

Role of Direct Tax Reforms in Shaping Savings and Investment Behaviour in India

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Abstract

This study examines the impact of recent direct tax reforms in India—particularly the introduction and expansion of the New Tax Regime—on household savings and investment behaviour. With the help of Life-Cycle Hypothesis and evidence-based support of behavioural economic insights, the research investigates whether the rationalization of tax slabs has shifted individual financial decision-making from deduction-driven savings toward goal-based investment allocation.

Using secondary data obtained from official publications of the Ministry of Finance and the Income Tax Department that includes ITR filing statistics and regime adoption patterns, the study analyses structural changes in taxpayer preferences. The substantial migration of taxpayers toward the New Tax Regime (72% in AY 2024–25) suggests a declining reliance on tax-incentivized instruments under provisions such as Section 80C. Historically, these deductions functioned as fiscal incentives influencing long-term savings decisions. Their reduced relevance under the simplified regime potentially alters intertemporal allocation choices consistent with the Life-Cycle Hypothesis (Modigliani & Brumberg, 1954).

The study uses behavioural economics and rational choice theory to interpret the reform, especially the idea that policy "nudges" affect financial behaviour (Thaler & Sunstein, 2008). Results show that tax slab rationalization increases allocative flexibility and decreases distortions linked to deductions, but it also places more of the burden of disciplined long-term savings on individuals. The study concludes that in order to maintain national savings goals, complementary policies in financial literacy and retirement security are required, even though tax simplification improves administrative effectiveness and financial autonomy.

Keywords: Direct Tax Reforms, New Tax Regime, Household Savings, Life-Cycle Hypothesis, Behavioural Economics, Fiscal Policy, Investment Behaviour

Introduction

India's direct tax system has undergone significant structural reforms over the past decade with the objective of simplifying compliance, widening the tax base, and improving administrative efficiency. A major milestone in this process was the introduction of the New Tax Regime in the Union Budget 2020–21. The reform has departed from traditional deduction-based framework by offering lower tax rates in exchange for most deductions and exemptions. Previously, provisions such as Section 80C, 80D, and related tax-saving instruments played a pivotal role in shaping household savings decisions by encouraging investments in specified financial products.

In a country like India, where household savings constitute a major component of gross domestic savings, tax incentives have long functioned as revenue instruments and behavioural tools. The Old Tax Regime has effectively created a system of structured savings by linking tax liability reduction to investments in provident funds, insurance policies, equity-linked savings schemes (ELSS), and other long-term instruments. As a result, many individuals have engaged in tax-induced or compliance-driven savings behaviour.

The rationalization of tax slabs under the New Tax Regime represents a structural shift in the incentive architecture governing financial decision-making. By reducing the relevance of deductions and exemptions, the reform potentially alters the allocation choices of taxpayers. Individuals are now presented with a choice between a deduction-heavy regime and a simplified rate-based regime.

In terms of academic contribution, this study adds to the limited empirical literature examining behavioural consequences of direct tax reforms in emerging economies, particularly in the Indian context. While prior research has extensively examined tax compliance and revenue implications, relatively fewer studies have explored how slab rationalization affects household savings allocation decisions. By integrating fiscal policy analysis with behavioural economic interpretation, the study bridges the gap between public finance reform and individual financial behaviour research. It contributes to understanding how structural tax simplification can reshape financial planning patterns beyond mere revenue outcomes.

Understanding these behavioural consequences is particularly important in the Indian context, where financial literacy levels vary significantly and long-term savings discipline has historically been supported through tax-linked mechanisms. While prior studies have examined tax deductions and savings preferences at micro levels, limited research has analysed the macro-structural impact of direct tax slab rationalization on savings orientation using secondary fiscal data.

The objective of the study is to analyse the transition from tax-incentivized savings to goal-based investment allocation among individual taxpayers following the rationalization of direct tax slabs in India.

Review of Literature

Singh K., Devi A., & Jyoti (2022)(1) comprises of a study conducted at Hisar, Haryana on how withdrawal of tax deduction affected the savings and investment behaviour conducted using data from 337 respondents which was collected through a structured questionnaire. The research analysed preferences of the respondents among various entities such as bank/post office savings, fixed deposits, provident funds, insurance plans, mutual funds, real estate, gold funds and stock market investments. The analysis was conducted using statistical tests that included Cronbach's alpha, ANOVA, Welch test and post-hoc comparisons which showed no significant differences in savings and investment behaviour across different levels of income earned, even after the removal of tax deductions. The insights from the survey are relevant for the policymakers in understanding individual investment responses to tax policy changes. This study looks at the immediate aftermath of withdrawing deductions. The question would arise as- would people eventually stop saving once the tax is removed or lessened or would the discipline of saving still remain?

From the study "Taxation and Household Behaviour: Analysing the Effect of Taxes on Savings and Spending Habits" by Mandala et al.,(2) conducted on 180 participants to analyse how the tax rules in India influence the individual decisions about spending and saving, the research has determined how the taxes affect the financial decisions of the people by means of incentives, price changes etc. On a behavioural aspect, knowing about taxes encourages people to spend rationally. So, the tax policies are not just financial tools but they also are behavioural incentives that shape the financial decisions of the household by framing the costs and benefits of saving and spending.

The study titled "The role of tax deductions in shaping individual financial behaviour in India" by Madiwalar(2024)(3) examines how tax deductions under Indian Income Tax act influence individual's financial decisions focusing on savings and investment behaviour. It explains the deductions like Section 80C, 80D, and 80E (investments, health insurance and education loans) respectively not only reduce the taxable income but it also encouraged disciplined saving and long-term financial planning. Instruments like PPF and ELSS has become attractive because of dual benefits that is; returns plus tax savings. These benefits have been found to be unevenly accessed by formal sector taxpayers. The study has not proceeded to analyse how these tax deductions affect aggregate savings and investment patterns at a macro level over time. At the national level, it is not known how these deductions affect aggregate savings or national economy over time.

In another study titled "A study on Tax savings strategy adopted by salaried assesses in Mumbai city" by Mr. Sanjay Kumar Tiwari, et al (2024)(4), tax planning while organizing one's own finances that maximizes tax advantages while also ensuring compliance with the law and minimizing any tax liabilities has been found to be challenging for many salaried individuals. The complexities of understanding tax laws and investment options was difficult and a complex process since salaried individual's tax saving opportunities are linked to their investing habits which is a result of their income levels and financial goals which if often times complex in nature because of their lack of knowledge in tax law thereby hindering them from tax planning wisely. It is highlighted in this study that salaried individuals in Mumbai

struggle with the lack of knowledge. It suggests that there is a gap in Tax Literacy- and how much of this behaviour is a choice and how much of it is confusion.

Though previous studies have examined the influence of tax deductions and tax planning behaviour and psychological responses to taxation shaping savings and investments, most of them are region specific and based on primary data. These studies have focused on individual awareness, preferences and the behavioural responses to specific deductions like in the case of salaried individuals and formal sector taxpayers. There was limited research about analysing broader structural reforms in the direct tax system, and the long-term impact of direct tax reforms on household savings and investment patterns using secondary data. There is found to be a lack of analysis that links reform phases with shifts in savings composition and investment allocation across time in India.

Theoretical Framework

This study is theoretically anchored in the Life-Cycle Hypothesis developed by Franco Modigliani and Richard Brumberg (1954)(5), and further supported by insights from Behavioural Economics. The Life-Cycle Hypothesis (LCH) shows that individuals allocate consumption and savings across their lifetime in order to smooth consumption and maximize long-term utility. According to this framework, individuals save during their earning years and dissave during retirement, making financial decisions based on long-term income expectations rather than short-term incentives.

In the Indian context, the Old Tax Regime encouraged tax-incentivized savings through deductions under provisions such as Section 80C. These deductions functioned as structured fiscal incentives that influenced household savings behaviour. From a life-cycle perspective, such tax incentives may distort optimal allocation decisions by encouraging individuals to invest in specific financial instruments primarily to reduce taxable income rather than to meet long-term financial goals.

The rationalization of direct tax slabs and the introduction of the New Tax Regime represent a structural policy shift from deduction-based incentives toward lower marginal tax rates with minimal exemptions. This reform reduces the external incentive to engage in tax-motivated savings, thereby potentially allowing individuals to allocate funds according to personal financial objectives, liquidity preferences, and risk tolerance. Within the Life-Cycle framework, this transition can be interpreted as a movement from tax-distorted saving behaviour toward more consumption-smoothing, goal-oriented investment planning.

Additionally, insights from Behavioural Economics suggest that tax incentives act as “nudges” that shape financial behaviour (Thaler & Sunstein, 2008) (6) When such nudges are reduced or removed, individuals may shift from compliance-driven savings toward autonomous financial decision-making. Therefore, the observed transition from tax-incentivized savings to goal-based investment allocation aligns with both rational intertemporal choice theory and behavioural adjustment mechanisms.

Thus, the theoretical foundation of this study supports the proposition that direct tax reforms influence not merely compliance levels but also the underlying structure of household savings and investment behaviour. The rationalization of tax slabs may gradually reorient taxpayers from deduction-driven allocation strategies toward financially optimized, life-cycle consistent investment decisions.

Methodology

This study adopts a descriptive and analytical research design using secondary macro-level data to examine the behavioural implications of direct tax slab rationalization on household savings and investment patterns in India. The methodology integrates fiscal trend analysis with behavioural economic interpretation to assess structural shifts in financial allocation decisions.

1. Research Design

The research follows a descriptive-analytical design combining quantitative secondary data analysis with theoretical interpretation. It seeks to examine whether structural changes in the direct tax regime correspond with observable shifts in taxpayer behaviour.

Rather than establishing causal relationships, the study identifies behavioural trends and structural transitions inferred from regime adoption patterns, filing statistics, and policy changes. The design is interpretative in nature but grounded in measurable fiscal indicators.

2. Data Sources

The study relies exclusively on secondary data obtained from credible and official sources, including:

- Press releases and annual reports published by the **Ministry of Finance**
- Income Tax Return (ITR) filing statistics released by the **Income Tax Department**
- Official publications of the **Press Information Bureau**
- Supplementary macroeconomic data from the **Reserve Bank of India**

The data covers Assessment Years 2023–24 to 2024–25 and includes:

- Total number of ITR filings
- Regime-wise distribution (Old vs New Tax Regime)
- First-time filers
- Filing growth trends
- Migration percentages between regimes

These datasets serve as observable indicators of behavioural preference in response to tax slab rationalization.

3. Analytical Framework

The analysis is theoretically anchored in the Life-Cycle Hypothesis developed by Franco Modigliani and Richard Brumberg (1954), which explains intertemporal allocation of income between consumption and savings.

Additionally, insights from Behavioural Economics — particularly the concept of policy “nudges” articulated by Richard Thaler and Cass Sunstein (2008) — are used to interpret how fiscal incentives influence financial decision-making.

Within this framework:

- Deduction-based incentives are treated as behavioural nudges shaping structured savings.
- Slab rationalization is viewed as an alteration in incentive architecture.
- Regime migration is interpreted as a behavioural response to incentive restructuring.

4. Analytical Method

The study employs the following analytical techniques:

1. Trend Analysis

Year-wise comparison of ITR filing data to observe growth patterns and structural changes in taxpayer participation.

2. Comparative Regime Analysis

Examination of Old versus New Tax Regime adoption rates to assess shifts in preference toward simplified taxation.

3. Migration Ratio Analysis

Calculation and interpretation of the proportion of taxpayers opting for the New Tax Regime as a proxy indicator of declining dependence on deduction-linked savings.

4. Policy-Behaviour Mapping

Linking observed regime adoption trends with theoretical constructs from life-cycle and behavioural economics frameworks to interpret behavioural transitions.

The migration percentage toward the New Tax Regime is treated as an indirect but observable behavioural indicator suggesting a shift from tax-induced savings behaviour toward autonomous financial allocation.

5. Limitations of the Study

The study is subject to certain limitations:

- It relies on secondary data and does not include primary survey-based behavioural evidence.
- Regime adoption is used as a proxy indicator and does not directly measure changes in actual savings amounts or asset-level allocation.
- The New Tax Regime is relatively recent; therefore, long-term behavioural effects cannot yet be conclusively evaluated.
- Causal inference cannot be established due to the descriptive nature of the research design.

Future research incorporating micro-level household data, longitudinal savings patterns, and demographic segmentation would strengthen empirical validation of behavioural shifts identified in this study.

Analysis and Interpretation

The below table is extracted from the press release by Ministry of Finance that shows

Table 1: ITR Filing Statistics for AY 2024–25 (as of 31 July 2024)(7)

Indicator	AY 2024–25	AY 2023–24	% Change / Share
Total ITRs Filed	7,28,80,318 (7.28 crore)	6,77,42,303 (6.77 crore)	+7.5%
New Tax Regime Filers	5.27 crore	—	72% of total
Old Tax Regime Filers	2.01 crore	—	28% of total
First-Time Filers	58.57 lakh	—	—
Highest Single-Day Filing	69.92 lakh (31 July 2024)	—	—
Aadhaar-based e-Verification	5.81 crore	—	93.56% of verified returns
Returns Processed (till 31 July)	2.69 crore	—	43.34% of e-verified ITRs

Table 2: Trend in ITR Filing Over the Years

Assessment Year	Due Date	No. of Returns Filed
2020–21	10/01/2021	5,78,45,678
2021–22	31/12/2021	5,77,39,682
2022–23	31/07/2022	5,82,88,692

Assessment Year	Due Date	No. of Returns Filed
2023–24	31/07/2023	6,77,42,303
2024–25	31/07/2024	7,28,80,318

The data for AY 2024–25 provides preliminary evidence of a behavioural transition consistent with the rationalization of direct tax slabs in India. The substantial migration of 72% of taxpayers to the New Tax Regime — which offers lower rates with minimal deductions — signifies a reduced reliance on tax-incentivized savings instruments traditionally used under the Old Regime. Earlier, investment decisions were significantly influenced by tax-saving provisions, compelling individuals to allocate funds toward specified instruments primarily to reduce taxable income. However, the preference for the simplified regime suggests a potential shift from deduction-driven financial planning toward more autonomous, goal-oriented investment allocation.

With fewer tax-linked distortions, individuals may now prioritize liquidity, risk-return considerations, and personal financial objectives over mandatory tax-saving compliance. While the data does not directly measure savings patterns, the structural shift in regime preference indicates that direct tax rationalization may be weakening tax-induced savings behaviour and encouraging a transition toward goal-based financial decision-making among individual taxpayers.

Theoretical and Behavioural implications of direct tax slab rationalization.

1. Theoretical background:

The relationship between taxation and savings behaviour has long been examined within the frameworks of life-cycle hypothesis, behavioural finance theory, and public finance theory.

The rationalization of direct tax slabs in India represents more than a structural fiscal reform; it alters the incentive architecture influencing household financial decision-making. Under the Old Tax Regime, savings behaviour was significantly shaped by deduction-linked incentives, particularly under provisions such as Section 80C. These deductions created a tax-induced allocation bias, encouraging individuals to invest in specific instruments primarily to reduce taxable income. Consequently, savings decisions were often compliance-driven rather than aligned with long-term financial objectives.

With the introduction of the New Tax Regime, characterized by lower marginal tax rates and minimal exemptions, the incentive structure shifted from deduction-based encouragement to rate-based simplification. This transition reduces the marginal tax benefit associated with specific savings instruments. As a result, individuals may reallocate financial resources based on liquidity needs, risk tolerance, and long-term wealth accumulation goals rather than solely on tax-saving considerations. Behavioural research suggests that reduced complexity improves decision efficiency and encourages rational allocation patterns. Therefore, the New Tax Regime may facilitate a transition from structured, tax-incentivized savings to goal-based investment allocation.

From an intertemporal choice perspective, tax slab rationalization influences how individuals allocate income between present consumption and future savings. Lower marginal tax rates increase disposable income, potentially enhancing financial flexibility. In the absence of strong tax-linked deductions, savings behaviour may increasingly reflect autonomous financial planning rather than policy-induced compulsion.

2. Behavioural Transition: From Tax-induced to goal-based allocation.

The data for AY 2024–25 indicates that 72% of taxpayers opted for the New Tax Regime. This dominant preference signals a structural realignment in financial decision-making. Under the earlier regime, investment in tax-saving instruments was frequently motivated by tax liability reduction rather than intrinsic financial goals. As slab

rationalization reduces dependency on exemptions, savings decisions may increasingly reflect individual objectives such as retirement planning, wealth accumulation, risk diversification, or liquidity management.

This suggests a transition from compliance-driven allocation to goal-oriented investment behaviour. Without the constraint of deduction ceilings, individuals may adopt more flexible portfolio strategies aligned with risk-return optimization rather than statutory limits. In theoretical terms, this may reduce allocative distortions created by fiscal incentives, thereby enhancing efficiency in household capital allocation.

The reform also removes implicit mechanisms that enforced long-term savings discipline. Tax-incentivized instruments typically carried lock-in periods, indirectly supporting capital formation and retirement security. The decline in such incentives may weaken structured long-term saving habits, particularly among middle-income households.

3. Reconfiguration of household financial savings.

The potential reallocation of funds away from deduction-linked schemes could reshape the composition of household financial assets. In the Old Tax Regime, tax incentives contributed to stable inflows into provident funds, insurance products, and equity-linked savings schemes. With the reduced attractiveness of these instruments under the New Tax Regime, investment flows may shift toward diversified equity funds, direct market participation, or more liquid instruments.

This reconfiguration could enhance capital market dynamism by aligning investments with personal financial goals and risk preferences. Conversely, it may introduce greater volatility in savings patterns and reduce guaranteed long-term contributions to retirement-focused instruments.

4. Policy implications

The observed behavioural shift carries several important policy implications.

1. Redesign of Savings Incentives

If tax incentives under the Old Regime played a significant role in promoting long-term savings, policymakers may need to reassess alternative mechanisms to encourage retirement security and insurance penetration. Non-tax incentives, financial literacy programs, or targeted pension reforms may become increasingly relevant.

2. Strengthening Financial Literacy

As individuals transition toward goal-based allocation, the effectiveness of reforms depends on financial awareness. Without adequate literacy, taxpayers may substitute structured long-term savings with short-term consumption or speculative investments. Therefore, slab rationalization should be complemented with strong investor education initiatives.

3. Monitoring Impact on Household Savings Rate

India's macroeconomic stability has traditionally relied on high household savings. Policymakers must monitor whether reduced tax-induced savings leads to a measurable decline in long-term financial savings or merely a reallocation across asset classes.

4. Enhancing Pension and Social Security Architecture

With reduced reliance on mandatory tax-linked savings, the role of formal pension systems and contributory retirement schemes becomes more critical. Policy reforms may need to ensure adequate retirement security independent of tax incentives.

Discussion

The present study examined the role of direct tax reforms in shaping savings and investment behaviour among individual taxpayers in India, with a more focused approach on the transition from tax-incentivized savings to goal-based investment allocation following the rationalization of direct tax slabs. Using secondary data on tax regime adoption

patterns, filing trends, and structural changes introduced under the New Tax Regime, the study analysed whether policy reforms influenced behavioural allocation of financial resources. The analysis was interpreted through Life-Cycle Hypothesis and supported by reasoning to understand behavioural adjustments in response to fiscal restructuring.

The findings indicate a substantial shift toward the New Tax Regime, suggesting that a growing proportion of taxpayers are opting for lower tax rates without availing to traditional deductions. This behavioural transition reflects a possible decline in deduction-driven savings decisions that were previously concentrated around tax-saving instruments such as provident funds, life insurance policies, and other Section 80C investments. The reduced reliance on exemption-based planning suggests that taxpayers may increasingly prioritize liquidity, flexibility, and personalized financial goals over structured tax-saving commitments.

From a behavioural and economic standpoint, the findings imply that tax reforms are not merely administrative adjustments but active instruments influencing household financial allocation patterns. The implications of this transition are significant. On a microeconomic level, it suggests increasing financial autonomy among taxpayers and potential growth in diversified investment behaviour. On a macroeconomic level, it may gradually alter the composition of household financial savings in India, potentially influencing capital market participation and long-term wealth formation trends. However, it also raises important policy considerations: while simplification improves efficiency, reduced tax-linked incentives could impact disciplined long-term savings in certain segments.

Overall, the study reinforces the proposition that direct tax reforms function as behavioural signals within the economy. The transition observed in taxpayer regime preference reflects not only administrative reform success but also an evolving shift in savings orientation — from tax-induced investment behaviour toward goal-based financial decision-making.

Future scope of study

The present study analyses the behavioural implications of direct tax slab rationalization on savings and investment patterns; however, several areas remain open for further exploration. First, the study is primarily based on secondary data and observable regime adoption trends. Future research may incorporate primary data through surveys or interviews to better understand taxpayer motivations, financial awareness, and psychological factors influencing regime choice.

Second, since the New Tax Regime is relatively recent, its long-term impact on retirement planning, wealth accumulation, and savings discipline remains uncertain. Longitudinal studies using time-series or panel data could provide deeper insights into whether the shift toward goal-based investment allocation is sustained over time.

Further research may also segment taxpayers by income level, age group, or occupation to examine whether behavioural responses to tax reforms vary across demographic categories. Additionally, future studies can assess the broader macroeconomic implications of reduced deduction-linked savings on capital markets and financial product participation.

Such extended analysis would strengthen understanding of how structural tax reforms shape household financial behaviour in evolving economic environments.

Conclusion

The present study analysed the structural and behavioural implications of direct tax reforms in India, particularly focusing on the rationalization of tax slabs and the increasing adoption of the New Tax Regime. The findings reveal a significant behavioural shift, as evidenced by the migration of approximately 72% of taxpayers toward the simplified regime in AY 2024–25. This transition indicates a declining reliance on deduction-linked savings instruments that historically shaped household financial allocation decisions.

Interpreted through the Life-Cycle Hypothesis framework (Modigliani & Brumberg, 1954), the reform appears to reduce tax-induced distortions in savings behaviour, allowing individuals to allocate resources based on long-term utility maximization rather than statutory compliance. Simultaneously, behavioural economics suggests that removal of deduction-based incentives (Thaler & Sunstein, 2008) shifts financial responsibility toward individual discretion, potentially increasing financial autonomy but also exposing households to risks of under-saving.

While slab rationalization enhances tax neutrality, administrative simplicity, and allocative efficiency, it also necessitates complementary policy interventions in financial literacy, retirement planning awareness, and pension architecture to safeguard long-term savings stability. At the macroeconomic level, the evolving savings composition may influence capital market participation, asset allocation trends, and national savings patterns. Therefore, direct tax reforms should not be evaluated solely through revenue or compliance metrics but also through their behavioural and structural effects on household financial decisions.

In conclusion, the rationalization of direct tax slabs in India signifies more than a fiscal reform—it represents a behavioural transformation in savings and investment orientation. The sustainability of this transition will depend on how effectively individuals adapt to autonomous financial planning in the absence of deduction-driven incentives.

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