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The Family Savings Account: A Practical Tax Incentive to Stimulate Personal Savings Rates

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THE FAMILY SAVINGS ACCOUNT: A PRACTICAL TAX INCENTIVE TO STIMULATE PERSONAL SAVINGS RATES

I. INTRODUCTION

This article will discuss a proposal before Congress to allow Americans to create tax-deferred family savings accounts of up to $2,500 per year, provided that the taxpayers agree to keep the savings in the account for seven years.

A. The Need to Stimulate Personal Savings Rates

President Bush has made increasing the personal savings rate a top priority. As one commentator has stated, "conventional wisdom holds that Americans don't save and collectively spend too much on [personal items]." With the U.S. budget deficit reaching record levels, and American productivity rates continuing to lag behind the productivity rates of other Western countries, the incentive to increase personal savings rates has become a far more pressing concern. The President argues that countries like Germany and Japan dominate the world market because they have a large personal savings rate. Consequently, President Bush has suggested several in-

3. Current statistics from the Department of Commerce indicate that the United States
come tax initiatives to increase the American personal savings rate.

Macroeconomists agree that the President could benefit the economy by effecting an increase in the personal savings rate. Rudiger Dornbusch and Stanley Fischer, economists at the Massachusetts Institute of Technology, contend that the economy is aided both in the short run and the long run by an increase in the savings rate. In the short run, an increase in the personal savings rate raises the growth rate of the nation's output. Although the growth rate of output stabilizes over time, according to the Dornbusch/Fischer model, total output and capital per head permanently rises. As total output climbs the unemployment rate decreases, and the country becomes more prosperous.

Macroeconomics aside, there is also a perceived social imperative to encourage the savings rate, to assist in the realization of personal goals for Americans. For example, due to general inflation during the post-war period, many young families can no longer afford a house in major metropolitan areas. A recent study in Orange County, California, a suburb of Los Angeles, indicated that in that area only 11% of all families could afford to buy a house based upon their current salaries.

Equally significant is the high cost of tuition at private colleges. A recent Harvard study suggested that in order to effectively finance a child's education through a four-year private school, at prevailing interest rates, parents should save $313 per month from the birth of the child through the time the child enters college. Since the pov-

Personal Savings Rate for 1987 was 4.4%. By contrast, in West Germany the rate was 12.6%, in Japan it was 15.2%, and in Portugal it was 24%. U.S. Dept. of Commerce Statistical Abstract.


5. Id. If savings matches the so-called "investment requirement," i.e., that amount of spending necessary to maintain the stock of capital, and then savings increases, output will correspondingly increase until investment requirements rise to meet the savings increases. At that point, the growth rate of output will no longer increase. But see E.F. DENISON, The Sources of Economic Growth in the United States, Supp. Paper No. 13, Comm. for Econ. Dev. (1962), which states that a 25% increase in savings would only increase the growth rate of output by .1% each year.


7. The theory assumes that savings equals investment, which may not be true; the economy is certainly not improved by individuals saving by placing money in their pillowcases. P. SAMUELSON, ECONOMICS (1989). However, since the Family Savings Account requires that individuals place their savings in a qualified bank fund (see infra p. 114), the savings in the Family Savings Account will indeed be invested.


9. The study assumed the child would enter college at age 18, and that interest rates
The family savings account of a family of four in this country is only $976 per month, and one-fifth of all children are in families below the poverty level, it is unrealistic to assume that the poor will be able to save close to 30% of their income for future college tuition payments.

Responding to the problem of a low savings rate, in 1990 the President proposed the Savings and Economic Growth Act [SEGA], an assortment of tax incentives to increase savings. Although Congress failed to ratify the SEGA, several of the individual tax incentives have been individually reproposed in 1991.

This note will discuss the Family Savings Account, one of these proposed tax initiatives designed to stimulate the personal savings rate. It is this author's belief that the Family Savings Account provides an effective and attractive approach to solving the problem of low savings rates. Furthermore, it is well worth its cost.

B. The Tax Code: A Cost-Benefit Analysis

Our current federal tax system as mandated in the Internal Revenue Code has three major purposes. The first and most palpable reason for the income tax is to provide a method for Congress to raise revenue. Indeed, section 61, the "backbone" of the code, includes "[a]ll income from whatever source derived. . ." in its calculation of gross income. This definition gives Congress considerable

would average 9% per year for the period. Actually, since the convention suggests conservative investments for those saving for college, and money market accounts are currently paying below 8%, even this figure may be low. Harvard Convention on Financing Children's Education (unpublished notes available from the author).

10. Colleges themselves have since the early 1980's been lobbying for the government to create incentives for savings.

11. H.R. 3972, 101st Cong., 2nd Sess. (1990); S. 2071, 101st Cong., 2nd Sess. (1990). The SEGA has three sections. The first section (§ 101) reduces the tax on capital gains held over one year for noncorporate taxpayers. The second section (§ 201) expands the IRA to allow premature withdrawal without penalty for first-time purchasers of a principal residence. The third section (§ 202) provides the details of the Family Savings Account.

12. Probably the most controversial provisions in the SEGA were the sections that reduced the tax on income from capital gains to 22%. See H.R. 3972, 101st Cong., 2nd Sess. (1990); S. 2071, 101st Cong., 2nd Sess. (1990). The capital gains provisions received the most dissent in congressional debate and may well have been responsible for the bill's fate. The 1991 version, H.R. 1291, 102nd Cong., 1st Sess. (1991), retained the expansion of the IRA as well as the family savings account, but does not contain the capital gains provisions.

13. SEGA § 292.

14. Title 26 of the United States Code is the Internal Revenue Code. [hereinafter the code].

15. The sixteenth amendment gives Congress the right to collect tax on income without regard to any census. U.S. Const. amend. XVI.
flexibility in the collection of taxes. Further enhancing this flexibility are the so-called "double regimes" of the code, the corporate and personal tax levels, which allow the government to tax a corporation's profits, and tax the same funds again should the funds be distributed to the shareholder through a dividend.

According to some scholars, the only purpose in levying taxes should be revenue raising. The code, however, unquestionably reflects another purpose, namely what Professor Russell Osgood has bluntly called "the subsidization of certain taxpayer activities." By allowing deductions or credits against the tax for certain activities, or by granting a specific statutory exclusion to gross income, Congress is able to encourage certain activities and discourage others. Typically, Congress has elected to favor subsidization for two reasons—to bolster the economy and to effect certain socially desirable ends. Examples of the former include ordinary and necessary business expense deductions and nonrecognition provisions when a sole proprietor exchanges his assets for stock in a closely held corporation. Examples of the latter include deductions for charitable contributions and nonrecognition provisions for the rollover of gain on the sale of a principal residence.

Professor Osgood suggests that the third theme of the code is the regulation of certain areas of national concern. For example, if

17. See 26 U.S.C. § 1 (1991); 26 U.S.C. § 11 (1991). There have, of course, been several suggestions in recent years for so-called integration of the income tax, the combining of corporate and individual tax regimes. The major 1986 tax revision, however, which not only retained the double regime but for the first time in history raised the corporate tax rate above the individual tax rate, seems to indicate that the current structure will be with us for quite some time. R. Doernberg, H. Abrams, B. Bittker, & L. Stone, Federal Income Taxation of Corporations and Partnerships (1987). For a detailed, though pre-1986 tax reform discussion of the possibility of tax integration, see Warren, The Relation and Integration of the Individual and Corporate Income Taxes, 94 Harv. L. Rev. 717 (1981).
18. See, e.g., Clotfelter, Tax-Induced Distortions in the Voluntary Sector, 39 Case W. Res. 663 (1989), which essentially argues that incentives for charitable giving create massive disparities in the economy; see also Vickrey, Agenda for Progressive Taxation 131 (1972), which argues all tax subsidies have a "plutocratic bias."
20. See Osgood, supra note 19, at 526.
25. Osgood, supra note 19, at 526.
a taxpayer makes a charitable contribution, he will receive a tax deduction. This is a subsidization. But the code in other areas prescribes such concrete and specific rules for a taxpayer who wishes the deduction that, in effect, the code has regulated that behavior. 26

A good example of this phenomena is in the area of employee fringe benefits. Section 132, enacted in 1986, has strict non-discrimination provisions which only permit highly-compensated employees to take advantage of the exclusions of fringe benefits from gross income if the lower paid employees also receive the benefits. 27 Such rules, Osgood suggests, are too detailed to merely represent a subsidization—what Congress is actually accomplishing is the regulation of the fringe benefits field. 28 The principal advantage of such an approach is that it offers a "carrot" to the taxpayer who follows the regulation; this better comports with a free market system than do coercive regulations.

Osgood suggests that Congress should openly admit that the code has evolved with these three purposes, and analyze prospective tax incentives from a cost-benefit standpoint. 29 Specifically, then, Congress should ask whether the economic or moral benefit which will be gained by tax incentive (subsidy or regulation) will outweigh its revenue cost. 30

This note will examine the Family Savings Account through the cost-benefit perspective suggested by Professor Osgood. The first section will suggest that the Family Savings Account, though a recently developed concept, is actually a modest step in a long line of proposals which would move from a tax on all income earned to a tax on only income which is consumed. The next section will discuss the Individual Retirement Account ("IRA"), another program designed to expand savings which has existed in the tax law since 1974. Although some congressmen cite the IRA program as evidence that the Family Savings Account will not stimulate savings, this article will suggest that several of the problems encountered with the IRA are avoided by the current construction of the Family Savings Account.

After discussing the putative benefits of such a plan, this article turns in the fourth section to the various estimates of what the plan

26. Id.
28. Osgood, supra note 19, at 528.
29. Id. at 530-32.
30. Id.
will cost. Both the White House and the Joint Committee on Taxation in Congress have issued reports on projected costs; the reports differ significantly.

II. **The Family Savings Account: An Attempt to Rectify Distortions in the Definition of Taxable Income Which Discourage Savings**

Although the definition of income under the code may seem simple to the layman, the question of what should constitute income for the purposes of the income tax has been an object of contention for the code since its inception. However, there are certain generally perceived goals which the tax code attempts to attain. First, the code should not discriminate between how the income is earned. For example, a person who earns a dollar through his wages should be treated no differently than one who earns a dollar from an investment. Second, the code should tax individuals upon their ability to pay—in general, those who have more should actually pay more. Tax analysts appear to refer to this aspect as "fundamental fairness." Finally, the code must be as practical and implementable as possible.

Essentially, there are two different ways that scholars have advanced to define income under the code. The first is a definition of income based upon "accretion." An accretion model defines income based upon the real increase in the individual's net worth. Thus it taxes both income which is spent and income which is saved, since either increases that individual's net worth. The model which the current code most closely resembles, of course, is the accretion model.

However, Professor Andrews, in a seminal article, suggested that an income tax system which defined income by reference to consumption would be more efficient, more fundamentally fair, and

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31. The Supreme Court has in several landmark cases dealt with the question of how to define gross income. See, e.g., Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).
32. The reason for this is primarily economic. We wish to promote an efficient economy by encouraging individuals to work in the most productive way possible.
34. This definition of income was originally termed an accumulation model. See H. Simons, *Personal Income Taxation* (1938). However, the term "accretion" was employed both by Professors Andrews and Warren and will also be employed here.
35. *Id.* at 50.
more administratively practical than our current system.\textsuperscript{36} He analyzed the current system, and concluded that it creates great distortions and inequities where individuals with high standards of living pay limited taxes and individuals with lower standards of living pay much higher taxes.\textsuperscript{37}

The distortions arise out of the code itself. One example that Andrews uses is the different treatment between savings out of ordinary income,\textsuperscript{38} and wealth in property already owned. An individual who places money in a bank account and earns interest is taxed on the interest annually as it is earned.\textsuperscript{39} On the other hand, an individual who buys an income-producing property will increase his net worth continually, but will only pay taxes as that wealth is realized.\textsuperscript{40} This discrepancy, Andrews contends, is only compounded by the nonrecognition provisions in the code which further defer taxation on the income.\textsuperscript{41}

These differences in the timing of the taxation, Andrews asserted, are crucial.\textsuperscript{42} If the individual manages to hold on to the property until his death, his devisees never pay any income tax on appreciation.\textsuperscript{43} But even in absence of the stepped-up basis at death, deferral lowers the tax burden because of the time value of money.\textsuperscript{44} Quite simply, a taxpayer is always getting a break if he can defer his taxes and get the use of that money for as long as possible. Andrews’ point recalls John Stuart Mill, the nineteenth century economist,

\textsuperscript{36} Andrews, \textit{supra} note 33, at 1117.

\textsuperscript{37} \textit{Id.} at 1115. It should be noted that this statement belies one of Andrew’s biases, \textit{i.e.}, that standard of living is the most important factor in determining how much tax should be paid. \textit{See infra} text and accompanying notes 70-75 for a discussion of Professor Warren’s critique of this bias.

\textsuperscript{38} In simple terms, a bank account.


\textsuperscript{40} 26 U.S.C. §§ 61, 1001, 1011, 1012 (1988).

\textsuperscript{41} Professor Andrews uses the corporate reorganization provision and its effect on individual shareholders (26 U.S.C. § 368 (Supp. 1989)) as an example, but the point is more obviously valid for other provisions, such as the nonrecognition of like-kind transfers (26 U.S.C. § 1031 (Supp. 1989)) and nonrecognition of money earned on installment sales (26 U.S.C. § 451 (1988)).

\textsuperscript{42} Andrews, \textit{supra} note 33, at 1124.

\textsuperscript{43} 26 U.S.C. § 1014 (1988) provides that the basis of property acquired from a decedent is the fair market value of the property at the decedent’s death. Consequently, any increase in the value of the property is never taxed. Andrews also discusses how an individual can wait until his income decreases at retirement in order to be taxed at lower rates on the accumulation. Andrews, \textit{supra} note 33, at 1124. However, this point is much less valid today than when the article was written due to the adoption of a modified flat tax rate schedule in 1986.

\textsuperscript{44} Andrews, \textit{supra} note 33, at 1124.
who opposed accretion-type income taxes because, he claimed, they imposed a double tax on savings. In essence, Mill argued that imposing a tax on accumulation to wealth reduces the return on invested earnings from savings.

Andrews wished to illustrate that this is not only unfair, but compels taxpayers to make economic decisions based not upon economic reasons, but upon tax reasons. Assume a person has $100. He has a choice of investing either in a 10% interest-bearing account (compounded annually), or a property that will appreciate at 9% per year for 30 years. In the absence of taxes, he would place the money in the interest-bearing account, since rate of return is greater. But now assume he is subject to a 31% tax under our current system. If he puts the money into the piece of property, he retains his earnings until they are realized; if he sells the property he retains $946.47. In the savings account, he must pay taxes on the interest each year. Therefore, an account which pays 10% interest only yields 6.9%. After 30 years, he is left with only $740.17, or 21.8% less than in the property! Thus the rational taxpayer will invest in the property, even though without the tax code it would be the poorer investment.

Certain scholars have argued that this disparity could be rectified.

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45. In First Essay on The Income and Property Tax, J.S. Mill wrote:

[The Income Tax] is equivalent to being taxed twice; first of all, it pays three per cent, supposing that to be the amount of the income tax [we should be so lucky], and afterward it pays in perpetual annuity, what is equivalent to another three per cent, so that in fact it pay as much as if it had had to pay six per cent at once.... I would not tax the investment and then the income derived from it; in fact, I would make the tax a tax upon expenditure and not upon income.

MILL, ESSAYS ON ECONOMICS AND SOCIETY 478 (1967).

46. Assume, arguendo, that the growth rate on the property is guaranteed.

47. He would have $1,744.94 from the account after 30 years, as opposed to $1,326.77.

48. Note he has already had to earn $131 to save $100.

49. (Amount realized - basis) * tax rate = tax paid. 26 U.S.C. § 1001. The remainder is his earnings. ($1,326.77 - $100) * 31% = $380.30; $1,326.77 - $380.30 = $946.47.

50. Of course, if income from capital gains is taxed at a lower rate than ordinary income, the distortion becomes even greater. Andrews, supra note 33, at 1124. As of 1991, the difference between the tax on capital gains and ordinary income is small (3%). 26 U.S.C. § 1. Consequently, this factor was omitted from the analysis.

51. Andrews also spoke at great length about subsidies in the Code which create distortions. For example, a taxpayer whose business sets up a tax-deferred defined contribution benefit plan under 26 U.S.C. § 401(k), does not pay taxes on his income, while a taxpayer whose company does not qualify for a 401(k) plan pays taxes, even if he intends to save the funds for retirement. The wealth of both individuals is being increased; therefore, it is just to tax them both equally.
fied by moving closer to the ideal of a pure accretion tax. For example, they argue, the code could compel taxpayers to value their property holdings annually and pay a tax on the appreciation. But this approach was flatly rejected by Andrews, who viewed such a step as impossible to administer. Instead, Andrews suggests a move in precisely the opposite direction. He suggested that only consumption and not savings should be taxed.

Thus, Andrews' model of a tax system would define income entirely as wealth which is spent:

Ordinary income—wages, salaries, fees, dividends, interest, rent, and so on—would be treated exactly the same way under a consumption-type personal income tax as under any personal income tax. The most obvious difference about a consumption-type income tax would be that ordinary investments would be accounted for on a pure cash basis. The cost of investment assets would be deductible in the year paid, while the proceeds of sale would be fully included in taxable income in the year received.

Under the Andrews approach, then, if a taxpayer chooses to save his earnings, those earnings would be considered income, but the taxpayer would deduct the amount placed in savings. When, at some future date, she withdrew the funds for use, the entire amount would become taxable.

After defining this plan and analyzing several specific applications of it, Andrews attempted to explain why he believed that such a plan would actually be fairer than our current system. He defined savings as "consumption deferred." By this definition, Andrews made the intuitive point that one does not save strictly for the pur-

52. See Simons, supra note 34.
53. Andrews, supra note 33, at 1114. First of all, this step would make owning property a particularly onerous prospect, and extremely expensive to value. Secondly, taxpayers without other liquid investments would be forced to sell off their properties each year in order to pay taxes on their illiquid investments.
54. Andrews, supra note 33, at 1153.
55. Id. Of course, much the same end could be reached by the government tallying receipts of spending of each individual taxpayer and levying a tax on receipts. One can only assume that Andrews considers this more of an economic burden.
56. Id. Much criticism of the Andrews tax approach lies in its strict adherence to the cash-flow aspect. See J.B. McCombs, Tax Incentives for Investment: A Free Market Future Versus Our Pork Barrel Past, 64 Ind. L.J. 665 (1989). Andrews, for example, suggests that money received as a loan should also become taxable income. As the loan is paid back, payments on the loan (both principal and interest) would be tax-deductible. Andrews, supra note 33, at 1154.
57. Andrews, supra note 33, at 1167.
pose of saving, but saves so that he will have the enjoyment of that money at some future date. If he chooses to defer this enjoyment, then we should defer taxing him on the funds until he actually elects to use and again, "enjoy" them.\textsuperscript{58}

This point brings us to Andrews' basic assumption about taxation, which is that wealth is really not measured by the size of one's bankbook, but by one's standard of living. Andrews discussed what should happen to funds which are in savings at the time of death. Andrews suggested that these funds should not be taxed at all, because they represent the ". . . excess of contributions to the economy over withdrawals."\textsuperscript{59} Further, the estate and gift taxes are a far better way to deal with the problem of wealth than the inclusion of accumulation in the tax base.\textsuperscript{60}

Unfortunately, Andrews was sketchy on the effect his radical transformation of the definition of taxable income would have had on personal savings rates.\textsuperscript{61} It seems likely, Andrews pointed out, that more individuals would save more of their income.\textsuperscript{62} But on the other hand, at any given time an individual might spend a higher portion of his income because the tax advantages of savings would enable the individual saving for a particular purpose to reach his goal much faster.\textsuperscript{63} Consequently, Andrews concluded, there are no a priori grounds for predicting these various effects.\textsuperscript{64}

Since Andrews originally suggested this plan, several commentators have suggested less drastic changes to the code which would nevertheless provide some resolution to the problem of the double taxation of savings. Professor J.B. McCombs, who began with the premise that the Andrews model provided a good start but "goes too far,"\textsuperscript{65} attempted to set up a system in which savings are subject to taxation, but at a lower rate. The lower rate would be designed to eliminate the distortion which makes saving an unattractive proposition.\textsuperscript{66}

\textsuperscript{58} It should be noted that Andrews here, then, is taking the argument further than Mill did in the nineteenth century. Andrews is not suggesting that savings be taxed once, but rather that savings not be taxed at all.

\textsuperscript{59} Andrews, \textit{supra} note 33, at 1172.

\textsuperscript{60} \textit{Id.} at 1173.

\textsuperscript{61} \textit{Id.}

\textsuperscript{62} \textit{Id.}

\textsuperscript{63} \textit{Id.}

\textsuperscript{64} \textit{Id.}

\textsuperscript{65} McCombs, \textit{supra} note 56.

\textsuperscript{66} \textit{Id.}
McCombs suggested that all business entities, including corporations, partnerships, sole proprietorships, and S corporations should be separately taxed; thus the present pass-through rules that apply to some of these entities would be abandoned.  However, personal income derived from the business entities would be taxed at a much lower level than other income: McCombs suggested 20% on entity income and 40% on other income. Individuals could create taxable trusts for their personal investments and take advantage of the lower rate structure for the earnings from those investments. In different terms, McCombs suggested that savings accounts be set up in trust form at a bank or other financial institution. The accounts would be similar, for example, to an Individual Retirement Account or KE-OGH. Earnings from monies deposited in those accounts would be subject to a lower tax rate than wage earnings. The McCombs model, then, is somewhat of a step toward eliminating the double tax on savings, with less extreme consequences than the Andrews model.

In a response to Professor Andrews, Professor Alvin Warren illustrated the problem that applies in some degree to all proposals that offer tax incentives to savings. Essentially, income derives from two sources—capital and labor. A tax system such as Andrews proposed moves close to a tax based upon labor alone. Further, since interest on savings is by definition income from capital, a tax incentive which encourages savings invariably will shift a percentage of the tax burden derived from by the earnings from capital to earn-

67. *Id.* at 677. The code currently provides that although partnerships and S corporations must file information returns, they are not separately taxed. Rather, the income "passes through" the entities to the partners or stockholders who are taxed on the income. See 26 U.S.C. §§ The retention of the pass-through rules for partnerships and S corporations after 1986, and the recent proliferation of small corporations selecting S corporation status, indicates that these provisions are likely to remain in the Code. R. Doernberg, H. Abrams, B. Bittker, & L. Stone, *Federal Income Taxation of Corporations and Partnerships* (1987).

68. McCombs, *supra* note 56, at 678. Although it may appear that the McCombs model is similar to the preferential tax for income earned from capital gains, it is far more inclusive. *Id.* at 669. It includes business inventories specifically exempted from capital gains treatment in 26 U.S.C. § 1223 (1988), and more importantly for the purpose of this paper, interest and dividend income. *Id.*


A shift from a tax on labor to a tax on capital is generally perceived to shift a greater portion of the tax burden from the wealthy to the poor. This is because in the United States while there is obviously an unequal distribution of income derived from wages, there is a far greater disparity in earnings derived from capital. Thus, it is argued, those few wealthy who derive more of their wealth from capital, the wealthy, will benefit disproportionally from the shift.

The Family Savings Account is a modest proposal in light of the above-discussed radical changes in the tax system, yet in important ways it is their progeny because it is designed to eliminate the double taxation of savings and thereby boost the personal savings rate. As proposed in the Savings and Economic Growth Act of 1990 [SEGA], the plan allowed individuals to make nondeductible contributions of a maximum of $2,500 or 100% of gross income to a savings account. Married couples could contribute $5,000 if both are employed. Earnings on the savings are tax-exempt, provided that the contributions remain in the account for seven years. If the funds are withdrawn within three years, a 10% penalty is applied to the premature withdrawal; if withdrawn between three and seven years, all earnings become taxable. The 1991 version of the Family Savings Account restricts the availability of the plan to taxpayers who earn less than $100,000 per year.

The Family Savings Account, owing to this design, will effect other positive consequences. Because the funds must be saved for seven years in order to be nontaxable, taxpayers will employ it as a device for long-term investment. Banks, receiving deposits which will not be liquid for a long term, will be free to invest the funds in long-term capital projects. According to the Doernbush model, investment in capital formation has the greatest positive effect upon the economy.

72. Warren, supra note 70, at 940.
73. Id.
74. Much of the debate over the reduction in the capital gains tax concerns precisely this issue. See Hearings of the Senate Labor and Human Services Committee on the U.S. Economy, 102nd Cong., 2nd Sess. 29 (1992) (statement of Professor J. K. Galbraith).
75. Id.
77. Id. at § 292(c)(2)(B).
78. Id. at § 292(e)(2).
79. Id.
Also unlike the more radical proposals, which have socially undesirable consequences, this proposal could have socially positive consequences for most Americans. In the example in the introduction, it was stated that parents who wished to finance a four year private education for their child would be required to set aside $313 per month at 9% for their child's education. Under the Family Savings Account, since earnings are not taxed, a 9% yield effectively becomes an 11.5% yield. Consequently, that family would only be required to set aside $226 per month. Families could also save for a downpayment on a residence using the Family Savings Account. The family that saved $5,000 per year for a home under such an account would have over $50,000 after the necessary seven-year holding period, as compared to approximately $40,000 in a traditional savings account.

Finally, the $2,500 personal limit/$5,000 family limit will prevent those with large liquid capital from shifting too much of the tax burden from income on capital to income on labor. At the very least, because it has a flat maximum, it should mollify the necessarily regressive features of such a tax. This issue will be discussed in detail in the fourth section of this note.

III. LESSONS TO BE LEARNED FROM THE INDIVIDUAL RETIREMENT ACCOUNT

Much of the discussion concerning adoption of the Family Savings Account has focused on analogizing the Individual Retirement Account, as evidence that the Family Savings Account will not accomplish its objectives. Many argue that the IRA was a tax break for the wealthy, which only channelled monies from taxable general savings to the nontaxable IRA. This section will discuss the Congressional expansion and subsequent contraction of the eligibility requirements of the IRA during the 1980's, and suggest what lessons should and should not be learned from the IRA concerning the Family Savings Account. Ultimately, this author will conclude that for the most part, the mistakes of the IRA will naturally be avoided by the Family Savings Account's different purpose and design.

Essentially, the structure of the IRA itself has remained fairly

81. Id.
constant except for small congressional tinkering, at least since 1981. The main controversy concerning the IRA has been the eligibility requirements to participate in the program. The IRA was created in 1974 as part of the Employment Retirement Income Security Act (“ERISA”), and provided tax advantages to encourage savings for those who were not covered in employer-sponsored pension plans.

Essentially, the IRA is a trust or custodial account with a maximum of $2,000 deposited each year. The individual himself or herself is the beneficiary of the trust. All funds contributed to the IRA are deducted from gross income. Funds contributed to an IRA may not be withdrawn until age 59½, without a penalty; however, if the funds are kept in the trust until that maturity age, no taxes are levied on the funds.

The major expansion in IRAs began in 1982 with the passage of the Economic Recovery Tax Act [“ERTA”], the largest tax cut in American history, sponsored by President Reagan. The expansion allowed anyone to open an IRA, regardless of whether or not one participated in an employer-sponsored pension plan. The response was tremendous. Banks pushed IRAs, citing statistics which indicated that a twenty year old person who made a maximum contribution to an IRA every year at 10% interest could retire at age sixty with an IRA worth close to $900,000. Moreover, the government matched IRA contributions on a one-for-one basis, through an immediate tax deduction in the period of the 50% tax bracket.

The justifications for the expansion were two-fold. First, it was believed in 1981 that Social Security was severely underfunded, and

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85. For example, the 1984 Tax Reform Act changed the due date for contributions to IRAs, and was changed to consider alimony as a portion of income. Lucas, IRAs, SEPs, and KEOGHS, 18 Akron L. Rev. 609 (1985).
87. Id.
88. Essentially keeping the money in a bank will satisfy the requirements of this section. Treas. Reg. § 1.408-2(d); 26 C.F.R. § 1091 (1990).
89. Originally the amount of the IRA was limited to $1,500. 26 U.S.C. § 408 (1974).
92. As will be explained later, after 1986 the nondeductible IRA was created; currently it is not very popular.
93. Note that IRA investments are not taxed at all; this is unlike the Family Savings Account, which taxes the income when it is originally earned, but does not tax interest earned on the savings. See supra p. 114.
95. Id.
that it would be difficult to fund social security benefits into the twenty-first century for younger, high-income individuals. President Reagan, before his election to the presidency, had in fact advocated privatizing the social security system. The IRA seemed a good way to "privatize" through the code, at least for those who could afford to save for themselves. In addition, since the ERTA was designed to aid the troubled economy, it was believed that the IRA would bolster capital formation by increasing the personal savings rate.

The IRA became extremely popular with middle and upper income taxpayers. In fact, the IRA produced a revenue loss to the government more than six times greater than anticipated. Interestingly, the IRA suddenly became a vehicle for all savings, apparently because of the assumption that even with a 10% penalty the tax deduction still made the IRA a good bargain. But the IRA's popularity with higher income taxpayers was criticized by liberals, who claimed it was a tax break for the rich. They asserted not only that the IRA was an inherently unfair program which provided a tax deduction to upper income taxpayers, but also that the program did not increase savings, because the rich were merely channeling their earnings from taxable accounts to the IRA.

When the Tax Reform Act of 1986 moved to a modified flat tax rate in 1986, deductions had to be eliminated to effect the decrease in the maximum individual tax rate from 50% to 28%. The IRA was one of many deductions which was severely restricted. After 1986, individuals who earned more than $25,000 per year (or married couples who earn more than $40,000) and were covered by employee pension plans were no longer eligible for the IRA tax deduc-

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96. See Osgood, supra note 19, at 533.
97. Id.
99. In 1982, 59.7% of all people earning over $50,000 per year had an IRA. Graetz, supra note 98, at 896.
100. In 1981, IRA and KEOGH (a similar plan designed for the self employed) assets totaled approximately $38 billion; by 1986, they totaled $224 billion. Id.
101. This, incidentally, was even sanctioned by the White House. In his letter to Congress concerning the 1984 Tax Reform Act, the then Secretary of the Treasury, Donald Regan suggested that the IRA would be retained by the government to enable large purchases such as first houses and children's education. Letter introducing the 1986 Tax Reform Act, Dep't of the Treasury, CCH Special No. 24, at 3.
102. See Graetz, supra note 98, at 898.
103. Id.
104. 26 U.S.C § 219 (1987); see also 26 U.S.C. § 408.
They may, however, create IRAs and defer taxes on earnings; but this has not proved to be very popular.106

The IRA, incidentally, has not died as an investment vehicle. As previously mentioned, President Bush proposed last year that IRAs be expanded to allow withdrawals for the purchase of a first home—an expansion sure to increase the IRA’s popularity once again.107

The fact that the government has not made up its mind about IRA eligibility requirements should not lead Congress to believe that all programs to encourage savings are ineffective. In fact, an economist at the National Bureau of Economic Research, R. Glenn Hubbard, has recently concluded that the previous belief that IRAs did not increase saving, but merely shifted funds from general savings to IRAs, was false.108 Hubbard found that, in general, rates of return on savings strongly influence the rate of personal investment. In addition, there is “strong evidence” that the expansion of the eligibility for IRAs and KEOGHs did raise rates of personal saving in the country during the ERTA period.109

Two other points about Hubbard’s study are equally relevant. First, although Hubbard concluded that higher income individuals contributed in greater amounts to the IRA during the ERTA period, the primary reason for their larger contributions was the higher marginal tax rates. Therefore, the wealthy received a higher rate of return on their investment.110 The modified flat tax rate schedule makes it equally profitable for all those in the 28% tax bracket (that is, all those married and earning more than $29,750 jointly per year or single and earning above $17,850) to enter a tax-advantaged savings account. Consequently, the IRA statistics concerning the rates of investment among social classes in the ERTA period probably are not very indicative of the rate of investment among social classes that would occur under a Family Savings Account option in the 1990s.

Hubbard also concluded that a main variable determining rate

106. See Graetz, supra note 98, at 898 (discussing the IRA which concluded that the post-1986 eligibility requirements are the most favorable to serve the country’s retirement goals; Graetz concluded that Congress achieved this result “[a]lmost by accident.”), Id.
110. Id. at 49.
of personal savings is the liquidity of investment.\footnote{111}{Hubbard, supra note 108, at 46.} As the rate of liquidity became greater, (thus making funds become available for use sooner), savings rose significantly, particularly among poorer individuals.\footnote{112}{Id.} Therefore, an IRA is a far more illiquid investment for young individuals, who cannot withdraw the money until age 59 ½ without a stiff penalty, than for older individuals. Since wages are highly correlated to age, age rather than wealth could be the factor encouraging higher income individuals to place monies in an IRA.

Under the Family Savings Account, there will be no such difference in liquidity between the older and the younger individual taxpayer.\footnote{113}{See supra.} The plan is designed so that each taxpayer will need to save the money for three years to avoid penalty, and seven years to receive full tax deductibility. Consequently, it seems likely that the country will see savings under the Family Savings Account by both lower and higher income taxpayers.

Even if not directly stated by Congress, the overall purpose of the IRA was to aid higher income taxpayers. As Graetz points out, the IRA was created as part of a three-tiered government retirement security program, which also includes the social security system and employer sponsored pensions.\footnote{114}{Graetz, supra note 98, at 853.} Since social security has a flat maximum payment, Graetz stated that even without an IRA, poorer people can often achieve 100% wage replacement after retirement through the other two tiers, social security and pension payments.\footnote{115}{Id. at 856.} These people understandably did not buy an IRA in the 1980s because, it did not serve their purposes. Their interests were better served by saving the money in a more liquid investment, where the funds could be used sooner.

In sum, the lesson learned from the IRA is that the personal rate of savings is indeed correlated to the rate of return on savings; consequently tax incentives will in fact increase savings. A lesson that should also be learned is that any tax incentive is not automatically a break for the wealthy.

IV. Costs of the Family Savings Account

Like all tax incentives, the Family Savings Account will cost the Treasury money—clearly not a popular idea with President Bush es-
timating a $281 billion deficit in fiscal 1992 (which began October, 1991). The Joint Committee on Taxation's most recent estimate of the revenue cost of the program, from July, 1991, approximates the total cost of the program to be $4.8 billion through fiscal 1995. This figure is already out of date, for it is clear that the Family Savings Account will not be adopted at least until late 1992. In any case, the Joint Committee on Taxation noted that such predictions are quite "rough," and considering the experience of the IRA, which caused revenue losses six times greater than expected, asserted that the potential cost could be much greater than anticipated.

It is virtually impossible to argue that the adoption of the Family Savings Account will make a significant change in the budget deficit. Rather, the detractors of the Family Savings Account assert that any tax incentive now sends "the wrong message to Americans." Only significant deficit reductions will create an environment in which people are inspired to save. Many assert that it is indeed contradictory to increase the budget deficit in order to increase savings.

Other economists argue, however, that the deficit argument is misguided. The amount, they argue, is so small that if Congress does not spend the money through tax incentives for capital forma-

116. N.Y. Times, Feb. 4, 1991, at A14, col. 1. The article noted that this number was "not worth much attention" since there are "so many variables to change things prior to October." Id.

117. The Committee estimates a cost in billions per year:
   1991—0.4
   1992—0.6
   1993—0.9
   1994—1.3
   1995—1.6
   Total 4.8

The progressive rise each year reflects the fact that the account only taxes income on earnings and offers no immediate tax deduction. Joint Committee on Taxation Estimated Budget Effects of Income and Excise Tax Provisions in President Bush's Fiscal Year 1991 Budget Proposal: Fiscal Years 1990-1995, 101st Cong., 2d Sess. (1990). The Treasury estimates are lower, totalling $4.7 billion over the same period. Id. In order to put these numbers in perspective, the Gramm Rudman Hollings Act sets the benefit programs for 1991 at $687 billion and other domestic programs at $211 billion. N.Y. Times, Feb. 4, 1991, at A14, col. 4.

118. Tax Notes, Mar. 12, 1990, at 17. For a discussion of the higher revenue cost of the IRA, see supra p. 117.

119. As illustrated, the expected cost of the Family Savings Account in 1992 represents less than one-hundredth of one percent of all benefit programs budgeted.


tion, the money will be lost—spent by Congress on other programs which will not benefit the economy as greatly. Further, they argue that the so-called "peace dividend," that is, the savings on strategic defense during the cold war, should definitely be channeled into a form which emphasizes capital formation.

V. CONCLUSION

The Family Savings Account represents a truly new plan to increase the personal savings rate to aid the economy. The plan is in the tradition of several suggested plans to alleviate the double taxation of savings. However, while other plans go too far, and would create a massive shift in taxes from income earned from capital to income earned from labor, the Family Savings Account is more moderate. Its design will aid all Americans, in saving for large expenditures, regardless of their social class.

The empirical evidence from the IRA indicates that a higher rate of return will indeed increase personal rates of savings. Although any tax incentive is difficult in the face of the spiralling budget deficits, this is a tax incentive which will go directly into capital formation, and help the United States become competitive again.

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122. Id.
123. Id.