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Retirement Saving Incentives and Personal Saving

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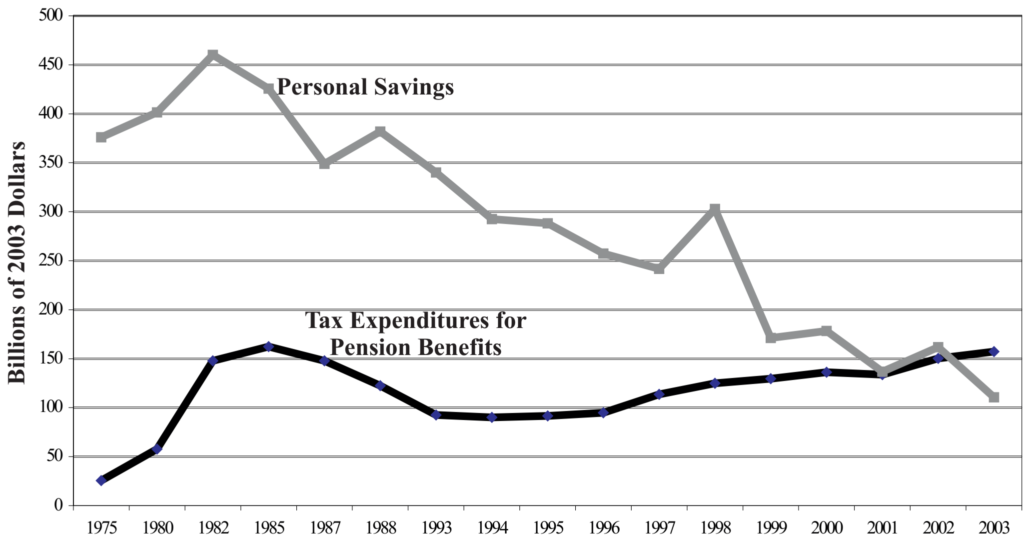
To encourage saving for retirement, private pensions such as employer sponsored 401(k) plans or IRAs receive favorable tax treatment by the federal government. A major goal of those tax provisions is to increase personal saving. A measure of the value of those tax benefits is provided by the Treasury Department, and the National Income and Product Accounts contains a measure of personal saving. Admittedly, both those measures have a number of weaknesses and limitations, but a comparison of them over time nonetheless provides a revealing portrait of their relationship. The chart below compares personal saving with income tax expenditures for pension benefits and personal savings for selected years from 1975 to 2003. These tax expenditures include ''subsidies'' for benefits in 401(k) plans, other employer plans, IRAs, and Keogh plans, as well as credits like the small-business retirement plan credit and the savers credit.

With the exception of some increases in 1982, 1988, and 1998, real personal savings has been declining over the 27-year period the chart presents. (As a percentage of personal income, the decline is much steeper.) Although on the rise again lately, tax expenditures for pension benefits fell off from the early 1980s until recently because of the stock market boom (which reduced required employer contributions for some types of pension plans), recent reductions in statutory tax rates (making deductions or deferral less advantageous), and legislative actions that restricted the limit on pension plan funding under the tax code.

With the sudden drop in personal savings in 1999 and its steady decline in more recent recession years, government tax expenditures on pension benefits began to approach the personal savings level by the end of the 1990s. In 2001 and 2002, personal savings exceeded tax expenditures by less than 8 percent. In 2003, tax expenditures on benefits actually surpassed the level of total personal savings by nearly $50 billion. That trend appears to be continuing in 2004: The personal savings through the third quarter is about $82 billion, while the Office of Management and Budget projects that tax expenditures on pension benefits will total roughly $163 billion for the fiscal year. One reason for those trends is that the government does not really subsidize saving. It subsidizes deposits, which can then be borrowed for consumption. People and companies can often generate tax benefits for saving and investment without any additional net saving or investment.

Retirement Savings Incentives vs. Personal Savings, 1975-2003



Note: Tax expenditures are not strictly additive. The cash flow measures above do not reflect the present value of pension subsidies.
Source: The Urban Institute, 2004. Based on data from the Office of Management and Budget, *Analytical Perspectives* (prior to 1990, Special Analyses), Budget of the United States Government, various years. Personal savings data from the Board of Governors of the Federal Reserve, 2004.