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# COULD THE SAVER'S CREDIT ENHANCE STATE COVERAGE INITIATIVES?

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## Introduction

At any given moment, about half of private sector workers are not covered by any sort of employer-sponsored retirement plan. This coverage gap means that many households must rely exclusively on Social Security in retirement. Since most of those without coverage work for small employers, policymakers for decades have tried to solve the problem by introducing simplified retirement plans. But these initiatives have not worked.

Recognizing the difficulty in getting small businesses to adopt plans, the Obama Administration proposed "Automatic IRAs" in 2009 to cover the uncovered. But no progress has been made at passing federal legislation. So several states have stepped into the breach and are setting up their own plans for uncovered workers. These state initiatives could potentially be enhanced by the federal Saver's Credit, an existing tax incentive that could, in essence, provide a match on contributions to a state plan. But the current credit is limited and not refundable; proposed legislation would extend the credit and make it refundable. This *brief,* using Connecticut as an example, examines the effectiveness of the current Saver's Credit and the proposed changes.

The discussion proceeds as follows. The first section describes the coverage problem, the state initiatives in general, and Connecticut's tentative plan in particular. The second section presents the current version of the Saver's Credit and how it works in theory and practice. The third section describes the impact of a typical legislative proposal to expand the Saver's Credit and make it refundable. The final section concludes that, in its current form, the Saver's Credit is limited in its effectiveness as a government match mechanism. However, changing the phase-out structure and making the credit refundable could considerably enhance state retirement initiatives by encouraging participation and increasing the amount of money going into the plans.

## Closing the Coverage Gap

With the need for retirement saving growing, the lack of access to an employer-based plan has emerged as a pressing problem. In Connecticut, as in the rest of the nation, the largest coverage gap occurs among workers at small firms (those with fewer than 100

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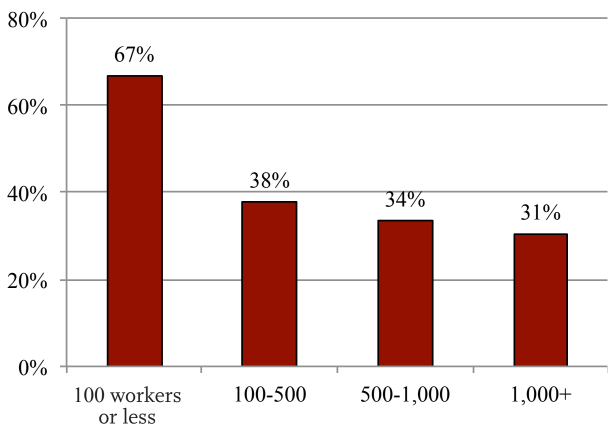
workers) (see Figure 1).[1] For decades, policymakers have tried to solve the problem by introducing simpler products that could be adopted by small business.[2] But these efforts have not moved the needle.[3]

Figure 1. Percentage of Connecticut Private Sector Workers Not Offered a Retirement Plan, by Employer Size, 2014




*Source:* Authors' calculations from U.S. Census Bureau, *Current Population Survey (CPS) March Supplement* (2015).

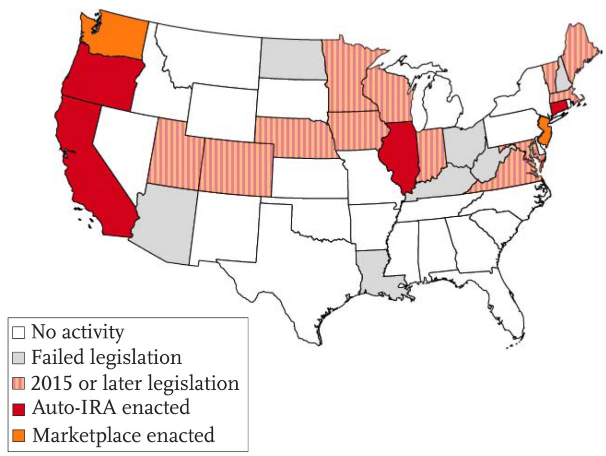
Recognizing the difficulty in getting small employers to introduce employer-sponsored plans, a number of proposals have emerged at the federal level to improve coverage.[4] Perhaps the best known is the Obama Administration's proposed Automatic IRAs, which would require that employers without workplace retirement plans enroll their workers in IRAs, with contributions from payroll deductions.[5] Employees would be free to opt out, but eligible employees who did contribute would have their contributions matched by the Saver's Credit. Unfortunately, no legislation has been enacted at the federal level to solve the coverage problem.[6] Instead, the states have stepped into the breach.

## *State Initiatives*

California led the way with an auto-IRA plan. In 2012, the state enacted the California Secure Choice Retirement Savings Program, and three other states – Connecticut, Illinois, and Oregon – have also passed legislation following the auto-IRA model.[7]

Two states – Washington and New Jersey – have adopted a marketplace approach, where participation is voluntary.[8] Other states, such as Massachusetts, are toying with the idea of having both an auto-IRA system and a state-run system of multiple employer plans (MEPs).[9] Figure 2 shows where plan activity has taken place.[10]

Figure 2. State Retirement Security Activity, as of March 2016




*Source:* Authors' analysis.

## *A Closer Look at Connecticut*

Half of Connecticut's private sector workers are not offered a retirement plan. Of this group, 50 percent are married, 40 percent are single, and the rest are heads of households or non-filers (see Table 1).

Table 1. Income Tax Status of Connecticut Workers Not Offered Retirement Plan, 2014

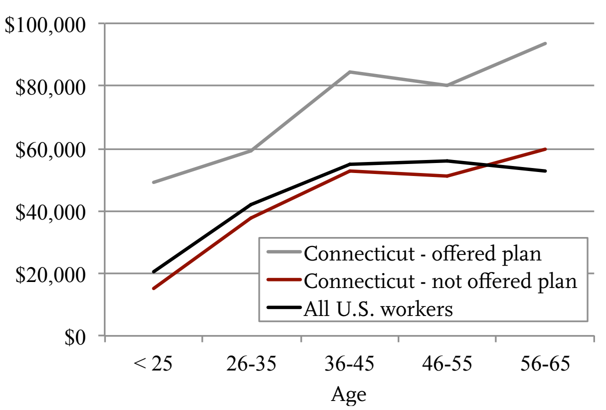
| Household status | Percentage of total |
|---|---|
| Married | 50% |
| with children | 32 |
| without children | 17 |
| Head of household | 6 |
| Single | 40 |
| Non-filers | 4 |
| Total | 100 |
| Addendum: Number of people | 757,080 |

*Source*: Authors' calculations from 2015 CPS.

Although uncovered workers range in age from 18 to 80, 37 percent of the singles are under 25, while the bulk of married and heads-of-households fall into the 26-45 range.

Connecticut has the second highest wages in the nation, just behind New York, so that Connecticut's average wage for the workers not offered a retirement plan is equal to the average wage for the nation (see Figure 3). High wages have two implications. First, because of Social Security's progressive benefit formula, Connecticut's workers will receive relatively low replacement rates – benefits as a percentage of pre-retirement earnings – so supplementary retirement saving is particularly important. Second, relative to other states, fewer workers in Connecticut are likely to be eligible for the Saver's Credit, which is based on household income.

Figure 3. Average Wages of Private Sector Workers in Connecticut, by Age, 2014




*Source:* Authors' calculations from 2015 CPS.

Nevertheless, it is useful to take a close look at Connecticut because it is quite far along in its process of expanding retirement savings coverage. Connecticut has completed its feasibility study and is asking the legislature for approval to get the program up and running. The current version of the Connecticut plan requires employers that have more than five employees and do not offer a retirement plan to automatically deduct 6 percent of their employees' wages and deposit those funds in an IRA, where they will be invested in an age-appropriate target date fund. Employees have the right to opt out or to reduce their contribution rate. The question under consideration here is the extent to which the existing Saver's Credit and proposals for an expanded credit could enhance Connecticut's proposed program. The potential benefits from the Saver's Credit include lower opt-out rates and more money going into the plans. Evidence suggests that such benefits have been associated with matching contributions in 401(k) plans.[11]

# The Saver's Credit

The federal Saver's Credit gives a special tax break to low- and moderate-income taxpayers who are saving for retirement. It was introduced in 2001 and scheduled to expire in 2006.[12] The Pension Protection Act of 2006, however, made the credit permanent and indexed the income thresholds to inflation. The Saver's Credit is in addition to the other tax benefits for retirement saving accorded to 401(k) plans and IRAs.

Depending on the household's adjusted gross income (AGI), it can claim a credit for 50 percent, 20 percent, or 10 percent of the first $2,000 contributed to a retirement account during the year. Thus, the maximum credit is $1,000 for an individual and $2,000 for a married couple when each is contributing to a plan. Table 2 shows the 2016 AGI limits for married couples, heads of households, and single individuals.

Table 2. Adjusted Gross Income Limits for Saver's Credit, 2016

| Credit | Married couples | Heads of households | Single individuals |
|---|---|---|---|
| 50% | $37,000 or less | $27,750 or less | $18,500 or less |
| 20 | $37,001-$40,000 | $27,751-$30,000 | $18,501-$20,000 |
| 10 | $40,001-$61,500 | $30,001-$46,125 | $20,001-$30,750 |

*Source*: Internal Revenue Service (2016).

In theory, the Saver's Credit looks great. Married couples with combined income of $37,000, who contribute $2,000 to their IRAs under Connecticut's new program are eligible for a $1,000 credit. The net result is the equivalent of a 50-percent match on the contribution ($1,000/$2,000).

Table 3. Saver's Credits in Theory and Practice for Connecticut Workers Not Offered an Employer-Sponsored Pension, 2014

| Income quartile | 6% contribution | Average credit rate | Credit amount | | Match rate | |
|---|---|---|---|---|---|---|
| | | | Theory | Practice | Theory | Practice |
| Lowest | $356 | 0.32 | $138 | $34 | 39% | 10% |
| 2nd | 1,204 | 0.22 | 244 | 157 | 20 | 13 |
| 3rd | 2,368 | 0.05 | 93 | 30 | 4 | 1 |
| Highest | 4,856 | 0.00 | 8 | 4 | 0 | 0 |

*Source*: Authors' calculations from 2015 CPS.

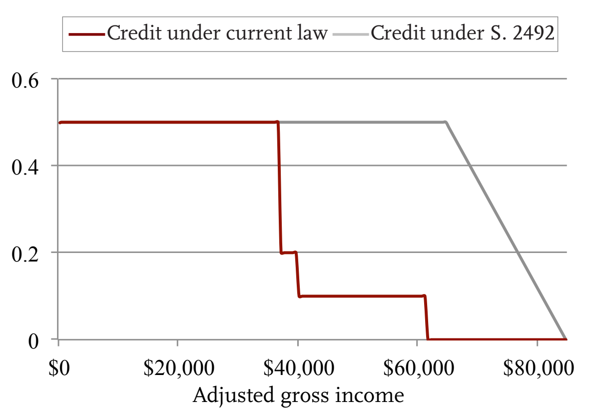
The problem is that the Saver's Credit does not work as smoothly as suggested above. The first issue is that the credit is nonrefundable so it can reduce the required tax repayment to zero but not below.[13] For example, if the couple had a tax liability of only $750, their credit would be limited to that amount. Second, the Saver's Credit is often not usable for taxpayers with children, because it is applied after the non-refundable Child Tax Credit.[14]

Table 3 compares for Connecticut's 757,080 uncovered workers, by income quartile, the Saver's Credit they would receive *in theory* assuming it was refundable and *in practice* recognizing the impact of the constraints.[15] The *Current Population Survey* provides data on household wages, AGI, and tax liability. The contribution is set equal to 6 percent of current wages (subject to IRA contribution limits), and the Saver's Credit rate is 50 percent, 20 percent or 10 percent depending on the household's income. The dollar amount of the credit, in theory, is determined by the credit rate multiplied by the contribution amount; the credit, in practice, is limited by the tax liability (for households with children, it is the tax liability after the Child Tax Credit).[16] The match rate is the ratio of the Saver's Credit to the worker's contribution. Clearly under current law, practice falls far short of theory, and the Saver's Credit would do little to enhance Connecticut's auto-IRA program.

## Proposals to Improve the Saver's Credit

Several bills have been introduced to improve the effectiveness of the Saver's Credit. The most recent is the *Encouraging Americans to Save Act* (S. 2492). Similar to many of the other proposals, S. 2492 makes the credit refundable to a retirement savings account, expands coverage to middle-income households, and introduces a smooth phase-out of the credit (see Figure 4).[17] Specifically, S. 2492 would provide a 50-percent credit up to a maximum contribution of $1,000 each taxable year for all households with AGI less than or equal to $65,000 (if married filing jointly).[18]

Figure 4. Saver's Credit Rate under Current Law and S. 2492 for those Married Filing Jointly, 2016




*Source:* Authors' calculations.

The impact of the proposed legislation on Connecticut's uncovered workers is shown in Table 4. Even though the maximum credit under S. 2492 ($500) is less than under current law ($1,000), making the credit refundable would greatly increase the money going to low- and moderate-income savers. Those in the lowest quartile would see a match equal to 44 cents per dollar and those in the second quartile 35 cents per dollar. These amounts are even larger than the theoretical amounts presented in Table 3, because the Saver's Credit under S. 2492 would be extended to households with higher AGI levels. In short, expanding the Saver's Credit would greatly increase the efficacy of Connecticut's savings program and would provide even greater enhancements in lower income states.

Table 4. Saver's Credit and Match Rates under Current Law and S. 2492 for Connecticut Workers Not Offered an Employer-Sponsored Pension, 2014

| Income quartile | Credit amount | | Match rate | |
|---|---|---|---|---|
| | Current law | S. 2492 | Current law | S. 2492 |
| Lowest | $34 | $157 | 10% | 44% |
| 2nd | 157 | 418 | 13 | 35 |
| 3rd | 30 | 265 | 1 | 11 |
| Highest | 4 | 43 | 0 | 1 |

Note: The $65,000 threshold in S. 2492, which is adjusted each year for inflation, was assumed to have been $63,000 in 2014.
*Source:* Authors' calculations from 2015 CPS.

# Conclusion

The current design of the Saver's Credit limits its effectiveness as a government match program for state retirement initiatives. Because the credit is non-refundable, it provides the least benefit for households with the lowest wages. Proposals to redesign the credit by making it refundable, smoothing the phase-out structure, and expanding eligible income brackets could considerably enhance state retirement initiatives by encouraging participation via a lower opt-out rate and increasing the money going into the plans.

# Endnotes

1 For example, in 2014, 55 percent of private sector workers ages 25-64 without coverage worked for a firm with fewer than 100 employees (authors' calculations from the 2015 *Current Population Survey March Supplement*).

2 The SIMPLE (Savings Incentive Match Plan for Employees of Small Employers) is a prime example. SIMPLE plans, which were introduced in 1996, generally replaced SARSEPs (Salary Reduction Simplified Employee Pensions), which were the earlier pension provisions for small employers. Firms with fewer than 100 employees can offer a SIMPLE, which can be set up as an IRA for each employee or as a 401(k) plan. The SIMPLE has a number of advantages. Firms can either match the contributions or contribute a fixed percentage of their payroll. Once established, the SIMPLE is administered by the employer's financial institution and does not even require the employer to file an annual financial report. Furthermore, most employers are eligible for modest tax credits for the first three years after starting the SIMPLE.

3 Studies by financial services providers suggest that lowering administrative and legal costs could potentially increase plan adoption (see Kalamarides, 2010 and AARP, 2015), but it is not clear why this approach would succeed given the lack of impact that similar efforts have had in the past.

4 For a brief description, see Ellis, Munnell, and Eschtruth (2014).

5 This proposal grew out of a 2006 study for the Retirement Security Project (Iwry and John 2006).

6 The Treasury introduced the *my*RA program in 2015, which is a "starter" savings account to encourage non-savers to acquire the habit of saving. It is voluntary for employers to adopt and does not automatically enroll employees (U.S. Department of the Treasury 2016).

7 State of California Legislature (2012); State of Connecticut General Assembly (2014); State of Illinois General Assembly (2014); and State of Oregon Legislature (2015).

8 State of Washington Legislature (2015); and State of New Jersey Legislature (2016).

9 The system could be either directly run by the state or run by a third party overseen by the state. See Commonwealth of Massachusetts (2015).

10 For a broader perspective on state savings initiatives, see Munnell, Belbase, and Sanzenbacher (2016). For additional details on specific states, see AARP (2016), Georgetown University Center for Retirement Initiatives (2016), and Pension Rights Center (2016).

11 With respect to participation, prior research has shown that both the introduction of and increases to employer matches have a positive effect. With respect to contributions, researchers have found that a match leads to higher total 401(k) contributions, though the studies show some variation in the effects on the employee's contribution. Specifically, some studies have found that increasing the match rate raises employee contributions. Others have found that the presence of a match raises employee contributions but the level of the match does not. Finally, still other studies have suggested that an increase in the match *lowers* employee contributions but not by enough to offset the effect of the higher match on total contributions. For more details, see Engelhardt and Kumar (2007) and Choi, Laibson, and Madrian (2004).

12 The Saver's Credit came about as a spinoff of more ambitious proposals introduced by President Clinton – Universal Savings Accounts in 1999 and Retirement Savings Accounts in 2000. These proposals would have devoted a portion of projected budget surpluses to provide matching funds for new individual saving accounts, with the match concentrated on low- and middle-income households. Neither of these proposals was enacted, but the idea of providing a federal match to encourage retirement saving survived in the form of the Saver's Credit. The Saver's Credit proposal was not accompanied by any new retirement accounts; instead it provided a credit for individuals contributing to 401(k)s and IRAs. The Credit was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001.

13 The original Saver's Credit proposal had a refundable credit, but this feature was eliminated before the legislation was adopted. For prior research on the Saver's Credit, see Duflo et al. (2007); Gale, Iwry, and Orszag (2004); Koenig and Harvey (2005); and Ramnath (2013).

14 The Saver's Credit is applied before other refundable credits, such as the Earned Income Tax Credit.

15 The median AGI for the income quartiles are about $10,000, $24,000, $53,000, and $125,000. The wage brackets for the quartiles are less than $14,000, $14,001-$29,000; $29,001-$56,000, and $56,000 and over.

16 Even the "practical" amount is not realistic given that many low-income individuals do not know that such a credit is available.

17 S. 2492 deposits the entire Saver's Credit into a worker's retirement account. In contrast, an earlier proposal would have first allocated the Saver's Credit to paying off the household's tax liability, depositing any residual into a retirement account if the worker chose to do so.

18 The income thresholds for those filing as heads of households or single are $48,750 and $32,550 respectively.

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