



REINVESTMENT ALERT

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Combating the Perilous State of Lower-Income Workers' Retirement Assets: The Recently Reenacted Federal Saver's Credit Provides a Modest Opportunity for Asset Building

Introduction

The U.S. faces a retirement income crisis with many couples and individuals lacking the financial assets to provide a modest-income post-retirement. Thirty percent of people aged 55 and over have less than \$25,000 in savings apart from the value of their homes. Forty-five percent of this age group has less than \$100,000.¹ Even at the top end of that range, following the generally accepted advice of withdrawing five percent of retirement assets a year, a person could only count on \$5,000 a year in personal retirement income.

With the recent passage of the federal Pension Protection Act of 2006, the Saver's Credit, a non-refundable tax credit to low- and moderate-income people who contribute to a retirement account, was made permanent. The law is a modest step in the right direction for providing lower-income people the level of incentives the federal government provides middle- and upper-income people to accumulate financial assets.²

I. Background: The Three Legs of Retirement Security

Policy-makers have long relied on the principle of a "three-legged stool" to ensure financial security in retirement-Social Security, employer provided pensions, and personal retirement savings. All three components of retirement income face challenges.

a) Social Security

The Social Security system requires real though modest adjustments now to ensure its financial viability at a time when people are living longer and the percent of working people (whose FICA

¹See money.cnn.com/2004/04/02/commentary/everyday/sahadi

²In 2005, the four largest tax expenditures for homeowners added up to about \$147 billion according to estimates by the Office of Management and Budget. This sum is more than three and one-half times the amount spent on all housing outlays, which are used to support the Section 8 rental voucher program, public housing, and military family housing. The four major homeownership tax expenditures are expected to cost the government more than \$946 billion between 2006 and 2010, more than six times the amount that federal housing outlays will cost in that same time period. Tax protected retirement contributions were over \$110 billion in 2004 according to the Office of Management and Budget. The Survey of Consumer Finances found that workers in the top income quartile participated in employer sponsored retirement plans at a much higher rate, 63.4 percent, than workers in the bottom income quartile, 23.2 percent.

taxes fund a large portion of current Social Security outlays) to retired people is declining.³ The Congressional Budget Office calculates that the Social Security Trust Fund, without any changes, will remain solvent until 2052 and will then be able to meet 70 percent of its payout obligations. A number of modest changes would permit the Fund to meet 100 percent of its obligations after 2052. These could include: the diversification of Trust Fund investments; increasing the percent of wages subject to the payroll tax; minor adjustments to the retirement age with safeguards for disabled and lower-income workers; and reducing starting benefits slightly to account for the fact that life-spans have increased.

b) Employer Provided Savings

The second leg of the stool, employer provided pensions, also faces challenges. Participation depends on two different decisions, the decision of employers to offer a plan, and the decision of a plan-eligible individual to participate. Currently in the U.S., 49 percent of workers are eligible to participate in such plans and 79 percent of eligible workers participate.

The percent of workers who participate in retirement schemes has changed at different rates and in different directions for different groups.⁴ Between 2001 and 2004, the number of workers aged 55-64 who participated in a retirement plan increased almost 18 percent while the number of workers aged 35-44 who participated decreased by almost 5 percent. Workers 35 years old and under saw a decrease of almost 4 percent and workers 45-54 increased plan participation by almost 10 percent. The people in the lowest income quartile saw an 8 percent decrease in participation rates between 2001 and 2004.

These variable participation rates occur despite the fact that employee contributions to employer schemes are tax excludable (or deductible) up to certain limits, accumulate tax free, and only attract taxes when they are drawn down during retirement. A provision of the Pensions Protection Act of 2006 contains a strategy to mitigate this problem. That provision makes it easier for employers to structure their plan so that employees have to opt out of an automatic enrollment in the plan rather than opt-in.⁵ Recent experience shows that an opt-out structure for voluntary pension schemes rather than an opt-in structure results in significantly higher enrollment rates.⁶

Another problem is that over the past 25 years, employers have been shifting from defined benefit (DB) pensions--which pay a retirement benefit in the form of a lifelong annuity--to defined contribution (DC) plans, which are more like savings accounts maintained by employers on behalf of each participating employee. One of the key distinctions between a defined benefit plan and a defined contribution plan is that in a DB plan, it is the employer who bears the investment risk. The employer must ensure that the pension plan has sufficient assets to pay the benefits promised to workers. In a DC plan, the worker bears the risk of investment losses and of not saving sufficiently for retirement.

³For more information on Social Security Reform see: Diamond, Peter A., and Peter R. Orszag, "Saving Social Security: A Balanced Approach," Brookings Institution Press, 2003.

⁴For the following data see: Purcell, Patrick, "Retirement Savings and Household Wealth: Trends from 2001-2004" Congressional Research Service Report for Congress, CRS web, updated May 22, 2006, pp 4-5.

⁵Pension Protection Act of 2006, 109th Congress, 2nd session, H.R. 4, Sec. 902. The new provision provides another safe harbor option from the ADP test of Code Section 401(k) and the ACP test of 401(m) to a plan that uses an automatic enrollment feature for all employees who do not affirmatively waive plan participation and meet several other criteria. For a summary of those criteria, see "Special Report to Clients: The Pension Protection Act of 2006", Hewitt Associates, LLC, 2006.

⁶Beshears, John, James J. Choi, David Laibson, and Brigitte C. Madrian, "The Importance of Default Options for Retirement Saving Outcomes: Evidence from the United States", presented at "Lessons from Pension Reform in the Americas", a Conference sponsored by the Federal Reserve Bank of Atlanta, Instituto Tecnológico Autonomo de Mexico (ITAM), and the Pension Research Council of the Wharton School of the University of Pennsylvania, March 2-3, 2006.

The worker's account balance depends on how much he or she contributes to the plan and how the plan's underlying investments perform. One result of this shift of responsibility has been that employees have over-invested in money market and bond funds rather than equities, thus overemphasizing security over growth. Another problem is employees' failure to rebalance the distribution of their savings between equities and bonds to account for changes in the percent of assets they hold in different types of funds and for their age.

Again, the 2006 Pensions Protection Act provides some remediation for this problem. Prior to the 2006 amendments, the rules related to prohibited transactions made it difficult for fiduciaries to expand their services to include investment advice for individual participants in defined contribution plans. The Act establishes a set of rules enabling plan fiduciaries to provide investment advice to plan participants.⁷

The last major problem with the employer leg of the pension stool is that some very large firms have forced a renegotiation of the provisions of DB plans in the face of bankruptcy proceedings and in consequence, many employees and retirees have seen large cuts in their promised or actual benefits. Recent terminations of severely underfunded pension plans, like US Airways, United Airlines, Polaroid, and Kemper Insurance, have focused attention on the financial condition of the Pension Benefit Guaranty Corporation's (PBGC) insurance program. In all, some 3,300 underfunded plans have been terminated and in 2006 an additional 400 plans were considered probable for termination. As of end of fiscal year 2005, PBGC reported a nearly \$23 billion deficit in the financial statements for its single-employer pension insurance program, largely due to a few very large pension plan terminations.⁸

c) Personal Savings

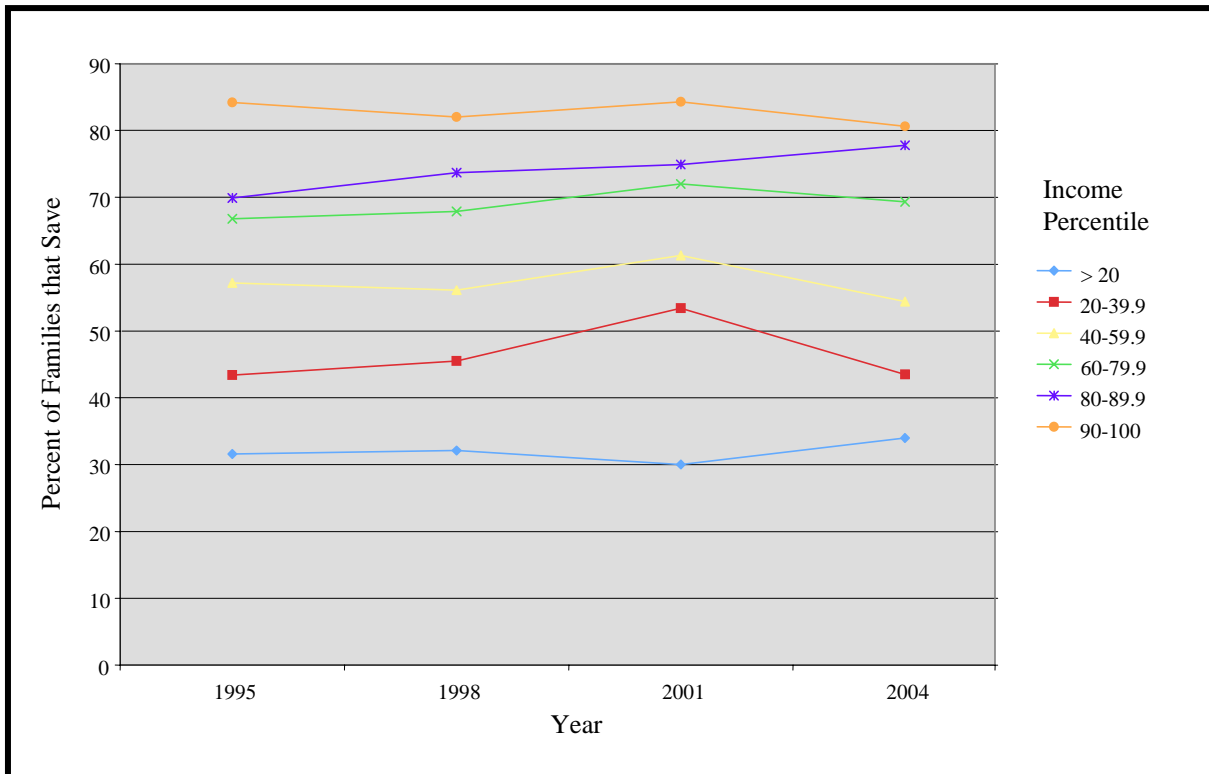
The third segment of retirement security is personal savings. Here the challenges for lower-income people are the lack of disposable income for savings and the generally very low-rate of savings in the United States. The poorest segment of the population dis-saves, that is to say only manages to survive by going into debt. But there is evidence that other lower-income people can save at quite high rates if provided convenient and cost-effective vehicles for savings.⁹ Figure 1 shows that while the percent of families that save increases with income, even in the lowest 20 percent income group, a substantial minority of families manages to save.

⁷Pension Protection Act of 2006, 109th Congress, 2nd session, H.R. 4, Sec. 601.

⁸Pension Benefit Guaranty Corporation "Annual Management Report Fiscal Year 2006" accessed on February 16th, 2007 at <http://www.pbgc.gov/docs/PBGCAMR.pdf>

⁹Allegretto, Sylvia, "Basic Family Budgets: Working Families' Incomes Fail to Meet Living Expenses Around the U.S.," Economic Policy Institute, Briefing Paper #165, Sept. 2005; Center on Budget and Policy Priorities, "Most Americans Treading Water or Falling Further Behind, Consumption Data Show Only High Earners Spending More Than Before Recession", Nov. 28, 2006.

Figure 1: U.S. Personal Savings Behavior 1995-2004: Evidence from the Survey of Consumer Finance



Source: Surveys of Consumer Finance, Federal Reserve Board

But the overall problem with savings in the U.S. is the declining average savings rate in the last 25 years. In fact, in 2005, aggregate household spending exceeded after-tax income for the first time since the Great Depression making the average savings rate negative (see Figure 2). By contrast, in 1980, the household saving rate was 10 percent of after-tax income.¹⁰ (We should note that there is some dispute about the way the savings rate is calculated.¹¹)

The flip-side of savings is debt, and debt levels as a percent of income have been increasing. Outstanding debt as a percent of disposable income went from 71 percent in 1979 to 126 percent in 2005.¹² Debt levels have also been rising as a percent of total assets. Between 1999 and 2004, for example, total household liabilities rose from 20 percent of total assets to 29 percent.¹³ Debt levels

¹⁰Katz, Jonah, and Malcolm Bush, "U.S. Household Debt Levels Are Worrying No Matter How You Look at Them", Woodstock Institute Reinvestment Alert, No. 30, May 2006 p. 9.

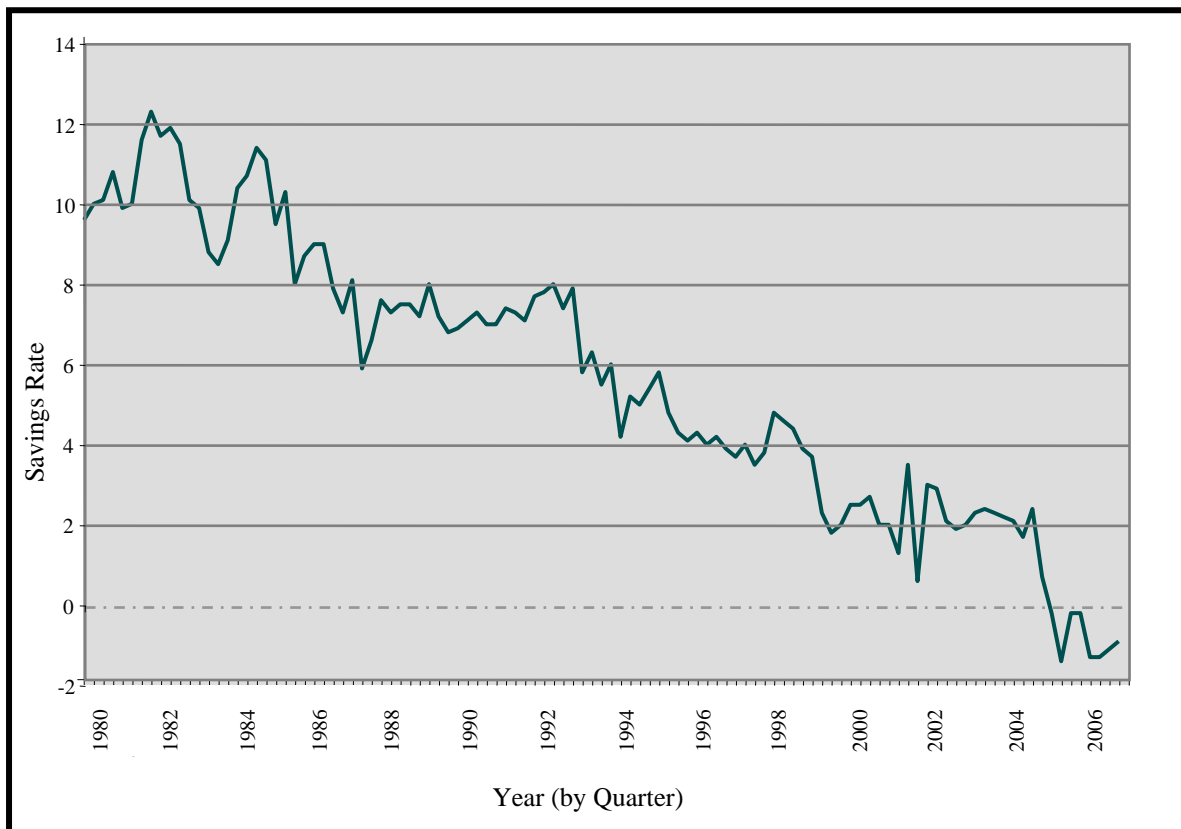
¹¹See, for example, Milt Marquis, "What's Behind the Low U.S. Personal Savings Rate?", Federal Reserve Bank of San Francisco, Economic Letter, 2002-09, March 29, 2002. This writer suggests both that the savings rate is under-measured, although not by a large amount, and that the run-up in other assets, namely stock market and housing assets, explains the lower-savings rate. Both those assets are, however, subject to short and medium-term declines, and a lower percentage of lower-income people possess such assets compared to other income groups. Moreover, a shortage of liquid assets has in the recent past driven people in a range of income groups to very costly consumer loans and to drawing down the equity in their homes for other than "productive" debt purposes.

¹²Katz and Bush, 2006, p. 2.

¹³Katz and Bush, 2006, p. 3.

have also been increasing as a percent of gross domestic product (GDP). In 1975, total household debt was 44 percent of GDP but rose to 96 percent of GDP by 2006.¹⁴

**Figure 2: Personal Savings as a Percentage of Disposable Personal Income
1980-2007**



Source: Surveys of Consumer Finance, Federal Reserve Board

High debt levels are particularly difficult for low-income people to manage, and, by some measures, they have high comparative debt levels. For example, in 2004, households with incomes at or below \$29,000 with credit card debt (i.e., unpaid balances at the end of the month), had credit card debts amounting to about 14 percent of their annual income. For households earning at or above \$100,000 with unpaid balances, the credit card debt was 2.3 percent of annual income.¹⁵

¹⁴Income Inequality and Rising Personal Debt; Coincidence? The Agonist, accessed June 18, 2007 at www.agonist.org/income_inequality_and_rising_personal_debt_coincidence.

¹⁵Katz and Bush, 2006, p.6.

II. Incenting Savings

The low levels of savings among lower-income people and the importance of savings for a variety of purposes including retirement is a good reason for the implementation of incentives to save. Another reason for such targeted incentives as mentioned earlier is the large federal tax expenditures on savings incentives for middle- and upper-income people. However, that it turns out to be difficult to incent savings above current rates. The new field of behavioral economics is charting actual economic behavior as opposed to the predictions of economic behavior based on “rational man” or utility theory premises and has developed a number of explanations for behavior that does not maximize certain economic outcomes.¹⁶ Those that apply the failure to save for retirement include the difficulty people may have computing accurately their economic needs; particularly many years in the future; the high cost people assign to current cuts in expenditures that would be necessary to enable savings compared with the lower value assigned to the benefits of savings for the future; and simple procrastination.

Despite these caveats about the difficulty in incenting savings, making the federal savings incentive targeted to lower-income people permanent is an important development.

III. The Saver’s Credit

a) How It Works

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act, a sweeping tax reform bill that included the creation of the Saver’s Credit. This non-refundable tax credit was a pilot program intended to provide a tax incentive structure that aligned the incentives to save for retirement for lower-income families with those of wealthier families. This tax credit was to sunset at the end of 2006. The Pensions Protection Act of 2006 made the credit permanent.¹⁷ It also amended the credit so that starting in 2007 the adjusted gross income levels used to determine eligibility and the credit rate are indexed for inflation.¹⁸

The Saver’s Credit is a government matching-contribution for individual contributions to IRAs, 401(k) plans, and similar retirement savings arrangements. This contribution is an addition to the regular tax advantage that adheres to contributions for retirement schemes. For example, an employee who earns \$20,000 and contributes \$2,000 to a 401(k) account would have a taxable income that year of \$18,000 because she/he does not have to pay federal income tax on the amount of the current income she/he defers to a 401(k) account. With the Saver’s Credit, however, the same person is eligible for an additional 50 percent credit on her retirement contributions, meaning that the person can subtract an additional \$1,000 (50 percent of \$2,000) off her/his tax liability that year. The effective match rate is higher for those households with lower-incomes. Below is an example of the

¹⁶The following are samples of the behavioral economics literature: Camerer, Colin, “Behavioral Economics: Reunifying Psychology and Economics,” *Proceedings of the National Academy of Sciences of the United States of America*, Vol. 96, No. 19 (Sept., 1999), pp. 10575-10577; Kahneman, Daniel, “A Psychological Perspective on Economics,” *The American Economic Review*, Vol. 93, No. 2, *Papers and Proceedings of the One Hundred Fifteenth Annual Meeting of the American Economic Association*, Washington, DC, January 3-5, 2003 (May, 2003), pp. 162-168; Thaler, Richard H., “The Psychology and Economics Conference Handbook: Comments on Simon, on Einhorn and Hogarth, and on Tversky and Kahneman,” *The Journal of Business*, Vol. 59, No. 4, Part 2: *The Behavioral Foundations of Economic Theory* (Oct., 1986), pp. S279-S284; and Thaler, Richard H., “From Homo Economicus to Homo Sapiens” *The Journal of Economic Perspectives*, Vol. 14, No. 1 (Winter, 2000), pp. 133-141.

¹⁷In early 2006, the Bush Administration was intent on scrapping the credit entirely from the Pension Protection bill, despite pushing to make almost all its other tax credits permanent, but the Administration position on the credit was defeated.

¹⁸Indexed amounts are also rounded to the nearest multiple of \$500.

effect of the saver's credit on the tax liabilities of a lower-income family. For the sake of simplifying the example, we assume that the family is not eligible for the Earned Income Tax Credit or for a dependent child credit.

An Example of the Saver's Credit

Fernando and Maria are married, file a joint return, and have \$30,000 adjusted gross income after each contributed \$2,000 to their employer-sponsored 401(k) plan and Individual Retirement Account (IRA) respectively. After receiving notice of the Saver's Credit from their employer, Fernando and Maria find out they qualify for a 50 percent Saver's Credit rate for their retirement contributions. As a result, the couple gets to subtract \$2,000 (50 percent of \$4,000) from their tax burden. To see how this works in detail, we will compute their tax burden without the Saver's Credit and then subtract the credit from that amount.

Tax Burden Without the Savers Credit

The amount of income that Fernando and Maria earn puts them in the 15 percent tax bracket, which means that their tax burden is calculated as follows:¹⁹

$$\$1,510 + [(\$30,000 - \$15,100) \times (.15)] = \$3,745$$

The tax formula for a married couple filing jointly is 10 percent of income up to \$15,100 (\$1,510) plus an additional amount taxed over the first \$15,100 based on how much you earn. In this case, our couple falls into the 15 percent marginal tax rate which means that they subtract \$15,100 from their total income \$30,000 and multiply the result by the tax rate 15 percent or .15.

Their tax burden prior to receiving the Saver's Credit is \$3,735.

Tax Burden With the Saver's Credit

To calculate the value of the Saver's Credit, the couple adds what they contributed to their retirement accounts (\$2,000 each) and multiply that by the credit rate, which in their case is 50 percent.

$$[(\$2,000)(2) \times (.5)] = \$2,000$$

Now they subtract the value of the Saver's Credit from the tax burden for the total taxes owed.

$$\text{Total federal taxes owed: } \$3,745 - \$2,000 = \$1,745$$

Fernando and Maria now only owe \$1,745 in federal income taxes, reducing their tax burden by 53 percent while they save \$4,000 for retirement in the process.

Table 1 provides more detailed information about matching rates, after-tax costs, and effective after-tax matching rates for the saver's credit. Note that the effective match rate is much higher than the advertised match rate because the effective rate represents the after-tax match rate.

¹⁹Calculations based on the 2006 Tax Rate Schedules provided by the Internal Revenue Service at <http://www.irs.gov/formspubs/article/0,,id=150856,00.html>. These calculations are estimates used to demonstrate the effects of the Saver's Credit.

Table 1: Effect of Saver's Credit by Filing Status and Income²⁰

Adjusted Gross Income (AGI) Range for:						
Joint Filers	Head of Household	Single	Match 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%

b) Additional Benefits of the Saver's Credit

The Saver's Credit has several other benefits. The Saver's Credit enhances employer sponsored retirement savings plans. Indeed, it was designed to have the additional benefit of encouraging participation in such plans. Eligible taxpayers can obtain higher effective federal matching rates when their contribution is enhanced by the employer matching contributions to a 401(k)-type plan. For example, a taxpayer who is income-qualified for an apparent 50 percent federal match and who is enrolled in a scheme with a 100 percent employer match and makes a \$2,000 before tax contribution, will end up with an effective after-tax matching rate of 200 percent.²¹ To the extent that the Saver's Credit encourages increased participation among lower-income earners, higher-income earners may also benefit. Highly compensated employees' ability to contribute on a tax-favored basis depends on the level of contributions by less highly paid employees.²² The new safe harbor provision in the 2006 law for automatic enrollment in 401k plans and the Saver's Credit work together by making more people eligible for the credit and making automatic enrollment more valuable.²³ The Saver's Credit also enhances the effectiveness of the Earned Income Tax Credit (EITC). By reducing tax liabilities of EITC recipients who owe taxes, the Saver's Credit can increase the amount of money a worker can qualify for through the EITC.

²⁰Gale, William G., J. Mark Iwry, and Peter R. Orszag (2004). "The Saver's Credit: Issues and Options." Tax Analysts Tax Break. May 3, 2004.

²¹For detailed explanation of how this works see Gale, William G., J. Mark Iwry, and Peter R. Orszag (2004). "The Saver's Credit: Issues and Options." Tax Analysts Tax Break. May 3, 2004 pp. 600-601.

²²Ibid. To help ensure that companies extend their 401(k) plans to low-income employees, non-discrimination testing is performed. Non-discrimination testing takes the deferral rates of "highly compensated employees" (HCEs) and compares them to non-highly compensated employees (NHCEs). An HCE is defined as an employee with compensation of \$100,000 or greater in 2006 and remains unchanged for 2007. However, as an option prior year compensation can be used in this testing, and often is. The average deferral percentage (ADP) of all HCEs, as a group, can be no more than 2 percent greater (or 150 percent of, whichever is less) than the NHCEs, as a group. This is known as the ADP test. To the extent that the saver's credit increases the pool of money contributed by NHCEs and increases their contribution rate, HCEs will also benefit by being able to defer more money to their tax preferred account.

²³Gale, William G., J. Mark Iwry, and Peter R. Orszag (2005), "The Saver's Credit: Expanding Savings for Middle- and Low-Income Americans", The Retirement Security Project.

c) Improvements to the Current and Future Versions of the Saver's Credit

While the Saver's Credit is a step in the right direction, it could be improved. The credit would be much more useful to lower-income people if it were made refundable with the result that lower-income people could get the scheduled matching payments no matter what their actual federal tax level. Only one-sixth of the 61 million income eligible tax filers can benefit from the credit because the remainder does not have sufficient federal tax liability. The match level could also be increased in the light of the large federal incentives for middle-income savings through tax deductions for 401k contributions and for mortgage interest and property taxes for homeowners.

Another way that the Saver's Credit could be enhanced is by making the credit easier to understand. Some studies have shown that taxpayers find it hard to exploit variations in the Saver's Credit rate via ongoing contributions to retirement accounts because the rate varies significantly over a narrow range of income, the calculation is complex, and taxpayers may not be able to calculate their adjusted gross income until tax preparation time.²⁴

The Saver's Credit also poses a challenge in its current form. Before the 2006 law, about 66 percent of eligible people used the credit.²⁵ Strategies should be developed by the federal government, employers and concerned nonprofits to maximize the use of the credit. Moreover, the first year after the credit came into effect, researchers found that only about 3 percent of those who took advantage of the Saver's Credit maximized their matched contribution.²⁶ Clearly, many more people could benefit from the Saver's Credit as currently enacted.

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²⁴Duflo, Esther, William Gale, Jeffrey Liebman, Peter Orszag, Emmanuel Saez, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block", *Quarterly Journal of Economics*, Vol. 121, No. 4, Nov. 2006, pp. 1311-1346.

²⁵Koenig, Gary, Robert Harvey, "Utilization of the Saver's Credit: An Analysis of the First Year", *National Tax Journal*, Vol. LVIII, No. 4, Dec. 2005.

²⁶Duflo, et. al. 2006.

The Saver's Credit At-A-Glance

What is The Saver's Credit?

- Made permanent by the Pension Protection Act of 2006, the Saver's Credit is a tax credit that can be claimed by low- and moderate-income people with taxable income who make voluntary contributions to a retirement vehicle: IRAs, 401(k), 401(k) type plans, and other employer-sponsored plans.
- It is the first and only retirement savings policy targeted to low- and moderate-income individuals.
- The Saver's Credit will provide approximately \$10 billion dollars in tax benefits to low- and moderate-income people over the next 10 years. This is compared to the \$120 billion of tax expenditures on tax-favored employee-based retirement benefits in FY2005 alone that mainly benefit middle- and upper-income tax payers.

Tax filers who qualify for the Saver's Credit

- Must be 18 years old or older
- Can not be a full-time student
- Not claimed as a dependent on someone else's tax return
- Have an adjusted gross income in 2006 no higher than:
 - \$50,000 for married filing jointly
 - \$37,500 for filing as a head of household
 - \$25,000 for filing single or married filing separately
- In the year prior to filing the federal income tax return, low-income taxpayers must contribute to a 401(k), 501(3)(b), or IRA tax excludable retirement account.
- The maximum amount of retirement contribution that will be matched is \$2,000.
- The amount of the federal match will be 50 percent, 20 percent, or 10 percent of the contribution depending on the filer's income and filing status.
- The maximum credit, therefore, for people of different income groups will be \$1,000, \$400, or \$100 per person respectively.
- The tax credit is non-refundable which means it can only be used as an offset up to the amount of federal taxes incurred. The Earned Income Tax Credit, in contrast, is payable to eligible workers no matter whether or not they owe federal taxes.

How Workers Can Claim the Saver's Credit

- Workers must complete IRS Form 8880, "Credit for Qualified Retirement Savings Contributions"
- Enter the amount of the credit on Form 1040 or form 1040A
- Attach Form 8880 to their tax return
- Form 8880 may be downloaded from the IRS website at: www.irs.gov/formspubs