An Approach for Using the Refundable Saver's Credit to Improve Retirement Outcomes

By Catherine Reilly

The Saver's Tax Credit ("Saver's Credit") is a program that aims to incentivize and support retirement savings for individuals with low and medium incomes. In its current form, eligible individuals who have made a contribution to a retirement account during the tax year can receive a tax credit that reduces their tax liability for that year.

Several bills currently contain proposals to make the Saver's Credit refundable. In its current form, the credit reduces the recipient's tax liability, but if it became refundable, the government would deposit the credit into a retirement account on behalf of the recipient. This would make the Saver's Credit similar to an additional government matching contribution for low- and middle-income individuals. Making the tax credit refundable creates a stronger incentive to save for retirement. It could also help raise awareness of the credit and encourage more people to take advantage of it, thereby supporting retirement readiness for a larger share of the population.

Furthermore, to the extent that lower-income individuals benefit less from the ability to make pre-tax contributions because they are in lower tax brackets, the Saver's Credit could also help equalize the tax benefits of retirement saving among different income groups.

50% Higher Income in Retirement — But Only With Appropriate Investments

A refundable Saver's Credit could significantly improve the retirement readiness of recipients. According to research by Georgetown University, a refundable Saver's Credit that is invested in a retirement plan with market-based returns could increase the retirement income of recipients by as much as 50%.

However, this calculation assumes that the refundable tax credits are invested in a typical retirement portfolio, with an allocation to equities and bonds that becomes more conservative as the individual approaches retirement. The average expected return of the portfolio used in these calculations is 4.8%. Some of the current federal proposals would invest the refundable tax credits in government bonds unless the recipient specifically designates an alternative account. Series I Savings bonds currently yield only about 1.6%. Based on our calculations, if the refundable Saver's Credits were invested in government securities instead of a retirement portfolio, the improvement in retirement income would be only about 24%, or only half as much as if the assets were invested in a typical retirement portfolio.

Rather than having the default be Treasury bonds, the government could establish a dedicated Saver's Credit IRA with an investment menu similar to that of a typical defined contribution (DC) retirement plan. The menu could comprise a low-cost, passive, QDIA-type investment option such as a target date fund (TDF) as the default and a limited range of additional menu options (e.g., equity fund, bond fund, money market fund) that investors could choose from. This way, Saver's Credit recipients would receive comparable returns on their "matching" government contributions as 401(k) or the federal Thrift Savings Program (TSP) participants. The federal government could select the investment manager of its choice to provide these investment funds, just as it does with the TSP.

The Private Sector Could Provide a Saver's Credit IRA

In the last year for which we have data (2018), approximately 8.5 million individuals claimed the Saver's Credit for an average amount of $200. This is only a small fraction of the individuals who could be eligible for the credit, based on their income level.

Some proposals for a refundable Saver's Credit have assumed that the refundable version would be paid into the retirement account designated by the recipient. The complexity and cost involved in paying such large volumes of small refundable credits into multiple retirement accounts, and the inevitable errors (including missing and incorrect account numbers), that this process would involve have raised questions about the workability of such a program.

The private sector could provide a simple and cost-effective way to administer the program. In many ways, this proposal is like the Obama Administration's myRA program, except with far higher net returns to participants. This approach would also simplify the administrative process and lower the cost to the government by reducing the number of transactions and making the program self-sustaining.

The federal government would initially pay all of the refundable tax credits into a dedicated Saver's Credit IRA. The IRS would not be responsible for administering this arrangement; rather, it would contract out management of the arrangement and its assets to private sector providers through competitive procurement. Saver's Credit recipients would have the ability to either leave their assets in the Saver's Credit IRA or transfer them to another qualified retirement plan of their choice.

Using this approach would not only simplify but significantly reduce the administrative complexity and cost to the government. The IRS would provide the Saver's Credit arrangement with one annual payment and the information that would be needed to set up accounts. The private sector technology provider would then set up the accounts for the individuals, invest the assets on their behalf using the external asset manager(s) selected by the government, and provide the digital consumer interface for the individuals to access and manage their accounts online and through their phones.

Best Practice Defaults and Technology Can Generate Higher Market Returns at Lower Cost

For participants, this solution would be comparable to receiving an employer matching contribution to a 401(k). They could change their investment allocations or move the deposit of their refund to an external 401(k) retirement plan or another IRA at any time if they wanted. However, we know from experience that inertia is a powerful force, and a majority of retirement plan participants stay in their default investment. In this proposal, even if participants do not engage with the plan, the refunds would automatically be put in an appropriate retirement investment that would offer the best chance of improving their retirement income. Participants also could choose to accumulate assets in the Saver's Credit IRA and then transfer their balance to an external plan later once they had amassed a sufficient balance.

Through the use of technology and digital communications, it would be possible to run the Saver's Credit IRA in a way that would be very low-cost for participants. Any fees would be more than made up for by the higher expected returns from the retirement portfolio compared to Treasury bonds.

To make the plan self-funding, it might be necessary to charge a low fee on incoming contributions in addition to an ongoing management fee. To illustrate this type of structure, the UK government plan, NEST, charges 1.8% on contributions and 0.3% on assets (this includes the cost of the underlying investments). The exact charging structure under which the Saver's Credit plan would be viable will depend on the precise specifications, which would be in the control of Congress and/or the Administration.

A Public-Private Partnership Can Improve Retirement Outcomes

Modern technology makes it possible to implement a refundable Saver's Credit in a way that is convenient and low-cost for both the government and the recipient, while providing full flexibility to individuals. Refundability could act as an incentive for more individuals to contribute to a retirement plan to gain the credit. It would also help equalize the retirement saving incentives directed at low- and medium-income taxpayers compared with those who have higher incomes. Investing the credit in an appropriate retirement portfolio, rather than government bonds, would significantly improve the expected income in retirement for recipients.

Most importantly, the refundable Saver's Credit offers a real opportunity to improve retirement security for millions of Americans.

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