USA Accounts

President Clinton proposed in his budget to increase retirement savings among lower and middle income people, using Universal Savings Accounts (USAs). Clinton would use $500 billion in budget surpluses over the next 15 years to put some seed money (e.g., $100) into their USA accounts, plus provide a partial match (e.g., a 50% match of up to $300 per year, for those who contributed $600), with a larger percentage match going to lower income workers.

Advantages and Disadvantages of USAs: USA accounts could be larger than Individual Accounts (IA) that have been proposed in some Social Security reform plans for some low income workers due to the government match and seed money, thus addressing the concern somewhat that expenses would be relatively high for a small account. (However, if the worker doesn't opt for the match, their account would be only $100. Concerns regarding small accounts are discussed later.) In addition, the beneficial effects of USAs on national savings and productivity could be better than other IA proposals (although not quite as good as reducing the national debt[1]). Other Individual Account proposals include middle and higher income people that might just reduce their other saving[2], which doesn't help national savings as much. Clinton says his proposal will use about $500 billion of surplus over the next 15 years. One concern is that the surpluses are temporary and may not be as large as projected. There are other concerns too about whether Individual Accounts (IA) for 100 million people (or more) are administratively feasible. However, USA might be easier to implement than other IA proposals, for the following reasons.

(1) Fewer workers are eligible, so there will be fewer accounts to administer.
(2) The match is voluntary, so there will be less enforcement problems than if a mandatory provision was enacted.
(3) Allocations of the surplus are only once a year, instead of at every pay period.
(4) Allocating the contribution through a tax credit could be easier to administer.
(5) Allowing the government contribution to be held in employer pension plans (as suggested later) would also ease the government's enforcement burdens and get better returns because groups are generally more efficient than individuals.

The Reluctance to Save for Retirement and the Policy Response: Retirement policy makers have for many years sought ways for the government to encourage lower income people to save for their retirement.

(1) IRAs proved unsuccessful (less than 16% of low-income people participated, even in the early 80's). Lower income people could rightfully point out that they get a smaller tax advantage from IRAs than high income people.
(2) The 401(k) features in pension plans have been more successful at covering low-income workers, because employers had to encourage their lower-income employees to participate in

[1] However, government interest rates would not go down as much, because individuals would probably not loan all of it to the government; some of it would go to stocks and corporate bonds.

[2] On the other hand, high income people may not spend much more either since they already have enough of everything, so this argument won't apply to all higher income people.

order for top management to participate. Employers made it easy to participate through payroll reduction, loans, education, and by giving matches. Still, less than ½ of low income workers participate generally. See attached.

(3) Traditional Defined Benefit retirement plans generally cover *all* employees[3] (sometimes after an initial waiting period of 1 year). However, many small companies have dropped these traditional pension plans in favor of 401(k) plans that have less participation and smaller employer contributions (the employees pay for all or most of it).

In fact, most small companies don't have 401(k) plans or any retirement plan for their employees. Polls show that this is due not only to the cost of a pension plan, but also the very complex rules required to set up and maintain it. In addition, earlier polls showed that many employees were not concerned about retirement and would prefer cash or health insurance instead. In that environment, there were less reasons for an employer to offer a pension plan. However, as the baby boomers age, it appears that retirement issues are becoming more important to employees and employers.

Increased Savings BUT in Small Accounts: The President's proposal could increase personal saving for many people who don't have a pension plan or savings. However, we note that the seed money (e.g., $100) is not much. The investment fees would probably exceed the interest earnings for years and many investment firms would rather not have these small accounts. Providing a larger amount makes more sense, but would cost more, unless it's paid to fewer people. In addition, we note that less than ½ of low income people will opt for the match based on 401(k) statistics (and that's with employers actively encouraging low income employees to participate with loans, payroll reduction, matches, education, etc.).

USAs Could Reduce Savings for Many with Low Incomes: Probably the biggest concern is that the USA proposal could discourage employers from sponsoring pension plans. Initially there was a concern that USAs would hurt 401(k) plans. However, it now appears the White House will allow the USA contribution to go to employer 401(k) plans[4]. That could encourage more low income people to participate, because they would get the employer match *and* the government match[5]. However, this will encourage some employers to drop their traditional pension plans in favor of less generous 401(k) plans. Past pension policy has tried to keep the rules for traditional pension plans more favorable than those for plans with 401(k) features, because traditional pension plans generally cover everyone (not just those that contribute as in a 401(k) plan) and the employer often contributes more. Providing USA contributions only to 401(k) plans would mean that they would get much more tax advantages than the traditional pension plan.

Example of Problem: A simple example demonstrates this. Suppose an employer gives $1000 to every employee in a traditional retirement plan. All employees participate and all employees get $1000. Once USA is enacted, the employer should drop the traditional retirement plan, start a 401(k) plan, give every employee $600 in cash, and pocket the $400 left over. The employees that

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[3] Except part-time & temporary workers and employees with less than one year of service or under age 22

[4] February 1999 *Pensions and Investments* article.

[5] Other 401(k) conforming issues to be decided are whether loans will be allowed in 401(k) plans that accept this government money. Will government allow money to leak out as soon as it is contributed? Will the money be pre-tax like other 401(k) matches and seed money? If not, the accounting will get complex, it will confuse people and irritate those who will have to pay tax on money they don't have. Will it vest immediately? Will employers be able to take advantage of the government money in the nondiscrimination testing? How will the government money get into the plan; directly from a government check or from employees who get a tax credit? Can money be invested anywhere? Internationally? In very risky junk bonds and derivatives? Will the safe harbor 401(k) plan be allowed as a vehicle, even if they are very discriminatory in favor of highly paid employees?

put the $600 into the 401(k) plan would get the $400 from the government and be just as well off. However, those employees that don't participate would lose the $300 government match, and they would most likely be lower paid employees - in fact, 401(k) statistics show that over half of them won't contribute and will lose out. Thus, the USA proposal would actually help employers, but hurt some low income people.

Is There A Way Out of this Problem? This is clearly not the intent of the Administration and there could be a way out of this problem. *The USA seed money and match could go to any type of retirement plan.* USA money should not discriminate between which kind of plan the employer has. All employer plans should be eligible, but employers wouldn't be required to participate. There would need to be rules, however, on how the government contribution is treated. First of all, it should be immediately vested. Secondly, there would have to be a minimum accrual of whatever the government plus employee contributions come to, plus interest. In Defined Benefit (DB) plans, that can be handled by the employee contribution rules[6], or by a minimum cash-balance-type formula[7] even in a traditional final pay DB plan. In fact, these ideas could help traditional DB plans become popular again, because it would fix one of the glaring problems of traditional DB plans, namely the small accruals at younger ages are not attractive to new young employees.[8] This would complement some of the ideas that David Strauss (Executive Director of the PBGC) is suggesting for DB plans, such as pre-tax employee contributions and employer matches.

Fewer Complex Rules and Confusing Accounts: The other advantage of tying into current retirement plans, is that people won't need to have another small retirement account for which they have to remember all the special new rules and pay another management fee. In fact, portability legislation has been proposed that would allow movement between most types of retirement plans[9]. Furthermore, the portability rules might force us to eventually consolidate all the rules into one set of good rules that apply to all retirement vehicles. In addition, employer plans have been around for a long time and rules are already in place to handle many of the questions that USA's proponents will have to answer, such as how to ensure that non-working spouses will benefit, should there be loans (and how much), and how should pension money be distributed. This could be helpful to the implementation of USAs.

Summary: In summary, USA accounts (as presently conceived) could increase national saving and especially personal savings among lower income people. In addition, they could be easier to implement and administer than other Individual Account proposals. However, they could have the

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[6] Some non-discrimination rules may need to be relaxed for contributory plans.

[7] A minimum interest credit might be required on the employee and government contribution too.

[8] Another alternative would be to use the same 11% of surplus to increase the tax incentives(including tax credits) and limits for all pension plans. It should be noted that this would be tax deferred, and not forever lost to the government. However, some people might still see this as helping employers too much, so a response could be to place restrictions on the plans that could get the additional tax incentives (e.g., minimum accrual, participation, and vesting rules; no integration, backloading, or age weighting; an automatic payment option in a Joint Life form with 75% continuation to the spouse; possibly with optional inflation indexing). In addition, there would have to be USA accounts for people not in a pension plan.

[9] For example, someone could have 5 types of IRAs (Roth, Traditional deductible and non-deductible, SIMPLE IRAs, and education IRAs), 401(k) accounts (pre- and post-tax money), DB benefits, and money purchase accounts with each past employer, a Section 457 benefit with a past governmental employer, a 403(b) annuity from a non-profit employer, and a SEP and/or Keogh plan for their self-employment work. (And this is on top of one's checking and savings accounts, money markets, mutual funds, and CDs.) Each has different rules and not all can be moved from one to the other. Distribution time will be interesting.

effect of reducing retirement savings for many low income people. An alternative could be to allow USA contributions to go to any type of employer pension plan. Not only would this improve the chances that lower income employees would increase their savings, it could eventually simplify retirement rules all around for everyone's benefit, including the government.

Ron Gebhardtsbauer
Senior Pension Fellow