The Administration's USA Account Proposal (Part 2 of 3)

Part Two: What's Right About It

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Despite the opposition of many Democrats to any "privatization" of social security, President Clinton's proposal to establish USA accounts in many ways resembles the individual account proposals that form part of social security "privatization" schemes. These new saving proposals would help to fill a gap that is not being addressed by either the social security system or the private pension system.

Social security has a base of protection for low-income individuals, but almost no saving. The private pension system has private saving, but inadequate protection for many in the middle- and lower-income classes. USA accounts attempt to get around the weaknesses of each of the systems by putting additional saving in the hands of low- and moderate-income families without reducing their base of protection.

Conceptually it's easier first to consider USA accounts in abstraction from the political debates of the day. The U.S. retirement system basically rests on two pillars. The first, which I will call the social security pillar, actually consists not just of social security but other pay-as-you-go programs, such as Medicare, Medicaid long-term care, and Supplemental Security Income for the elderly. For the most part, taxes are collected each year and paid out to recipients immediately. In the case of social security and one part of Medicare (Hospital Insurance), there are small trust funds that have a very modest build-up of taxes in excess of benefits paid. The build-up, however, is trivial compared to the long-term liabilities of these systems, and the asset build-up is only scheduled to be temporary. Soon, in fact, these systems are scheduled to go into a permanent deficit status, where benefit payments are in excess of taxes paid. The bottom line is that most government programs for the elderly are transfers from younger to older generations and involve little or no saving.

A second pillar is the private retirement system. Although tax subsidies are used to support this system, it is voluntary. Contributions are made by employees or by the employer on the employees' behalf. There is no coercion or mandate. Nor is there retirement protection for a large percentage of individuals who either do not participate or, if they participate, quickly withdraw any accumulated saving when it becomes available. The amount of saving achieved through this system varies widely among individuals and is mainly dependent on the amount of deposits made by or on behalf of each employee.

In sum, the U.S. retirement system is based largely on an unfunded, mandated system and a funded, unmandated one. Ignore for a moment the issue of the size of each of these pillars. As a structural matter, why should mandates be all right only if they are unfunded and funded systems all right only if they are not mandated? A funded, mandated system is merely a hybrid between the two current pillars. As such, it is very difficult to oppose on structural grounds. After all, it merely combines together features that are already in the pillars that already exist. If mandates are bad, then they probably shouldn't be used for social security. And if funding is bad, then it is probably bad for the private retirement system as well.

Opposition to a funded, mandated pillar rests, therefore, not on any inherent structural defect but rather on fears as to what will happen to the other pillars. Not long ago, funded mandates were proposed as a means of promoting minimum private pension benefits, but they were opposed by those who thought this would decrease the size or redetermine the shape of the private pension pillar. Today, funded mandates are largely opposed by those who fear that it will reduce the strength of the social security pillar.

The president's proposal tries to avoid this debate by suggesting no changes in either social security or the private pension system. Because of social security's imbalance and the poor coverage of many workers under private pensions, this strategy may be called into question. But it does neatly frame the issue of whether a third pillar is worthy of creation, independent of other reforms that may have to take place.

If properly designed, USA accounts could represent one step toward a 21st century social insurance policy that will be very different from the purer transfer policies of the past. These types of accounts give recognition to the importance of saving and of some individual responsibility over that saving. There are some who also believe that the lessons of saving can be learned only through experience. The hope, which has some merit, is that individuals who do not currently save will see the gains from saving, as well as the advantages of compounding interest and other returns over long periods of time. As a consequence they will become more likely to save additional amounts on their own.

As currently proposed, the USA account proposal also tries to give attention to the need to increase private pension saving among moderate- and low-income individuals. In our society, wealth is much more unevenly distributed than is income, and wealth ownership is strongly associated with opportunity.

If one examines saving patterns of households closely, those with modest resources tend to save mainly in homes or private pensions. Yet private pension wealth is still considerably concentrated, with the bottom half of the retiree population getting very little from pensions. USA accounts—like their first cousins, individual retirement accounts—would likely make more even the distribution of both pension wealth and private wealth in society.

Importantly, the president's proposal attempts to make sure that new tax subsidies would be concentrated in the middle and bottom of the income distribution. While it creates a number of administrative complexities, this pattern can be contrasted with the existing private pension system. There, subsidies are concentrated mainly at the top, both because those with higher incomes save more and because they are in higher tax brackets.

There is some evidence that individuals will save more if they are encouraged through regular withdrawals for pensions and if a match is provided. This evidence rests largely on experiences with 401(k) and similar plans. There are much higher levels of participation in these types of plans than in purely personal saving plans like individual retirement accounts.

The advantages of the administration's USA account proposal, therefore, are not few. It would attempt to use some general revenues to fortify and build up the private pension system. With luck, it would develop and reinforce better saving patterns by individuals. The distribution of wealth, pension wealth, and tax subsidies for pensions would all be made more equal. Although the accounts would not be large, they might serve as a catalyst for future private pension reform as well.

Other Publications by the Authors

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