

Key Elements of the U.S. Tax System

How does the availability of tax-favored retirement saving affect national saving?

TAXES AND RETIREMENT SAVING
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Q. How does the availability of tax-favored retirement saving affect national saving?

A. Incentives for retirement savings only increase *private saving* if the tax breaks encourage households to set aside additional cash rather than simply transfer it from other nest eggs. And it only increases *national saving* if the increase in private saving exceeds the revenue loss from the tax subsidy.

Tax-favored retirement savings accounts are popular: half of working adults take advantage of them. It's unclear, however, whether the accounts make much difference to overall savings and retirement preparedness. Although traditional pensions and other tax-deferred vehicles such as 401(k) plans and individual retirement accounts do make up a sizable share of households' wealth, the accounts only increase private saving if they encourage households to finance their own contributions through reduced consumption or increased earnings.

Put another way, incentives do not increase private saving if households finance their contributions by borrowing, by shifting their existing assets into tax-favored accounts, or by shifting funds they would have saved even in the absence of the incentive. Likewise, private saving does not increase if households respond to employer-provided pensions or contributions with equivalent reductions in other saving or with increased borrowing.

The earliest research on both traditional defined-benefit pensions and defined-contribution plans suggested that they had a strong impact on private wealth and saving. These studies, however, were marred by technical missteps. Later research has found a significantly smaller impact—and, in some cases, none at all. To the extent that the tax incentives do raise private saving, we can expect the impact to be greater for lower- and middle-income households than for high-income households, who tend to use the accounts to reduce present or future tax liability.

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Further Reading

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Bernheim, B. Douglas. 2003. "Taxation and Saving." In *Handbook of Public Economics*, vol. 3, edited by Alan Auerbach and Martin Feldstein, 1173–1249. Amsterdam: North-Holland.

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Engen, Eric M., William G. Gale, and John Karl Scholz. 1996. "[The Illusory Effects of Saving Incentives on Saving.](#)" *Journal of Economic Perspectives* 10 (4).

Poterba, James M., Steven F. Venti, and David A. Wise. 1996. "[How Retirement Saving Programs Increase Saving.](#)" *Journal of Economic Perspectives* 10 (4): 91–112.