001 legislation also included a temporary, nonrefundable “saver’s credit” for low and moderate earners who make voluntary contributions to qualified retirement plans. See I.R.C. § 25B. See generally William G. Gale et al., *The Saver’s Credit: Issues and Options*, 103 TAX NOTES 597 (May 3, 2004).

¹⁰⁷ MUNNELL & SUNDÉN, *supra* note 10, at 185. On the other hand, “[o]pponents point out that few workers actually contribute the maximum amount allowed and that

Annual contribution limits have traditionally been lower for voluntary contributions to 401(k)s and IRAs than for employer contributions to other types of pension plans. Underlying this structure is the familiar observation that voluntary contributions to 401(k)s and IRAs are disproportionately concentrated among high-income employees, coupled with a policy judgment that it makes sense to offer employers an additional tax incentive to maintain qualified plans that provide retirement benefits for employees at all income levels — especially for low- and moderate-income employees who are otherwise unlikely to save enough for retirement.¹⁰⁸ The efficacy of the structure depends on the willingness of highly-compensated employees to participate in qualified plans that spread at least part of the tax subsidy to “reluctant” employees further down the salary scale.¹⁰⁹ This tradeoff becomes even more difficult if high earners are allowed to accumulate tax-preferred retirement savings through individual accounts without the restrictions applicable to qualified plans. From this perspective, any proposal to expand tax incentives for highly-compensated employees should be carefully designed to preserve or improve participation and benefits for rank-and-file employees.¹¹⁰

Quite apart from their potential effects on qualified plans, proposals to increase contribution limits and relax restrictions on tax-preferred retirement savings have attracted interest from proponents of consumption taxation, who see such measures as a preliminary step toward eliminating capital income generally from the tax base.¹¹¹ Consumption tax proponents tend to favor allowing all individuals the opportunity to accumulate tax-free savings without restriction (even if some choose not to do so), while scaling back burdensome pension

increasing limits would only benefit high-income workers.” *Id.* at 185–86; cf. Daniel Halperin, *Employer-Based Retirement Income – the Ideal, the Possible, and the Reality*, 11 ELDER L.J. 37, 68 (2003) (describing this approach as “‘trickle-down’ economics at its worst”).

¹⁰⁸ See Halperin, *supra* note 22, at 3.

¹⁰⁹ See *id.* at 18.

¹¹⁰ See Halperin & Munnell, *supra* note 103, at 187–88 (“We adamantly oppose an increase in tax benefits for retirement savings that does not buy us increased retirement security for low and moderate earners.”).

¹¹¹ See e.g., Theodore R. Groom & John B. Shoven, *Deregulating the Private Pension System*, in THE EVOLVING PENSION SYSTEM: TRENDS, EFFECTS, AND PROPOSALS FOR REFORM 123, 141 (William G. Gale et al. eds., 2005) (arguing that limiting retirement savings “runs counter to the underlying themes supporting consumption taxes” and that “costly and redundant regulation” should be reduced to achieve “maximum flexibility”).

regulation.¹¹² By weakening the distinction between special-purpose retirement saving and general all-purpose saving, the Administration's proposals would move the existing hybrid tax system further away from an income tax toward a consumption tax and potentially weaken the existing tax subsidy for qualified plans.

IV. INCOME TAX PERSPECTIVE

From an income tax perspective, the treatment of qualified plans and IRAs is generally acknowledged as a major tax expenditure.¹¹³ Deferring tax (or exempting the yield) on retirement savings represents a significant departure from an accretion-type income tax which would tax all income when earned. In contrast, under a consumption tax, which would exempt the return to saving, a tax on saved income represents a "negative" tax expenditure.¹¹⁴ While the existing hybrid system features several consumption-type provisions, the treatment of retirement savings clearly occupies a special position. The special treatment of retirement savings, with all its revenue costs and regulatory burdens, can be justified only to the extent that it provides retirement security for employees at all levels, not just those at the top of the salary scale.¹¹⁵

A. Tax Expenditure Analysis

Under traditional tax expenditure analysis, the treatment of qualified plans and IRAs represents an upside-down subsidy that is skewed disproportionately in favor of upper-income, high-bracket

¹¹² See *id.* at 152 (advocating "significant deregulation" and arguing that pension regulation should be based on the principle of "equal opportunity to participate" rather than any mandatory level of actual participation).

¹¹³ See Halperin, *supra* note 22, at 46 (referring to this treatment as a "tax subsidy"); OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2006 324 tbl. 19-3 (2005) (estimating tax expenditures of \$51 billion for qualified employer plans, \$48 billion for 401(k)s, and \$7 billion for IRAs in 2006). *But cf.* Zelinsky, *supra* note 12, at 524 (objecting to the tax expenditure label for qualified plans as "conclusory and problematic").

¹¹⁴ See Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 221-28 (2004) (discussing Treasury's proposed changes to official tax expenditure baseline); see also Groom & Shoven, *supra* note 111, at 137 ("If one takes consumption as the appropriate tax base, then the current tax treatment of pensions is exactly appropriate and the tax expenditure of the treatment is zero.").

¹¹⁵ See Halperin, *supra* note 22, at 8, 46-50 (asking "whether the special tax treatment of qualified plans can be justified").

individuals.¹¹⁶ The tax subsidy is extremely valuable for affluent individuals who use retirement savings vehicles to shelter substantial amounts of earned income. However, although qualified plans and IRAs have attracted vast accumulations of wealth, they have not been especially effective in increasing retirement saving among lower-income individuals who encounter difficulty in saving adequately for retirement.¹¹⁷ Indeed, if the intended beneficiaries of the subsidy are lower-income individuals, the tax expenditure might well be considered a costly failure.¹¹⁸

Critics often view tax expenditure analysis as lending itself to a barely concealed agenda of progressive income taxation.¹¹⁹ In the pension area, tax expenditure analysis has also been attacked on the ground that it portrays pension regulation simply as the quid pro quo for an enormous tax subsidy and thus obscures the paternalistic underpinnings of such regulation.¹²⁰ By focusing attention on the

¹¹⁶ See Langbein, *supra* note 13, at 111 (describing the private pension system as “top weighted” and “skewed to the affluent because its central mechanism is deferral and abatement of income taxes”).

¹¹⁷ See John Karl Scholz et al., *Are Americans Saving “Optimally” for Retirement?* 7–8 (NBER Working Paper No. W10260, 2004) (“The metaphor of the ‘three-legged stool,’ in which retirement income security is supported by the three legs of social security, employer-provided pensions, and private wealth accumulation, appears to apply only to households in the top 70 percent of the lifetime income distribution because low-income workers lack employer-provided pension coverage.”); U.S. GEN. ACCOUNTING OFFICE, 401(K) PENSION PLANS: MANY TAKE ADVANTAGE OF OPPORTUNITY TO ENSURE ADEQUATE RETIREMENT INCOME 17 (GAO/HEHS-96-176, 1996) (noting that private pensions provide less than 5% of income for the bottom quintile).

¹¹⁸ See Halperin & Munnell, *supra* note 103, at 179–80 (suggesting that the only feasible option for low-income individuals may be “expansion of Social Security or the introduction of a government-subsidized retirement savings account,” and concluding that “today’s voluntary employer-provided pension system is not capable of providing coverage for most of those individuals who end up in the bottom two quintiles of the retirement income distribution”).

¹¹⁹ See Shaviro, *supra* note 114, at 204–05 (noting the hostility of conservative critics to “the liberal political agenda of many liberal supporters of tax expenditure analysis,” and suggesting that critics may have viewed tax expenditure analysis as “a stalking horse for greater progressivity”); *id.* at 190 (noting that fiscal language is “both a purportedly objective descriptive tool and a weapon of political combat”).

¹²⁰ See Zelinsky, *supra* note 12, at 525 (arguing that tax expenditure analysis fails to acknowledge the “paternalistic nature” of pension regulation and that “subsidy rhetoric allows such regulation to be characterized merely as the government guaranteeing that it receives something for its tax-based assistance”). In fact, most observers — including those who view the pension system as a tax expenditure — candidly acknowledge the paternalistic underpinnings of pension regulation. See, e.g.,

largely formal distinction between taxes and spending, however, tax expenditure analysis can provide a useful tool for understanding both budgetary and tax policy.¹²¹ The treatment of retirement savings illustrates the confusion engendered by failing to recognize the substantive interchangeability of tax cuts and spending.¹²² For beneficiaries of the existing pension system, receiving a tax-free return on investments in the first place is equivalent to paying tax and then receiving an offsetting refund, even though the general public may fail to grasp this functional equivalence.¹²³

Tax expenditure analysis also highlights the linkage between subsidizing retirement savings and raising taxes elsewhere in the system. Such analysis might even prompt advocates of expanded tax incentives to confront more directly the budgetary costs and distributional effects of their proposals, while forcing disclosure of the role of tax incentives in assessing the overall fairness of the pension system.¹²⁴ Although the Administration unfailingly portrays its savings proposals in terms of promoting national savings and

Halperin, *supra* note 22, at 3 (suggesting that the paternalistic approach may be justified for low and moderate earners due to the inability of individuals to foresee and provide for future needs and the inadequacy of Social Security benefits).

¹²¹ See Shaviro, *supra* note 114, at 219–20 (noting that tax expenditure analysis exposes “the speciousness of the otherwise prevailing fiscal language distinction between ‘taxes’ and ‘spending’”). Although a “more varied and informative” tax expenditure analysis may be desirable on methodological grounds, *id.* at 219, it is hardly surprising that the Treasury’s efforts to provide an alternative consumption tax baseline for tax expenditures have met with opposition from income tax proponents. See *id.* at 231. Clearly, claiming that the treatment of retirement savings is not a tax expenditure under a consumption tax baseline is no less a weapon of political combat than labeling the same treatment as a tax expenditure under an income tax baseline.

¹²² See *id.* at 189 (noting that proponents of particular provisions often “exploit the common tendency to define ‘taxes’ and ‘spending’ entirely formally, and yet to treat the categories as genuinely meaningful”).

¹²³ See DANIEL SHAVIRO, *WHEN RULES CHANGE: AN ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY* 87 (2000) (describing the heuristic bias that “induces people to draw an exaggerated distinction between money that is never paid in to the Treasury and money that is first paid in and then taken back out”); Shaviro, *supra* note 114, at 220 (noting that this “endowment effect” leads the general public to underestimate the cost of tax breaks, while “[t]he direct beneficiaries of tax benefits can readily grasp that an extra dollar in their pockets is a dollar either way”).

¹²⁴ See Graetz, *supra* note 18, at 898 n.188 (noting that the distributional consequences of tax incentives for retirement savings “call into question not only the fairness of such incentives themselves, but also of the routine practice of ignoring the existence of such incentives when assessing the overall fairness of our public retirement security policies”).

improving retirement security, it is impossible to reach an informed and impartial assessment of those proposals without taking account of their revenue costs and distributional effects.

B. Distributional Effects

The Administration's savings proposals would channel tax benefits primarily to a small group of high-income individuals who already make ample use of tax-preferred savings vehicles.¹²⁵ Even before the changes enacted in 2001, the benefits of 401(k)s and IRAs were markedly skewed in favor of high earners, and the trend continues.¹²⁶ In defined contribution plans, both the rate of participation and the average amount of contributions rise steadily with income.¹²⁷ Similarly, the overwhelming majority of low- and moderate-income earners do not contribute to IRAs, even though they are not constrained by the income limits.¹²⁸ To the extent that higher contribution limits for 401(k)s and IRAs encourage a shift toward these elective arrangements, the Administration's proposals are likely to undermine still further the coverage of low- and moderate-income employees under qualified employer plans.¹²⁹

¹²⁵ See Halperin & Munnell, *supra* note 103, at 187 (finding "not credible" the notion that "people in the bottom 90 percent or even the bottom 95 percent of the income distribution are in any way constrained in their retirement saving" by the contribution and benefit limits in place even before the 2001 changes).

¹²⁶ In 1996, the top 10% of wage-earning households received approximately 55% of the cumulative benefit of tax deferral on elective contributions to defined contribution plans, while the bottom 50% of wage-earning households received less than 10% of the cumulative benefit. David Joulfaian & David Richardson, *Who Takes Advantage of Tax-Deferred Saving Programs? Evidence from Federal Income Tax Data*, 54 NAT'L TAX J. 669, 683 (2001) (measuring distribution of cumulative tax benefit among wage-earning population and finding a "slightly more egalitarian" distribution if focus limited to wage-earning contributors); see also Leonard E. Burman et al., *Distributional Effects of Defined Contribution Plans and Individual Retirement Arrangements*, 57 NAT'L TAX J. 671, 678 tbl. 1 (2004) (noting that in 2004, nearly 50% of tax benefits of defined contribution plans and IRAs went to the top 10% of the income distribution, 70% to the top 20%, and 90% to the top 40%).

¹²⁷ See Burman et al., *supra* note 126, at 681 tbl. 4. In 1997, only 6% of employees earning less than \$20,000 — the bottom one-third of earners — participated in 401(k)-type plans. See CONGRESSIONAL BUDGET OFFICE, *supra* note 9, at 7 tbl. 3; see also *id.* at 9 (noting that only 22% of employees earning less than \$20,000 participated in any type of retirement plan, compared to nearly 80% of employees earning more than \$80,000); *id.* at 11 tbl. 5 (showing average contributions by income group).

¹²⁸ See Burman et al., *supra* note 126, at 682; CONGRESSIONAL BUDGET OFFICE, *supra* note 9, at 8 tbl. 4 (showing 6% overall participation rate in IRAs for 1997).

¹²⁹ See CONGRESSIONAL BUDGET OFFICE, *supra* note 9, at 9–10 (suggesting that

If the rationale for raising contribution limits is to increase savings across the board, one would expect to find that many workers are constrained by the existing limits. Even before 2001, however, only 6% of all participants in 401(k)-type plans contributed the maximum allowable amount,¹³⁰ and those constrained participants were heavily concentrated in the upper-income levels.¹³¹ A similar pattern emerged for IRAs, although IRA contributions are less sensitive to income levels than 401(k) contributions due to income limits and eligibility requirements.¹³² Lifting the income limit on IRA contributions would confer disproportionate benefits on upper-income individuals because they tend to contribute the maximum allowable amount and derive the greatest benefits from the tax subsidy.¹³³ Even the Administration recognizes that its proposals would provide no benefit to at least half of the population, since “[o]ne third of all Americans have no assets available for investment, and another fifth have only negligible assets.”¹³⁴

the nondiscrimination rules applicable to 401(k)-type plans “fail to spread the benefits of the tax incentives among all workers as evenly as is the case for noncontributory plans”).

¹³⁰ See *id.* at 12 Table 6. A 2001 study estimated that raising the contribution limits would benefit only 8% of all participants in defined contribution plans. U.S. GEN. ACCOUNTING OFFICE, PRIVATE PENSIONS: ISSUES OF COVERAGE AND INCREASING CONTRIBUTION LIMITS FOR DEFINED CONTRIBUTION PLANS 4 (GAO-01-846, 2001).

¹³¹ See CONGRESSIONAL BUDGET OFFICE, *supra* note 9, at 12 tbl. 6 (showing that, in 1997, 40% of participants earning \$160,000 or more contributed the maximum allowable amount, compared to 4% of those earning \$40,000 to \$80,000, and only 2% of those earning less than \$40,000). A 2001 study estimated that nearly three-fourths of the likely direct beneficiaries of an increase in the dollar limits on combined employer and employee contributions earned \$150,000 or more. U.S. GEN. ACCOUNTING OFFICE, *supra* note 130, at 21.

¹³² In 1997, IRA participation ranged from 2% for individuals earning less than \$20,000 to 17% for those earning \$160,000 or more. See CONGRESSIONAL BUDGET OFFICE, *supra* note 9, at 8 tbl. 4. While only 6% of 401(k) participants were constrained by the contribution limits, 62% of all IRA participants were constrained. See *id.* at 12 tbl. 6. Although most high-income households are ineligible to participate, the tax benefits of IRAs are heavily concentrated at the top of the income distribution. Burman et al., *supra* note 126, at 682 tbl. 5 (showing over 80% of tax benefits going to the top two quintiles, nearly 60% of benefits to the top quintile, and nearly 35% of benefits to the top 10%).

¹³³ See GRAVELLE, *supra* note 15, at 12 (noting that lifting the cap would benefit “the very small fraction of the population” — less than 5% of all taxpayers — with income in excess of the Roth IRA income limit).

¹³⁴ FY 2006 Revenue Proposals, *supra* note 2, at 16.

The Administration's proposals to increase the contribution limits and relax the eligibility requirements for back-loaded savings accounts are aimed primarily at high earners who already save substantial amounts in tax-preferred retirement vehicles. Removing the \$100,000 income limit for conversions from front-loaded to back-loaded accounts would channel additional tax benefits to high-income individuals, since only those with earnings above the cap would be affected.¹³⁵ Moreover, those high-income, high-saving individuals are also likely to be in the best position to engage in sophisticated planning and exploit the tax sheltering opportunities offered by the new accounts. For individuals who do not already contribute the maximum allowable amount to a 401(k) or an IRA, the new accounts offer no additional incentive for retirement saving. This type of targeted tax subsidy is inefficient because it rewards high earners who simply shift assets from taxable vehicles to tax-preferred accounts while doing little to promote new private retirement saving.

The regressive impact of the Administration's proposals will become even more pronounced over time, as increasingly large amounts of capital income are excluded from the tax base. By one estimate, households with adjusted gross income over \$200,000 — the top 2% — would receive more than 25% of the total tax benefits of the new accounts, while the bottom 40% would receive around 4% of the tax benefits.¹³⁶ Since upper-income individuals typically receive larger absolute benefits from tax cuts (absent income limits or ceilings), the relative benefits can be measured as a percentage of adjusted gross income (or after-tax income). Assuming plausible contribution limits, the relative benefits of the new accounts rise through the income distribution before reaching a peak at the 90th or 95th percentile.¹³⁷ Thus, except for groups at the very top of the income distribution, the Administration's proposals would generally redistribute income shares from lower-income individuals to higher-income individuals. Individuals with moderate income would quickly

¹³⁵ See Burman et al., *supra* note 6, at 1437 (estimating that conversion of traditional IRAs to RSAs would cause a one-time increase in after-tax income of around \$12 billion for households with income over \$100,000). The amount of the conversion windfall would depend on the amounts rolled over, the accumulation period, rates of return on investments, and tax rates. See *supra* notes 48–56 and accompanying text.

¹³⁶ See GRAVELLE & SHVEDOV, *supra* note 24, at 15.

¹³⁷ See *id.* at 16. For taxpayers in the top 5% or 10% of the income distribution, there is a slight decline in the relative share of tax benefits as a percentage of adjusted gross income.

exhaust their ability to shift balances from existing taxable accounts to the new tax-preferred accounts, exacerbating the regressiveness of the proposals in later years.¹³⁸

C. Budgetary Effects

The Administration's savings proposals are designed to conceal their long-term revenue costs for budget accounting purposes. Under cash-flow accounting, the LSA and RSA proposals are scored as raising net revenue of \$1.5 billion over a ten-year period,¹³⁹ although they are projected to lose as much as \$40 billion of revenue per year when fully phased in.¹⁴⁰ Both the short-term revenue enhancement and the long-term revenue loss are attributable mainly to the shift from front-loaded accounts to back-loaded accounts. Eliminating the upfront deduction for traditional IRAs and allowing conversions to back-loaded accounts will accelerate revenue collections in the short term; by the same token, foregoing the tax that would otherwise have been imposed on future withdrawals will lead to increasingly large revenue losses over time.

The revenue costs associated with the Administration's proposals are relatively small at the outset but grow rapidly over time as the investment earnings on the new back-loaded accounts compound free of tax. In the early years, the projected revenue costs of the proposals are more than offset by temporary revenue gains due to the termination of new contributions to traditional IRAs and conversions from existing traditional IRAs to new back-loaded accounts.¹⁴¹ However, those short-term gains will eventually be matched by losses of equal or greater magnitude, in present value terms, because the

¹³⁸ After 25 years, the top quintile of the income distribution would receive 80% of the tax benefits from LSAs under the proposals, and the top 5% would receive 50% of the benefits. See Burman et al., *supra* note 6, at 1436 tbl. 7.

¹³⁹ Treasury revenue estimates show a gain of \$16.8 billion for fiscal years 2006-2010 followed by a loss of \$15.3 billion for fiscal years 2011-2015, resulting in a net gain of \$1.5 billion for the ten-year period. See FY 2006 Revenue Proposals, *supra* note 2, at 159. Revenue estimates prepared by the Joint Committee on Taxation show a similar pattern. See STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2006 BUDGET PROPOSAL 1 (Joint Comm. Print 2005) (showing gain of \$14.6 billion followed by loss of \$17 billion, for \$2.4 billion net loss over ten years).

¹⁴⁰ See GRAVELLE & SHVEDOV, *supra* note 24, at 5 (extrapolating long-run steady-state revenue cost of \$40 billion per year).

¹⁴¹ See *id.* at 4.

accumulated yield on funds diverted from traditional IRAs will no longer be subject to tax upon withdrawal.¹⁴² The short-term gains thus help to conceal the full costs of the new back-loaded accounts.

Although shifting funds from traditional IRAs to new back-loaded accounts will temporarily increase tax revenues, the additional revenues are in effect merely a prepayment of the tax that would otherwise have been imposed on subsequent distributions from the original accounts. In theory, assuming a constant tax rate, the timing of the tax payment should not affect its present value.¹⁴³ Nevertheless, taxpayers may choose to convert existing front-loaded accounts to new back-loaded accounts because the new accounts will shelter a larger after-tax investment and thus reduce the overall tax liability.¹⁴⁴ For example, assume that an individual holds \$1 million in a traditional IRA that will double in value over a ten-year period.¹⁴⁵ Assuming a marginal tax rate of 30%, a \$1 million pre-tax investment in a traditional IRA is equivalent to an after-tax investment of \$700,000 in an RSA; the remaining \$300,000 represents the government's 30% share of the traditional IRA (including future investment returns).¹⁴⁶ If the holder chooses to convert to an RSA, she must pay a \$300,000 tax, but in doing so she can buy out the government's 30% interest on tax-advantaged terms, using funds from a separate taxable account to pay the tax and transferring the entire \$1 million account balance (rather than only \$700,000) to the new RSA. At the end of the ten-year period, the holder can withdraw the

¹⁴² See Burman et al., *supra* note 6, at 1435. In addition, any new savings that are shifted from otherwise taxable vehicles into the new back-loaded accounts will give rise to rapidly accelerating revenue losses over time. See GRAVELLE & SHVEDOV, *supra* note 24, at 3 (estimating first year's cost as around 3% of the steady state cost).

¹⁴³ See Halperin, *supra* note 33, at 1568 ("Accelerating the tax liability will not increase the present value of taxes if the reward for early payment is to discount the tax otherwise due by the after-tax rate of return.").

¹⁴⁴ Moreover, under the Administration's proposals, taxpayers who converted traditional IRAs to RSAs during the first year could obtain an additional tax benefit by spreading the resulting taxable income ratably over four years with no interest charge. See FY 2006 Revenue Proposals, *supra* note 2, at 9.

¹⁴⁵ Assuming a 7.2% pre-tax rate of return, the investment will double in value in approximately ten years.

¹⁴⁶ See *supra* notes 53–56 and accompanying text. If the conversion amount were limited to the after-tax value (\$700,000) of the traditional IRA, the RSA balance would double in value to \$1,400,000 and the \$300,000 tax collected by the government would double to \$600,000 – the same result, aside from timing differences, as if no conversion occurred.

entire \$2 million from the RSA free of tax.¹⁴⁷ The conversion allows the holder to increase her investment in the RSA by \$300,000 and reduce her investment in the separate taxable account by a like amount. As a result, she escapes paying tax on the investment yield on \$300,000 over the ten-year accumulation period and the government is left with a corresponding reduction in tax revenue.¹⁴⁸ Thus, the conversion not only accelerates revenue from later years to earlier years but also reduces the net present value of revenue collected by the government. In effect, the government is forced to borrow on unfavorable terms and give up more than a dollar of future revenue in present value terms for every dollar of tax that it collects on the conversion.¹⁴⁹

It is difficult to predict the short-term revenue gain that would be generated by conversions from front-loaded accounts to back-loaded accounts.¹⁵⁰ Financial institutions would undoubtedly respond to the elimination of the income cap by using the tax advantages of conversions as a marketing tool to attract new business from high-income customers. Conversions would be especially attractive to risk-

¹⁴⁷ Alternatively, suppose that the holder used \$300,000 of the withdrawn funds to pay the conversion tax and transferred only the after-tax amount (\$700,000) to the RSA, leaving an untapped balance of \$300,000 in the separate taxable account. Over the ten-year period, the RSA would double in value to \$1,400,000 and the taxable account would grow to around \$490,000 at an after-tax rate of around 5% (rather than a pre-tax rate of 7.2%). The combined value of the two accounts would thus be only \$1,890,000 at the end of the ten-year period, or \$110,000 less than the \$2 million value in the example given in text. The \$110,000 difference represents the tax savings where the entire \$1 million balance of the traditional IRA is transferred to the RSA.

¹⁴⁸ The foregone tax revenue of \$110,000 represents the difference between the tax-exempt yield on the additional funds transferred to the RSA (\$300,000) and the after-tax yield that would have been generated by those funds if they had remained in the taxable account (\$190,000).

¹⁴⁹ See Burman et al., *supra* note 6, at 1434 (noting that conversions “not only shift revenues to the present by mortgaging future revenues, *they do so at very unfavorable terms for the government*”) (emphasis in original). Moreover, the government will lose additional revenue if the holder earns a higher risk-adjusted rate of return on investments than the government, because the conversion to an RSA deprives the government of the opportunity to share in the return on investments in the traditional IRA. See *id.* at 1435 n.14; see also *supra* notes 40–42 and accompanying text.

¹⁵⁰ In 1998, when taxpayers with adjusted gross income below \$100,000 became eligible to convert to Roth IRAs, only around 4% of eligible balances were converted. See Burman et al., *supra* note 6, at 1435–36. In the absence of an income cap, the volume of conversions and the resulting revenue impact would likely be much greater. See *id.* at 1436 (estimating that conversions would result in short-term revenue gain of \$37 billion and long-term revenue loss with present value of \$49 billion).

averse taxpayers concerned about a potential rise in future tax rates. Future tax rate increases would depress the value of traditional IRAs relative to RSAs, and taxpayers who wished to lock in the benefits of current low rates could do so by converting from traditional IRAs to RSAs.¹⁵¹ From an estate planning perspective, the new back-loaded accounts would also be more attractive than traditional IRAs because high-income holders would not be required to take any minimum distributions before death and accordingly could preserve their tax-free accumulations of wealth intact for their surviving beneficiaries.¹⁵²

By expanding tax subsidies and draining long-term revenue, the Administration's proposals would limit opportunities to achieve distributional goals. Over time, the new back-loaded accounts would remove large flows of capital income from the tax base and eventually lead to higher rates on a narrower base. Moreover, the magnitude of the revenue losses would become apparent precisely when the retirement of the baby-boom generation generated urgent new budgetary pressures. It should come as no surprise that the Administration's proposals fare poorly under a tax expenditure analysis within the structure of the existing income tax. What is perhaps less obvious is that the proposals exhibit equally serious defects when viewed as a transitional step in the direction of a consumption tax.

V. CONSUMPTION TAX PERSPECTIVE

The Administration's savings proposals appear to play a central role in an ambitious tax-cutting agenda that in recent years has produced income tax rate reductions, expensing of business investments, estate tax repeal, and reduced rates on dividends and capital gains.¹⁵³ Indeed, some observers see the expansion of tax-preferred savings accounts as the next logical step in the direction of a consumption tax.¹⁵⁴ If the ultimate goal is to move from the existing

¹⁵¹ See *supra* notes 48–52 and accompanying text.

¹⁵² See *infra* notes 193–97 and accompanying text.

¹⁵³ See Gale & Orszag, *supra* note 7, at 1228–30 (describing “five easy pieces” approach).

¹⁵⁴ See Mitchell L. Engler & Michael S. Knoll, *Simplifying the Transition to a (Progressive) Consumption Tax*, 56 SMU L. REV. 53, 62 (2003) (observing that the principal change required to move from the existing system to a cash-flow consumption tax is “expansion of the current tax treatment of qualified [savings] accounts . . . to all investments, in effect providing an unlimited deduction for new savings”); McCaffery, *supra* note 5, at 932 (“Practically, all that need be done is to repeal the limits on traditional IRAs and include debt as income.”); Zelinsky, *supra*

hybrid income tax system to a workable consumption tax, however, the transition cannot be accomplished simply by exempting capital income from the tax base. To achieve the goals of raising national saving and economic growth, a well-designed consumption tax must remain revenue neutral, broaden the tax base, reach existing capital, and provide consistent treatment of capital income and capital expense.¹⁵⁵ Unfortunately, in framing its tax-cutting agenda the Administration has shown no inclination to expend the necessary political capital to satisfy these requirements.¹⁵⁶ Instead of improving the existing hybrid tax system, the new back-loaded savings accounts point in the direction of a flat-rate wage tax with none of the efficiency gains of a well-designed consumption tax.¹⁵⁷

The existing hybrid income tax has long included various consumption-type features, most notably the treatment of retirement savings exemplified by 401(k)s and traditional IRAs. In recent years tax-preferred treatment has been extended to other special-purpose vehicles to encourage saving for purposes such as education and medical care.¹⁵⁸ Some observers view the Administration's proposals as merely an "incremental" extension of these provisions, arguing that "the resulting changes would expand existing patterns of tax-deferred savings, not initiate new patterns."¹⁵⁹ Nevertheless, in two important respects the proposals depart dramatically from the traditional tax-preferred treatment of savings: they weaken the link between the tax subsidy and special-purpose savings, and they also follow a yield-exempt model instead of the traditional cash-flow model.¹⁶⁰ It may be

note 12, at 520 (describing formal conversion to a cash-flow consumption tax as "the ultimate step" in an "incremental process" propelled by the expansion of tax-deferred savings accounts).

¹⁵⁵ See Gale & Orszag, *supra* note 7, at 1220.

¹⁵⁶ Cf. Graetz, *supra* note 5, at 1581 (noting the possibility that the political process would produce a consumption tax that merely excluded savings from the tax base without achieving significant base broadening).

¹⁵⁷ See McCaffery, *supra* note 33, at 50 (describing proposed expansion of back-loaded savings accounts as "steps in the direction of prepaid consumption taxation" that would make the system "look more and more like a wage tax – the wrong kind of a consumption tax from a fairness perspective"); Gale & Orszag, *supra* note 7, at 1221 (arguing that "recent tax cuts and current proposals do not move the system toward a well-designed consumption tax or a well-designed wage tax").

¹⁵⁸ See *supra* note 34 and accompanying text.

¹⁵⁹ Zelinsky, *supra* note 12, at 515.

¹⁶⁰ See McCaffery, *supra* note 5, at 902–03 (noting relaxation of special-purpose limitations and adoption of back-loaded model as "important recent developments in the field of ad hoc, prosavings deviations from the income tax").

true, broadly speaking, that under the existing hybrid system the vast majority of taxpayers already receive consumption tax treatment for the bulk of their savings, leaving upper-income taxpayers to bear the brunt of the income tax on capital income.¹⁶¹ Nevertheless, it borders on the fanciful to suggest that introducing general purpose back-loaded savings accounts would inaugurate a smooth and seamless transition to a normative consumption tax.¹⁶²

A. Debt-Financed Investments

From a consumption tax perspective, one of the most serious omissions in the Administration's proposals is the failure to address the treatment of debt.¹⁶³ A cash-flow consumption tax would account for debt by including loan proceeds in income and allowing a deduction for repayments of interest and principal.¹⁶⁴ Equivalent treatment can be achieved under a yield-exempt model by excluding loan proceeds but disallowing any deduction for repayments of interest and principal.¹⁶⁵ If loan proceeds are excluded but interest payments remain deductible, the yield-exempt model would subsidize capital income instead of producing a zero tax rate.¹⁶⁶ The treatment of debt-financed investments would be more generous than under a consumption tax that provided consistent treatment of interest income and interest expense.

¹⁶¹ See Zelinsky, *supra* note 12, at 514–15; *id.* at 515 (noting that “families in the bottom half of the income spectrum generally do not undertake financial savings”); see also *supra* note 134 and accompanying text.

¹⁶² See Zelinsky, *supra* note 12, at 515–16 (arguing that the Administration's proposals would “institutionalize and reinforce the consumption tax features of the Code rather than break sharply from current law” and would “move the Code closer to consumption tax norms”).

¹⁶³ See Roger Gordon et al., *Toward a Consumption Tax, and Beyond*, 94 AM. ECON. REV. 161, 161 (2004) (describing failure to address interest deductibility as a “glaring omission”); Gale & Orszag, *supra* note 7, at 1227 (noting that the Administration has embraced proposals to reduce or eliminate tax on interest and other capital income but has “neither endorsed nor proposed any such restrictions on deductions for interest payments”).

¹⁶⁴ See Andrews, *supra* note 5, at 1153.

¹⁶⁵ See Graetz, *supra* note 5, at 1599–600; Gale & Orszag, *supra* note 7, at 1227 (“A well-designed consumption tax could . . . allow for nontaxation of interest income coupled with nondeductibility of interest payments. The key point is that *any* well-designed tax system would treat capital income and capital expenses in a consistent manner.”) (emphasis in original).

¹⁶⁶ See Gordon, *supra* note 163, at 161.

Exempting capital income from tax while allowing a deduction for interest payments would create new opportunities for tax arbitrage.¹⁶⁷ For example, an individual could take out a loan and invest the proceeds in an LSA or RSA with a tax-exempt yield equal to the rate of interest on the loan. Although the debt-financed investment obviously yields no pre-tax profit, the transaction would generate tax-exempt capital income coupled with deductible interest expense and thus allow individuals to shelter earned income from tax.¹⁶⁸ A comparable result would arise under the existing income tax system if an individual were allowed to deduct interest on a loan that was taken out to purchase or carry tax-exempt investments.¹⁶⁹ High-income individuals are generally better situated to engage in tax arbitrage because they tend to be financially more sophisticated and have greater borrowing capacity. By exempting capital income from tax without curtailing the deduction for interest expense, the Administration's proposals "would lead not just toward a wage tax, but toward a wage tax that was only paid by low- and moderate-income households."¹⁷⁰

B. Effect on Savings

One of the central arguments in favor of a well-designed consumption tax is that by eliminating taxation of capital income it would encourage saving and promote economic growth. Similarly, the Administration seeks to justify its savings proposals on the ground that they will increase aggregate private saving, even though it remains far from clear how changes in the after-tax rate of return on

¹⁶⁷ See *id.* at 161 (noting that eliminating tax on interest income while allowing a deduction for interest expense "vastly expands" tax arbitrage opportunities); see also Graetz, *supra* note 18, at 904 (describing tax arbitrage as "the practice of borrowing and subsequently making deductible interest payments to purchase or carry assets that produce tax-preferred income").

¹⁶⁸ In contrast, a cash-flow model would eliminate the opportunity for tax arbitrage. The inclusion of loan proceeds would be offset by a deduction for the original investment, and the tax on the investment return would be offset by a deduction for repayments of interest and principal on the loan, leaving the taxpayer with no net profit and no tax reduction.

¹⁶⁹ Cf. I.R.C. § 265(a)(2) (denying deduction for interest incurred to purchase or carry tax-exempt obligations); Andrews & Bradford, *supra* note 3, at 294-96 (discussing limited efficacy of restrictions on deductibility of interest incurred to purchase or carry tax-favored retirement investments).

¹⁷⁰ Gale & Orszag, *supra* note 7, at 1228.

investments affect individual saving behavior.¹⁷¹ The benefits of expanding opportunities for tax-preferred saving will flow primarily to high-income earners who are constrained by the 401(k) contribution limits or the IRA income limits of existing law,¹⁷² and experience with universal IRAs from 1981 to 1986 suggests that targeting such opportunities at high-income earners is unlikely to stimulate significant new private saving.¹⁷³ In analyzing the economic impact of the Administration's proposals, the Congressional Budget Office acknowledges that many individuals will simply save the same amount in the new accounts that they would have saved in existing tax-preferred accounts, or perhaps shift funds from taxable vehicles into the new accounts. Such substitution or shifting of assets "would create no new saving and thus would have no effect on the total amount of private saving."¹⁷⁴ Indeed, the proposals might even reduce net private saving.¹⁷⁵

¹⁷¹ See GRAVELLE & SHVEDOV, *supra* note 24, at 10 (describing the empirical evidence concerning the relationship between the rate of return and the saving rate as "mixed, indicating mostly small effects of uncertain dimension"); Annamaria Lusardi et al., *Saving Puzzles and Saving Policies in the United States*, 17 OXFORD REV. ECON. POL'Y 95, 107 (2001) (noting that even if the overall savings rate is too low, tax incentives targeted at personal saving may be "both expensive and not necessarily beneficial"); STAFF OF JOINT COMM. ON TAXATION, *supra* note 78, at 16 (noting that increasing the after-tax return to saving might cause some individuals to save less because a lower level of saving would be needed to achieve a future accumulation "target").

¹⁷² The proposed new accounts provide no additional incentive for the vast majority of individuals (around 95%) who currently fail to take full advantage of tax-preferred saving opportunities through 401(k)s and IRAs. See GRAVELLE & SHVEDOV, *supra* note 24, at 11 (noting that there is "no marginal incentive" for individuals who already save in excess of contribution limits to substitute additional saving for current consumption because "the income effect dominates").

¹⁷³ See *supra* notes 24–25 and accompanying text.

¹⁷⁴ CONGRESSIONAL BUDGET OFFICE, AN ANALYSIS OF THE PRESIDENT'S BUDGETARY PROPOSALS FOR FISCAL YEAR 2006, at 53 (2005) (concluding that "[m]ost new saving would involve small amounts set aside by taxpayers with few taxable assets to shift"). After 2015, the proposals might have a "modestly positive" impact on saving because "more and more taxpayers would run out of assets that could be shifted." *Id.*

¹⁷⁵ See GRAVELLE & SHVEDOV, *supra* note 24, at Summary (summarizing findings that "[n]either theory nor empirical evidence seems to present much of a case for a significant (or even positive) effect on private savings"); see also Daniel Altman, *Accounts Chock-Full, or a Plan Half Empty?*, N.Y. TIMES, Feb. 1, 2003, at C1 (noting that the Administration's savings proposals "may not increase saving" and citing skeptical views of leading economists). Moreover, any increase in private saving might be outweighed by long-term revenue losses, resulting in reduced national saving. See

A significant feature of traditional IRAs that encourages new saving is the immediate deduction for contributions. By denying a deduction for new contributions to LSAs and RSAs and prohibiting new contributions to traditional IRAs, the Administration's proposals may well reduce participation by individuals who would otherwise have been inclined to make contributions to front-loaded accounts.¹⁷⁶ In opting for back-loaded accounts that minimize short-term revenue costs, the Administration appears to have chosen the model that is "least likely to increase private savings and most likely to reduce them."¹⁷⁷ After the tightening of the IRA eligibility requirements in 1986, IRA participation declined even among those who remained eligible to make deductible contributions. Some proponents of lifting income limits on IRAs attribute this decline to diminished promotional activities by financial institutions. They argue that if tax-preferred accounts were universally available, financial institutions would respond with an aggressive marketing campaigns that would ultimately induce increased saving at all income levels.¹⁷⁸ In estimating the likely effects of the Administration's proposals on low- and moderate-income earners, however, speculation about the potential trickle-down effects of commercial advertising is no substitute for rigorous policy analysis. There is a real risk that the proposed new accounts would merely create a costly new tax shelter for high-income earners instead of stimulating increased saving.

In assessing the efficiency gains of consumption-type treatment of savings, a crucial issue involves the treatment of "old" wealth accumulated before the introduction of the new tax system. In contrast to a cash-flow consumption tax, which generally reaches old wealth as well as wages, a yield-exempt consumption tax would not impose any tax burden on old wealth (absent special transition

GRAVELLE & SHVEDOV, *supra* note 24, at 12.

¹⁷⁶ See STAFF OF JOINT COMM. ON TAXATION, *supra* note 78, at 16–17 (noting the argument "that the upfront deduction provides a greater psychological inducement to save, and that the elimination of traditional IRAs may reduce saving by those who would have been able to make deductible contributions").

¹⁷⁷ GRAVELLE & SHVEDOV, *supra* note 24, at 12.

¹⁷⁸ See STAFF OF JOINT COMM. ON TAXATION, *supra* note 78, at 16 n.25; see also Pamela Olson, Ass't. Sec'y. for Tax Policy, Treasury Dep't., Remarks to 2003 ICI/SIA Retirement Savings Conference (June 2, 2003) (stating that eligibility restrictions enacted in 1986 generated "complexity" which "sidelined our financial institutions whose marketing abilities . . . made the IRA popular and successful," and arguing that "[g]etting rid of the restrictions and qualifiers simplifies marketing and participation").

rules).¹⁷⁹ Accordingly, the particular consumption tax model under consideration — cash-flow or yield-exempt — may well affect both the efficiency and the perceived fairness of shifting from an income tax to a consumption tax.¹⁸⁰ Since old wealth tends to be held disproportionately by high-income individuals, a cash-flow consumption tax (without transition relief) may be significantly more progressive than a yield-exempt consumption tax that raises the same amount of revenue. By excluding old wealth from the tax base, a yield-exempt consumption tax would provide a windfall to holders of old wealth and would generally require higher rates on a narrower base consisting solely of wage income. The omission of old wealth from the tax base may also be perceived as unfairly redistributing the tax burden from older to younger generations who tend to have less accumulated wealth.

C. Incentives for Retirement Saving

A pure consumption tax would extend tax-exempt treatment to all savings. As a result, it would no longer be possible to encourage saving for retirement or other special purposes simply by reducing the tax rate. Retirement savings would lose their tax-advantaged status relative to other savings, and it would become increasingly difficult to enforce the restrictions and requirements that are linked to the tax subsidy under current law.¹⁸¹ Most individuals would probably prefer the greater liquidity of unrestricted general purpose savings accounts, and without a strong tax incentive most employers would have little reason to continue to accept the regulatory burdens of maintaining qualified plans. Although the Administration's savings proposals stop

¹⁷⁹ See Weisbach, *supra* note 5, at 609; cf. Bankman & Fried, *supra* note 5, at 540 (noting that a cash-flow consumption tax with no exemption for old wealth “would effectively impose a one-time tax on previously invested capital”).

¹⁸⁰ See Bankman & Fried, *supra* note 5, at 565 (noting that a one-time tax on old wealth accounts for “a significant portion of the efficiency gains” from shifting to a cash-flow consumption tax and “significantly moderates the regressive effect” of switching to such a tax, at least at the top of the income scale); see also Weisbach, *supra* note 5, at 607 (“The transition tax, which falls on all existing wealth, is a substantial portion of the tax base in a consumption tax, and elimination of this huge lump sum tax significantly reduces the efficiency of a consumption tax.”).

¹⁸¹ See Daniel I. Halperin & Michael J. Graetz, *Comprehensive Tax Reform and Employee Benefits: The Case of Employment-Based Pensions and Health Insurance*, in TAX REFORM: IMPLICATIONS FOR ECONOMIC SECURITY AND EMPLOYEE BENEFITS 35, 39 (Dallas L. Salisbury ed., 1997) (noting that “there would be great pressure to remove the restrictions from existing arrangements”).

well short of a full-fledged consumption tax, they would undoubtedly erode the protective features of existing employment-based retirement plans and might ultimately undermine the viability of such plans.¹⁸²

To discourage IRA holders from diverting tax-preferred retirement savings for nonretirement purposes, current law imposes a 10% penalty tax on early withdrawals. The penalty provision applies to Roth IRAs as well as traditional IRAs, but its deterrent effect is much weaker for Roth IRAs due to statutory ordering rules which permit tax-free withdrawals of prior contributions.¹⁸³ As a result, Roth IRAs are more susceptible to leakage than traditional IRAs and are “much closer substitutes for short-term savings not intended for retirement.”¹⁸⁴ Furthermore, although the 10% penalty tax is intended to reinforce the special-purpose nature of retirement savings accounts, it is subject to exceptions which allow individuals to withdraw funds without penalty to purchase a home or pay for higher education costs or medical expenses.¹⁸⁵ These “hardship” exceptions have been criticized for facilitating leakage of retirement savings and undermining the effectiveness of the tax subsidy.¹⁸⁶

The Administration’s proposed new back-loaded accounts would exacerbate the leakage of retirement savings.¹⁸⁷ In essence, an LSA

¹⁸² See Eric M. Engen & William G. Gale, *Comprehensive Tax Reform and the Private Pension System*, in TAX REFORM: IMPLICATIONS FOR ECONOMIC SECURITY AND EMPLOYEE BENEFITS 65, 72 (Dallas L. Salisbury ed., 1997) (noting that “the reduction in saving due to changes in pensions could substantially or completely offset an increase in nonpension saving”); Halperin & Graetz, *supra* note 181, at 39 (noting that erosion of restrictions on qualified retirement accounts might have “a substantial adverse effect on the total level of savings”).

¹⁸³ See I.R.C. §§ 72(t), 408A(a). In the case of a Roth IRA, distributions are treated as nonqualified distributions if they occur before the account holder reaches age 59½ or within five years after the establishment of the account. See I.R.C. § 408A(d). A nonqualified distribution does not trigger income inclusion or the 10% penalty tax until all prior contributions have been recovered tax-free. See I.R.C. § 408A(d)(4)(B) (treating distributions as a return of capital to the extent of all prior contributions). In contrast, early withdrawals from traditional IRAs face “steep tax burdens” because (with certain exceptions) the entire distribution is taxable as income and subject to the 10% penalty tax. GRAVELLE, *supra* note 15, at 4.

¹⁸⁴ GRAVELLE, *supra* note 15, at 5. Early withdrawals can be made more easily and with lighter penalties from a Roth IRA than a traditional IRA. *Id.*

¹⁸⁵ See I.R.C. § 72(t)(2).

¹⁸⁶ See, e.g., Richard L. Kaplan, *The Curious Evolution of Individual Retirement Accounts*, 87 TAX NOTES 671, 683 (May 1, 2000) (arguing that exceptions “are misguided and should be repealed”).

¹⁸⁷ As the chairman of one financial institution observed, “LSAs target the wrong

resembles a Roth IRA with no restrictions on early withdrawal; for individuals over age 58, an RSA would be equivalent to a supplemental LSA. Indeed, to the extent that easy access to funds increases the attractiveness of current consumption relative to long-term saving, LSAs might plausibly be viewed as lifetime *spending* accounts.¹⁸⁸ For low- and moderate-income individuals, LSAs would probably emerge as the primary saving vehicle. For high-income individuals, the preferred investment strategy would be to contribute the maximum allowable amount each year to LSAs and then to contribute additional savings to RSAs. Over time political pressure to relax the restrictions on RSAs might lead to a consolidation of RSAs and LSAs in a new super-LSA with increased contribution limits and no restrictions on early withdrawals.¹⁸⁹

D. Accumulating and Transmitting Wealth

The shift from defined benefit plans to defined contribution plans and IRAs has coincided with a subtle but important shift in the perceived nature and function of retirement savings. To a large extent, pension wealth is no longer viewed as a lifetime stream of annuity payments to meet consumption needs during retirement but rather as a lump sum of bequeathable capital. If offered the choice, most individuals elect to withdraw pension benefits in a single lump sum rather than in the form of a single-life or joint-and-survivor annuity.¹⁹⁰ Some observers speculate that the prevalence of lump sum

kind of savings. Because individual savers can withdraw money for any reason at any time with no penalty, investors will have little incentive to save long-term for financial security at retirement.” PATRICK J. PURCELL, CONGRESSIONAL RESEARCH SERVICE, RETIREMENT SAVINGS ACCOUNTS: PRESIDENT’S BUDGET PROPOSAL FOR FY2005 6 (2004) (quoting chairman of Principal Financial Group). According to another critic, “LSAs will harm the retirement security of American families by siphoning long-term savings into a short-term vehicle where it would be accessed early and often for nonretirement purposes.” *Id.* (quoting the president of the American Council of Life Insurers).

¹⁸⁸ For low- and moderate-income individuals, it seems unrealistic to expect that new saving through LSAs would fully compensate for the reduction in retirement security attributable to reduced coverage and lower benefits under the Administration’s ERSA proposal. See *supra* notes 102–03 and accompanying text.

¹⁸⁹ Alternatively, hardship exceptions similar to those under current law might be grafted onto RSAs, ostensibly to avoid the deterrent effect of early withdrawal restrictions. Cf. Engen & Gale, *supra* note 182, at 71 (noting that lifting restrictions on early withdrawal of retirement savings could lead to a “consumption boom”).

¹⁹⁰ See Alicia Munnell et al., *The Impact of Defined Contribution Plans on Bequests*, in DEATH AND DOLLARS: THE ROLE OF GIFTS AND BEQUESTS IN AMERICA

distributions may lead to increased bequests of pension wealth because individuals who receive lump sum distributions tend to be reluctant to spend them down.¹⁹¹ It is also clear, however, that in assessing their own wealth many individuals have unrealistically optimistic expectations and fail to understand that they will probably consume most of their savings during life, leaving little or nothing to be passed on at death.¹⁹² The Administration's proposals do nothing to guard against risk that some individuals may squander lump sum distributions. Instead, the proposed new accounts would reinforce the notion of retirement savings as a tax-preferred vehicle for accumulating and transmitting wealth.

The concept of retirement savings as bequeathable wealth challenges the basic premise of the existing system of retirement income security. Traditional pension policy encourages retirement saving by means of a powerful tax incentive in the form of tax deferral on contributions and investment earnings. The tax incentive is limited both in amount and in duration, reflecting the goal of ensuring that individuals will have sufficient income to maintain an adequate standard of living during retirement. Accordingly, tax deferral for retirement saving is subject to various restrictions, including a limit on the maximum amount of annual contributions; above this amount, individuals can and should be expected to save on their own. In addition, the minimum distribution rules limit the duration of tax deferral by requiring that annual distributions commence when the employee reaches a specified age.¹⁹³ Indeed, there is a strong

265, 268-72 (Alicia H. Munnell & Annika Sundén eds., 2003) (discussing the shift from annuities to lump sum distributions). Since 2000, defined contribution plans have been allowed to require that employees take distributions in a lump sum. See T.D. 8900, 2000-38 I.R.B. 279 (2000) (amending Treas. Reg. § 1.411(d)-4 A-2(e) to allow qualified defined contribution plans to eliminate optional forms of distribution other than lump sum).

¹⁹¹ See Munnell et al., *supra* note 190, at 272 (discussing the impact of "mental accounts" on spending behavior).

¹⁹² See Olivia S. Mitchell, *Comment*, in *DEATH AND DOLLARS: THE ROLE OF GIFTS AND BEQUESTS IN AMERICA* 312, 313 (Alicia H. Munnell & Annika Sundén eds., 2003) (noting that while 41% of survey respondents expect to leave bequests of at least \$100,000, "people's intentions are greatly at odds with what may be left by the time they die"); Patrick Purcell, *Retirement Savings and Household Wealth in 2000: Analysis of Census Bureau Data*, 29 J. PENSION PLAN. & COMPLIANCE 48, 65 (2003) (noting that in 2000, workers age 55 to 64 had a median retirement account balance of \$33,000, which would provide an annuity of \$236 per month for a person retiring at age 65).

¹⁹³ See I.R.C. §§ 401(a)(9) (requiring minimum distributions), 408(a)(6) (applying rules to traditional IRAs). Under existing law, the required minimum distributions

argument that the distribution rules should be tightened to prohibit tax deferral after the deaths of the employee and his or her surviving spouse, since at that point the underlying purpose of encouraging saving for retirement income has run its course.¹⁹⁴ In any event, it seems incongruous to invoke retirement income security as a justification for subsidizing the accumulation of wealth that will be passed from one generation to the next.¹⁹⁵

In effect, the Administration's proposals represent a thinly veiled assault on the policy of tailoring tax deferral to promote retirement income security. The new back-loaded accounts are modeled on Roth IRAs, which are already exempt from the minimum distribution rules during the holder's lifetime¹⁹⁶ and have accordingly become popular in estate planning circles as a tax-preferred means of transferring wealth at death.¹⁹⁷ Similarly, the proposed RSAs would allow tax-free accumulations of wealth with no required minimum distributions during the holder's lifetime and would therefore function more as a general savings vehicle than a source of retirement income. Allowing penalty-free conversions would encourage a flood of retirement savings out of 401(k)s and traditional IRAs into the new back-loaded accounts, reducing future lifetime withdrawals from front-loaded accounts to a trickle. Not only the minimum distribution rules, but the viability of front-loaded accounts themselves, would come under increased strain.

More generally, if the Administration's proposals are viewed as the harbinger of a broader shift toward consumption-type taxation, they raise serious distributional concerns. One of the most powerful arguments in favor of a consumption tax is that, unlike an accretion-

may be based on actuarial life expectancies of the employee and a spouse or other designated beneficiary, thereby allowing tax deferral for a portion of the account beyond the employee's death. See I.R.C. § 401(a)(9)(A), (B); Treas. Reg. § 1.401(a)(9)-5 (2004); see also Zelinsky, *supra* note 12, at 517 (describing existing minimum distribution rules as a "minimal impediment to the testamentary transmission of individual account wealth").

¹⁹⁴ See Kaplan, *supra* note 186, at 683.

¹⁹⁵ See Jay A. Soled & Bruce A. Wolk, *The Minimum Distribution Rules and Their Critical Role in Controlling the Floodgates of Qualified Plan Wealth*, 2000 BYU L. REV. 587, 616 (2000).

¹⁹⁶ See I.R.C. § 408A(c)(5) (exempting Roth IRAs from minimum distribution rules).

¹⁹⁷ See Kaplan, *supra* note 186, at 680 (noting that Roth IRAs are "regularly trumpeted as a planning opportunity of tremendous importance"); Soled & Wolk, *supra* note 195, at 596 (describing Roth IRAs as "a new favorite among tax planners and their clients").

type income tax, it preserves tax neutrality between immediate and deferred consumption.¹⁹⁸ The vast majority of individuals consume all their earnings (and earn all that they consume) over a lifetime without making or receiving large net wealth transfers; for them, lifetime saving is essentially equivalent to deferred consumption.¹⁹⁹ Moreover, the cash-flow treatment of retirement savings under current law allows such individuals to smooth their lifetime consumption and largely avoid the extra burden of the income tax on saved income.²⁰⁰ Although a cash-flow model is fully compatible with a progressive rate structure, the yield-exempt model incorporated in the Administration's proposals is not. Indeed, the back-loaded accounts proposed by the Administration turn the consumption-smoothing rationale on its head in order to reward a small but extremely affluent group of individuals who accumulate more wealth than they consume over a lifetime.²⁰¹

Consumption-type taxation is sometimes perceived as inherently less progressive than accretion-type income taxation because it shifts the tax burden from upper-income savers to lower-income nonsavers.²⁰² The distributional consequences of switching to a consumption tax are likely to depend, however, on the nature of investment assets held by various groups and the treatment of returns to capital and labor under the particular form of consumption tax. Instead of exempting all returns to capital, a cash-flow model would continue to reach inframarginal returns to capital as well as disguised

¹⁹⁸ See Andrews, *supra* note 5, at 1167 (maintaining that the "most sophisticated argument" for a cash-flow consumption tax is that it "ultimately imposes a more uniform burden on consumption, whenever it may occur" than does an income tax); McCaffery, *supra* note 5, at 811.

¹⁹⁹ See Karen C. Burke & Grayson M.P. McCouch, *A Consumption Tax on Gifts and Bequests?*, 17 VA. TAX REV. 657, 668–69 (1998).

²⁰⁰ By incorporating consumption-type features for special-purpose savings vehicles, the existing hybrid system targets those savings for tax-favored treatment based on their intended use. See McCaffery, *supra* note 5, at 816 (arguing that "ordinary savings" that are used to smooth out lifetime consumption are appropriately taxed less heavily than "yield to capital" that enhances lifetime standards of living).

²⁰¹ The cash-flow treatment of retirement savings under current law benefits individuals whose marginal tax rates decline during retirement, but the Administration's yield-exempt model would have the perverse effect of imposing a tax penalty on such individuals. See *supra* notes 48–49 and accompanying text.

²⁰² For an argument that the overall welfare gains from implementing a consumption tax might outweigh any detriment to nonsavers, see Bankman & Weisbach, *supra* note 39, at 63–64.

returns to labor.²⁰³ If such returns are disproportionately concentrated at the top of the income scale, a cash-flow consumption tax may be more progressive than might initially appear.²⁰⁴ Nevertheless, because unconsumed savings would remain outside the tax base, it might be difficult to impose sufficiently high marginal rates to achieve the desired level of progressivity.²⁰⁵ Indeed, it is precisely the problem of indefinite tax deferral through intergenerational wealth transfers that has prompted interest in retaining a robust wealth transfer tax as a “logical complement” to a cash-flow consumption tax.²⁰⁶

Although recent academic literature emphasizes that a cash-flow consumption tax could be made as progressive as the existing income tax,²⁰⁷ the yield-exempt model adopted by the Administration in its proposals suggests a markedly different agenda. Yield exemption would categorically exclude all returns (including inframarginal returns) to capital from the tax base and thereby exacerbate existing inequalities in the distribution of wealth. Moreover, because the yield-exempt model assumes a constant flat tax rate, it stands in fundamental contradiction to the notion of implementing a progressive consumption tax. To the extent that the revenue costs of the Administration’s proposals must ultimately be financed from across-the-board tax increases, the end result will be a clear gain to high earners (who are in the best position to shift existing savings to new tax-preferred vehicles) at the expense of low and moderate earners (who are least able to do so). While it may be tempting for the Administration to portray its proposals as a broad-based savings incentive or part of a program of fundamental tax reform, in reality they amount to little more than a disguised tax cut for high-income individuals.

²⁰³ See *supra* note 40 and accompanying text.

²⁰⁴ See Bankman & Fried, *supra* note 5, at 546; William M. Gentry & R. Glenn Hubbard, *Distributional Implications of Introducing a Broad-Based Consumption Tax*, 11 TAX POL’Y & ECON. 1, 38 (James M. Poterba ed., 1997); see also Shaviro, *supra* note 39, at 103 (noting that a cash-flow consumption tax can reach inframarginal returns, which form the “real foundations” of large personal fortunes).

²⁰⁵ See Shaviro, *supra* note 39, at 113. An income tax might nevertheless be viewed as “more likely to be progressive in practice” than a consumption tax. *Id.*

²⁰⁶ BLUEPRINTS, *supra* note 4, at 125; see also Andrews, *supra* note 62, at 956–58; Burke & McCouch, *supra* note 199, at 699–706.

²⁰⁷ See Shaviro, *supra* note 39, at 92 (referring to a “new consensus favoring progressive consumption taxation”); see also Weisbach, *supra* note 39, at 24–25 (arguing that the choice between income and consumption taxes should turn on administrative considerations because both taxes are essentially equivalent in terms of distributional, efficiency, and fairness effects).

VI. CONCLUSION

In the long run, the Administration's savings proposals would lose enormous amounts of revenue and produce perverse distributional consequences. The overall revenue cost would temporarily be masked by an influx of taxable new contributions and conversions to the new back-loaded savings accounts, but over time the revenue costs would increase dramatically as the stream of taxable withdrawals from front-loaded savings accounts slowed to a trickle and eventually dried up. The regressive effects of the back-loaded accounts would become even more pronounced over time as increasingly large flows of capital income were siphoned off from the tax base. Although ostensibly intended to promote savings by individuals at all income levels, the Administration's proposals would channel benefits primarily to those at the top of the income scale who could shift substantial amounts from taxable vehicles to the new back-loaded accounts. In light of experience with universal IRAs in the early 1980s as well as the failure to address the problem of deductible interest expense, the proposed back-loaded accounts appear to be conceived less as a broad-based savings incentive than as a tax shelter for high-income individuals.

In terms of retirement security policy, the Administration's trickle-down policy of expanding tax-preferred saving opportunities for high-income individuals seems seriously misguided. As indicated by the initial reaction from pension plan sponsors and administrators, the Administration initially formulated its proposals with little consideration of the implications for qualified plans. The Administration has failed to acknowledge the inherent tension between promoting individual saving through unrestricted tax-preferred accounts and preserving the existing system of employer-based retirement plans with their delicate balance of tax incentives and regulatory restrictions. Even with a substantial tax subsidy for individual savings accounts, however, it may be unrealistic to expect many low and moderate earners to save adequately on their own. If employer-based retirement plans are further weakened, such individuals will become even more dependent on Social Security benefits just as significant benefit cuts appear increasingly likely. Despite the Administration's unwillingness to link its savings proposals explicitly with partial privatization of Social Security, both initiatives raise similar distributional and fiscal concerns which should be addressed within the framework of a coherent national retirement security policy.

Even proponents of moving further in the direction of a

consumption tax should balk at the Administration's proposed back-loaded savings accounts. It may be reasonable, on grounds of administrative convenience, to adopt a yield-exempt approach to deal with specific problems (e.g., consumer durables and borrowing) within a cash-flow consumption tax. Nevertheless, the theoretical equivalence between the cash-flow and yield-exempt models is highly stylized and cannot accommodate realistic assumptions involving graduated tax rates or rate changes over time. To the extent that progressivity is desired in designing a consumption tax, only a cash-flow model is capable of reaching inframarginal returns to capital as well as disguised returns to labor. While the Administration's proposed back-loaded savings accounts appear to be driven largely by short-term budget considerations, they may also reflect a desire to introduce an especially regressive form of flat-rate consumption tax that falls exclusively on labor income. By granting a permanent tax exemption for capital income without making any of the necessary painful tradeoffs, the Administration's proposals pose a threat of lasting damage both to the existing hybrid tax system and to prospects for fundamental reform.