

Key Elements of the U.S. Tax System

How might low- and middle-income households be encouraged to save?

TAXES AND RETIREMENT SAVINGS

Q. How might low- and middle-income households be encouraged to save?

A. Expanding access to savings vehicles and scaling back deductions to provide low- and middle-income households with better incentives could make a difference.

Low- and middle-income families receive significant income support through tax breaks, notably through refundable credits such as the earned income tax credit and the child tax credit. But when it comes to building wealth—defined as what you own minus what you owe—the federal tax code offers such families far less.

Wealth is important: It keeps people afloat during financial emergencies like job loss or unexpected expenses. It provides a foundation for a secure retirement. And it opens doors to upward mobility, such as a down payment on a first home or college tuition.

The main wealth-building vehicles for most people in the United States are homeownership (through building equity and, hopefully, appreciation) and retirement savings accounts. Perversely, large tax subsidies for these assets mostly benefit the already wealthy. Most tax benefits for the mortgage interest deduction, state and local property tax deductions, and 401(k)s and similar retirement plans accrue to the highest-income taxpayers. That's because these tax subsidies are structured as deductions and exclusions, which provide households in higher tax brackets with bigger subsidies. Further, lower-income households are less likely to have enough deductions to make itemizing on their tax returns worthwhile, and itemization is required to claim major homeownership tax breaks. The Tax Cuts and Jobs Act of 2017 further reduced the share of the tax units itemizing deductions to only about 10 percent. Lower-income workers, particularly those in part-time or temporary employment, have less access to and are less likely to participate in employer-based retirement plans.

At the same time, many low- and middle-income taxpayers simply do not participate in the regular and automatic saving vehicles through which much wealth is accumulated, such as paying off a mortgage and making regular deposits to retirement accounts.

A variety of changes would reduce the bias toward higher-income households by replacing existing subsidies with better-targeted incentives. Almost all these proposals favor some movement toward tax credits and away from deductions, and many use insights from behavioral economics to get more bang for a tax buck forgone.

HOMEOWNERSHIP

Credits to encourage homeownership can take different forms. They can provide an up-front credit for first-

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time homebuyers of primary residences, similar to the temporary credit employed as a stimulus measure from 2008 to 2009. (An early version of this credit served as an interest-free loan to be paid back to the Internal Revenue Service.) Alternatively, homeowners could receive smaller annual credits proportional to their home equity, up to a designated maximum. Another approach is to provide a credit against property taxes to defray a significant cost of homeownership. Reforms that reward building equity instead of subsidizing mortgage interest (which a badly designed credit could also do) would encourage saving instead of acquiring debt.

RETIREMENT

A saver's credit is available to moderate-income taxpayers who contribute to qualified retirement plans. However, the credit is nonrefundable and phases out quickly at higher incomes, making few people eligible for the maximum amount. Some economists have proposed expanding the credit and making it refundable, so that workers with no net income tax liability could claim it.

More expansive proposals include reshaping the complicated pension landscape to simplify plans and increase access to employer-based retirement accounts with automatic enrollment. Maximum contribution limits to tax-favored accounts would be lowered, and the government would instead match low- and moderate-income workers' contributions. Any credits or matching employer contributions could not be accessed until retirement. Pension antidiscrimination rules could be revised to favor plans that support more full- and part-time employees.

SAVINGS AND ACCOUNT OWNERSHIP

Many low- and middle-income workers receive large refunds from refundable tax credits. A "saver's bonus" could encourage taxpayers to save a portion of their refunds in qualified savings accounts. Taxpayers are already able to contribute to individual retirement accounts until the tax-filing deadline and apply any deductions or saver's credits against their tax year's liability. Some tax preparers and tax preparation software remind taxpayers that they can do this and make clear how much tax they would save if they do. Tax time could also be used to link taxpayers to savings vehicles, such as children's savings accounts or prepaid cards with savings features for taxpayers without bank accounts.

Updated May 2020

Further Reading

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