A Small Change to the Saver's Credit Can Go a Long Way

Low- and Moderate-Income Families Need Help Building Household Wealth

By Camille Busette and Jordan Eizenga January 2012

Introduction

Homeownership has long helped low- and moderate-income families build wealth that allows them to start businesses, educate their children, and retire with dignity. As a result of the recent housing and financial crises, American families will not have the same opportunity to build wealth through homeownership anytime soon. While sustainable homeownership remains an important goal, policymakers should explore other avenues to help low- and moderate-income families build household wealth. If we want to put these families on the path to homeownership, then we have to develop a comprehensive set of national policies that provide opportunities for and incentivize savings.

Unfortunately, the existing government incentives to save, invest, and build wealth are poorly advertised to the households that could use them the most. For instance, the mortgage interest deduction, the lower tax rates on capital gains and dividends, and the tax advantages for certain retirement savings vehicles are all examples of tax subsidies whose benefits often pass over those who most need to save—low- and moderate-income families.

The saver's tax credit is aimed at addressing this need. The saver's credit is a tax credit for low- and moderate-income households who make voluntary contributions to eligible retirement plans. Its design and modest size, however, limit its impact.

In this issue brief, we adapt previous proposals to convert the existing saver's tax credit for voluntary contributions to eligible retirement plans or other longer-term savings vehicles into a refundable credit by proposing to offer it to low- and moderate-income families not benefiting from the mortgage interest deduction.[1] A refundable tax credit differs from a nonrefundable tax credit in that it provides a benefit (in the form of a cash refund) to those whose tax liability is less than the value of the credit. To pay for the refundable saver's credit, we propose changes to the mortgage interest deduction that will somewhat reduce its benefits for high-income households.

Our proposed changes build on previous work on tax subsidy reform and essentially focus on repurposing certain elements of the mortgage interest deduction that currently benefit higher-income households, such that they reach low- and moderate-income families and, where appropriate, enable them to embark on a path to sustainable homeownership.

Policies to incentivize saving and asset building

Traditionally, the primary incentives to save and invest are contained within the tax code. The tax code offers lower rates on dividends and capital gains, and excludes tax for investment income on life insurance and annuities, which provide annual fixed or variable payments to investors. There are also tax preferences for savings through 401(k) plans, individual retirement accounts, and other qualified savings vehicles. These incentives, however, tend to disproportionately benefit higher-income households, which derive the most value from a tax deduction, are more likely to have a retirement plan with an employer contribution, and, of course, have more disposable income to save.

The mortgage interest deduction is similarly "upside down." The mortgage interest deduction allows homeowners to deduct from their income the interest payments they make on mortgage debt up to $1 million on first and second homes. The tax code also allows a deduction for interest paid on up to $100,000 in home equity debt. The deduction's purpose is to promote and expand homeownership, but its structure limits its effectiveness. The deduction does not effectively target low- and lower-middle-income homebuyers, for whom a tax incentive is most likely to mean the difference between buying and renting.

A Tax Policy Center study found that households with incomes between $40,000 and $75,000 receive an average benefit of $523 from the deduction, while households with incomes above $250,000 receive $5,459.[2] This is because higher-income households tend to have more expensive homes with larger mortgages, which means larger interest payments. Yet even for two taxpayers with the same amount of mortgage interest expenses, the mortgage interest deduction will still benefit the higher-income taxpayer more.

Because the tax preference is structured as a deduction, by its very nature, it is disproportionately more valuable for taxpayers in higher marginal tax brackets. A recent *National Tax Journal* study by three Treasury Department officials found that the top 10 percent of households by income account for 35 percent of the total mortgage interest expenses, but receive 56 percent of the total benefit of the mortgage interest deduction.[3]

Even the saver's credit, which was designed to address the upside-down nature of savings and asset-building subsidies, often provides little to no benefit for low-income families. The saver's credit can be claimed by low- to moderate-income households that make voluntary contributions to eligible retirement plans. And the credit applies to the first $2,000 in contributions per year per individual, with the rate set progressively so there are higher credit rates for lower-income savers. Yet because the saver's credit is currently nonrefundable, it does not benefit those who need it most—low-income households that have little or no liability for federal income tax (even though they pay payroll taxes and other federal taxes as well).

Existing policy proposals

In recent years, there have been a variety of proposals to restructure tax incentives to make them more progressive, with benefits shared by low- and moderate-income households. One common way to do that is to convert existing deductions for retirement savings and for homeownership to tax credits. The advantage of tax credits is that they provide a benefit equal to all those with tax liability, regardless of their tax bracket.

Former Center for American Progress Senior Fellow Gene Sperling proposed in 2005 to replace the tax deduction for contributions to eligible retirement savings with a flat tax credit of 30 percent for all savings. Similarly, the Bipartisan Policy Center proposed a 12 percent refundable tax credit for retirement savings, which would provide a benefit to lower-income households with no federal income tax liability.

The National Commission on Fiscal Responsibility and Reform plan—commonly known as the Simpson-Bowles plan after its co-chairs, former Sen. Alan Simpson of Wyoming and former White House Chief of Staff Erskine Bowles—also proposed to replace the mortgage interest deduction with a 12 percent nonrefundable credit to lower the maximum level of mortgage debt eligible for the deduction to $500,000 and to restrict the credit only to first home mortgages.

These are all proposals that would significantly reform the existing tax incentives to save and build assets. Each would introduce a more efficient distribution of the benefits of these tax incentives to ensure they better reach low- and moderate-income households.

"Upside-down" federal subsidies driven through the tax code should be made more equitable and better targeted to benefit low- and moderate-income families. The Center for American Progress's recently released long-term budget plan, "Budgeting for Growth and Prosperity," converted the mortgage interest and charitable deductions into a 15 percent refundable credit. The plan also transformed the deductions and exclusions for savings for defined contributions plans, such as 401(k) plans and individual retirement accounts, into refundable tax credits worth 33 percent of employee or employer contributions, deposited directly into savings accounts.

These changes were significant and would shift the benefits toward low- and moderate-income families, while still preserving efforts to reduce our national deficit. While the suggested changes in this issue brief differ modestly from those in "Budgeting for Growth," they still build on CAP's institutional view that the tax code should be made fairer.

Recommendations

Recent policy discussions about the future of housing finance and the mortgage market, as well as how to reform our tax code, provide a valuable opportunity to restructure a variety of tax credits and deductions to enable low-income families to accumulate savings.

First, we propose expanding on President Obama's fiscal year 2011 budget proposal to make the saver's credit refundable, which the Tax Policy Center estimates will cost approximately $29.8 billion over 11 years, or less than $3 billion annually. The president's proposal offered a progressive credit rate structure, with low-income taxpayers receiving a greater credit rate than those with slightly higher incomes.

Our proposal goes one step further. We propose a refundable credit of 50 percent for up to $500 in contributions per individual for all households earning less than $55,000 and for individuals earning less than $27,750, respectively. Clearly this would expand the maximum value of the credit to more low- and moderate-income households.

Even if there are some households currently taking both the nonrefundable saver's credit and the mortgage interest deduction, they probably would not be harmed because the new saver's credit will be more generous and could be more valuable than both the nonrefundable credit and the mortgage interest deduction to a low-income household. Moreover, the number of affected households should be very small, as lower-income households—those eligible for the saver's credit—tend not to itemize and claim the mortgage interest deduction, but instead take the standard deduction.

Second, to cover the cost of the refundable tax credit, we propose eliminating the deduction for interest paid on home equity loans, and we adopt the Simpson-Bowles plan to gradually reduce the amount of mortgage debt eligible for the deduction to $500,000. The rationale for these changes is that households with larger mortgages will tend to be those of higher income earners and thus do not need additional tax incentives to save and invest in a home. Recent research shows that only 2.6 percent of tax returns would be impacted by the latter change.[4]

Third, we question whether it is sensible policy to give a deduction for removing equity from housing (and thus savings), regardless of the use of these proceeds. Worthwhile purchases, such as student tuition payments, may be financed with home equity loans. But it is not clear why there should be a deduction for home-equity-financed purchases while no such deduction exists for interest payments on other forms of debt.

The Joint Committee on Taxation estimated in 2005 that repealing the deduction for interest on home equity debt would save approximately $22.6 billion over 10 years. And the Congressional Budget Office that same year estimated that reducing the amount of mortgage debt eligible for the deduction to $500,000 would save approximately $2.7

billion annually. All savings realized from these changes should be sufficient to cover the cost of the refundable credit and any savings in excess of the credit's costs will be allocated for deficit reduction.

Conclusion

The recent housing crisis and economic recession presented barriers for many people to save and build wealth. Unstable home prices and weak access to credit mean fewer people are able or willing to buy a home. In this difficult context, our proposal helps households struggling most through the aftereffects of the housing and financial crisis to save and build wealth.

While the proposal will not be a panacea to building assets for low- and moderate-income households, it can be one piece of a broader solution that includes better employment opportunities, rising incomes, and stronger safety net programs that prevent the depletion of savings during periods of unemployment.

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Endnotes

1 Clearly, eligible savings vehicles cannot include regular bank accounts. It may be necessary for Treasury to establish guidelines for what constitutes an eligible savings vehicle outside of traditional retirement accounts.

2 Richard K. Green, "Mortgage interest deduction." In Joseph J. Cordes, Robert D. Ebel, and Jane Gravelle, eds., *The Encyclopedia of Taxation and Tax Policy*, 2nd ed. (Washington: The Urban Institute Press, 2005).

3 Adam J. Cole, Geoffrey Gee, and Nicholas Turner, "The Distributional And Revenue Consequences of Reforming the Mortgage Interest Deduction," *National Tax Journal* (2011): 977-1000.

4 Ibid. The report notes that only 2.6 percent of tax returns had mortgage interest expenses in excess of $25,000 per year. The $25,000 figure is approximately the interest paid in the first year of a 30-year fixed rate mortgage of $500,000 with an interest rate of 5 percent.