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Personal Savings and Tax Reform

Principles and Policy Proposals for Reforming the Tax Code

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The tax code is riddled with inequities, especially for families with lower incomes and fewer resources. While some low-income households benefit from refundable credits provided in the tax code such as the Earned Income Tax Credit, many more are categorically excluded from benefiting from valuable tax incentives. The nearly 70 percent of Americans that do not itemize on their tax returns cannot access a range of valuable benefits, deductions, and write-offs that amount to huge tax-saving benefits to higher-income households.[1] High percentages of lower-income families do not own a bank account, do not work for employers that offer savings plans or matched deposits, and do not have sufficient tax liabilities to access tax benefits. Many more are simply confused about the rules governing tax-advantaged accounts that ostensibly are designed to promote increased savings for all Americans.

As currently designed, our tax system facilitates substantial rewards for high-income earners without advancing the intended social goals of providing inducements to save for the low- and middle-income families that need saving incentives the most. This is a policy failure. A large-scale and systematic reform of the tax code offers an opportunity to more effectively promote increased saving and asset building as a means to help families increase their financial security and economic mobility. This paper makes the case for reforming the tax system to better reflect the true purpose of personal savings tax incentives: to encourage saving among those who otherwise could not afford to.

[1] Only about 33 percent of taxpayers itemized deductions rather than claimed the standard deduction in 2010; Tax Policy Center (2012).

Personal Savings as a Policy Objective

In a fair and meritocratic society, people expect to be able to benefit from their efforts and abilities. Beyond basic social protections, Americans believe in the possibility of improving their condition and moving up the economic ladder. Because there is a clear conceptual link between a family's having savings and its chances of improving its socio-economic position over time,[2] building savings and assets is an important way to achieve those goals. Access to a pool of resources enables a family to navigate a potential storm of unexpected financial shocks. This pool of resources in turn creates a stable foundation from which a family can confidently begin its economic ascent. With greater financial security, families can invest in their future by saving for education, homeownership, and retirement, all of which have clear connections to economic success. In

[2] Cramer, O'Brien, Cooper, and Luengo-Prado (2009), 9.

addition to the positive economic effects of maintaining assets, the mere act of saving has been found to be associated with aspirational effects that contribute to positive financial outcomes throughout the life course.[3] These aspirational effects have been found to improve outcomes as early as childhood, especially for children who start out in families with low incomes, by increasing their likelihood of attending college and by improving their prospects for economic mobility later in life.[4]

Building a secure financial foundation is the primary reason for saving among American families, according to the 2010 Survey of Consumer Finance.[5] This finding is a shift from previous surveys, which found that retirement was Americans' top savings objective, with education a distant third. While a plurality of families believes that building a pool of savings to weather financial shocks is a financial priority, the existing policy supports to achieve these goals are limited, ill-targeted, and poorly designed.

Families have a hierarchy of savings needs. In addition to retirement security, families need to be able to respond to emergencies and make strategic investments that can pay off over a lifetime.

Ensuring financial security among retired adults is a worthwhile public policy goal, but it is just one of many savings objectives that sound policy should address. Families have a hierarchy of savings needs. In addition to retirement security, families need to be able to respond to emergencies and make strategic investments that can pay off over a lifetime. Current policy allocates a large portion of the nation's resources to promote retirement security, amounting to almost 1 percent of GDP in 2013,[6] yet it offers few supports for low- and middle-income earners seeking to build a personal safety net. As a result, over half of all U.S. households lack sufficient liquid assets to replace 75 percent of their household income for one month in the event of an economic shock like a sudden layoff or a medical emergency.[7] This means that a $4,000 medical bill or emergency repair of a house's heating system could put half of U.S. families in dire economic straits. A policy failure to support a diversity of saving needs, including precautionary savings, may unintentionally serve as a barrier to increased saving for all other purposes.

Encouraging greater personal savings is a vital public policy goal. Historically, it has been a bipartisan issue, on which politicians from widely disparate backgrounds and with vastly different policy priorities can agree. Since 2005, a bipartisan group of members of the U.S. House of Representatives has led the Congressional Savings and Ownership Caucus, which brings together key members of Congress, their staffs, and leading outside experts to discuss—in a non-partisan, forward-looking manner—recent research findings, policy options, and potential legislative opportunities to advance the goal of expanding savings and asset ownership in America. The Caucus for the 113th Congress is currently co-chaired by Rep. Jim Cooper (D-TN), Rep. Tom Petri (R-WI), Rep. Niki Tsongas (D-MA), and Rep. Joe Pitts (R-PA). While the Caucus supports a range of policy proposals, the members share a special commitment to expanding opportunities for economic mobility by increasing the levels of personal savings held by American families.

Traditionally, the policy method most often used to promote saving has been the tax code, through an array of

[3] Elliott (2009).
[4] Ibid.
[5] Bricker et al. (2012), 16.

[6] Tax expenditures associated with retirement savings are expected to cost $140 billion in 2013 (Office of Management and Budget 2013); U.S. GDP was $15 trillion in 2011 (World Bank 2013). See figure 1.
[7] Key (forthcoming); 75 percent of household income is considered to be the lowest proportion to which a family could reasonably reduce its expenses in the short-term, given the long-term nature of most mortgages, rents, car payments, and so on.

tax credits, deductions, exemptions, and deferrals. Collectively, these tax rules establish and allocate benefits to the population by modifying the prevailing tax rules in order to promote behavior that "further[s] societal goals."[8] According to the Congressional Budget Office, policymakers have previously supported a range of goals that include promoting ownership and community stability, facilitating economic mobility, supporting retirement security, and increasing national saving.[9] Key provisions of the tax code are designed to achieve these goals. Yet given that public resources are limited, it is worth examining whether existing tax provisions actually promote public policy objectives and effectively allocate resources in a cost-effective manner to those who need them the most.

The Case for Tax Reform

Recognizing the positive social effects of increasing personal savings, policymakers have amended the U.S. tax code from time to time with the explicit purpose of encouraging more saving. In 1974, Congress created Individual Retirement Accounts (IRAs) to allow individuals to defer paying taxes on their contributions until after retirement. In 1978, Congress created the 401(k) plan, which, like the IRA, offers tax-deferred retirement savings, but is established by employers on behalf of employees. The two savings vehicles attracted little attention before the Economic Recovery Tax Act of 1981, which expanded the tax benefits associated with participation in these plans. With the decline in defined benefit pensions in the subsequent years, these vehicles have gained prominence. Additional changes to the tax code created new types of accounts, including Roth, SIMPLE, and SEP IRAs. In the early 2000s, Congress strengthened tax benefits linked explicitly to saving for post-secondary education through the expansion of 529 College Savings Plans and the creation of the Coverdell Education Savings Account.

The proliferation of tax-preferred savings plans reflects the growing popularity of tax expenditures, rather than direct spending, as the preferred policy method to allocate public resources. Since the last major tax reform effort in 1986, the cost of tax expenditures has greatly increased and the greater reliance on them as a policy method has added complexity to the tax code.[10] Tax expenditures as a policy vehicle to promote social goals work best when the incentives associated with them are correlated inversely with income and are made widely available. While some tax expenditure programs may subsidize worthy activities and generate sizeable social and economic returns, much is still

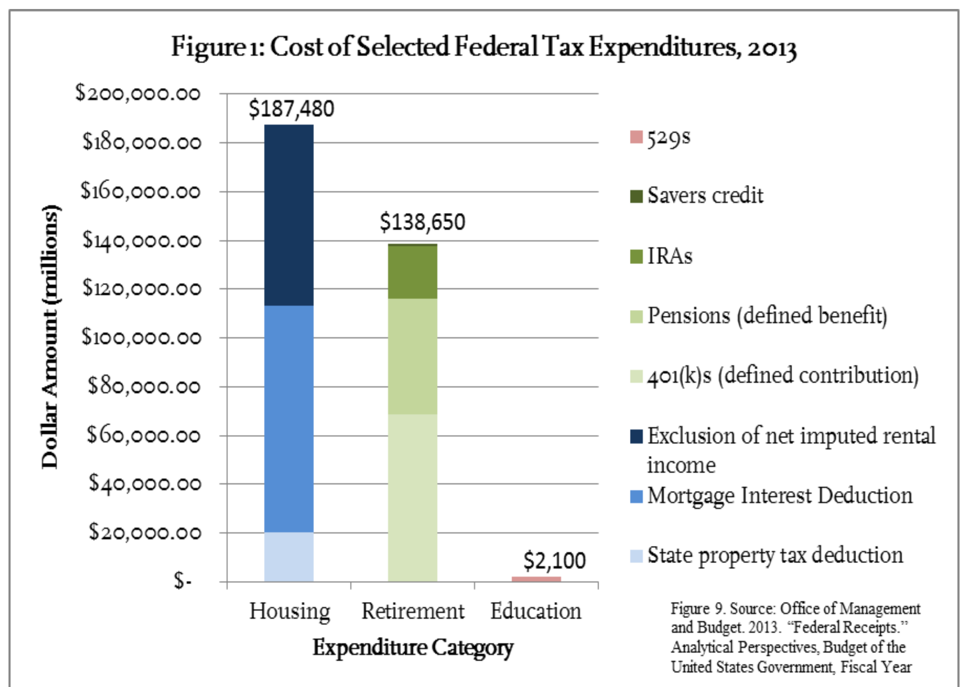


Figure 9. Source: Office of Management and Budget. 2013. "Federal Receipts." Analytical Perspectives, Budget of the United States Government, Fiscal Year

[8] Congressional Budget Office (2013), 7.

[9] Ibid, 7.

[10] There are several methods for estimating the value of tax expenditures. The two most common measures are revenue losses, attributed to provisions in the tax code, and budget outlays. The difference between the two is that *revenue losses* count money that would otherwise come in to the Treasury under a baseline tax system without changes to the tax law, and *outlays* are monies actually spent by the government out of existing Treasury funds or by taking on debt. The methods for arriving at cost estimates vary depending on the specific activity and its tax treatment. In the case of some refundable tax credit programs, such as the Earned Income Tax Credit, outlays and revenue effects should be considered together to capture the ultimate scale of the policy effort.

unknown about the degree to which they are actually effective at inducing socially beneficial outcomes. Still, in recent years direct expenditure programs have been subject to increased budgetary scrutiny and performance assessment, while tax expenditures have been comparatively ignored, despite their large-scale impact on the federal budget.

Recent estimates project that the federal government will spend a combined $1.34 trillion on tax expenditures in FY 2013.[11] To understand the scale of resources in play, this figure can be compared to the total annual federal net outlays to the public, which all together have averaged less than three times that amount at $3.6 trillion in recent years.[12] Yet many of these tax expenditures fail basic tests for cost-effectiveness by being inefficient, inaccessible, and regressive.

According to a recent Congressional Budget Office (CBO) report, half of the benefits from ten major tax expenditures went to the highest income quintile, with 17 percent going to just the top 1 percent of income earners.[13] This means 50 percent of the public resources allocated through the tax code for the vast majority of tax expenditures benefit the top 20 percent of households. The tax expenditures under review by CBO include the mortgage interest deduction, exclusions for retirement contributions, preferential tax rates on capital gains and dividends, and progressive tax credits like the child tax credit and the earned income credit.[14] The ten tax expenditures under study cost the federal government an estimated $900 billion in FY 2013, and make up the vast majority of the total cost of the more than 200 tax expenditures in the tax code. Focusing in on several discrete policy areas related to personal savings and the accumulation of assets (retirement, homeownership, and education) reveals the extent to which these policies are regressive and in many respects ineffective. Specifically, the benefits offered by the current tax code are not accessible to a large number of citizens that would potentially benefit from them the most, and fall short of achieving their intended policy objectives.

Retirement

Among those 200 expenditures, the exclusion from taxable income for pension assets and retirement contributions is one of the most expensive, costing the federal government $139 billion in FY 2013.[15] The Office of Management and Budget expects that amount to rise sharply in future years to $152 billion in FY 2014 and $168 billion in FY 2015.[16]

Figure 2: Cost of Tax Expenditures for Retirement Savings (millions)

Type of Plan	2012	2013 (expected)	2014 (expected)
401(k)s (DC plans)	$51,830	$68,820	$79,720
Defined-benefit pensions	$38,740	$47,410	$53,060
IRAs	$16,180	$21,240	$19,260
Saver's credit	$1,110	$1,180	$1,220
Total	$107,860	$138,650	$153,260

Source: Office of Management and Budget. 2013. "Federal Receipts." Analytical Perspectives, Budget of the United States Government, Fiscal Year 2014.

Most of that amount, 66 percent, goes to the highest income quintile,[17] which receives a significantly more generous benefit in proportion to income. Earners in the highest quintile—the top 20 percent—receive a tax expenditure worth 2 percent of their income, compared with 0.4 percent and 0.7 percent of income for the lowest two quintiles respectively.[18] Part of this variation can be explained by normal distributions in earning throughout the life course, since workers in their peak earning years tend to have more assets accumulated in tax-favored

[11] Marron (2012). The Office of Management and Budget provides estimates of the static cost (as opposed to taking into account cross-over effects) of individual tax expenditures, but does not provide a total estimate of the budgetary effect from all tax expenditures. Third-party analysts, like Marron (2012), provide this estimate.
[12] Office of Management and Budget (2013), 222. Total annual net outlays takes into account all direct spending of the federal government, less offsetting receipts like user charges for government services like national park fees and agency inspection fees.
[13] Congressional Budget Office (2013), 2.
[14] Ibid., 1.

[15] See figure 2.
[16] Calculations derived from Office of Management and Budget (2013), 252.
[17] See figure 3.
[18] Congressional Budget Office (2013), 15.

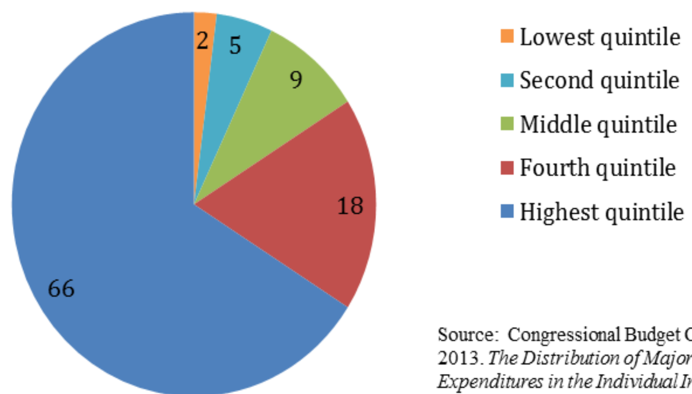
retirement accounts. But other explanations for the variation are less benign.

Many wealthy households make contributions to tax-preferred accounts primarily in order to shelter resources from taxation, not to save for retirement security. These contributions reflect the economic decision to shift assets to a more favorable account, rather than the decision to accrue new net savings.[19] The tax rules effectively create a wasteful and pointless windfall for certain high-saving households. Additionally, high-income earners are offered access to employer-based retirement plans, both defined-benefit (pensions) and defined-contribution (401(k)s), at much higher rates than low-income earners. In total, about 85 million U.S. workers, or 55 percent of the civilian workforce, have access to a defined-contribution retirement plan.[20] Of those who work at places that offer such plans, 68 percent participate. In total, then, only 37 percent of the civilian workforce, or about 57.4 million workers, are enrolled in a defined-contribution plan in the United States.

The distribution of defined-contribution plans is highly skewed by income. Only 35 percent of the workers in the lowest quartile have access to a plan, compared to 68 percent of those in the highest quartile. In terms of the take-up rate, the differences are just as severe: 44 percent for the lowest quartile compared to 79 percent for the highest. This disparity could represent better information or more prudent financial planning among higher income earners, but in large part the disparity also evinces systemic inequities in the tax code: the lowest-income earners face little incentive to save through tax-favored savings vehicles. The resulting participation rates in defined-contribution plans among that group are low: 16 percent for the lowest quartile compared to 53 percent for the highest. For the lowest 10 percent, the rate is only 7 percent.[21]

In the absence of employer-based retirement plans, all taxpayers in theory have access to individual retirement account (IRA) arrangements, which offer similar tax benefits to defined-contribution plans. There are two types of IRAs: traditional IRAs, which offer tax benefits in the current year through a deduction from gross income of the amount saved, and Roth IRAs, into which taxable income is deposited, but which offer tax-free earnings throughout the life of the account and tax-free withdrawals after age 65. Though maximum income restrictions apply to Roth IRAs at about $130,000 for single taxpayers, no income restrictions apply to traditional IRAs for taxpayers without an employer-based retirement plan.[22] About 40 percent of U.S. households participate in IRA plans, though as with employer-based plans, participation rates are highly skewed towards upper-income earners.[23] Nearly three-quarters of

Figure 3: Share of Total Public Tax Benefit from Retirement Savings Tax Expenditures



Source: Congressional Budget Office. 2013. *The Distribution of Major Tax Expenditures in the Individual Income Tax System*. Congress of the United States.

[19] See, for example, Chetty et al. (2012) for a study of the extent to which "active" savers shift assets between savings vehicles in response to incentives, rather than save net new assets.

[20] This and the following information on participation in employer-based retirement plans are derived from data on employee benefits tabulated by the U.S. Bureau of Labor Statistics (2012).

[21] U.S. Bureau of Labor Statistics (2012).

[22] Steep income restrictions do apply to traditional IRAs for taxpayers who take part in employer-based plans. The phase-out range begins at $59,000 for single taxpayers.

[23] Holden and Schrass (2012), 1.

households making more than $200,000 a year own IRAs compared with only 13 percent for households making under $25,000. For middle-income earners making between $50,000 and $75,000, the rate is close to the national average at 43 percent.[24]

In 2001, Congress enacted the Saver's Credit, a tax incentive targeted to lower-income workers, as a way to correct some of these imbalances in participation rates between income groups. In practice, however, it largely fails to encourage saving among its target population for several reasons. Though the beginning of the phase-out range (where the benefit drops from a 50 percent credit to a 20 percent credit) is set at a relatively low income level of $35,500 for married filers, the credit is limited in its usefulness to the population of low-income earners that can meet this threshold because the credit is nonrefundable. Even at its maximum benefit level, it can only reduce tax liability to zero for taxpayers who very often already make use of other tax deductions to reduce or eliminate their tax liability. As currently structured (as a non-refundable benefit), the Saver's Credit has been found to have only a minimal effect on low-income earners' decisions to save at tax time, and very little compared to the effects of matched incentives arrangements, which lead to outcomes four to seven times greater.[25]

Homeownership

The value of owner-occupied homes accounts for a significant portion of the total assets of households across the income distribution.[26] About 67 percent of all households own a home,[27] and the primary residence is by far the most valuable nonfinancial asset, amounting to almost half of the total nonfinancial holdings.[28]

In order to encourage community building and personal investment, policymakers have maintained in the tax code an exclusion from income of the value of interest paid on an owner-occupied home. Over 34 million households[29] (43 percent of all homeowners[30]) took advantage of this tax expenditure, known as the mortgage interest deduction (MID), in 2012 at a cost to the federal government of $68 billion.[31] That amount is expected to rise as a share of GDP in future years.[32]

Figure 4: Cost of Tax Expenditures for Homeownership (millions)

Type of Tax Deduction	2012	2013 (expected)	2014 (expected)
State and local property tax deduction	$15,460	$20,310	$25,160
Mortgage Interest Deduction	$81,890	$93,090	$101,470
Exclusion of net imputed rental income	$68,230	$74,080	$75,520
Total	$165,580	$187,480	$202,150

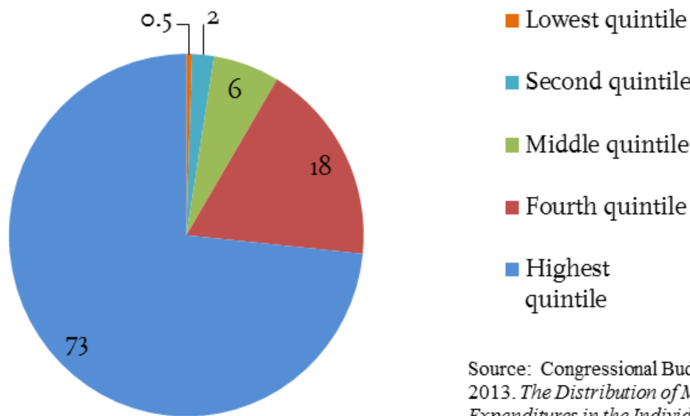
Source: Office of Management and Budget. 2013. "Federal Receipts." Analytical Perspectives, Budget of the United States Government, Fiscal Year 2014.

A number of factors contribute to this cost. Deductions can be taken on mortgages up to $1 million for the primary residence and up to $100,000 for second homes. The rules for claiming the mortgage interest deduction also account for the unequal distribution of benefits across income groups. Three-quarters of the entire cost of the expenditure goes to benefit the highest income quintile alone. The bottom 60 percent of earners receive only 8 percent of the benefit.[33] As a share of after-tax income, the highest quintile receives nearly twice as much as the next highest quintile and 10 times the benefit of the lowest two quintiles.[34] Ironically, it is those households who receive the least

[24] Holden and Schrass (2011), 5.
[25] Duflo et al. (2007), 658.
[26] Bricker et al. (2012), 48.
[27] Ibid., 47.
[28] Ibid., 42.

[29] Joint Committee on Taxation (2013), 48.
[30] The total number of households owning homes was just over 79 million in 2011, according to the 2012 Annual Social and Economic Supplement to the Current Population Survey (U.S. Census Bureau 2012). The number of homes with active mortgages, however, was only 48 million in 2011, according to the Department of Housing and Urban Development's American Housing Survey for 2011 (U.S. Department of Housing and Urban Development 2011, Table C-14A-OO). Therefore, the percentage of households claiming the MID in 2012 *of those that had a mortgage* in 2011 is about 70 percent.
[31] Joint Committee on Taxation (2013), 48. This estimate differs sharply from the OMB estimate in figure 4.
[32] Congressional Budget Office (2013), 6.
[33] Congressional Budget Office (2013), 15. See figure 5; the bottom 60 percent consists of the bottom three quintiles.
[34] See figure 6.

Figure 5: Share of the Total Public Tax Benefit of the Mortgage Interest Deduction



Source: Congressional Budget Office. 2013. *The Distribution of Major Tax Expenditures in the Individual Income Tax System*. Congress of the United States.

benefit from the MID that are the most sensitive to the economic incentives for either buying or renting a home.[35]

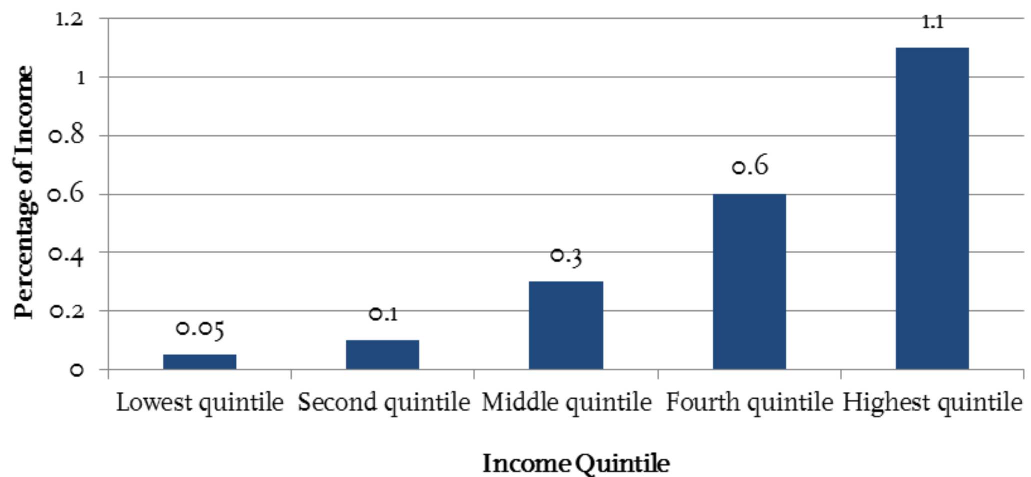
If this tax expenditure is to be effective at promoting homeownership, it must be targeted at those households whose decision to buy a home would be most influenced by an economic incentive like a tax benefit, rather than the households who would likely buy a home regardless of the tax benefits associated with that decision.[36] Many low- and middle-income families who buy homes do not itemize on their tax return and thus gain no benefit from the mortgage interest deduction.[37]

Rather than encouraging upwardly mobile families to become homeowners, current policy functions more as just a reward for wealthier families who choose to buy more expensive (or just more) homes. Additional tax expenditures associated with homeownership (deduction of state and local property taxes and value of imputed rent) further contribute to the regressivity of this part of the tax code.[38]

Education

Less than 3 percent of U.S. families actively participate in 529 Plans or Coverdell Education Savings Accounts, making these tax-favored savings vehicles particularly exclusive.[39] The cost to the federal government of offering these tax-favored plans in

Figure 6: Benefit from the Mortgage Interest Deduction as a Percentage of Income, by income quintile



Source: Congressional Budget Office. 2013. *The Distribution of Major Tax Expenditures in the Individual Income Tax System*. Congress of the United States.

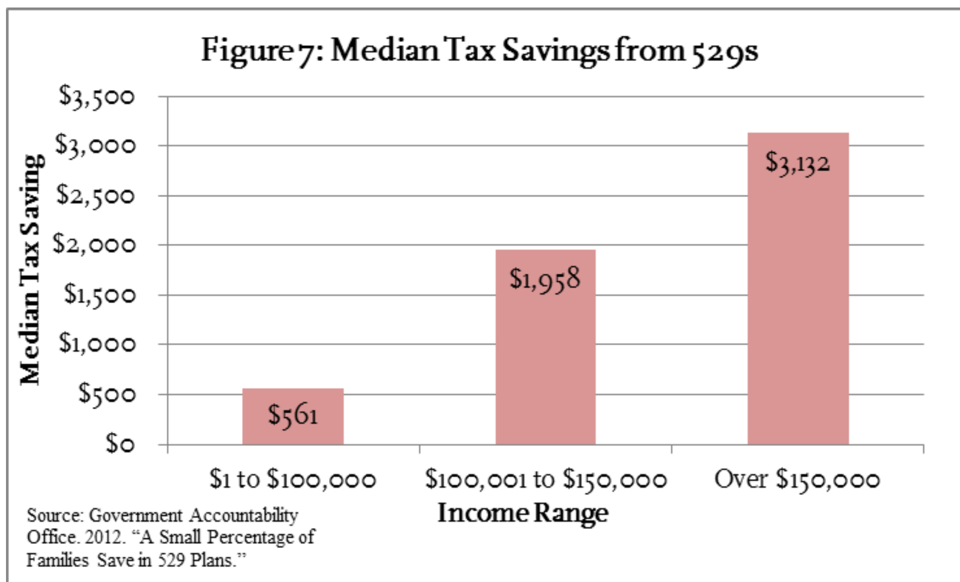
35 Fischer and Huang (2013), 4.

36 Recent and ongoing research by the Urban Institute suggests that reforming or eliminating the MID would have little effect on the housing market, providing further evidence that the expenditure is failing to positively affect behavior to the benefit of society. See Turner, Toder, Pendall, and Sharygin (2013).

37 66 percent of households claim a standard deduction, meaning they do not itemize their tax returns (Tax Policy Center [2012]).

38 See figure 1.

39 Government Accountability Office (2012), 14. Neither the Federal Reserve's Survey of Consumer Finance (see Bricker et al. [2012]) nor the Government Accountability Office distinguishes between 529s or Coverdells for purposes of calculating participation rates.



terms of foregone tax revenue was about $2 billion in 2012, which means that these tax expenditures are much smaller relative to those associated with retirement and homeownership.[40] However, the value of the assets held in these plans will increase over time, thereby increasing the cost to the federal government.[41]

Most of the families participating in 529 College Savings Plans have relatively high incomes. The median income for families with 529s was $142,400 in 2010; 47 percent of families with 529s had incomes over $150,000.[42] That same 47 percent also accrued median tax benefits of $3,132 a year through the tax benefits associated with 529s, compared with only $561 for the 30 percent of families that own 529s and make less than $100,000.[43] Though the cost to the government of offering 529 Plans is minimal, and the number of families participating is small, the unequal distribution of benefits resembles that of other more costly tax expenditures.

Framework for Reform

By many measures, current tax policy fails in its aims to encourage socially beneficial behavior and achieve its key social goals. Resources are allocated inefficiently through tax expenditures, and the tax benefits associated with them are regressive in their distribution. The system is set up to reward contributions to tax-advantaged accounts regardless of whether those contributions represent new net savings, or are merely shifted from other, taxable accounts. As a set, these policies have huge costs but fail to successfully influence the behavior of those groups most in need of support. The reliance on nonrefundable credits and deductions makes the potential tax benefits inaccessible to economically vulnerable groups, which in turn means that the vast majority of the costs associated with federal tax expenditures ends up benefiting higher-income earners. At best, this is merely a lost opportunity; at worst, this is a colossal waste of our limited public resources.

It is time to reform the tax code to better reflect crucial public policy goals. Beyond maintaining an effective means of generating revenues to meet long-term government commitments, these goals must also support personal savings. A useful framework for such reform takes into account four interrelated concepts: simplicity, efficiency, inclusivity, and fairness.

Simplicity

Tax-favored savings plans must be designed to support a coherent saving strategy. Such a system would work to reduce the complexity associated with the current set of tax incentives for saving. The proliferation of federally sanctioned savings plans provided in the tax code creates a high degree of complexity and has become a source of confusion among potential savers, thereby diluting the effectiveness of the incentives. The full range of eligibility rules, contributions limits, qualified uses, exemptions, and penalties can be difficult to understand and distinguish

[40] See figure 1.
[41] Office of Management and Budget (2013).
[42] Government Accountability Office (2012), 16.
[43] See figure 7.

from one another, which creates obstacles to making affirmative decisions to save.

Having a simplified set of rules, accomplished by consolidating the existing array of plans, would reduce compliance costs and administrative expenses. The process of saving must be made as easy as possible. Rules should be simplified and the number of special accounts reduced. This may entail creating one class of accounts that are only for retirement, as we have today with the 401(k),[44] and another that can be used for multiple purposes, such as saving for education, homeownership, and emergency expenses. This would allow households to save for multiple purposes while taking advantage of tax benefits, and without a great risk of "breaching" designated accounts (and paying exorbitant early-withdrawal penalties) in order to survive an unexpected economic shock.[45]

Efficiency

Tax reform should be pursued in a way that prevents tax benefits from subsidizing behavior that would have occurred anyway. The features of current policy that do subsidize such behavior represent the prevailing fault of the system. Existing rules, such as those that allow for tax-free earnings, may induce some new savings, but in large part they merely encourage asset shifting, have high long-term costs, and are less transparent than other potential incentive structures. The rational response to incentives of moving assets from existing taxable accounts into tax-free accounts removes assets from the tax base without necessarily promoting new personal savings. This inefficiency in the tax code helps explain the discrepancy between the dismal personal saving rate and the huge cost of tax expenditures intended to improve that saving rate.

Instead of an incentive structure that relies on tax-free earnings and deductions, an alternative approach to maximize efficiency would be a system that provides direct matches to deposits in designated accounts. A direct match of account contributions provides transparency both in its benefit to the individual and its cost to the government. This approach could provide an economically responsible and socially beneficial solution to cover the nearly half of Americans who have zero or negative tax liability and thus cannot benefit from additional nonrefundable tax credits.[46] While a matched incentive approach would in one sense favorably affect the efficiency of the tax code by offering a more streamlined approach to achieving the specific social goals of the tax system, more needs to be done to ensure that efficient use is being made of the federal government's tax expenditures.

Inclusivity

In order to establish a more inclusive tax system, accessible savings vehicles must be designed to facilitate the participation of all potential savers, not just those who are most likely to save. Since a higher participation rate is essential, everyone should have access to a savings plan. Since automatic enrollment programs have been shown to consistently increase saving across all income groups,[47] payroll deduction programs that can be used to facilitate savings contributions should be a standard workplace practice.[48] Recent policy changes[49] have made it easier for

[44] Though not, as many believe, the IRA, which is not solely for retirement, because it can be used without penalty for expenses related to education and buying a home.

[45] Over one-fourth of all defined-contribution retirement plan participants "breach" (or withdrawal funds early and pay an IRS penalty) their retirement account balances (Fellowes and Willemin [2013], 5). 30 percent of all households that have insufficient emergency savings breach their retirement account, compared with 15 percent of those that have sufficient emergency savings (ibid., 6).

[46] 46.4 percent of "tax units" (families or individuals) had no tax liability in 2011. Tax Policy Center (2011).

[47] See VanDerhei (2010); Butrica and Johnson (2011).

[48] Chetty et al. (2012) have found that automatic contribution arrangements raise total saving in the long run among "passive" savers, those who do not actively make choices about their retirement savings such as routinely shifting assets to more profitable vehicles or investments.

[49] Specifically, the Pension Protection Act of 2006 (PPA) allowed employers to more easily provide for automatic enrollment for their employees in defined-contribution plans. The PPA preempted state laws regarding unelective employer deductions from employee pay and established "safe harbor" rules that would be more attractive to employers offering defined-contribution plans. The safe harbor plans under the PPA are generally considered to be less onerous for employers than previous safe harbor requirements and, like the safe harbor provisions in previous legislation (specifically, the Small Business Job

employers to automatically enroll employees in savings plans while allowing workers to opt out. This approach has increased participation rates among workers at all income levels.[50] Once workers are enrolled, an effective policy would be to automatically increase contribution amounts over time in order to help savers reach favorable asset levels. Contributions can be facilitated by the employer, but the opportunity should not be contingent on the relationship with a specific employer.

A fair policy, and an efficient one, would offer meaningful saving incentives for people who do not currently save.

Beyond these policies, however, tax policy cannot be considered to be inclusive until it can take into account the millions of workers with multiple employers and uneven work histories who are least likely to own, and be able to sustainably manage, tax-favored savings accounts. One solution is to offer access to basic bank accounts and savings plans directly through the tax filing process. Decoupled from the workplace, people should be able to open an account and designate funds to be set aside right on a tax form at tax time. This would offer an inclusive and scalable system for workers to save, and would fill a gap in the employer-based system for delivering tax benefits.

Fairness

While many of the provisions in the current tax system have income ceilings, benefit caps, or contribution limits, existing rules are insufficient to prevent wide disparities in benefits from accruing across income groups. The problem with income disparities with regard to the receipt of tax benefits is not that higher income earners are taking advantage of tax expenditures at higher rates than lower income earners per se, but that the existing tax expenditures are failing to meet the needs of the groups that need the most help. Sincere efforts to promote greater rates of saving for all Americans must target incentives at low-income earners. For that group, low tax benefits, low earnings, and low savings are all correlated. A fair tax code would ensure that benefits and incentives can be accessed by households with these characteristics, for it is precisely this group of low savers for whom these policies can make the most difference. Conversely, there is a need for limitations to be placed on the amount of benefits that accrue to those that need the least economic persuasion to save and build assets.

The aim of any genuine effort to increase saving rates for the population overall must be to motivate low-income earners to save. Research has shown that tax incentives for saving, as they are currently structured, may have an "illusory" effect on savings, encouraging more asset shifting than asset building.[51] People respond to incentives, so, logically, the government's establishing a tax shelter for certain savings will prompt existing savers to shift their resource allocations to those vehicles, without necessarily bringing about an increase in the saving rate. A fair policy, and an efficient one, would offer meaningful saving incentives for people who do not currently save. And these people, the evidence shows, tend to be low-income earners. Our current, upside-down tax policy must be righted to motivate low- and middle-income Americans to make the sacrifice to save, without unduly rewarding the saving behavior of high-income, high-saving groups. Such a policy would not only be a more cost-efficient use of limited resources; it is the right thing to do.

Policy Proposals

There are many policy routes to broadening savings and asset ownership. The tax system should be employed to promote these important policy goals, not to work against

Protection Act of 1996), would not trigger legal complaints regarding non-highly-compensated employee discrimination in plan administration. See O'Hare and Amendola (2007); Public Law 109–280, Sec. 902.

[50] See VanDerhei (2010); Butrica and Johnson (2011).

[51] See, for example, research conducted soon after the expansion of saving incentives like the 401(k) and the IRA in the 1980s: Engen, Gale, and Scholz (1996).

them. Some routes can be achieved through small changes to existing financial products, government programs, or tax rules, while others require new structures and broad reforms. By whatever means, promoting savings should be a central element of any future tax-reform efforts.

Pursuing measures through tax reform that simplify rules and consolidate the many existing tax-advantaged accounts would be a step in the right direction. Still, this approach alone would be unlikely to significantly raise the saving rate of low- and middle-income taxpayers, those being the very households that could benefit the most from increased savings. The successful improvement of the saving process will require not just a more coherent framework, but also one that ultimately creates an inclusive savings platform and a fairer incentive structure. An effective approach requires that all people have a place to save, that the process of saving is easy and accessible, and that there are clear and tangible benefits for all income groups participating in the saving process.

Two proposals for tax reform are offered here. The Financial Security Credit would offer a meaningful, accessible, and flexible incentive to save, and the Universal 401(k) would ensure that everyone is connected to a high-quality, long-term savings plan.

Create a Financial Security Credit

The scale of existing infrastructure provided by the tax filing process presents an attractive alternative method for building retirement security, particularly among those workers who are most disadvantaged by the employer-based system. By providing a direct-match incentive to save and a vehicle to support saving for multiple purposes including emergencies, the Financial Security Credit would fill the gaps where current policy fails. This proposal would have the added benefit of shoring up the lack of short-term saving incentives, which could bring longer-term goals like saving for retirement within reach for more savers.

The Financial Security Credit would support low- and middle-income individuals and families who choose to invest in their economic future by saving at tax time by: (1) allowing households without a preexisting account to open one directly on their federal income tax form, thereby extending the opportunity to save to those with little or no previous savings experience; (2) supporting a variety of restricted savings products designed to meet a range of savings needs, including IRAs, 401(k)s, 529 College Savings Plans, Coverdell Education Accounts, U.S. Savings Bonds, and certificates of deposit; (3) matching every dollar that low- and moderate-income tax-filers deposit in a designated savings product with an additional dollar from the federal government, up to a $500 annual maximum; and (4) depositing the matched credit directly into a designated account, rather than returning it in the form of a refund, to help build sufficient balances.

The successful improvement of the saving process will require not just a more coherent framework, but also one that ultimately creates an inclusive savings platform and a fairer incentive structure.

One of the most innovative features of the Financial Security Credit is that it does not restrict participation to those with a pre-existing savings account, but rather extends the opportunity to save even to those with little or no previous saving experience. The ability to open an account directly on a tax form was cited in pilot studies as one of the most effective mechanisms for generating savings among disadvantaged groups, and led to much higher savings for unbanked families.[52] This proposal's capacity to increase savings among those who would not otherwise respond to existing savings incentives is a key indication of its effectiveness. Furthermore, it is estimated that the Financial Security Credit would cost only $4 billion

[52] Black and Cramer (2011), 9. For this 2011 paper, the Financial Security Credit was referred to as the "Saver's Bonus."

a year to administer, which is less than 3 percent of the federal government's existing outlays in one year to provide retirement savings tax incentives.[53] Rather than provide benefits for behavior that produces little net new savings, as we have under our current system, the comparatively miniscule cost expended on this worthy proposal would be put to use to implement a proven method of inducing saving among those for whom saving would be otherwise unaffordable.

Establish a Universal 401(k) System

To ensure that all workers, regardless of employment status or work history, are enrolled in a retirement savings plan, future policy should support a Universal 401(k) system. This policy would be modeled on the components of the current employer-based 401(k) system, which has had success in limited areas, while making modifications to achieve broader coverage and to motivate higher rates of deposits for a wider population. Specifically, a worker-based Universal 401(k) would include: (1) a single, portable account that provides coverage for all employees, including those in part-time, contract, temporary, or other non-standard arrangements; (2) a new flat, refundable tax credit of 30 percent for all retirement savings by all workers; and (3) government matching contributions for the initial savings of lower- and middle-income families. To facilitate easier deposits into Universal 401(k) accounts, automatic payroll deductions would be offered by employers. A "clearinghouse" would also be set up to create default accounts for workers with very low incomes who might initially have minimal account balances, or who were otherwise unable to navigate the process of setting up and managing a private account.

This proposal would ensure greater retirement savings among low- and middle-income Americans through the favorable interaction of its design features. By delivering both the refundable credit available to all workers, and the matching contributions available to low-income workers, in the form of deposits directly into Universal 401(k) retirement accounts, the policy would establish not only a greater saving incentive for this less advantaged population of earners, but also a more sustainable model for delivering saving incentives in a form that more quickly builds assets for retirement. Furthermore, the refundable credit would function like an employer match, which has been shown to be an effective inducement to save, but would be offered without regard to the status of a specific employer's retirement plan.[54] Yet regardless of the fact of whether an employer offers a retirement savings plan, the cost of this proposal would be near zero for nearly every employer. Since most employers use automatic payroll systems, all it would take is an extra line on the IRS Form W-4 to route employee contributions to an existing employer plan, or, in the case of an employer without a plan, to route the contributions to one of the plans set up through the government clearinghouse on behalf of the employee.[55] The cost-effectiveness of this low-cost and high-impact proposal should make it especially appealing to a broad range of political actors.

Given the enormous inefficiencies and inequities in the delivery of personal savings incentives under current tax policy, it is imperative that meaningful reform of the tax system is diligently pursued. A framework for reform of the kind outlined here, one that promotes simplicity, efficiency, inclusivity, and fairness, would meet that standard and promote not only more net new savings for the population as a whole, but also greater rates of saving among the most financially vulnerable households. It is these improved outcomes, for the wider society and for its most economically disadvantaged members, for which tax reform must be pursued. Enabling personal savings for all, not just those fortunate enough to have the requisite incomes to take full advantage of our existing set of tax benefits, would spur economic mobility and put prosperity within reach for millions of Americans.

[53] "The Financial Security Credit" (2012), 2; see figure 1.

[54] Calabrese (2007), 9-10.

[55] Ibid., 11-12. For more information on the Universal 401(k) proposal, see Calabrese (2011).

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