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HOUSE PENSION BILL WOULD MAKE SOME 2001 TAX CUTS PERMANENT FOR THE FIRST TIME

Bill Also Discriminates Against Moderate-Income Taxpayers

by James Horney and Robert Greenstein

Pension legislation passed by the House on December 15 contains a series of pension-related individual income tax provisions that raise serious budgetary concerns and pose significant equity issues. The legislation (H.R. 2830, the Pension Protection Act of 2005) contains measures crafted by the Ways and Means Committee that would — for the first time — make permanent some of the tax cuts enacted in 2001, and would do so *without* offsetting the costs. (H.R. 2830 also includes various non-tax pension provisions adopted by the House Education and Workforce Committee. The Senate has passed pension legislation — S. 1783 — that deals with many of the issues addressed in H.R. 2830 but does not include the Ways and Means individual income tax provisions discussed in this paper.)

This action by the Ways and Means Committee ignores recent warnings by outgoing Federal Reserve Chair Alan Greenspan that expiring tax cuts should be extended only if the costs are fully offset. The Ways and Means Committee action would start the federal government down a path that would make the troubling long-term deficits the nation faces substantially worse.

The bill's tax provisions also contain a serious inequity. They would fully protect the generous pension tax cuts for higher-income taxpayers enacted in 2001 from the effects of inflation over

KEY FINDINGS

- **The House pension bill would, for the first time, make permanent some of the tax cuts enacted in 2001, without offsetting the costs. This could open the door to piecemeal tax-cut extensions that could add $2.3 trillion to the deficit over the next ten years.**
- **The bill would protect from inflation all of the retirement-related tax cuts for high-income taxpayers enacted in 2001, but would *not* do the same for the only retirement-related tax cut aimed at people under $50,000.**
- **As a result, the bill would protect large tax breaks for those who least need help saving for retirement, while the main retirement-related tax incentive for people with modest incomes — the saver's credit — is allowed to erode sharply.**
- **A married couple without children that earns $30,000 now gets a $1,000 tax credit if it contributes $2,000 to a retirement account. Under the House bill, if the couple's income supply keeps pace with inflation, the couple's tax credit will be reduced from $2,000 to $200 within several years.**
- **Under the bill, the pension tax breaks for upper-income people enacted in 2001 will swell in cost over the next ten years, while the principal retirement tax incentive for moderate-income families is sharply scaled back and eventually disappears altogether, due to the failure to index it for inflation.**

time, while allowing inflation to erode severely the one significant retirement tax benefit enacted in 2001 for lower- and moderate-income taxpayers. By 2015, a significant portion of this retirement tax benefit for lower- and moderate-income families — known as the saver's credit — would cease to exist.

Today, as a result of the saver's credit, a couple without dependent children that earns $30,000 a year and contributes $2,000 to an IRA or 401(k) plan receives a tax credit of $1,000, which cuts in half the cost of the couple's contribution and thereby provides a powerful incentive for the family to save for retirement. This tax credit is available to married filers with adjusted gross incomes up to $50,000 (and single filers with incomes up to $25,000) and is used by more than 5 million households.

Under the bill's tax provisions, however, if the income of the couple making $30,000 today merely keeps pace with inflation, the tax credit that the couple receives for making a $2,000 contribution would fall from $1,000 today to $200 by 2009. Eventually, the couple would become ineligible for the credit altogether, even through its income would not have increased at all once inflation was taken into account.

Benefit of Saver's Credit Declines Over Time

Benefit to Sample Family*		
Selected Years	Current-Year Dollars	2005 Dollars
2005	$1,000	$1,000
2006	$400	$388
2009	$200	$181
2015	$200	$159
2028	$0	$0

*Benefit to a married couple with no dependent children that has income that equals $30,000 in 2005 and grows at the rate of inflation in succeeding years. The couple is assumed to make a $2,000 annual contribution to a Roth IRA.

This result would occur because the bill's tax provisions fail to adjust for inflation either the various income thresholds at which the saver's credit is phased down or the thresholds at which families become ineligible for the credit ($25,000 for a single filer, $50,000 for a couple).

The Joint Committee on Taxation's estimates of the cost of the tax provisions in the bill confirm that these provisions would have increasingly regressive effects over time. The cost of extending the pension provisions enacted in 2001 that primarily benefit *higher-income* households — including provisions that increase the limits on the amount of annual contributions that can be made to IRAs, 401(k)s and other retirement plans — would rise every year, increasing from $3.6 billion in 2012 (the first year that the full effects of extending those provisions would be felt) to $5.6 billion in 2015. (The Urban Institute-Brookings Institution Tax Policy Center estimates that three quarters of the benefits of extending these provisions would go to taxpayers with incomes over $100,000 a year.) In contrast, the tax benefits provided through the saver's credit would fall every year, dropping from $1.43 billion in 2008 (the first full year that the legislation's effects on the saver's credit would be felt) to $943 million in 2015. This decline would continue every year after that, until nothing of the credit remained.

Background

At President Bush's request, Congress enacted major tax-cut legislation in 2001 and 2003.[1] The substantial reduction in revenues that resulted from these pieces of legislation has been a major

[1] The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Act of 2003 (JGTRRA).

contributing factor to the large deficits the nation now confronts. According to estimates of the Congressional Joint Committee on Taxation, the tax cuts enacted in 2001 and 2003 reduced revenues by $225 billion in fiscal year 2005 (they added a total of $260 billion to the deficit when the related increase in interest payments is taken into account), an amount equal to more than two-thirds of the $319 billion deficit the federal government ran last year. Moreover, the Congressional Budget Office projects that making the 2001 and 2003 tax cuts permanent without paying for them would add $2.3 trillion to the deficit over the coming decade (including the added interest costs) and would cost $513 billion in 2015 alone.

Under current law, the tax cuts enacted in 2001 and 2003 all are due to expire by the end of 2010. The architects of the 2001 and 2003 bills designed those bills so all of the tax cuts in them would expire; they did so both to pack more tax cuts into these bills without breaching the ceilings that had been set for the cost of the bills, and to comply with a Senate prohibition against using the budget reconciliation process to enact provisions that increase the deficit in years beyond the five-year or ten-year budget period that a reconciliation bill covers.[2]

Although making the 2001 and 2003 tax cuts permanent has been a priority of President Bush and the Congressional Republican leadership, lawmakers concerned about the effects of such a step on long-term deficits have resisted making permanent even the most popular of the provisions in the 2001 and 2003 legislation. They argue that the nation cannot afford all of the tax cuts enacted in 2001 and 2003, especially if their costs are not offset, and that none of the 2001 or 2003 tax cuts should be made permanent until Congress and the President agree on which provisions to scale back or how to offset the costs of the tax-cut extensions. They fear, quite reasonably, that making the tax cuts permanent in a piecemeal fashion without offsetting their costs will make it harder to reach agreement on a fiscally responsible, comprehensive approach to the nation's looming budget problems.

This view has received support from Federal Reserve Chair Alan Greenspan. In fact, Greenspan has stated that the extension of the special low rate on dividends, which he strongly supports, should *not* be extended if their revenue losses are not offset. (See box below.)

Chairman Greenspan Says Expiring Tax Cuts Should Be Extended Only If the Extension is Paid For

Outgoing Federal Reserve Chairman Alan Greenspan has consistently expressed his belief that Congress should reinstitute a "pay-as-you-go" rule (often called PAYGO) that requires the cost of both entitlement increases and tax cuts — including extensions of existing tax cuts — to be offset, so that they do not increase the deficit. He has made clear that the Pay-As-You-Go rule should apply even to extensions of tax cuts that he strongly supports and has indicated that tax cuts, no matter how desirable, should be enacted or extended only if their costs are fully offset.

For instance, at a Joint Economic Committee hearing on November 3, 2005, Chairman Greenspan responded to a question about extending the special low rate on dividends that was enacted in 2003 and is scheduled to expire at the end of 2008. He said: "I would like to see the extension of that provision in the tax law, but I would insist that it be done in the context of PAYGO, which is not currently on the books."

The Provisions that Would Make the 2001 Pension Tax Cuts Permanent

The Ways and Means Committee-approved pension measures would make permanent all of the pension-related tax provisions in the 2001 Economic Growth and Tax Relief Reconciliation Act (or EGTRRA, as the 2001 tax-cut legislation is known) without offsetting the costs.[3] Among the provisions that would be made permanent are provisions that increased substantially the maximum amounts that individuals can contribute each year to Individual Retirement Accounts (IRAs) and employer-sponsored defined benefit plans such as 401(k)s, as well as a provision that established a tax credit for taxpayers with incomes under $50,000 who make contributions to retirement plans.[4]

Background on the 2001 Provisions

Prior to 2001, the maximum amount that a taxpayer could contribute to a tax-favored IRA plan was $2,000 a year. EGTRRA increased that limit in steps to $5,000 by 2008. (The limit is $4,000 today.) The $5,000 limit will then be increased each year after 2008 to reflect inflation. The 2001 tax-cut legislation also raised the IRA contribution limit by an additional $1,000 (as of 2006) for taxpayers aged 50 or older. By 2008, the IRA contribution limit consequently will be $6,000 for taxpayers 50 and over, a level that will grow with inflation in subsequent years.[5]

The 2001 legislation similarly increased the limits on the maximum tax-deductible amount that an employee can contribute to an employer-sponsored defined contribution retirement plan such as a 401(k) plan.[6] This limit was increased in steps from the $10,500 a year in effect in 2001 to $15,000 a year in 2006. That limit will then be adjusted to reflect inflation in years after 2006. In addition, EGTRRA allowed employees 50 years of age or older to contribute an additional $5,000 a year (by 2006); this figure, too, will be adjusted for inflation. Starting in 2006, high-income executives age 50 and over will be able to place $20,000 each year in a 401(k) plan and deduct the full amount. Their firms generally contribute thousands of dollars to their 401(k) accounts each year on top of that.

The 2001 legislation also established a modest “saver’s credit,” designed to encourage retirement saving by moderate-income taxpayers. Taxpayers with incomes below $50,000 for a married couple (below $25,000 for an individual) are eligible to receive a tax credit of up to 50 percent of contributions (up to $2,000) that they have made during the year to employer-sponsored retirement plans or IRAs. If a couple without dependent children that has income of $30,000 contributes $2,000 to an eligible retirement account, the couple receives a $1,000 tax credit.

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3 The new Ways and Means-approved tax legislation also includes a number of other provisions, including an admirable provision to boost enrollment in employer-sponsored retirement plans by facilitating action by firms that operate such plans to enroll their employees in the plans automatically unless the employees opt out. The Ways and Means Committee-approved tax provisions are part of a larger pension bill dealing with the Pension Benefit Guaranty Corporation and other pension-related issues.

4 The House- and Senate-passed reconciliation tax cut bills both contain a *temporary* extension of the saver’s credit. The House bill (H.R. 4297) would extend the credit (which is scheduled to expire at the end of 2006 under current law) for two years, through 2008. The Senate bill (S. 2020) would extend the credit for three years, through 2009.

5 The inflation adjustment applies to the basic limit of $5,000. The additional $1,000 contribution allowed for taxpayers 50 or older is not indexed.

6 These limits do not apply to the contributions that employers can, and generally do, make to employees’ 401(k) plans.

Who Benefits from the Pension Provisions Enacted in 2001?

The increases enacted in 2001 in the contribution limits for IRAs and employer-sponsored defined contribution plans overwhelmingly benefit higher-income taxpayers.

- The increases in IRA and 401(k) contribution limits benefit only the small number of workers who, prior to enactment of the legislation, were already contributing the maximum $2,000 amount allowed to IRAs or the maximum $10,500 amount allowed to 401(k)s.[a] Studies by the Treasury Department, the Congressional Budget Office, and the Employee Benefit Research Institute show that prior to the 2001 increase, only about 5 percent of taxpayers eligible for IRAs, and only about 5 percent of participants in 401(k) plans, made the maximum allowable contribution.[b]

- For these reasons, a General Accounting Office study estimated in 2001 that increasing the contribution limits for 401(k)s would directly benefit fewer than three percent of participants.[c]

- On a related front, CBO analysis has shown that those who make the maximum contributions to 401(k) plans tend to have high incomes. CBO found that only one percent of 401(k) participants who earned less than $40,000 contributed the maximum amount in 1997, but *40 percent* of those earning over $160,000 did.[d]

There is little question that the large increases in IRA and 401(k) contribution limits enacted in 2001 primarily benefit people at higher income levels. The saver's credit, by contrast, benefits only taxpayers with modest incomes; married taxpayers filing jointly are ineligible for the credit if their income exceeds $50,000, while single filers are ineligible if their income exceeds $25,000.

a. A study conducted by a Treasury Department economist concluded that taxpayers who did not contribute at the maximum "would be unlikely to increase their IRA contributions if the contribution limits were increased." See, Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of Treasury.

b. Robert Carroll, op. cit.; David Joulfaian and David Richardson, "Who Takes Advantage of Tax-Deferred Savings Programs? Evidence from Federal Income Tax Data," Office of Tax Analysis, Department of Treasury, 2001; Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003; and Craig Copeland, "IRA Assets and Characteristics of IRA Owners," EBRI Notes, December 2002.

c. General Accounting Office, "Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans," GAO-01-846, September 2001.

d. Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," Table 6.

The saver's credit is limited, however, in several key respects. It is *not* refundable, which means that lower-income taxpayers cannot use it. For example, a couple with two dependent children that makes retirement contributions cannot benefit from this credit in 2005 until its income surpasses $23,700.[7]

[7] At lower income levels, either the couple would have no income tax liability for the saver's credit to offset, or the saver's credit that the couple could claim would reduce, dollar for dollar, the child tax credit the couple could claim. (An estimated 20 percent of tax filers who claim the saver's credit do not actually benefit from it, because each dollar of their saver's credit results in a dollar loss in their child credit. See Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Savings Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," Retirement Security Project 2005-5, page 22.)

If the couple in this example also qualified for other tax credits, such as the dependent care tax credit or education credits, the income level below which the saver's credit would be of no value to the couple in 2005 would be higher than $23,700.

In addition, the 50 percent "credit rate" phases down sharply after a family's income surpasses $30,000. For example, the credit rate is only 10 percent for married families with incomes between $32,500 and $50,000. (In other words, for married filers in that income range, the tax credit equals 10 percent — rather than 50 percent — of their eligible retirement contributions.)

Finally, and of particular note, *none* of the features of the saver's credit are adjusted for inflation. As a consequence, moderate-income families whose incomes simply keep pace with inflation have their credit reduced sharply over time and can become ineligible for the credit altogether. Under the terms of the 2001 tax-cut legislation, the saver's credit is slated to expire at the end of 2006.

What the House bill's Tax Provisions Would Do

The tax provisions in the pension bill passed by the House would make permanent the increases in IRA and 401(k) contribution limits enacted in 2001, *with* their full adjustments for inflation. The bill also would make permanent the saver's credit, *without* adjusting it for inflation (and without lifting the restrictions that prevent families that do not earn enough to owe federal income tax from qualifying for the credit).

According to the Urban Institute-Brookings Institution Tax Policy Center, nearly three-fourths of the benefits of extending the IRA, 401(k), and related pension provisions go to taxpayers with incomes of more than $100,000 a year.[8] In contrast, virtually all of the benefit of extending the saver's credit goes to taxpayers with incomes under $100,000.[9]

Under the bill, the extensions of the IRA, 401(k), and related pension provisions enacted in 2001, which will primarily benefit higher-income households, would swell in cost over time. By contrast, the saver's credit would shrink sharply over time. The Congressional Joint Committee on Taxation estimates that the cost of extending the IRA and pension tax-cut provisions enacted in 2001 would grow from $3.6 billion in 2012 (the first full year affected by the provision) to $5.6 billion a year by 2015. But the cost of extending the saver's credit would fall from $1.4 billion in 2008 (the first full year affected by that provision) to $943 million by 2015. (See page 10 for further discussion of why the saver's credit would decline so much.) In 2012, the saver's credit would account for one fourth of the total benefits of all of these provisions. By 2015, the saver's credit would account for only 14 percent of the total benefits. According to the Tax Policy Center, under the House bill, the average benefit from the IRA and pension tax-cuts will grow by 9 percent from 2011 to 2015, while the average benefit from the saver's credit will *shrink* by nearly half from 2008 to 2015. The saver's credit would dwindle further after that, eventually fading away, while the upper-income pension tax changes would become still more robust.

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[8] The Tax Policy Center estimates, as well as CBPP estimates of the levels of income at which taxpayers in 2015 will be able to benefit from the saver's credit, assume that the other EGTRRA and JGTRRA tax cuts will be extended through 2015.

[9] The Tax Policy Center measure of income is cash income. In rare cases, a taxpayer with cash income in excess of $100,000 could have exemptions and deductions that reduce his or her adjusted gross income below the maximum income limit for eligibility for the saver's credit.

Little Evidence Exists that Upper-income Pension Provisions Enacted in 2001 Are Raising Retirement Saving Significantly

The increases enacted in 2001 in the maximum amounts that may be contributed annually to IRA and 401(k)-type plans were promoted at that time, and have been justified since, as being necessary to increase retirement saving. Yet little evidence supports that claim.

As the box on page 5 explains, studies by the Treasury, the Congressional Budget Office, the Government Accountability Office, and the Employee Benefit Research Institute all confirm that prior to the increases in IRA and 401(k) contribution limits enacted in 2001, *only about five percent* of eligible taxpayers were making contributions at the previous limits. As various of these studies also explained, the only taxpayers who would be affected by increasing the contribution limits, as the 2001 tax cuts did, would be people who already were at these limits. As some of these studies showed (and as common sense would suggest), those already at the limits were primarily upper-income households.

This is particularly significant, because research suggests that increases in IRA and 401(k) contributions by people at high income levels are likely primarily to represent *shifts in assets* to take advantage of the expanded IRA and 401(k) tax breaks, rather than new saving**.** For example, economists Eric Engen of the American Enterprise Institute and William Gale of the Brookings Institution found that high-income families tend to shift existing savings into 401(k)s to take advantage of pension tax breaks *without* increasing their current saving. (In contrast, they found that contributions to 401(k)s made by moderate-income families often do represent net increases in savings.) Engen and Gale wrote that, "In the top earnings group [i.e., people with incomes above $75,000 in 1991], there appears to be *no impact* [emphasis added] of 401(k)s on financial assets or wealth, and a significant reduction in other assets due to 401(k)s." They estimated that "between 70 and 80 percent of 401(k) balances accrue in earnings groups where eligibility has no noticeable impact on wealth accumulation."[a]

To the extent that the federal government is going deeper into debt to finance tax breaks that reward retirement saving that would largely have occurred anyway, policymakers are following an unsound course. This issue needs to be investigated carefully before the increases in IRA and 401(k) contribution limits that were enacted in 2001 are made permanent, at considerable cost. Since those provisions do not expire until the end of 2010, there is ample time to study this matter carefully, and assemble the evidence on it, *before* policymakers have to reach judgment on it. The Ways and Means Committee bill, however, would short-circuit that process, acting now to make permanent provisions that are not slated to expire for another five years despite the costs involved and the lack of evidence to date of the efficacy of these provisions.

Furthermore, some analysts have warned that some of the pension provisions enacted in 2001 may *reduce* pension coverage for low- and moderate-income workers, by reducing incentives for small business owners to offer retirement plans for their employees. Because of the 2001 law, business owners will, by 2008, be able to put away $10,000 a year in IRAs for themselves and a spouse — $12,000 a year if the business owner is 50 or older — *without* having to set up an employer-sponsored retirement plan that also covers their employees. Prior to enactment of the 2001 tax law, business owners who wished to place more than $4,000 a year in a tax-advantaged retirement account for themselves and their spouse had to set up a plan that covered their employees as well. Many pension experts expect that this significant change in pension law will, over time, reduce the proportion of small businesses that offer retirement plans for their workers. To the extent that these concerns are well founded, the Ways and Means Committee bill would lock in this undesirable effect permanently, even as the bill takes the nation deeper into debt.

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[a] Eric Engen and William Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," National Bureau of Economic Research Working Paper No. 8032, December 2000.

Problems with the Tax Provisions

The bill's tax provisions contain some attractive elements, such as a provision to induce firms that sponsor retirement plans to enroll their workers in the plans *automatically*, unless the workers opt out. Nevertheless, these provisions are fundamentally flawed in two important respects. They would increase deficits and set the stage for further deficit-increasing legislation in subsequent years, and they contain gross inequities in their treatment of taxpayers at different income levels, heavily favoring the affluent over those making less than $50,000. These two problems are discussed below.

Impact on the Deficit

The Joint Committee on Taxation estimates that the tax provisions in the bill would reduce revenues by almost $72 billion over the next 10 years (fiscal years 2006 through 2015). Some $30.3 billion of this revenue loss would result from making the pension and retirement provisions of EGTRRA permanent.

These figures, however, make the adverse fiscal impacts of the legislation's tax-cut extensions appear smaller than they actually are; the Joint Committee's ten-year cost estimate reflects *only five years of actual costs* for the measures in the pension bill that extend provisions of the 2001 tax-cut legislation that already run through 2010. As a result, the Joint Tax Committee estimate shows that $25.8 billion of the $30.3 billion ten-year cost of extending the 2001 pension tax provisions would occur in the *second* five years, with the cost reaching $6.6 billion a year in 2015.

Adding $30 billion to the deficit over the next ten years — and more than double that amount over the first ten years that the extensions of these provisions would all be in full effect (i.e., from 2011 to 2020) — would not be fiscally responsible. Of even greater concern from a fiscal-discipline standpoint, making the EGTRRA pension tax cuts permanent without offsetting their cost could initiate a process by which many provisions of the 2001 and 2003 tax-cut legislation are made permanent in a piecemeal fashion over several years, without much consideration being given to the combined effects such actions would have on long-term deficits. According to the Congressional Budget Office, making all of the provisions of the 2001 and 2003 tax cuts permanent (including Alternative Minimum Tax relief) would reduce revenues by *nearly $2 trillion* over the next ten years. Taking into account the increase in interest payments that would result, the deficit would rise by a total of $2.3 trillion over the ten-year period.

Such an addition to the deficit would be unaffordable regardless of whether it occurred through a series of extensions of parts of the 2001 and 2003 tax-cut legislation or through a single bill making all of the tax cuts permanent. It is not responsible to start down a path of making the tax cuts permanent until there is agreement, in the context of a comprehensive deficit reduction package, on which of the tax cuts we can afford to extend and what offsets should be adopted to cover the costs.

Furthermore, as the box on page 7 explains, there is little empirical evidence at this point that the increases in IRA and 401(k) contribution limits enacted in 2001 are being effective in achieving their stated goal of increasing retirement saving. To the contrary, there is considerable reason to think these measures will be inefficient and rather ineffective in this regard.

Recent Research Shows Progressive Tax Credits Can Encourage Retirement Saving

Current tax incentives for retirement saving give the largest tax breaks to the highest-income families, while giving moderate-income families little or no tax incentives for such saving. The existing incentives are structured as tax deductions. As a result, a high-income family in the 35 percent tax bracket gets $350 off its taxes for a $1,000 contribution to a 401(k), while a moderate-income family in the 10 percent tax bracket gets $100 off its taxes for the same size contribution. A family that does not earn enough to owe income tax gets no tax incentive for retirement saving.

In addition, high-income families can afford to save more than families of more modest means. They consequently benefit to a still greater degree from the retirement tax breaks in current law, relative to people of lesser means.

The overall effect is quite regressive. Analysis by the Urban Institute-Brookings Institution Tax Policy Center shows that *less than 5 percent* of the tax benefits from federal tax breaks for IRAs and defined contribution plans go the bottom 40 percent of taxpayers, while *nearly 50 percent* of these tax benefits go to the top 10 percent of taxpayers.[a]

Yet the regressive effect of the current tax incentives for retirement saving is not the only weakness of the current provisions. Perhaps an even more fundamental shortcoming is that existing tax benefits are poorly designed to accomplish their core mission: encouraging *new* retirement saving. As noted elsewhere in this analysis, various studies — such as the analysis by economists Eric Engen of the American Enterprise Institute and William Gale of Brookings that is discussed in the box on page 7 — have found that high-income families tend to shift existing savings into 401(k)s to take advantage of the available tax breaks, *without* increasing the overall amount that they save.[b]

The saver's credit, enacted in 2001, represents a modest and imperfect step to help remedy these problems. It attempts both to make the distribution of tax incentives for retirement saving somewhat less skewed to high-income filers and to encourage *new* saving. The saver's credit provides modest-income families with a tax credit equal to between 10 percent and 50 percent of their contributions to IRAs and 401(k)s.

The best evidence of the effect of tax credits of this nature on retirement saving comes from a recent randomized experiment designed by a team of researchers for the Retirement Security Project, and conducted by H&R Block.[c] The researchers found that if appropriately designed, a tax credit can be highly effective in encouraging retirement saving by low- and moderate-income families, with a larger credit resulting in more savings. The researchers found that the tax credit they tested produced sharp increases in contributions to retirement accounts by married couples in the bottom quartile of the income distribution (i.e., couples with incomes below $35,000). The credit raised both the percentage of couples that make such contributions and the average dollar amount they contributed.

This research also found the impact of the current saver's credit on IRA contributions to be significantly smaller than the impact of the credit that the researchers designed and tested. The credit they designed essentially modified the saver's credit to make the matching contribution that the saver's credit provides simpler and more transparent to tax filers, and to extend the credit to savers who do not earn enough to have income tax liability. The results of the test of the credit the researchers designed strongly indicate that the current saver's credit, if modified to make it simpler and more transparent and to extend it to low-income filers who do not earn enough to owe income tax, could boost increasing retirement saving substantially among low- and moderate-income households.

a. Leonard Burman, William Gale, Matthew Hall, and Peter Orszag, "Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts," Tax Policy Center Discussion Paper No. 16, August 2004.

b. Eric Engen and William Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," National Bureau of Economic Research Working Paper No. 8032, December 2000.

c. Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Savings Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," Retirement Security Project 2005-5.

Major Inequities in Provisions Affecting High- and Lower-Income Taxpayers

In addition to opening the door to other tax-cut extensions that would increase the deficit substantially, the bill's tax provisions would, as noted above, make permanent a highly inequitable feature of the 2001 legislation.

Once the generous increases in the limits on contributions to IRAs and employer-sponsored retirement plans are phased in fully and reach $5,000 and $15,000, respectively, in 2008, they will be adjusted upward every year for inflation. The bill would make these annual upward adjustments permanent. As a result, higher-income taxpayers who can afford to set aside these large amounts every year would not lose any of these tax-cut benefits to inflation.

In contrast, both the income thresholds and the maximum contribution amount for the saver's credit would remain frozen over time with *no* adjustment inflation. Under the bill, inflation would eat away heavily over time at the credit and sharply reduce the tax benefits (and the incentive to save for retirement) that the credit provides for moderate-income taxpayers.

Consider, for example, a married couple with no children that earns $30,000 a year in 2005 and contributes $2,000 to a retirement account. The couple now receives a tax credit of $1,000. This essentially lowers the cost to the couple of making a $2,000 retirement contribution to $1,000, providing a powerful incentive for the couple to undertake retirement saving.

- Under the bill, if this couple's income simply keeps pace with inflation, the tax credit the couple receives for making a $2,000 contribution will plunge to $200 in 2009 and remain at that level through 2015. The credit that the family receives in 2015 will be worth $159 in today's dollars.[10]
- In other words, the real value of the saver's credit that the family receives will be reduced by *84 percent* over the coming decade, from $1,000 today to $159 in 2015, measured in 2005 dollars.

Furthermore, with each passing year, fewer and fewer families will be eligible for the credit at all. The credit is not refundable, so families that do not earn enough to incur income tax liabilities cannot use it, and hence receive no incentive from it to save for retirement. The income levels at which families begin to owe federal income tax *are* adjusted each year for inflation.[11]

In other words, the failure of the bill to address two key shortcomings of the saver's credit as enacted in 2001 — its lack of indexing for inflation and its lack of "refundability" (i.e., its lack of availability to working families that earn wages too low to owe income tax, even through these are some of the families that most need help in saving for retirement) — would condemn the saver's credit to continuous decline and ultimately to extinction.

In summary, under the bill, the upper-income pension provisions enacted in 2001 would be made permanent in a way that preserved all of their benefits, while the saver's credit would be made permanent on paper but would shrink markedly over time and ultimately fade away.

[10] This assumes inflation would rise at an average rate of 2.2 percent, as projected by CBO.

[11] The income level below which a family does not owe federal income tax (before taking into account either the child or earned income credit) generally equals the sum of the personal exemptions and the standard deduction for which the family qualifies. Both the personal exemption and the standard deduction amounts are adjusted annually for inflation.

Conclusion

To allow the severe erosion over time of the principal tax incentive for modest-income families to save for retirement does not make sense as retirement policy. To do so while protecting very generous retirement tax-cut benefits that go overwhelmingly to higher-income taxpayers who generally are able to save adequately for retirement anyway, without these tax subsidies, is even less defensible. And incorporating regressive tax policy of this nature into a bill that swells budget deficits, and opens the door to still more deficit-increasing tax cuts in the future, stands sound policy on its head.

The tax provisions of the House pension bill contain some beneficial features, such as provisions that would encourage "automatic enrollment" in employer-sponsored retirement plans. The tax provisions as a whole, however, manage simultaneously to represent irresponsible fiscal policy, inequitable social policy, and unsound retirement-saving policy.