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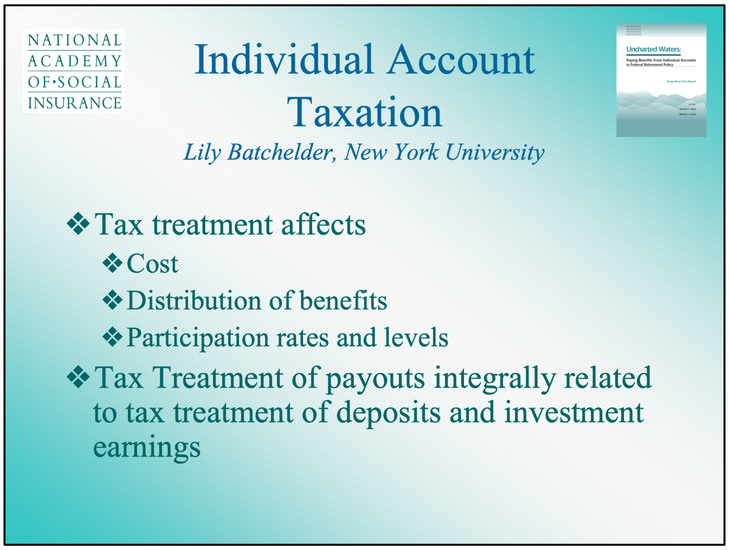

The tax treatment of individual accounts may fall last in this panel because it probably seems the most boring. But actually it can have a dramatic impact on a number of quite interesting issues. For example, it affects:

The cost of the accounts;

Who the winners and losers are;

Who participates in the accounts if they are voluntary; and

What the participation levels are.

In order to get to these interesting issues, though, it is necessary to first understand a little bit about taxing savings in general. What I'm going to do is give you an overview of the different models for taxing individual accounts. Then if people are interested we can talk about the implications afterwards.

The most important thing to understand is that you can't look at the tax treatment of distributions from individual accounts in a vacuum. This report generally focuses on the withdrawal phase. But, unlike many of the other areas we cover you really can't think about how payouts from the accounts should be taxed without understanding how contributions and investment earnings were taxed as well.

The reason is something called "tax equivalences," which I will try to explain briefly and in a fairly simplified way.

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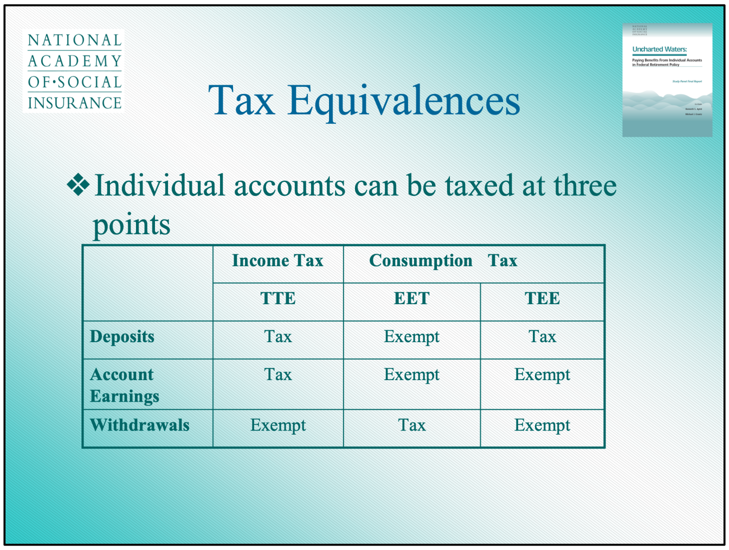

	Income Tax	Consumption Tax	
	TTE	EET	TEE
Deposits	Tax	Exempt	Tax
Account Earnings	Tax	Exempt	Exempt
Withdrawals	Exempt	Tax	Exempt

Basically, individual accounts can be taxed at three points. We can tax deposits. We can tax investment earnings. And we can tax withdrawals.

An income tax generally taxes deposits and investment earnings but not withdrawals. The shorthand is TTE.

So, for example, if you put your paycheck in the bank, your paycheck itself has been taxed before you receive it, and you are then taxed on the interest that you receive when it is in the bank. But you are not taxed when you eventually withdraw and spend the money. This is the “normal” way that we tax savings.

A consumption tax is different and can actually operate in two ways at the individual level.

It can tax withdrawals but not deposits or investment earnings, which is how we tax 401(k)s and IRAs. This is what we usually think of as a consumption tax, where you are just taxed on your paycheck when you withdraw it from the bank and spend it, but not before. The shorthand is EET.

But there is another way that a consumption tax can work. It can tax deposits, but not investment earnings and withdrawals, which is how Roth IRAs work. Basically the earnings on the money you save, which we call capital income, is never taxed. The shorthand is TEE.

What is important to understand is that, under certain assumptions, these two forms of a consumption tax are economically equivalent. The main assumption is that an individual's tax rate is constant over time.

And this equivalence is why you can't understand how to tax payouts without understanding how deposits and investment earnings were taxed.

The last very general way to tax individual accounts is to exempt savings in them at all three points. This is generally considered a bad idea unless you are trying to redistribute because people who participate in the program can then receive a transfer from the government without increasing their net savings at all – basically through borrowing.

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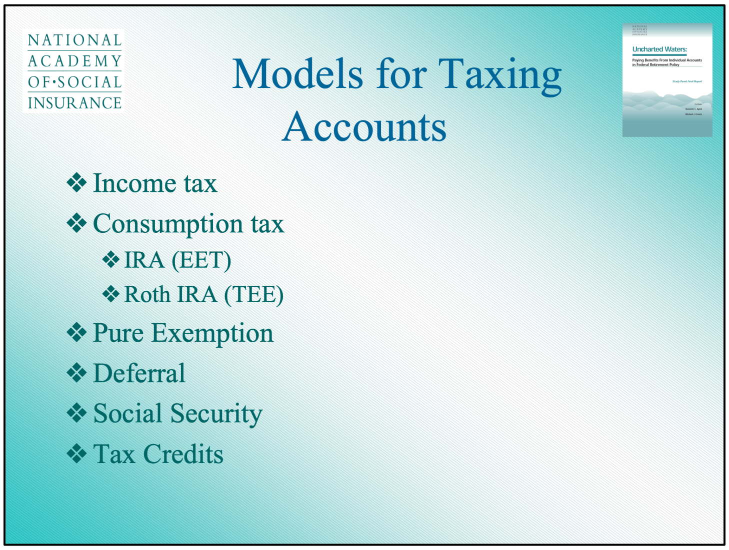

Of course, we don’t always follow general, theoretical models for taxing savings. So there are also three other approaches out there that I would like to mention.

The first is the deferral model. It is in between an income tax and consumption tax. You are taxed on deposits and investment earnings, but only on investment earnings when you withdraw funds from the account. This is the way we currently treat annuities and deposits to 401(k)s that are above the contribution limits.

The second is the way we tax Social Security, which is completely different. We tax 50% of deposits because the employee share of payroll taxes is after-tax. We then tax nothing else if you are low-income. But we tax between 50-85% of benefits if you are higher-income. (I should emphasize that these percentages do not refer to your tax rate, which is much lower, but to the portion of benefits that you have to include income.)

What this means is that Social Security model is more favorable than a consumption tax or income tax for lower-income workers, but it's less favorable than either for higher-income workers. For workers in the middle, it's a bit like a consumption tax.

The last model isn't really a model exactly, but more of a tweak. Any of these models that I've described can be combined with tax credits.

For example, right now we have a Saver's Credit in the Code where low-income people get a tax credit that matches up to 50% of any funds that they deposit in a retirement account.

There are a couple of important advantages of tax credits.

First, if the accounts are voluntary and you want to provide everyone with the same incentive to participate in the program then you are going to want to use tax credits. This because deductions and exclusions provide larger incentives to higher-income people on a proportionate basis and both the consumption tax models and the deferral model rely on deductions and exclusions.

The other advantage of tax credits is that they can be made refundable, which means that people can receive the incentive or subsidy even if they don't have any federal income tax liability. This important because more than a third of taxpayers actually don't pay any federal income tax, although they do pay a number of other taxes. So if an individual account program is voluntary, the only way you can provide <u>tax</u> incentives to all workers to participate is generally through refundable tax credits.

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Before closing, there are two final thing I want to emphasize.

First, I have been discussing general models for taxing individual accounts. But there are also a number of ways that the tax code can be used to promote specific policy objectives regarding them.

For example, you could say that married couples can only receive the full tax benefits associated with the account if they split their contributions equally.

You could create tax incentives to annuitize.

Or you could impose tax penalties for pre-retirement withdrawals.

Also, I have only been discussing models for taxing individual accounts themselves. But if the accounts are voluntary and created as part of the Social Security system, policymakers may want to rethink the tax treatment of traditional Social Security benefits.

All of this is to say that tax issues actually bear on a number of the topics that we have been discussing and that we will be discussing the rest of this afternoon.