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The economics of saving

The shift away from thrift

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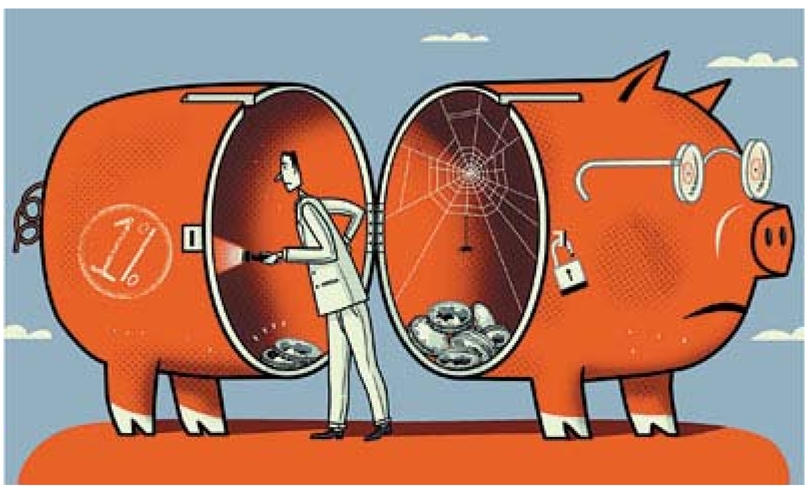


Across the rich world, people are saving less. Does that matter?

IT MAY be a virtue, but in much of the rich world thrift has become unfashionable. Household saving rates in many OECD countries have fallen sharply in recent years. Anglo-Saxon countries—America, Canada, Britain, Australia and New Zealand—have the lowest rates of household saving. Americans on average, save less than 1% of their after-tax income today compared with 7% at the beginning of the 1990s. In Australia and New Zealand personal saving rates are negative as people borrow to consume more than they earn.

Other countries with rapidly greying populations—especially Japan and Italy—have also seen their personal saving rates plummet, though from a higher level. The Japanese today save 5% of their household income, compared with 15% in the early 1990s. A few rich countries, notably France and Germany, have bucked the trend away from thrift. Germans saved around 11% of their after-tax income in 2004, up slightly from the mid-1980s.

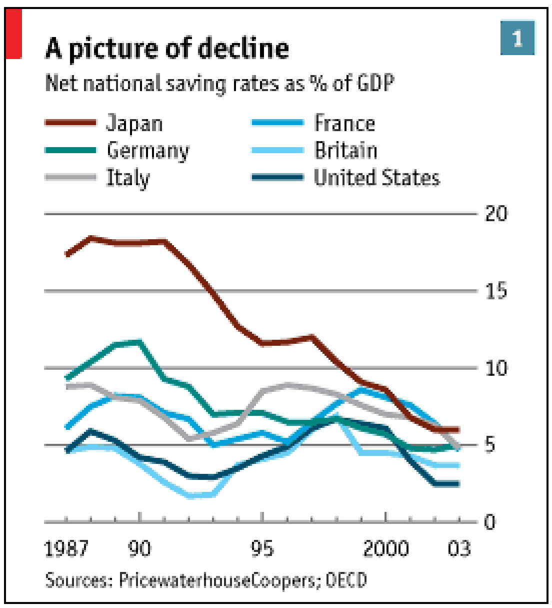
These shifts raise important questions. Are people saving too little? What are the consequences of falling saving rates? Should governments try to encourage people to save more, and if so, how?

One school of thought, led by Ben Bernanke, a prominent American central banker, suggests that the world suffers from too much rather than too little saving. Mr Bernanke, who was nominated to be head of George Bush's Council of Economic Advisers on April 1st, points out that long-term interest rates are extremely low across the globe. He attributes this, in large part, to high saving by Asian economies. If this "savings glut" argument is correct, then presumably there is little need to worry about falling thrift in the rich world.

Others argue that declining thrift is a sign of economic vigour. Thanks to high returns from shares and, more recently, from house prices, people can achieve their financial goals with less discretionary saving. The sophistication of financial markets in Anglo-Saxon economies allows people to tap their wealth more easily, by refinancing their mortgages, for example. For people who live in bank-dominated systems, such as Germany, that is much harder. Higher saving rates in Germany, according to this logic, are the result of poor returns and underdeveloped financial markets.

Pessimists, in contrast, fret that the shift away from thrift is dangerous. The demographic profile of Japan or Italy may explain their falling saving rates, but other rich countries, including America, should have been saving more as the baby-boomers entered their peak earning years. Instead, people are putting aside far too little money to pay for their retirement, relying on unfulfillable promises from bankrupt government pension plans and absurdly rosy assumptions about capital gains from their shares and houses. This myopia greatly reduces the pool of capital available for investment and also worsens existing imbalances in the global economy.

The truth is more complicated. For a start, both the right measure of saving and the appropriate rate of saving depend on whether you are looking at individuals or economies.



From a macroeconomic perspective the right measure is the national saving rate: the sum of private saving (which is household saving and corporate saving, or companies' retained profits) and public saving (ie, a budget surplus) or dis-saving (a budget deficit). It does not matter who in an economy is doing the saving. What matters is how much in aggregate is being set aside to finance the investment that supports economic growth.

During the mid-1990s national saving rates rose in many OECD economies despite the decline in household thrift, thanks to improved public finances. (Japan, where national saving has been falling since the early 1990s, is a big exception.) In some Anglo-Saxon economies, such as New Zealand, healthy budget surpluses still dampen the impact of low personal saving. But in America, the dramatic shift from budget surplus to deficit since 2001 has amplified the effect of falling household saving. Not only is household saving close to a record low, but net national saving (at around 2% of GDP) is at its lowest rate since the Great Depression.

Does this matter? The relationship between thrift and economic growth is complicated. High rates of saving do not guarantee rapid economic growth (think of Germany). Nor, as global capital markets integrate, must investment be funded by domestic saving alone. Countries can borrow cheaply from abroad and run current-account deficits. Most low-saving Anglo-Saxon economies do just that: America's current-account deficit has reached a gaping 6.3% of GDP. Low long-term interest rates do imply that, for now, global savings are more than adequate relative to investment opportunities.

The true cost of borrowing

But is this sustainable? Even in a more global capital market, there are limits to foreign borrowing. The debts incurred must be serviced, capping how big the current-account deficit can become. More important, today's “saving glut” has less to do with a structural surplus of saving than a shortfall in investment that may prove temporary. Despite its plummeting national saving rate, Japan still exports capital to the rest of the world because its investment rate has fallen even more.

Nor have Asia's economies—with the exception of China's—seen a substantial rise in saving. In some countries, such as South Korea, whose population is ageing rapidly, national saving rates are falling. These countries have become net lenders because their investment rates plummeted after the financial crises of the late 1990s. If investment rises, the savings glut will quickly disappear. Over the longer term, demographic trends suggest national saving in rapidly greying countries (Japan, South Korea, Italy, etc) will continue to fall, further reducing the prospect of surplus saving to finance the Anglo-Saxon deficits.

Furthermore, America—despite its huge external borrowing—itself has a relatively low investment rate. To maintain high productivity growth, investment rates probably need to rise. Add together the need for greater investment and the likelihood of less easy access to foreign borrowing, and the conclusion is clear: Anglo-Saxon economies with low national saving rates, particularly America, need to save more.

Economists agree about the surest way to do this: focus on the government's finances. Alan Greenspan recently called greater fiscal discipline “the most significant vehicle we have” to raise national saving. However, some budgetary prudence may be offset by lower private saving. A theory called “Ricardian equivalence” holds that increases in public saving are cancelled out by falls in private saving as individuals anticipate future tax cuts.

A recent OECD study of 16 rich countries between 1970 and 2002 finds that, on average, around half of any improvement in public finances is offset by lower private saving in the short term, and around two-thirds in the long term. But the most extreme case of low national saving (America) had the weakest offset. A change in America's fiscal stance had no statistically significant impact on private saving, suggesting fiscal discipline will be particularly effective. But even in other low-saving economies, budgetary prudence is the surest route to higher national saving.

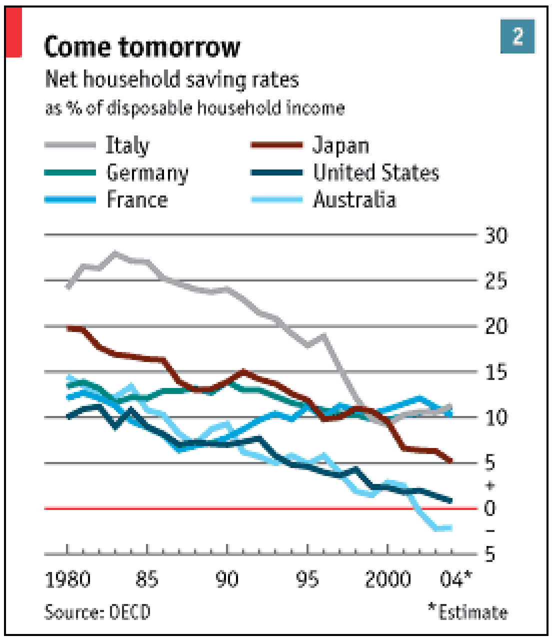
That does not mean private saving rates are irrelevant. Encouraging higher private saving would clearly help raise national saving. Moreover, the adequacy of personal saving is important from the perspective of individual welfare. Even if a country overall is saving adequately to fund future economic growth, savings might be distributed in a way that leaves certain groups with insufficient wealth.

But the concept of “adequate” saving is tricky. People have many reasons to save: as a precaution against a sudden drop in income; to smooth their consumption over their lifetime; or to leave assets to their children. Gauging whether people are setting aside enough from their current income depends on what you assume those people will want to consume or bequeath in future, what wealth they have already accumulated and what returns on those assets will be.

Measurement problems bedevil this process. The household saving rate is calculated by subtracting consumption spending from after-tax income. But the definitions of both income and spending that statisticians use in the national accounts often bear little resemblance to what people think of as saving and spending. Realised capital gains, for instance, are not included in income, even though the taxes paid on capital gains are deducted from income. And differences between countries' tax structures and government services can mean the same basic saving behaviour can yield quite different measured saving rates.

Mind the gap

Adjusting for these problems, however, does not change the basic picture. A study by the OECD and European Central Bank shows that, once adjusted for different tax and pension structures, the saving gap between America and continental Europe widens further. Martin Barnes of the Bank Credit Analyst, a consultancy in Montreal, reckons that, once adjusted for measurement problems, America's personal saving rate was relatively stable until 2001. Since then, however, it has plunged.



But does less saving mean too little saving? The most extensive academic work on individuals' savings adequacy has been in America. Ironically, economists there have become more sanguine even as measured saving rates have fallen. In the mid-1990s a slew of academic papers fretted about inadequate saving rates. In particular, work by Douglas Bernheim, an economist at Stanford, suggested a dramatic undersaving by most households.

A second group of studies, pioneered by Eric Engen of the Federal Reserve, Bill Gale of the Brookings Institution, and Cori Uccello of the Urban Institute, built more sophisticated models of optimal saving, and painted a less gloomy picture. The most recent, and optimistic, study, published in January 2004 by John Karl Scholz and Ananth Seshadri of the University of Wisconsin, and Surachai Khitatrakun of the ERS Group, a consultancy, argues that 80% of American households have more accumulated wealth than they need.

But these studies make a number of rosy assumptions. First, they include individuals' equity in their house as part of their financial assets. That may be a mistake not just because the recent run-up in house prices could prove to be a bubble, but also because houses are lumpy assets. Not all old people will want to sell their house to finance their retirement consumption. If only half an individual's house equity is included, the most optimistic study suggests that just under 60% of American households have adequate savings—a dramatic change.

Second, these studies assume that future state pension benefits will be paid as promised. Given the budgetary pressures posed by the baby-boomers that looks unlikely. If Mr Bush succeeds in passing social-security reform (a big “if”, at present), some form of benefit cut is almost certain to be part of it. For poorer Americans, any cut in promised pension benefits would sharply reduce the adequacy of their saving today. Projected payments from social security exceed the value of all other financial assets for the bottom one-third of the income distribution.

A look at Britain, where the government's level of pension provision is set to replace a much smaller proportion of earnings than in America makes the point. A recent report by Britain's Pension Commission argued that, given downward trends in the occupational pensions provided by employers and the erosion of state pensions, 60% of workers over 35 are not saving enough.

A return to saving?

In all of these analyses much depends on assumptions about the rate of return on savings. In recent years, the biggest difference between high-saving and low-saving OECD countries has been the return on assets. As a recent report from the McKinsey Global Institute points out, between 1975 and 2003 asset appreciation was responsible for almost 30% of the increase in the value of household financial assets in America, whereas in Japan high saving rates made up for negative returns on assets. Based on current rates of return and saving patterns in big industrial economies, the McKinsey study takes a dim view of the adequacy of global wealth accumulation. But it notes that more saving is an unhelpful prescription for countries that already save a lot, such as Germany. The answer there is to raise returns on saving, through financial and corporate restructuring, greater competition and so forth. In other words, these economies need to become more Anglo-Saxon.

In low-saving Anglo-Saxon economies, by contrast, raising people's saving rate must be part of the mix. But how, if at all, can governments encourage people to save? Monetary policy is one tool, albeit a blunt one. In recent years, unusually low interest rates have encouraged borrowing and caused asset bubbles, particularly in Anglo-Saxon economies. While this consumption in the short term supported the global economy, it has accelerated the saving decline. A return to more normal levels of interest rates ought to boost saving.

Another approach is simply to force people to save more, for instance by introducing compulsory contributions to new pension accounts. Australia and Switzerland have both done this. (In Australia's case the impact on saving is not clear cut: the saving rate has fallen nonetheless, though arguably by less than it would have done without the mandatory component.) While compulsion may be an important possibility for extreme low-savers, it is decidedly illiberal and most countries have tried to encourage rather than compel more saving.

Their main route has been the tax code. Income-tax systems deter saving by taxing the returns twice (first when the company makes a profit and again when an individual receives the investment income). From the perspective of maximising the incentive to save, the best policy would be a wholesale shift to a consumption-based tax system.

But no OECD country has done this, although many raise some revenue from consumption taxes. Instead, policymakers create incentives for saving within the income-tax system. Most industrial countries offer some tax-sheltered retirement-saving accounts. One OECD study suggests the typical rich country offers a subsidy worth 20 cents for every dollar in these retirement accounts. America, with a subsidy of 27 cents on the dollar, is 10th highest. This subsidy costs over 1% of GDP in forgone tax revenue, considerably more than the country's total personal saving. These subsidies make sense only if they are encouraging saving that would not otherwise take place. The evidence for this is mixed, at best. Studies suggest tax-favoured retirement accounts essentially divert existing saving or encourage only modest new saving.

By giving a break on progressive income taxes, these accounts give a fatter subsidy to richer people who are more likely to save anyway. In most countries, the tax system discourages poor people (who are more likely to be low savers) from thrift. In America, eligibility for welfare assistance such as food stamps is phased out if a couple has assets over $3,000. In Britain, the means-tested pension credit, designed to help pensioners, has the perverse result of making saving for workers on moderate incomes a foolish idea. For every pound of savings income they can incur marginal tax rates of at least 40%.

Housing is another area where the tax code distorts saving behaviour. Mortgage-interest deductions and exemptions from capital gains for residential property both favour excessive saving in property. John Makin, an economist at the American Enterprise Institute, reckons that America's tax breaks for property will cost around $1 trillion over the next five years, a huge drag on the budget and hence national saving.

Decisions, decisions

Rather than focusing on tax incentives, recent economic research suggests politicians ought to look harder at what stops people saving. A slew of studies by behavioural economists suggest people are deterred from thrift by the decision-making involved. Poorer people, for instance, are more likely to be enrolled in private retirement plans if that is the employer's default option than if workers have to elect to enrol. In one study by Brigitte Madrian of the Wharton School, University of Pennsylvania and Dennis Shea of the United Health Group, shifting to automatic enrolment raised participation among poorer workers from just over 10% to 80%. Other studies suggest that people will raise their saving rate as their earnings increase, provided these increases are automatic. Behavioural economics suggest many intriguing policy ideas, such as encouraging employers to make membership the default option for pension plans.

None of these changes will dramatically increase household saving rates. But they will make it easier and more attractive for those who are saving least to put aside some money, while at the same time reducing the fiscal burden of misplaced tax subsidies to the rich. Poorer people, government budgets and national saving rates would all see some benefit.

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