COMPARING APPLES AND ORANGES: SOME THOUGHTS ON THE PENSION AND SOCIAL SECURITY TAX EXPENDITURES

BY

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I. INTRODUCTION

Under an ideal income tax, individuals would pay tax each year on the sum of all of their compensation for services and all of their investment income. Of course, the federal income tax deviates from this ideal in a number of ways. For example, under an ideal income tax, employer contributions to pension plans and the investment income earned by those plans would be taxed currently to the covered workers. Instead, none of this income is taxed until these workers retire and begin receiving their pension benefits. Social Security benefits, too, are not taxed until received, and then only a portion of those benefits are subject to tax.¹

Such deviations from the income tax ideal are routinely identified as tax expenditures in the tax expenditure budgets prepared annually by the federal government.² For example, according to the 2001 Federal Budget, the exclusion of pension contributions and earnings is estimated to cost around $114 billion in fiscal year 2001, and the partial exclusion of Social Security benefits is estimated to cost almost $26 billion in fiscal year 2001.³ Policymakers often use these tax expenditure estimates as a rough guide to the cost of special income tax provisions.

Despite the similarities between pension benefits and Social Security benefits, two completely different methods are used to estimate their related tax expenditures. When it comes to estimating the tax expenditure associated with pen-

1. See I.R.C. § 86.
sions, the tax expenditure estimators consider the way that an ideal income tax would treat contributions to pension plans, the investment income of pension funds, and pension benefits. When it comes to estimating the tax expenditure associated with Social Security, however, the tax expenditure estimators instead look only at how an ideal income tax should treat current Social Security benefits and ignore current contributions and the investment returns on those contributions.

The tax expenditure estimators could use the same approach for both pensions and Social Security, but they do not. As a result, comparisons between the pension and Social Security tax expenditures are distorted. It’s like trying to compare apples and oranges.

Worse still, the current method for estimating the Social Security tax expenditure significantly underestimates the revenue losses associated with the special tax benefits for Social Security. This underestimation of the Social Security tax expenditure has some serious policy implications. First, underestimating the costs associated with Social Security distorts the way that policymakers view the need for Social Security reform and the mechanisms to be chosen for that reform. Second, underestimating the Social Security tax expenditure relative to the pension tax expenditure invariably results in more pressure to curtail the special tax benefits for pensions and less pressure to curtail the special tax benefits for Social Security.

This article considers how the tax expenditure estimators could estimate the tax benefits associated with Social Security and pensions in more comparable terms. In addition, this article considers the policy implications that would result from making such a change. Part II provides an overview of both pensions and Social Security. Part III explains how the tax expenditures associated with pensions and Social Security are currently estimated and some alternative methods for estimating the costs associated with the special tax benefits for pensions and Social Security. Part IV discusses some of the policy implications of the current method of estimating the pension and Social Security tax expenditures and the policy implications of using alternative, more comparable meth-
ods to estimate those tax expenditures. The most important conclusion is that viewing pensions and Social Security in more comparable terms is the best way to help ensure that policymakers develop a coherent national retirement policy.

II. AN OVERVIEW OF THE RETIREMENT SYSTEM

Social Security and pensions are the principal components of this nation's retirement system. The following sections explore these components.

A. Social Security

The Social Security system includes two programs that provide monthly cash benefits to workers and their families. The Old-Age and Survivors Insurance (OASI) program provides monthly cash benefits to retired workers and their dependents and to survivors of insured workers, and the Disability Insurance (DI) program provides monthly cash benefits for disabled workers under age 65 and their dependents. A worker builds protection under these programs by working in employment that is covered by Social Security and paying the applicable payroll taxes. At present, about 96 percent of the work force are in covered employment. At retirement, disability, or death, monthly Social Security benefits are paid to insured workers and to their eligible dependents and survivors. In 1999, for example, the OASI program paid more than $334 billion in benefits to more than 38 million retired workers and their spouses and dependents. The average benefit paid to a retired worker was about $805 per month. Also in 1999, the Disability Insurance (DI) program paid about $51 billion in benefits to another 6.5 million disabled workers and their spouses and dependents.

5. 2000 GREEN BOOK, supra note 4, at 4.
7. Id. at 74.
8. Id. at 71, 72.
Social Security benefits are overwhelmingly financed through payroll taxes imposed on individuals working in employment or self-employment that is covered by the Social Security system. For 2001, employees and employers each pay a tax of 6.2 percent on up to $80,400 of wages earned in covered employment, for a combined OASDI rate of 12.4 percent (the lion's share of the total rate of 15.3 percent that is collected for OASI, DI, and Medicare). Employees are not allowed to deduct their portion of Social Security taxes for income tax purposes. On the other hand, the employer's portion of Social Security taxes is excluded from the employee's income for income tax purposes.

Self-employed workers pay an equivalent OASDI tax of 12.4 percent on up to $80,400 of net earnings. In order to put self-employed individuals in an approximately equivalent position as employees, self-employed individuals can deduct half of these taxes for both Social Security and income tax purposes.

In addition, as much as 85 percent of a taxpayer's Social Security benefits is subject to income taxation. The actual amount to be included is determined by applying a complicated two-tier formula. Basically, single taxpayers with incomes over $25,000 and married couples with incomes over $32,000 must include as much as half of their Social Security benefits in income, and single taxpayers with incomes over $34,000 and married couples with incomes over $44,000 must include as much as 85 percent of their Social Security benefits in income. For 2000, an estimated 12.5 million Social Security beneficiaries will pay tax on at least some of their benefits (32 percent of all beneficiaries). All in all, the federal government will collect about $17.3 billion in taxes from those beneficiaries.

12. Social Security Administration, supra note 9.
15. 2000 GREEN BOOK, supra note 4, at 65.
16. Id.
The Social Security system operates largely on a pay-as-you-go basis.\(^7\) Social Security benefits are primarily paid out of current-year Social Security payroll taxes, and the Social Security Trust Funds maintain only enough reserves to cover a year or two of benefits. For example, in 1999, the Old Age and Survivors Insurance Trust Fund received $396.3 billion in payroll tax contributions, paid out $334.3 billion in benefits, and had $798.8 billion on hand at the close of the year.\(^8\) Similarly, in 1999, the Disability Insurance Trust Fund received $63 billion in payroll tax contributions, paid out $51.3 billion in benefits, and had $97.3 billion on hand at the close of the year.\(^9\) As of January 1, 2000, the unfunded liability of the Social Security system was estimated to be about $10.8 billion.\(^10\)

**B. Pension Plans**

In addition to Social Security benefits, many Americans will receive pension benefits from employment-based pension plans or Individual Retirement Accounts (IRAs). At the end of 1998, total pension plan assets in the United States were estimated at about $9.5 trillion, with about $2 trillion in IRAs.


\(^8\) *Current Operating Statistics: List of Tables*, supra note 6, at 70.

\(^9\) *Id.* at 71.

\(^10\) Office of the Chief Actuary, Social Security Administration, Unfunded Obligations and Selected Transition Costs for the Combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) Program (April 5, 2001) [hereinafter Social Security Unfunded Obligation]; (copy on file with author); personal communication from Alice H. Wade of the Social Security Administration, February 12, 2001. The $10.8 trillion figure is an estimate of the maximum transition cost as of January 1, 2000, in connection with replacing the current form of Social Security benefits with a new form of benefits. Thus, the maximum transition cost represents the cost for terminating the current Social Security program but continuing to pay benefits that have already been earned. This maximum transition cost is computed as the difference between (a) the present value of all future benefits payable after the valuation date based on earnings prior to the valuation date (earnings credited under the old form); and (b) the value of the assets on the valuation date plus the present value of revenue from taxation of future benefits payable on the old form. Future benefits payable on the old form for workers who have not reached benefit eligibility age (62) are calculated on a proportional past service credit basis.
and the rest in public and private pension plans.\textsuperscript{21}

1. Employment-based Retirement Plans

In 1999, more than 60 million wage and salary workers (46.8 percent) were covered by an employment-based pension plan.\textsuperscript{22} Among full-time, full-year wage and salary workers ages 18 to 64, some 60.8 percent were covered.\textsuperscript{23} Private employment-based plans paid out about $178 billion in pension benefits in 1999, federal civilian retirement plans paid about $47 billion in benefits, and state and local retirement plans paid about $91 billion in benefits.\textsuperscript{24}

Most employment-based pension plans qualify for favorable tax treatment. Basically, an employer’s contributions to a tax-qualified pension plan on behalf of an employee is not taxable to the employee.\textsuperscript{25} Nevertheless, the employer is allowed a current deduction for these contributions (within limits).\textsuperscript{26} Moreover, the pension fund’s earnings on these contributions are tax-exempt.\textsuperscript{27} Workers pay tax only when they receive distributions of their pension benefits,\textsuperscript{28} and, at that point, the usual rules for taxing annuities apply.\textsuperscript{29} Pension plans for sole proprietors and partnerships are called Keogh plans.\textsuperscript{30}

Employment-based plans generally fall into two broad categories based on the nature of the benefits provided: de-

\textsuperscript{23} Id.
\textsuperscript{24} Salisburry, supra note 21, at 50.
\textsuperscript{25} I.R.C. § 402(a).
\textsuperscript{26} I.R.C. § 404(a).
\textsuperscript{27} I.R.C. § 501(a).
\textsuperscript{28} I.R.C. § 402.
\textsuperscript{29} I.R.C. § 72; I.R.S. PUB. NO. 575, \textit{PENSION AND ANNUITY INCOME} (for use in preparing 2000 returns). The amounts received under private annuities (and pensions) are taxed after excluding a fraction of each payment. The "exclusion ratio" is determined at the annuity starting date by dividing the "investment in the contract" by the "expected return under the contract." The investment in the contract is the participant's premium costs for the annuity. The expected return is simply the total amount expected to be received under the annuity. This method of taxation allows the annuitant to recover her own contributions tax-free.
fined benefit plans and defined contribution plans.

a. Defined Benefit Plans

Defined benefit plans typically provide each worker with a specific annual retirement benefit that is tied to the worker's final average compensation and number of years of service. For example, a plan might provide that a worker's annual retirement benefit is equal to 2 percent times years of service times final average compensation ("FAC"). Under this formula, a typical worker with 30 years of service would receive a retirement benefit equal to 60 percent of her pre-retirement earnings (B = 60% x FAC = 2% x 30 yrs x FAC). Final average compensation is typically computed by averaging the worker's salary over the three or five years immediately prior to retirement.

b. Defined Contribution Plans

Under a typical defined contribution plan, the employer simply contributes a specified percentage of the worker's compensation to an individual investment account for the worker. For example, contributions might be set at 10 percent of annual compensation. Under such a plan, a worker who earned $30,000 in a given year would have $3,000 contributed to an individual investment account for her. Her benefit at retirement would be based on all such contributions plus investment earnings thereon. There are a variety of different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans ("ESOPs").

Profit-sharing and stock bonus plans may include a 401(k) feature which allows workers to choose between receiving cash currently or deferring taxation by placing the money in a retirement account.31 Consequently, they are sometimes called cash or deferred arrangements (CODAs). The maximum annual amount of elective deferrals that can be made by an individual in 2001 is $10,500.32

31. I.R.C. § 401(k).
c. Funding

Defined contribution plans are always fully funded. On the other hand, defined benefit plans are often underfunded, and defined benefit plans can accumulate significant funding obligations as a result of employee service over time. The employees earn the right to future benefits as they work, but the employer does not always fully fund its accruing pension liabilities. Moreover, a defined benefit plan can easily become underfunded because of a decline in value of the pension fund’s investment portfolio or even because of changes in the employer’s work force (such as increasing life expectancies).

Since the enactment of the Employee Retirement Income Security Act ("ERISA") in 1974, private employers have had relatively little leeway to avoid their funding obligations. On the other hand, governmental plans are not governed by ERISA. In that regard, for example, a recent survey of 451 state and local pension plans found that 75 percent of them were underfunded, and 38 percent were less than 80-percent funded.

According to estimates by the Employee Benefit Research Institute, private employment-based plans held around $5 trillion in assets at the end of 1998, federal government plans held $668 billion in assets, and state and local government plans held around $1.7 trillion in assets.

2. IRAs and Roth-IRAs

Favorable tax rules are also available for certain individual retirement accounts (IRAs). Under the current IRA rules, almost any worker can set up an IRA account with a bank or other financial institution and contribute up to $2,000 (or, if less, 100 percent of compensation) each year to that account. Workers who are not covered by another re-

36. Salisbury, supra note 21, at 6.
37. I.R.C. §§ 219, 408.
tirement plan may deduct their IRA contributions. If the worker is covered by another retirement plan, however, the deduction may be reduced or eliminated if the worker’s income exceeds $30,000 for a single taxpayer or $50,000 for married taxpayers. Like private pensions, IRA earnings are tax-exempt, and distributions are taxable.

Also, since 1998, individuals can set up so-called Roth IRAs. Unlike regular IRAs, contributions to Roth IRAs are not deductible. Instead, withdrawals are tax-free. Like regular IRAs, however, the earnings of these Roth IRAs are tax-exempt.

III. THE TAX EXPENDITURE APPROACH

A. Tax Expenditure Analysis

Under a theoretically pure income tax, individuals would pay tax on the sum of the wages, interest, dividends, and other forms of economic income that they earn. Of course, the federal income tax deviates from this pure income tax ideal in a number of ways. For example, the current taxa-

38. I.R.C. § 219(g).
39. I.R.C. § 408A.
40. The classic economic definition of income (also known as the Haig-Simons definition of income) is as follows:
   Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the beginning of the period. The sine qua non of income is gain, as our courts have recognized in their more lucid moments, and gain to someone during a specified time interval. Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.


41. The current federal tax system is really a hybrid income-consumption tax system in which some investments are taxed on the income tax model and others are taxed on the consumption tax model. See generally, UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX (Henry J. Aaron et al. eds. 1988); Edward J. McCaffery, Tax Policy Under a Hybrid Income-Consumption Tax, 70 TEX. L. REV. 1145 (1992). In general, wages, interest, dividends, and other forms of income are taxed when received, regardless of whether or not saved. On the other hand, pension
tion of pensions deviates from the income tax ideal in that employer contributions are typically excluded from gross income and pension fund earnings are exempt from tax.\textsuperscript{42} The tax treatment of Social Security benefits is even more generous. Only those single Social Security beneficiaries with incomes over $25,000 and married couples with incomes over $32,000 have to pay any tax on their Social Security benefits.\textsuperscript{45}

The Congressional Budget and Impoundment Act of 1974 requires the federal government to keep track of the revenue "lost" as a result of deviations from an ideal income tax through so-called tax expenditure budgets.\textsuperscript{44} The Congressional Budget and Impoundment Act of 1974 defines tax expenditures as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."\textsuperscript{45}

Thus, the definition of a tax expenditure draws a distinction between the ideal provisions of an income tax and the special or preferential provisions that are exceptions to that ideal structure. For example, according to the Joint Committee on Taxation:

[T]he normal structure of the individual income tax includes the following major components: one personal exemption for each taxpayer and one for each dependent, the standard deduction, the existing tax rate schedule, and deductions for investment and employee business expenses. Most other tax provisions can be viewed as exceptions to

\textsuperscript{42} See supra Part II.B.

\textsuperscript{43} I.R.C. § 86(b). See supra Part II.A.

On the other hand, under an ideal income tax, individuals would include in income the value of their Social Security benefits as those benefits accrued. That is, individuals would be taxed on the increase in the present value of their expected future Social Security benefits. Conceptually, a worker would be taxed on her and her employer's Social Security contributions, plus any additional income implicit in the increasing value of the government's promise of future benefits.


\textsuperscript{45} Pub. L. No. 93-344, supra note 44, at § 3(a)(3).
"normal law tax law." 46

These exceptions from an ideal income tax are routinely identified as tax expenditures in the tax expenditure budgets prepared annually by the Office of Management and Budget 47 and by the Joint Committee on Taxation. 48 For example, the 2001 Federal Budget estimates that the exclusion of employer contributions for employee medical insurance and medical care results in $80.57 billion tax expenditure for fiscal year 2001. 49 Policymakers often use these tax expenditure estimates as a rough guide to the cost of special income tax provisions. 50

The Congressional Budget Act of 1974 does not, however, actually specify the ideal structure of a tax law, so deciding which provisions are special or preferential is necessarily a matter of judgment, over which there is often much debate. 51

46. Staff of the Joint Comm. on Taxation, supra note 2, at 3.
47. See, e.g., Executive Office of the President and Office of Management & Budget, supra note 2, at 109.
48. See, e.g., Staff of the Joint Comm. on Taxation, supra note 2.
49. Executive Office of the President and Office of Management & Budget, supra note 2, at 109.
50. Admittedly, however, "tax expenditure estimates do not necessarily equal the increase in Federal revenues that would result from repealing the special provisions." Id. at 108. For example, "eliminating a tax expenditure may have incentive effects that alter economic behavior." Id.

Moreover, many tax experts would prefer if tax expenditure estimates were based on a consumption tax ideal rather than an income tax ideal. Under a consumption tax, savings are not supposed to be taxed until consumed. Consequently, using a consumption tax ideal would lead to a quite different set of tax expenditure estimates. For example, the tax expenditure associated with pensions would be zero (or, to the extent of any "over-taxation" of pensions, negative). See, e.g., Jonathan B. Forman, The Impact of Moving to a Consumption Tax on Pension Plans and Their Beneficiaries, in Comprehensive Tax Reform: Implications for Economic Security and Employee Benefits 51, 56-57 (Dallas L. Salisbury ed., Employee Benefit Research Institute, 1997); Jonathan Barry Forman, The Once and Future Social Security Tax Expenditure. 13 Benefits Q. 77, 78 (3d Quarter 1997) [hereinafter Forman, Once and Future].


Nevertheless, the special tax benefits for pensions and Social Security have been routinely identified as tax expenditures in the tax expenditure budgets prepared annually by the government.\footnote{See also James A. Wooten, The ‘Original Intent’ of the Federal Tax Treatment of Private Pension Plans, 85 TAX NOTES 1305 (1999).}

\textbf{B. Current Estimates of the Tax Expenditures Associated with Private Pensions and Social Security}

\textbf{1. Tax Expenditure Estimates Under the Usual Method (The Cash-Flow Method)}

Table 1 reproduces the Office of Management and Budget's 2001 \textit{Federal Budget} estimates of the revenue losses attributable to the special income tax benefits for pensions and Social Security.\footnote{See, e.g., \textit{EXECUTIVE OFFICE OF THE PRESIDENT AND OFFICE OF MANAGEMENT & BUDGET, supra note 2, at 109; STAFF OF THE JOINT COMMITTEE ON TAXATION, supra note 2.}} Table 1 shows, \textit{inter alia}, that the exclusion of pension contributions and earnings was estimated to cost around $114 billion in fiscal year 2001,\footnote{EXECUTIVE OFFICE OF THE PRESIDENT AND OFFICE OF MANAGEMENT & BUDGET, supra note 2, at 109-11.} and the partial exclusion of Social Security benefits was estimated to cost almost $26 billion in that year.\footnote{814,260 million = $92,390 million + $15,975 million + $85,895 million.} The 2001 \textit{Federal Budget} also ranks many of its tax expenditure estimates by the amount of revenue loss in fiscal year 2001.\footnote{825,765 million = $18,885 million + $82,830 million + $84,050 million.} The net exclusion of pension contributions and earnings for employer plans leads that list at $92.4 billion in 2001 (and almost $514 billion over the period 2001-2005).\footnote{EXECUTIVE OFFICE OF THE PRESIDENT AND OFFICE OF MANAGEMENT & BUDGET, supra note 2, at 117.} The partial exclusion of Social Security benefits for retired workers came in at thirteenth, with a revenue loss of $18.9 billion in 2001 (and a 2001-2005 revenue loss of $99.1 billion).\footnote{\textit{Id.}}
TABLE 1.
CASH-FLOW METHOD REVENUE LOSS ESTIMATES FOR THE PENSION AND SOCIAL SECURITY TAX EXPENDITURES^{59}

(In millions of dollars)

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<tbody>
<tr>
<td>Net exclusion of pension contributions and earnings:</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employer Plans</td>
<td>83,780</td>
<td>88,830</td>
<td>92,390</td>
<td>97,085</td>
<td>102,575</td>
<td>108,020</td>
<td>113,705</td>
<td>513,775</td>
</tr>
<tr>
<td>Individual retirement plans</td>
<td>13,350</td>
<td>15,050</td>
<td>15,975</td>
<td>17,030</td>
<td>17,630</td>
<td>18,250</td>
<td>18,750</td>
<td>87,635</td>
</tr>
<tr>
<td>Keogh plans</td>
<td>5,230</td>
<td>5,550</td>
<td>5,895</td>
<td>6,255</td>
<td>6,635</td>
<td>7,040</td>
<td>7,465</td>
<td>33,290</td>
</tr>
<tr>
<td>Exclusion of social security benefits:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social Security for retired workers</td>
<td>17,135</td>
<td>18,010</td>
<td>18,885</td>
<td>19,995</td>
<td>21,230</td>
<td>22,505</td>
<td>16,515</td>
<td>99,130</td>
</tr>
<tr>
<td>Social Security benefits for disabled</td>
<td>2,390</td>
<td>2,595</td>
<td>2,830</td>
<td>3,090</td>
<td>3,375</td>
<td>3,700</td>
<td>3,150</td>
<td>16,145</td>
</tr>
<tr>
<td>Social Security benefits for dependent and survivors</td>
<td>3,775</td>
<td>3,900</td>
<td>4,050</td>
<td>4,210</td>
<td>4,385</td>
<td>4,555</td>
<td>3,625</td>
<td>20,825</td>
</tr>
</tbody>
</table>

^{59} EXECUTIVE OFFICE OF THE PRESIDENT AND OFFICE OF MANAGEMENT & BUDGET, supra note 2, at 110-11.
The revenue loss estimates shown in Table 1 are computed on a cash-flow basis. They endeavor to estimate the revenue losses that result from deviations from an ideal income tax. For example, since all employee compensation would be taxable under an ideal income tax, the revenue estimators classify the exclusion for employer – provided health care benefits as a tax expenditure and estimate that another $81 billion in revenue would be collected by the federal government if all employer – provided health care benefits were included in income and taxed.

A similar approach is used to calculate the tax expenditure associated with pension plans. Dallas L. Salisbury explains the method as follows:

First, the contributions made to plans and estimated investment earnings are treated as taxable wages. Second, benefits paid by the plans are treated as taxable income. Third, the tax to be paid on benefits is subtracted from the tax that would have been paid on contributions and earnings to get a net tax expenditure estimate.

A completely different approach is used to calculate the tax expenditure associated with Social Security, however. For example, according to the Joint Committee on Taxation:

Under present law, social security retirement benefits are fully or partially excluded from gross income. Under normal income tax law, retirees would be entitled to an exclusion for only the portion of social security retirement benefits that represents a return of the social security taxes that they paid during their working years. Thus, the exclusion

60. I.R.C. § 106.

Similarly, the Joint Committee on Taxation describes the cash-flow method for calculating the tax expenditure associated with pensions as follows:

Under normal income tax law, employer contributions to pension plans and the income earned on pension assets would be taxable to employees as the contributions are made and as income is earned, and employees would not receive any deduction or exclusion for their pension contributions. Under present law, employer contributions to qualified pension plans and employee contributions made at the election of the employee through salary reduction are not taxed until distributed during retirement. The tax expenditure for "net exclusion of pension contributions and earnings" is computed as the income taxes foregone on current tax-excluded pension contributions and earnings less the income taxes paid on current pension distributions to retirees.

STAFF OF THE JOINT COMM. ON TAXATION, supra note 2, at 4.
of social security retirement benefits in excess of social security tax payments is classified as a tax expenditure.\textsuperscript{62}

In short, the tax expenditure estimators do not estimate the tax expenditure associated with Social Security in anywhere near the same way that they estimate the tax expenditure associated with pensions. When it comes to estimating the tax expenditure associated with pensions, the tax expenditure estimators consider the way that an ideal income tax should treat both contributions to pension plans and the investment returns on pension funds. When it comes to estimating the tax expenditure associated with Social Security, however, the tax expenditure estimators look only at benefit payments and ignore the excluded contributions and investment returns. The Social Security tax expenditure is estimated as the difference between the amount of benefits that "should" be taxed and the amount that actually is taxed.

Of course, the tax expenditure estimators could use the same approach for both pensions and Social Security, but they don't. One consequence is that comparing the tax expenditure associated with pensions and the tax expenditure associated with Social Security is like comparing apples and oranges.

Yet the similarities between pensions and Social Security are overwhelming. Both are primarily retirement programs. In 1999, for example, employment-based pension plans paid out about $316 billion in pension benefits,\textsuperscript{63} and Social Security paid out about $384 billion in benefits.\textsuperscript{64} Both Social Security and pensions are financed by means of contributions made by, or on behalf of, current workers. In 1999, for example, employees and their employers each "contributed" around $230 billion to Social Security,\textsuperscript{65} and employees and their employers together contributed between $206 billion and $354 billion to pensions and IRAs.\textsuperscript{66}

\textsuperscript{62} Staff of the Joint Comm. on Taxation, supra note 2, at 4 (footnote omitted).
\textsuperscript{63} Salisbury, supra note 21, at 50 (summing the pension benefits paid out by private employment-based plans ($178 billion), federal civilian retirement plans ($47 billion), and state and local retirement plans ($91 billion)).
\textsuperscript{64} Current Operating Statistics: List of Tables, supra note 6, at 70, 71 ($384 billion = $334 billion in OASI benefits + $50 billion in DI benefits).
\textsuperscript{65} Id. $459,555 billion = $396,352 billion + $63,203 billion.
\textsuperscript{66} Salisbury, supra note 21, at 51-52. (summing employer contribution ($60.4 billion for private plans, $40.2 billion for federal civilian retirement plans, $42.5 bil-
Moreover, it would be relatively easy to use the same method to estimate the tax expenditures associated with pensions and Social Security. The most logical approach would be to estimate the tax expenditure associated with Social Security in the same way as the tax expenditure associated with pensions. The Social Security tax expenditure would be computed as the income taxes foregone on current tax-excluded (i.e., employer) contributions to Social Security, plus the income taxes foregone on Social Security Trust Fund earnings, minus the income taxes paid on Social Security distributions to current beneficiaries. Under this approach, one might estimate that the Social Security tax expenditure for the year 1999 was in the neighborhood of $41 billion, nearly double the $23 billion estimate for the 1999 Social Security tax expenditure as reported in the 2001 Federal Budget (see Table 1). 67

Here’s where that $41 billion Social Security tax expenditure estimate comes from. Under current law, employees already pay income tax on their own payroll tax “contributions” to Social Security, but employer “contributions” to the Social Security system are excluded from income. 68 In 1999, both employers and employees were required to contribute 6.2 percent of the first $72,600 of earnings to the Social Security system to pay for retirement and disability benefits. 69 Total payroll contributions that year came to $460 billion, and employers’ (excluded) half came to $230 billion. 70 Moreover, at the close of 1999, the Social Security Trust Funds held $896 billion, 71 and these assets earned an average of 6.9 percent interest on the Treasury bonds that they held. 72 Also in 1999,

67. EXECUTIVE OFFICE OF THE PRESIDENT AND OFFICE OF MANAGEMENT & BUDGET, supra note 2, at 111 ($23.3 billion = $17,135 million + $2,390 million + $3,775 million).

68. See supra Part II.A.


70. See supra note 65 and accompanying text.


72. OFFICE OF THE CHIEF ACTUARY OF THE SOCIAL SECURITY ADMINISTRATION, OLD-
the federal government actually collected about $17 billion from the taxation of Social Security benefits. Assuming an average income tax rate of 20 percent on the employer contributions and Social Security Trust Fund earnings, a ballpark estimate of the Social Security tax expenditure computed would come to around $41 billion.

Alternatively, it might make sense for the revenue estimators to use the same method to estimate the pension tax expenditure that they currently use to estimate the Social Security tax expenditure. That is, the revenue estimators could determine the difference between the amount of pension benefits that "should" be taxed and the amount that actually is taxed. However, since virtually all pension benefits that should be taxed are, in fact, included in gross income and taxed in the year of receipt, this method would lead to a $0 estimate for the pension tax expenditure. Of course, this is a somewhat surprising result.

Clearly, the deferral of income from working years to retirement years is a valuable tax benefit that should show up in a properly calculated income tax expenditure. Of course, that is true for both pension and Social Security benefits. The point here is that the benefit-based, cash-flow method currently used to estimate the Social Security tax expenditure almost certainly underestimates its true cost.

2. Tax Expenditure Estimates Under the Present-Value Method (The Accrual Method)

To be sure, there are significant problems with using any cash-flow method to estimate the revenue losses associated with pension and Social Security benefits. For example, with respect to pensions, the cash-flow method estimates the taxes that "should" be collected on contributions to pension plans

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73. 2000 Green Book, supra note 4, at 65 ($17.3 billion estimate for calendar year 2000).

74. The federal effective tax rate for all families was projected to be around 23 percent in 1993. J. Andrew Hoerner, Economists Examine Whether Progressivity Has Regressed, 56 Tax Notes 1520 (1992).

75. $41 billion = 20% x $230 billion + 20% x $896 billion x 6.9% - $17 billion.

76. In general, amounts received under pensions are taxed by excluding a fraction of each payment. See supra note 29 and accompanying text.
and the income earned on pension plan assets, but it does not measure the value of deferral of income as benefits accrue. Put simply, "no value is placed on the pension promise itself, only on the advance funding of that promise." As a result, cash-flow method tax estimates tend to underestimate the revenue loss associated with underfunded retirement plans.

A better approach would be to calculate the tax expenditures associated with retirement plans on the present-value (or "accrual") basis. This approach would better reflect the value of the pensions promised by employers (or governments), independent of the level of funding. While switching to the present-value method may not make all that much difference in our estimates of the tax expenditures associated with well-funded private pension plans, it would make a tremendous difference in the way we estimate the tax expenditures associated with government plans, as these plans are frequently funded on a pay-as-you-go basis.

In recent years the Office of Management and Budget has begun to recognize this problem with cash-flow tax expenditure estimates:

Cash-based estimates reflect the difference between taxes deferred in the current year and incoming revenues that are received due to deferrals of taxes from prior years. Although such estimates are useful as a measure of cash flows into the Government, they do not accurately reflect the true economic cost of these provisions. For example, for a provision where activity levels have changed, so that incoming


78. On the other hand, cash method estimates tend to overestimate the tax expenditure associated with over-funded retirement plans.

79. Alicia H. Munnell, Are Pensions Worth the Cost?, 44 Nat’l Tax J. 393, 395 (1991) describes the accrual method as follows:

A better estimate of the annual revenue loss resulting from deferral would be the difference between (1) the present discounted value of the revenue from current taxation of employer contributions and pension fund earnings as they accrue over the employee’s working life, and (2) the present discounted value of the taxes collected when the employer’s contributions and investment returns are taxable to the employee after retirement.

80. Id.
tax receipts from past deferrals are greater than deferred receipts from new activity, the cash-basis tax expenditure estimate can be negative, despite the fact that in present-value terms current deferrals do have a real cost to the Government. Alternatively, in the case of a newly enacted deferral provision, a cash-based estimate can overstate the real cost to the Government because the newly deferred taxes will ultimately be received.  

Consequently, the Office of Management and Budget has determined that present-value estimates of certain tax expenditures can be a useful supplement to its usual cash-flow estimates, at least for certain provisions involving deferrals. As a result, the Federal Budget now provides present-value estimates for many Internal Revenue Code provisions that involve tax deferrals or other long-term revenue effects. To date, this present-value method has been applied to pensions but not to Social Security. Table 2 compares the 2001 Federal Budget’s cash-flow and present-value tax expenditure estimates for the pertinent pension provisions.

**TABLE 2.**

A COMPARISON OF THE CASH-FLOW AND PRESENT-VALUE METHODS FOR ESTIMATING PENSION TAX EXPENDITURES IN 1999

(In millions of dollars)

<table>
<thead>
<tr>
<th>Cash-Flow Method</th>
<th>Present-Value Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exclusion of pension contributions-employer plans</td>
<td>83,780</td>
</tr>
<tr>
<td>Exclusion of IRA contributions and earnings</td>
<td>13,350</td>
</tr>
<tr>
<td>Exclusion of contributions and earnings for Keogh plans</td>
<td>5,230</td>
</tr>
</tbody>
</table>

81. EXECUTIVE OFFICE OF THE PRESIDENT AND OFFICE OF MANAGEMENT & BUDGET, supra note 2, at 108.
82. *Id.* at 108, 119.
83. *Id.* at 109-11, 119.
84. *Id.*
The 2001 Federal Budget explains the present-value tax expenditure estimates in Table 2 as follows:

The present-value estimates represent the revenue losses, net of future tax payments, that follow from activities undertaken during calendar year 1999 which cause the deferrals or other long-term revenue effects. For instance, a pension contribution in 1999 would cause a deferral of tax payments on wages in 1999 and on pension earnings on this contribution (e.g., interest) in later years. In some future year, however, the 1999 pension contribution and accrued earnings would be paid out and taxes would be due; these receipts are included in the present-value estimate.85

It is somewhat reassuring that the cash-flow and present-value tax expenditure estimates for pensions in Table 2 are somewhat similar. For example, the tax expenditure associated with employer plans in 1999 is about $84 billion under the cash-flow method and about $95 billion under the present-value method. On the other hand, the tax expenditure associated with Individual Retirement Accounts in 1999 is about $13 billion under the cash-flow method but just $6 billion under the present-value method.86

It is particularly unfortunate that the Federal Budget does not provide a present-value estimate of the tax expenditure associated with Social Security. In that regard, a present-value estimate of the Social Security tax expenditure would likely be significantly higher than the $25-billion-a-year, benefit-based, cash-flow estimates in Table 1.87 My own back of the envelope estimate suggests that a present-value estimate of the Social Security tax expenditure would be around $54 billion a year.

Here’s where that $54 billion estimate comes from. Theoretically, under the present-value method, the annual income tax revenue loss from Social Security should be estimated by determining the excess of (1) the present value of the revenue from current taxation of employer contributions and the earnings implied by the Social Security benefit promise as these accrue over the worker’s life, over (2) the present value

85. Id. at 108.
86. IRAs are a relatively new form of retirement savings, and relatively few workers have begun to draw their benefits. Perhaps, once more IRA account holders draw their benefits, the cash-flow and present-value estimates will converge.
87. See supra notes 3, 67 and accompanying text.
of the income taxes to be paid on Social Security benefits after retirement. 88

But the current cash-flow tax expenditure budget makes no effort to estimate the revenue lost from excluding employer Social Security contributions from income. Employer contributions to the Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) programs run at roughly $230 billion a year. 89 Consequently, taxing those employer contributions at an average income tax rate of 20 percent would raise about $46 billion a year. 90

Nor does the current tax expenditure budget try to estimate the revenue that would be raised on OASI and DI earnings as benefits accrue over the worker’s life. One way to get some perspective on the size of this benefit accrual number is to imagine that Social Security were fully funded, rather than pay-as-you-go. In that regard, the Social Security trust funds have about $900 billion on hand, 91 but they have an unfunded liability of about $10.8 trillion, 92 for a total of $11.7 trillion.

If there really were $11.7 trillion sitting around in the Social Security trust funds collecting interest at a 6.9 percent rate, 93 the funds would earn around $800 billion a year in income. 94 Taxing that $800 billion of interest to the individuals accruing benefits at an average tax rate of 20 percent would raise about $160 billion a year. 95

Finally, the taxation of Social Security benefits currently raises about $17 billion a year. 96 The present value of the government’s right to receive revenue from the future taxation

88. See supra note 79 and accompanying text.
89. See supra note 65 and accompanying text.
90. $46 billion = 20% x $230 billion.
91. See supra note 71 and accompanying text.
93. Office of the Chief Actuary of the Social Security Administration, supra note 72.
94. $807.3 billion = .069 x $11.7 trillion.
95. $160 billion = 20% x $800 billion.
96. 2000 Green Book, supra note 4, at 65 ($17.3 billion estimate for calendar year 2000).
of Social Security benefits might be estimated at, ten times that, or $170 billion.  

All in all, the government loses around $54 billion a year because of the special tax benefits associated with Social Security ($54 billion = $64 billion + $160 billion – $170 billion). That's more than double the $23 billion cash-flow tax expenditure estimate for 1999 as reported in the 2001 Federal Budget.  

In short, the theoretically correct estimate of the Social Security tax expenditure is significantly larger than the usual, cash-flow estimate that shows up in the typical tax expenditure budget.

C. An Alternative to Tax Expenditures: The Benefit Payment Approach

The House Ways and Means Committee offers an alternative approach for measuring the amount of benefits that result from the tax provisions that relate to pensions and Social Security. According to the Committee's 2000 Green Book:

Several different types of income tax provisions are available to provide economic incentives. Examples include: exclusions, exemptions, deductions, preferential rates, deferrals and credits. Measuring the amount of benefit afforded by a tax provision is difficult. However, one way to measure the benefit is to review the total estimated amounts excluded, exempted, or otherwise afforded special treatment under various provisions of the income tax.

In short, the 2000 Green Book's approach is to look at the amount of benefits received by taxpayers and estimate the portion of those benefits that is exempted from taxation because of some special tax base exception. Table 3 sets forth the 2000 Green Book's estimates for the tax provisions relating to pension and Social Security benefits.

98. See supra note 67.
99. 2000 GREEN BOOK, supra note 4, at 780-82.
100. Id. at 778.
101. Id. at 780-82, tbl. 13-2.
**TABLE 3.**

ESTIMATED TAX BASE EXCEPTIONS UNDER THE PRESENT INCOME TAX FOR PENSIONS AND SOCIAL SECURITY, CALENDAR YEARS 2001-05

(In millions of dollars)

<table>
<thead>
<tr>
<th>Item</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>Total 2001-5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net exclusion of pension contributions and Earnings</td>
<td>372.9</td>
<td>361.5</td>
<td>344.9</td>
<td>341.3</td>
<td>344.3</td>
<td>1,764.8</td>
</tr>
<tr>
<td>Keogh plans</td>
<td>20.1</td>
<td>20.4</td>
<td>20.6</td>
<td>21.9</td>
<td>23.7</td>
<td>106.8</td>
</tr>
<tr>
<td>Individual retirement plans</td>
<td>55.5</td>
<td>62.9</td>
<td>67.6</td>
<td>73.3</td>
<td>76.7</td>
<td>336.1</td>
</tr>
<tr>
<td>Exclusion of Social Security benefits in excess of employee share of payroll tax</td>
<td>269.7</td>
<td>279.3</td>
<td>288.4</td>
<td>298.8</td>
<td>307.1</td>
<td>1,443.3</td>
</tr>
</tbody>
</table>

Unlike tax expenditure estimates of lost revenue, the Ways and Means Committee estimates identify the amount of benefits that receive more favorable tax treatment than they would under an ideal income tax. For comparison sake, however, the numbers in Table 3 could easily be converted into tax-expenditure-like estimates if we knew the applicable tax rate. For example, assuming that a 20 percent tax rate

102. *Id.* at 780-82, tbl. 13-2.
should apply to the excluded pension and Social Security benefits in Table 3, one would conclude that pension beneficiaries saved about $90 billion in taxes in 2001,\textsuperscript{103} and that Social Security beneficiaries saved about $54 billion.\textsuperscript{104} That would be the equivalent of saying that federal government had a revenue loss in 2001 of about $90 billion because of the special tax rules relating to pension plans and a revenue loss of about $54 billion because of the special tax rules relating to the Social Security system.

IV. IMPLICATIONS FOR PUBLIC POLICY

Part III showed that the current cash-flow method for estimating the Social Security tax expenditure significantly underestimates the income tax revenue losses associated with the Social Security system. This underestimation of the Social Security tax expenditure has some serious policy implications. First, underestimating the Social Security tax expenditure distorts the way policymakers view the need for Social Security reform and the mechanisms chosen for that reform. Second, underestimating the tax expenditure associated with Social Security relative to the tax expenditure associated with pensions invariably results in more pressure to curtail the special tax benefits for pensions and less pressure to curtail the special tax benefits for Social Security.

A. Implications for Social Security Reform

The Social Security system is in financial trouble. The Trustees of the Social Security Trust Funds estimate that Social Security benefits will exceed trust fund income starting around 2016, and the Social Security system will be unable to pay full benefits after about 2038.\textsuperscript{105} In fact, the Trustees estimate that the deficit over the traditional 75-year projection period is about 1.86 percent of payroll. In short, the fed-

\textsuperscript{103} $89.7 \text{ billion} = 20\% \times $448.5 \text{ billion} = 20\% \times (\$372.9 \text{ billion} + \$20.1 \text{ billion} + \$55.5 \text{ billion}).$

\textsuperscript{104} $53.94 \text{ billion} = 20\% \times $269.7 \text{ billion}.$

eral government will need to either raise Social Security taxes or cut Social Security benefits. Not surprisingly, Social Security reform has become a hot topic in the past few years. 106

Historically, the government has usually fixed any projected shortfall in Social Security revenues by raising payroll taxes. Under the usual cash-flow method for computing the Social Security tax expenditure, this change would, over time, result in a modest decrease in the government’s estimates of the Social Security tax expenditure. Those workers called upon to pay more payroll taxes, would, in the future, be allowed to recover more benefits tax-free after retirement. 107 Even if the payroll tax increases had the effect of shifting the current Social Security system from a pay-as-you-go status to a fully funded status, 108 there would be no significant change in the tax expenditure associated with Social Security. 109

On the other hand, many analysts have called for replacing all or a portion of the current Social Security system with a system of individual retirement savings accounts (IRSA}s). 110 For example, in January of 1997, the 1994-1996 Social Security Advisory Council issued a long-awaited report on how to reform the Social Security system. 111 The Council members were unable to achieve a consensus, but a majority of the


107. In the absence of any other changes, a worker’s future benefit entitlement would be unchanged by a payroll tax increase; however, her “investment in the contract” within the meaning of I.R.C. § 72(c)(1) would increase, so more benefits “should” be recovered tax-free under the benefit-based, cash-flow method.

108. See, e.g., Seidman, supra note 17; Lok Sang Ho, A Universal Fully Funded Pension Scheme, 15 CONTEMP. ECON. POL’Y. July 1997, at 13. Funding Social Security would require two essential elements: fund accumulation and portfolio diversification. Fund accumulation would require substantially higher payroll tax rates (or lower benefits), and portfolio diversification would be achieved by having the Social Security Administration invest in the stock market. Presumably, the Social Security system would continue to operate as a defined benefit plan with the beneficiary’s benefits linked by a legislated formula to the retiree’s wage history, but Social Security benefits would be paid out of a mix of payroll taxes and portfolio investment income, rather than just out of payroll taxes and Treasury debt instruments.

109. The benefit-based, cash-flow Social Security tax expenditure would decrease, however, if solvency were achieved by cutting future Social Security benefit entitlements. Such benefit cuts would reduce each beneficiary’s “expected return” within the meaning of I.R.C. § 72(c)(3) and so reduce the amount of untaxed income.


Council agreed that at least a portion of Social Security payroll tax contributions should be redirected into individual retirement savings accounts (IRSAs) that would invest in the stock market. Under the so-called Individual Accounts (IA) approach, these individual accounts would be held by the government, invested in secure equity funds, and annuitized on retirement. Alternatively, under the so-called Personal Security Accounts (PSA) approach, these individual accounts would be held by financial institutions and their investment would be directed by individual workers.

Unlike the current Social Security system, a system of individual retirement savings accounts would look a lot like an employment-based 401(k) plan or a system of IRAs. Presumably the tax expenditures associated with these individual accounts would be estimated under the same cash-flow method currently used to estimate the revenue losses associated with 401(k) plans and IRAs, rather than under the benefits-based, cash-flow method currently used to estimate the Social Security tax expenditure. As a result, proposals to replace all or a portion of the current Social Security system with a system of individual accounts would appear to result in a significant increase in tax expenditures, even if the ultimate amount of benefits received in retirement by Social Security beneficiaries stayed about the same.

In short, adding funds to our vastly underfunded Social Security system while retaining its defined-benefit structure would result in, at most, a modest decrease in the current Social Security tax expenditure. On the other hand, replacing all or a portion of the current Social System with funded indi-

112. Id., Vol. 1, at 28-29.
individual retirement savings accounts would increase the pension tax expenditure.\textsuperscript{114}

Of course, it might make sense to increase the funding levels of both Social Security and pensions. Such a change would have little or no impact on the current Social Security tax expenditure, but it would cause a significant increase in the pension tax expenditure. Also, it might make sense to move away from Social Security’s traditional defined benefit plan model and towards a system of individual accounts.\textsuperscript{115} Without more, however, taking money from Social Security and putting it in individual accounts costs the government nothing. Unfortunately, given the very different ways that the government currently estimates the Social Security and pension tax expenditures, moving money from Social Security to individual accounts could dramatically increase tax expenditures.

The future direction of Social Security reform will not turn on questions about how the tax expenditures for Social Security and pensions are estimated. Nevertheless, it would make sense if both the tax expenditure for Social Security and the tax expenditure for pensions were estimated in a consistent manner. Perhaps, the best approach would be to provide present-value tax expenditure estimates for both pensions and Social Security. Alternatively, policymakers would do well to make their comparisons using tax base exception estimates like those in the 2000 Green Book, rather than the inconsistent cash-flow tax expenditure estimates in the typical tax expenditure budget.

\textbf{B. Implications for National Retirement Policy}

Underestimating the tax expenditure associated with Social Security relative to the tax expenditure associated with pensions has resulted in significant pressures to curtail the special tax benefits for pensions and almost no pressure to curtail the special tax benefits for Social Security. In that regard, for example, tax expenditure budgets often rank tax ex-

\textsuperscript{114} Cf. Forman, Once and Future, supra note 50.

\textsuperscript{115} See, e.g. Jon Forman, Rescue in the Balance: Here’s a Plan to Save Social Security That Will Work, BARRON’S, Dec. 18, 2000, at 54.
penditures by the amount of revenue loss. For example, the tax expenditure associated with employment-based pension plans leads the 2001 Federal Budget’s list of tax expenditures (at $93 billion in fiscal year 2001 and almost $514 billion over the period 2001-2005). The exclusion of Social Security benefits for retired workers came in a mere twelfth on the list (with a fiscal year 2001 revenue loss of about $18.9 billion and a 2001-2005 revenue loss of 99.1 billion). No wonder the special tax benefits for pensions have been the target for more than a dozen bouts of revenue-driven tax "reforms" in the past couple decades.

On the other hand, when it comes to Social Security, Congress has generally heard more from those want to cut the taxation of Social Security benefits than from those who would instead repeal the current partial exclusion for Social Security benefits and tax Social Security benefits like other pensions and annuities. Properly estimating the tax expenditures associated with Social Security and pensions just might help achieve proper taxation of both types of retirement benefits.

V. CONCLUSION

Because Americans are living longer and retiring earlier, they will need more resources than ever to ensure that they will have adequate incomes throughout their retirement years. Much of that income will come from two very similar retirement systems: Social Security and pensions. The tax expenditure budgets need to stop treating these two retirement systems like apples and oranges.

Instead, it would make sense to use the same method to estimate the tax expenditures associated with Social Security

116. EXECUTIVE OFFICE OF THE PRESIDENT AND OFFICE OF MANAGEMENT & BUDGET, supra note 2, at 117.
117. Id.
121. See, e.g., Forman, Universal Pensions, supra note 106, at 101-05.
and pensions. Perhaps, the best approach would be to provide present-value tax expenditure estimates for both pensions and Social Security. Alternatively, it would make sense to use tax base exception estimates like those in the 2000 Green Book. Either way, shifting to a consistent method for estimating the tax benefits associated with pensions and Social Security would help policymakers better compare these two retirement systems and so develop the best solutions for meeting the retirement income needs of all Americans.