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SAVINGS AND TAX REFORM:
ANALYSIS OF THE SAVINGS PROPOSALS OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

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In recognition of the challenges inherent in pursuing tax reform, President Bush established an advisory panel in January 2005 which was asked to develop options for reforming the tax code. The President's Advisory Panel on Federal Tax Reform took its mandate seriously, and its final report, issued in November, includes a range of far reaching ideas and specific proposals worthy of public debate. A number of recommendations would affect fundamental decisions about how households choose to save or consume, and thus directly impact the broader process of asset building. This issue brief focuses on this aspect of the Panel's work, beginning with a description of the proposals with respect to savings, followed by an analysis of the effects of these proposals on lower-income and lower-resource households, and a presentation of some alternative ways to promote savings within the context of tax reform.

Given the complexity of today's tax code, the Panel's call for simplification should create a more efficient tax system, yet the impact of their savings proposals is less clear. This is because the Panel relies on incentives that promote asset shifting rather than net new savings. A more effective way to encourage savings would be to create an accessible and inclusive savings platform, one that would be supported by targeted incentives and policies to ensure maximum participation in the savings process.

INTRODUCTION

In previous budgets the Bush Administration has proposed a significant restructuring of existing tax-preferred accounts into a more consolidated system, one with fewer types of accounts, simplified rules, and expanded benefits.[2] But these proposals have not been pushed actively by the White House or received much attention in Congress. In the coming year the White House is expected to continue its advocacy to "make the tax cuts permanent," signaling a general interest in reducing income tax rates and shifting the tax base away from capital, but will these proposals be expanded to include calls for a more dramatic overhaul of the tax code?

Tax laws are amended often in the legislative process, especially in recent years with the growing popularity of pursuing policy objectives through targeted tax expenditures. Major overhauls of the tax code are less frequent, the last one occurring in 1986 during the second term of the Reagan Administration. Getting Congress to act on this type of legislation is difficult because the task is inherently complex, involves making hard political choices, and usually requires bipartisan support. Perhaps in recognition of the challenge inherent in pursuing tax reform, President Bush opted to convene an advisory panel which was asked to develop options for reforming the tax code. This body was established by Executive Order in January of 2005 and was specifically directed to present revenue neutral policy recommendations that would:

- Simplify the tax code to reduce administrative costs and compliance burdens;

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[1] Reid Cramer is Research Director of the Asset Building program at the New America Foundation.
[2] The proposal to create Retirement Savings Accounts (RSAs), Lifetime Savings Accounts (LSAs), and Employer Retirement Saving Accounts (ERSAs) are described in the President's Budget (2005).

- Share the burdens and benefits of tax policy in an “appropriately progressive manner.”
- Recognize historic importance of homeownership and charitable giving; and
- Promote investment, economic growth, job creation, and savings with the intent to strengthen America’s competitiveness in the global economy.[3]

The President’s Advisory Panel on Federal Tax Reform convened a series of public meetings, received analytical support from staff at the Treasury Department, and deliberated privately over the course of the year. The panel issued its final report in November 2005.[4]

The panel’s report makes a compelling case for tax reform and includes a range of far reaching ideas and specific proposals worthy of public debate. A number of their recommendations would affect fundamental decisions about how households choose to save or consume, and thus directly impact the broader process of asset building. This issue brief focuses on this aspect of the panel’s work, beginning with a description of the panel’s proposals with respect to savings, followed by an analysis of the effects of these proposals on lower-income and lower-resource households, and a presentation of some alternative ways to promote savings within the context of tax reform.[5]

Given the complexity of today’s tax code, action on the panel’s call for simplification should create a more efficient tax system, yet the impact of their savings proposals is less clear. This is because the panel relies on incentives that promote asset shifting rather than net new savings. A more effective way to encourage savings would be to create an accessible and inclusive savings platform, one that would be supported by targeted incentives and policies to ensure maximum participation in the savings process.

DESCRIPTION OF THE TAX PANEL’S SAVINGS PROPOSALS

The panel’s final report includes two unanimously endorsed reform options, along with an analysis of several other options that were considered but did not receive consensus support. The first option is called a Simplified Income Tax (SIT) plan and the second is called the Growth and Investment Tax (GIT) plan. Each has some beneficial features that, if implemented, could contribute to creating a tax system with simplified rules, a broader tax base, and, potentially, would justify lower marginal tax rates. While the two plans differ with respect to how capital income is taxed and how businesses investment is expensed, the plans share many characteristics. Both would entail a repeal of the Alternative Minimum Tax, a reduction of existing tax breaks, a lowering of the tax rate on capital income, and a restructuring of current savings incentives.

As they pursued their work, the panel acknowledged that “it became clear that both reform proposals shared a common set of goals that could be achieved with identical recommendations.”[6] Accordingly, with few exceptions, analysis of each plan’s impact with respect to savings and potential implications for asset building activities can be considered together.

Specifically, the panel recommends:

- Creating two new tax credits (a Family Credit and a Work Credit) that would replace existing credits and deductions linked to work and family status.

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[3] George W. Bush, “Executive Order 13369: President’s Advisory Panel on Tax Reform,” January 7, 2005.
[4] Former Senator Connie Mack (R-FL) chaired the Panel and former Senator John Breaux (D-LA) served as Vice Chairman. Additional members included William Frenzel, Elizabeth Garrett, Edward Lazear, Timothy Muris, James Poterba, Charles Rossotti, and Liz Ann Sonders. The Panel’s final report and other related material is available at www.taxreformpanel.gov.
[5] An excellent description and analysis of the Tax Panel overall recommendations beyond the savings issues is provided by Leonard Burman and William Gale. “A Preliminary Evaluation of the Tax Reform Panel’s Report.” Tax Notes, December 5, 2005.
[6] President’s Advisory Panel on Federal Tax Reform, page 60.

- Simplifying tax benefits for charitable giving and homeownership by changing these benefits from tax deductions to tax credits that would be capped but available to all taxpayers.
- Providing a simplified way to save free of taxes by consolidating the existing array of tax-preferred accounts into 3 account types (Save at Work plans, Save for Retirement accounts and Save for Family accounts).

Family Credit

The proposed Family Credit would replace the standard deduction, personal exemption, head of household filing status, and child tax credit. This credit would be available to all taxpayers at a value of $3,300 for married couples, $2,800 for unmarried persons with a child, and $1,150 for taxpayers claimed by others as a dependent. An additional $1,500 credit for each additional child would be provided. The panel suggests that this change would simplify the filing process by "transforming these duplicative and overlapping provisions."[7] The Family Credit would not be restricted based on income and would be adjusted annually for inflation. Unlike the current system where a taxpayer must choose between claiming the standard deduction and itemizing their deductions, the benefit of the Family Credit would be available regardless of other tax benefits.

<u>Existing Provisions</u>		
Standard Deduction		
Personal Exemption	→	New Family Credit
Child Tax Credit		
Head of Household Filing Status		

Work Credit

The proposed Work Credit would replace the Earned Income Tax Credit (EITC) and the refundable portion of the Child Tax Credit, which have been effective tools for transferring income and encouraging work but have created complexity and high administrative burdens. The new Work Credit is designed to maintain a work incentive "comparable to that of the current system" by providing a maximum credit similar to the combined amounts of the current EITC and refundable child tax credit.[8] It would increase as earnings go up and still be tied to the number of children in a household. The Work Credit would start at $412 for workers with no children, increasing to $3,570 for workers with one child and $5,800 for workers with two or more children. It would be adjusted annually for inflation. Unlike the Family Credit, the benefits of the Work Credit would phase-out for households whose earnings exceeded a defined income threshold.

<u>Existing Provisions</u>		
Earned Income Tax Credit	→	New Work Credit
Refundable Child Tax Credit		

Save at Work Plans

The panel proposes to combine all of the existing employer-based retirement savings plans into one type of plan that would be administered by any employer. These Save at Work plans would have a single set of administrative rules. Many of the current rules were implemented to ensure that highly paid employees

[7] President's Advisory Panel on Federal Tax Reform, page 63. Among the benefits would be creating a single definition of "child," replacing the multiple ways such offspring are currently defined in different sections of the tax code.

[8] President's Advisory Panel on Federal Tax Reform, page 68.

don't receive a disproportionate share of the benefits of these plans. These "nondiscrimination rules" would be retained and applied to the new plan structure. The panel also proposes to implement a set of rules for small businesses that would lower their costs in offering these plans.

The panel argues that a well-designed savings plan has the potential to overcome many current impediments to saving. The consolidated rules will create a stream-lined structure that can be built upon with features that promote savings, which the panel calls AutoSave. Although these features would not be mandatory, they reflect the potential benefits of providing access to a savings plan structure. These features include the ability to automatically enroll employees in a plan, automatically increase their contributions over time, and automatically invest these contributions in balanced and diversified portfolios that can take advantage of low fees and extended time horizons.

Existing Provisions		
401(k) Plans		
SIMPLE 401(k) Plans		
403(b) Plans	→	Save at Work Plans
Governmental 457(b)		
SARSEP		
SIMPLE IRA		

Save for Retirement Accounts

Existing tax-preferred retirement savings accounts include vehicles that have post-tax and pre-tax benefits. These would be replaced by a single account vehicle, the Save for Retirement account. These accounts would allow a taxpayer to make after-tax deposits of up to $10,000 in accounts where the earnings would be tax-free. No income limits would be imposed on taxpayers making these deposits and the contribution limits would be indexed to inflation. This structure is similar to current Roth IRAs and, like Roth IRAs, these accounts are intended to supplement Save at Work plans. In an important departure from current Roth IRA rules, the panel proposed that qualified distributions from these accounts be restricted to retirement security, death and disability. Non-qualified distributions would be reported as income and subjected to an additional 10 percent tax on earnings. Current Roth IRA rules allow for an exemption to the 10 percent penalty if distributions are used for homeownership, post-secondary education, and medical expenses, but the panel believes these will no longer be necessary if Save for Family accounts are also created.

Existing Provisions		
Individual Retirement Accounts		
Roth IRAs	→	Save for Retirement Accounts
Nondeductible IRAs		

Save for Family Accounts

Beyond retirement, Americans will be able to save for specific purposes, such as health, education, and purchasing a home, through Save for Family accounts. These accounts would allow every taxpayer to save $10,000 each year for these purchases, replacing a number of existing accounts. These accounts would also not be restricted by income, age, family structure, or martial status. Contributions will be after-tax and earning will grow tax free. Taxpayers will be afforded extra flexibility to make withdrawals from these accounts, withdrawing up to $1,000 of earnings each year tax-free for any reason. Non-qualified distributions that exceed this $1,000 will be considered taxable income and subject to an additional 10 percent tax.

<u>Existing Provisions</u> Health Savings Accounts Archer Medical Savings Accounts Flexible Spending Arrangements Coverdell Savings Accounts Section 529 College Savings Plans	→	Save for Family Accounts

Refundable Saver's Credit

The current income tax structure relieves many lower-income households from paying any income tax. While they pay payroll taxes, many also receive tax refunds as a result of the Earned Income Tax Credit and Child Credit. The panel recognizes that the tax-free features of the its saving proposals would "provide little, if any, additional tax benefit if these taxpayers save for their future."[9] To address this, the panel proposes strengthening the existing Saver's Credit, a provision that offers taxpayers of low- and moderate-income a tax credit for contributions to qualified retirement savings accounts. In current law the Saver's Credit offers a credit for 10, 20, or 50 percent for contributions of up to $2,000 made to IRAs or employer-based defined contribution plans. The credit phases out with higher earnings. The credit's effectiveness has been limited by its lack of refundability—which makes it unavailable to taxpayers with low or no tax liability—as well as a steep and complex phase-out structure.

Addressing these design flaws, the panel proposes a new refundable Saver's Credit. This new credit would be calculated on a per-person basis; as with the current credit, the maximum annual contribution would be $2,000 at a credit rate of 25 percent, making the maximum credit amount $500. At this rate, the credit would effectively offer an implicit government match rate of 33 percent because a $2,000 contribution would reduce a taxpayer's liability by $500. In other words, a contribution of $1,500 would net an additional $500 credit that could lead to a balance of $2,000 if the full value of the credit was deposited in a savings account.

PRELIMINARY ANALYSIS

Our current tax code is deficient from a number of perspectives and the case for reform is strong. The consensus agenda is to identify the means to revamp the system of funding government in ways that are fair, efficient and simple. The final report of the President's Advisory Panel on Federal Tax Reform represents a serious effort to analyze the limitations of the current system and propose some alternatives; their recommendations deserve consideration and debate. As other analysts have noted, the panel was constrained by the set of parameters laid out in the original Executive Order—the primary restriction being the requirement to propose revenue neutral recommendations. Of course, tax rates can be adjusted up or down in the current system or in a new structure, so while the specific rate levels and eligibility thresholds proposed by the panel should not be discounted, the substantive core of their recommendations could be implemented with different rates.

The panel made other decisions that affected the form that their recommendations would take. These included opting to present only recommendations that received consensus support. This meant that their report included an assessment of several other far reaching reform proposals, such as implementing a value-added tax and a national retail sales tax, but only two proposals that received unanimous support were presented as recommendations. These two have much in common, and approach the consolidation and simplification of savings incentives identically.

[9] President's Advisory Panel on Federal Tax Reform, page 122.

The Growth and Investment Tax Plan makes a greater effort to move toward a consumption tax structure and in this manner could be expected to alter behavior in the aggregate with respect to savings and investment. The GIT plan proposes combining a change in the manner that business investment is calculated with a flat-rate tax on capital income and maintenance of a progressive tax on labor income. This theoretically moves the tax system toward a consumption tax because it reduces the household-level tax on capital income. Still the GIT plan is a hybrid system, which retains a tax on both capital and labor income. A pure consumption tax, even one that is implemented with progressive rates, would be expected to raise the return to saving and lower the cost of future consumption relative to current consumption and lead to economic growth. The implications and choices inherent in implementing such a system and their impact on lower-income and lower-resource households merit further analysis. In its report, the panel recognized the merits of this approach but ultimately declined to endorse the necessary structural changes to the tax system.[10] What both the endorsed plans share is a move to restructure the current savings incentives embedded in the tax code, mainly through a consolidation and simplification, but also through an endorsement of refundability.

Debate of the panel's work should recognize that any change to the tax system will have distributional effects. New tax rules will be expected to increase tax liabilities for some and lower it for others, which immediately create a political challenge for any advocates of specific reforms. Not surprisingly, the panel's work has received a mixed reception. For some, it was not bold enough and others felt it went too far. Specific provisions have been criticized and praised. Anticipating the debate, the panel argued in its report that its recommendations should be considered as a whole and not dissected from one another. This is understandable but not necessarily helpful. The issues embodied in a tax overhaul reach a level of complexity that exceed the comprehension of even well-informed analysts and many of the panel's ideas, such as the ones related to savings and asset building activities, could easily be pursued independently of one another in an effort to improve the tax code.

For example, the proposal to replace the homeowner's mortgage deduction with a Home Credit is good policy because it would promote homeownership among households that would benefit from it the most. Currently, the homeowner's deduction is an expensive provision of the tax code, costing the government an estimated $76 billion a year in lost receipts. Not surprisingly, most of the benefit of this provision goes to higher-income households since mortgages up to $1 million along with those of second homes, qualify for the benefit.[11] Further, the tax deduction serves as a windfall since many of these households would purchase homes or remain homeowners even without the provision. At the same time, many lower-income households that are striving for homeownership or own less expensive homes don't qualify for the benefit because their potential mortgage interest deduction does not exceed the standard deduction offered all taxpayers. The panel's proposal to replace the current income deduction linked to mortgage interest with a tax credit equal to 15 percent of mortgage interest paid and capped at levels linked to the average regional price of housing is a more effective approach of using the tax code to support homeownership. It creates an incentive through the tax code that is accessible, meaningful, and limited in ways that are fiscally responsible yet potentially beneficial.

The Potential of Consolidation and Simplification

Similarly, the consolidating of existing credits and deductions linked to children, families, and work could be pursued independently from more fundamental choices about the structure of a tax system. Such consolidation would undoubtedly affect savings behavior. Although many other factors will determine the advantages and disadvantages of tax reform for specific taxpayers, simplification would have broad benefits. That is because complex and often conflicting rules lead to confusion, raise compliance burdens,

[10] The Panel's report describes their deliberation as follows: "Several Panel members were concerned that the Growth and Investment Tax Plan would not move far enough towards a consumption tax because it retains a household-level tax on capital income. The Panel therefore developed a proposal for a consumption tax, referred to as the Progressive Consumption Tax Plan, which would not tax capital income received by individuals. Although the Progressive Consumption Tax Plan proposal did not emerge as a consensus recommendation, the interest in it led to substantial discussion." page 152.

[11] According to the U.S. Congress Joint Committee on Taxation (2003), 90 percent of the homeowner's deduction tax expenditure reaches households with incomes above $50,000 a year.

and lower the efficiency of the tax system. The panel's choice to pursue simplification through a consolidation of tax provisions into two broad categories related to work and family is a logical first step.[12]

The proposed Work Credit recognizes that the existing EITC is a valuable policy tool that is undermined by complicated administrative rules, especially when used in tandem with the Child Tax Credit, dependent exemption, and other credits. Simplified eligibility criteria should reduce erroneous payments but the new credit maintains the positive attributes of existing policy, such as refundability and income restrictions. The panel proposes a starting point that is similar to current benefits but the precise value of the credit for each family is affected by the number of children in a household, income level, and family structure.[13] The ultimate impact of the new credit could be increased with a higher benefit level which could be applied to the new structure as well.

The Family Credit consolidates a greater number of tax subsidies than the Work Credit and thus represents a greater move toward simplification. As with current policy, the consolidated Family Credit will not be means-tested and will be available to all taxpayers. But the value of benefits relative to current law would vary according to family structure and current use of relative tax benefits. Several provisions linked to children, such as the exclusion for child-care assistance, tax credit for employer provided daycare facilities, child and dependent care tax credit, and the adoption credit, would be eliminated. The removal of these subsidies could raise taxes on families that use them but since they are not refundable, the impact of their elimination will not be felt by most low-income families.

The implementation of a Work Credit and Family Credit influence personal saving in so much as they may alter a household's bottom line or work effort, but the panel's targeted savings incentives reflect quite clearly the panel's priority to promote savings and their preferred means of achieving it. Their recommendations clarify many of the possibilities and obstacles in achieving this objective, especially for those that could benefit from savings the most—families with low incomes or little savings. These families are offered fewer and less attractive ways to build wealth, yet it is precisely these families that should be encouraged to save, as it provides a means to invest in their future and move up and out of poverty.

Savings and Taxes: Is Simplicity Fair?

The evidence is quite clear that Americans in general are failing to save and the panel attributes some of this to the current tax system's discouragement of savings through the imposition of a higher tax on those who choose to save than those who spend. In fact, the decline in the personal savings rate has become a troublesome and long-term trend. Over the last ten years the amount of unspent income has declined precipitously. Dropping from its historic average of about 9 percent, the personal saving rate dipped below one percent for the first half of 2005 and has been in negative territory since the summer of 2005, which means that personal outlays now exceed disposable income. Some explain this decline by claiming people feel wealthier when they look at the value of their homes and stock portfolios. Yet this "wealth effect" may be fleeting if housing prices fall and stock prices remain anemic. The fact is that many families lack the resources to buffer against unexpected events or invest in their future. Certainly the need to increase saving is shared by most Americans, as the erosion of national and personal savings undermines economic growth and household security. Public policies that incentivize savings and provide support for more Americans to participate in the savings process should be an integral part of tax reform.

The prevailing policy in recent years has been to expand opportunities for tax-free savings with an array of tax-preferred account vehicles, each with its own purpose and set of rules. Further, other policy objectives have also been pursued via the tax code. In this respect, tax policy has become a primary means of implementing social policy. But it has also created a degree of complexity that creates unnecessary obstacles for achieving these objectives. In this context, simplification should be a central

[12] This approach has already been proposed in Congress. H.R. 3655, co-sponsored by Representatives Dennis Kucinich (D-OH), Bernie Sanders (I-VT), and Barbara Lee (D-CA), unifies eligibility criteria for a refundable payroll tax credit and a refundable child tax credit.

[13] See Burman and Gale (2005).

feature of any meaningful tax reform. The question becomes whether such simplification serve other policy objectives as well. With respect to savings incentives, the proposal to restructure the existing accounts into three types of targeted savings accounts would be beneficial to the extent that it removes complexity of conflicting rules.

Currently, many Americans save for retirement through employer-provided retirement plans. Saving for retirement through such a plan can be an effective approach to saving, especially if employers offer a match and employees makes good choices as to where and how much of their paycheck is saved. Employers are induced to provide such plans through tax incentives and other policies. These rules are complex and may actually create barriers to savings. The tax code currently provides for a number of distinct plans, including 401ks, SIMPLE 401(k)s, 403(b)s, and Governmental 457(b)s, each offering different benefits to employees and subject to different rules. This diversity can spur confusion among employers and thus creates compliance and administrative costs which actually deter some employers from offering these savings opportunities. As a result, only about half of all employers offer defined contribution plans to their employees and the benefits of these plans are unevenly distributed.

The consolidation of existing employer-based retirement structures into a single type of plan would address the growing complexity that prevents many employers from offering such plans and many employees from participating. Having a single set of simplified rules will reduce compliance costs and administrative expenses. Contributions to these plans will still be tax advantaged through deductions from earned income, and this is a significant benefit. But the panel rightfully notes that it is the structure of such plans and the manner they are presented to employees that affects their decisions to use them. Beyond the tax incentives that accrue to making contributions, connecting employees to a savings plan is one of the most important steps in encouraging savings behavior. Savings plans have many attributes that lend themselves to good saving and investment decisions, including diversified investments, low-cost administration and centralized accounting; further, they have the potential to establish sound defaults that support automatic enrollment, payroll deduction, and rising contributions linked to rising earnings.

The AutoSave features of the panel's proposals are good ideas that should be used to reform the existing policies regardless of whether consolidation occurs. In sum, the panel's savings plan recommendations would be expected to increase participation in such plans, but stop short of ensuring that all employers offer them. Given the mobility of today's workforce, it may be that administering retirement savings plans through employers is no longer a good idea. Despite this uncertainty, encouraging worker participation in savings plans should be a priority. In fact, the value of access to a savings plan structure is so great that we should ultimately ask whether every worker should be entitled access to one.[14] The panel proposes to narrow the gap but leaves a hole.

The issue is whether or not this hole can be filled through other means. The panel proposes the establishment of two types of savings accounts accessed outside the work setting. On its face, it also appears to make sense to distinguish retirement purposes from other pre-retirement objectives. The Save for Family accounts can be used for health, education, and home purchase—deemed by the panel as worthy of public subsidy. These accounts are also afforded additional flexibility by allowing up to $1,000 a year of earnings to be withdrawn each year without penalty. Given this structure, it appears that the greatest flexibility will be afforded to a household that maxes out on their contributions to these accounts before contributing to the Save for Retirement accounts.

This division of accounts raises the question of how to prioritize savings among competing purposes. Theoretically, Save for Family accounts offer more latitude in making withdrawals, which may undermine long-term saving objectives but potentially support asset building purchases throughout the life course. A beneficial aspect of the proposal would be to deter pre-retirement withdrawals from accounts devoted primarily to retirement security. Save for Retirement accounts would be more restrictive than current Roth IRAs because a number of penalty exceptions, such as medical and unemployment

[14] This was the proposal of a much-heralded report in the UK by the Pensions Commission, headed by Adair Turner. The Commission recommended the establishment of a national savings scheme that would be accessible to all workers.

expenses, would not apply to these accounts. Since Save for Retirement accounts could only be used without penalty after retirement, death, or disability, they would more effectively deter withdrawals unrelated to retirement, addressing the leakage problem that many ascribe to Roth IRAs.

The construction of Save for Family and Save for Retirement accounts would represent major changes from current law, replacing the entire system of IRAs, Roth IRAs, Health Savings Accounts, and Section 529 College Savings Plans. The proposals are similar to those proposed by the Bush Administration to create Retirement Savings Accounts and Lifetime Savings Accounts. Critiques of these proposals would also apply here.[15] The tax treatment of these accounts would replicate the Roth IRA structure where contributions would be after-tax, but earnings would accumulate tax free. The higher contribution limit of $10,000 a year per household member represents a significant expansion of opportunities to shelter income or existing resources from taxation.

Over the long-term, a move toward these types of savings accounts would have a significant budget impact but not necessarily promote net new savings. This is because the main beneficiaries of such a change would be people with incomes above the current limits for IRA contributions ($160,000) and those households that are already maxing out their contributions to existing retirement accounts, such as 401(k)s. Recent figures show that approximately six percent of all participants are contributing the maximum amount to their 401(k) accounts. While only one percent of participants in households with incomes below $40,000 make the maximum contribution, 40 percent of participants in households with more than $160,000 in income make the maximum contribution.[16] Because there is no income restriction or age limit for the Save for Family and Save for Retirement accounts, a high-income couple could shelter up to $40,000 each year, or up to $800,000 over twenty years.

The incentive of tax-free earnings associated with these new accounts may induce some new savings but it will certainly encourage asset shifting, have long-term costs, and be less transparent. Deposits from *existing* taxable assets to these accounts will remove these assets from the tax base without promoting new personal savings. Also, the placing of *future* savings in these accounts rather than in a taxable asset will not increase private savings because it would have been done otherwise. This phenomenon explains the discrepancy between the low personal savings rate, which recently has been in negative territory, and the high cost of tax expenditures linked to federally-sanctioned savings accounts.

The general approach of the panel to recommend a consolidated system of accounts where earnings are tax-free is a means of back-loading the benefits. This means that the cost to the government comes in future years when the tax base is reduced by this preferential treatment. The argument for doing so is that, over the long-run, this will encourage savings. However, this approach also effectively hides its real costs. Front-loading tax benefits may be just as effective with respect to their impact on savings behavior and have the added advantage of a greater transparency from a budget perspective. The panel recognized this limitation and wrote, "A substantial share of the revenue loss from the reduced taxation of future capital income for each dollar contributed to these accounts occurs outside the ten-year window."[17] And the budget impact of these provisions would be substantial. Further, the distributional impacts of expanding the opportunity to contribute to these accounts are skewed up the income scale.

Efforts to Target Savings Incentives and Support Structures

The panel recognized that lower-income and lower-resource families are not as well served by these provisions, and included a reformed Saver's Credit. In its recommendations for a new refundable Saver's Credit, the panel notes several design flaws in the current structure of the credit which contribute to complexity and limit accessibility. The panel proposes to address several limitations of the current credit in a reasonable manner. The primary innovation of this proposal is refundability, which would allow more households to take advantage of the credit even if they have low tax liabilities.

[15] See Burman, Gale, and Orszag (2003).
[16] See Burman, Gale, and Orszag (2003).
[17] President's Advisory Panel on Federal Tax Reform, page 47.

In total, the proposed reform package for the Saver's Credit is a sensible and necessary reform. However, there are several limitations of the panel's approach that could be subsequently addressed. Eligibility for the credit is triggered by a deposit to a qualified retirement account, and thus it is not a replacement for the more flexible benefits of the Save for Family accounts. Also, the credit is awarded after a deposit has been made but the panel proposes that the credit must be made to a Save for Retirement account or a restricted Save for Family account. Unlike the regular Save for Family account, this restricted account will not permit annual, unrestricted withdrawals of up to $1,000.[18] This proposal runs counter to the panel's simplicity objective by mandating two types of Save for Family accounts, one for lower-income taxpayers that receive the Saver's Credit and another for everybody else. This seems to add unnecessary complexity, especially given the Panel's proposal to cap the Saver's Credit at $500 a year. Finally, the value of the new credit at this level, even with its improvements, may not be adequate to achieve the levels of savings that may be most beneficial. It is debatable whether this expansion is commensurate with the additional opportunities offered to higher income households by the panel's other savings proposals.

Among the most significant aspects of the panel's work with regard to how their savings proposals would affect lower-income and lower-resource families is their acknowledgement of the importance of well-structured incentives and the detrimental impact of poorly-designed asset limits for eligibility in public assistance programs.

Delivering incentives to a targeted lower-income population through the tax system is problematic for several reasons. Firstly, tax deductions and tax-free earnings are more valuable to higher-income households. Secondly, refundability of tax credits increases the utility of tax subsidies but also adds complexity. Thirdly, a growing body of research indicates that direct matches to savings deposits are an effective and transparent means of delivering savings incentives. As the President's Advisory Panel on Federal Tax Reform panel put it in their report:

> "Recent studies suggest that lower-income taxpayers are responsive when given clear incentives to contribute to retirement accounts. These studies suggest that the presence of a meaningful match that is presented at the time of tax preparation can have a sizeable impact of the percentage of lower-income taxpayers who save and the amounts saved."[19]

The panel's recommendation that a taxpayer not lose eligibility for means tested programs such as TANF, Medicaid, and Food Stamps if they make deposits into savings accounts deserves promotion. This proposal reflects a growing awareness of how these asset limit provisions serve as savings disincentives.[20] The panel proposes that these assets be ignored for "purposes of determining whether the taxpayer is eligible for a means-tested federal assistance program."[21]

Two additional taxes that have distributional impacts were not considered by the panel: the payroll tax and estate tax. This is unfortunate since the best way to analyze an optimal tax system is to include all tax effects, including the impact of state and local taxes as well as the effects of other payroll, sales and excise taxes. This omission, as well as the constraints placed on the panel by the initial Executive Order, limited the potential for more profound tax reform proposals.

Pursuing tax reform is not an unprecedented occurrence, but it is a challenging political task, one that usually requires bipartisan support and engagement. It is difficult to enact major changes to the tax code and hold everybody harmless at the same time. Undoubtedly, some will perceive themselves to come out ahead and others behind under a new tax regime. Further, changes to the tax system will impact the government's balance sheet, over the short and long-term. Regardless of what legislative action the

[18] If a taxpayer doesn't qualify for a match over five years, funds in this account can be transferred to a regular, unrestricted Save for Family account.

[19] President's Advisory Panel on Federal Tax Reform, page 122.

[20] Parrish (2005).

[21] President's Advisory Panel on Federal Tax Reform, page 123.

panel's recommendations spur, the panel's work indicates that the promotion of savings should play a central role in future tax reform deliberations.

Summary of Current Law and Tax Reform Panel Recommendations

	Current Law (2005)	Simplified Income Tax Plan and Growth and Investment Tax Plan
Households - Families		
Personal exemption	$3,200 deduction for each household member, phases out	Replaced with Family Credit for all taxpayers: $3,300 credit for married couples, $2,800 for unmarried taxpayers with child, $1,650 for unmarried taxpayers, $1,150 for dependent taxpayers; additional $1,500 for each child and $500 for additional dependents.
Standard deduction	$10,000 deduction for married filing jointly, $5,000 for singles, $7,300 for household head, only for non-itemizers	
Child tax credit	$1,000 per child; phases out between $110,000 and $130,000	
Earned income tax credit	Refundable credit tied to earnings. Max. credit for families with 2 or more children is $4,536	Replaced with Work Credit; maximum credit for working family with two or more children is $5,800
Credits and Deductions		
Home mortgage interest	For itemizers for interest up to $1.1 million of mortgage debt	Home Credit equal to 15% mortgage interest paid; available to all; mortgage limited to average regional price of housing (limits from $227,000 to $412,000).
Charitable giving	For itemizers only	Deduction available to all taxpayers (who give more than 1% of income)
Health insurance	Tax-free status to an unlimited amount of premiums paid by employers or self-employed	Taxpayers may purchase insurance with pre-tax dollars, up to the average premium (estimated to be $5,000 for single and $11,500 for family)
State and local taxes	For itemizers only	Not deductible
Education	HOPE Credit, Lifetime Learning Credit, tuition deduction, student loan interest deduction; all phase out with income	Taxpayers can claim Family Credit for some full-time students; simplified savings plans
Savings and Retirement		
Defined contribution plans	401(k), 403(b), 457 and other employer plans	Consolidated into Save at Work plans that use current law 401(k) contribution limits; AutoSave features promote savings (GIT plan would make Save at Work accounts "pre-paid" Roth-style)
Defined benefit plans	Pension contributions by employers are untaxed	No change
Retirement savings plans	IRAs, Roth IRAs, spousal IRAs – subject to contribution and income limits	Replace with Save for Retirement accounts ($10,000 annual limit) available to all taxpayers
Education savings plan	Section 529 and Coverdell accounts	Replace with Save for Family accounts ($10,000 annual limit); covers education, medical, new home, and retirement; available to all taxpayers; refundable Saver's Credit available to low-income taxpayers
Health savings plans	MSAs, HSAs, and Flexible Spending Arrangements	

Source: President's Advisory Panel on Federal Tax Reform (2005).

ALTERNATIVES APPROACHES TO A MORE INCLUSIVE SAVINGS PLATFORM

Currently, there are inequities throughout the tax code for families with low-income or little savings. While some households benefit from the refundable EITC, many more are hit especially hard by the payroll tax, and non-itemizers can not access many valuable benefits, deductions, and write-offs. For several reasons most of these tax benefits do not work well for lower-income people. Some do not have bank accounts, others do not work for employers that offer savings plans or provide matches, and many are confused by the rules. Most significantly, lower-income taxpayers usually do not have sufficient tax liabilities to take advantage of the tax benefits.

Simplification and consolidation are appropriate principles for tax reform, but the panel's savings proposals are unlikely to significantly raise the level of savings by lower- and middle-income taxpayers, the very households that could benefit from increased savings the most. The tax code should be reworked in ways that reward real savings rather than asset shifting. The promotion of savings will require a more coherent savings framework, one that ultimately creates an accessible and inclusive savings platform. This savings framework will be most effective if it combines meaningful, targeted incentives with policies that maximize participation in the savings process. This will require that people have a place to save and the practice of savings is easy and accessible.

For people with lower incomes or fewer resources, effective incentives are matched savings accounts, not deductions or tax-free earnings. A direct match to account contributions provides transparency both in its benefit to the individual and a cost to the government. Another alternative is to give all Americans access to the same amount of subsidy to promote savings, perhaps available over their lifetime. This could establish a national savings standard and send a valuable signal. A corollary to this is the need to remove policies that discourage savings, such as the application of low asset limits to determine eligibility for public assistance benefits. Many states have raised the asset limits as part of their TANF and Medicaid programs, but these limits should be revised at the federal level as well.[22]

Participation is paramount. Recently, much as been made of the potential to automatically enroll employees in savings plans when their employers offer 401Ks. This is a good idea since the savings plan comes with the requisite structures that support savings even when investments are not actively managed by account holders. *A better idea is ensure that all Americans have access to such a savings plans.* Accounts in this national savings plan should be portable, not tied to an employer, and devoted to specific goals like retirement, education, and homeownership.

One way to implement such a system is to start it at birth. There is widespread consensus that the earlier savings begin the better. Every child could be provided with an account that would be administered by a savings plan that would offer a limited set of low-cost, investment choices.[23] These accounts could be support by financial education and targeted savings incentives, and eventually be rolled out to the private sector. These features are present in the America Saving for Personal Investment, Retirement, and Education Act (ASPIRE Act) which has been introduced in Congress with bipartisan sponsors in both the House and Senate.

Finally, the savings process must be easy and accessible. There is a prime opportunity to leverage savings in the one activity that almost every household undertakes—paying taxes. Last year the average tax refund was over $2,000. Tax forms should be amended to make it easier to save these refunds. This could be done by allowing households to split their refunds among multiple accounts, instead of receiving a lump sum paper check or direct deposit as is now required. Allowing for split refunds would simplify the

[22] See Parrish (2005) for a fuller discussion of this issue.
[23] The ASPIRE Act of 2005 (KIDS Accounts) S 868/HR 1767 is sponsored in the Senate by Senators Rick Santorum (R-PA) Jon Corzine (D-NJ), Charles Schumer (D-NY), and Jim DeMint (R-SC) and in the House by Representatives Harold Ford, Jr. (D-TN), Patrick Kennedy (D-RI), and Phil English (R-PA). It would provide every child with an account at birth—called a KIDS Account—that would be endowed with $500. Accounts would be supported with progressive, targeted savings incentives until age 18, at which point it could be used for going to college, buying a home, or building up a nest-egg for retirement.

savings process, maximize taxpayer choice, and provide tax preparers with an opportunity to educate their clients about the benefits of saving. This change has been proposed by the Administration and is currently under review by the IRS for a potential rollout for the 2006 tax filing season. The value of the split refund option is that it enables the tax filing process to become a vehicle for connecting tax refunds with savings and asset building activities.

People spend rather than save their refunds if they don't have an easy way to direct a portion of their refunds into savings products. Recent research finds that many Americans—including lower income ones—can and will save their refunds if offered appropriate incentives and a clear way to do so. [24] The challenge is to facilitate and encourage the savings of tax refunds into existing, and possibly new, savings products, such as retirement accounts or savings bonds. This is also a potential avenue for addressing the needs of the 10 to 20 million American families that are "unbanked." These families do not own basic transaction accounts and are not fully integrated into the financial mainstream, paying more for basic financial services. Tax filing should be amended to allow these households to open a checking, savings, or IRA account with the check of a box and obtain refunds electronically.[25]

There are many policy routes to broadening savings and asset ownership. The tax system should be employed to promote these important policy goals, not work against them.[26] Some routes can be achieved through small changes to existing financial products, government program, or tax rules, while others require new structures and dramatic reforms. Either way, the promotion of savings should be a central principle of future efforts of tax reform.

FOR MORE INFORMATION

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[24] Stuhldreher (2004).
[25] Stuhldreher (2004).
[26] See Boshara, Cramer, and Parrish (2005) for a fuller description of policy options to promote savings and asset building.

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