economic prosperity for future generations. It is odd, therefore, that the tax laws discourage the most direct way in which one generation can help the next.

In addition to the tax code, many other policies and institutions in our society reduce the incentive for households to save. Some government benefits, such as welfare and Medicaid, are means-tested; that is, the benefits are reduced for those who in the past have been prudent enough to save some of their income. Colleges and universities grant financial aid as a function of the wealth of the students and their parents. Such a policy is like a tax on wealth and, as such, discourages students and parents from saving.

There are various ways in which the tax code could provide an incentive to save, or at least reduce the disincentive that households now face. Already the tax laws give preferential treatment to some types of retirement saving. When a taxpayer puts income into an Individual Retirement Account (IRA), for instance, that income and the interest it earns are not taxed until the funds are withdrawn at retirement. The tax code gives a similar tax advantage to retirement accounts that go by other names, such as 401(k), 403(b), Keogh plan, and profit-sharing plans. There are, however, limits to who is eligible to use these plans and, for those who are eligible, limits on the amount that can be put in them. Moreover, because there are penalties for withdrawal before retirement age, these retirement plans provide little incentive for other types of saving, such as saving to buy a house or pay for college. A small step to encourage greater saving would be to expand the ability of households to use such tax-advantaged savings accounts.

A more comprehensive approach would be to reconsider the entire basis by which the government collects revenue. The centerpiece of the U.S. tax system is the income tax. A dollar earned is taxed the same whether it is spent or saved. An alternative advocated by many economists is a consumption tax. Under a consumption tax, a household pays taxes only on the basis of what it spends. Income that is saved is exempt from taxation until the saving is later withdrawn and spent on consumption goods. In essence, a consumption tax puts all saving automatically into a tax-advantaged savings account, much like an IRA. A switch from income to consumption taxation would greatly increase the incentive to save.

Con: The Tax Laws Should Not Be Reformed to Encourage Saving

Increasing saving may be desirable, but it is not the only goal of tax policy. Policymakers also must be sure to distribute the tax burden fairly. The problem with proposals to increase the incentive to save is that they increase the tax burden on those who can least afford it.

It is undeniable that high-income households save a greater fraction of their income than low-income households. As a result, any tax change that favors people who save will also tend to favor people with high income. Policies such as tax-advantaged retirement accounts may seem appealing, but they lead to a less egalitarian society. By reducing the tax burden on the wealthy who can take advantage of these accounts, they force the government to raise the tax burden on the poor.

Moreover, tax policies designed to encourage saving may not be effectiv at achieving that goal. Economic theory does not give a clear prediction abou whether a higher rate of return would increase saving. The outcome depend on the relative size of two conflicting forces, called the *substitution effect* and th *income effect*. On the one hand, a higher rate of return raises the benefit of saving Each dollar saved today produces more consumption in the future. This substitu tion effect tends to increase saving. On the other hand, a higher rate of return low ers the need for saving: A household has to save less to achieve any target leve of consumption in the future. This income effect tends to reduce saving. If th substitution and income effects approximately cancel each other, as some studie suggest, then saving will not change when lower taxation of capital income raise the rate of return.

There are ways to increase national saving other than by giving tax breaks t the rich. National saving is the sum of private and public saving. Instead of tryin to alter the tax code to encourage greater private saving, policymakers can simpl raise public saving by reducing the budget deficit, perhaps by raising taxes on th wealthy. This offers a direct way of raising national saving and increasing pros perity for future generations.

Indeed, once public saving is taken into account, tax provisions to encourag saving might backfire. Tax changes that reduce the taxation of capital incom reduce government revenue and, thereby, lead to a larger budget deficit. T increase national saving, such a change in the tax code must stimulate privat saving by more than the decline in public saving. If this is not the case, so-calle saving incentives can potentially make matters worse.

QUICK QUIZ Give three examples of how our society discourages saving. What are th drawbacks of eliminating these disincentives?

CONCLUSION

This chapter has considered five classic debates over macroeconomic policy. F each, it began with a controversial proposition and then offered the arguments p and con. If you find it hard to choose a side in these debates, you may find son comfort in the fact that you are not alone. The study of economics does not alwa make it easy to choose among alternative policies. Indeed, by clarifying the ine table trade-offs that policymakers face, it can make the choice more difficult.

Difficult choices, however, have no right to seem easy. When you hear poli cians or commentators proposing something that sounds too good to be true, probably is. If they sound like they are offering you a free lunch, you should lo for the hidden price tag. Few if any policies come with benefits but no costs.] helping you see through the fog of rhetoric so common in political discourse, t study of economics should make you a better participant in our national debat