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Tax uncertainty and retirement savings diversification☆

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Abstract

We investigate the optimal savings decisions for investors with access to pre-tax (traditional) and post-tax (Roth) versions of tax-advantaged retirement accounts. The model features a progressive tax schedule and uncertainty over future tax rates. Traditional accounts are valuable for hedging retirement account performance and managing current income near tax-bracket cutoffs, whereas Roth accounts allow investors to mitigate uncertainty over future tax schedules. The optimal asset location policy for most households involves diversifying between traditional and Roth vehicles. Contrary to conventional advice, the substantial economic benefits from Roth investments are not limited to investors with low current income.

JEL classification: G11, H31, J32

Keywords: Tax uncertainty, Asset location, Retirement savings, IRA, Roth

1. Introduction

Financial decisions have significant effects on household welfare and must often be made within complex economic and regulatory environments (Campbell, 2006, 2016). Among the most important of such decisions are choices related to saving for retirement, including the optimal amount of savings, portfolio allocation across assets, and location of assets within various accounts. In this context, locating retirement savings in tax-advantaged vehicles is of critical importance, and the current United States (US) tax code provides investors with a number of alternatives, such as Individual Retirement Accounts (IRAs) and employer-sponsored 401(k)

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