

Few eligible taxpayers presently are utilizing the "personal pension" deductions in either the United States or the Canadian programs—about 1 percent and 2 percent of those eligible, respectively. The evaluation in this paper indicates that taxpayers indeed may be wise in ignoring this particular tax incentive scheme. In short, the attraction of this program in inducing incremental personal saving may be overrated. The income tax advantages in participation superficially may appear attractive, but a closer examination shows that the relative dollars-and-cents advantages in fact may be quite nominal. Moreover, these "personal pension" programs have severe constraints on liquidity and on forms of investment, and these restrictions must be weighed against any supposed increase in investment yields because of preferential income tax treatment.

A. THE UNIVERSAL PERSONAL-PENSION DEDUCTION: RELATIVE NET YIELD ADVANTAGES IN PARTICIPATION

The present individual income tax does tend to discourage personal saving for future needs—by the compound effect of permitting current deductions on borrowing charges, coupled with the taxation of interest earnings on savings.⁵ This announcement effect can be mitigated by permitting special income tax treatment of selected transactions, thereby increasing their net (aftertax) yields on taxpayer investment. This difference in net yields is the stimulus for increased personal saving. Response will depend on the interest elasticity of personal saving to changes in net yields, and, of course, the magnitude of change in yield.

Given the mechanics of alternative income tax treatment, one can compare the relative net yield advantages of two or more taxpayer alternatives. Some abstractions are in order, however, to provide a consistent basis for comparison. Assume initially that a taxpayer is restricted in investment to a specific corporate bond, but has income tax alternatives in purchasing and realizing income from these bonds. The gross (before tax) yields, risk, and liquidity aspects of the tax options are equal, but alternative tax treatment may affect net (after-tax) yields.

Assume further—for comparative purposes—that the taxpayer withholds a specified sum from gross income, for retirement saving purposes.⁶ This is not to suggest that the individual in question is a "target" saver, because we in fact are interested in changes in the rate of personal saving as a consequence of the income tax incentive. Rather, this model illustrates the relative change in net yields, as the basis for taxpayer response.

The taxpayer's savings would be subject to "standard" tax treatment if he had no tax options. This approach (designated option A) may be termed the "no tax break" situation. The individual has set aside a certain sum from gross income, but current income taxes first must

⁵ Alan Williams, *Public Finance and Budgetary Policy*. (New York, 1963), pp. 62–65.

⁶ One alternatively can structure the argument with retirement saving as a function of disposable income. The advantage of tax deductibility can be illustrated as an addition to the initial investment; e.g., $Ra(1 + \frac{r}{1-r}) = R$, where Ra = desired savings from disposable income, and R is the actual increased basis for investment because of the current deduction.