Would Major Tax Reform Be Good For Retirement Programs?

Earlier this year, President Bush announced two major domestic policy initiatives for his second term. One of these was Social Security reform, including privatization. The second was tax reform. A lot of energy was expended by the Administration during the first part of the year promoting Social Security privatization, seemingly to no avail. Consideration of changes to the tax system were deferred, pending analysis by a distinguished panel, including former Senators Connie Mack (R-FL) and John Breaux (D-LA).

The tax reform panel has now issued its report. The panel proposed major reforms to our tax system by making two alternative, but similar, recommendations: a simplified income tax rate proposal and a more progressive consumption tax proposal. Both proposals move us further away from our current income tax system and toward a consumption-based tax system. Both proposals include a simplified and lower interest rate structure, elimination of state and local tax deductions, limitations on charitable deductions, replacement of the mortgage interest deduction with a tax credit, and elimination of the alternative minimum tax. Among other things, many of the proposed reforms are politically sensitive and could adversely impact major segments of the U.S. economy. Nevertheless, because the proposal would presumably simplify Internal Revenue Code complexities and address some of the burdens and inequities in the current system, the panel's recommendations could generate some appeal in the media and in Congress.

Notably, the tax reform panel's recommendations include re-packaged versions of the Employer Retirement Savings Account (ERSA), Retirement Savings Account (RSA), and Lifetime Savings Account (LSA) proposals contained in previous Bush Administration budget proposals and make other fundamental changes to the tax treatment of employer-provided retirement and health plans. Specifically, the panel's recommendations would:

- create "Save At Work Accounts" to replace 401(k)s, 403(b)s, 457(b)s, SIMPLEs, and SARSEPs, with simpler nondiscrimination rules and rules intended to facilitate "auto enrollment";
- create "Save For Retirement Accounts" to replace IRAs and Roth IRAs, with no income limitations and permitting annual contributions up to $10,000;
- create "Save For Family Accounts" to replace all other types of tax-favored savings accounts (e.g., HSAs, FSAs, section 529 education accounts), with annual contributions of up to $10,000;
- make the savers' tax credit permanent and refundable, and make it applicable to 25 percent of contributions up to $2,000; and
- cap the exclusion for employer-provided health insurance at $11,500 for families and $5,000 for singles, with both amounts indexed for inflation.

A key indicator of whether these proposals will receive serious Congressional consideration is whether they will be included as part of the Administration's budget proposal which will be released next February.

From the standpoint of those who sponsor and maintain retirement programs for American workers, there are really two fundamental issues to be considered. First, is the move from an income-based tax system to a consumption-based tax system going to generate more savings? In other words, if, in the final analysis, the United States were to

adopt a system that taxed consumption (e.g., a retail sales tax) and did not tax earnings in savings and investment accounts, would the average American worker save more than he or she does today?

Second, and relatedly, if these retirement/savings proposals are enacted, this would no doubt begin what would likely be a major shift away from employer-based retirement programs. If individuals can save up to $20,000 per year in a "Save For Retirement Account" and a "Save for Family Account," why should employers, especially small employers, undertake the administrative burden, added cost and fiduciary liability of establishing and maintaining an employer-based plan? This begs the question (and my second point) of whether, without the benefit of employer matches and employer-paid participant education, the average American worker would voluntarily contribute the amounts necessary, up to $20,000 per year to the "Save For Retirement" and "Save For Family" Accounts, to provide for a secure retirement. I don't think so.