



Matching Private Saving with Federal Dollars: USA Accounts and Other Subsidies for Saving

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PRESIDENT CLINTON PROPOSES SPENDING about \$540 billion over 15 years on a new savings initiative called “Universal Savings Accounts” or “USA Accounts.” USA Accounts would provide low- and middle-income workers with automatic annual contributions for retirement savings. Matching contributions would also be available to stimulate additional savings. Many proposals for individual savings accounts have been introduced in Congress this year as part of the debate over the future of Social Security. Perhaps seen as just another look-alike proposal, USA Accounts have received little attention.

But USA Accounts are innovative and deserve a closer look. They borrow the popular technique of matching contributions from the private pension system and surround it with a new federal program of savings incentives and subsidies. Two subsequent reform proposals under Social Security have similar features. The Bipartisan Social Security Reform Act of 1999 (S. 1383), introduced in the Senate on July 16, 1999, and the 21st Century Retirement Act (H.R. 1793), introduced in the House of Representatives on May 13, 1999, also use federal dollars to match individual savings. The federal government currently supports

savings by providing indirect subsidies to the pension system through the tax code. These proposals envision a new role for the federal government in leveraging individual savings through direct, progressive incentives and subsidies.

WHAT IS THE RATIONALE FOR A FEDERAL SAVINGS PROGRAM?

The Clinton administration argues that a federal program is needed because millions of Americans are not able to accumulate adequate savings for retirement. This concern is shared by many across the political spectrum. In the United States, there are three traditional sources of retirement income: Social Security, private pensions, and personal savings. The traditional sources, individually and collectively, are often insufficient for many workers, with low- and middle-income workers particularly at risk.

Social Security is in danger of being unable to pay promised benefits, largely because of demographic pressures. People are living longer and retiring earlier. The number of retirees will grow rapidly beginning in 2010, when the baby boom generation starts to retire. Eventually, the payroll taxes of remaining workers will be insufficient to fund benefits at their current levels. Restoring Social Security to long-term actuarial balance is a top political priority of both parties, but to ensure the program’s future solvency, many reform proposals include benefit reductions. In addition, some would try to fund a portion of benefits through individual savings accounts. Under these proposals, Social Security would no longer provide the same level of guaranteed, basic income that it does today.

The private pension system has the opposite problem. It consistently fails to achieve its potential to provide retirement benefits to millions of workers. The federal government encourages employers to provide pensions through special tax benefits. But employers are not required to sponsor a plan, and many do not. Complicated pension laws, employee preference for

cash compensation, high compliance and administrative costs, and fiduciary liability are often contributing factors in the decision not to offer a plan. Coverage of low-income and part-time workers, employees of small businesses, and women is particularly problematic.¹ Moreover, the nature of the pension promise is itself changing. Fewer companies today offer defined benefit plans that provide guaranteed income at retirement. As defined contribution plans become the dominant form of plan, employees bear more of the risk and responsibility for retirement income. In fact, the fastest-growing type of plan, the 401(k) plan, largely requires employees to fund their own retirement benefits. The private pension system has little to offer workers who have no employer plan, other than a limited contribution to an individual retirement account (IRA), and nothing to offer workers who cannot afford to contribute to a 401(k) plan when one is available.

Many people do not save on their own. One out of every three workers is not saving for retirement.² Many families with workers reaching retirement age have little savings. According to a recent General Accounting Office study, 25 percent of these families have less than \$25,000 in assets and do not own their own home. Some 60 percent have no IRA, more than 70 percent own no stocks, 92 percent own no bonds, and 50 percent have less than \$5,000 in the bank.³ Although the federal government now promotes education to encourage saving for retirement, it is unlikely that such campaigns will have more than marginal success.

So the rationale for a federal savings program is simple: Federal dollars will be used to provide incentives to induce people to take more responsibility for their retirement savings and to provide subsidies to augment those savings. If the program is successful in helping low- and middle-income workers to save, it will indirectly relieve some of the pressure on Social Security, fill the gaps in the private pension system, and increase personal savings and, ultimately, national savings.

HOW ARE THESE PROPOSALS DESIGNED TO WORK?

The model for these proposals is the very popular 401(k) plan. In a 401(k) plan, employees decide how much to save for retirement each year, within limits set by the tax code. Employers often provide matching contributions to induce employees—particularly low-income workers—to save more, which then enables higher-income employees to save more as

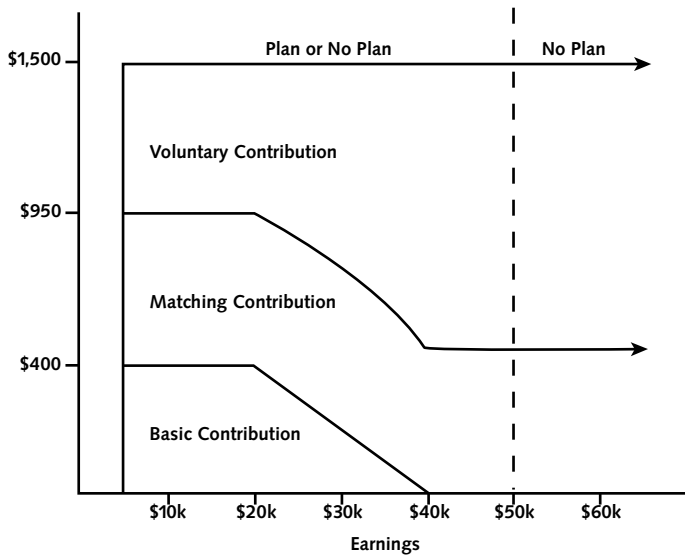
well. Employers may also make basic contributions, which are allocated to all eligible employees independent of any contributions.

The proposals for federal subsidies differ from the 401(k) model in several respects. First, the federal government plays a role similar to that of an employer, but the rate of contributions is fixed by statute. Second, in most 401(k) plans, the match is usually uniform for all workers; USA Accounts provide a progressive match that phases out at higher income levels. Third, employee contributions to a 401(k) plan are made from pretax dollars. So far, these proposals permit only after-tax contributions. Finally, differences in design reflect the political rationale behind each proposal. For example, the administration supports preserving Social Security as a defined benefit plan without benefit cuts, payroll tax increases, or individual savings accounts. USA Accounts are designed to be an add-on, stand-alone, and broad-based savings program that will allow the administration to claim credit for increasing individual savings—and ultimately national savings—without tampering with Social Security. In contrast, the Senate Bipartisan Plan and the 21st Century Plan are primarily Social Security reform proposals; both mandate that workers establish an account funded with 2 percent of their earnings taxable under the Federal Insurance Contributions Act (FICA) payroll tax. The savings incentives in these plans are more modest and targeted to a lower income group. They provide only “top-up” contributions by offering matching contributions for additional voluntary contributions to increase the size of accounts that would otherwise be very small.

There are substantial differences between USA Accounts and the other programs. USA Accounts provide incentives through a progressive tax subsidy. Eligible workers receive a basic government contribution, called a refundable tax credit, of up to \$400 each year. The government also provides matching contributions to encourage additional savings, through a USA Account or a 401(k)-type plan. Depending on income, workers who do not qualify for the basic contribution could still qualify for matching contributions. Workers at any income level who do not have an employer-sponsored pension plan also qualify for matching contributions. Each year, a total of \$1,500 could be contributed in combined basic, voluntary, and matching contributions.⁴

Figure 1 illustrates how a single worker at various income levels fares under USA Accounts. A single worker earning \$10,000 receives the basic contribution of \$400 and a 100 percent match on every dollar of additional contributions up

FIGURE 1.
USA Accounts Contributions



to a maximum of \$550. Basic and matching contributions begin phasing out at \$20,000 of income. A worker earning \$40,000 earns no basic contribution but could receive matching dollars up to \$500. At income levels greater than \$50,000, only workers who have no employer-plan coverage could make contributions and receive matching contributions.

The Senate Bipartisan Plan and the 21st Century Plan are similar to each other and different from the USA Accounts proposal. They begin by establishing a savings ceiling for each eligible worker. In the Senate Bipartisan Plan, the ceiling is established each year by subtracting the worker's mandatory 2 percent contribution from an amount equal to 1 percent of the Social Security taxable wage base for that year (\$726 in 1999). The remainder is allocated between voluntary and matching contributions so that the first worker dollar earns a very high contribution of \$100 and each subsequent dollar earns a 100 percent match. The 21st Century Plan uses a similar computation, but its ceiling is calculated by subtracting the mandatory contribution from \$600: The first dollar earns \$150 and each subsequent dollar earns a 50 percent match.

The following examples illustrate how these proposals would work for workers earning \$20,000 in 1999 who wish to make a \$200 contribution. With a USA Account, they would receive a \$400 basic contribution, and their \$200 would receive a \$200 federal match for a total contribution of \$800, 25 percent from worker contributions and 75 percent

from federal contributions. Under the Senate Bipartisan Plan, they must contribute \$400 (2 percent of earnings) in mandated savings. They would be eligible for total federal contributions of \$326 (\$726 minus \$400). An additional \$200 contribution would receive a basic contribution of \$100 and \$199 in matching contributions from that \$326 for a total account contribution of \$899, 67 percent from worker contributions and 33 percent from federal contributions. Under the 21st Century Plan, these workers would make the same mandatory \$400 contribution and be eligible for a total federal contribution of \$200 (\$600 minus \$400). The first dollar of the additional \$200 contribution would receive a basic contribution of \$150. But because only \$50 remains available for matching contributions, they would not receive the full 50 percent match of \$99.50 on their additional contribution of \$199. Their total account contribution would be \$800, 75 percent from worker contributions and 25 percent from federal contributions.

HOW WELL DO THESE PROPOSALS WORK?

The three proposals are compared below on the following dimensions: (1) incentives and subsidies, (2) ease of use, (3) coordination with other savings vehicles, and (4) administrative expense.

Incentives and Subsidies

In the private sector, 401(k) plans are popular because they offer employees a flexible and tax-advantaged means to save for retirement. Employees are not taxed on contributions and their earnings until they receive a distribution, and employers get an immediate deduction for their plan contributions. Such plans are most popular among middle- and upper-class workers who have discretionary income and prefer to save on a tax-deferred basis.

Many 401(k) plans offer matching contributions because they are believed to be effective in encouraging moderate-income workers to save. Because the amount high-paid employees (those who earn more than \$80,000 a year) can save depends on how much moderate-income workers have saved, employers use matching contributions to boost participation rates. But there is no profound psychological theory behind matching contributions. It is not clear what type of matching contribution performs best, either in general or for particular employees. There is some evidence that they stimulate saving,

but contrary evidence exists as well.⁵ Because employers also use psychological tools such as educational and promotional campaigns to motivate participation, it is difficult to estimate the effect of the financial incentive alone. Therefore, the following comparisons are descriptive in nature.

All proposals provide a savings subsidy through a basic government contribution.⁶ Figure 2 illustrates how the subsidy is allocated across income levels in the case of a single worker. For income levels over \$5,000, USA Accounts are most generous in terms of both the size of the contribution and the income levels at which it is available.

Each proposal also provides matching contributions as incentives for additional savings. The USA Accounts match begins at 100 percent and is phased down linearly to 50 percent at certain income levels. Workers who have no employer plan are eligible for a 50 percent match at any income level. The Senate Bipartisan Plan and the 21st Century Plan have fixed match rates of 100 percent and 50 percent, respectively. Figure 3 illustrates the maximum matching contribution available at all income levels for a single worker covered by an employer plan. Again, except for workers with incomes between \$0 and \$5,000, to whom USA Accounts are not available, USA Accounts always provide the most generous match in terms of the maximum dollars available.

But maximums are not the whole story. To earn the maximum match at \$5,000 in income, for example, workers would have to contribute \$550 to a USA Account to earn \$550. In addition to their \$100 mandatory savings, workers would have to contribute \$526 to the Senate Bipartisan Plan to earn \$526 and \$700 to the 21st Century Plan to earn \$350. These contributions (not including mandatory savings) would represent 11 percent, 10.5 percent, and 14 percent, respectively, of their incomes. It is difficult to imagine many workers at this income level contributing enough to earn the maximum match under any of these proposals. The parallel figures at \$15,000 are 3.6 percent, 2 percent, and 2 percent of income, which are perhaps more realistic savings targets.

Although these descriptions are interesting, they do not illustrate how these proposals might be expected to perform in practice. It is difficult to predict how many workers would actually participate and how much they might contribute to any of these plans. By looking at one level of savings, however, it is possible to compare the subsidy available to workers at different income levels in each proposal. Figure 4 illustrates how much single workers saving 2 percent of earnings would receive in additional subsidy by contributing \$1 more in savings. With a USA Account, workers who had an employer plan and earned up to \$20,000 would earn an additional

FIGURE 2.
Basic Contributions

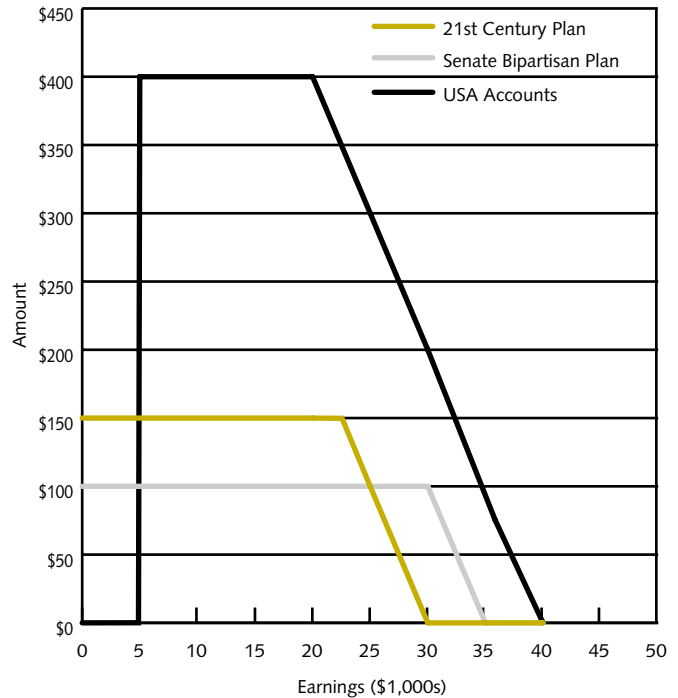


FIGURE 3.
Matching Contributions

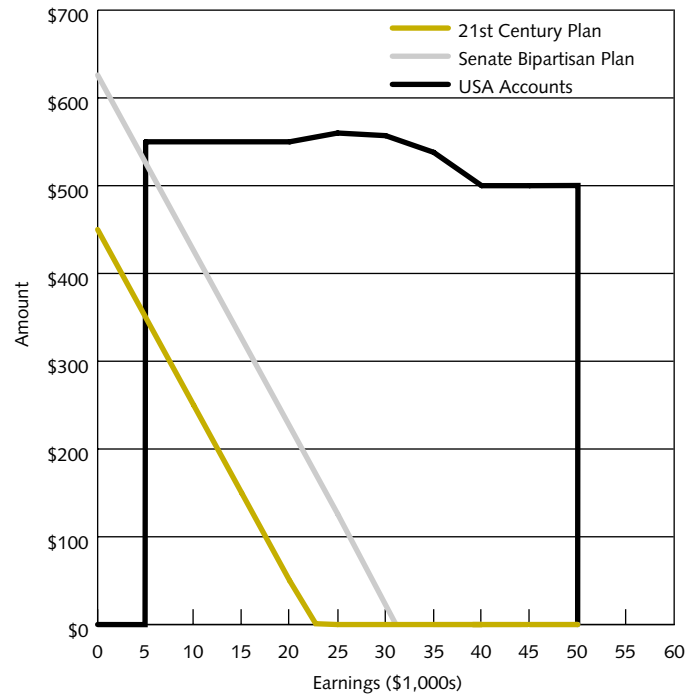
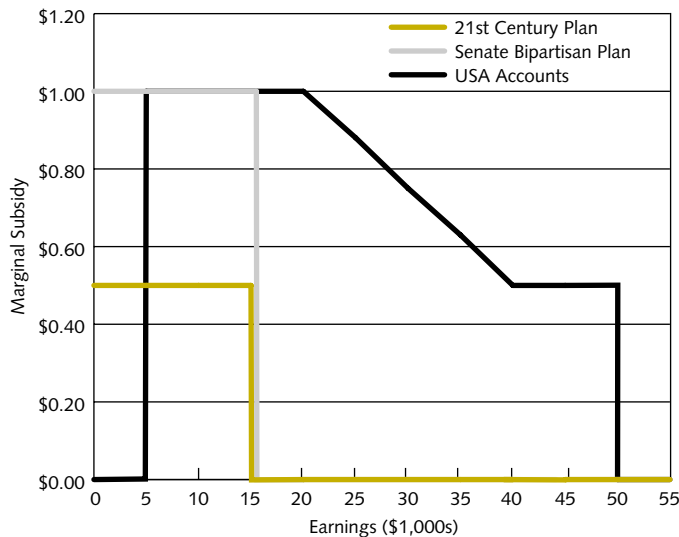


FIGURE 4.
Marginal Subsidy When Saving 2 Percent of Earnings



dollar. The marginal subsidy would then taper off to an additional 50¢ at \$40,000 before ending at incomes over \$50,000. Under the Senate Bipartisan Plan, workers earning less than about \$15,000 would earn \$1 for each additional dollar saved. Under the 21st Century Plan, workers earning less than about \$16,000 would earn 50¢ for each additional dollar saved.

Alternatively, it is useful to examine the structure of the subsidy in each proposal, because there is an important difference between USA Accounts and the other proposals: Because USA Accounts phase down from 100 percent to 50 percent at higher income levels, higher-income workers (incomes over \$20,000) are required to contribute more for a match than lower-income workers. This indicates more reliance on a match in the composition of the subsidy. The other proposals shift toward a more basic subsidy and less of a match at incomes over \$20,000, although the number of subsidy dollars per worker is small. This relationship holds at all rates of savings. Whether or not this effect was intended, it is largely caused by the low ceiling on contributions at upper income levels and the large first-dollar match. As income levels rise, workers are unable to make more than minimal voluntary contributions before hitting their contribution ceiling.

In summary, USA Accounts are more generous than the other two proposals. They provide a larger government contribution in terms of absolute dollars available and cover a wider income range. USA Accounts provide at least double the government contribution of the other proposals at all

levels above \$5,000 in earnings. At income levels above about \$37,000, only USA Accounts provide any contribution.

Ease of Use

No matter how generous the financial incentives, a savings program will not be effective if people find it difficult to use or understand. Complex rules discourage people from participating and financial service companies from offering a convenient product. When income limits were placed on deductible contributions to IRAs in the 1980s, the popularity of IRAs fell even among those who still qualified for the tax subsidy.⁷ Many taxpayers either wrongly believed they were not eligible or found the effort to master the rules greater than the available tax benefit. It is likely that many eligible workers will not find these new proposals attractive or convenient, resulting in a low participation rate.

In a 401(k) plan, it is easy, at least for low-income workers, to estimate in advance how much can be saved each year. This can increase the response to matching contributions because it increases the ability of workers to take advantage of such incentives. In these proposals, workers will not have such necessary information as earnings, Social Security contributions, or pension coverage until they receive their W-2s in the following year. As a result, workers will almost inevitably be limited to one annual contribution. The automatic payroll deduction contributions that are believed to be effective in 401(k) plans in keeping employees to a regular savings schedule will be impracticable. Without this opportunity, low- and moderate-income workers may find it difficult to accumulate the funds for voluntary contributions. Although workers may have until their tax filing deadline for that year to determine whether they are eligible and how much they may contribute, some of the value inherent in the incentive will be lost because of these complexities.

Workers generally find saving through a 401(k) plan convenient because the plan opens accounts and handles other administrative details. While the two Social Security-based programs feature automatic accounts, it is not clear that the USA Accounts proposal does. Even if USA Accounts are held by the government so that workers do not have to choose among private providers, requiring them to open an account as a precondition for contributions will discourage many people, particularly those with limited savings experience, from participating.

As is usually the case with 401(k) plans, workers in all three proposals must decide how to invest their accounts. All three intend to offer a limited number of investment funds through

the government, similar to the funds offered under the Thrift Savings Plan available to federal employees. This requirement will not intimidate workers who have some experience in choosing investments, either on their own or through an employer plan, but it may discourage many others from participating.

Coordination with Other Savings Vehicles

No matter how generous or easy to use, a savings program will not be effective in generating new savings if it merely causes people to shift their savings among vehicles. Government revenues would also be poorly spent if they drained resources from other sources of savings or required people to forgo otherwise available incentives. A particular concern is that a government-sponsored savings plan could jeopardize the viability of 401(k) plans. All three proposals offer matches that are more generous than those offered under many employer plans. If low-paid workers find the government plan to be more attractive than their employers' 401(k) plan, the savings opportunities of other workers would be significantly diminished and the additional savings available through an employer matching contribution would be wasted.

Only USA Accounts are explicitly integrated with the private pension system. They are in fact a complementary system, because matching contributions can be earned by contributions to an employer's 401(k)-type plan. This insulates such plans from harm.⁸ It may even encourage greater participation if the employer match alone is insufficient to generate much enthusiasm among low-paid workers, thus stimulating new savings. Indeed, employers themselves may promote USA-related contributions to low-income workers, with the government match as an extra inducement to 401(k) plan participation. USA Accounts also extend matching contributions to workers with no employer plan, independent of income level. Although the contributions permitted are far smaller than those available under a 401(k) plan, matching contributions may make a USA Account a more valuable savings vehicle than an IRA, the only alternative for those without an employer plan.

One advantage of the other plans, however, is that they permit workers to save more in absolute dollars. USA Accounts are limited to \$1,500 in contributions each year, which is less than the \$2,000 IRA contribution limit and the much higher employer plan limits. While USA Accounts owners could also contribute to an IRA, that would require maintaining

two small savings accounts. The other proposals permit the equivalent of an IRA contribution in matched and unmatched voluntary contributions in one account on top of the automatic 2 percent FICA contributions. But all worker contributions are made on an after-tax basis. From a tax perspective, a worker eligible for a tax-deductible IRA (as most would be) would not benefit by making contributions beyond those required for the maximum match. Even though 15 percent of each distribution from a USA Account and a portion of each distribution attributable to worker contributions in other proposals would not be taxed when paid, workers would always be better off by contributing their unmatched contributions to an IRA or to the private pension system on a tax-deductible basis.

Administrative Expense

No savings plan will be effective if its costs significantly reduce account accumulations. All three proposals are at risk in this regard. First, implementing these proposals will be expensive. Each proposal requires the federal government to build a record-keeping system and establish an investment program for millions of small accounts. This will be an enormous and expensive undertaking, and no proposal specifies who will bear this cost. Because accounts under the Senate Bipartisan Plan and the 21st Century Plan would be embedded in the Social Security system, their implementation costs might be less than those of the USA Accounts, which would require a new, independent administrative structure.

Second, the costs of maintaining individual accounts can be significant. All three proposals anticipate minimizing investment fees and expenses by limiting the number of permitted funds and managers and investing accounts on a pooled basis. This will be helpful in reducing costs, although the investment program itself will not be as attractive or flexible as those available under most employer plans and IRAs. Record-keeping costs are less easily constrained. Individual account plans require complex systems to account for contributions, distributions, investment earnings, and investment changes on an individual basis. The necessary technology is expensive and requires frequent upgrading. Again, none of the proposals specifies who will bear these continuing costs. Charging them against accounts, the majority of which will receive annual contributions of just a few hundred dollars, could reduce accumulations significantly even if investment returns are high.

CONCLUSION

All three proposals have ideas that could stimulate innovative approaches to increase retirement savings. They are all targeted to an appropriate population—low- and middle-income workers—that, in reality, could use some help from the government in saving for retirement. Of the three proposals, USA Accounts offer more generous federal contributions for savings at very modest income levels and devote more resources to those most in need of assistance. They also work well with the private pension system.

On the other hand, all three are very complex programs, conceptually and administratively. Participation rates for voluntary contributions may be low. Even if each proposal generates millions of accounts, each account will be small and unlikely to produce significant additional savings. Each proposal will be expensive to implement and administer. The federal government will need to establish and maintain an extensive record-keeping system as well as a special investment program.

A lingering question is whether a 401(k)-type plan design is sensible when the target population consists of low- and very low income workers, as is the case with the two Social Security-based proposals. Incentives provided by matching contributions will be successful only if workers can afford to take advantage of them, and many low- and very low income workers cannot or do not. Perhaps federal resources would be better spent on direct subsidies for the poor in retirement than on a complicated incentive program that may produce only a marginal increase in savings. It might also be better to target savings incentives to those who can afford to save and are motivated to respond. With these considerations in mind, a federal 401(k) approach has some merit, but creating a stand-alone federal program does not. One alternative to consider is subsidizing contributions into IRAs and other 401(k)-type plans while providing very similar rules for taxing contributions and benefits. This would preserve the savings incentives that are the essence of these proposals while reducing their complexity and cost.

ENDNOTES

¹U.S. Department of Labor, “Final Report on the National Summit on Retirement Savings,” 1998, pp. 6–7. See also Richard W. Johnson, “The Gender Gap in Pension Wealth: Is Women’s Progress in the Labor Market Equalizing Retirement Benefits?” The Retirement Project Brief Series, No. 1, Washington, D.C.: Urban Institute, March 1999, which suggests that women retiring in the next few decades will have substantially more pension wealth than current retirees.

²U.S. Department of Labor, 1998, p. 4.

³U.S. General Accounting Office, 1997, “Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform,” Washington, D.C.: U.S. Government Printing Office, p. 47.

⁴Under USA Accounts, the full basic contribution of \$400 and a 100 percent match are available to those earning less than \$20,000 (single), \$30,000 (heads of households), and \$40,000 (married, filing jointly). The basic contribution is phased out through the following income levels: \$20,000–\$40,000 (single), \$30,000–\$50,000 (heads of households), and \$40,000–\$80,000 (married, filing jointly). The match is also phased out, ending at 50 percent for workers whose incomes are less than \$50,000 (single), \$75,000 (heads of households), and \$100,000 (married, filing jointly). Workers who have no employer plan are entitled to a 50 percent match, independent of income level.

⁵See, for example, Andrea L. Kusko, James M. Poterba, and David W. Wilcox, “Employee Decisions with Respect to 401(k) Plans: Evidence from Individual-Level Data,” 1994, National Bureau of Economic Research (NBER) Working Paper No. 4635, concluding that employee contributions are relatively insensitive to a match rate, and Leslie E. Papke, “Participation in and Contributions to 401(k) Pension Plans: Evidence from Panel Data,” 1992, NBER Working Paper No. 4199, Cambridge, Mass.: NBER, finding that participation increases with the match rate and a 5 percent increase in the match rate is associated with a 1 percent to 5 percent increase in contributions.

⁶The Senate Bipartisan Plan and the 21st Century Plan call this contribution a match, but only a \$1 contribution is required to earn it. So it seems appropriate to treat it as equivalent to the basic contribution under the USA Accounts proposal.

⁷James M. Poterba, Steven F. Venti, and David A. Wise, 1995, “The Effects of Special Saving Programs on Saving and Wealth,” NBER Working Paper No. 5287, Cambridge, Mass.: NBER.

⁸To equalize the tax treatment of 401(k) contributions receiving a USA Account match, workers over certain income levels will pay current income tax on 80 percent of those contributions. Distributions from a 401(k) plan are taxed at a 100 percent rate, while USA distributions are taxed at an 85 percent rate. For the majority of workers, who will be in a lower tax bracket in retirement, these tax rules give USA/401(k) contributions an advantage in overall tax treatment. In addition, workers can still contribute as much as their 401(k) plan permits, and USA-related contributions are treated as ordinary 401(k) contributions while in the plan and when distributed.



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The Retirement Project

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