

# Tax Incentives and Retirement Savings

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# Purpose

- Tax incentives used to promote savings in funded pension plans (EET)
  - Contributions and returns on investments tax exempt
  - Benefits (payouts) are taxed
  - NPV tax break  $>$  NPV future tax payments (compounding interest)  $\rightarrow$  tax incentive
- Do tax incentives promote retirement savings?

# Objective

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- Tax incentives promote savings earmarked for retirement, but it could be the result of
  - People shifting savings from other traditional saving vehicles → re-allocation (take advantage tax break)
  - People actually increase their overall saving reducing consumption → new savings
- Do tax incentives increase retirement savings through reallocation or new savings?

# Why this distinction is important?

- If reallocation → national saving constant (or fall). Costly way of increasing saving earmarked for retirement.
- If new savings → national saving increases (important for countries with low saving rates).

# Structure of the presentation

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1. Reallocation vs. new savings
2. Tax incentives increase new savings for mid to low-income individuals
3. Other mechanisms to promote retirement savings.
4. The impact of changes in the structure of the tax incentive

# Reallocation vs. New Savings

- Theoretically: effect of tax incentives ambiguous.
  - Income effect (tax incentive changes total amount needed to save).
  - Substitution effect (change composition portfolio)

# Reallocation vs. new savings: empirical evidence (1)

- Important empirical research concludes that tax incentives lead mainly to reallocation
  - Attanasio et al. (2004), Disney et al. (2007), Chung et al. (2006) for the UK.
  - Gale and Scholz (1994), Engle et al (1994, 1996), De Leire (2002), Attanasio et al. (2004) for the USA.

# Reallocation vs. new savings: empirical evidence (2)

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Other research concludes that tax incentives create mainly new savings, raising national savings.

- Poterba et al. (1995, 1996a, 1996b), Hubbard and Skinner (1996), Engelhardt (2001) and Benjamin (2003) for the USA.
- Ayuso et al. (2007) for Spain.
- Fehr and Habermann (2006, 2007) for Germany.

# Reallocation vs. new savings: empirical evidence (3)

- Empirical evidence is mixed.
- On balance, the impact of tax incentives on retirement savings is likely to lie somewhere between the extremes of “no new saving” and “all new saving” but with a fairly wide range of plausible estimates
- Why such diversity of empirical results?

# Reasons for such diverse empirical results

- In principle, the effect of tax incentives on saving could be gauged by comparing
  - the total savings of individuals who contribute to retirement plans with tax incentives
  - with those of individuals who do not contribute,
  - under the assumption that participations is exogenous to saving propensities.

# Reasons for such diverse empirical results

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- In practice, higher savings of those participating in such plans could mainly reflect higher saving preferences rather than a genuine net increase in saving.
- The wide range of empirical results is partly explained by differences in the approach taken by authors to control for the potential heterogeneity in savers' preferences and other unobservable characteristics.

# Reasons for such diverse empirical results

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- Additionally, there is not appropriate data
  - describing saving and consumption behaviour
  - following individuals over time (longitudinal)
- Researches resort to diverse econometric proxies to build a reliable indicator.

## Summing up

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- Tax incentives increase retirement savings through a combination of reallocation and new savings.
- The empirical literature is mixed about the relative importance of reallocation and new savings due to savers' heterogeneity.

## Mid to low-income individuals

- It is generally argued that high income individuals tend to reallocate savings in the face of tax incentives,
- while for mid- to low-income individuals, participating in funded pension plans, their contributions tend to come from new savings (Engen & Gale, 2000).
- However, recent work suggest that high income individuals close to retirement age also increase new savings (Ayuso et al., 2007).

# Other mechanisms to promote retirement savings

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- Compulsion: Australia (Connelly and Kohler, 2004; Barret and Tseng, 2007).
- Soft-compulsion: automatic enrolment with opt-out clause.
- Matching contributions.

# Automatic enrolment with opt-out clause

- Literature on behavioural economics stresses the importance that “inertia” or “passive decision” plays in the decision to participate in funded pension plans (Choi et al., 2002; Mitchell and Utkus, 2003; and Beshears *et al.*, 2006)
- Hence automatic enrolment with opt-out clause increases participation and thus retirement savings (Madrian and Shea, 2001 for the USA; Cronqvist and Thaler, 2004; and Sunden 2004 for Sweden).

# Matching contributions

- Employers, as long as employees contribute to their personal plans, will match entirely or partially their employees' contributions.
- Matching contributions promotes retirement savings and new savings, given that employees tend to maximise their contributions knowing that employers will match it.

## Matching contributions: Evidence

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- Gale et al. 2004; Choi et al. 2004; and Duflo et al. (2005), among other authors, report a positive relationship btw matching contributions and retirement savings
- Beshears et al. (2007) and Card and Ramson (2007) argue that matching contributions may not increase retirement savings. Their evidence focus in particular groups, like college professors, and very small samples.

## Summing up

- Tax incentives increase retirement savings through a combination of reallocation and new savings.
- Increasing participation of low to mid-income individuals will increase the likelihood of increases through new savings.
- Automatic enrolment with an opt-out clause, and matching contributions increases the participation of low to mid-income individuals.

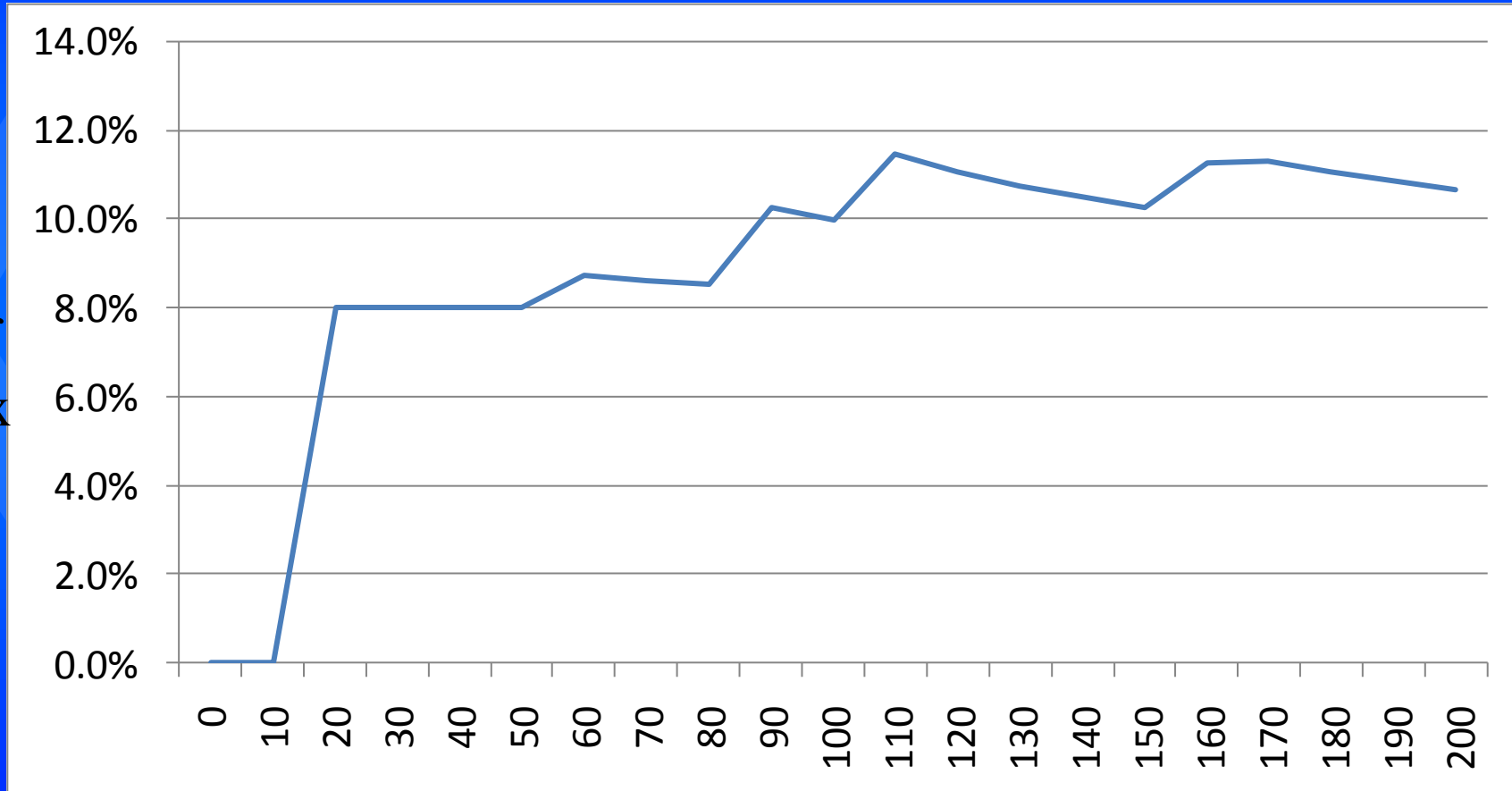
# Impact of alternative incentive structures

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- Tax credit instead of tax subsidy: improves incentives for low and middle income individuals (those who participate less in funded pension plans), thereby increasing new saving (Engle and Gale, 2000).
- Matching contributions instead of tax incentives

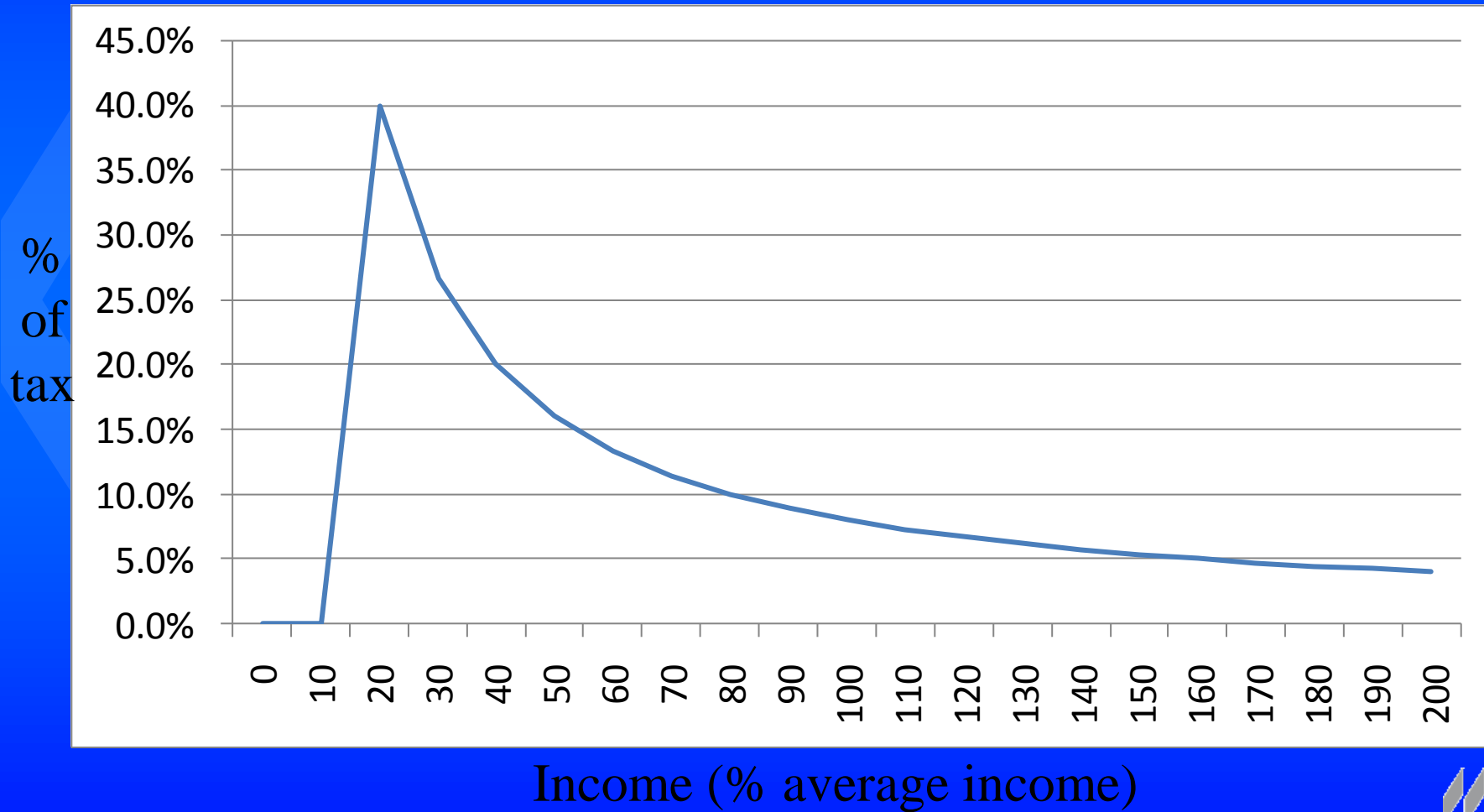
# Tax incentives - Tax deduction

%  
of  
tax

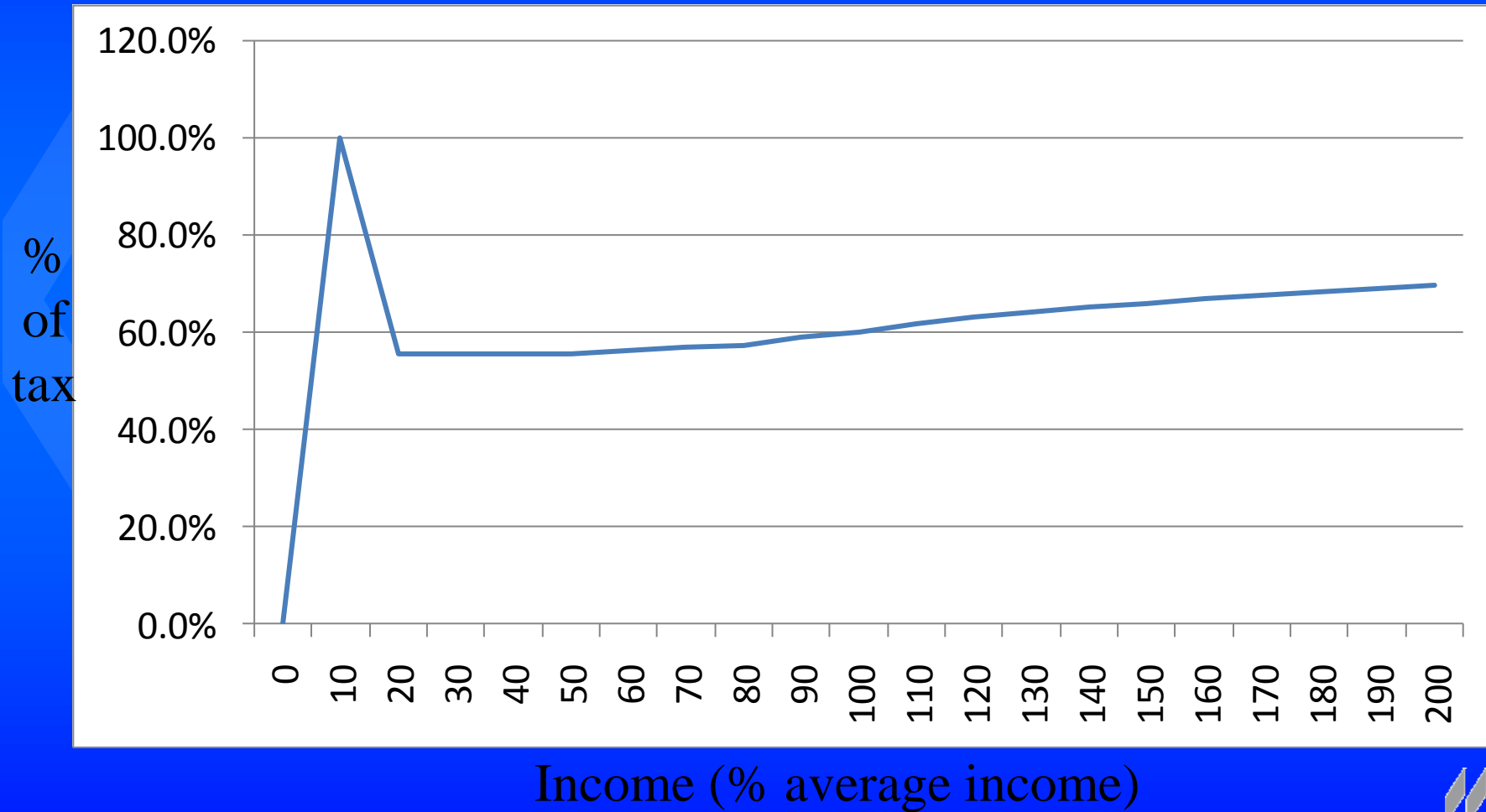


Income (% average income)

# Tax incentive – Tax credit



# Incentive – Matching contributions



# Results of different incentives

- Tax deductions provide incentives that increase with income.
- Tax credits provide incentives that are inversely related with income
- Matching contributions provide incentives that are more evenly distributed across income groups.

# Conclusions

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- Tax incentives increase retirement savings through a combination of reallocation and new savings.
- Increasing participation low to mid-income people increase likelihood increases through new savings.
- Automatic enrolment with opt-out, and matching contributions increases the participation of low to mid-income individuals.
- Incentives are more evenly distributed across income groups using matching contributions.



# THANK YOU!

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