

A New Government Matching Program for Retirement Saving

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The results of a recent randomized experiment suggest that the presence of an easily understandable and transparent 50 percent match significantly raises participation in and contributions to IRAs.¹ The results confirm the basic idea behind the existing Saver's Credit, which provides a match for retirement saving contributions by low and moderate-income households through the tax code. The study also suggests, however, that the presentation and perhaps the structure of the Saver's Credit could be modified to produce much higher participation rates and contribution levels. In this brief note, we therefore propose a revised version of the Saver's Credit that we believe would prove to be more effective at encouraging contributions among middle- and lower-income households.

Many families approaching retirement age have meager retirement saving, if any.² In 2001, half of all households headed by adults aged 55 to 59 had \$10,000 or less in an employer-based 401(k)-type plan or tax-preferred savings plan account. One explanation for this result is for most families, existing incentives for retirement saving are weak or non-existent. Instead, too much of our existing tax preferences for retirement saving simply subsidize asset shifting into tax-preferred accounts by households who are already well-prepared for retirement. Policy changes to bolster retirement saving should instead be focused on middle- and lower-income households who typically have few other assets that could be shifted into tax-preferred saving and who are not fully taking advantage of existing opportunities to save. Our proposal focuses its incentives on such households.

Background on the existing Saver's Credit

The Saver's Credit, enacted in 2001, provides a government subsidy, in the form of a nonrefundable tax credit, for voluntary individual contributions to 401(k) plans,

¹ Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," Retirement Security Project Policy Brief No 2005-5, May 2005.

² For a broader discussion of these issues, see William G. Gale and Peter R. Orszag, "Private Pensions: Issues and Options," in *Agenda for the Nation*, edited by Henry J. Aaron, James M. Lindsay, and Pietro S. Nivola (Brookings, 2003), pp. 183-216.

IRAs, and similar retirement saving arrangements.³ The Saver's Credit applies to contributions of up to \$2,000 per year per individual. The credit rate is 50 percent for married taxpayers filing jointly with adjusted gross income (AGI) up to \$30,000, 20 percent for joint filers with AGI between \$30,001 and \$32,500, and 10 percent for joint filers with AGI between \$32,501 and \$50,000. The same credit rates apply for other filing statuses, but at lower income levels: the AGI thresholds are 50 percent lower for single filers and 25 percent lower for heads of households.

The credit represents an implicit government matching contribution for eligible retirement saving contributions. The implicit matching rate generated by the credit, though, is significantly higher than the credit rate itself. The 50 percent *credit* rate for gross contributions, for example, is equivalent to having the government *match* after-tax contributions on a 100 percent basis. Consider a couple earning \$30,000 who contributes \$2,000 to a 401(k) plan or IRA. The Saver's Credit reduces that couple's federal income tax liability by \$1,000 (50 percent of \$2,000). The net result is a \$2,000 account balance that cost the couple only \$1,000 after taxes (the \$2,000 contribution minus the \$1,000 tax credit). This is the same result that would occur if the net after-tax contribution of \$1,000 were matched at a 100 percent rate: the couple and the government each effectively contribute \$1,000 to the account. Similarly, the 20 percent and 10 percent credit rates are equivalent to a 25 percent and an 11 percent match, respectively.

Proposal for matching government contributions

Based on our research and that of other scholars, we suggest four changes to the Saver's Credit:

First, experimental work has shown that credit rates are much less effective than the equivalent match rates at inducing people to contribute to charities.⁴ By a similar logic, it is possible that presenting the Saver's Credit as a 100 percent match rather than a 50 percent credit rate could have a large effect on take-up. We therefore suggest that the credit be redesigned as a matching contribution that goes directly into the account, rather than a tax credit that generates cash for a worker.

Second, the non-refundability of the current credit complicates its presentation and substantially reduces the number of people eligible for it. In 2005, 59 million tax filers will have incomes low enough to qualify for the 50 percent credit.⁵ Since the existing credit is non-refundable, however, only about one-seventh of them actually would benefit from the credit at all by contributing to an IRA or 401(k). Furthermore,

³ For more detail on the Saver's Credit, see William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit: Expanding Retirement Savings for Middle-and Lower-Income Americans," Retirement Security Project Policy Brief, No. 2005-2, March 2005.

⁴ Catherine Eckel, and Philip J. Grossman, "Rebate versus Matching: Does How We Subsidize Charitable Contributions Matter?" *Journal of Public Economics*, 87(3-4), 681-701, 2003.

⁵ These estimates are generated by the Urban-Brookings Tax Policy Center microsimulation model.

only 43,000 -- or fewer than one out of every 1,000 -- filers who qualify based on income could receive the maximum credit (\$1,000 per person) if they made the maximum contribution. These are the households who have sufficient tax liability to benefit in full from the Saver's Credit but sufficiently low income to qualify for the highest match rate. The incentives provided by a matching program for retirement contributions should be extended to lower-income working families.

Third, the Saver's Credit contains steep declines in the credit rate as income rises, resulting in very high effective marginal tax rates for savers who use the credit. For example, consider a married couple contributing \$2,000 to an IRA. If the couple's AGI increases from \$30,000 to \$30,001, the tax credit for that contribution declines from \$1,000 to \$400 -- a \$600 increase in tax liability triggered by a \$1 increase in income. Our proposal avoids these "cliffs" by gradually phasing out the eligible contribution amount, rather than discretely changing the credit rate, as income rises. It thus generates a smooth phase-out with minimal administrative complexity.

Finally, the existing Saver's Credit is vulnerable to potential gaming. In particular, an individual could deposit \$2,000 into a Roth IRA, claim the Saver's Credit of up to \$1,000, and then withdraw the \$2,000 deposit in the Roth IRA. Since withdrawals of principal from a Roth IRA can be made tax-free, the tax filer would net \$1,000 in tax savings without altering his or her saving at all. The anti-churning rules associated with the Saver's Credit would disqualify the taxpayer for the Saver's Credit for the current tax year and the following two tax years, but the process could be repeated again after that. We propose a change in the rules to close this gaming possibility.

A new government matching program

Given the four design issues discussed above, we propose a new government matching program of the following form:

- **Eligibility:** Tax filers would be eligible if they have made IRA or 401(k)-type contributions and have Adjusted Gross Income below the qualifying thresholds.⁶
- **Match rate:** The government would match 50 percent of first \$2,000 in contributions made by eligible tax filers to an IRA or 401(k)-type plan. Each spouse in a couple filing a joint return would be eligible for a match on up to \$2,000. The same match rate would apply regardless of the tax filer's income tax liability. This uniform match rate along with the simpler eligibility rules would make the credit much easier to understand.
- **Phase-out:** The maximum contribution eligible to be matched would fall from \$2,000 to \$0 linearly between \$30,000 and \$50,000 in Adjusted Gross Income for

⁶ In addition, eligibility would be restricted to filers age 18 or over who are not full-time students and are not claimed as dependents on another return. These eligibility conditions are the same as the existing Saver's Credit.

joint filers (the phase-out would occur from \$15,000 to \$25,000 for singles and married filing separately; and from \$30,000 to \$40,000 for heads of households).

- **Matching contribution deposited to account:** The matches would be deposited directly to the IRA and 401(k) accounts of eligible taxpayers.⁷
- **Anti-gaming rules:** The government would recapture its match on any funds withdrawn before retirement that do not meet the exceptions to early withdrawal penalties under current rules for IRAs. As an example, consider an individual who contributes \$1 to an account and receives \$0.50 in matching contributions. The individual then withdraws the \$1 before retirement. If the \$1 withdrawal does not meet one of the specified exceptions to the early withdrawal penalties, the government would impose a penalty to reclaim the \$0.50 match.⁸

Table 1 below, based on results from the Tax Policy Center micro-simulation model, suggests that the proposal above would cost roughly \$12 billion a year.⁹ In our view, a matching contribution of this type offers significant potential to help correct the nation's upside-down tax incentives for retirement. The current tax preferences for 401(k)-type plans and IRAs deliver 70 percent of their benefits to the top 20 percent of the income distribution (Table 2). By contrast, our proposal delivers more than two-thirds of its benefit to the bottom half of the income distribution. Finally, Table 3 shows aspects of our proposal with and without the assumed behavioral change. As the average tax change columns in the table show, given our behavioral assumptions, the proposal would significantly increase retirement contributions by (and therefore the associated tax benefits accruing to) middle- and lower-income households.

⁷ Several possible mechanisms for contributing the match to the account exist. One possibility is for the government to deposit the match directly into the account, which is the most straightforward approach but may pose challenges (e.g., for IRAs or 401(k)s that lack bank routing numbers). Another possibility is for the financial institution or employer holding the account to deposit the match and then receive an offsetting tax credit from the government.

⁸ Any contributions made to the account and any associated matches would be tracked. This amount would be called the “matched principal amount,” recorded in nominal dollars, and not adjusted for earnings or inflation. The entire matched principal amount could be withdrawn without penalty for qualified withdrawals, as defined by the tax law for the account in which the funds are held. Qualified withdrawals would reduce the “matched principal amount” dollar-for-dollar. Non-qualified withdrawals of the matched principal amount would trigger a 33.3 percent penalty, to recapture the government's matching contribution. Regular income tax and penalties (as would apply to any 401(k), or Roth or traditional IRA) would then apply to the other 66.6 percent of the matched principal amount withdrawal. The details of the anti-gaming provisions for those 59½ or older, the stacking order of withdrawals of matched principal amount and other funds (including earnings on the matched principal amount) from the account, and the tax treatment of the match itself and its withdrawal remain to be determined.

⁹ This cost and the distributional effects shown are net of the existing Saver's Credit. In estimating the table, we assumed that 20 percent of tax filers in each eligible income category would make contributions to a 401(k) or IRA given the match. Since currently observed participation rates were lower than this level, we randomly assigned tax filers to contributor status to increase the participation rate within each cash income class to 20 percent. We also randomly increased contribution rates among those already participating to roughly match the averages from our randomized experiment.

Table 1: Distributional effects of proposal

Government Matching Contributions to 401(k)s and IRAs
Distribution of Federal Tax Change by Cash Income Class, 2005¹

Cash Income Class (thousands of 2005 dollars) ²	Tax Units ³		Percent with Tax Cut	Percent Change in After-Tax Income ⁴	Percent of Total Tax Change	Average Tax Change (\$)	Average Federal Tax Rate ⁵	
	Number (thousands)	Percent of Total					Current Law	Proposal
Less than 10	19,561	13.5	9.4	1.5	13.8	-79	3.5	2.1
10-20	25,611	17.7	15.0	0.8	25.4	-111	4.7	4.0
20-30	19,954	13.8	21.9	0.6	25.7	-144	10.1	9.5
30-40	15,289	10.6	21.6	0.5	18.9	-138	14.4	14.0
40-50	11,738	8.1	18.7	0.3	11.0	-104	16.8	16.5
50-75	20,700	14.3	5.1	0.0	3.1	-17	18.5	18.4
75-100	11,936	8.3	0.6	0.0	0.5	-5	20.0	20.0
100-200	14,432	10.0	0.5	0.0	0.5	-4	22.3	22.3
200-500	3,797	2.6	0.4	0.0	0.1	-3	25.4	25.4
500-1,000	642	0.4	0.3	0.0	0.0	-3	27.2	27.2
More than 1,000	336	0.2	0.1	0.0	0.0	-1	31.2	31.2
All	144,575	100.0	11.6	0.2	100.0	-77	20.7	20.6

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Table 2: Distributional effects of existing retirement savings tax incentives

Tax Benefits of Defined Contribution Plans and IRAs
by Cash Income Percentile, 2004

Cash income percentile ^a	Percent of tax units with benefit ^b	Benefit as percent of after- tax income ^c	Share of total benefits	Average benefit (\$)
Lowest quintile	2.0	0.1	0.2	-6
Second quintile	12.7	0.5	2.9	-78
Middle quintile	25.0	0.8	8.2	-218
Fourth quintile	43.0	1.1	19.3	-513
Top quintile	61.0	1.4	69.3	-1,838
All	28.7	1.2	100.0	-531
Top 10 percent	63.8	1.4	48.4	-2,567
Top 5 percent	61.9	1.2	30.2	-3,211
Top 1 percent	53.3	0.6	7.7	-4,111
Top 0.5 percent	51.6	0.4	4.0	-4,252
Top 0.1 percent	51.4	0.2	0.9	-4,645

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

Note: Table shows distribution of the present value of lifetime tax benefits for new contributions made in 2004.

a. Tax units with negative cash income are excluded from the lowest income class but are included in the totals. See <http://www.taxpolicycenter.org/TaxModel/income.cfm> for a description of cash income.

b. Both filing and nonfiling units are included. Filers who can be claimed as dependents by other filers are excluded from the analysis.

c. After-tax income is cash income less individual income tax net of refundable credits, payroll and estate tax liability, and imputed burden from corporate taxes.

Table 3: Proposal effects with and without behavioral assumptions

**Government Matching Contributions to 401(k)s and IRAs
Distribution of Federal Tax Change by Cash Income Class, 2005¹**

Cash Income Class (thousands of 2005 dollars) ²	Tax Units ³		Percent with tax benefit		Percent of tax benefit		Average tax change	
	Number (thousands)	Percent of Total	With no behavioral change	With assumed behavioral change	With no behavioral change	With assumed behavioral change	With no behavioral change	With assumed behavioral change
Less than 10	19,561	13.5	4.0	9.4	5.2	13.8	-16	-79
10-20	25,611	17.7	9.7	15.0	19.6	25.4	-45	-111
20-30	19,954	13.8	16.7	21.9	28.0	25.7	-82	-144
30-40	15,289	10.6	18.0	21.6	24.6	18.9	-94	-138
40-50	11,738	8.1	16.5	18.7	15.7	11.0	-78	-104
50-75	20,700	14.3	4.4	5.1	4.0	3.1	-11	-17
75-100	11,936	8.3	0.5	0.6	0.7	0.5	-4	-5
100-200	14,432	10.0	0.4	0.5	0.9	0.5	-4	-4
200-500	3,797	2.6	0.4	0.4	0.2	0.1	-3	-3
500-1,000	642	0.4	0.3	0.3	0.0	0.0	-3	-3
More than 1,000	336	0.2	0.1	0.1	0.0	0.0	-1	-1
All	144,575	100.0	8.6	11.6	100.0	100.0	-40	-77

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.