RETURN ON INVESTMENT:
PENSIONS ARE HOW AMERICA SAVES

by

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FOREWORD

The Association of Private Pension and Welfare Plans has long made the case that the employer-sponsored retirement system is central to the well-being of all Americans. While acknowledging the role of the employer-sponsored system in providing retirement security for millions of Americans, we have heretofore ignored the role of retirement funds in creating wealth for the U.S. economy. This paper fills that gap in our understanding of the role of employer-sponsored retirement plans.

Just as the APPWP has been forthright in extolling the virtues of the voluntary retirement system, we have also been outspoken in decrying much of the misguided legislation of the 1980's which cut back incentives and created gobs of administrative red tape for those who want to establish and maintain a retirement plan. We have lamented the resulting stagnation in coverage because it means that in the future retirees will have less than those of today. We have also lamented the artificial limitations placed on an employer's ability to set aside funds to provide for its future retirees. These changes are not only undermining the future of prospective retirees, but, as this paper demonstrates, America's economic future as well.

The employer-sponsored system provides a return on investment that would stagger any money manager. In a prior paper, Benefits Bargain: Why we Should Not Tax Employee Benefits, we demonstrated that for every dollar of federal revenue expenditure, the employer-sponsored pension system returned approximately five dollars in benefits. In this paper we find that pensions are how America saves. In short, the employer-sponsored retirement system has proven its worth. We urge those who read this paper to do what they can to restore its former lustre and get America saving for retirement again.

This paper was written at our behest by Dr. John Shoven of the Stanford University Economics Department. Dr. Shoven is a widely recognized scholar who has written extensively on savings. In preparing this paper, the Association stayed out of the author's way so that he could tell the story as he saw fit. While we agree wholeheartedly with his results, it is his independent view of these issues which adds to the weight of its conclusions.

The APPWP is proud that so many of our members, acknowledged herein, chose to support the preparation of this paper. An Association is only as strong as its membership and if the backing of this paper is any indication, the APPWP will be around for a good while.

Howard C. Weizmann
Executive Director
APPWP
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Executive Summary

The most fundamental problem of the American economy today is the collapse of national saving, which is producing dire consequences for our Nation's future. This paper makes clear that while pensions are how America saves, public policy has unwisely acted to curtail the private pension system.

Almost all types of saving in the 1980's were weak -- household saving, business saving, and government saving, and real national wealth per employee actually fell. Our collective saving behavior also looks disastrous from an international perspective. In the 1980's the U.S. saving rate was the lowest of any major industrialized country in the world. Our net saving rate was less than one-fifth the rate in Japan and at least 60 percent lower than Canada and most European countries. For a nation determined to regain its international competitive edge, while rebuilding needed domestic programs, this is not encouraging news.

Pension fund accumulations, which are included as a part of household saving, have been the only bright spot in the nation's savings picture, especially during the high-consumption binge of the 1980's. Americans' accrual of significant wealth in their pension plans resulted in an astounding fact -- the total increase in real (inflation-adjusted) pension assets in the 1980's exceeded the total real increase in the country's wealth, i.e. these assets provided for all of national savings. That is, if one measures savings as the real increase in wealth, pension accumulations accounted for more than 100 percent of all savings in the 1980's,
while other activity has diminished savings. Since the 1950's, when pensions represented only 2 percent of national wealth, pensions have increased more than eight-fold so that by 1990, more than 17 percent of all wealth was held by pension funds.

Yet, despite these remarkable achievements, short-sighted public policy in this country has actually contributed to our national savings drought. As the paper shows, despite its central role in national savings, the 1980's saw enlightened policy incentives, designed to maintain tax qualified pensions, severely reduced. And during that decade, aggregate net national saving as a fraction of the GNP fell to one-third of the level of the 1950's, 60's, and 70's.

With eyes only on the short-term, yet illusive, goal of shaving the deficit, new limits on retirement benefit levels that qualify for preferential tax treatment, and tightened limitations on the funding of retirement plans were imposed. Pension sponsors were faced with increasing, rapidly changing, and costly-to-comply-with regulations. These regulations substantially increased the cost of establishing and maintaining a pension plan, particularly for small firms. The result has been dramatic: In FY 1990, for example, there were seven times as many defined benefit plan terminations as new plans established. Pension saving maintained its central role in the total saving picture only because of the high returns earned on pension assets.

Public policy in the 1980's not only helped drive the decline in pension plans established, but also weakened funding as well.
Total real pension contributions were ratcheted back to their pre-ERISA 1972 level. A pension system that is not expanding by bringing in younger workers also results in reduced contributions by employers. A decline in contributions occurred at a time when there were huge increases in the size of the work force, the absolute number of pension participants covered by the employer-sponsored retirement system grew, and the aging of the population began in earnest. Just when we should be providing more for the future, we are providing less.

Unless we reverse our savings drought, current and future generations of Americans will be hurt. Without robust saving, our economy cannot create the wealth that will be needed to address fundamental domestic needs, such as education, public infrastructures, and fighting poverty. Workers in America, whose inflation-adjusted average hourly wage in 1990 was no higher than 25 years earlier, will continue to suffer. The next generation of workers will have an enormous foreign debt to service as well as a greatly enlarged elderly population to help support. Without increased saving, we can anticipate a stagnant economy with more pressing problems than resources to devote to them.

However, because of a misperception of the true cost of pension incentives during the decade of the 1980's, Congress consistently reduced the amount of savings that could be contributed to retirement plans during the period. Nothing reflects the government's concentration on its near term budgetary situation at the expense of the long term health of the economy more than the official measure of the revenue expenditure of the
tax preference towards pensions. This tax expenditure is estimated to be the largest of all those listed by the Joint Committee on Taxation. However, the number grossly exaggerates the cost of current policy. Completely ignored is the roughly $750 billion present value of tax receipts which will eventually be collected from the $3 trillion currently in public and private pension funds in the country.

If one looks at the actual return on investment from the pension system, it becomes clear that the federal government is getting a good deal. In fact, the government's investment in the future will earn a rate of return comparable to that earned by the pension plan participant. This profit will be realized as the number of retired people with taxable income grows substantially over the next few decades. Unfortunately, official accounts ignore the asset created by this investment. A more accurate approach to calculating pension costs would be to measure the enormous benefits to the economy pensions provide, rather than mismeasure their cost to this year's budget deficit.

Just how high are the stakes in raising national saving? If we return to the saving behavior of the 1950-80 period rather than continue the consumption binge of the 1980's, real wages would be roughly 15 percent higher by 2020. Working households would have approximately 15 percent higher incomes just when the burden of the retiring baby-boom generation begins to mount. For a country which has been experiencing declining real wages, the possibility of a 15 percent increase seems worth the cost of withdrawing from current consumption behavior.
The failure to enact policies to encourage saving of all forms must be reversed. Improving government saving (i.e. decreasing the deficits) by curtailing private saving makes no sense. More saving is the most reliable recipe for faster growth and greater domestically-financed investment. The government has to pay attention to the future and encourage the private sector to do likewise. The importance of employer-provided pensions to total national saving is hard to overstate. Imperative to getting America saving again is the restoration of the workhorse of retirement saving to its central role. We must simplify and stabilize the regulation of pensions and provide sufficient incentives rather than tighten down on benefit and funding limitations.

We need to return to the "good old days" of saving in 1950-80. We need to go "back to the future" to make life better for the next generation of Americans. We need to appreciate that pensions are how America saves.
SECTION I
INTRODUCTION

Economic analysts and public policy makers have been looking for the better part of a decade now for the adverse consequences of the enormous U.S. federal government deficits that have been with us since 1982. People have predicted or feared runaway inflation, a collapse of the stock market, a severe recession or depression, and yet nothing of the kind has occurred, with the possible exception of the 1987 stock market crash. Even that unprecedented market drop proved to be relatively temporary. So, what is going on? Are the deficits as damaging as many say? If so, what is the nature of the damage and what steps can be taken to protect the economy from the negative consequences? Can we design tax policy in such a way as to mitigate the problem? Are all ways of lowering the deficit of equal social value or are some ways pernicious and counterproductive? Are the deficits the true fundamental problem in the first place? If not, what is? These are some of the questions that this essay attempts to address.

The first question -- are the federal government deficits all that harmful? -- has the usual answer of economists -- "It depends." Deficits in and of themselves need not be particularly damaging. The impact of the deficits on things that we care about depends on other aspects of the economic environment in which they occur. However, the circumstances of the U.S. economy since roughly 1980 are just those for which large federal deficits are
most harmful. Further, and most importantly, the U.S. economy is and has been suffering from a very serious economic malady and the deficits have greatly contributed to the problem.

The fundamental economic problem of the country is not the deficits per se, but the lack of national saving and thus our collective failure to provide adequately for the future. To claim that this is the fundamental problem is pretty sweeping. However, I take that position after considerable research and thought. The anemic saving rate in the U.S. is a much greater problem than the savings and loan fiasco, for instance. For if Americans were saving today as they did in the 1950's, 1960's and 1970's, then the total saving available to the economy would be higher by at least $250 billion annually. The saving rate may even be more important than our environmental concerns in that if we don't save, we won't be able to afford to tackle such crucial problems as nuclear waste disposal. The same can be said about the state of disrepair of our national infrastructure. Clearly, that is a problem of the first magnitude. However, if we don't solve the saving problem, it is unlikely that we will be able to make progress on many of the pressing social needs. Almost all of our social concerns -- from the decay of our cities to the state of our public schools, to our ability to help the countries of Eastern Europe -- require massive economic resources. The only way that we will have the ability to address these problems is if we first secure our economic future by increasing current saving.
The primary problem of the economy is the lack of national saving. The federal government deficits are a problem in the context of weak national saving. But, they are only part of the problem. Household saving is also extremely weak in the U.S., and business saving has been declining. Only saving in the form of accumulating pension assets (which is counted as part of household saving) has been strong in this country, and even in this area public policy initiatives have curtailed the growth of the pension system. All components of national saving will have to increase if we are to have the ability to solve other pressing national problems. Imperative to getting Americans saving again is the restoration of retirement saving to its central role. Even the position of the United States as the world’s greatest political and military power will be undermined unless we take steps to increase economic growth. The most reliable recipe for a faster rate of growth is more saving which would be translated into additional domestically-financed investment.

Section II of this document, entitled "The National Saving Rate", reviews the definition of national saving and documents the saving rate for the U.S. since 1950. American saving behavior is compared with that in other advanced economies. The recent reliance on foreign capital by the U.S. is seen to be a direct consequence of the low level of national saving.

Section III entitled "The Consequences of the Low National Saving Rate", explores further this serious problem. It is argued that most Americans judge the performance of the U.S. economy by
the purchasing power of their weekly paycheck. The facts are that the U.S. economy has been performing extraordinarily poorly in this regard. Both weekly and hourly earnings of non-supervisory employees have been declining steadily since 1973 and have reached levels last seen 25 to 30 years ago. This paper links this depressing fact to inadequate national saving.

Section IV, entitled "Pensions Are How We Save", turns to the question of how and why people save. The accumulation of pension assets is examined with particular scrutiny, since pension saving appears to be the most important and vibrant form of saving in the United States. It is shown that pension saving has contributed a staggering fraction of all saving since 1980. There are, however, some disturbing trends buffeting even this most robust form of saving.

Section V of the paper, entitled "Why Do We Save So Little?", addresses the question of why Americans save so little, although all explanations must be considered reasonable speculation. It is extraordinarily difficult to look behind what people do and determine motives. Certainly, it is next to impossible to prove why people behave as they do. Further, it is difficult to be certain how people's behavior would change under a different set of government policies. Some responses can be ruled out as impossible or improbable, while others may be considered logical and likely. Policy makers should consider the spectrum of possible responses to their actions and they should be extremely cautious about taking steps that risk our economic future. Since national saving should
be the country's highest priority, policies with the potential to affect national saving negatively should be carefully scrutinized.

The issue of the federal government deficit is returned to in Section VI, entitled "Public Policy Towards Pension Saving", via a discussion of the concept of and the figures for tax expenditures. It is argued that the pervasive tax expenditure concept used for evaluating the costs of providing certain incentives in the tax law, the largest of which is pensions, is very flawed for pro-saving policies such as the tax treatment of pensions. Policy makers could be seriously misled if they rely on the official tax expenditure figures as guides to alternative ways of lowering the federal deficit and thereby increasing national saving and economic growth.

Section VII, entitled "How Much Difference Would Additional Saving Make?", examines the question: How much better off would Americans be if they increased their saving? Would it be worth the effort? How sure can we be of our answers to this question? Surprisingly, it will be argued that we can be quite certain about the nature of the effects and even relatively precise about their magnitude. Paradoxically, it appears in some cases economists can predict the distant future with far more reliability than the near term outlook. The bottom line answer is that increased saving would have substantial beneficial effects -- effects that can be achieved in no other way.

Finally, Section VIII, entitled "How Can We Raise National Saving?" addresses reasonable policy goals and actions with respect
to the encouragement of additional national saving. The goal which is espoused is to return the net national saving rate to its average level in the 1950's, 60's, and 70's. While reducing government deficits is probably a necessary condition to accomplish the increased saving, this section stresses that not all ways of improving the deficit are of equal social value. One definitely wants to be certain that the improvement in public sector saving does not come at the expense of private sector saving. If it does, no progress is being made towards solving the fundamental saving problem.

The number one national priority should be a dramatic increase in the national saving rate; and an appreciation of the role played by pensions in achieving that goal should be understood. Sound policies and political leadership are urgently needed to get this country on course for a prosperous beginning to the 21st century.
SECTION II
THE NATIONAL SAVING RATE

If we assert that the low rate of national saving is the number one problem facing the United States, it is necessary to establish what is meant by national saving and then document that it is indeed low. Fortunately, national saving is a straightforward generalization of individual saving, a concept that, hopefully, almost everyone understands. Individual or household saving is simply the difference between after tax income and the amount of money spent on consumption. It is income not spent on consumption and is therefore the funds available for adding to wealth (i.e., investments). The money saved can be invested in the stock market, deposited in a bank or saving institution, or used to finance a real investment such as an addition to the family home.

On average, the real or inflation adjusted increase in a household’s wealth will be equal to its saving. The actual increase in wealth of the household depends on both the household’s saving and on the revaluation of the existing assets held by the family. However, the change in real value of existing assets (over and above the income that they generate) tends to be zero over the long run.

Most individuals know that their household can spend more than its income over relatively short time intervals, perhaps even for a year or two. However, they also know that if spending exceeds
income (i.e., saving is negative) then they must either sell off assets or borrow money or both. Further, they know that they cannot spend more than income over the long run. They would eventually run out of assets to sell and also lenders would become unwilling to advance them additional funds.

All of these characteristics of saving at the household level translate directly to national saving. National saving is simply national income which is not spent on consumption. It is the sum of all household saving plus all corporate saving (i.e., retained earnings) plus government saving (the sum of federal, state, and local government surpluses). Just as at the individual level, national saving generates the expected or average increase in real national wealth. Countries can spend (consume and invest) more than national income, but just as with households the necessary consequences of such behavior would be a sell-off of assets to foreigners or borrowing from abroad. Presumably, countries cannot sustain spending above income over the long run, as assets to sell and borrowing opportunities will eventually dry up.

With this basic understanding of national saving, let us now turn to the statistics regarding U.S. national saving. There are two primary sources for these statistics: the Department of Commerce’s National Income and Product Accounts (NIPA), and the Federal Reserve’s Flow of Funds (FOF) Accounts. Although the numbers don’t always agree, the stories that they tell are remarkably similar. The NIPA numbers are shown in Figure 1. The three bars for each five year interval show the saving rate
Figure 1
U.S. Net National Saving, 1951-1990
Based on National Income Accounts Data

Percent of GNP

51-55 56-60 61-65 66-70 71-75 76-80 81-85 86-90

Pers Saving  Bus Saving  Govt Surplus  Natl Saving
(relative to GNP) of the three components of national saving — personal saving, business saving, and government saving. The line in the graph shows total net national saving, i.e. the sum of the three components. The "net" aspect of these figures simply refers to the fact that this is saving after depreciation of existing assets due to wear, tear, and obsolescence. Net national saving is the difference between net national income and aggregate consumption.

The story of Figure 1 is that aggregate net national saving as a fraction of GNP was remarkably constant between 1950 and 1980, ranging from approximately seven to eight percent. The 1980's were sharply different, with net national saving being a little over three percent of GNP in the first half of the decade and exactly two percent of GNP in the second half. All three components of national saving are seen to contribute to the massive decline in the aggregate. Personal saving, business saving, and government saving are all significantly lower in the 1980's than in the previous thirty years. Roughly two percentage points of the five percentage point drop in national saving by the latter half of the 1980's was caused by increased government deficits, while responsibility for the remaining three percentage point fall is split between households and business.

The fall in net national saving is quite dramatic in Figure 1, but even it understates how low the level of national saving has become in the United States. In the figure, net national saving is compared with GNP simply because GNP is a commonly used denominator
when analyzing economy-wide aggregates. However, since net national saving represents the expected increase in national wealth (it is the money that we can devote to domestically financed investments), a more natural denominator would be total national wealth. One constant that American economists learn early on in their study of the American economy is that the value of tangible assets in the U.S. (i.e., total national wealth) is about three times either annual national income or GNP. Two percent of GNP therefore translates to two-thirds of one percent of national wealth. This means that the saving rate of the last half of the 1980's was such as to permit real national wealth to grow on average at 0.67 percent per year. The labor force and population grow at least that fast. Thus, our saving performance is such that we can expect no growth in per capita wealth. This has obvious negative implications for the economy's growth rate of output and productivity, which we will explore further in this study.

What Figure 1 establishes is that at least according to the NIPA numbers, net national saving collapsed in the 1980's. Figure 2 shows somewhat comparable statistics from the other major source, the Federal Reserve's FOF numbers. What is shown in Figure 2 is the rate of net capital formation (i.e., investment) in the U.S. and the division between domestically financed and foreign financed investment. The bars showing U.S. investment financed by Americans are another estimate of the net national saving rate. The levels differ slightly from Figure 1. Here, the FOF statistics show that net saving ranged from eight to ten percent in the 1950 to 1980
Figure 2
Based on Flow of Funds Accounts, Federal Reserve System

Percent of GNP

51-55 56-60 51-65 66-70 71-75 76-80 81-85 86-90

US Inv fin by US  US Capital Import  Net Cap Formation
period, but fell to 5.7 per cent in the first half of the 1980’s and further to 4.5 per cent in the last half of the 1980’s. The FOF numbers again show the same sharp slide in the net national saving rate with the fall from the 1950 to 1980 average to the level of the last half of the 1980’s being about five percent of GNP. The main story is exactly the same as that told by the Department of Commerce’s NIPA figures. At least part of the reason that the absolute level of the numbers differ is that the two concepts of saving are defined differently. For instance, the purchase of consumer durables such as furniture and stereos is treated as consumption in the NIPA accounts, but as investment in the FOF statistics. Nonetheless, the two sources are in agreement about the big story. U.S. net national saving collapsed in the 1980’s.

Figure 2 does make clear that our need to import capital (borrow from abroad and sell assets to foreigners) is a necessary consequence of our consumption, saving, and investment decisions. Remarkably, aggregate consumption plus investment exceeded national income in the last half of the 1980’s by more than two percent of GNP. That is, as a country we spent more than 102 percent of our income. Such behavior is only possible if one turns to external sources to finance the excess spending. Figure 2 also indicates that the excess spending did not result from a boom in investment. It would have been nice if that had been true, but net investment in the U.S. was lower in the 1980’s than in any of the three previous decades. The only conclusion that one can draw from the
official evidence is that the country went on a consumption binge at the expense of saving and the economic future.

Figure 3 compares the U.S. net national saving rate with the average of the European OECD members and Japan for the period 1980 to 1987. The figures were compiled by the OECD and were adjusted so that saving was defined in a comparable way across the countries. The story of this figure is no more pleasant than that of the earlier two. The U.S. net national saving rate over 1980–87 was well under half of the rate in Europe and roughly one-fifth the level in Japan. The rate of saving in the other high growth Asian economies such as South Korea and Taiwan was even higher than the rate in Japan.

The conclusion is obvious. The U.S. saving rate in the 1980's was low both by historical standards and by international standards. This figure also emphasizes that it is the national saving rate (and not the government deficits) which constitute the fundamental problem. In the 1980's, Japan experienced government deficits as large a fraction of GNP as those in the United States. However, with robust household and business saving, the Japanese had high overall saving and were able to purchase all of their government debt obligations, finance all of their domestic investment, and accumulate considerable foreign assets. It is my contention that government deficits are not particularly harmful in such an abundant saving environment. Unfortunately, the U.S. is a country with a shortage of private saving and therefore the dissaving of the government sector is particularly deleterious.
Figure 3
An International Comparison of Net National Saving 1980-87  Source: OECD

Percent of GDP

U.S.  OECD-Eur Country  Japan
3.7%  9.1%  17.6%
SECTION III
THE CONSEQUENCES OF THE LOW NATIONAL SAVING RATE

We have seen that the net national saving rate in the U.S. was extraordinarily low in the 1980's. One should ask the obvious question -- so what? Didn't we have the longest uninterrupted peacetime economic expansion in history from 1982 to 1990? Wasn't the stock market strong during most of the decade? Weren't both unemployment and inflation declining? What's so terrible about the low national saving rate?

A little deeper look at the statistics on the performance of the economy does show that the emphasis on consumption at the expense of saving did have some important negative consequences. Figure 4 shows a rather startling trend in real net wealth per worker, measured in constant 1982 dollars. Real net wealth per worker can be interpreted as domestically owned capital per worker or, more loosely, as "tools" per worker. After steadily increasing from 1950 to 1980, this measure of the capital intensity of American production has fallen sharply since 1980. Real wealth per worker in 1990 was almost precisely at the level it had been in 1976.

The emphasis on domestically owned capital or real wealth is appropriate because it is not obvious that Americans gain a great deal from foreign owned assets. The owners naturally expect to receive the bulk of the productivity of those assets as a return on their investment. Even if Americans finance their own physical
Figure 4
Real Net National Wealth Per Employee

Source: Author's calculations based on Federal Reserve FOF Accounts & BLS statistics
installations but rely on foreigners to finance our government deficits, it is not at all clear that U.S. workers and taxpayers will enjoy the full benefits of their investments. Much of the return on American owned assets will have to be transferred abroad (most likely through taxes) in order to service the foreign debt.

Figure 4 illustrates an indirect measure of economic performance. Figure 5, however, shows measures of economic performance which are the vital to most American households. For most people, productivity is translated into real (inflation adjusted) wages or earnings. Statistics regarding economic growth don’t mean too much unless they show up in the weekly paycheck. The message of Figure 5 is that real weekly and hourly earnings have fallen sharply since 1973. In the case of hourly earnings, by 1990 the figure had fallen to its 1965 level. For real weekly earnings the 1990 number is more than 15 percent less than the 1973 one and now is at the 1959 level. Such a great leap backwards hasn’t been experienced in America except in the Back to the Future movies.

The statistics illustrated in Figure 5 refer to non-supervisory employees only. It is likely that supervisors and executives have done considerably better. Also, the weekly earnings figures are down more in percentage terms than the hourly ones because the average work week has been shortening, particularly in the rapidly expanding service sector. However, no matter how you interpret this figure, the main message is startling and discouraging. Real wages and earnings are now the same as they
Figure 5
Real Wages and Real Weekly Earnings
1947-1990, Constant 1982 Dollars

Source: Economic Report of the President, February 1991, Table B-44
were a generation ago, and substantially less than they were 15 to 18 years ago. The American dream that each generation would be substantially better off than its predecessor has become just that -- a dream. In fact, the only way the typical blue collar family in America has achieved even a modestly rising standard of living is by having more workers per family. As women's labor force participation rates approach those of men, it is obvious that this cannot remain the major source of real income growth for families.

Figure 5 should at least cause those who say that they haven't seen any negative consequences of our anemic saving and large budget deficits to pause and think. Something is obviously wrong in this economy. The primary culprit is our failure to force growth and provide for the future by saving. One problem with this explanation is timing. The official saving statistics don't show a collapse occurring until 1980, and yet the labor income measures start their slide in 1973.

How can the symptoms precede the disease? The reconciliation lies in the failure of the official statistics to capture the effect of the dramatic OPEC oil price shocks of 1973 and 1979 on the value of the American capital stock. Large amounts of capital were either made obsolete or at least sharply reduced in value by the increase in oil prices. You may remember what happened to the price of gas guzzler cars after these oil shocks. Their dramatic fall in price reflected their reduced economic value in an environment of high gasoline prices. However, their decline in value was only a small portion of the total losses suffered by the
economy from these events. The official saving statistics completely miss this loss of wealth (i.e., dissaving). What one would have hoped for after such an unexpected loss would be high saving to replace the now obsolete capital stock with more modern and efficient units. Unfortunately, just the opposite happened. The oil shocks of the 1970's were followed by the saving drought of the 1980's.

Certainly the terrible performance of real wages and weekly earnings are not due only to the saving and investment declines that we have experienced. The composition of the work force has changed considerably, union power has diminished substantially, and there has been a relative decline of manufacturing compared with the service sector. Further, saving and investment conceptually should include human capital as well as physical capital. Workers can be made more productive (and therefore enjoy higher wages) by either providing them additional and more modern tools or by giving them the extra knowledge and capabilities that come with better education. Unfortunately, the performance of the U.S. education system has also deteriorated over the past 20 to 30 years. One objective measure of this deterioration is offered by the average SAT scores of college bound high school seniors. The 1967 average verbal score was 466; by 1988 the average had fallen to 428. The story about the math SAT scores is similar with the 1967 average of 492 falling to 476 by 1988 (College Examination Board, 1990). Unfortunately, our failure to provide abundant physical capital has not been offset by a large accumulation of human capital.
SECTION IV
PENSIONS ARE HOW WE SAVE

The now conventional economics model of household consumption and saving behavior is the so-called lifecycle model associated with Modigliani and Brumberg (1954). This model assumes that people plan their desired consumption path over their entire lifetime taking into account their current wealth and expectations regarding future income, prices, and rates of return. The basic problem for such a farsighted household is that their desired consumption pattern may differ markedly from the pattern of the receipt of income which they anticipate. The period where anticipated income and desired expenditures may differ the most is retirement. By the definition of retirement, labor income is insignificant during this phase of life, but desired expenditures may be quite high due to health expenses or leisure plans. Many households can anticipate at least one person living in retirement for twenty years or longer. The difference between income and consumption is saving. If one anticipates a long period in retirement where consumption will exceed income (i.e., a period of dissaving), one must prepare for this by accumulating a great deal of wealth during the work years. Most economists think that saving for retirement is the largest motivation for saving, although they recognize that other major purchases such as college educations for children, a house, or a car provide additional reasons to save.

A common image of a saver is someone who periodically makes
deposits in a saving institution, building up a considerable stock of funds. While there undoubtedly are many people who save in this way, much of their saving is offset from the entire economy’s point of view by people who take out consumption loans by such practices as accumulating credit card debt. In the aggregate, there are several ways to save which are quantitatively more important than the traditional deposit route. One important form of household saving is done quite automatically and systematically by those who have a mortgage on their home. The mortgage payments include an amount for the reduction of the principal, and that clearly is private saving and household wealth accumulation. In fact, due to the lack of inflation indexation of mortgages, a homeowner’s equity usually increases much faster than the principal payments. Many households own their own house free and clear by the time they reach retirement and the house represents one of their most valuable assets. One should note, however, that if an existing house is being purchased by one household from another, while the acquiring household is accumulating an asset, society is not getting wealthier. What is going on is simply a transfer of ownership of one of the society’s assets. Only newly constructed homes (or additions to existing homes) represent saving and investment from an economy-wide perspective.

Another way that many people save is through an employer provided or sponsored pension plan. There are several types of plans, but they all involve the gradual accumulation of the right to a retirement benefit. Participation in the majority of plans is
automatic and mandatory, although many plans provide for the possibility of supplementary contributions. This mandatory and automatic participation may be desirable because of the "Christmas Club" effect. Many people seemingly don't trust themselves to have the discipline to accumulate a substantial amount of money. They are afraid that they might be tempted to squander it along the way. They actually prefer to enter a contractual arrangement which will force them to stay in a long run accumulation plan.

There is a third important way in which households provide for their retirement, namely the earning of Social Security benefits. Social Security provides people with inflation-indexed life annuities of enormous value. The present value of future Social Security payments is often the largest single asset that a person has at retirement. A married couple where both spouses are age 65 might have a present value of Social Security retirement payments of perhaps $300,000. The exact present value depends on their earnings history. In addition, Social Security provides Medicare coverage for people over 65. This coverage can easily have a present insurance value of more than $150,000. The number for the average present value of Medicare benefits may turn out to be considerably higher than this if health care costs continue to escalate at roughly twice the rate of inflation. These figures loom very large relative to other asset values and even amount to a significant percentage of all the resources needed to finance a modest, but long retirement.

The problem with Social Security is that for the most part the
system is not accumulating assets to match the apparent accumulation of wealth of its participants. For most of its history, Social Security has strictly been a pay-as-you-go system whereby benefits are paid out of the current contributions or taxes of workers. The right to a future annuity that workers are accumulating is not funded by stocks and bonds or other investments, but rather by taxes on future workers. The point is that while Social Security appears to create wealth for its participants, actually it is a transfer scheme between generations. Today's workers are supporting today's elderly. The next generation of workers will support this generation's workers in their retirement. This may be a good deal for today's workers, but only if the system is continued and the next generation of workers does indeed support them.

There is no social saving corresponding to the apparent private saving in the Social Security system. Without too great an exaggeration, we can refer to Social Security wealth as "phantom wealth." All of this discussion about the pay-as-you-go nature of the Social Security system has to be qualified somewhat in the present circumstances since the system adopted in 1983 a plan of partial pre-funding of the retirements of the baby-boom generation. The system is running a surplus now (around $57 billion per year), although in effect that surplus is more than offset by the enormous deficits accumulating in other government accounts. It certainly is clear that the Social Security surpluses are not sufficient to dramatically improve national saving, since national saving remains
near its all time low.

The importance of employer provided pensions to total national saving is hard to overstate. Figure 6 provides one picture of the growing importance of pensions. It shows pension fund assets relative to national wealth, both as reported in the Flow of Funds statistics of the Federal Reserve System. The increase in pension assets relative to GNP since 1950 is extraordinary. Pension assets amounted to two percent of national wealth in 1950. The relative importance of pensions has increased more than eightfold since then. By 1990, slightly more than 17 percent of all wealth was held by pension funds.

Pension assets gained on all other forms of holding wealth. For instance, pension fund assets amounted to 44 percent of life insurance reserves on the aggregate household sector balance sheet in 1950. By 1990, pension fund assets were more than 7.5 times life insurance assets, a more than 15-fold relative increase. In 1950, households held far more wealth by directly owning equities or by owning mutual funds than they did in the form of pension assets. By 1990, pension fund assets exceeded the value of directly held equity and mutual fund shares by approximately $600 billion. Clearly, pensions were the one form of wealth holding that proved immensely successful.

Figure 7 presents pretty much the same facts in a different and perhaps more revealing form. It shows the real or inflation-adjusted increase in pension wealth and in national wealth, again relying on the Federal Reserve statistics. In the period 1950 to
Figure 6
Pension Assets relative to Natl Wealth

Source: Author's Calculations based on Federal Reserve FOF Balance Sheets for the U.S. 1945-90
Figure 7
Increase in Real National Wealth vs. Increase in Real Pension Assets

Source: Author's Calculations based on Fed Res FOF Balance Sheets 1945-90

Billions of 1982 Dollars

51-55 56-60 61-65 66-70 71-75 76-80 81-85 86-90

Real Natl Wealth  Real Pens Assets
1980, the growth in the real value of pension assets amounted to between 15 and 20 percent of the increase in the real value of total national wealth. Things changed rather dramatically in the 1980's. While real pension assets grew at a somewhat faster rate than before (the real return on financial assets was quite high in the 1980's), the growth in real aggregate wealth completely ceased in the first half of the 1980's and was very low in the latter half. This is just another manifestation of the collapse in saving.

The result is that for the decade of the 1980's the real value of pension assets went up by more than did the real value of national wealth! At least in this sense, the growth in pension assets provided for all of national saving. We are not talking about "a large fraction of", or "most", but all. This is one of the most amazing and unappreciated facts about the performance of the United States economy.

The combined implication of Figures 6 and 7 is that pensions are an enormously important part of the U.S. capital stock and are a vital part of national saving. While it is not quite true that there wouldn't have been any national saving if it weren't for pensions (presumably other forms of saving would have materialized somewhat), it is true that pensions were and are the mainstay of saving in America.

Even the saving picture regarding pensions is not all beautiful, however. If you look at the inflation adjusted value of
employer contributions to pension plans, the numbers are down as shown in Figure 8. In fact the contributions of 1990 are roughly equivalent after inflation adjustments to those in pre-ERISA 1972, and are down by at least one-third since 1980. This decline is even more dramatic when the circumstances of it are considered. The number of pension participants increased by more than 62 percent between 1970 and 1988 (U.S. Dept of Labor, 1991), and yet total real pension contributions were roughly unchanged over approximately the same interval. The average age of the work force has been increasing and with normal actuarial practice greater retirement benefits are thought to accrue to older workers. Despite these facts which would tend to cause pension contributions to grow considerably, the trend for the past 10 years has been for smaller aggregate contributions.

Why are pension contributions down when everything else about pension saving is so robust? There are at least two answers to the question. One reason that pension contributions are down is that pension assets have experienced such high rates of return. Retirement accumulation is the goal of both the employer and the employee, of course, regardless of the design of the pension plan (be it a defined contribution plan or a defined benefit one). When asset returns exceed all projections, as they did in the 1980’s, a natural adjustment is to reduce contributions. The retirement income goal can be met with lower contributions. Government regulations have formalized this argument. Firms are restricted in the amounts that they can contribute to plans that have been
Figure 8
Employer Contributions to Private Pension & Profit-Sharing Plans 1949-89

Source: Author's Calculations based on Dept of Commerce NIPA Accts Table 6.13 and GNP deflator
determined to be overfunded. These restrictions were tightened during the 1980’s through a variety of legislative actions designed to reduce the size of current deductions for pension contributions. Further, a 15 percent excise tax is imposed on distributions in excess of certain limits.

A second reason that the growth in pension contributions stopped in 1980 was that the growth in pension coverage ceased. The fraction of all employees who participate in pension plans peaked in 1980 at 55.7 percent and declined noticeably by 1986 to 51.6 percent (APPWP, May 1989). What has happened can be inferred from Figure 9. Almost all "ERISA workers" associated with firms with more than 250 workers have an employer sponsored pension plan. ERISA workers are all workers between the ages of 21 and 64 who work at least half time and have been with their employer for more than one year. Pension plans are much less universal for smaller firms. Coverage is only 75 percent for medium sized firms (100 to 249 employees), and only 42.2 percent for firms with fewer than 100 workers. The pension coverage of the truly small firms with fewer than 25 workers is certainly well below 25 percent. This concentration of pensions among large employers contrasts with where job growth has been occurring in recent years -- in small, predominately service-sector firms.

Why don’t more small firms offer their workers pension plans? Part of the answer is certainly cost - not just the cost of putting money aside for retirement purposes, but also the enormous administrative cost of establishing and maintaining a pension plan.
Figure 9
Percent of ERISA Work Force with Pension Coverage by Size of Firm

Source: Author's Calculations based on Table 4, APPWP's Benefits Bargain, 1990
These costs result from the multitude of forms that must be filed with the government and the increasingly complex nondiscrimination compliance tests that all retirement plans must meet. Extensive record keeping is required in order to compare the treatment of highly compensated employees relative to the less highly compensated, for example. Pension fund regulation is imposed by the Pension Benefit Guaranty Corporation (PBGC), the Internal Revenue Service, and the Labor Department. Some of the administrative costs associated with offering a pension recur every year, while other one-time costs are imposed by the rapidly changing rules imposed by new legislation and the steadily changing legal interpretations of existing legislation. In the 1980’s there were changes in the maximum amount that could be contributed to plans, in the speed of amortization of unfunded liabilities, in the constraints on patterns of vesting, in the structure and levels of PBGC premiums, in the treatment of excess distributions, in the rules applying to plans which are integrated with Social Security, etc.

Both the ongoing costs and the one-time costs due to new regulations for defined benefit plans were estimated by the Hay/Huggins Company (1990) in a study commissioned by the PBGC. Figure 10 shows their results for the distribution of ongoing administrative costs as a function of plan size. The graph implies significant economies of scale in the administration of a defined benefit pension. The cost per employee goes from $439 for plans with 15 participants to $53 for plans with 10,000.
Figure 10
Ongoing Administrative Cost Per Worker
Defined Benefit Plans by Size  1990

Source: Hay/Huggins Co., Pension Plan Expense Study for the PBGC, September 1990, Table 4
Figure 11 includes both the one-time costs to institute required changes in plan designs and administration and the ongoing expenses for small 15-participant plans between 1981 and 1991. In some years, the one-time costs rival the routine ones. The Hay/Huggins study finds that the total cost of administering a 15-participant plan in 1990 was over $805 per worker. Given that the average pension contribution per worker in these small plans is about $1400, the burden of administration is enormous. It would cost the average small employer $2,200 in order to fund $1,400 worth of retirement benefits for each employee. It is no wonder that in many cases the firms (and the workers) decide that this is not in their interest. These administrative burdens overwhelm even the considerable tax advantages of pension saving. It is true that defined contribution plans and 401(k) plans are somewhat cheaper to administer (and they have grown in importance relative to the defined benefit plans), but even the defined contribution plans place large administrative burdens on small employers.

The knowledge that pension participation is low for the employees of small firms and that the administrative costs are high causes one to support the initiatives to simplify the administration associated with pension plus -- especially for small firms. There has been a spate of proposals to do just that. Perhaps pension coverage can resume its growth with the adoption of some of these proposals.

The decline in pension contributions is far more than just a small-firm effect, however. The large firms have cut back their
Figure 11
Administrative Cost Per Plan Member
15 Participant Plan  1990 $
contributions as well, largely because of government policy to limit the contributions that companies make on behalf of their employees' pensions. Both the full funding limitations and the IRS Section 415 limitations on the generosity of benefits have curtailed pension saving. These policies to restrict the size and funding of pension plans emanate from the concentration in Washington on this year's tax revenue rather than on the growth rate of the economy and the economic circumstances of the next generation of Americans.

It would be beneficial if there were a general effort to simplify pension administration and regulation. The frequency of legislative change should be reduced, redundant regulation eliminated, and limitations on contributions and payouts should be eased. These issues have been thoroughly addressed in the APPWP's September 1989 publication entitled, Gridlock: Pension Law in Crisis and The Road to Simplification. There it is documented that the complexity issue affects not only small firms, but big firms as well. It affects not only defined benefit plans, but defined contribution plans, 401(k) plans and all other pension structures.
SECTION V
WHY DO WE SAVE SO LITTLE?

The answer to the question of this section, why do we save so little, is undoubtedly complex and multifaceted. People have posited a wide array of explanations ranging from the fear of nuclear war to the amount of television advertising encouraging impulse buying. Surely, a major part of the story is the public provision of insurance, particularly long-life insurance through the institution of Social Security and Medicare. If, as posited earlier, the primary motivation to save is to provide adequate resources for retirement, then the existence of a universal government program providing an indexed life annuity and substantial lifetime health insurance for those over age 65 is likely to reduce the need for private accumulation.

In his seminal paper, Feldstein (1974) finds that private saving was almost exactly halved due to the existence of Social Security. Despite an important flaw in his original work, later examinations using more recent data get qualitatively the same result. While researchers are not in full agreement, it is probably fair to say that most economists today feel that Social Security curtails private saving, although to scientifically prove the point is immensely difficult, if not impossible.

The Social Security system became significantly more generous in the 1970’s, in large part due to a mistake in the way the system was originally adjusted for inflation. Inadvertently, benefits
were double-indexed for a period of about three years, resulting in a scaling up of benefits by amounts as much as 20 percent. The scale of Social Security benefits can be judged from Figure 12. The average earner is simply someone who earns the average annual earnings for each year of his or her career. The low earner is someone who earns approximately half of the average, while the high earner always earns at least as much as the maximum amount of taxable earnings. The statistics graphed in Figure 12 are the ratio of Social Security retirement benefits in the first year of retirement at age 65 to earnings in the last year of work. This ratio is commonly referred to as the "replacement rate." Note that the replacement rate for single average earners ranged from 30 to 35 percent between 1950 and 1970, but ranged from 41 to 51 percent in the 1980's. The replacement rates are much higher for low earners who are single. They approach 70 percent in 1990. Note also that all of the numbers illustrated in Figure 12 are for single individuals. One-earner couples get 150% of these amounts, so the number for the one low-earner couple would be approximately 100 percent in the 1980's.

The situation in this country is that those who own a home, and who have uninterrupted careers with a pension plan will be able to accumulate enough resources to maintain in retirement the lifestyle of their earlier years. In such circumstances there may be little incentive to save more than is implicit in the accrual of pension and Social Security rights and the equity in the family home. However, those whose careers are interrupted or who do not
Figure 12
Social Security Replacement Rates for Single Workers at Age 65

Source: Aaron, Bosworth, & Burtless, Can America Afford to Grow Old?
have lengthy tenure in a job with a pension need to supplement the more or less automatic accumulations with private, discretionary saving. Failure to do so can and will lead to a lower living standard in retirement than in the working years.

The evidence is that many people are incapable or unwilling to plan for expenditures 20 or more years in the future. They do so when convenient plans are available or heavily marketed (as with the individual retirement accounts) or when voluntary plans are clearly subsidized by employers. The last point was documented in an unpublished survey compiled by The Wyatt Company which found that the participation rate in 401(k)-type plans was 57 percent if there was no employer match, but 72 percent if the match was 1 for 1 or better. Further, the amount deferred was almost double when such a generous match (relative to none) was offered, so the total saving from this source is quite responsive to the employer’s matching terms.

There is also some evidence that people participate in various saving activities quite independently, indicating that they do not have an integrated plan of saving. If they took an integrated approach to saving, then those participating in a pension plan would have lower non-pension saving rates than those who are non-participants, particularly if their income levels were comparable. The facts as reported by the Bureau of Labor Statistics’ Consumer Expenditure Survey from 1981 to 1988 do not support the hypothesis on integrated saving. The raw fact is that those within pension plans have higher, not lower, non-pension saving rates. This
observation of higher non-pension saving rates could be due to the fact the people with pension coverage have higher incomes than those without such coverage. However, an examination of the data suggests that non-pension saving is very comparable for people with and without pension participation within a given income rage. So the evidence does not support the argument that pension saving displaces other forms of personal saving.

Even more compelling evidence on the segregation of saving into separate activities has been uncovered by Professor David Wise of the Kennedy School at Harvard. In work that has not yet been published, he has recently examined survey evidence on the saving of individual retirement account participants. As the rules changed in the 1980's regarding IRA accounts, the levels of their contributions varied. However, there is no evidence that increases in IRA contributions led to decreases in the non-IRA saving of IRA participants. Quite the contrary. Their non-IRA saving appears to have been substantially unaffected by their IRA contributions.

This substitution (or lack thereof) of different saving instruments is important in determining policy to encourage saving. For instance, it implies that when we curtail one saving vehicle (be it IRAs or employer-sponsored pension plans) we cannot expect that other means of saving will automatically offset the loss in saving. In order to institute a pro-growth national saving policy, we must encourage all forms of saving (household direct saving, pension saving, business saving, and government saving). This view suggests that one should be particularly cautious about public
policy with the potential to retard pension saving, given that it has been by far the most important source of saving in the economy.

Even with all of this analysis, it must be admitted that the explanation for the collapse in saving in the 1980’s is illusive. If Social Security depresses saving, it has been doing so for roughly 50 years. The phenomenon of the 1980’s collapse is probably as much psychological as economic. It does appear that the consumption orientation of the 1980’s (e.g., the Yuppies), so widely reported, was indeed an important social trend. It was sufficient in magnitude to upset the traditional relationship between consumption and income. Unfortunately, at least in this regard, the 1980’s are not yet over. The extraordinarily low levels of national saving which characterized that decade continue without significant improvement to this very moment.
SECTION VI
PUBLIC POLICY TOWARDS PENSION SAVING

Employer-related private pensions have been encouraged by the federal income tax laws for as long as we have had an income tax (since 1913). However, the nature of that encouragement is not well understood, and for numerous reasons is not accurately captured by the tax expenditure figures computed annually by the Joint Committee on Taxation. The concept of a tax expenditure is well described in the 1990 APPWP publication, Benefits Bargain: Why We Should Not Tax Employee Benefits, written by Sylvester Schieber. Basically, revenue not collected because of a special feature of the tax code designed to encourage particular activities in the private sector is similar to collecting the full revenue (i.e. without the special treatment) and spending additional tax proceeds as a subsidy for the favored activity.

Accurately calculating tax expenditures is extremely difficult. If the favorable tax treatment of the activity was eliminated, at what level would it occur in the economy? How much extra revenue would be generated? How should you treat provisions which reduce tax collections today, but actually increase tax receipts in the future? The official Joint Committee projections, which are shown in Table 1 for the years 1992-96, are calculated as the current cost in revenues from the various provisions assuming no behavioral response in the economy.
<table>
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| **LARGEST FEDERAL TAX EXPENDITURE ESTIMATES**
| FOR FISCAL YEARS 1992-96 |
| --- | --- | --- | --- | --- | --- |
| **Net Exclusion of Pension Contributions and Earnings** | 54.0 | 57.0 | 59.0 | 61.0 | 64.0 | 295.0 |
| **Deductibility of Mortgage Interest on Owner-Occupied Residences** | 38.8 | 42.2 | 45.9 | 50.0 | 54.4 | 231.2 |
| **Exclusion of Contributions by Employers and Self-Employed of Medical Ins Premiums and Medical Care** | 37.7 | 41.3 | 45.1 | 49.0 | 53.2 | 226.4 |
| **Exclusion of Untaxed Social Security & Railroad Retirement Benefits** | 25.6 | 27.0 | 28.4 | 29.9 | 31.4 | 142.3 |
| **Deduction of nonbusiness State and local income and personal property taxes** | 23.8 | 25.5 | 27.4 | 29.5 | 31.7 | 137.9 |
| **Depreciation on Equipment in Excess of Alternative Depreciation System** | 18.1 | 18.7 | 19.4 | 20.0 | 21.0 | 97.0 |
| **Deductibility of charitable contributions, other than for education and health** | 13.0 | 13.9 | 14.3 | 15.7 | 16.7 | 74.1 |
| **Deductibility of Property Tax on Owner-Occupied Homes** | 11.0 | 12.3 | 13.6 | 15.2 | 16.9 | 69.0 |
| **Exclusion of Interest on Public Purpose State and Local Government Debt** | 11.5 | 12.3 | 13.2 | 14.3 | 15.0 | 66.3 |
| **Deferral of Capital Gains on Sales of Principal Residences** | 11.5 | 12.1 | 12.7 | 13.6 | 15.5 | 65.3 |
| **Sum for 10 Tax Expenditures** | 245.0 | 262.3 | 279.5 | 298.2 | 319.8 | 1,404.5 |
| **Other Tax Expenditures** | 129.9 | 136.6 | 145.0 | 153.6 | 163.0 | 728.4 |
| **Total Fed Tax Expenditures** | 374.9 | 398.9 | 424.5 | 451.8 | 482.8 | 2,132.9 |

Source: Joint Committee on Taxation, March 11, 1991
The official figures show that the largest tax expenditure of them all results from the favorable tax treatment of pensions. The Joint Committee reports that pensions cost the Treasury 30 percent more than deductibility of mortgage interest on owner-occupied houses. They estimate that the current tax treatment of pensions will cost the IRS $295 billion over the five-year period. However, as pointed out by Schieber, the official statistics of the Joint Committee grossly overstate the revenue cost of the treatment of pensions.

The tax expenditure methodology is most seriously flawed for pro-saving features of the tax code (such as the treatment of pensions) because of the failure to adequately credit these features with the extra revenue that will be produced by the wealthier society which will materialize in the future due to their existence. The way tax expenditure numbers are computed for pensions is that the tax that would be collected if pension contributions were taxed as ordinary income is added to the tax that would be collected if the earnings on pension assets were also subject to the income tax. From that total, the Joint Committee subtracts the taxes that are collected on current pension benefit payments, rather than the more relevant present value of the taxes that will be collected on the future benefits resulting from this year's contributions. With a rapidly growing pension system, an aging population, and tax rules that will be changing, the difference between taking a present value approach rather than a cash flow approach is enormous. The present value of the
government's revenue resulting from today's pension contributions greatly exceeds the amount that they are collecting on current pension receipts.

In fact, the current treatment of pensions may not reduce the present value of the government's tax collections at all. With the likelihood of rising marginal tax rates, the present value of the government's take from the future benefits attributable to current contributions at least matches the loss from not taxing current contributions. Related to this point, it should be noted that the government will ultimately capture at least 25 percent of the roughly $3 trillion in public and private pension assets (with the conservative assumption that the average marginal tax rate of pension benefit recipients will be at least 25 percent). That is, the government has an asset worth at least $750 billion due to the pension system, an asset which offsets the flows of "tax expenditures" which have been associated with the tax treatment of pensions.

The only present value revenue loss remaining due to the treatment of pensions is the failure to tax the earnings on pension assets (the "inside buildup"). Even here, there are reasons to doubt that the government ends up worse off financially. If, in the absence of the present treatment of pensions, households would have chosen to use the funds to finance consumption rather than saving, then there wouldn't be any inside buildup to tax. That is, to the extent the current tax treatment of pensions increases saving, it does so without costing the government resources. If
the money would have been saved anyway, then the government loses revenues since it doesn't collect on the earnings of the assets. It loses revenues, but only relative to a system (an income tax) which double-taxes saving. The current treatment of pensions is exactly proper relative to a consumption tax standard. The money is taxed once and only once -- when it is received and presumably used for consumption by the pension beneficiary.

We clearly should be concerned with the present value of tax collections and not solely current revenues. Provisions which lose revenues today but bring extra receipts in the future (like the treatment of pensions) should not be treated as the equivalent of the government spending the money on public goods or consumption items.

The government is basically funding a fraction of the pension plans for American workers, but at the same time it is accumulating a claim to get roughly the same fraction of the payouts of those pension plans. The result is that the government is making an investment and will earn a rate of return comparable to that earned by the pension plan participant. Given the shortage of capital in the United States, the investment will likely turn out to be profitable for the taxpayers as well as the plan participants. This profit will be realized as the number of retired people with taxable pension income grows substantially over the next few decades.

This discussion of the inappropriateness of the official tax expenditure numbers for pensions should also be related to the
earlier discussion of the deficit and national saving. If we focus on the real problem -- national saving -- then it should be immediately apparent that improving the federal government deficit by taxing pensions more heavily is a pretty crazy idea. In order to improve government saving (or, more accurately, to reduce government dissaving) one doesn't want to discourage the main source of private saving. And while we can't be certain of what would happen to pension saving and private saving if we worsened the tax law with respect to them, it is at least likely that this saving would weaken. That is a risk that is best not taken. When the problem of national saving is kept in mind, then any tax-related solution must involve raising taxes on consumption, not saving or even income.
SECTION VII
HOW MUCH DIFFERENCE WOULD ADDITIONAL SAVING MAKE?

The appeal of additional saving is that it is the only reliable way of reversing the negative trends in real wages and weekly earnings. Additional savings, translated into more domestically owned capital, will ultimately raise capital per worker, worker productivity, and real wages. The impact would be much stronger, of course, if the additional accumulation of domestically owned tangible assets were accompanied by an improvement in the stock of human capital. If the talents of the workforce can be enhanced and workers can be provided with abundant and modern tools, the standard of living in the country is sure to rise. Only then will we be able to afford the many pressing needs that we are bound to face.

Just how much difference would the additional saving make? Surprisingly, economists can offer some answers to this question with a fair degree of certainty. The same people who have great difficulty in forecasting the direction of the economy over the next couple of quarters are much more reliable at determining the consequences of certain behavior over a much longer period of perhaps thirty years. How can this be so? Consider as an example of a situation where long run forecasting is much easier than short run forecasting the following scenario: two families look in many ways identical. They both have considerable wealth ($150,000) which is invested in the stock market. They both have the same
income ($60,000) and feature the same family structure and members of the same age. One family regularly saves 18 percent of income the other 3 percent. If asked which family will be richer in a couple of months, the best economist in the world will be right only about 50 percent of the time. It simply depends on which family is fortunate to have the better performing stock portfolio over this short interval of time. If you ask which family will be wealthier in 15 years, even an amateur economist will be right 99.9 percent of the time. The family which saves 18 percent will almost certainly be the richer one after 15 years. This situation is almost a perfect analogy with the case of the two economies of Japan and the United States. It is difficult to predict which of the two economies will perform better over short intervals like a quarter or a year. However, in the long run we can be quite certain that the country with the higher saving rate, in this case Japan, will enjoy the higher standard of living.

Figure 13 shows the predictions of a model developed by Henry Aaron, Barry Bosworth, and Gary Burtless (1989) of the Brookings Institution, of the long run effect of a relatively small increase in the net national saving rate of 1.5 percent of GNP. Their model forecasts that the extra saving would result in a capital stock which would be 13 percent higher than it otherwise would be by 2020. Real wages would be a little more than 4 percent higher. Consumption in 2020 would be 1.5 percent higher. By then, the sacrifice of less consumption in the present would be paying off as more consumption in the future.
Recall the admittedly arbitrary goal set earlier in this paper; to raise the net national saving rate by 5 percent of GNP. The numbers of Figure 13 suggest that real wages would be roughly 15 percent higher in that eventuality. For a country in which real wages were the same in 1990 as 25 years earlier, that seems like a major effect; one that would give the American Dream a little more claim to reality. The difference between returning to our saving behavior of 1950-80 and staying with the 1980’s levels is enormous.
SECTION VIII

HOW CAN WE RAISE NATIONAL SAVING?

The goal for the U.S. should be a net national savings rate of eight percent of GNP. This is not impossible; after all, the saving rate was approximately that level throughout the 1950's, 60's, and 70's. A saving rate of eight percent would put the U.S. in the same league as Canada and most European countries.

One shouldn't minimize how difficult it will be to achieve this goal. Restoring the five percent fall in the saving rate which occurred in roughly 1980 means that we will have to curtail consumption by five percentage points relative to income. We might be able to achieve a 2.5 percent growth rate in GNP over a five year period. If we did so, we would need to have policies in place to hold the growth rate of aggregate consumption to 1.5 percent over the same five year interval. During the five year adjustment period, the per capita standard of living would have to be quite stagnant. That is the minimum that would be necessary in order for the country to withdraw from its consumption binge. After the adjustment period, consumption could resume its growth at 2.5 percent per year, or perhaps at a faster rate if the additional saving begins to pay off in a more rapid rate of growth for potential GNP.

What policies could likely improve saving to this degree? First, there are the government deficits. As was discussed earlier, even though the large deficits are not the problem per se,
they cannot be tolerated in a saving-starved economy such as the U.S. In order to increase saving to eight percent of GNP it will be necessary to eliminate the consolidated deficits of the federal, state, and local governments, or even create an aggregate surplus. However, as has already been emphasized, all methods of reducing the deficit are not equivalent. Since we are trying to increase net national saving, additional taxes and regulations on private saving should be ruled out. Pensions provide the prime example. Pensions are how the vast majority of people save. Lowering the deficits by taxing private saving is senseless public policy. Since what we are trying to do is restore the historical relationship between consumption and income, the obvious tax (if we need to raise taxes to balance budgets) is one on consumption. Increasing income taxes, while not as counterproductive as raising taxes on saving, is somewhat inappropriate as a means of stimulating national saving.

So, part of the answer is to balance the government's budget without placing additional taxes or restrictions on pensions or other forms of private saving. In fact, a policy of actively encouraging private saving (whether in the form of pensions, individual retirement accounts, or whatever) would be appropriate and desirable. Further, the corporation income tax still treats the return on debt far more favorably than the return on equity. This bias should be eliminated, thereby encouraging firms to retain and invest additional earnings.
I am somewhat optimistic that steps will be taken to improve saving in this country. Recognition that the shortage of saving is a fundamental national problem is a first step towards finding a solution. It is my sense that this recognition is becoming more widespread. What is needed now is considerable political leadership and a marketing of the idea that saving is socially desirable and respectable. We need to get the country focused on the future rather than almost solely on the present: and to recognize that pensions are how America saves.
References


