The Saver's Credit: Issues and Options

William G. Gale, J. Mark Iwry, and Peter R. Orszag

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William G. Gale is Arjay and Frances Fearing Miller Chair in Federal Economic Policy in the Economic Studies Program at the Brookings Institution, and a co-director of the Tax Policy Center, a joint venture of the Urban Institute and Brookings. J. Mark Iwry is a Nonresident Senior Fellow at the Brookings Institution, and played a leading role in developing and advancing the saver's credit while serving from 1995 to 2001 as the Benefits Tax Counsel of the U.S. Department of the Treasury. Peter R. Orszag is Joseph A. Pechman Senior Fellow in Economic Studies at the Brookings Institution and a co-director of the Tax Policy Center. *The Retirement Security Project is supported by a grant from The Pew Charitable Trusts. The authors thank Matt Hall and Jennifer Derstine for outstanding research assistance, and Robert Greenstein and Robert Weinberger for helpful comments. The views expressed in this paper are those of the authors alone and should not be attributed to the Brookings Institution, the Tax Policy Center, or The Pew Charitable Trusts.*

ABSTRACT

This paper provides an overview of the rationale, history, and possible modifications to the saver's credit, which was enacted as part of the 2001 tax legislation. The tax system in general provides little incentive for participation in tax-preferred saving plans to households who most need to save more for retirement and who, if they do contribute, are most likely to use the accounts to raise net saving. By contrast, the tax code provides its strongest incentives to those who are generally already better prepared for retirement, and who are more likely to use tax-preferred vehicles as a shelter than as an opportunity to increase overall saving.

The saver's credit helps to correct this "upside down" structure of tax incentives for retirement saving. It is the first and only major federal legislation directly targeted to promoting tax-qualified retirement saving for moderate- and lower-income workers.

The limited experience with the saver's credit to date has been encouraging. Options for strengthening the credit include making the credit refundable, making it permanent, expanding it to provide larger incentives for middle-class households, and rationalizing the phase-out of the credit. Such changes — which are under active consideration by leading pension policymakers — would help lower- and middle-income families save for retirement, reduce economic insecurity and poverty rates among the elderly, and raise national saving.

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I. Introduction

For decades, the U.S. private pension system has provided preferential tax treatment to employer-provided pensions, 401(k) plans, and individual retirement accounts relative to other forms of saving. The effectiveness of this system of subsidies is controversial. 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 saving, and in particular to improve saving outcomes 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 subsidy to 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 a taxpayer's marginal tax rate: the subsidies are worth more to households who face higher marginal tax rates, and less to households who face lower marginal tax rates.[2] The pension tax subsidies,

[1] For a broader discussion of these issues, see William G. Gale and Peter R. Orszag, "Private Pensions: Issues and Options" in H. Aaron et. al., eds., *Agenda for the Nation* (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.

[2] Technically, the lifetime subsidy from such accounts comes from (a) the difference (if any) between the tax rate at which the contribution is deducted and the tax rate at which the withdrawal is taxed, and (b) the accumulation of funds

therefore, are problematic in two important respects: They reflect a mismatch of subsidy and need, and also represent a poorly targeted strategy for promoting national saving.

- First, the tax subsidies are worth the least to lower-income families, and thus provide minimal incentives to the households who, on average, most need to save more to provide for their basic needs in retirement. The tax preferences instead give the strongest incentives to participate in pensions to higher-income households who least need to save more to achieve an adequate retirement living standard.[3]

- Second, higher-income households are disproportionately likely to respond to pension tax incentives by shifting assets from taxable to tax-preferred accounts. To the extent such shifting occurs, the net result is that the pensions serve as a tax shelter, rather than as a vehicle to increase saving, and the loss of government revenue does not generate an increase in private saving. The implication is that national saving declines. In contrast, moderate- and lower-income households, if they participate in pensions, are most likely to use the accounts to raise net saving.[4] Because moderate-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 saving rather than asset shifting.

The saver's credit, enacted in 2001, was expressly designed to help address these problems. The saver's credit in effect provides a government matching contribution for voluntary individual contributions to 401(k) plans, individual retirement accounts (IRAs), and similar retirement savings arrangements. Like traditional pension subsidies, the saver's credit currently provides no benefit for households that do not owe any federal income tax after other credits. However, for households that do owe income tax, the effective match rate in the saver's credit is higher for those with lower income, exactly the opposite of the incentive structure created by traditional pension tax preferences.

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at a tax-free rate. 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*, vol. 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* 1994(1), 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, deductible IRAs which provide the tax advantage at the time of contribution rather than distribution) may be an important determinant of whether people make contributions.

[3] Evidence indicates that low- and moderate-income households are the most likely, and high-income households are the least likely, to need additional saving to have adequate living standards in retirement. See, for example, Eric M. Engen, William G. Gale, and Cori E. Uccello, "The Adequacy of Household Saving," *Brookings Papers on Economic Activity* 1999(2), pp. 65–165).

[4] Evidence indicates that high-income households are the most likely to shift assets from other accounts into tax-preferred form, and hence not raise private or national saving, while low- and moderate-income households, when they do participate, tend to raise their net private saving (see Eric M Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," The Brookings Institution, August 2000; and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," Journal of Public Economics. 2003. 87 (5-6), 1259-90.

The saver's credit is thus the first and only major federal legislation that is directly targeted to promoting tax-qualified retirement saving for moderate- and lower-income workers.[5] Although this is an historic accomplishment, that should not divert attention from some key design problems in the version of the credit that was enacted, not the least of which is the scheduled expiration of the credit at the end of 2006. Policy-makers, including Representatives Rob Portman (R-Ohio) and Benjamin Cardin (D-Md.), are actively exploring possible expansions of the saver's credit. Representative 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…" by expanding the saver's credit.[6] This paper is intended to inform such efforts.

Section II of the paper provides background on the evolution and design of the saver's credit. Section III discusses the rationale behind the saver's credit and the role of a saver's credit in the pension system as a whole. Section IV examines empirical data and model estimates of the revenue and distributional effects of the saver's credit. Section V discusses measures that would expand the scope and improve the efficacy of the saver's credit.

II. Design and Evolution of the Credit

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 moderate- or lower-income households who make voluntary retirement saving contributions to 401(k) plans, other employer-sponsored plans (including SIMPLE plans), or IRAs.[8] In practice, however, millions of moderate-income households receive no incentive from the credit because it is non-refundable; those who have no income tax liability against which

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[5] Retirement saving for these workers is promoted – or designed to be promoted — indirectly by non-discrimination and certain other provisions of the Internal Revenue Code of 1986, as amended (Code), and the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Those provisions, which are subject to extensive exceptions, are intended to impose at least some constraint on the degree to which tax-favored benefits accrue to a limited number of owners and executives relative to the benefits accruing to the large majority of workers. The Code and ERISA also protect and regulate the accumulation and preservation of retirement benefits. For additional discussion of these issues by the Treasury Department, see Testimony of Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, 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 Code 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. (Oct. 29, 2001), IRS Announcement 2001-120, 2001-2 CB 583 (Nov. 23, 2001), and IRS News Release IR 2001-107, 2001-44 I.R.B. (Oct. 29, 2001).

The credit was officially entitled "Elective Deferrals and IRA Contributions By Certain Individuals," although it is now generally referred to as the "saver's credit." The term "saver's credit" actually appears nowhere in the law; it 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, as discussed further below. See IRS Announcements 2001-106 and 2001-120.; and IRS News Release IR 2001-17, 2001-44 I.R.B. (Oct. 29, 2001).

[8] The only exceptions are relatively minor: the credit cannot be used by who have not reached age 18 by the end of the taxable year; full-time students; or individuals 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.

to use the credit cannot currently benefit from it.[9]

The design of the saver's credit reflects two key objectives. First, the credit represents an initial step to help redress the "upside-down" structure of other savings tax incentives — leveling the playing field for moderate-and lower-income workers by matching contributions at higher rates for savers with lower incomes. Second, the credit was designed to coordinate with and support the employer-based pension system.

Higher matching rates for 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 pension system subsidize saving. The saver's credit is currently a relatively small exception to this general pattern: The Treasury Department estimates that the tax expenditures associated with retirement saving preferences in 2005 total roughly $150 billion, of which only about $1 billion is attributable to the saver's credit.[10]

Table 1: Saver's credit by filing status and income

AGI range for:						
Joint filers	Heads of households	Singles	Credit rate	Tax credit for $2,000 contribution	After-tax cost incurred by individual to create $2,000 account balance	Effective after-tax matching rate
0-$30,000	0-$22,500	0-$15,000	50%	$1,000	$1,000	100%
$30,001-$32,500	$22,501-$24,375	$15,001-$16,250	20%	$400	$1,600	25%
$32,501-$50,000	$24,376-$37,500	$16,251-$25,000	10%	$200	$1,800	11%

Note: Figures in table assume that couple has sufficient income tax liability to benefit from the nonrefundable income tax credit shown, and do not take into account the effects of tax deductions or exclusions that might be associated with the contributions or any employer matching contributions.

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 rates apply for others, too, with the AGI levels

[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 income group eligible for the saver's credit.

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

[11] Both spouses in a married couple can obtain the credit. For example, if each spouse contributes $2,000 to his or her IRA, and they file jointly with AGI 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 below, however, because of the nonrefundable nature of the credit, very few taxpayers actually qualify for the 50 percent rate.

reduced by 50 percent for single filers, and by 25 percent for heads of households.[12]

The effect of the credit is to correct the inherent effect of deduction- or exclusion-based tax incentives in favor of high-marginal-rate taxpayers. Without the saver's credit, a $100 401(k) contribution 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, for a taxpayer in the 15 percent marginal bracket, the same $100 401(k) contribution generates only a $15 exclusion from income, resulting in a $85 after-tax cost. The tax deduction is 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 help level the playing field by increasing the tax advantage of saving for moderate- 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 an individual who contributes $2,000 to a 401(k) plan or IRA. The saver's credit reduces federal income tax liability by $1,000 (50 percent of $2,000). The net result is a $2,000 account balance that costs the individual only $1,000 after taxes (the $2,000 contribution minus the $1,000 tax credit). This is the same result as occurs if the net after-tax contribution of $1,000 were matched at a 100 percent rate: The individual and the government each effectively contributes $1,000 to the account. Similarly, the 20 percent and 10 percent credit rates are equivalent to a 25 percent and 11 percent match, respectively (Table 1).[14]

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[12] The level of contributions eligible for the credit is reduced by the amount of distributions from any retirement saving plan or IRA by the participant or 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 Gale, and Peter 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 footnote 2, the entire subsidy associated with saving 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 magnitude of these substantial 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) matching contributions may well invite some households who are or have been eligible for a 401(k) to view the credit rate as a matching rate, even though the implicit matching rate is far higher than the credit rate and the

How the saver's credit works

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% of pay (in previous years) to nearly 6% of pay ($2,000/$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.

Enhancement of employer-sponsored plans

The saver's credit was designed to support, rather than undermine, employer pension plans. Employer-sponsored plans encourage participation through employer contributions, non-discrimination rules encouraging 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 moderate- 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).

Moreover, the saver's credit applies in addition to any employer matching contributions. It can thus raise the return on 401(k) contributions: Eligible taxpayers can obtain higher effective matching rates when 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, 2-3. In particular, the saver's credit applies to both pre-tax and after-tax contributions by eligible individuals. In addition, although 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)).

saver's credit is combined with employer matching contributions to a 401(k).[16] For households who receive a 20 percent saver's credit, for example, a 50 percent employer matching contribution with respect to the employee's 401(k) contributions implies that the overall (employer plus government) effective match rate on the first $3000 of after-tax contributions is 87.5 percent. That is, for every $1 in net contributions the taxpayer puts in, up to the appropriate match limits, the account will generate $1.87 in value.

To see how an 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, so the taxpayer has invested a net 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 and so adds $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. The account balance is thus 187.5 percent of the net contribution. (This does not take into account the value of the exclusion from income.) Similar calculations 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, as shown in Table 2.[17]

In evaluating these high effective matching rates, it is important to emphasize that they apply only to the first $2,000 of an individual's contributions. Moreover, they apply only to moderate- and lower-income households, who tend to be more reluctant savers than higher-income households because, among other reasons, those with lower incomes 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 moderate- and lower-income households, many of whom currently engage in no saving.

[16] The exclusion of IRA and 401(k) 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 that has pre-tax gross earnings of $34,000. If one spouse contributes $2,000 to a 401(k) plan and the other contributes $2,000 to a traditional IRA, AGI would 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) and IRA contributions combined with taxation of withdrawals further increases the net overall return to the extent that the tax rate that applies when the contributions are withdrawn is lower than the tax rate that applies at the time the contributions are made. If the tax rate upon withdrawal is the same as the tax rate at which the contributions were deducted, the results of the saver's credit and employer match, if any, are like those in Tables 1 and 2, depending on whether an employer match exists. Even if the tax rates are the same at contribution and withdrawal, 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 in the first place.

Table 2: Effective match rates including the saver's credit and a 50 percent employer matching contribution (assumes $2,000 before-tax contribution)

Credit rate (percent)	Tax Credit	Net after-tax contribution	Account balance, including 50% employer matching contribution	Account balance divided by after-tax contribution	Effective after-tax matching 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

Note: Figures in table assume that couple has sufficient income tax liability to benefit from the nonrefundable income tax credit shown, and do not take into account any effects of tax deductions or exclusions that might be associated with the contributions.

Employee 401(k) contributions that qualify for the saver's credit also count toward meeting the 401(k) non-discrimination tests. Accordingly, to the extent the saver's credit encourages increased participation among lower earners, the result can help higher earners, since highly paid employees' ability to contribute on a tax-favored basis is dependent on a certain level of contributions by non-highly paid employees.[18]

Recognizing the potential benefits of the saver's credit for plan sponsors, the IRS has provided employers a model notice they can use (or adapt) to inform employees of the credit.[19] Moreover, some employers that have been deterred from adopting a 401(k) 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) plan.

Another way in which the saver's credit was designed to complement employer plans involves its interaction with automatic enrollment. Automatic enrollment makes it easier for employees to save in a 401(k) (or 403(b) or 457) plan by enrolling employees to participate automatically without being required to complete and sign an election form. Thus, if an employee takes no action , the default mode under an

[18] See IRS Announcement 2001-106, A-10. Under the 401(k) nondiscrimination standards, the work force eligible to contribute to the plan is divided into highly compensated employees (largely those earning $90,000 or more) ("HCEs") and nonhighly 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 with a view to reducing the number of zeros.

[19] IRS Announcement 2001-106. With a view to reaching as many employees as possible, former IRS Commissioner Charles Rossotti issued a news release shortly before the saver's credit first took effect on January 1, 2002, encouraging employees to take advantage of the credit and enroll in 401(k) plans (see IR 2001-107, 44 I.R.B (Oct. 29, 2001)), and the IRS took the unusual step of preparing and publishing a Spanish-language version of the model employer notice to employees. IRS Announcement 2001-120 ("Employers are encouraged to tell their employees about the credit.")

automatic enrollment plan is that the employee participates at a stated percentage of compensation.[20]

Automatic enrollment, as a practical matter, is particularly geared to encouraging participation by moderate- and lower-income employees, who are the least likely to participate in its absence. (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 tends to expand the application of the saver's credit by making it available to employees who would not otherwise receive the credit because they would not otherwise contribute to a 401(k). 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).

Brief history of the saver's credit

The savers' credit evolved from a series of efforts in the late 1990s to expand pension coverage among low- and moderate-income workers and distribute tax-preferred retirement benefits more evenly along the income scale. In 1999, President Clinton proposed Universal Savings Accounts (USAs). Instead of providing tax benefits based on an individual's marginal income tax rate, these accounts included a matching contribution from the Federal government, designed as a refundable tax credit, with the match rate falling as household income rose. In addition to matching voluntary contributions, the Federal government would also have provided automatic contributions to the accounts of workers with family incomes below a specified level regardless of whether they made voluntary contributions.

A key feature of USAs was the mechanism by which they were designed to integrate with employer plans. The USA government matching contributions were triggered by employee contributions to 401(k) and other employer plans (or by individuals' contributions to USA accounts). This government match of employees' contributions to 401(k)s – structured progressively to match lower-income individuals' contributions at higher rates – survived to become, essentially, the saver's credit.

In 2000, the Clinton Administration introduced "Retirement Saving Accounts" (RSAs), to address two concerns with the USA plan. To reduce the budgetary costs (roughly $30 billion per year), RSAs eliminated the automatic, nonmatching government contribution. To address concerns that the government contributions would be treated as outlays rather than tax cuts for budgetary scoring purposes, RSAs provided that individuals would receive the matching contribution from the employer or the financial institution maintaining the account. The employer or financial institution, in turn, would receive income tax credits covering those contributions and administrative costs. Discussion of the RSA proposal raised concerns related to the administrative functions employers would have to perform and the difficulty of using tax credits to reimburse employers or financial institutions that were nonprofits or that otherwise had no income tax liability. In addition, in the context of this proposal, the financial services industry sought to avoid a new

[20] Automatic enrollment has been approved in IRS Revenue Ruling 2000-8. See also IRS General Information Letter to J. Mark Iwry (March 17, 2004). For evidence on the effectiveness of automatic enrollment approaches, see, for example, Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics*, February 2002, 116(4): 1149-87; and Richard H. Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy*, February 2004, Part 2, S164-S187.

separate individual account with tighter withdrawal restrictions and more limited investment options, pressing instead for a version of the proposal that would rely solely on existing forms of IRAs and 401(k) plans.

In response to these discussions, and based on input from various private sector sources, the Treasury Department designed a refundable tax credit for low and moderate income savers in 2000. The proposal offered workers earning at least $5,000 a year with AGI of up to $75,000 (for married couples filing jointly) a refundable credit for their voluntary contributions to 401(k) and other employer plans and IRAs. Thus, the government matching deposit was transformed from a government deposit to an account to a tax credit that taxpayers would receive in the normal course of filing their income tax returns.

Related proposals were introduced in Congress. A similar proposal gained the support of then Senate Finance Committee Chairman Bill Roth (R. Del.) and Ranking Member Max Baucus (D. Mont.). However, largely in order to meet their tight revenue targets for the pension package in which it was included — and to preserve revenue to pay for increased IRA and employer pension contribution limits and other elements of the overall pension package — this version of the proposal stripped out the refundable feature of the credit and drastically reduced the income eligibility limits and credit rate, while phasing the credit rate down through abrupt transitions from 50 percent to 20 percent to 10 percent to zero.[21] This truncated provision was reported favorably by the Senate Finance Committee in September 2000, but was not taken up by the full Senate until 2001. The proposal was again reported favorably by the Senate Finance Committee in 2001, and was enacted as part of the pension provisions in the 2001 tax legislation. Unlike the other pension provisions in the 2001 act, which sunset at the end of 2010, the saver's credit was enacted with a 2006 sunset.

III. The role of a 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 saving are becoming increasingly apparent.[22] As noted, the existing structure is upside down for two reasons:

- First, the subsidies are worth the least and thus provide minimal incentives to households who most need to save more to provide for their basic needs in retirement, while giving the strongest incentives to participate in pensions to higher-income households who least need to save more to achieve an adequate retirement living standard.

- Second, higher-income households, who benefit from the greatest pension tax subsidies, are the most likely to use pensions as a tax shelter, rather than as a vehicle to increase saving. High-income households are disproportionately likely to respond to pension tax incentives by shifting assets from taxable to tax-preferred accounts; the net result is a loss of government revenue without an increase in

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

[22] For a broader discussion of these issues, see William G. Gale and Peter R. Orszag, "Private Pensions: Issues and Options," in H. Aaron et. al., eds., *Agenda for the Nation* (Brookings: 2003). For a broader discussion of the objectives of the private pension system and why the system has not done more to address the needs of moderate- 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.

private saving.

In part reflecting these incentives:

- Only about half of workers participate in an employer-based pension plan in any given year, and participation rates in Individual Retirement Accounts (IRAs) are substantially lower.

- Even those workers who participate in tax-preferred retirement saving plans rarely make the maximum allowable contributions. Only about 5 percent of 401(k) participants make the maximum contribution allowed by law, and only about 5 percent of those eligible for IRAs make the maximum allowable contribution.[23]

Despite the shift from defined benefit to defined contribution plans, many households approach retirement with meager defined contribution balances.[24] The median defined contribution balance among all households aged 55 to 59 in 2001 was only about $10,000 (Table 3). Even after excluding the 36 percent of households who had no IRA or defined contribution plan account, the median balance for this age group was still just $50,000.

In this context, focusing new incentives for retirement saving on lower- and moderate-income households makes sense for two 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 tend to be better prepared to provide for their basic needs in retirement than other households. For some low-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.[25]

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[23] For example, an unpublished study by a Treasury economist found that only four percent of all taxpayers who were eligible for conventional IRAs in 1995 made the maximum allowable $2,000 contribution. Robert Carroll, "IRAs and the Tax Reform Act of 1997," unpublished mimeo, 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 small shares of 401(k) contributors constrained by the statutory dollar maximum. For example, the General Accounting Office found that an increase in the statutory contribution limit for 401(k)s would directly benefit *fewer than three 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 only 6 percent of all 401(k) 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, US Treasury Department, 2001.

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

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

Experience with a program that provides tax advantages and matching funds to encourage saving among participating low-income families suggests that poor families will save, at least to some degree, if presented with incentives to do so.[26]

Table 3: Ownership of defined contribution and IRA assets, for households aged 55-59 (2001)

Percentiles of income	Percentage of households with DC/IRA retirement assets	Median DC/IRA assets	Median DC/IRA assets among those with an account	Share of aggregate DC/IRA assets
Less than 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%
Total	63.6%	$10,400	$50,000	100%

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

Second, a key issue is the impact of tax incentives for saving on national saving. National saving is the sum of public saving and private saving. All else being equal, every dollar of forgone revenue reduces public saving by one dollar. Consequently, for national saving to increase, private saving must increase by more than one dollar in response to each dollar in lost revenue. To raise private saving, the incentives must not simply cause individuals to shift assets into the tax-preferred pensions but must generate *additional* contributions.

Since those with modest or low incomes are less likely to have other assets to shift into tax-preferred pensions, focusing pension tax preferences on moderate- and lower-income workers increases the likelihood that lost tax revenue will reflect additional contributions rather than shifts in assets.[27] The empirical evidence suggests that tax-preferred retirement saving undertaken by lower-income workers is much more likely to represent new saving (rather than asset shifting) than tax-preferred retirement saving undertaken by higher-income workers.

IV. Effects of the saver's credit

Although it is much too soon to obtain a definitive reading of the impact of the saver's credit, preliminary

[26] Michael Sherraden, "Asset Building Policy and Programs for the Poor," in Thomas Shapiro and Edward Wolff, eds., *Assets for the Poor: The Benefits of Spreading Asset Ownership* (New York: Russell Sage Foundation, 2001).

[27] Economists continue to debate the impact on private saving 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 non-taxable forms is likely to produce a larger increase in private saving for any given reduction in government revenue.

estimates and evidence can be useful in identifying some basic themes.

Eligibility

Non-refundability of the credit substantially reduces the number of people eligible for the credit, and the low match rate for moderate income households substantially reduces the number eligible for a significant incentive. Non-refundability means that the credit provides no incentive to tens of millions of low-income filers who qualify on paper for the 50 percent credit rate, but who do not have any income tax liability against which to apply the credit.

Table 4 shows that 61 million returns have incomes low enough to qualify for the 50 percent credit.[28] Since the credit is non-refundable, however, only about one-sixth of these tax filers could actually benefit from the credit *at all* if they contributed to an IRA or 401(k).[29] Furthermore, only 64,000 — or *roughly one out of every 1,000* — of the returns that qualify based on income could receive the maximum possible credit ($1,000 per person) if they made the maximum eligible contribution. These households have sufficient federal income tax liability to benefit in full from the saver's credit.

Table 4: Eligibility for 50 percent credit rate

	Returns by Filing Status (thousands)[1]				
	Single	**Married Filing Jointly**	**Head of Household**	**Other**	**Total**
(A) Total Returns	58,108	60,779	20,446	2,444	141,777
(B) Returns Eligible for 50 Percent Credit Based on Income[2]	26,627	21,121	12,360	549	60,657
(C) Returns That Would Receive Any Benefit from 50 Percent Credit[3]	6,315	3,091	825	223	10,454
As a share of those eligible based on income (=C/B)	23.7%	14.6%	6.7%	40.6%	17.2%
(D) Returns That Would Benefit in Full for Maximum Allowed Contribution[4]	1	3	60	0	64
As a share of those eligible based on income (=D/B)	0.0%	0.0%	0.5%	0.0%	0.1%

Source: 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 form 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 alowable 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.

[28] These estimates are generated by the Urban-Brookings Tax Policy Center micro-simulation model. The model is based on data from the 1999 public-use file produced by the Statistics of Income (SOI) Division of the Internal Revenue Service (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 (CPS) of the U.S. Census Bureau. The retirement savings module also uses data from the Survey of Consumer Finances (SCF) and the Survey of Income and Program Participation (SIPP). For more detail about the model, see www.taxpolicycenter.org.

[29] Some of households who can benefit have positive pre-EITC tax liability but do not have positive income tax liability after the EITC. The reason is that their EITC refund is increased to the extent that the saver's credit reduces their pre-EITC tax liability.

For families with somewhat higher incomes, the fact that the credit is not refundable poses much less of a problem. But for these families, the credit provides only a modest incentive for saving. 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 represents only a modest matching rate (see Tables 1 and 2 above) and therefore provides little incentive to participate.

Preliminary IRS data from 2002 tax returns suggest that 5.4 million returns claimed the saver's credit, and that the total credits claimed amounted to more than $1 billion.[30] (Earlier data from the IRS Taxpayer Usage Study had found that 3.7 million returns claimed the credit in 2002.) The 5.4 million figure likely reflects more than 5.4 million qualifying individuals savers, however, since a significant portion of those returns represent married couples filing jointly, and each of the spouses may have made a separate qualifying contribution.[31]

Table 5 shows the estimated distributional effect of the saver's credit. The data suggest that almost 60 percent of the benefits accrue to filers with AGI between $10,000 and $30,000. Households with income below $10,000 receive almost none of the benefits, which reflects the non-refundability of the credit.

[30] Brian Balkovic, "Individual Income Tax Returns, Preliminary Data, 2002," SOI Bulletin, Winter 2003-2004.

[31] 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 2003 tax return, the saver's credit is claimed by entering an amount on line 48; on the 2002 return, it was line 49.) 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 because a significant portion of the returns claiming a saver's credit were filed with the aid of tax preparers.

Table 5: Distributional effect of saver's credit, by AGI class, 2003[1]

AGI Class (thousands of 2003 dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change
	Number (thousands)	Percent of Total	Percent with Tax Cut		
Less than 10	36,022	25.4	0.7	0.0	1.6
10-20	23,541	16.6	8.4	0.2	26.7
20-30	18,049	12.7	11.4	0.2	32.1
30-40	13,442	9.5	10.9	0.1	17.2
40-50	10,498	7.4	17.0	0.1	22.4
50-75	17,846	12.6	0.0	0.0	0.0
75-100	9,541	6.7	0.0	0.0	0.0
100-200	9,111	6.4	0.0	0.0	0.0
200-500	2,192	1.5	0.0	0.0	0.0
500-1,000	337	0.2	0.0	0.0	0.0
More than 1,000	175	0.1	0.0	0.0	0.0
All	141,777	100.0	5.3	0.0	100.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law minus the saver's credit.

(2) Returns with negative AGI 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 AGI less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

Effects on private saving

A full assessment of the effects of the credit on private saving requires much more information than is currently available, but some possibly suggestive information is available. A necessary, but not sufficient, condition for the credit to raise private saving is that there be an increase in 401(k) and IRA contributions among the credit-eligible population.[32] In one survey of plan sponsors in 2002, representatives of 71 percent of 401(k) plans in the survey indicated that they believed the saver's credit had already increased participation in their plan's 401(k) (and 18 percent indicated that they believed the saver's credit had caused a "major increase" in participation).[33] Tax preparer H&R Block, which has indicated that it claimed the credit in 2002 on behalf of more than a million clients, has estimated that average tax savings for its clients who claimed the credit for 2002 were $175. An H&R Block representative has been quoted as saying that many clients whom

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

[33] See www.plansponsor.com (Plan Sponsor magazine website), 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 represented a small sample that appears to have been selected in a fairly 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 only half a year after the credit took effect.

H&R Block assisted in claiming the credit were first-time contributors to a retirement savings plan.[34]

V. Options for expansion

We consider several significant changes to 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 under active discussion among policy-makers.

Eliminating the 2006 sunset

In order to reduce the apparent revenue cost, policy-makers legislated that the saver's credit would expire (or "sunset") at the end of 2006.[35] The revenue cost of making the saver's credit permanent, without any other changes, is between $1 and $2 billion a year (final two columns in Table 6). As Table 6 shows, estimates generated by the Tax Policy Center model are relatively similar to those published by the Congressional Budget Office.

Table 6: Revenue effects of saver's credit, $ billion

Fiscal year	Joint Tax Committee initial score, revenue effect given 2006 sunset	Administration FY 2005 Budget, tax expenditure estimate[36]	Congressional Budget Office, revenue effect from eliminating sunset	Tax Policy Center model, revenue effect from eliminating sunset
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	1.8
2009	0.1		1.7	1.7
2010	0.9		1.6	1.6
2011	0.1		1.4	1.6
2012			1.4	1.8
2013			1.3	1.7
2014			1.1	1.6

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

[35] Various proposals – including the Bingaman and Gephardt bills (S. 2733 and H.R. 4482) and H.R. 1776, the Pension Preservation and Savings Expansion Act of 2003, introduced by Congressmen Portman and Cardin (see section 102) – would remove the sunset on the saver's credit.

[36] This column is included because it is relevant and of interest, even though tax expenditure estimates differ in certain respects from revenue estimates.

Making the credit refundable

As noted above, tens of millions of low-income workers are unable to benefit from the credit because it is nonrefundable. Extending the intended saving incentive to most lower-income working families would require making the saver's credit refundable.[37]

Some Members of Congress and others have long been concerned about making tax credits refundable. This 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, to the extent they are valid, are applicable to making the saver's credit refundable. In order 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, policy-makers could require tax filers to have at least $5,000 in earnings per person in order to claim the refundable credit.

Table 7 reports the revenue effects of making the saver's credit refundable for all tax filing units, as estimated using the Tax Policy Center micro-simulation model. The table shows that refundability would add $2 billion to $3 billion per year to the cost (second column of Table 7). Since the current cost amounts to between $1 billion and $2 billion, adding refundability would raise the cost to about $4 billion per year.[38]

Table 7: Revenue cost of extending credit and making it refundable, $ billion

	Extend existing credit	Extend and make refundable
2005		1.1
2006		3.1
2007	0.6	3.7
2008	1.8	4.8
2009	1.7	4.7
2010	1.6	4.5
2011	1.6	4.3
2012	1.8	4.1
2013	1.7	3.9
2014	1.6	3.8
Total, 2005-2014	12.3	38.0

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

[37] This change was proposed in a bill introduced by former House minority leader Richard Gephardt (D-Mo.) in 2002 (H.R. 4482, 107th Cong., 2d Sess.). It was also proposed in a bill introduced by Senator John Edwards (D-N.C.) in 2004 (S. 2303, 108th Cong., 2d Sess.).

[38] 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 to $0.7 billion per year.

no income tax liability. Refundability would significantly benefit lower-income earners, with almost 60 percent of the tax benefit accruing to tax units with $20,000 or less in AGI (Table 8).

Table 8: Distributional effect of making saver's credit refundable, 2003[1]

AGI Class (thousands of 2003 dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change
	Number (thousands)	Percent of Total	Percent with Tax Cut		
Less than 10	36,022	25.4	3.7	0.5	17.2
10-20	23,541	16.6	12.7	0.4	40.1
20-30	18,049	12.7	12.0	0.3	31.5
30-40	13,442	9.5	9.2	0.0	5.5
40-50	10,498	7.4	9.9	0.0	2.8
50-75	17,846	12.6	0.0	0.0	0.0
75-100	9,541	6.7	0.0	0.0	0.0
100-200	9,111	6.4	0.0	0.0	0.0
200-500	2,192	1.5	0.0	0.0	0.0
500-1,000	337	0.2	0.0	0.0	0.0
More than 1,000	175	0.1	0.0	0.0	0.0
All	141,777	100.0	6.3	0.1	100.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law.
(2) Returns with negative AGI 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 AGI less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

Short of direct income tax refundability, other variations and alternatives are possible.[39] For example, a bill introduced by Senator Bingaman (D-NM) in 2002 would in effect make the saver's credit refundable, but only by matching qualifying contributions of individuals who have no income tax liability with an inflation-indexed U.S. savings bond that they cannot redeem until they reach retirement age.[40] Another possibility would involve providing a tax credit to financial institutions for contributions they make to savings accounts. The effect would be similar to a refundable tax credit at the individual level. A final possibility would be to

[39] If the saver's credit remains non-refundable, it should be coordinated better with the child tax credit. Currently, the saver's credit is taken into account after most other nonrefundable or partially refundable tax credits, notably the partially refundable child tax credit. This means that, other things equal, the saver's credit is less effective in reaching filers with children than those without children. 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. In contrast, the earned income tax credit is refundable and does not reduce the amount of the saver's credit. If the child tax credit completely eliminates a taxpayer's income tax liability, it effectively crowds out the saver's credit so that the latter loses its incentive effect. To preserve the incentive value of the saver's credit in these circumstances, the tax code could be amended to provide that the saver's credit would be taken into account to offset tax liability before the child tax credit. Stacking the saver's credit before the child credit would cost about $500 million per year. This is a second-best solution, however.

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

deposit the refund directly into the saving account or 401(k), an option that is apparently under active discussion but that raises significant issues that would need to be addressed.[41]

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. In general, the tax code is indexed to inflation, so that inflation by itself does not increase tax burdens. The saver's credit thresholds could be indexed to inflation to conform to this general tax treatment. As shown in Appendix Table 1, indexation would add about $8 billion over 10 years to the cost of the refundable credit.

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.[42] This would make the 50 percent credit available to tens of millions of additional households that, 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. TPC model estimates show that 96 percent of the households who would benefit from this expanded 50 percent credit are in the 15 percent or lower marginal tax bracket. These households typically have fewer additional assets to help them provide for their basic needs in retirement, and are among those who most need help in saving for retirement. According to the TPC 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 of up to $60,000

[41] One apparent problem is the lack of easily accessible bank routing numbers for many IRAs and 401(k)s. 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 is being 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 and would give higher-income employees an indirect "double-dipping" benefit from the saver's credit. As noted, the saver's credit already helps improve the results under the nondiscrimination tests insofar as it induces additional contributions by moderate-income workers.

[42] 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, 4.

or $70,000 (joint filers).[43] 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 of the affected households, 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 lower-income families in the same tax bracket. These households may thus be more likely than lower-income households to respond to the incentive, while being more likely than higher-income households to respond with an increase in their net saving rather than a mere shift of assets designed to generate a tax benefit. If the 50 percent credit rate were expanded to joint filers with incomes of up to $70,000, the TPC model suggests that the newly eligible filing units are households that have median financial assets of $42,000 and mean financial assets of $83,000.

Finally, wherever eligibility for the 50 percent credit rate stops (e.g., $50,000 of joint AGI), the credit rate could then phase down ratably from 50 percent to zero over a specified range of AGI, such as $10,000. Such a smooth phase-down would address 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 contributing $2,000 to an IRA. If the couple's AGI increases from $30,000 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 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. 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 revenue cost of the credit. Each $10,000 increment above $50,000 then adds another $3 to $5 billion a year in revenue cost.

[43] Income eligibility levels would be increased by 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).

Table 9: Revenue cost of extending and expanding saver's credit, $ billion

	Extend	Extend and expand 50 percent credit rate eligibility for joint filers to:		
		$50,000	$60,000	$70,000
2005	0.0	2.2	3.9	5.7
2006	0.0	6.2	11.0	16.1
2007	0.6	6.5	11.1	16.1
2008	1.8	7.2	11.7	16.6
2009	1.7	6.6	10.9	15.6
2010	1.6	6.2	10.2	14.7
2011	1.6	6.2	9.9	14.3
2012	1.8	6.8	10.3	14.6
2013	1.7	6.5	9.7	13.7
2014	1.6	6.2	9.2	12.9
Total, 2005-2014	12.3	60.5	97.8	140.3

Appendix Tables 2 through 7 provide more details about 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 $115 billion over 10 years (final column of Appendix Table 2). Table 10 shows the distributional effects of those combined changes. Tax filing units with AGI under $40,000 would receive about 63% of the tax benefits; the other 37% of the tax benefits would accrue to tax filing units with AGI between $40,000 and $75,000.

Table 10: Distributional effect of reforming the saver's credit, 2003[1]

AGI Class (thousands of 2003 dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change
	Number (thousands)	Percent of Total	Percent with Tax Cut		
Less than 10	36,022	25.4	3.7	0.5	4.9
10-20	23,541	16.6	14.6	0.6	16.1
20-30	18,049	12.7	22.4	0.7	23.4
30-40	13,442	9.5	16.9	0.6	18.1
40-50	10,498	7.4	22.7	0.7	21.1
50-75	17,846	12.6	14.2	0.2	15.5
75-100	9,541	6.7	0.0	0.0	0.0
100-200	9,111	6.4	0.0	0.0	0.0
200-500	2,192	1.5	0.0	0.0	0.0
500-1,000	337	0.2	0.0	0.0	0.0
More than 1,000	175	0.1	0.0	0.0	0.0
All	141,777	100.0	11.4	0.2	100.0

Source: 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 AGI 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 AGI less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

VI. Conclusion

The saver's credit offers the potential to help correct the nation's "upside down" tax incentives for retirement saving, in which the 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 saving than to serve as a shelter from tax.

The limited experience with the saver's credit has been encouraging. Among the options for improving the design of the credit are making it refundable, making it permanent, expanding it to provide more powerful incentives for middle-income households, and indexing its thresholds to inflation. The fiscal outlook is now so troubling, however, that even the most beneficial tax cuts should be offset by other revenue increases or expenditure reductions. Changes to the saver's credit, offset by other deficit-reducing policies, would further help lower- and middle-income families save for retirement, reduce economic insecurity and poverty rates among the elderly, and raise national saving.

Appendix Table 1: Revenue effect from indexation, $ billion

	Extend and Make Refundable	Extend, Index, and Make Refundable
2005	1.1	1.1
2006	3.1	3.2
2007	3.7	3.9
2008	4.8	5.2
2009	4.7	5.3
2010	4.5	5.4
2011	4.3	5.3
2012	4.1	5.3
2013	3.9	5.3
2014	3.8	5.4
2005-2014	38.0	45.4

Appendix Table 2: Revenue effect from extending credit, indexing it, making it refundable, and expanding 50 percent credit to $50,000 for joint filers, $ billion

	Extend, Index, and Make Refundable	Extend, Index, Make Refundable, and Increase 50 Percent Credit Rate for Joint Filers to $50,000
2005	1.1	3.8
2006	3.2	11.0
2007	3.9	11.7
2008	5.2	12.9
2009	5.3	12.9
2010	5.4	13.0
2011	5.3	12.8
2012	5.3	12.6
2013	5.3	12.6
2014	5.4	12.6
2005-2014	45.4	115.9

Appendix Table 3: Distributional effect from extending credit, indexing it, making it refundable, and expanding 50 percent credit to $50,000 for joint filers, 2003[1]

AGI 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 ($)
	Number (thousands)	Percent of Total	Percent with Tax Cut			
Less than 10	36,022	25.4	3.7	0.6	4.4	-17
10-20	23,541	16.6	15.5	0.8	17.8	-105
20-30	18,049	12.7	24.0	0.9	24.8	-191
30-40	13,442	9.5	16.9	0.7	18.0	-186
40-50	10,498	7.4	22.7	0.8	21.3	-282
50-75	17,846	12.6	14.3	0.2	13.1	-102
75-100	9,541	6.7	0.0	0.0	0.0	0
100-200	9,111	6.4	0.0	0.0	0.0	0
200-500	2,192	1.5	0.0	0.0	0.0	0
500-1,000	337	0.2	0.0	0.0	0.0	0
More than 1,000	175	0.1	0.0	0.0	0.0	0
All	141,777	100.0	11.7	0.3	100.0	-98

Source: Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law minus the saver's credit. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $50,000, indexing it to inflation, and phasing out the limit over $10,000.
(2) Returns with negative AGI 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 AGI less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

Appendix Table 4: Revenue effect from extending credit, indexing it, making it refundable, and expanding 50 percent credit to $60,000 for joint filers, $ billion

	Extend, Index, and Make Refundable	Extend, Index, Make Refundable, and Increase 50 Percent Credit Rate for Joint Filers to $60,000
2005	1.1	5.6
2006	3.2	16.1
2007	3.9	16.8
2008	5.2	18.0
2009	5.3	18.0
2010	5.4	18.0
2011	5.3	17.7
2012	5.3	17.4
2013	5.3	17.2
2014	5.4	17.1
2005-2014	45.4	161.8

Appendix Table 5: Distributional effect from extending credit, indexing it, making it refundable, and expanding 50 percent credit to $60,000 for joint filers, 2003[1]

AGI 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 ($)
	Number (thousands)	Percent of Total	Percent with Tax Cut			
Less than 10	36,022	25.4	3.7	0.6	3.2	-17
10-20	23,541	16.6	15.5	0.8	12.8	-105
20-30	18,049	12.7	24.0	1.1	20.9	-222
30-40	13,442	9.5	23.8	0.8	15.5	-221
40-50	10,498	7.4	24.7	0.9	17.0	-311
50-75	17,846	12.6	29.5	0.7	30.1	-324
75-100	9,541	6.7	0.0	0.0	0.0	0
100-200	9,111	6.4	0.0	0.0	0.0	0
200-500	2,192	1.5	0.0	0.0	0.0	0
500-1,000	337	0.2	0.0	0.0	0.0	0
More than 1,000	175	0.1	0.0	0.0	0.0	0
All	141,777	100.0	14.4	0.4	100.0	-136

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law minus the saver's credit. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $60,000, indexing it to inflation, and phasing out the limit over $10,000.

(2) Returns with negative AGI 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 AGI less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

Appendix Table 6: Revenue effect from extending credit, indexing it, making it refundable, and expanding 50 percent credit to $70,000 for joint filers, $ billion

	Extend, Index, and Make Refundable	Extend, Index, Make Refundable, and Increase 50 Percent Credit Rate for Joint Filers to $70,000
2005	1.1	7.5
2006	3.2	21.3
2007	3.9	22.0
2008	5.2	23.2
2009	5.3	23.2
2010	5.4	23.1
2011	5.3	22.8
2012	5.3	22.5
2013	5.3	22.3
2014	5.4	22.1
2005-2014	45.4	210.0

Appendix Table 7: Distributional effect from extending credit, indexing it, making it refundable, and expanding 50 percent credit to $70,000 for joint filers, 2003[1]

AGI 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 ($)
	Number (thousands)	Percent of Total	Percent with Tax Cut			
Less than 10	36,022	25.4	3.7	0.6	2.5	-17
10-20	23,541	16.6	15.5	0.8	10.1	-105
20-30	18,049	12.7	24.0	1.1	16.4	-222
30-40	13,442	9.5	31.0	1.0	15.8	-288
40-50	10,498	7.4	24.7	0.9	13.6	-318
50-75	17,846	12.6	37.1	1.1	39.3	-538
75-100	9,541	6.7	11.9	0.1	1.9	-49
100-200	9,111	6.4	0.0	0.0	0.0	0
200-500	2,192	1.5	0.0	0.0	0.0	0
500-1,000	337	0.2	0.0	0.0	0.0	0
More than 1,000	175	0.1	0.0	0.0	0.0	0
All	141,777	100.0	16.9	0.5	100.0	-173

Source: Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law minus the saver's credit. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $70,000, indexing it to inflation, and phasing out the limit over $10,000.
(2) Returns with negative AGI 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 AGI less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social
(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.