Testimony of J. Mark Iwry[1]

Before the Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
United States House of Representatives

Expanding the Saver's Credit

Chairman Johnson, Ranking Member Andrews and members of the Subcommittee, I am submitting this written statement in response to the Subcommittee's request for additional views following its June 4, 2003 hearing on defined benefit pension plans. Among other issues,[2] I have been asked to submit my views as to how Congress might expand pension coverage by making better use of the saver's credit under section 25B of the Internal Revenue Code.[3] That is the subject of this statement.

I. The Saver's Credit

In 2001, Congress established a nonrefundable income tax credit for voluntary retirement savings contributions to 401(k) and other employer-sponsored retirement plans, and to IRAs (the "saver's credit").[4] The saver's credit provides what is in effect a government matching contribution for individuals' contributions to 401(k)s, SIMPLE plans, IRAs and other plans -- in the form of a tax credit of up to 50% of an individual's contributions up to $2,000 per year. It applies to individuals whose adjusted gross income (AGI) does not exceed $50,000 a year (for those filing their federal income tax return jointly; $25,000 for single filers).

The saver's credit is one of the most significant targeted initiatives ever enacted to promote tax-qualified retirement savings for moderate- and lower-income workers. This is important not only as a matter of relative need and equity. It is

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[1] The witness served as the Benefits Tax Counsel of the U.S. Department of the Treasury from 1995 through 2001. In that capacity, he played a central role in developing the saver's credit, together with his staff in the Office of Benefits Tax Counsel and with Len Burman and his staff in the Office of Tax Analysis, within the Treasury Department's Office of Tax Policy. The witness currently is a lawyer and a nonresident Senior Fellow at the Brookings Institution. The views expressed in this testimony are those of the witness alone. They should not be attributed to the staff, officers, or trustees of the Brookings Institution or to any other organization.

[2] At or after the Subcommittee's June 4, 2003 hearing on defined benefit pension plans, where I testified on a panel that included Messrs. Gebhardtsbauer, Leary and VanDerhei, the witnesses were asked on behalf of members of the Subcommittee to submit additional statements regarding several specific issues. The requests directed to me included a request for information regarding possible approaches for addressing the cash balance pension issue. I have submitted a separate written statement to the Subcommittee on that issue. In addition, in response to requests on behalf of the Subcommittee for data on the incidence and uses of lump sum distributions from retirement plans and for views regarding a possible approach that would provide relief from certain regulation of defined contribution plans to employers that also spons or certain defined benefit plans, I have submitted a separate written statement on behalf of myself and Mr. VanDerhei.

[3] This request for a written expansion of my remarks for the record was made by Congressman Andrews.

[4] Section 618 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Public Law 107-16, 115 Stat. 38, enacted the saver's credit into law by adding section 25B to the Internal Revenue Code (IRC). See also IRS Announcement 2001-106, 2001-44 I.R.B. (Oct. 29, 2001); IRS News Release IR 2001-107, 2001-44 I.R.B. 416 (Oct. 29, 2001).

also important as a matter of efficiency in promoting national saving. Tax expenditures that are of use mainly to the affluent tend to be inefficient to the extent that they induce higher-income people simply to shift their other savings to tax-favored accounts. But contributions and saving incentives targeted to moderate- and lower-income workers tend to increase net long-term saving, thereby enhancing retirement security for those who need it most and advancing the goals of our tax-favored pension system in a responsible, cost-effective manner.

The saver's credit was long in the making. It emerged as the end product of much larger-scale efforts to expand pension coverage during the late 1990s and 2000. The proposal was developed chiefly within the Treasury Department, with substantial involvement of private-sector stakeholders, including representatives of plan sponsors, the financial services industry (as providers to plans and IRA trustees and custodians), participants, pension professionals, and others. Its design was substantially influenced by comments from these stakeholders, and the proposal was revised in the House and Senate, before it was enacted on a bipartisan basis in EGTRRA (under the leadership of Senator Max Baucus, Ranking Member, and Senator Bill Roth, then Chairman, of the Senate Finance Committee, as well as Congressman Earl Pomeroy in the House).

The credit was designed to address the fact that more than 75 million workers and their spouses have no employer plan coverage, to help correct the top-heavy distribution of benefits in our current pension system, and to counteract what might be the central defect of our pension tax incentive structure: that the incentives – whether exclusions from income of contributions and earnings or tax deductions – are based mainly on the individual's marginal income tax rate or tax bracket. Therefore, those who most need the additional retirement security – those in the lower tax brackets, especially workers who are in the zero income tax bracket but who pay payroll taxes – have the least to gain from contributing or from demanding employer pensions. Accordingly, participation in tax-qualified plans is far lower among moderate- and lower-income individuals.

A tax credit, especially if refundable, as the savers credit was originally designed to be, puts individuals in different tax brackets on a more equal footing. The saver's tax credit is provided in addition to any other tax benefits generated by the retirement contributions (such as a tax deduction for a contribution to a traditional IRA).

The saver's credit was also carefully designed to support and enhance the employer plan system, instead of competing with it. By in effect matching lower-income workers' contributions to 401(k) and other plans – in addition to any matching contributions the employer might make under the plan – the saver's credit encourages contributions by workers who might not otherwise save. This makes it easier for plans to pass the 401(k) nondiscrimination tests, which in turn

increases the amount of tax-favored 401(k) contributions highly paid employees can make.

An IRS news release issued shortly before the saver's credit took effect stated,

> "Qualifying employees should make plans now to benefit from the new Saver's Credit next year, the Internal Revenue Service advises. This tax credit …will help offset the cost of the first $2,000 contributed to IRAs, 401(k)s and certain other retirement plans.
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> "The credit encourages saving for retirement," said IRS Commissioner Charles O. Rossotti. "We want workers to know about the Saver's Credit so they can take full advantage of it."[5]

The saver's credit also may induce more small businesses to adopt 401(k) and SIMPLE plans. As noted, it increases employees' financial incentive to demand the opportunity to contribute to such plans. In addition, some small businesses would consider adopting a 401(k) plan if they had the wherewithal to make matching contributions in order to induce enough participation by nonhighly paid employees to meet the 401(k) nondiscrimination standards. The saver's credit steps in to provide some of that incentive for nonhighly paid employees to participate in a 401(k) or other contributory plan.

It is worth noting that the saver's credit incentive applies to encourage voluntary employee contributions to defined benefit plans as well as defined contribution plans (such as contributions (pretax or after-tax) to 401(k)s, 403(b)s, 457 plans, and SIMPLE plans) and IRAs.

II. Experience to Date

The first tax year for which the saver's credit was available was 2002. Based on initial IRS data, I have estimated that roughly 3 1/2 million tax returns claimed the saver's credit for 2002.[6] The number of individuals who benefited from the credit would be larger because many of the returns were filed jointly by married couples, and in at least some cases, each spouse would have made a contribution for which a credit was claimed.

In addition, in a survey of 401(k) plan sponsors conducted in mid-2002 by Diversified Investment Advisers, 71% of plan sponsors surveyed said that the

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[5] IRS News Release IR 2001-107, 2001-44 I.R.B. 416 (Oct. 29, 2001).

[6] See, e.g., Albert B. Crenshaw, "A Saving Credit for Those Who Aren't Already Rich," Washington Post (May 11, 2003), page F4.

saver's credit had increased plan participation, and 18% said it had caused a major increase in participation.[7]

Before it was enacted, the revenue cost of the saver's credit was estimated by the Joint Committee on Taxation to be about $10 billion.[8] I am not aware of reliable data on the revenue cost of the saver's credit for 2002, but my impression, based on the very rough and fragmentary data available to date, is that the actual cost is unlikely to exceed, and may well fall below, the originally estimated revenue cost for that year.

III. Need for Expansion

Eligibility for the saver's credit was drastically curtailed as the proposal went through the legislative process. First, it was made nonrefundable, cutting out as much as ¾ of the working population that was originally eligible for the 50% credit.[9] Second, the income limits were reduced to the point that a 50% credit designed for working families earning up to $60,000 or more was limited to working families earning up to $30,000, with the credit rate reduced to 20% for joint filers earning up to $32,500 and only 10% for joint filers earning between $32,500 and $50,000. Third, Congress provided for the credit to sunset after five years (2002 through 2006), even though the remainder of the EGTRRA pension provisions were enacted to remain effective for ten years.

Accordingly, I would recommend the following changes to expand the current saver's credit and make it more effective:

First, the saver's credit should be made refundable, in accordance with its original design.[10] Tens of millions of low-income workers who were intended to be helped by the savers credit are ineligible because the credit, as enacted, is nonrefundable, and these workers have no income tax liability. If direct income tax refundability proves to be politically impossible, it is worth exploring variations and alternatives. For example, a bill introduced by Senator Bingaman last year would make the saver's credit refundable, but only by matching qualifying contributions of individuals who have no income tax liability with an inflation-indexed US savings bond that is not redeemable until retirement age.[11]

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[7] See www. plansponsor.com (Plan Sponsor magazine website), July 23, 2002.
[8] Joint Committee on Taxation, JCX 51-01 (May 26, 2001) page 5. Most of this estimated revenue cost is associated with the 2002-2006 period in which the credit is effective; a modest portion of this revenue cost is attributed to the years 2007-2011, following the scheduled sunset of the credit.
[9] Peter R. Orszag and Matt Hall, The Saver's Credit, 99 Tax Notes 1541 (June 9, 2003).
[10] See, for example, H.R. 4482 (107th Cong., 2d Sess.), introduced in 2002 by then Minority Leader Gephardt, which proposed to make the saver's credit refundable.
[11] See S. 2733 (107th Cong., 2d Sess.), introduced by Senator Bingaman on July 16, 2002. In addition, if the saver's credit were to remain nonrefundable, attention would need to be given to its interaction with the child tax credit in order to ensure that the interaction does not unnecessarily reduce the incentive effect of the saver's credit .

Second, instead of a 50% credit that phases down to 20% for joint filers with AGI over $30,000, the 50% saver's credit should be expanded to cover joint filers with significantly higher incomes within the middle-income range, for example, up to $60,000, phasing out at about $70,000 or $75,000. These are workers who earn enough that they might have a greater ability and propensity to save. A similar approach was reflected in a bill introduced last year by then Minority Leader Gephardt.[12]

Third, the phasedown of the credit should be smooth, more closely resembling the phasedown of IRA eligibility by income, instead of the current saver's credit phasedown "cliffs" under which the rate drops precipitously from 50% to 20%, then to 10%, then to 0. The cliffs have the effect of creating very high marginal tax rates on additional income within certain ranges.

Fourth, instead of sunsetting after five years, the saver's credit should be made permanent or at least coextensive with the other recently enacted pension provisions.[13]

Fifth, Congress should encourage "public marketing" of the saver's credit by authorizing funds for a public service announcement campaign or other appropriate outreach and publicity, and by directing the IRS and Department of Labor to increase their efforts in this regard.

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[12] See H.R. 4482 (107th Cong., 2d Sess.). Under current law, as well as under H.R. 4482 and S. 2733, saver's credit income (AGI) eligibility levels for single filers are ½, and for head of household filers are ¾, of the AGI levels for joint filers. This statement is not proposing to change that relationship.

[13] See H.R. 1776, Pension Preservation and Savings Expansion Act of 2003, introduced by Congressmen Portman and Cardin, sections 102 (saver's credit made permanent), 401 (income limits for saver's credit eligibility expanded, but significantly less than proposed in this written statement). S. 2733 and H.R. 4482, referred to above, would also make the saver's credit permanent.