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# Right Side Up? Tax System Solutions

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# Right siding the tax system

## Some approaches

- Number of possible ways:
  - Cap deductions
  - Target deductions / credits to lower income
  - Make taxation more progressive
  - Make Credits refundable
  - Others ?
- Will present tax credit Refund-ability  
Disclaimer – - Not a tax preparer  
Presentation about policy not tax preparation

# Agenda

- Encouraging Socially Valued Activities Thru the Tax Code
- Addressing inequities thru Savers' Tax Credit
  - How it works
  - ..or Does it?
- A Proposal – Uniform Refundable Tax Credits
  - Example
- Questions & Discussion

# Tax Code – Used to Encourage Socially-valued Activities

- Deductions for Desired Activities

■ Homeownership	■ Charitable	■ Retirement
■ Healthcare	■ Education	

- Impact- results ?

- Links size of tax break to HH's marginal tax bracket
- Result: higher-income taxpayers receive larger incentives than lower-income taxpayers
- Implication: the more you make the more “socially valued” your activity.
- More than one third of HHs have NO federal income tax liability
- 80% of children in single parent households- no tax liability

# Deductions based on Marginal rate – Example \_ Retirement Accounts

- Individual Retirement Accounts (IRAs): Deposit deductible based on whether an active participant in retirement plan, tax status and have adequate earned income.
  - Ex: Married filing jointly (w/out employer plan ) can deduct up to \$8,000 in contributions.
- But, For filers without taxable income, no deduction. Resulting:
  - Bottom 40% Income held 5.3% of all IRA assets
  - Top 20% income bracket held 69% of IRA assets  
**(2001)**

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# Savers' Credit (2001; extended 2005)

## – a Right Side Up approach?

- Applies to retirement plan contributions
  - IRAs, 401(k)s, etc.
- Provides different percentages of tax credit (highest 50%) depending on income
- Implicit savings “match” through progressive deduction rate
- Can be claimed by LMI HHs who make retirement savings plans contributions
  - Example for 50% - Married/joint – \$30,000 or less
- Applies to contributions up to \$2,000 p.a. per individual

# New Savers' – Eligibility Table – Progressive

Savers' Credit	AGI Married Filing Jointly
50% of contribution	\$0 - \$30,000
20% of contribution	\$30,001 – \$32,500
10% of contribution	\$32,501 - \$50,000
Not Eligible	\$50,001 and over

# How it works – a best case example

## Story of Joe & Sally

- Married filing jointly - \$34,000 Income
  - Each open an IRA at tax time
  - Both contribute \$2,000 (\$4,000); lowers AGI to \$30,000 – changes bracket.
  - Qualify for 50% credit; receive \$2,000 deduction off federal tax bill.
- In effect, a 50% match on savings

What a deal!

Joe & Sally have started retirement saving

# New Savers' ..... does it work?

- Who would be eligible
  - 2005 – 59 MM tax filers were eligible for 50% credit based on income
    - 14% of these qualify for the credit ( 8.4mm)
      - The rest –no taxes from which to deduct
      - One quarter of taxes filed w/out tax liability
    - Of 8.4mm:
      - 43,000 (less than one tenth of a percent) capable of taking **full** credit
  - Less than 1/10<sup>th</sup> of % of income at/below Joe & Sally can join them.
  - IRS data indicate that in each of 2002 and 2003, approx. 5mm filers claimed some portion of tax credit

# Savers' Credit

## How to fix it

### 1. Make Credit Refundable

- ❑ Brookings estimates this would double program cost to \$4Bn p.a.
- ❑ Examples of Refundable Tax Credit Programs:
  - Earned Income Tax Credit
  - Child Tax Credit

### 2. Index AGI limits to Inflation

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# Uniform Refundable Tax Credits

- Refundable Credits -examples:
  - Earned Income Tax Credit
  - Child Tax Credit
- Make these credits uniform:
  - Not depend on household's marginal tax bracket
  - A refundable credit of \$1 is worth the same to all households, no matter their bracket, regardless of whether income owed or not.

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# Proposal – Uniform Refundable Tax Credits

- Transform existing tax incentives (housing, charitable and other) into uniform refundable tax credit
- Make Refundable credit available to **all** qualifying households even those that owe no Income Tax
- Make the Transfer ‘Revenue Neutral’- by capping cap size

# An Example – Uniform Retirement Refundable Credit

- Retirement Savings Plans
  1. Dispense with all deductions
    - Get rid of IRA deduction / 401(k) employer deduction
  2. Replace with 30% matching refundable credit / provide for cap (as current IRA)
- Revenue Neutral
- Equitable