The Retirement Security Project

The Saver's Credit:

Expanding Retirement Savings for Middle- and Lower-Income Americans

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The Saver's Credit:

Expanding Retirement Savings for Middle- and Lower-Income Americans

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Introduction

For decades, the U.S. tax code has provided preferential tax treatment to employer-provided pensions, 401(k)-type plans, and Individual Retirement Accounts (IRAs) relative to other forms of savings. The effectiveness of this system of subsidies remains a subject of controversy. Despite the accumulation of vast amounts of wealth in pension accounts, concerns persist about the ability of the pension system to raise private and national savings, and in particular to improve savings among those households most in danger of inadequately preparing for retirement.[1]

Many of the major concerns stem, at least in part, from the traditional form of the tax preference for pensions. Pension contributions and earnings on those contributions are treated more favorably for tax purposes than other compensation: they are excludible (or deductible) from income until distributed from the plan, which typically occurs years if not decades after the contribution is made. The value of this favorable tax treatment depends on the taxpayer's marginal tax rate: the subsidies are worth more to households with higher marginal tax rates, and less to households with lower marginal rates.[2] The pension tax subsidies, therefore, are problematic in two important respects:

- First, they reflect a mismatch between subsidy and need. The tax preferences are worth the least to lower-income families, and thus provide minimal incentives to those households who most need to save more to provide for basic needs in retirement. Instead the tax preferences give the strongest incentives to higher-income households, who, research indicates, are the least likely to need additional savings to achieve an adequate living standard in retirement.[3]
- Second, as a strategy for promoting national savings, the subsidies are poorly targeted. Higher-income households are disproportionately likely to respond to the incentives by shifting existing assets from taxable to tax-preferred accounts. To the extent such shifting occurs, the net result is that the retirement savings plans serve as a tax shelter, rather than as a vehicle to increase savings, so the loss of government revenue does not correspond to an increase in private savings. In contrast, middle- and lower-income households, if they participate in retirement savings plans, are most likely to use the accounts to raise net savings.[4] Because middle-income households are much less likely to have other assets to shift into tax-preferred accounts, any deposits they make to tax-preferred accounts are more likely to represent new savings rather than asset shifting.

The Saver's Credit, enacted in 2001, was expressly designed to address these problems. The Saver's Credit in effect provides a government matching contribution, in the form of a nonrefundable tax credit, for voluntary individual contributions to 401(k)-type plans, IRAs, and similar retirement savings arrangements. Like traditional retirement savings plan subsidies, the Saver's Credit currently provides no benefit for households that owe no federal income tax. However, for households that owe income tax, the effective match rate in the Saver's Credit is higher for those with lower income, the opposite of the incentive structure created by traditional pension tax preferences.

Concerns persist about the ability of the pension system to raise private and national savings, and in particular to improve savings among those households most in danger of inadequately preparing for retirement.

The Saver's Credit is the first and so far only major federal legislation directly targeted at promoting tax-qualified retirement savings for middle- and lower-income workers.[5] Although this is an important step, several options are available to improve the design, not the least of which is the credit's scheduled expiration at the end of 2006.

Policymakers, including Representatives Rob Portman (R-OH) and Benjamin Cardin (D-MD), are exploring possible expansions of the Saver's Credit. Rep. Portman recently emphasized his desire to "get at what I think is the biggest potential for saving in this country, and that is those who are at modest and low income levels."[6] This paper is intended to inform such efforts.

The first section of the paper provides background on the evolution and design of the Saver's Credit. The second section discusses the rationale behind the Saver's Credit and the role of such a credit in the retirement income security system as a whole. The third section examines empirical data and models of the revenue and distributional effects of the Saver's Credit. The fourth section discusses measures that would expand the scope and improve the efficacy of the Saver's Credit.

The Saver's Credit is the first and so far only major federal legislation directly targeted at promoting tax-qualified retirement savings for middle- and lower-income workers.

Basic Design and Evolution

The Saver's Credit was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).[7] In principle, the credit can be claimed by middle- or lower-income households who make voluntary retirement savings contributions to 401(k)-type plans, other employer-sponsored plans (including SIMPLE plans), or IRAs.[8] In practice, however, the nonrefundability of the credit means it offers no incentive to save to the millions of middle- and lower-income households with no federal income tax liability.[9]

The design of the Saver's Credit reflects two key objectives. First, the credit represents an initial step toward addressing the "upside-down" structure of other tax incentives for saving—leveling the playing field for middle- and lower-income workers by, in effect, matching contributions at higher rates for savers with lower incomes. Second, the credit was designed to coordinate with and support the employer-based retirement system.

Higher Matching Rates for Middle- and Lower-Income Savers

The matching rates under the Saver's Credit reflect a progressive structure — that is, the rate of government contributions per dollar of private contributions falls as household income rises. This pattern stands in stark contrast to the way tax deductions and the rest of the retirement system subsidize savings. The Saver's Credit is currently a small exception to this general pattern: the Treasury Department estimates that the tax expenditures associated with retirement savings preferences in 2005 will total roughly $150 billion, of which only $1 billion is attributable to the Saver's Credit.[10]

The Saver's Credit applies to contributions of up to $2,000 per year per individual.[11] As Table 1 shows, the credit rate is 50 percent for married taxpayers filing jointly with adjusted gross income (AGI) up to $30,000, 20 percent for joint filers with AGI between $30,001 and $32,500, and 10 percent for joint filers with AGI between $32,501 and $50,000. The same credit

Table 1. Saver's Credit Rates and Effective Matching Rates by Income[1]

Dollars except where stated otherwise

Adjusted gross income: Married filing jointly	Adjusted gross income: Singles and married filing separately	Credit rate (percent)	Tax credit for $2,000 contribution	After-tax cost of $2,000 contribution	Effective after-tax match rate (percent)
0-30,000	0-15,000	50	1,000	1,000	100
30,001-32,500	15,001-16,250	20	400	1,600	25
32,501-50,000	16,251-25,000	10	200	1,800	11

Source: Authors' calculations using the 2001 Survey of Consumer Finances.

(1) Calculations assume that the taxpayer has sufficient federal income tax liability to benefit from the nonrefundable credit shown, and exclude the effects of any tax deductions or exclusions associated with the contributions or with any employer matching contributions.

How the Saver's Credit Works for Employees and Employers

Ruth and Tom are married, file a joint return, and have $34,000 of income, all from Ruth's salary. Ruth is eligible to participate in her employer's 401(k) plan but has not done so in the past. Neither spouse has an IRA. After Ruth receives a notice about the Saver's Credit from her employer, she and Tom decide that she will contribute $2,000 to the 401(k) and he will contribute $2,000 to an IRA.

Their contributions reduce their adjusted gross income from $34,000 to $30,000, which means they qualify for the 50 percent credit rate. As a result, they receive a $2,000 tax credit (50 percent of $4,000).

The couple begins to benefit from the Saver's Credit early in the year, when Ruth reduces the federal income tax withholding from her employer to reflect the fact that she and Tom will be entitled to the credit for the year. When the time comes to file their federal income tax return for the year, they claim the credit on their return.

Ruth's contribution also affects her employer's 401(k) nondiscrimination test results. Ruth's contribution has increased from 0 percent of her pay in previous years to nearly 6 percent ($2,000 divided by $34,000), which increases the average 401(k) contribution percentage for the group of non-highly compensated employees eligible to participate in the plan. That increase, in turn, raises the permissible 401(k) contribution percentage for the highly compensated employees in the firm.

rates apply for other filing statuses, but at lower-income levels: the AGI thresholds are 50 percent lower for single filers and 25 percent lower for heads of households.[12] Of course, the figures in Table 1 assume that the couple has sufficient income tax liability to benefit from the nonrefundable income tax credit shown.

The credit's effect is to correct the inherent bias of tax deductions or exclusions in favor of high-marginal rate taxpayers. A $100 contribution to a 401(k)-type plan by a taxpayer in the 35 percent marginal federal income tax bracket generates a $35 exclusion from income, resulting in a $65 after-tax cost to the taxpayer. In contrast, a taxpayer in the 15 percent marginal bracket making the same $100 contribution to a 401(k)-type plan gets only a $15 exclusion from income, resulting in an $85 after-tax cost. The tax deduction is thus worth more to the higher-income household.[13] However, if the lower-income taxpayer qualifies for a 20 percent Saver's Credit, the net after-tax cost is $65 ($100 minus the $15 effect of exclusion minus the $20 Saver's Credit). Thus, the Saver's Credit works to level the playing field by increasing the tax advantage of saving for middle- and lower-income households.

The credit represents an implicit government matching contribution for eligible retirement savings contributions. The implicit matching rate generated by the credit, though, is significantly higher than the credit rate itself. The 50 percent *credit* rate for gross contributions, for example, is equivalent to having the government *match* after-tax contributions on a 100 percent basis. Consider a couple earning $30,000 who contributes $2,000 to a 401(k)-type plan or IRA. The Saver's Credit reduces that couple's federal income tax liability by $1,000 (50 percent of $2,000). The net result is a $2,000 account balance that costs the couple only $1,000 after taxes (the $2,000 contribution minus the $1,000 tax credit). This is the same result that would occur if the net after-tax contribution of $1,000 were matched at a 100 percent rate: the couple and the government each effectively contribute $1,000 to the account. Similarly, the 20 percent and 10 percent credit rates are equivalent to a 25 percent and an 11 percent match, respectively (table 1).[14]

Enhancement of Employer-Sponsored Plans

The Saver's Credit was designed to support, rather than undermine, employer-sponsored retirement savings plans. These plans encourage participation through employer contributions, nondiscrimination rules designed to require cross-subsidies from eager to reluctant savers, the automatic character of payroll deduction, peer group encouragement, and, often, professional assistance with investments (for example, through employer selection of investment options or provision of investment management). To support these benefits of employer-sponsored plans, the Saver's Credit matches contributions to 401(k) and other plans by middle- and lower-income employees.[15] As a result, employees need not choose between the Saver's Credit or an employer matching contribution in their 401(k)-type plan.

Since the Saver's Credit applies in addition to any employer matching contributions, it can raise the return on 401(k)-type contributions: eligible taxpayers can obtain higher effective matching rates when the Saver's Credit is combined with employer matching contributions to a 401(k)-type plan.[16] For households who receive a 20 percent Saver's Credit, for example, a 50 percent employer match of the employee's 401(k)-type plan contributions implies that the total (employer plus government) effective match rate on after-tax contributions is 87.5 percent. That is, for every $100 in net contributions the taxpayer puts in, up to the appropriate match limits, the account will generate $187.50 in value.

To see how the 87.5 percent effective match rate occurs, consider a taxpayer eligible for a 20 percent credit rate under the Saver's Credit who contributes $2,000 to a retirement account. The government gives a tax credit of $400, which means the taxpayer has invested a net amount of $1,600. This alone generates an effective match of 25 percent. At the same time, the employer matches 50 percent of the $2,000 contribution, adding $1,000 to the account. A total of $3,000 is thus deposited in the account, at a cost to the taxpayer of only $1,600 net of the tax credit. Similar calculations in Table 2 show that, for taxpayers who receive a 50 percent government matching contribution, the effective matching rate, including a 50 percent employer match, is a striking 200 percent.[17]

In evaluating these high effective matching rates, it is important to emphasize that they apply only to

The Saver's Credit was designed to support employer-sponsored retirement savings plans.

Table 2. Total Effective Match Rates with Saver's Credit and a 50 Percent Employer Matching Contribution[1]

Dollars except where stated otherwise

Credit rate (percent)	Tax credit for $2,000 before-tax employee contribution	Net after-tax contribution	Total contribution after 50 percent employer match	Ratio of total contribution to employee's after-tax contribution	Effective after-tax match rate (percent)
50	1,000	1,000	3,000	3.000	200.0
20	400	1,600	3,000	1.875	87.5
10	200	1,800	3,000	1.667	66.7

Source: Authors' calculations using the 2001 Survey of Consumer Finances.

(1) Calculations assume that the taxpayer has sufficient federal income tax liability to benefit from the nonrefundable credit shown, and exclude the effects of any tax deductions or exclusions associated with the contributions.

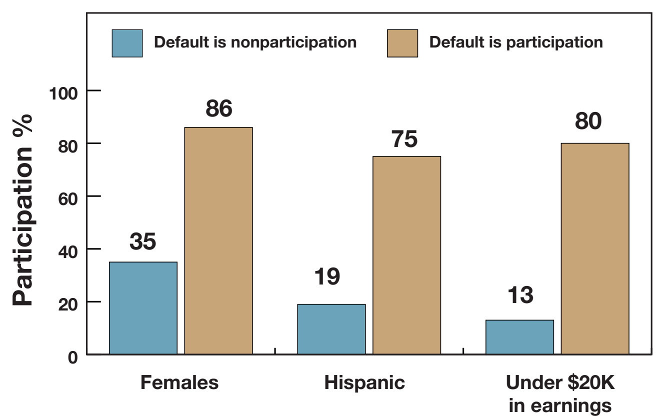
The credit not only makes it easier for the employer to pass the nondiscrimination test but also gives eligible employees a greater incentive to demand a 401(k)-type plan.

the first $2,000 of an individual's contributions. Moreover, they apply only to middle- and lower-income households, who tend to be more reluctant savers than higher-income households because, among other reasons, they tend to have less disposable income after providing for basic necessities. A higher effective matching rate focused on the first dollars of saving may help to “jump start” voluntary contributions by middle- and lower-income households, many of whom currently do not save at all.

Employee contributions to 401(k)-type plans that qualify for the Saver’s Credit also count toward meeting the employer’s nondiscrimination tests. Accordingly, to the extent the Saver’s Credit encourages increased participation among lower earners, higher earners may also benefit, since their ability to contribute on a tax-favored basis depends on the level of contributions by less highly paid employees.[18]

Recognizing the potential benefits of the Saver’s Credit for plan sponsors, the Internal Revenue Service (IRS) has provided employers a model notice to inform employees of the credit.[19] Moreover, some employers that have refrained from adopting a 401(k)-type plan because of expected difficulty in meeting the nondiscrimination test may be encouraged by the Saver’s Credit to set up a plan. The credit not only makes it easier for the employer to pass the nondiscrimination test but also gives eligible employees a greater incentive to demand a 401(k)-type plan.

Impact of 401(k) Auto Enrollment



Actual results from employees with between 3 and 15 months of tenure. Study by Brigitte Madrian, Universty of Pennsylvania’s Wharton School, and Dennis Shea, UnitedHealth Group.

The Saver’s Credit is also designed to complement employer plans through its interaction with automatic enrollment. Automatic enrollment makes it easier for employees to save in a 401(k)-type plan by enrolling employees to participate automatically without being required to complete and sign an election form. Thus, unless an employee affirmatively expresses a different preference, the default mode under an automatic enrollment plan is that the employee participates at a stated percentage of compensation.[20] Automatic enrollment is a particularly effective mechanism for raising savings and is another focus of The Retirement Security Project.[21]

Automatic enrollment, as a practical matter, is particularly geared toward encouraging participation by middle- and lower-income employees, who are least likely to participate without it. For example, a recent analysis showed that, before the adoption of automatic enrollment, only 12.5 percent of workers with annual earnings under $20,000 participated in a 401(k)-type plan offered by the employer; after the adoption of automatic enrollment, 79.5 percent participated.[22] (Automatic enrollment, like the Saver’s Credit, also enables higher-paid employees to contribute more by making it easier to obtain favorable results under the 401(k) nondiscrimination test.)

Automatic enrollment makes the Saver’s Credit available to more employees who otherwise would not receive it because they did not contribute to a 401(k)-type plan. By the same token, the Saver’s Credit may encourage wider use of automatic enrollment because the credit makes automatic enrollment more valuable, and hence more acceptable, to employees who are entitled to the credit (without requiring the employer to make any additional matching contributions).

Table 3. Ownership of Assets in Retirement Accounts Among Households Aged 55-59, by Income, 2001[1]

Dollars except where stated otherwise

Income percentile	Percentage of households in indicated income range with assets	Median assets: All households in income range	Median assets: Households with assets only	Share of aggregate assets of all households (percent)
Below 20	25.0	0	8,000	1.1
20-39.9	49.6	0	12,000	4.2
40-59.9	61.6	7,200	28,000	8.6
60-79.9	91.0	50,000	54,000	16.7
80-89.9	95.4	148,000	190,000	18.8
90-100	92.1	215,000	299,000	50.6
All households	63.6	10,400	50,000	100

Source: Authors' calculations using the 2001 Survey of Consumer Finances.

(1) Throughout table, "assets" refer only to assets held in defined contribution plans or Individual Retirement Accounts.

The Role of the Saver's Credit in the Pension System

As the baby boomer generation nears retirement, the shortcomings in the nation's upside-down system of incentives for retirement savings are becoming increasingly apparent.[23] As already noted, the existing structure is upside down for two reasons:

- First, the tax preferences are worth the least, and thus provide minimal incentives to save, to households who most need to save more to provide for basic needs in retirement. These preferences give the strongest incentives to higher-income households, who least need to save more to maintain an adequate retirement living standard.[24]

- Second, higher-income households, who receive the greatest benefit from the tax subsidies, are the most likely to use pensions as a tax shelter, rather than as a vehicle to increase savings. High-income households are disproportionately likely to respond to retirement savings tax incentives by shifting assets from taxable to tax-preferred accounts; the net result is a loss of government revenue with no increase in private savings.

Reflecting these upside-down incentives, the nation's broader pension system has several serious shortcomings:

- Only half of workers are covered by an employer-based pension plan in any given year, and participation rates in IRAs are substantially lower.

- Even workers who participate in tax-preferred retirement savings plans rarely make the maximum allowable contributions. Only 5 percent of 401(k)-type plan participants make the maximum contribution allowed by law, and only 5 percent of those eligible for IRAs make the maximum allowable contribution.[25]

- Despite the shift from defined benefit to defined contribution plans, many households approach retirement with meager defined contribution balances.[26] The median defined contribution balance among all households ages 55 to 59 was only $10,000 in 2001 (Table 3). Excluding the 36 percent of households who had no IRA or defined contribution plan account, the median balance for this age group was $50,000.

Given this reality, focusing incentives for retirement savings on middle- and lower-income households makes sense for two

To raise private savings, the incentives must not simply cause individuals to shift assets into tax-preferred pensions but instead must generate *additional* contributions.

reasons. First, such incentives are more likely to bolster long-term economic security and reduce elderly poverty, since higher-income households already tend to have substantial assets and to be better prepared to provide for their needs in retirement than other households. For some lower-income families, income may be so modest that it is impossible to save after paying for necessities. Yet 60 percent of households at or below the poverty line indicate that they save at least something.[27] Experience with a program that provides tax breaks and matching funds to encourage saving among lower-income families suggests that they will participate in savings programs if presented with incentives to do so.[28] The evidence cited above on the efficacy of automatic enrollment also suggests that lower-income workers will save if presented with incentives and a sound structure within which to do so.

The second reason for focusing incentives on middle- and lower-income households is the potential impact on national savings. National savings is the sum of public savings and private savings. All else equal, every dollar of foregone tax revenue reduces public savings by one dollar. Consequently, for national savings to increase, private savings must increase by more than one dollar in response to each dollar in lost revenue. To raise private savings, the incentives must not simply cause individuals to shift assets into the tax-preferred pensions but instead must generate *additional* contributions.

Since those with modest or low incomes are less likely to have other assets to shift into tax-preferred retirement savings accounts, focusing tax preferences on middle- and lower-income workers increases the likelihood that lost tax revenue will reflect additional contributions rather than shifts in assets.[29] The empirical evidence suggests that tax-preferred retirement savings undertaken by middle- and lower-income workers is much more likely to represent new savings than tax-preferred retirement savings undertaken by higher-income workers.[30]

Effects of the Saver's Credit

Although it is too soon to obtain a definitive reading of the impact of the Saver's Credit, preliminary estimates and evidence can be useful in identifying some basic themes.

Eligibility

The nonrefundability of the credit substantially reduces the number of people eligible for it. Further, the low match rates for middle-income households substantially reduce the number of people eligible to receive a significant incentive. Nonrefundability results in a credit that provides no incentive to tens of millions of lower-income filers who qualify on paper for the 50 percent credit rate, but who have no federal income tax liability against which to apply the credit.

Table 4 shows that 59 million tax filers in 2005 will have incomes low enough to qualify for the 50 percent credit.[31] Since the credit is nonrefundable, however, only about one-seventh of them actually would benefit from the credit *at all* by contributing to an IRA or 401(k)-type plan.[32] Furthermore, only 43,000 — or fewer than one out of every 1,000 — filers who qualify based on income could receive the maximum credit ($1,000 per person) if they made the maximum contribution. These are the households who have sufficient tax liability to benefit in full from the Saver's Credit but sufficiently low income to qualify for the highest match rate.

For families with somewhat higher incomes, the nonrefundability of the credit poses much less of a problem, since more of these families have positive income tax liabilities. For these families, however, the credit provides only a modest incentive to save. For example, a married couple earning $45,000 a year receives only a $200 tax credit for depositing $2,000 into a retirement account. This small credit reflects the modest matching rate at that level of income (see Tables 1 and 2), which provides less incentive to participate.

Table 4. Eligibility for 50 Percent Credit Rate, 2005

	Returns by Filing Status (thousands)[1]				
	Single	Married Filing Jointly	Head of Household	Other	Total
(A) Total returns	59,235	61,658	21,915	2,513	145,321
(B) Returns eligible for 50 percent credit based on income[2]	25,679	20,105	12,916	511	59,211
(C) Returns that would receive any benefit from 50 percent credit[3]	5,195	2,327	743	183	8,448
As a share of those eligible based on income (=C/B)	*20.2%*	*11.6%*	*5.8%*	*35.8%*	*14.3%*
(D) Returns that would benefit in full for maximum allowed contribution[4]	1	3	39	0	43
As a share of those eligible based on income (=D/B)	*0.0%*	*0.0%*	*0.3%*	*0.0%*	*0.1%*

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Both filing and nonfiling units are included. Filers who can be claimed as dependents by other filers are excluded.
(2) Eligible returns exclude filing units above the relevant AGI threshold and those claimed as dependents on other tax returns.
(3) Returns that would receive any benefit from the Saver's Credit are eligible and would see some reduction in taxes as a result of the credit if a contribution were made to an approved retirement account.
(4) Returns that would benefit in full from the 50 percent Saver's Credit for the maximum allowable contribution are both eligible and would see a reduction in taxes equal to the size of the credit if the maximum contribution were made to an approved retirement account.

Table 5. Distributional Effect of Saver's Credit[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				No Credit	Current Law
Less than 10	20,301	14.0	0.3	0.0	0.1	0	3.3	3.3
10-20	26,357	18.1	5.0	0.1	19.9	-15	5.5	5.4
20-30	20,537	14.1	9.9	0.1	26.3	-25	10.9	10.8
30-40	15,633	10.8	7.8	0.1	19.2	-24	15.0	14.9
40-50	11,543	7.9	10.9	0.1	16.1	-27	17.0	17.0
50-75	20,112	13.8	5.5	0.0	16.9	-17	19.0	18.9
75-100	11,773	8.1	0.3	0.0	0.6	-1	20.4	20.4
100-200	14,039	9.7	0.2	0.0	0.7	-1	22.6	22.6
200-500	3,588	2.5	0.1	0.0	0.0	0	25.6	25.6
500-1,000	593	0.4	0.0	0.0	0.0	0	27.6	27.6
More than 1,000	284	0.2	0.0	0.0	0.0	0	31.1	31.1
All	145,321	100.0	4.9	0.0	100.00	-14	20.7	20.7

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law without the Saver's Credit.
(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Usage Patterns and Distributional Effects

IRS data indicate that in each of 2002 and 2003, about 5 million tax filers claimed the Saver's Credit.[33] This figure likely understates the true number of qualifying individual savers, however, because a significant portion of these returns are from married couples filing jointly, where each of the spouses may have made a separate qualifying contribution.[34]

Table 5 shows the estimated distributional effect of the Saver's Credit. The data suggest that over 45 percent of

Table 6. Alternative Estimates of Revenue Effects of Saver's Credit[1]

Billions of dollars

Fiscal Year	Joint Tax Committee, revenue effect given 2006 sunset	Administration fiscal 2005 budget, tax expenditure estimate[1]	Revenue effect from eliminating sunset	
			Congressional Budget Office	Urban-Brookings Tax Policy Center
2002	1.0			
2003	2.1	0.9		
2004	2.0	1.0		
2005	1.9	1.1		
2006	1.8	1.2		
2007	0.9	0.7	0.6	0.6
2008	0.1		1.9	1.7
2009	0.1		1.7	1.6
2010	0.1		1.6	1.5
2011	0.1		1.4	1.6
2012			1.4	1.8
2013			1.3	1.7
2014			1.1	1.6
2015				1.5

Sources: Joint Tax Committee; Office of Management and Budget; Congressional Budget Office; authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Note that tax expenditure estimates do differ in certain respects from estimated revenue effects.

In one survey of 401(k) plan sponsors in 2002, representatives of 71 percent of the plans indicated that they believed the Saver's Credit had already increased participation in their plans, and 18 percent believed the Saver's Credit had caused a "major increase" in participation.

the benefits accrue to filers with cash income between $10,000 and $30,000. Households with income below $10,000 receive almost none of the benefits, an outcome that reflects the nonrefundability of the credit.

Effects on Private Savings

A full assessment of the effects of the credit on private savings would require more information than is currently available, but some possibilities suggest themselves. A necessary, but not sufficient, condition for the credit to raise private savings is to see an increase in IRA and 401(k)-type plan contributions among the eligible population.[35] In one survey of 401(k) plan sponsors in 2002, representatives of 71 percent of the plans indicated that they believed the Saver's Credit had already increased participation in their plans, and 18 percent believed the Saver's Credit had caused a "major increase" in participation.[36] The tax preparer H&R Block has said that it claimed the credit in 2002 on behalf of more than a million clients, who saved an average $175 on their tax bills. An H&R Block representative has been quoted as saying that many of these clients were first-time contributors to a retirement savings plan.[37]

Options for Expansion

Several significant changes should be considered that could be made to improve the Saver's Credit: making the credit permanent, making it refundable, expanding it to provide stronger incentives for middle-income households, changing the rate at which it phases out, and indexing it to inflation. Most of these options are already under active discussion among policymakers.

Eliminating the 2006 Sunset

In order to reduce the apparent revenue cost, Congress stipulated that the Saver's Credit would sunset at the end of 2006.[38] It would cost between $1 billion and $2 billion a year to make the Saver's Credit permanent. As Table 6 shows, estimates generated by the Tax Policy Center model are similar to those published by the Congressional Budget Office.

Making the Credit Refundable

As noted above, tens of millions of lower-income workers are unable to benefit from the credit because it is nonrefundable. To extend the intended savings incentive to most lower-income working families would require making the Saver's Credit refundable.[39]

Some public policymakers and others have long had reservations about making tax credits refundable. Their concern is often based on a sense that refundability converts a tax credit into a form of "welfare," which is viewed as undesirable, and that refundable credits tend to pose an unacceptable risk of fraud or other noncompliance. It is not clear, however, that the concerns typically raised about refundable credits are applicable to making the Saver's Credit refundable. To qualify for the Saver's Credit, an individual must make a contribution to a tax-preferred account, which is verified by third-party reporting (by the IRA trustee or plan administrator). In addition, to limit potential abuses, policymakers could require tax filers to have at least $5,000 in earnings per person to claim the refundable credit.

Table 7 reports the revenue effects of making the Saver's Credit refundable, as estimated using the Tax Policy Center microsimulation model. The second column of the table shows that refundability would add $2 billion to $3 billion a year to the cost. Since the current cost amounts to between $1 billion and $2 billion, adding refundability would raise the cost to about $4 billion a year.[40]

Making the credit refundable would help equalize the tax benefits of saving for higher- and lower-income households, leveling the playing field between income tax payers and workers who pay payroll tax but have no federal income tax liability. Refundability would significantly benefit lower-income earners, with almost 38 percent of the tax benefit accruing to individuals and families with $20,000 or less in cash income (table 8).

Short of direct income tax refundability, other variations and alternatives are possible.[41] For example, a bill introduced by Sen. Jeff Bingaman (D-NM) in 2002 would in effect make the Saver's Credit refundable, but only by matching qualifying contributions of individuals with no federal income tax liability who purchase an inflation-indexed U.S. savings bond that they cannot redeem until retirement age.[42] Another possibility would involve providing a tax credit to (essentially through) financial institutions for contributions that they make to their clients' savings accounts, as was proposed in the Treasury Department's February 2000 Retirement Savings Accounts approach.[43] The effect would be similar to that of a refundable tax credit at the individual level. A final possibility would be to deposit the refund directly into the savings account or 401(k)-type plan, an option that is under discussion but raises significant technical issues.[44]

Indexing AGI Limits to Inflation

The AGI phase-out limits for the credit rates are currently not indexed to inflation. As a result, the credit grows less generous over time, as inflation pushes more households above the phase-out thresholds. Most features of the tax code are indexed to inflation, so that inflation by itself does not increase tax burdens. The Saver's Credit thresholds could be made to conform to this general tax treatment. As shown in Appendix Table 1, indexation would add about $9.2 billion over ten years to the cost of the refundable credit.

Table 7. Revenue Cost of Extending The Saver's Credit and Making It Refundable

Billions of dollars

Year	Extend existing credit beyond 2006	Extend and make refundable
2006	0.0	1.1
2007	0.6	3.8
2008	1.7	4.8
2009	1.6	4.7
2010	1.5	4.5
2011	1.6	4.3
2012	1.8	4.1
2013	1.7	4.0
2014	1.6	3.8
2015	1.5	3.7
Total, 2006-15	13.5	38.8

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

Making the credit refundable would help equalize the tax benefits of saving for higher- and lower-income households, leveling the playing field between income tax payers and workers who pay payroll tax but have no federal income tax liability.

Table 8. Distributional Effect of Making Saver's Credit Refundable[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	8.4	-14	3.3	3.1
10-20	26,357	18.1	8.2	0.2	29.2	-36	5.4	5.1
20-30	20,537	14.1	8.1	0.2	30.6	-49	10.8	10.6
30-40	15,633	10.8	6.6	0.1	16.3	-34	14.9	14.8
40-50	11,543	7.9	4.6	0.1	7.1	-20	17.0	16.9
50-75	20,112	13.8	1.5	0.0	4.2	-7	18.9	18.9
75-100	11,773	8.1	0.3	0.0	1.0	-3	20.4	20.4
100-200	14,039	9.7	0.3	0.0	1.5	-3	22.6	22.6
200-500	3,588	2.5	0.1	0.0	0.2	-2	25.6	25.6
500-1,000	593	0.4	0.1	0.0	0.0	-1	27.6	27.6
More than 1,000	284	0.2	0.1	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	4.5	0.0	100.00	-22	20.7	20.7

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law.
(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Expanding Eligibility to More Middle-Income Households

Another set of possible expansions to the Saver's Credit would extend eligibility to additional middle-income households. The credit could be expanded in this way along three dimensions: changes to the credit rate, the income limit, and the manner in which the credit is phased out.

First, the 20 percent and 10 percent credit rates available to eligible joint filers with AGI between $32,500 and $50,000 could be raised to 50 percent.[45] This would make the 50 percent credit available to tens of millions of additional households who, for the most part, confront zero, 10 percent, or 15 percent marginal income tax rates and therefore have relatively little to gain from the traditional income tax incentive structure. Estimates using the Tax Policy Center model show that 96 percent of the households who would benefit from the expanded 50 percent credit are in the 15 percent marginal tax bracket. These households typically have fewer additional assets to help meet basic needs in retirement and are among those who most need help to save for retirement. According to the model, median financial assets among those households who would benefit from the expanded 50 percent credit rate are currently about $30,000.

Second, the 50 percent credit rate could be expanded to working households with AGI up to $60,000 or $70,000 (for joint filers).[46] Some of these households — about 5 percent under the option that increases eligibility for the 50 percent credit to $70,000 for joint filers — are in the 25 percent marginal tax bracket and therefore already receive a somewhat larger incentive to save under the traditional system of tax subsidies. The vast majority, however, are in the 15 percent bracket, and many of these households have somewhat more disposable or discretionary income remaining after meeting essential short-term needs than do lower-income families in the same tax bracket. These households may thus be more likely than lower-income households to respond to the incentive, and more likely than higher-income households to respond by increasing their net savings rather than merely shifting assets. (If the 50 percent credit rate were expanded to joint filers with incomes of up to $70,000, the Tax Policy Center model suggests that the newly eligible households would have median financial assets of $42,000 and mean financial assets of $83,000.)

Finally, whatever the level of AGI at which eligibility for the 50 percent credit rate stops, the credit rate could be made to phase down ratably from 50 percent to zero over a specified range of AGI, such as $10,000. Such a smooth phase-down would remove the "cliffs" in the current credit structure, which involves steep declines in the credit rate as income rises, resulting in very high effective marginal tax rates for many savers who use the credit. For example, consider a married couple earning $30,000 in AGI and contributing $2,000 to an IRA. At present, if the couple's AGI increases to $30,001, the tax credit for that contribution declines from $1,000 to $400 – a $600 increase in tax liability triggered by a $1 increase in income.

We examine three potential expansions of the 50 percent credit: to joint filers with AGI of $50,000, $60,000, and $70,000. Each involves a ratable phase-down of the credit from 50 percent to zero over a $10,000 AGI range. The income cutoffs for single filers and heads of households would remain in the same proportion to the joint filer thresholds as under the current Saver's Credit. As Table 9 shows, extending the 50 percent credit rate to joint filers with AGI of $50,000 adds about $5 billion a year to the cost of the credit. Each $10,000 increment above $50,000 then adds another $3 billion to $5 billion a year in revenue cost.

Appendix Tables 2 through 7 provide more details about the effects of combining these expansions with making the credit refundable. For example, extending the Saver's Credit past its 2006 sunset, making it refundable, indexing its AGI thresholds to inflation, and expanding the 50 percent credit rate to joint filers with $50,000 of AGI is estimated to cost about $118.5 billion in tax revenue over ten years (final column of Appendix Table 2). Table 10 (reprinted as Appendix Table 3) shows the distributional effects of these combined changes. Tax filers with cash income under $40,000 would receive about half the tax benefits; the rest would mostly accrue to tax filers with cash income between $40,000 and $75,000.

Table 9. Revenue Cost of Extending Saver's Credit and Expanding Eligibility for Top Credit Rate

Billions of dollars

Year	Extend existing credit beyond 2006	Extend and expand eligibility for 50 percent credit rate to joint filers with AGI up to: $50,000	$60,000	$70,000
2006	0.0	1.9	3.5	5.3
2007	0.6	6.0	10.4	15.4
2008	1.7	6.7	11.0	15.8
2009	1.6	6.3	10.4	15.1
2010	1.5	6.0	9.9	14.4
2011	1.6	6.2	9.9	14.3
2012	1.8	6.9	10.4	14.7
2013	1.7	6.6	9.9	13.9
2014	1.6	6.2	9.4	13.1
2015	1.5	5.9	8.9	12.4
Total, 2006-15	13.5	58.7	93.9	134.5

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

The income cut-offs for single filers and heads of households would remain in the same proportion to the joint filer thresholds as under the current Saver's Credit.

Middle-income households may be more likely than lower-income households to respond to the incentive, and more likely than higher-income households to respond by increasing their net savings rather than merely shifting assets.

Table 10. Distributional Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $50,000 for Joint Filers[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	2.5	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	10.6	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	21.6	-117	10.8	10.4
30-40	15,633	10.8	16.8	0.4	16.8	-119	14.9	14.6
40-50	11,543	7.9	17.7	0.4	16.9	-163	17.0	16.6
50-75	20,112	13.8	17.8	0.3	29.1	-161	18.9	18.7
75-100	11,773	8.1	1.2	0.0	1.2	-11	20.4	20.4
100-200	14,039	9.7	0.6	0.0	0.8	-7	22.6	22.6
200-500	3,588	2.5	0.4	0.0	0.1	-3	25.6	25.6
500-1,000	593	0.4	0.2	0.0	0.0	-2	27.6	27.6
More than 1,000	284	0.2	0.1	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	10.5	0.2	100.00	-76	20.7	20.6

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $50,000, and phasing out the limit over $10,000.
(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Conclusion

The Saver's Credit offers the potential to help correct the nation's "upside-down" tax incentives for retirement savings. The current tax system provides the weakest incentives for participation in tax-preferred saving plans to those who most need to save for retirement and who are more likely to use tax-preferred vehicles to increase net savings than to serve as a shelter from tax.

The experience thus far with the Saver's Credit has been encouraging. Several options are available, however, to improve the design of the credit: making it refundable, making it permanent, expanding it to provide more powerful incentives for middle-income households, and indexing its thresholds to inflation. These changes would further help middle- and lower-income families save for retirement, reduce economic insecurity and poverty rates among the elderly, and raise national savings.

About The Retirement Security Project

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers. The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

Appendix Table 1. Revenue Cost of Comprehensive Saver's Credit Reforms

Billions of dollars

Year	Extend and make refundable	Extend, index, and make refundable	Extend, index, make refundable, and extend 50 percent credit rate up to indicated AGI (for joint filers) $50,000	$60,000	$70,000
2006	1.1	1.2	3.9	5.7	7.5
2007	3.8	4.0	11.8	16.8	22.1
2008	4.8	5.2	13.0	18.0	23.2
2009	4.7	5.3	13.0	18.0	23.2
2010	4.5	5.4	13.0	18.0	23.1
2011	4.3	5.3	12.8	17.8	22.9
2012	4.1	5.3	12.7	17.6	22.7
2013	4.0	5.4	12.7	17.4	22.5
2014	3.8	5.4	12.7	17.3	22.3
2015	3.7	5.5	12.8	17.2	22.2
Total, 2006-15	38.8	48.0	118.5	163.9	211.8

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

The income cut-offs for single filers and heads of households would remain in the same proportion to the joint filer thresholds as under the current Saver's Credit

Appendix Table 2. Revenue Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $50,000 for Joint Filers

Billions of dollars

	Extend, Index, Make Refundable	Extend, Index, Make Refundable and Increase 50 Percent Credit Rate for Joint Filers to $50,000
2006	1.2	3.9
2007	4.0	11.8
2008	5.2	13.0
2009	5.3	13.0
2010	5.4	13.0
2011	5.3	12.8
2012	5.3	12.7
2013	5.4	12.7
2014	5.4	12.7
2015	5.5	12.8
Total, 2006-2015	48.0	118.5

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

Appendix Table 3. Distributional Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $50,000 for Joint Filers[1]

Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	2.5	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	10.6	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	21.6	-117	10.8	10.4
30-40	15,633	10.8	16.8	0.4	16.8	-119	14.9	14.6
40-50	11,543	7.9	17.7	0.4	16.9	-163	17.0	16.6
50-75	20,112	13.8	17.8	0.3	29.1	-161	18.9	18.7
75-100	11,773	8.1	1.2	0.0	1.2	-11	20.4	20.4
100-200	14,039	9.7	0.6	0.0	0.8	-7	22.6	22.6
200-500	3,588	2.5	0.4	0.0	0.1	-3	25.6	25.6
500-1,000	593	0.4	0.2	0.0	0.0	-2	27.6	27.6
More than 1,000	284	0.2	0.1	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	10.5	0.2	100.00	-76	20.7	20.6

Source: Authors' calculations of Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $50,000, and phasing out the limit over $10,000.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Appendix Table 4. Revenue Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $60,000 for Joint Filers

Billions of dollars

	Extend, Index, Make Refundable	Extend, Index, Make Refundable and Increase 50 Percent Credit Rate for Joint Filers to $60,000
2006	1.2	5.7
2007	4.0	16.8
2008	5.2	18.0
2009	5.3	18.0
2010	5.4	18.0
2011	5.3	17.8
2012	5.3	17.6
2013	5.4	17.4
2014	5.4	17.3
2015	5.5	17.2
Total, 2006-2015	48.0	163.9

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

Appendix Table 5. Distributional Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $60,000 for Joint Filers[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3] Number (thousands)	Tax Units[3] Percent of Total	Percent with Tax Cut	Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5] Current Law	Average Federal Tax Rate[5] Proposal
Less than 10	20,301	14.0	3.8	0.2	1.7	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	7.3	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	15.2	-120	10.8	10.3
30-40	15,633	10.8	22.9	0.6	17.5	-181	14.9	14.4
40-50	11,543	7.9	18.5	0.5	12.9	-182	17.0	16.6
50-75	20,112	13.8	27.9	0.6	40.9	-329	18.9	18.4
75-100	11,773	8.1	7.1	0.1	3.4	-46	20.4	20.4
100-200	14,039	9.7	0.9	0.0	0.8	-9	22.6	22.6
200-500	3,588	2.5	0.6	0.0	0.1	-6	25.6	25.6
500-1,000	593	0.4	0.2	0.0	0.0	-2	27.6	27.6
More than 1,000	284	0.2	0.2	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	13.2	0.2	100.00	-111	20.7	20.5

Source: Authors' calculations of Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $60,000, and phasing out the limit over $10,000.
(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Appendix Table 6. Revenue Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $70,000 for Joint Filers
Billions of dollars

	Extend, Index, Make Refundable	Extend, Index, Make Refundable and Increase 50 Percent Credit Rate for Joint Filers to $70,000
2006	1.2	7.5
2007	4.0	22.1
2008	5.2	23.2
2009	5.3	23.2
2010	5.4	23.1
2011	5.3	22.9
2012	5.3	22.7
2013	5.4	22.5
2014	5.4	22.3
2015	5.5	22.2
Total, 2006-2015	48.0	211.8

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

Appendix Table 7. Distributional Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $70,000 for Joint Filers[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3] Number (thousands)	Percent of Total	Percent with Tax Cut	Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5] Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	1.3	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	5.5	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	11.5	-120	10.8	10.3
30-40	15,633	10.8	24.0	0.7	15.7	-216	14.9	14.3
40-50	11,543	7.9	24.7	0.6	11.4	-212	17.0	16.5
50-75	20,112	13.8	29.2	0.8	37.0	-395	18.9	18.3
75-100	11,773	8.1	26.5	0.4	16.1	-293	20.4	20.1
100-200	14,039	9.7	1.6	0.0	1.1	-17	22.6	22.6
200-500	3,588	2.5	0.7	0.0	0.1	-8	25.6	25.6
500-1,000	593	0.4	0.3	0.0	0.0	-4	27.6	27.6
More than 1,000	284	0.2	0.2	0.0	0.0	-3	31.1	31.1
All	145,321	100.0	15.6	0.3	100.00	-148	20.7	20.5

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $70,000, and phasing out the limit over $10,000.
(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Footnotes

1 For a broader discussion of these issues, see William G. Gale and Peter R. Orszag, "Private Pensions: Issues and Options," in *Agenda for the Nation*, edited by Henry J. Aaron, James M. Lindsay, and Pietro S. Nivola (Brookings, 2003); Peter R. Orszag, "Progressivity and Saving: Fixing the Nation's Upside-Down Incentives for Saving," Testimony before the House Committee on Education and the Workforce, February 25, 2004, and J. Mark Iwry, Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003. These and related publications are available on The Retirement Security Project website (www.retirementsecurityproject.org).

2 Technically, the lifetime subsidy from such accounts comes from two sources: the difference (if any) between the tax rate at the time of contribution and that at the time of withdrawal, and the tax-free accumulation of funds. See Leonard E. Burman, William G. Gale, and David Weiner, "The Taxation of Retirement Saving: Choosing between Front-Loaded and Back-Loaded Options," *National Tax Journal* 54, no. 3 (September 2001), and Eric M. Engen, John Karl Scholz, and William G. Gale, "Do Saving Incentives Work?" *Brookings Papers on Economic Activity*, no. 1 (1994), pp. 85-151. In practice, however, these items are often correlated with the tax rate at the time of the contribution, and casual evidence suggests that the up-front deductibility of most of these plans (such as 401(k)s and traditional IRAs, which provide the tax advantage at the time of contribution rather than distribution) is an important determinant of whether people make contributions.

3 See, for example, Eric M. Engen, William G. Gale, and Cori E. Uccello, "The Adequacy of Household Saving," *Brookings Papers on Economic Activity*, no. 2 (1999): pp. 65-165.

4 Ibid.

5 Retirement saving for these workers is promoted – or designed to be promoted — indirectly by nondiscrimination and certain other provisions of the Internal Revenue Code of 1986 (IRC) and the Employee Retirement Income Security Act of 1974 (ERISA). Those provisions, which are subject to extensive exceptions, are intended to impose some constraint on the degree to which tax-favored benefits accrue to a limited number of owners and executives rather than the large majority of workers. The IRC and ERISA also protect and regulate the accumulation and preservation of retirement benefits. For additional discussion of these issues by the Treasury Department, see Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, Testimony before the House Committee on Ways and Means, Subcommittee on Oversight, March 23, 1999.

6 Michael Wyand, "Savings Effort to Continue Based on RSA Plus Savers Credit, Not LSA, Portman Says," BNA, March 16, 2004.

7 Section 25B of the IRC of 1986 was added by section 618 of EGTRRA, Public Law 107-16, 115 Stat. 38. See also IRS Announcement 2001-106, 2001-44 I.R.B. (October 29, 2001), and IRS News Release IR 2001-107, 2001-44 I.R.B. (November 7, 2001). The credit was officially titled "Elective Deferrals and IRA Contributions By Certain Individuals." Although now generally referred to as the "Saver's Credit," that term actually appears nowhere in the law. "Saver's Credit" was first used in IRS/Treasury administrative guidance at the suggestion of one of the authors in mid-2001 with a view to facilitating the "public marketing" of the provision. See IRS Announcement 2001-106, 2001-44 I.R.B. (October 29, 2001); IRS News Release IR 2001-107, 2001-44 I.R.B. (November 7, 2001).

8 The only exceptions are relatively minor: the credit may not be used by individuals who have not reached age 18 by the end of the taxable year, are full-time students, or are claimed as dependents on another return. IRC section 151(c)(4) and IRS Announcement 2001-106 elaborate on the definition of "student" for this purpose.

9 The Saver's Credit can be used to offset regular income tax liability as well as alternative minimum tax liability (IRC section 25B(g)(1)), although the latter generally is not a concern for the eligible income group.

10 Office of Management and Budget, *Fiscal Year 2005 Analytical Perspectives*, table 18-2.

[11] Both spouses in a married couple may receive the credit. For example, if each spouse contributes $2,000 to his or her IRA, and they file jointly with adjusted gross income not exceeding $30,000, the couple will receive a nonrefundable tax credit of $2,000 ($1,000 each) if they have sufficient federal income tax liability to use the credit. As discussed later, however, because of the nonrefundable nature of the credit, very few taxpayers actually qualify for the 50 percent match.

[12] The level of contributions eligible for the credit is reduced by the amount of distributions from any retirement savings plan or IRA by the participant or the participant's spouse during the year for which the credit is claimed, the two preceding years, or the portion of the following year that precedes the tax return due date. Distributions that are rolled over to another plan or IRA are not counted against the participant for this purpose. The IRS uses the following example to illustrate how this anti-churning provision works: "Mark's adjusted gross income for 2002 is low enough for him to be eligible for the credit that year and he defers $3,000 of his pay to his employer's 401(k) plan during 2002. During 2001, Mark took a $400 hardship withdrawal from his employer's plan and during 2002 he takes an $800 IRA withdrawal. Mark's 2002 Saver's Credit will be based on contributions of $1,800 ($3,000 – $ 400 - $800)." Some gaming is still possible despite these rules (see Leonard Burman, William G. Gale, and Peter R. Orszag, "The Administration's Saving Proposals: A Preliminary Analysis" Tax Notes, March 3, 2003). However, in the process of designing the Saver's Credit, other, more restrictive anti-churning provisions were considered and rejected in the interest of keeping the proposal simple and workable.

[13] As discussed in note 2, the entire subsidy associated with savings incentives depends not only on the tax rate at which the contribution is deducted, but also on the tax rate that applies to withdrawals, the length of time the funds are held in the account, the tax rate that would have applied to taxable funds while the funds are held in the tax-preferred account, and the rate of interest. Controlling for the latter factors, taxpayers who can deduct the contribution at a higher rate will generate larger tax savings.

[14] The true magnitude of these effective matching rates may not be evident to many taxpayers, however, because the Saver's Credit is presented as applying at a 50 percent, 20 percent, or 10 percent rate. Indeed, the prevalence of employer 401(k)-type plan matching contributions may well invite some households who are or have been eligible for a 401(k)-type plan to view the credit rate as a matching rate, even though the implicit matching rate is higher than the credit rate and the overall combined subsidy is substantially higher if there is an employer match. To the extent that taxpayers make such misleading comparisons, even the maximum Saver's Credit rate would appear to be no higher than the common 50 percent employer match. In short, the "optics" of the Saver's Credit may well reduce its incentive effect.

[15] See J. Mark Iwry, "Expanding the Saver's Credit," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, July 1, 2003. In particular, the Saver's Credit applies to both before-tax and after-tax contributions by eligible individuals. In addition, although this is not widely recognized, the credit can be claimed for voluntary employee contributions to an employer-sponsored defined benefit plan, although typically it applies to employee contributions to a defined contribution plan such as a 401(k).

[16] The exclusion of IRA and 401(k)-type plan contributions from AGI measures also will make more households eligible for the credit and for a higher credit rate. As a simplified example, consider a married couple filing jointly who have before-tax gross earnings of $34,000. If one spouse contributes $2,000 to a 401(k)-type plan and the other contributes $2,000 to a traditional IRA, AGI will be reduced to $30,000, which would increase their Saver's Credit rate to 50 percent from 10 percent (the rate that would have applied with AGI of $34,000).

[17] The upfront deductibility of 401(k)-type plan and IRA contributions combined with taxation of withdrawals further increases the net overall return to the extent that the tax rate at the time of withdrawal is lower than the tax rate at the time the contributions were made. If the two tax rates are the same, the results of the Saver's Credit and employer match are like those in tables 1 and 2, depending on whether an employer match exists. Even if the tax rates are the same, however, the value of tax deferral with respect to the earnings on the deductible portion of the contribution — in addition to the Saver's Credit and any employer match — may still encourage taxpayers to contribute to the plans.

[18] See IRS Announcement 2001-106, A-10. Under the 401(k)-type plan nondiscrimination standards, the work force eligible to contribute to the plan is divided into highly compensated employees, or HCEs (largely those earning $95,000 or more, as indexed for 2005) and non-highly compensated employees (NHCEs). The tests compare the average pretax contribution rates (as a percentage of pay) of the two groups, limiting the HCE group to a collective average that does not exceed the corresponding collective average for the NHCE group by more than a specified margin. (A parallel test applies to employees' after-tax contributions and employer matching contributions.) Eligible NHCEs who fail to contribute to the plan bring down the average for their group (and hence the allowable average for the HCE group) because they are counted as zeros in determining the NHCE average. The Saver's Credit was designed to reduce the number of zeros.

[19] IRS Announcement 2001-106. With the aim of reaching as many employees as possible, then-IRS Commissioner Charles Rossotti issued a news release shortly before the Saver's Credit took effect on January 1, 2002, encouraging employees to take advantage of the credit and enroll in 401(k)-type plans, and the IRS took the unusual step of preparing and publishing a Spanish-language version of the model employer notice to employees. See IR 2001-107, 44 I.R.B. (November 7, 2001).

[20] Automatic enrollment was approved in IRS Revenue Ruling 2000-8. The IRS has recently affirmed that plans are permitted to increase the automatic contribution rate over time in accordance with a specified schedule or in connection with salary increases or bonuses. See letter dated March 17, 2004, from the Internal Revenue Service to J. Mark Iwry.

[21] William G. Gale, J. Mark Iwry, Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," *Policy Brief* No. 2005-1. These and related publications are available on The Retirement Security Project website (www.retirementsecurityproject.org).

[22] Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics* 116, no. 4 (November 2001): 1149-87.

[23] For a broader discussion of these issues, see William G. Gale and Peter R. Orszag, "Private Pensions: Issues and Options." For a broader discussion of the objectives of the private pension system and why more has not been done to address the needs of middle- and lower-income households, see J. Mark Iwry, Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003.

[24] See Engen, Gale, and Uccello, "The Adequacy of Household Saving."

[25] For example, an unpublished study by a Treasury economist found that only 4 percent of taxpayers eligible for conventional IRAs in 1995 made the maximum allowable $2,000 contribution. Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000. For IRA contributors at the limit, see also Craig Copeland, "IRA Assets and Characteristics of IRA Owners," *EBRI Notes*, December 2002. Other studies have found a paucity of 401(k)-type plan contributors to be constrained by the statutory dollar maximum. For example, the General Accounting Office (now the Government Accountability Office) found that an increase in the statutory contribution limit for 401(k)-type plans would directly benefit fewer than 3 percent of participants (General Accounting Office, "Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans," GAO-01-846, September 2001). Data from the Congressional Budget Office suggest that only 6 percent of all 401(k)-type plan participants made the maximum contribution allowed by law in 1997. (Author's calculations based on Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003, table 2.) See also David Joulfaian and David Richardson, "Who Takes Advantage of Tax-Deferred Saving Programs? Evidence from Federal Income Tax Data," Office of Tax Analysis, U.S. Department of the Treasury, 2001.

[26] For a discussion of this shift from defined benefit to defined contribution plans, see J. Mark Iwry, Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003.

[27] Jeanne M. Hogarth and Chris E. Anguelov, "Can the Poor Save?" *Proceedings of Association for Financial Counseling and Planning Education* (2001).

[28] Michael Sherraden, *"Asset Building Policy and Programs for the Poor," in Assets for the Poor: The Benefits of Spreading Asset Ownership*, edited by Thomas Shapiro and Edward Wolff (N.Y. Russell Sage Foundation, 2001). Also, homeownership rates rose in a demonstration program that gave strong incentives for lower-income families to purchase housing. See Gregory Mills and others, "Evaluation of the American Dream Demonstration: Final Evaluation Report" (Cambridge, Mass.: Abt Associates, August 2004).

[29] Economists continue to debate the impact on private savings from existing pension incentives. Most economists agree, however, that whatever the overall effect, focusing incentives on those with fewer opportunities to shift assets from taxable to nontaxable forms is likely to produce a larger increase in private savings for any given reduction in government revenue.

[30] See, for example, Eric M. Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," Working Paper 8032 (Cambridge, Mass.: National Bureau of Economic Research, December 2000), and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Economics* 87, no. 5-6 (2003): 1259-90.

[31] These estimates are generated by the Urban-Brookings Tax Policy Center microsimulation model. The model is based on data from the 1999 public-use file produced by the Statistics of Income Division of the IRS. The model contains additional information on demographics and sources of income that are not reported on tax returns through a constrained statistical match of the public-use file with the March 2000 Current Population Survey of the U.S. Census Bureau. The retirement savings module also uses data from the Survey of Consumer Finances and the Survey of Income and Program Participation. For more detail about the model, see www.taxpolicycenter.org.

[32] Some households who can benefit from the Saver's Credit do not have positive income tax liability, but do have positive income tax liability before taking into account the Earned Income Tax Credit (EITC). For these households, the EITC refund is increased to the extent that the Saver's Credit reduces their pre-EITC tax liability.

[33] Individual Income Tax Returns, Preliminary Data: Selected Income and Tax Items, Tax Years 2002 and 2003 <http://www.irs.gov/pub/irs-soi/03in01fg.xls>. Unpublished SOI Data. February 2005.

[34] The IRS data are based on the number of tax returns that claimed the Saver's Credit by entering an amount on line 49 of Form 1040 "retirement savings contributions credit" and filing Form 8880 "Credit for Qualified Retirement Savings Contributions". (On the 2004 tax return, the Saver's Credit is claimed by entering an amount on line 50.) The data do not show a breakdown of contributions by type of plan (employer plan versus IRA, for example) or size of contribution. However, partial data that shed some light on these issues are available from other sources, such as professional tax preparers, with whose aid a significant portion of returns claiming a Saver's Credit were filed.

[35] If 401(k)-type plan or IRA contributions were offset by reduced savings in other accounts or more borrowing, the net effect on overall savings rates could be zero even if the effect on 401(k)-type plan and IRA contributions were positive.

[36] See the website of *Plan Sponsor* magazine (www.plansponsor.com), July 23, 2002. It should be noted that the survey was targeted to compliance with the EGTRRA legislation generally; the questions regarding the Saver's Credit constituted only a small fraction of the total questions in the survey. In addition, the plan sponsors surveyed represented a small sample that appears to have been selected in an informal manner from among clients of the surveying firm, and the basis for determining the impact on participation in the 401(k) was not made clear. Nonetheless, the results, reflecting the perceptions of those who administer 401(k) plans, are striking, especially given that they were sampled only six months after the credit took effect.

[37] B. Tumulty and C. Burnett, "Bush Shuns Retirement Tax Credit," Gannett News Service, March 1, 2004; B. Tumulty, "White House Drops Saver Credit," *Green Bay Press-Gazette*, February 21, 2004.

[38] Various proposals – including bills introduced by Sen. Jeff Bingaman (D-NM) and Rep. Richard Gephardt (D-MO), S. 2733 and H.R. 4482, respectively and H.R. 1776, the Pension Preservation and Savings Expansion Act of 2003, introduced by Reps. Portman and Cardin (see section 102 of that bill) – would remove the sunset on the Saver's Credit.

[39] This change was proposed in a bill introduced by then House Minority Leader Richard Gephardt in 2002 (H.R. 4482, 107th Cong., 2d Sess.). It was also proposed in a bill introduced by then Senator John Edwards (D-NC) in 2004 (S. 2303, 108th Cong., 2d Sess.).

[40] Requiring tax filers to have at least $5,000 in earnings per person ($10,000 for joint filers) in order to claim a refundable credit would reduce the cost by about $0.5 billion to $0.7 billion a year.

[41] If the Saver's Credit remains nonrefundable, it should be coordinated better with the child tax credit. The legislation enacting the Saver's Credit provided originally that it would be taken into account after most other nonrefundable or partially refundable tax credits, notably the partially refundable child tax credit. See IRC sections 24(b)(3)(B) and 25B(g)(2) and IRS Announcement 2001-106 (sample notice). The nonrefundable component of the child tax credit "competes" with the nonrefundable Saver's Credit to reduce the same income tax liability. Accordingly, if the child tax credit completely eliminated a taxpayer's income tax liability, it would effectively crowd out the Saver's Credit, so that the latter would lose its incentive effect. (In contrast, the EITC is refundable and does not reduce the amount of the Saver's Credit.) However, since enacting the Saver's Credit, Congress has made temporary changes to the interaction of the credits that have had the effect of temporarily reversing this stacking order and taking the Saver's Credit into account before the nonrefundable portion of the child tax credit. Congress could make these changes permanent, preserving the incentive value of the Saver's Credit by amending the tax code to provide on a permanent basis that the Saver's Credit is taken into account to offset tax liability before the child tax credit. Stacking the Saver's Credit before the child tax credit, if scored as a change in law, would cost about $500 million a year. This is a distinctly second-best solution, however, compared with the far more effective step of making the Saver's Credit refundable.

[42] See S. 2733 (107th Cong., 2d Sess.).

[43] See U.S. Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals" (February 2000), pp. 49-52.

[44] One apparent problem is the lack of easily accessible bank routing numbers for many IRAs and 401(k)-type plans. Other complications include the need for plan sponsors to administer the account balances resulting from such deposits, including the possible need for additional "buckets" in plan data systems to keep separate track of different kinds of funds. This would be a particularly challenging problem if the balance attributable to the Saver's Credit were taxable when withdrawn from a Roth IRA, even after retirement. On the other hand, if the Saver's Credit balance were not taxable when withdrawn from a Roth IRA, it would escape tax permanently. In addition, consideration reportedly has been given to the possibility of treating the government's deposit as satisfying some of the employer's contribution obligations under the nondiscrimination standards, as if the government deposit were an employer contribution. This would in effect shift part of the employers' responsibility for funding retirement benefits for lower-income employees from employers to the government. As noted, the Saver's Credit already helps plans pass the nondiscrimination tests insofar as it induces additional contributions by middle-income workers.

[45] See J. Mark Iwry, "Expanding the Saver's Credit," Testimony before the Subcommittee on Employer-Employee Relations of the House Committee on Education and the Workforce, July 1, 2003, p. 4.

[46] Income eligibility levels would be increased to various degrees by the Bingaman and Gephardt bills (S. 2733 and H.R. 4482) and slightly by the Portman-Cardin bill (H.R. 1776, section 401).

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Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

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