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Tax Reform and Savings

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Building a Savings Society: Can Tax Reform Help All Americans?

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In November 2005, the President's Advisory Panel on Federal Tax Reform issued its final report, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System."[1] The Panel was charged with designing a tax system that would "better encourage work effort, saving, and investment." In December, the Aspen Institute Initiative on Financial Security (Aspen IFS) brought together a group of policymakers, experts, and business leaders to discuss the savings proposals made by the Panel.

The breakfast roundtable featured former House Majority Leader Dick Armey (R-TX), and Congressman George Miller (D-CA). Fred Goldberg, Partner at Skadden, Arps, Slate, Meagher & Flom, provided an overview of the report. Eugene Steuerle, Senior Fellow at the Urban Institute, Maya MacGuineas, Director of the Fiscal Policy Program at the New America Foundation, and Christian Weller, Senior Economist at the Center for American Progress, analyzed the recommendations from a budgetary and tax policy standpoint.

Christian Weller of the Center for American Progress, Maya MacGuineas of the New America Foundation, former House Majority Leader Dick Armey (R-TX), IFS Executive Director Lisa Mensah, Congressman George Miller (D-CA), and former IRS Commissioner Fred Goldberg participate in an Aspen IFS roundtable on the Tax Reform Panel's savings recommendations.

Simplifying the Savings System

The Panel proposes two different systems: a "Simplified Income Tax Plan" and a "Growth and Investment Tax Plan." The first strips our current income tax system of much of its complexity while the second moves the U.S. closer to a consumption tax system. A pure consumption tax system would eliminate the income tax and would essentially tax all spending. The roundtable focused on the four savings proposals found in the simplified plan: Save at Work accounts, Save for Retirement accounts, Save for Family accounts and a re-formulated Saver's Credit.

Save at Work

The Save at Work accounts consolidate today's many work-based plans such as 401(k) and 457(b) plans, 403(b) accounts, SIMPLE plans for small employers, and the federal Thrift Savings Plan. Save at Work accounts would continue to offer today's pre-tax saving opportunities at current levels ($15,000 in 2006) while simplifying non-discrimination rules. They would also be designed with "AutoSave" features – automatic enrollment, contribution increases and rollovers as well as default investment programs – designed to make saving easier and more attractive to employees.

The Tax System and How it Would Change

Current Plans	2006 Contributions	Tax Reform Panel Proposal
Work-Based Retirement Savings Plans		
401(k), 403(b), 457(b) plans, SIMPLE 401(k)s and SIMPLE IRAs, federal Thrift Savings Plan	$15,000, (401(k) plans may limit contributions by high-paid workers)	**Save at Work Account $15,000 limit**
Individual Retirement Savings Plans		
IRAs, Roth IRAs	$4,000 combined, income limits apply	**Save for Retirement Account $10,000 limit**
Savings Plans for Education or Healthcare		
HSAs	$2,700 single/$5,450 family	**Save for Family Account $10,000 limit**
FSAs	No limit but unspent funds are forfeited	
Coverdell (Education) IRAs	$2,000 per child, income limits apply	
529 Plans for Education	No limit	
Savings Bonds	$30,000 per person, income limits apply to tax exclusion on interest	

Save for Retirement

Today's individual-based retirement savings plans – IRAs and Roth IRAs – would become Save for Retirement accounts. Annual contribution limits would be increased from $4,000 ($5,000 in 2008) to $10,000, and Roth taxation rules would apply without any phase-out for high-income savers.[2]

Save for Family

New accounts called Save for Family accounts would replace current education and healthcare savings programs such as healthcare savings accounts (HSAs), flexible spending arrangements (FSAs), Coverdell IRAs, 529 plans and savings bonds. These accounts would also have $10,000 annual contribution limits and Roth treatment. They could be used for healthcare or medical costs, education expenses, as well as first-time home purchases. Annual withdrawals of $1,000 would be permitted.

New Saver's Credit Proposal

The current Saver's Credit provides a tax credit on contributions up to $2,000 made by low-income savers to a work-based plan or IRA, but is nonrefundable. This means it can only be applied against a tax liability so it does not reward saving by the millions of Americans whose incomes are below tax thresholds. The Panel improves the Saver's Credit by making it refundable, but it is also less generous. The maximum new credit of 25 percent applies to contributions of up to $2,000, and the credit amount decreases by $5 for each additional $100 in earnings. The tax credit phases out entirely on incomes greater than $40,000 for married couples – which is $10,000 less than under current law – but maintains the same limit of $25,000 for single filers. In addition, the new Saver's Credit must be deposited in a Save for Retirement or Save for Family account (without the $1,000 annual withdrawal option).

The Trade-offs between Fairness and Simplicity

The roundtable took on the Panel's goals of "simplicity" and "fairness" and discussed whether the reforms would effectively increase personal savings, particularly among low- and moderate-income Americans. MacGuineas explained that to obtain net new saving, it is important to "target low-income people who aren't saving now." Steuerle suggested that a problem with current savings plans designs is that they "always start with high-income populations." A better alternative, Steuerle said, would be to "put savings policies in place that would work" for low- and middle-income savers.

The Saver's Credit was viewed as critical for effectiveness because it is dedicated to low- and moderate-income savers who could generate new net saving. Although the credit rate and income limits are lower in the proposed credit, participants applauded the Panel's move to make it refundable. Goldberg and Bill Sweetnam, former Benefits Tax Counsel in the Treasury Department and currently Chair of the Public Policy and Legislation Practice Group at the Groom Law Group, noted that making the credit refundable signaled that both Republicans and Democrats now agree on its importance. Bob Weinberger, Vice President of Government Relations at H&R Block, reinforced this point by explaining how saving among low-income taxpayers increased after H&R Block brought the credit "to the attention of the 20 million or so tax payers we serve" and endorsed making the credit refundable.

Although the refundable credit is a step in the right direction, many felt that it could have been more generous. Mark Iwry, former Benefits Tax Counsel in the Treasury Department and currently Senior Adviser to the Retirement Security Project and Of Counsel at Sullivan & Cromwell LLP, said that the Saver's Credit was initially intended to be larger and reach more moderate-income Americans, noting that "a 50 percent rate uniform up to $50,000-60,000 AGI [adjusted gross income] would be better."

Some participants also felt the Save for Retirement and Save for Family accounts were too generous and might cause small business owners to abandon or avoid workplace plans entirely. Brian Graff, Executive Director and CEO of the American Society of Pension Professionals and Actuaries (ASPPA), suggested that any significant shift away from workplace plans could negatively affect saving by low-income Americans because when "those earning between $30,000 and $50,000 are in a [work-based] plan, they are twenty times more likely to save." Iwry agreed, saying that "individual citizen-based accounts are great but not to the detriment of the employer plan system" and explained that "these are not $10,000 accounts – they are $40,000 accounts once you include spouses and children." Weller pointed to the need to increase pension coverage and suggested that the AutoSave features in the Save at Work accounts could help strengthen and expand work-based savings plans.

"We have people who don't have enough money to save for retirement…Fewer and fewer people are going to be able to look to their employer for much assistance. When your car breaks down and costs you a job, you've got trouble…For many American families, that's the major economic setback of the year." — Congressman George Miller (D-CA)

Roundtable discussants gave the savings proposals high marks for delivering a simplified system of saving. Expressing the consensus opinion that the current system is counterproductive, Armey noted that "the tax code is a morass" that only serves to complicate an already complex system. MacGuineas observed that, in the private pension system, "simplicity plays a huge role … all the paperwork involved is very alienating and sooner or later it's much easier to just put it aside and miss the tax incentives." In addition, Tippets suggested that tax reform is important for reinforcing the "natural desire of people to save."

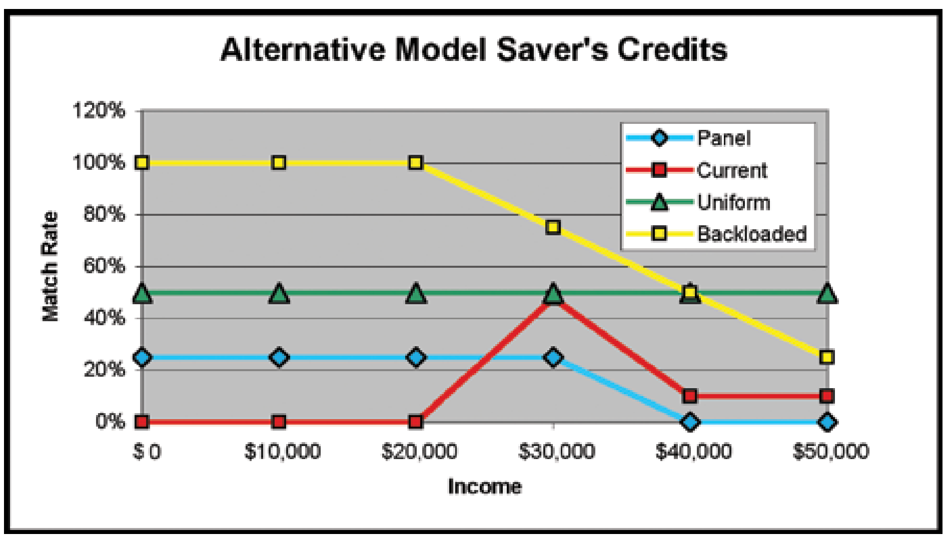
Making the Saver's Credit More Generous

To evaluate the Panel's Saver's Credit, IFS performed the following analysis. Beginning with the question, "Could the credit enable savers to accumulate assets equal to one year's income after 10 years of saving?", IFS tested four model credits to see how each performed for a married couple with two children. The four models were:

- the Panel's refundable credit;
- the current nonrefundable Saver's Credit now in effect;[3]
- a uniform credit, suggested by Iwry, of a 50 percent match for everyone; and
- a backloaded credit designed to give the poorest savers a large incentive.

<u>Design of Alternative Model Saver's Credits</u>:[4] All four models allowed individuals to save $2,000 annually, but varied on how much of this contribution would be matched. The maximum credit available was $500 for the Panel's refundable credit, $1,000 for the current credit and the uniform credit, and $2,000 for the backloaded credit. The backloaded credit is designed to provide the highest match (100 percent) for low-income savers. The uniform credit provides all savers with the same match (50 percent). Because the current credit is nonrefundable, it provides no match for the lowest-income savers, and only a modest match for moderate-income savers. The Panel's proposed credit provides a modest match (25 percent) for low-income savers and phases out completely at $40,000 for a married couple. The analysis generated the following results, as shown in Example 2:

Example 1: Alternative Model Saver's Credits[5]



The model credits were tested by asking the following question:
Could a married couple with two children accumulate one year's earnings after 10 years of saving?

- Current credit: worst performance. Came closest to goal (94 percent for families earn-ing $30,000) but gave nothing to those earning the least and the most and gave only a slight boost to those earning $40,000 and $50,000.
- Panel's credit: slightly better. Families earning up to $30,000 achieved 80 percent of goal but higher earners received no benefit.
- Uniform credit: good results. Families earning up to $40,000 achieved 94 percent of goal and families with higher incomes also came close to goal (88 percent for $50,000).
- Backloaded credit: best results for low-income families. Families earning under $30,000 achieved 126 percent of goal. In dollar terms, families earning $10,000 will have almost $13,000 and those earning $20,000 will have $25,000 after 10 years of saving – which is not enough to fund a couple's retirement or college education for two children.

This analysis does not predict real world outcomes, but it argues for a more generous Saver's Credit that would be a more effective savings incentive. Compared to the current Saver's Credit, the Panel's proposal is not significantly better at helping families saving at reasonable rates and earning reasonable investment returns meet a relatively modest savings goal. Refundability is important, but both the uniform and backloaded credits provide better incentives and better outcomes. With a more generous match and broader coverage of low- and moderate-income families, the Panel's Saver's Credit could be more effective at achieving the President's goal of encouraging saving for all Americans.

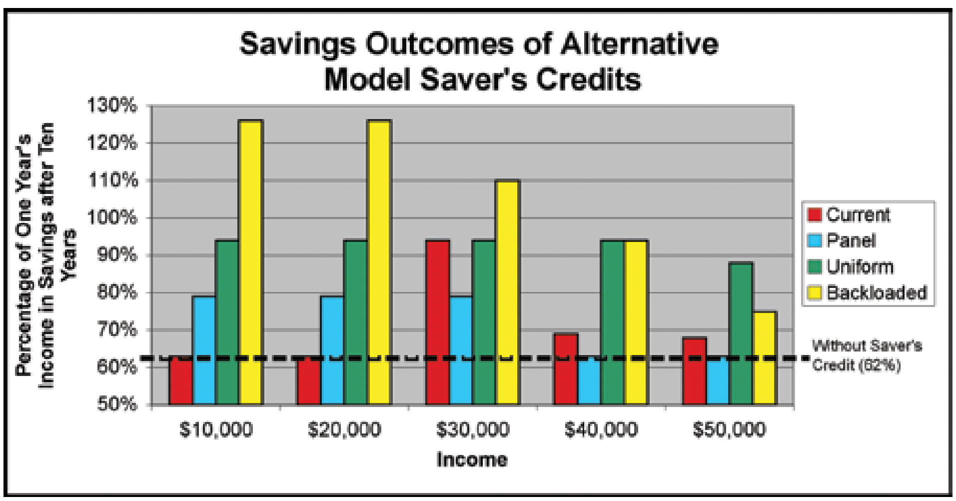
A Step in the Right Direction

The Tax Reform Panel made considerable strides in developing a proposal for savings that addresses its three stated goals of simplicity, fairness and economic growth. In particular, the Panel moved one step closer towards building a savings system that benefits all Americans through the following changes:

- Consolidating 15 different provisions for saving into 3 simple plans
- Making the Saver's Credit accessible to more low-income Americans by making it refundable
- Incorporating AutoSave features into Save at Work accounts

As several roundtable participants pointed out, however, more work lies ahead. "The proposal is a starting point, not an answer," said Goldberg. The roundtable discussion revealed significant concern about fairness; although the proposal considerably simplifies the country's existing savings system, it could do more to stimulate stronger savings habits among low- and moderate-income Americans.

Example 2: Savings Outcomes of Alternative Model Saver's Credits



Savings incentives such as a Saver's Credit should be designed to achieve specific savings objectives. Even the most generous of the four models – the backloaded credit – would not provide low-income families with enough savings to reach key assets goals.

[1] Available at: http://www.taxreformpanel.gov/index.shtml.

[2] In today's work-based saving plans and Save at Work accounts, contributions are made from pre-tax dollars and withdrawals are taxed at ordinary income tax rates. Contributions to a Roth account today and to a Save for Retirement or Save for Family accounts are made instead from after-tax dollars while withdrawals, if for qualified purposes, are exempt from tax.

[3] Because this credit is non-refundable, savers with no taxable income do not benefit from it. Therefore, a large number of low-income Americans are not eligible for the credit.

[4] Assumptions for Saver's Credit analysis: (1) We look at 5 families, earning respectively $10,000, $20,000, $30,000, $40,000 and $50,000; (2) Savings = 5 percent of income per year; annual interest earned = 5 percent; (3) Income does not change over 10-year period; no inflation; (4) Baseline: Without a match, families at all income levels are able to accumulate assets equal to 63 percent of yearly income. Poorest savers accumulate slightly more than $6,000 over 10 years and richest savers accumulate about $31,000 over 10 years.

[5] Our thanks to Lily Batchelder, Assistant Professor of Law and Public Policy, New York University Law School, for her help with an initial version of this analysis.

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