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

Part Three: Why It Won't Work as Crafted

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The Clinton administration wanted to put forward a private pension proposal that would involve additional saving, particularly for low-income individuals. Similar in ways to the individual accounts proposed in many social security reforms, Universal Savings Accounts would encourage additional pension saving, increase wealth ownership among those in the middle- and lower-income classes, decrease the inequality of private wealth, and make more even the distribution of tax subsidies for pensions.

Laudable as those goals might be, the fatal flaw in the administration's strategy is that it is not integrated either with social security reform or with further reform of the private pension system. Accordingly, if adopted as proposed, USA accounts would increase substantially the administrative burdens imposed on taxpayers and the IRS. Some parts of the proposal would be very hard to understand, and, as one consequence, participation could be reduced.

Start with Treasury's first problem in developing the USA proposal. The amount of revenues to be made available was determined politically before a draft of a proposal had even been developed. The amount wasn't all that large relative to the pension needs of individuals. That led Treasury to its first distinction from a more traditional design. It decided to make voluntary contributions to USA accounts come out of after-tax income, rather than, like most pension accounts, before-tax income.

Why? In the early years, based on only fixed amounts of revenue to be spent on the credit that would help fund the individual accounts, the revenue loss from the entire proposal would be reduced. Down the road, however, the up-front payment of taxes would be offset a bit by reduced taxes on withdrawals.

Unfortunately, this simple decision had a number of perverse consequences for tax policy. It added all sorts of layers of complication. One came when some alert person noted that the administration probably wanted to allow voluntary contributions to 401(k) plans to qualify as personal saving in much the same way as voluntary contributions to the USA account. But that required yet another correction. The drafters of the proposal had just required the voluntary contribution to the USA account to come out of after- tax income. To reduce that disparity, Treasury decided that "[b]ecause contributions to a 401(k)-type plan are excludable from taxable income while USA contributions are not, joint filers with AGI of more than $50,000 ($25,000 for single filers, $37,500 for head of household filers) who elect to receive government matches will be required to include in taxable income 80 percent of the portion of the 401(k) contribution that is matched."

That offset, therefore, represents an attempt to provide rough parity for those who enter in through a 401(k) door and those who enter in by way of voluntary contributions. Because it's rough, however, it grants differential tax benefits to the same individual just depending on which door he or she enters. It is not so much the inequities involved as the complication that is most bothersome.

Note also that a taxpayer with both a 401(k) and the ability to contribute through a separate individual account may decide to do alternative calculations of which would be better—in longstanding opposition to Treasury's traditional position that these types of options are not good tax policy. Meanwhile, at the time of withdrawal, only 85 percent would be taxed, so withdrawals from this account would look different than those from other pension plans, again adding to the complexity of understanding and filing.

Tax policy analysts have also noted for years that it is not necessary to try to introduce progressivity into every provision in the code—that this is likely to violate simplicity standards without being more progressive. (See testimony of Eugene Steuerle before the Oversight Subcommittee, Committee on Ways and Means, May 25, 1999, on introducing phaseout after phaseout into the tax code. Doc 1999-18680 (14 original pages).) One can usually adjust the rate schedules or some basic credit amount (e.g., social security minimum) to

achieve an equal degree of progressivity.

Because the administration did not want to deal with social security or private pension or tax reform, however, it decided to tackle progressivity within the confines of the USA account proposal only. Therefore, it created several phaseouts of benefits. Both a base credit amount, called an "automatic tax credit," and a "matching tax credit," which provides a match rate for voluntary contributions, are phased out. The phaseout ranges differ for the two types of subsidies, and yet another phaseout range is created for those with and without an employer-provided pension.

These complications all but ensure that an employer would have trouble figuring out how much to adjust wage withholding because of USA account activity. We already have much experience here: the main reason the earned income tax credit is not reflected in withholding for most employees is that the amount of the credit varies so much with income and family status that it is hard to know how much is likely to be available until after the end of the year. During the year, few have any idea of how much credit they will be eligible to receive.

For a variety of reasons, the administration set up the USA accounts separately from other retirement accounts held by individuals. For instance, withdrawals are much more restricted before age 65. Unfortunately, individuals already have multiple retirement vehicles—individual retirement accounts, 401(k) plans, money purchase plans, profit sharing plans, and so forth. That extremely messy universe would just be made messier.

The attempt to create maximum progressivity with the small amount of revenues available created yet another problem. A large percentage of low-income and even middle-income individuals do not contribute to retirement plans like IRAs. Treasury decided, therefore, that it would grant large portions of the credit to individuals regardless of their level of contributions. Where there was to be a match, moreover, the match rate would be very high—either dollar-for-dollar at low-income levels or 50 percent at middle-income levels and above, as long as some eligibility was sustained. Because there was limited revenue to use for matching, the high match rate required that a taxpayer's maximum subsidized deposits be limited to very modest amounts.

This distributional arrangement is also very different from what is offered in the rest of the private and public pension system. Subsidies for private pension plans are usually capped, rather than phased out (although there are exceptions). Social security achieves its redistributional objectives by offering individuals with higher earnings higher levels of benefits, although less than proportional to earnings and taxes paid.

A much simpler arrangement would have been simply to cap the subsidy without phasing it out. There is no reason that the social security benefit formula could not be adjusted to provide the slight offset needed. Or one could freeze caps on maximum private pension contribution levels for a year or two and effectively create an offset to any gains at the top of the income distribution. In effect, there are a lot of ways to deal with distributive issues without all the machinations of the USA account proposal.

There are some other glitches. In an attempt to prevent individuals with very low labor force participation from getting a windfall, the taxpayer would have to earn at least $5,000 to get the government subsidy. That would create a cliff effect at $4,999 or demand yet another phase-in schedule. All the phase-ins and phaseouts and cliffs, including this one, also create new marriage penalties.

Still, I do not want to pick and pick away at the details. There are a lot of problems, as well, with existing private pension subsidies and with some of the redistribution within social security that goes to the rich, not the poor. The idea of a government-match plan is not a bad one, it simply has to be better coordinated with existing law. On net there should be some simplification, not additional complexity, as well as a better rationalization of the overall subsidies in the combined system. Or else the idea of a government match is simply too complicated to merit being patched onto the existing system.

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