Taxing Ourselves

A Citizen's Guide to the Debate over Taxes

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able to *step up* the basis of inherited assets to the value at the date of the donor's death so that any unrealized capital gains accumulated to that point escape income taxation forever. This provides an effective avenue for avoiding income taxes. In fact, the income arising from unrealized capital gains can effectively be consumed during the lifetime of the asset's owner without the owner ever paying tax on it, and the owner can even reduce other taxes in the process. For example, someone could hold an appreciated asset until his or her death and thus never pay tax on the gains, borrow through a home equity loan and use the proceeds to consume, and deduct the interest payments on the loan from the income tax. When the heir sells the asset (with no tax) after the asset owner's death, he or she can use the appreciated asset to pay off the debt.

One reform option would tax unrealized capital gains at death, which would greatly reduce the lock-in effect and avoidance opportunities. Another option would require heirs to carry over the donor's basis on inherited assets, so capital gains that had accumulated prior to the donor's death would eventually be taxed whenever the heirs sell the assets.[18]

As discussed earlier in this chapter, indexing the income tax for inflation could limit inadvertent overtaxation of capital gains but would be difficult to implement. However, indexing capital gains but not other capital income or deductions is flawed. Taxing capital gains at a rate that is below the rate levied on other income is often defended as a means of reducing the lock-in effect, encouraging risk-taking, and reducing double taxation. But applying differential rates on different types of income leads to all the problems mentioned above. It is a blunt instrument for attacking double taxation because there are many appreciating assets besides corporate stock.

For all these reasons, the tax treatment of capital gains under an income tax involves a conceptually and practically unsatisfying compromise between (1) the desire to tax all income uniformly to minimize distortions and complexity and (2) the difficulty of implementing a truly uniform regime. Whatever uneasy compromise is reached, one caveat about changes in capital gains taxation applies. Expanding the preferential treatment of existing accrued capital gains provides no incentive to buy new stock or new real estate; instead, it just provides a windfall gain related to past decisions. Any new preferences should, if feasible, be restricted to new gains.

Savings Incentives in the Income Tax

As we have emphasized throughout the book, the U.S. federal income tax is in fact an awkward hybrid of aspects of an income and a consumption tax. This is partly because a variety of provisions—including IRAs, Keogh plans, 401(k) and 403(b) pension plans, and numerous other tax-preferred pension plans and saving accounts—reduce the tax on the return to savings. In recent years, these kinds of plans have been expanded considerably. Their popularity partly reflects a growing enthusiasm for consumption taxation, perhaps combined with a skeptical appraisal of the likelihood of fundamental tax reform, so that tax-preferred savings accounts are seen as a feasible way to move toward consumption taxation. However, for reasons we discuss below, most recent proposals to expand these sorts of accounts would be highly imperfect substitutes for a revenue-neutral switch to a consistently designed consumption tax.

These plans have three essential features. First, the ordinary return on contributions to such plans is exempt from tax as it would be under a consumption tax. In most cases, this is accomplished by excluding employer and employee contributions from tax; allowing interest, dividends, and other returns on the assets in the account to accumulate tax-free; and then taxing withdrawals from the accounts. In some cases, such as Roth IRAs, contributions cannot be deducted from taxable income, but no tax is charged on either the assets' returns or on withdrawals, which also effectively exempts the return to saving from tax. Second, maximum limits are imposed in various ways on the amount of contributions that can receive favorable tax treatment. For example, in 2007, annual individual contributions to IRAs were limited to $4,000 for those under age 50 and $5,000 for those age 50 and over. Third, in some cases, eligibility is limited to people with incomes below a certain level. For example, eligibility for conventional IRAs was phased out for married couples with AGI between $80,000 and $100,000 in 2007, unless neither spouse has access to an employer-provided pension plan. Eligibility for Roth IRAs was phased out for married couples with AGI between $150,000 and $160,000.

Advocates of tax-preferred saving plans argue that they provide many people with the opportunity to attain the economic advantages of a consumption tax—no tax on the return to saving—but that they do so in a "limited" way that, compared to abandoning completely all

taxation of returns to saving, costs less government revenue and restricts the size of the tax advantage obtained by very high-income people with large amounts of capital income. However, in some cases this compromise between income and consumption taxation essentially provides the worst of both worlds—losing revenue without actually affecting the incentive to save or increasing saving.

To see the problem, consider the implications of contribution limits—for example, the current $4,000 limit on contributions to IRAs for those under age 50. This limit makes no difference to taxpayers who would not in any event want or be able to contribute as much as $4,000 in a year, so for them an IRA could provide an incentive to save more than they otherwise would. For those taxpayers who would otherwise save more than that, however, and don't mind subjecting their funds to a penalty for early withdrawal, the IRA deduction is a nice gift, but *at the margin* it will have absolutely no influence on how much they save. If you're trying to decide whether to save $5,000 or $6,000, the IRA program is immaterial because you've already maxed out on your contribution. Thus, the IRA provides a reward for saving you would have done anyway rather than an inducement to do more saving. In fact, because the tax reduction you obtain from it adds to your disposable income, having an IRA should therefore increase your consumption, which *reduces* rather than increases national saving. Moreover, reducing taxes without improving incentives is inefficient because it means we have to forgo some other equal tax reduction that would have improved incentives. This is a major reason why, in the Tax Reform Act of 1986, eligibility for deductible IRAs was restricted mainly to people with incomes low enough that they would have been unlikely to save more than the contribution limits anyway.

The other key problem is that, while IRAs and other tax-favored saving plans are intended to encourage saving, they actually subsidize deposits into an account, and making a deposit is not at all the same as saving. As a result, people who have assets outside of these accounts or an ability to borrow can use IRAs and pensions to reduce their taxes without doing any new saving at all. To see how this works, consider an individual who over the years has saved up $12,000, which is now invested in stocks and bonds. If she takes $4,000 of this and deposits it into a traditional IRA account, she gets the tax benefits even though her saving has not increased or decreased; it's just been moved from one account to another. Of course, if she deposits $4,000 every year into an IRA account and does no more new saving, after three years she

will have transferred all of her wealth into the IRA account. At that time, she may face the decision that the IRA is designed to alter: to get any further tax benefit, she might have to do some new saving. But even then, she could avoid actually doing any net saving by increasing her borrowing by the same amount that that she contributes to her account (or equivalently, reducing the rate at which she pays back an outstanding loan). The taxpayer makes money on this strategy as long as the interest on the loan is deductible from tax, as it would be on a home mortgage, for example.

One reason that current savings incentives subsidize deposits rather than saving itself is that deposits are a lot easier to measure. Accurately measuring saving would probably require every taxpayer to keep track of all additions to assets, subtract out all withdrawals, and record and report to the IRS all borrowing. As discussed earlier, this procedure would substantially complicate the tax system.

Some basic facts about IRAs and pensions can help illustrate the nature and extent of the problem. In 2002, when the IRA contribution limit was $3,000 for those under 50 and $3,500 for those 50 and over, 42 percent of people who contributed to either a traditional or Roth IRA contributed exactly the maximum amount for their age group.[19] For many IRA participants, therefore, the IRA probably provided a windfall rather than an incentive to save.[20] Moreover, the vast majority of people *eligible* to contribute to a deductible IRA simply didn't contribute anything. In 2002, only 10.3 percent of households eligible to contribute to tax-deductible IRAs actually did so.[21]

The story for pensions is a bit more complicated. In 2004, among all families headed by someone younger than age 65, just over half (50.5 percent) had at least one member participating in an employer-provided pension plan, 38.5 percent had a defined-contribution plan such as a 401(k), and 24.2 percent had a defined-benefit plan, with some overlap between the two groups.[22] Defined-benefit plans have essentially no impact on individuals' incentive to save at the margin because individual workers have no control over how much is saved in these plans on their behalf. Most participants in defined-contribution plans do have the opportunity to increase their tax-deductible contributions, so that these plans do increase the incentive to save (or at least to contribute to the account). For example, a study by the Congressional Research Service found that in 2003, only 3 percent of defined-contribution pension-plan participants were making employee contributions of $1,000 per month, which corresponded to the annual employee tax-

deductible contribution limit of $12,000 that was then applicable. Thus, the vast majority could have contributed more but did not.[23]

The bottom line is that, between IRAs and defined-contribution pension plans, most people probably have the opportunity to do additional retirement saving that receives consumption tax treatment, although apparently many do not take advantage of this opportunity. On the other hand, a substantial fraction of the people who actually participate in IRAs are making the maximum allowable contribution. For these people, the special tax treatment applied to such plans generally provides a windfall rather than an incentive to save.

Some economists maintain that retirement saving accounts provide an important institutional commitment device that helps people overcome their natural tendency not to do the retirement saving that they ultimately know is good for them. Traditional economic models assume that people are forward-looking, well informed, and fully rational with regard to their saving (and all other) behavior. But increasingly well-documented evidence shows that many people suffer from problems like temptation to spend cash in hand today, have a poor understanding of basic principles of financial planning, and put little thought into saving decisions. For example, recent research suggests that employee decisions regarding pension saving often follow the "path of least resistance," accepting whatever default plan the employer provides. By contrast, a model of fully rational saving behavior would tend to predict that employees would take advantage of options provided by these plans to finely tailor the amount and kind of saving they do to match their tastes, circumstances, and incentives. This suggests that institutions like employer-provided pensions may have important impacts on saving independent of their effects on incentives.[24] Thus, tax preferences that create an incentive for employers to operate such plans might increase saving. But switching all the way to a consumption tax could conceivably weaken the employer-provided pension system, as the tax advantage to setting up such plans with an employer would disappear. As a result, this theory suggests that such a reform might actually reduce saving.

Many economists now take seriously the idea that certain people are unable to commit to save as much as they "should" and that the problem is particularly severe for low- and moderate-income people, as both the pressures to spend today and the consequences of undersaving are the worst for this group.[25] Moreover, low- and moderate-income workers are also much less likely to be enrolled in a pension

plan and thus do not benefit from private pensions' role as a commitment device. This could support a case for going beyond removing distortions and perhaps subsidizing saving among low-income people, as well as creating institutions that do a better job of getting low- and moderate-income people in the habit of saving. The 2001 tax act took a step in this direction by creating a tax credit of up to 50 percent for contributions to retirement savings accounts such as IRAs by low-income people, with a maximum annual credit of $1,000 for an individual or $2,000 for a couple.[26]

Increasing contribution limits reduces the number of people who are constrained by contribution limits, and for those people the plans might now provide an incentive to do additional saving rather than serving *solely* as a windfall.[27] On the other hand, it would increase the size of the windfall going to those who remain above the limits. Extending eligibility for contribution-limited saving accounts like IRAs to higher-income people might improve incentives to save for some of them, but for many it would just provide an opportunity to shift assets from taxable to tax-free accounts. The vast majority of people, who are already contributing less than the limits, would be unaffected, and most of the benefits of the changes would go to upper-income people.

While expanding tax-deferred saving accounts is sometimes promoted as a step in the direction of a consumption tax, this approach is in fact fundamentally different from switching to a consumption tax. As explained in chapter 6, moving to a consumption tax would impose a tax on preexisting wealth as it is consumed, and much of the economic benefit of such a reform comes from that transitional tax. In contrast, expanding tax-deferred saving accounts enables people to avoid taxes on the returns to their preexisting assets by moving those assets into the accounts, without imposing any transitional burden. As such, this approach is more like adopting a wage tax. Moreover, this approach retains elements of the income tax that are inconsistent with a consumption tax, such as deductibility of interest, which exacerbates inefficient tax-sheltering opportunities and continues to subsidize immediate consumption relative to saving.

All in all, the array of tax-preferred saving plans is an inefficient way to reduce the disincentives to save under an income tax. If people are presumed to systematically undersave—and this is by no means obvious—then other policies, such as providing refundable credits for low-income savers and expanding their participation in pension plans,

are worth considering. Finally, if private pensions are the key to more saving, the tax incentive for employers may be the most important incentive of all. The fact that, under a consumption tax system, employer-provided pensions might be cut back suggests that private saving might actually decline.

The Estate Tax

Estate taxation serves purposes similar to income taxation, and the arguments for and against each are closely related. The modern estate tax was enacted in 1916, just three years after the income tax, but until recently received little attention in the political arena. However, while thus far talk of abolishing the income tax has been just that, talk, a law that eventually abolishes the estate-tax has already been passed. The 2001 tax legislation has scheduled a gradual increase in the estate tax exemption and a reduction in rates through 2009, eliminates the tax in 2010, and then restores the tax to its pre-2001 condition in 2011. This bizarre situation guarantees that the issue will be revisited in the near future.

Why have an estate tax? The main argument made by proponents of the estate tax is that it is an important component of a progressive tax system. In 2005, there were only 20,250 taxable estate tax returns filed, which represented approximately the richest 0.9 percent of adult deaths in the United States.[28] Most of these returns represented deaths from the year 2004, when the estate tax exemption was $1.5 million. The exemption has been raised to $2 million in 2007, and it is scheduled to rise to $3.5 million by 2009. So as time goes by, the estate tax will apply to a thinner and thinner slice of only the very wealthiest segment of society. In 2005, the 3,600 taxable estate tax returns filed which had gross estates over $5 million, representing approximately the richest 0.15 percent of adult decedents in the United States), accounted for 73 percent of the $21.7 billion in federal estate tax revenues.[29] Given the recent dramatic rise in wealth and incomes at the top of the distribution documented in chapter 3, the amount of revenue that would be raised by a tax imposed only on the wealthiest could be expected to grow significantly in the future. Above the exempt level, a tax rate of 45 percent applies in 2007, although unlimited deductions are allowed for gifts to a spouse or to charity. These features make the estate tax by far the most progressive component of the tax system.

Although estate and gift tax revenues collected in 2005 represent only about 1 percent of federal tax revenues, they represent a nontrivial portion of the tax burden placed on upper-income people.[30] For instance, taxpayers with adjusted gross income above $200,000 represented the top 2.6 percent of income tax returns filed ranked by income, and the personal income tax raised $472 billion in revenue from that group in 2005. Estate and gift tax liability was equal to 5.3 percent of that.[31]

The cases for and against a progressive tax system are addressed in chapter 3. But if the goal of the estate tax is to achieve progressivity, this raises the question of why an estate tax is preferable to levying somewhat higher income tax rates on upper-income people. One argument for using an estate tax as a supplement to income taxation is that our income tax fails to tax a considerable portion of income, which may make it difficult to achieve the degree of vertical and horizontal equity that society might desire. For instance, estimates by economists James Poterba of MIT and Scott Weisbenner of the Federal Reserve Board of Governors suggest that 42 percent of the value of estates over $5 million represents unrealized capital gains, income that would never be taxed by the personal income tax.[32] Taxing estates is also an administratively convenient way of raising tax revenue from the very wealthy. Even in the absence of taxes, estates are required to go through a detailed legal process that reveals much information about the decedent's economic resources that would be difficult to obtain in any other way.

Horizontal equity arguments are invoked by both supporters and opponents of the estate tax. Supporters of the estate tax contend that people who receive very large inheritances start off unfairly with a big unearned advantage in life. Opponents of the tax focus on the donor rather than the donee, questioning whether people who prefer to "spend" their money on their children via bequests should be penalized relative to people who prefer to spend their money while they are alive. Between two people who earn the same incomes over their lives, the one who saves more of it will face a higher estate tax burden (if they are sufficiently wealthy to face the tax, that is).

The estate tax is also defended on the grounds that it creates a strong incentive for the wealthy to give to charity, both during life and at death. Because charitable bequests are fully deductible from the estate tax, someone who faces a 45 percent marginal estate tax rate can leave $1 to charity while sacrificing only 55 cents of bequests to heirs. Thus,