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SAVING FOR THE 21ST CENTURY: IS AMERICA SAVING ENOUGH TO BE COMPETITIVE IN THE GLOBAL MARKETPLACE?

HEARING

BEFORE THE

SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

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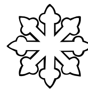

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SAVING FOR THE 21ST CENTURY: IS AMERICA SAVING ENOUGH TO BE COMPETITIVE IN THE GLOBAL MARKETPLACE?

THURSDAY, APRIL 6, 2006

U.S. SENATE,
SUBCOMMITTEE ON LONG-TERM
GROWTH AND DEBT REDUCTION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:30 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Gordon Smith (chairman of the subcommittee) presiding.

Also present: Senator Kerry.

OPENING STATEMENT OF HON. GORDON SMITH, A U.S. SENATOR FROM OREGON, CHAIRMAN, SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION, COMMITTEE ON FINANCE

Senator SMITH. We will call this hearing to order. This is the U.S. Subcommittee on Long-Term Growth and Debt Reduction of the Finance Committee. I apologize to you that many of your colleagues got scrambled with the latest bomb scare. So perhaps you were not in a building affected by that.

I know Senator Kerry is headed here, and we will certainly turn to him when he arrives. But we thank you for being here to discuss a topic of growing concern in America, simply our national savings.

The bottom line is, Americans simply are not saving enough. This is true of both our government, and our citizens. Our national savings rate is among the lowest of any other major industrialized country. For the first time since the Great Depression, we have a negative personal savings rate in this country.

These saving trends are especially troubling because of the dramatic demographic shift our country is unavoidably about to experience. By 2030, the segment of our population over age 65 will become twice as large as it was in the year 2000. This shift has been described by some as an aging tsunami.

Americans are living longer than ever before and spending more years in retirement. A person who reaches age 65 can expect to live another 18 years, and most Americans retire before they reach the age of 65.

If you boil it down, that is 18 years a person is consuming medical care, housing, food, and other resources while in retirement, while not producing or contributing to the national economy in

terms of employment. Americans are simply consuming more in retirement than any previous generation as well.

You compound this problem with the new wave of baby boomers going into retirement, and you have a demographic train wreck. The first of the baby boomers will turn 60 this year. Therefore, over the next few years as the boomers reach retirement age, a huge wave of Americans will be leaving the workforce. This trend will have significant impact on our economy.

Unless our immigration policies change, it will likely result in future labor shortages. This will hurt the competitiveness of American businesses, and our economy will stagnate. Because of the sheer number of baby boomers, we must also be concerned with the potential brain drain. Our workforce will be losing some of our most experienced workers, many of whom have skills that are simply not replaceable, or not soon replaceable.

All of these trends—the aging of our population, our increased life expectancy, and the impending retirement of baby boomers—will place significant strains over the next several decades on our senior entitlement programs of Social Security, Medicare and Medicaid. While these programs have improved many Americans' lives, the reality is that they simply cannot be sustained long-term in their current forms.

Under current law, benefits will grow much more rapidly than revenues because of the increases in the number of retirees versus workers. In 1950, there were about 16 workers for every Social Security recipient.

Today, this ratio has fallen to about three workers per retiree. By 2030, there will only be two workers for every retiree receiving benefits. Federal spending on these programs will increase considerably.

In 2004, Social Security and Medicare spending accounted for 6 percent of GDP; by 2030, it is projected to increase to about 9 percent. Reforming our entitlement programs is necessary, but we must do so in a thoughtful manner so as not to hurt those Americans who rely on these benefits the most. These reforms will require some difficult political decisions.

I think most of my Senate colleagues realize that we must take action to ensure that the vital retirement and health programs are around for the next generation—in addition, our entitlement programs. I have spent a great deal of time over the last year examining the issue of retirement savings.

As I noted earlier, most Americans are saving less than ever before, and many Americans are not saving at all. This is a very, very disturbing thing. For that reason, Senator Conrad and I have introduced a bipartisan Retirement Savings Security bill.

One of the key savings proposals in our bill encourages employers to adopt automatic enrollment in 401(k) plans. It has other features as well, but all of it is designed to simply incentivize people to save for their retirement.

I will put the balance of my statement in the record.

[The prepared statement of Senator Smith appears in the appendix.]

Senator SMITH. I want to welcome our witnesses today, who have a wealth of experience on savings issues.

Our first witness will be Dr. Thomas McCool, who is the Director of the Center for Economics with the Government Accountability Office. Dr. McCool will discuss the impact of the national savings on our economy.

He will be followed by Mr. Jurrien Timmer, who is the director of market research for Fidelity Investments. Mr. Timmer's testimony will focus primarily on personal savings and retirement.

Dr. Barry Bosworth is someone known to me through a television set for many years. He is a senior fellow in economic studies at the Brookings Institution. He will examine international saving trends in human behavior.

Dr. Lael Brainard is also from the Brookings Institution. I pronounced your name wrong. How do you pronounce it?

Dr. BRAINARD. Lael.

Senator SMITH. Lael. Very nice. She is vice president and director of the Brookings Global Economy and Development Center. Dr. Brainard will discuss the impact of national savings on international competitiveness.

We thank you all for being here. Dr. McCool, we will start with you.

STATEMENT OF DR. THOMAS J. McCOOL, DIRECTOR, CENTER FOR ECONOMICS, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Dr. MCCOOL. Thank you, Mr. Chairman. I appreciate the opportunity to talk with you today about national savings and the central role it plays for our Nation's long-term economic growth and future living standards. National savings is the sum of savings by households, businesses, and all levels of government.

It represents resources available for investment to replace old factories and equipment and to buy more and better capital goods. Higher savings and investment in the Nation's capital stock contributes to increased productivity and stronger economic growth over the long run.

Comptroller General Walker has spoken frequently about the fact that our Nation faces a number of deficits, including three that are directly related to this hearing. These three interrelated deficits are our Nation's budget deficit, savings deficit, and current account deficit.

Unfortunately, America has been heading in the wrong direction on all three deficits in recent years. Nonetheless, we have a window of opportunity to turn things around, but we need to act, and act soon, because the miracle of compounding is currently working against us.

Today's savings and investment decisions have profound implications for the level of well-being in the future. Increasing personal saving is an important way to bolster retirement security for current workers, and increasing national saving will allow future workers to more easily bear the cost of financing the Federal retirement and health programs, while maintaining their standard of living.

In my testimony today I will describe these three deficits and why they raise concerns about our Nation's long-term growth and its ability to finance the health and retirement needs of an aging

population. Finally, I will discuss the Federal Government's role, or potential role, in increasing national savings.

The first deficit we face is the Federal budget deficit. In 2005, the unified budget deficit was around $318 billion, or 2.6 percent of GDP. This figure is an approximation of what the Federal Government absorbs from private saving.

Although a single year's deficit is not a cause for concern, persistent deficits are. The U.S. faces the prospect of persistent, large deficits in the near future and significantly larger deficits further out in the future. Federal deficits reduce the amount of national saving available for investment. They also lead to growing Federal debt on which net interest must be paid by current and future generations.

More significantly, over the next few decades Federal spending on retirement and health programs, Social Security, Medicare, Medicaid, and other Federal pension, health, and disability programs will grow dramatically.

Absent policy changes on the spending and/or revenue sides of the budget, a growing imbalance between expected Federal spending and tax revenues will mean escalating, and eventually unsustainable, Federal deficits and debt that could threaten our future economy and standard of living.

The budget deficit represents dissaving by the government, but the U.S. suffers from an even broader national savings deficit. National saving is the sum of personal saving, corporate saving, and government saving.

Last year, the net national saving declined to less than 1 percent of GDP, and the personal saving rate was slightly negative. A negative personal saving rate means that, in the aggregate, households are spending more than their current income by drawing down past savings, selling existing assets, or borrowing.

No one is sure why the personal saving rate has declined. One possible explanation is increases in household wealth, which surged in the late 1990s due to the stock market boom, and more recently due to the run- up in housing prices.

If people feel wealthier, they may feel less need to save. Continued financial liberalization and innovation have also made it easier for Americans to borrow, particularly against real estate wealth, which may have led to greater consumption.

Now let me turn to the third deficit, our current account deficit. The current account deficit is the difference between domestic investment and national saving. That is, it is the amount of domestic investment financed by borrowing from abroad.

Over most of the past 25 years, the U.S. has run a current account deficit. But in 2005, the current account deficit hit an all-time record, $782 billion, or over 6 percent of GDP. That is twice what it was only 6 years ago.

While current account deficits support domestic investment and productivity growth, they also translate into a rising level of indebtedness to other countries. In our testimony, we have a figure that shows that net foreign ownership of U.S. assets grew to more than 20 percent of GDP in 2005. The fact that our net indebtedness to other Nations is rising so rapidly raises concerns that the U.S. current account balances are on an unsustainable path.

Because investors generally try to achieve some balance in the allocation of their portfolios, and U.S. assets already represent a growing and significant share of foreign portfolios, economists and policy makers are concerned about what would happen to the stock and bond markets if these foreign investors began to reallocate their portfolios, lowered their rates of accumulation, or worse yet, started to sell off their holdings. This could raise U.S. interest rates, reduce investment and growth, unless offset by increased U.S. savings.

Now let me turn to the Federal Government's role in national saving. From a macroeconomic perspective, it does not matter who does the saving. Any mix of increased saving by households, businesses, and government would help to grow the economic pie.

In light of the virtual disappearance of personal saving and concerns about U.S. reliance on borrowing from abroad to finance domestic investment and the looming fiscal pressures of an aging population, now is an opportune time for the Federal Government to begin reducing Federal deficits.

And although there may be ways for the government to effect private saving, the only sure way for the government to increase national saving is to decrease government dissaving, that is, the deficit.

Higher Federal saving, to the extent that the increased government saving is not offset by reduced private saving, would increase national saving and tend to improve the Nation's current account balance, although typically not on a dollar-for-dollar basis.

As the Comptroller General has said, meeting our Nation's large, growing and structural fiscal imbalance will require a three-pronged approach that includes restructuring existing entitlement programs, reexamining the base of discretionary and other spending, and reviewing and revising the existing tax policy, including tax expenditures which can operate like mandatory spending programs.

Let me turn to a particular subset of those expenditures: savings incentives. The Federal Government has sought to encourage personal saving, both to enhance households' financial security and to boost national saving. Tax incentives may affect how people save for retirement, but do not necessarily increase the overall level of personal saving.

For example, although tax benefits seem to encourage individuals to contribute to these kinds of accounts, the amounts contributed are not always new saving. Some contributions may represent saving that would have occurred even without the tax incentives and may even be shifted from taxable assets or financed by borrowing.

As with other tax expenditures, it makes sense to see if these incentives are achieving their goals or could potentially be better targeted.

Then, lastly, I would just like to talk briefly about education with respect to saving. A leading obstacle to expanding retirement saving has been that many Americans do not know how to save for retirement, let alone how much to save.

The need to provide consumer financial literacy, their ability to make informed judgments and effective decisions about the management of money and credit, has become increasingly important.

In the recent Comptroller General Forum Report, we discussed the Federal Government's role in improving financial literacy. Among other things, forum participants suggested that the Federal Government serve as a leader, using its influence and authority to make financial literacy a national priority.

Now, I would just like to conclude by saying, increasing the Nation's economic capacity is a long-term process. Acting sooner rather than later could allow the miracle of compounding to turn from enemy to ally.

This is why the Comptroller General has called for reimposing budget controls, reforming Social Security, Medicare and Medicaid, and reexamining the base of all major spending programs and tax policies to reflect 21st-century challenges.

As I said before, every generation is responsible for the economy it passes on to the next. Our current saving decisions have profound implications for the Nation's future well-being.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions.

[The prepared statement of Dr. McCool appears in the appendix.]

Senator SMITH. Dr. McCool, we have heard some people in high places say that deficits do not matter. Are there some deficits that matter more than others?

Dr. MCCOOL. Well, I think that, again, the point is not that deficits do or do not matter. They matter much more in certain contexts than others. In particular, the concern we have is with persistent, large deficits, and even more so the fact that, looking out 10, 15, or 20 years to the baby boom retirement, again, under the assumption that health care costs are rising at a much more rapid rate than the rest of the economy, that the deficits become huge—not just large, but huge—and in fact they could take up a substantial part of the economy, up to the 20- to 25-percent range. Again, those are projections. They are not likely to happen, but that is the thing I think we can all agree, those deficits would clearly matter.

Senator SMITH. It seems to me that, between now and 2030, the consequences of at least our entitlement deficits are going to so crowd out all other government spending that it is going to help align the need for policy change with the political requirement that we change. Do you have a sense when that day might arrive?

Dr. MCCOOL. Well, again, there may come a day when the deficits become so large we have to do something. I guess the concern we have is, it would be, to some extent, easier and less costly if we started sooner rather than later.

Senator SMITH. If we do it now.

Dr. MCCOOL. The longer you wait, the more expensive it becomes.

Senator SMITH. But to make those kinds of hard choices, it seems like there has to be a political imperative, and that just does not exist right now in this country.

Dr. MCCOOL. Right.

Senator SMITH. How do you see this playing out? I mean, what cannot go on forever will not go on forever. It just will not.

Dr. MCCOOL. Right. That is what Herb Stein said.

Senator SMITH. So, how long do you think it will be before the politics and the policy can align?

Dr. MCCOOL. Well, if I knew the answer to that I would be on Wall Street. If I could predict the future that well, I would be in a different business, I think.

Senator SMITH. And as you speak of deficits, whether individual, government spending, or current accounts, how is America relative to other western countries? Are we worse off? Are we any better off?

Dr. MCCOOL. In terms of saving? I think Dr. Bosworth has a lot of data on that. But I think, certainly with respect to the G–7 and the OECD countries, the U.S. is pretty close to the bottom on the personal saving and the national saving fronts.

Senator SMITH. And in terms of entitlement obligations, where are we?

Dr. MCCOOL. I do not know the answer to that.

Senator SMITH. All right. That is all right.

Dr. MCCOOL. I mean, I think lots of other countries certainly have aging populations and certainly have requirements.

Senator SMITH. And they have higher, more generous benefits, older population, and smaller birth rates than we do.

Dr. MCCOOL. Smaller birth rates. Right.

Senator SMITH. So I was just wondering where we stand in that regard to the competition.

Anyway, Mr. Timmer, thank you for being here.

STATEMENT OF JURRIEN TIMMER, DIRECTOR OF MARKET RESEARCH, FIDELITY INVESTMENTS, BOSTON, MA

Mr. TIMMER. Thank you for the opportunity to speak to you today. It is an honor to have been invited.

In my opening remarks, I will refer to the charts on pages 5 through 8 in your handout. I have also included some supplemental charts, which I would be happy to address during the question and answer period.

Retirement security is, and will remain, a dominant issue for a very long time. America is growing older and living longer and is not saving enough. The chart on page 5 illustrates what is perhaps the most profound demographic trend of our time, that is, the baby boom tidal wave that is under way.

In 1985, by far the largest segment of the population consisted of 25- to 29-year-olds. Currently, the largest segment consists of 40- to 44-year-olds. By 2025, this same group will be reaching retirement.

At the same time, Americans are living longer, with the average life expectancy increasing from 66 years 5 decades ago to an expected 80 years 5 decades from now. This prompts the question, are American households saving enough? The answer is no, although by some measures the news is not as bad as it appears.

The chart on page 6 addresses household savings. The savings rate in the U.S. is negative and has been declining for years. However, things may not be as bad as they seem. There are flaws in the way the savings rate is calculated, in that it includes the taxes on capital gains, but not the capital gains themselves. If we adjust

the savings rate by including capital gains, it improves to 5.75 percent.

The other shortcoming is that the savings rate does not account for accumulated household wealth. When considering household balance sheets, the picture brightens considerably. Household net worth stands at $52 trillion, which is 5.6 times disposable income above the average of the past 50 years. Assets are 6.9 times income, and liabilities are 1.3 times income.

This lack of income savings and the much better state of household balance sheets is probably no coincidence. It is likely that American households simply have not felt the need to save out of their paycheck, given that their assets have appreciated in value.

This is especially true in recent years, given how low interest rates have been and how fast home prices have risen. However, the result is that Americans are increasingly relying on their home as their nest egg.

The charts on pages 7 and 8 address retirement security. Over the past 30 years, defined contribution plans have taken over from defined benefit plans as the primary workplace savings program.

Senator SMITH. Can I stop you right there? Because I want to understand what you just said.

Mr. TIMMER. Yes, sir.

Senator SMITH. The savings rate is not as bad because of the way it is calculated, because the savings are in our real estate?

Mr. TIMMER. It does not account for wealth and it does not handle the capital gains versus capital gains taxes, in my opinion, very efficiently. The capital gains are reported with a several-year lag, and they are only reported annually, so it is hard to construct the savings rate.

So by some measures it is quite a bit higher than where it is. I mean, it has been declining over the years, but by some measures it is not nearly as bad as it seems.

Senator SMITH. But for somebody to have a nest egg, they have to sell their assets to go to a nursing home or whatever.

Mr. TIMMER. Household wealth is the much better picture, but that is homes and financial assets.

Senator SMITH. All right. I am sorry to interrupt you, but I wanted to understand that.

Mr. TIMMER. That is all right.

Let me just start at this paragraph. The charts on pages 7 and 8 address retirement security. Over the past 30 years, defined contribution plans have taken over from defined benefit plans as the primary workplace savings program for American workers.

Since 1975, the number of workers covered by a DB plan has fallen from 29 million to 21 million, while at the same time the number of employees covered by their company's 401(k) or similar plan has grown from 11 million to 64 million.

Page 8 illustrates that, while the rise in DC plans is a very positive trend, more needs to be done. Of the 122 million working Americans today, 58 million are not covered at all, and of the 64 million who are covered, 22 million choose not to participate for one reason or another.

Senator SMITH. Can I ask you another question? Why is one going down and the other going up, defined benefit versus defined

contributions? For the same reasons as Social Security, in terms of promises and the number of people working underneath?

Mr. TIMMER. Company pension plans have been in decline. At the same time, DC plans, where people can take some control over their own destiny, have risen quite a bit. It is somewhat of a generational thing. It is certainly our generation where we have seen that.

Making matters worse, many workers do not properly manage their 401(k) plan. To a large degree, this is understandable. Creating a retirement savings plan when you are in your 20s, picking the right investments, maximizing your deferral rate, and then rebalancing your portfolio on a regular basis over the subsequent 4 decades, and all this without consistent guidance, is something that even some professional investors have trouble with.

How can we better prepare America for retirement? The continuing stresses on defined benefit pensions make it even more urgent that we do everything we can to strengthen the DC system. Trends already under way to automatic enrollment, automatic savings escalation, and to the use of life-cycle strategies all promise to do exactly that.

In addition, initiatives such as a national small business 401(k) plan and reforms to the IRA system will help to ensure that all Americans have the opportunity to save for their retirement.

By their very nature, the demographic and retirement savings trends I have discussed are long-term, but they are also incredibly powerful, and they will impact us all in just a few years, not decades. The sooner we act to meet these challenges, the better.

Again, thank you very much for listening. I would be pleased to take any questions you may have.

Senator SMITH. I will likely have some more.

[The prepared statement of Mr. Timmer appears in the appendix.]

Senator SMITH. Dr. Bosworth, it is great to have you here.

STATEMENT OF DR. BARRY P. BOSWORTH, SENIOR FELLOW, ECONOMIC STUDIES, ROBERT V. ROSSA CHAIR IN INTERNATIONAL ECONOMICS, BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. BOSWORTH. Thank you. I had some prepared remarks which I submitted, so I am just going to try to summarize quickly some of the points I wanted to make.

Senator SMITH. We will actually include your prepared remarks as if read in the record. So, we appreciate your summary.

[The prepared statement of Dr. Bosworth appears in the appendix.]

Dr. BOSWORTH. I was asked to focus on two things. One, the international implications of the decline in U.S. saving, and second, a comparison of U.S. saving and investment behavior with that in a variety of other countries.

I want to do this in a very simple framework in which a nation's saving, minus its investment that it undertakes domestically, is just equal to the current account investment that it can make abroad.

Within that framework, you can sort of illustrate it in the handout I gave for U.S. savings investment by just noting that in the U.S., national savings, up until about 1980, ran at a very constant rate of between 10 and 12 percent of GDP.

Since 1980, it has just engaged in steady decline. Much of the decline, or a push, I should say, has been these fluctuations in public-sector saving. In the 1980s, we had a very large public-sector deficit, went back to a surplus for a couple of years in the 1990s, and now we are back in a large deficit again.

But probably more striking is that the private-sector savings rate just steadily has gone down over these last 25 years at a pretty much constant rate, and it has now reached the point that the household savings rate, as you mentioned, is negative by a small amount.

The only type of savings that has held up very well in the United States, and is doing very well today, is corporate saving, and that mainly reflects the fact that there has been a boom of corporate profits since the 2002 recession, and corporations have hung on to and reinvested a large portion of those profits.

So we have, today, an incredibly low national savings rate. It was 11 percent historically. We are now down to 1 percent of our national income, meaning that as a country we consume 99 percent of all our income in any given year, both in the public sector and the private sector.

Senator SMITH. Well, how would we compare to Japan, for example?

Dr. BOSWORTH. Japan, actually, today, in the national savings, is fairly low as well. I will discuss that a little bit more.

Senator SMITH. That is a fairly recent development.

Dr. BOSWORTH. Yes, it is. Japan was historically noted as a very high-saving country. It is low because it has had so many problems in the 1990s, that the government of Japan now has a very large budget deficit, trying to use deficit spending as a way to sustain its economy.

Senator SMITH. They are encouraging spending, are they not?

Dr. BOSWORTH. Right. It has a high private savings rate, but a very negative public savings rate, about the size of ours.

Senator SMITH. Yes.

Dr. BOSWORTH. So there is not as big a difference as there used to be.

But the other striking thing, I think, about the United States is not just the saving, but if you turn over to the investment side, unlike saving, the United States has great investment opportunities.

So we are a country where we do not save anything, but we have a lot of investment opportunities. So the result of that in the United States is we tend to borrow the money abroad. It turns out we now have a current account deficit with the rest of the world.

How much do we borrow? Seven percent of our income every year. This is truly an unprecedented situation. There has never been a time in which a country the size of the United States ran current account deficits with the rest of the world like this.

The debt has now accumulated to between $2.5 and $3 trillion with the rest of the world. We are the world's most indebted country by a huge magnitude, despite the fact, at the same time, we are

the world's richest country. It really is a strange situation that we live in today.

Senator SMITH. Can you tell me what it means? What does it mean in the lives of people, eventually, in America? How is this going to translate into our experience as Americans?

Dr. BOSWORTH. You can make an analogy of people and compare it to the Rockefeller family. The first Rockefeller earned an incredible amount of wealth, and his family has been living off his wealth now for over 100 years. So far, they have not run out. They have been selling it off, but there is still some wealth left.

Americans, the current generation, are living off the wealth of past generations, in effect. What we are doing is no longer adding positive savings. We are, instead, consuming the wealth of the past. That is not, in the long run, probably, a sustainable situation. But we are an incredibly rich country, so we can do this probably for quite a period of time.

What I think has been remarkable about all this is the ease with which we have been able to do this financing. The rest of the world, in effect, agrees with us: the United States is a great place to invest. So they have not minded having this capital inflow into the United States of about $800 billion a year. It is very sustainable from that respect.

Will there not come a day when they will doubt whether we intend to repay? At that point, yes, you begin to get a crisis when they worry that they are not going to get their money back, say in Argentina, would be an extreme example. But we are a long ways from being Argentineans.

Senator SMITH. And where are we relative to our European allies in this regard?

Dr. BOSWORTH. European countries, on balance, have zero net debt with the rest of the world. They no longer have a large foreign asset position. A couple do, but most do not. They do not have a large foreign debt, either. They have tended, over long periods of time, to have basically a zero balance in their external affairs.

Senator SMITH. And they do that through protectionism?

Dr. BOSWORTH. No. I think they do it by, one, in the case of Europe, savings has stayed higher than it is in the United States. Number two, they do not have good investment opportunities in Europe, so they are not faced with the same pressures that we are.

We are a very contrasting situation. No savings, very good investment opportunities. Everybody wants to invest in the United States. Europe, reasonably good savings, very limited investment opportunities. It tends to see the money go abroad.

Senator SMITH. And why is that, their policies or receptivity?

Dr. BOSWORTH. I think it is due to other economic policies. You are seeing a demonstration in France at the present time, a public dispute over economic policy in France. So, France is a slowly growing economy with a great deal of difficulty finding jobs for its citizens. That tends to not make it a very good place to have a very high level of investment.

Senator SMITH. Yes.

Dr. BOSWORTH. So in some ways, our current account deficit is both good news and bad news. Good news, because of the strength of the U.S. economy and the great investment opportunities that

exist here, and our rapid economic growth. The bad news is, we are not willing to finance any of it ourselves. We are, instead, just engaged in consumption of our own income.

Senator SMITH. Isn't that why some in high places say deficits do not matter?

Dr. BOSWORTH. That is right. In the short run, deficits do not seem to matter.

Senator SMITH. But eventually they will.

Dr. BOSWORTH. I think, eventually in the long run, all these things catch up to you. But the United States still has a very good economic system where rules of the game, so to speak, in the United States are probably better than anyplace else in the world.

People trust our institutions. Maybe Americans will not do very well living here because we are not going to be saving and accumulating a lot of wealth, but our economy can continue to do well. It is just that the economy will come to be owned, more and more, by foreigners.

There are two separate issues here: how well Americans are doing as citizens living in this country—and there have been disputes about the distribution of income, for example, and issues like that, and good job opportunities—and the performance of the economy. The economy is performing very well. You are probably going to hear more in future decades, are American citizens participating in that benefit very much? That is a legitimate concern.

Senator SMITH. All right.

Dr. BOSWORTH. The last point I would just end with, you can do this saving and investment comparison for lots of countries around the world. What strikes you about the whole thing, I think, is there is just an enormous disparity of savings rates across countries and across regions.

China is currently saving in excess of 40 percent of their national income. At the same time, I said the United States was down. To be on a comparable basis, we are doing about 12 percent, because it is a gross savings rate.

So there are enormous variations in savings, but it is, at the same time, large variations across countries and investment. If you are growing rapidly, you need lots of investment, you need lots of saving. So countries like China tend to absorb all their own saving, even though it is very high. They just re-invest it in their own country. They do not have much of a current account surplus or deficit.

The United States, in this comparison, stands out in this extreme imbalance between our investment opportunities and our savings behavior. That is not comparable with any other country in the world.

Senator SMITH. What do you think of Mr. Timmer's point, that our calculation of the savings rate is not entirely accurate because so much is in our homes?

Dr. BOSWORTH. That is true. Although, actually, if you made the adjustment for homes, it does not change the calculation very much. More accurately, the wealth figure he cited, that is a lot of investment in equities, the stock market.

That is the biggest part. If the market continues to be strong and there are continued capital gains, it looks very good. The trouble

with capital gains is that they can quickly turn into losses, as you saw in 2002.

Housing. Nowadays, the same issue has come up. Some people are afraid. Housing prices have gone up, and that sounds very good to me, maybe when I retire. But who am I going to sell my home to in the future? It is going to have to be my children's generation that buys it.

I think housing is an example of, the gain of one generation is the loss of another generation. It is inside the United States, so to speak. If housing has a big capital gain for me, it implies a big capital loss for my children if they do not yet own a house, because they will have to pay that.

There is a concern that it is a bubble, that as we go out in future generations there is no way our children are going to be able to pay us for these inflated values of housing. So I agree that, right now, the story on wealth is more positive than implied by savings. It has been a remarkable 20-year run of capital gains.

The stock market has been going up since 1982, on average, with some fluctuation. Home values have continuously increased. So capital gains have offset the weak savings performance of most Americans, and they continue to have fairly good wealth holdings.

Senator SMITH. I have always assumed, Doctor, that part of the reason Wall Street has done so well, and some real estate investment so well, is to your point that we are a good investment society, good investment opportunities, and that is bringing in all of the capital. So you have capital from all over the world competing for these limited American assets. Obviously that means inflation in the value of those assets.

Am I right in that assumption?

Dr. BOSWORTH. I think you are absolutely right. The U.S., for the 100 years that we have data for, has been a low-saving society. But we use our saving very efficiently in this country, in part because we have a very vigorous financial institution and financial markets, probably better financial markets than any other country.

So we allocate and utilize our saving very efficiently compared to countries like Japan, which has not had that same sort of strong financial system, and they wasted a lot of their saving.

Senator SMITH. You made a statement I find very interesting, and I would like to pick your brain on it a little bit. You talk about, on the one hand, the great investment opportunities in this country that attract capital from all over the world.

Then you talk about the political question that will likely be debated in future campaigns, are Americans participating in it? It seems to me the answer to that is, maybe not enough.

If the answer is, maybe not enough, what will be the policies coming out of those election results that might transform us, perhaps, into acceding to policies such as you have in France that might produce more savings, but destroy our investment environment? Do you see what I am saying?

Dr. BOSWORTH. That is exactly what will happen if you get too much social discontent. In a democracy, you depend on the assumption by a wide majority of your population that "I am going to gain from this system." That has been a very strong American belief for a long time.

But if it turns out that all the benefits begin to accrue to a few and the average, typical American feels they are not participating in the benefits, then you will see a lot of social disruption like you are now being faced with in France, which is exactly the problem.

Senator SMITH. But if that is the conclusion, then the election results manifest themselves in policies such as our European friends have adopted, and what happens? We have destroyed the investment climate and this American dynamo comes to hit the brakes, it seems to me.

Dr. BOSWORTH. I think I would agree with that. It is a dangerous situation. But just because the economic situation deteriorates does not mean that you will respond in a positive fashion. You can do what is happening in Europe. They are responding in a negative fashion, and they are making their own situation worse.

Senator SMITH. Very interesting. Thank you.

Dr. Brainard?

STATEMENT OF DR. LAEL BRAINARD, VICE PRESIDENT AND DIRECTOR, GLOBAL ECONOMY DEVELOPMENT CENTER, NEW CENTURY CHAIR IN INTERNATIONAL ECONOMICS, BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. BRAINARD. Thank you, Mr. Chairman and Senator Kerry. Thank you very much for the opportunity to address this topic. I think this topic is one of the most vital long-term challenges facing the Nation, and one of the least addressed.

America is not saving nearly enough to be competitive or secure, in what is an accelerating global economy. The base, I think, of the concern is really the eye-popping fiscal turnaround that we have seen in the last 5 years, going from historical surpluses to deficits really into the indefinite future.

What is interesting is that so far we have been able to be relatively complacent about the situation. After all, we are kind of having our cake and eating it too. We have had low interest rate mortgages, we have had low inflation, we have had cheap borrowing all around.

So what has enabled this fiscal binge? Well, I think it is pretty clear: it is the very large and growing reliance on foreign borrowers. As Barry said, about 7 percent of our income was actually borrowed from foreigners last year. If you look at current trends, we will pass the half-way mark in terms of foreign ownership of Treasury securities by the end of this year. That is a pretty important marker.

It is also true that America has borrowed a lot from foreigners in earlier periods. If you look back into the 1980s, there was a concern then as well. But during that period we were net creditors to the rest of the world. We have now swung into the net indebtedness position, and it is growing very rapidly.

If you look only at the last 5 years, our ratio of indebtedness to foreigners to GDP has gone from 14 to 25 percent of GDP. Now, that may not seem like a large number, but if you look at Brazil and Argentina, on the eve of their financial crises in 2001, we are nicely situated right between their debt-to-GDP ratios.

The other thing that is quite anomalous about it is, historically super powers have been suppliers of capital to the rest of the

world, not a net drain. Other rich countries have borrowed a similar share of GDP historically, but we are talking about places like Australia and New Zealand, not countries that account for about one-third of the world economy.

So are there risks? The current course suggests that, no, there are no risks. The rest of the world is all too eager to finance our borrowing and, hence, the relatively low interest rates that we have seen to this point. I think that is a fair observation, but it is also a bit misleading. You were talking earlier about, what are the risks of having increased foreign ownership.

Well, there is another risk. If you look inside the aggregates, it masks a big shift away from private investors from Europe and other places in the world, investing mainly in private securities in the United States, to foreign, official lenders, central banks, mainly in Asia, buying Treasury securities.

So we have a different kind of lender lending for different purposes, and they are lending different kinds of securities. They are financing, increasingly, our fiscal deficit.

I think that the projected levels of foreign borrowing do pose risks to our economic competitiveness and our economic security. Of course, the hard-landing scenario is the one that we hear the most about, that is, a sudden rush to the exit, some kind of sudden change in investor perceptions where people dump dollar assets and the Fed has to precipitously raise interest rates. That is, as many people will tell you, a low-probability event. It is not a very pleasant event to live through.

But here is the bad news. The other scenario is hardly reassuring. Even with smooth adjustment, time is simply not our friend. If we delay adjustment, if foreign central banks continue to indulge this consumption binge, it is going to get more and more painful to fix it.

The cost of servicing that debt to foreigners will eat up a larger share of our export earnings and will require a greater turnaround in our trade balance and more compression in domestic growth to stabilize it.

If you look at some of the projections out there, in only 2 years or 3 years, because of the compounding effect, we will be at 50 percent of GDP in terms of indebtedness.

Senator SMITH. Can I ask you this?

Dr. BRAINARD. Yes.

Senator SMITH. How would you fix that? Just put up protectionist barriers to stop Americans from buying abroad?

Dr. BRAINARD. In fact, that would be the last thing in my tool kit.

Senator SMITH. All right. How do you fix it?

Dr. BRAINARD. Yes. This is not actually a difficult conundrum to get out of if we start working on it now. We have seen historical episodes, like the 1980s, where we have been in a similar situation and gotten out of it, but it requires, first and foremost, taking tough action here at home on the fiscal side, looking out into the future and our needs in terms of the fiscal, and trying to get our hands around that right now.

If we do that, we are in a very strong position internationally to put a lot more pressure on our foreign partners to do their piece

of the puzzle, whether it be adjusting the exchange rates in Asia or whether it be stimulating growth and getting rid of some of the structural barriers in Europe and Japan.

If you put those three pieces together, you get a pretty positive scenario in a relatively quick period of time. But, of course, the first piece of that is extremely, extremely difficult to do.

Senator SMITH. Just to follow up: if we go fix our fiscal house, do you see the problem in the discretionary spending or in the entitlement spending?

Dr. BRAINARD. Well, you are asking a really tough question. But if you look at non-defense discretionary, it is an increasingly tiny percentage of the budget.

Senator SMITH. Exactly.

Dr. BRAINARD. The reality is, looking out, we have big problems that we are going to have to get our hands around. The fixes are going to take looking at all the pieces, looking at the entitlements, looking at the tax side. Brookings has a lot of work, I think, as you may be aware, on this subject.

Senator SMITH. And has Brookings figured out sort of a point between now and 2030 when we are going to hit the wall and have no choice but to fix it?

Dr. BRAINARD. No. I should say that Brookings has a whole series of different paths; some of them rely much more heavily on taxes, some of them rely more heavily on entitlements, so it is sort of a menu of options. But all of them say, the sooner you start, the less harsh the out years are.

Senator SMITH. I just want Senator Kerry to know that I have been asking each of them when the politics are going to line up with the policy imperatives.

Dr. BRAINARD. Let me just wrap up. I do not want to go over here.

On this connection, connecting the dots between our deficit and competitiveness, I think we are at a moment when, like it or not, the competitive landscape is shifting at a breathtaking pace. We are seeing the entry of hundreds of millions of workers from low-wage countries into the global labor force.

We are seeing for the first time higher-skilled services jobs being now in the global marketplace. And, of course, we now have a very serious challenge on the energy security front.

There is no doubt that America can deal with all those challenges and be the most competitive economy in the world, but it requires very proactive policies to invest in skills for the 21st century, to invest in the game-changing technologies of the 21st century, sustainable energy supplies, and, of course, the health care system, which is our biggest competitive disadvantage.

You cannot do all of that with our current fiscal strait jacket. You cannot do all of that by borrowing from foreigners. At the end of the day, if we want to be competitive, we need to invest. If we want to invest, we are going to have to save. Thank you.

[The prepared statement of Dr. Brainard appears in the appendix.]

Senator SMITH. I just have one other question, and then I will turn the mic over to Senator Kerry for his statement or questions.

These all have been fabulous witnesses, and you have heard two of them.

It seems to me that most of the people who work here on the Hill are involved in the Federal pension program. I do not know about others, but I take the maximum all the time. I know that I have given a menu of things to direct these dollars into. They are securities, investments, bonds in some cases. Is that savings or is that investment? How are you calculating that in all of this?

Dr. BOSWORTH. It is savings.

Senator SMITH. It is savings.

Dr. BRAINARD. Well, it enters on both sides.

Senator SMITH. It is both.

Dr. BRAINARD. It is savings that enables investment. So if, as some of the gentlemen were suggesting earlier, we put some automatic options on the table in terms of 401(k)s and we actually increase net savings—and there is a question mark there—it provides greater capital for investments, here and abroad.

Senator SMITH. I ask that question because recently a friend of mine in Oregon said that his housekeeper wanted to buy his car, and they agreed on a price of $20,000. She gave him a roll of money, of $20,000. How much of that is going on in the country that is not accounted for in this? Is that just in the immigrant community? Is there any way to gauge that?

Dr. BOSWORTH. There is a series of studies that have been done, none of them very convincing, about, how big is the so-called "underground economy" in the United States. I think the best summary of them is, this goes on, you are absolutely right.

It is relatively low in the United States, somewhere between 5 and 10 percent of the national income. The evidence that it has been growing over time is pretty limited. It has stayed in that range. It was a common phenomenon back in the 1950s.

Senator SMITH. And after the recession, I assume, when people had no confidence in banks.

Dr. BOSWORTH. Right. Right. It is true here. There are people who circumvent the financial system, for example, with their saving and their incomes. But if you use the IRS measures, which I think have done the best job of trying to judge the magnitude of this economy—I am not talking about the illegal, I am only talking about activities that are not being reported in the statistics—I would say it is between 5 and 10 percent of GDP, with no evidence it is growing over time.

Senator SMITH. Would anyone disagree with the bill that Senator Conrad and I have to encourage savings that involves extending the Saver's Credit, and obviously it relates to 401(k) programs, an automatic program? You can opt out, but you automatically enroll. Does anybody disagree with that policy?

Second, can you give us any other ideas to turn this around, the savings?

Mr. TIMMER. I would illustrate how effective automatic enrollment would be. There is a page in here somewhere that shows the system in Europe for organ donor programs, and in some countries it is an opt-in program, and in some countries it is an automatic enrollment, and you can opt out through negative election.

For instance, in Germany, the participation rate is 12 percent. In Austria, which is in many ways very similar as a country to Germany, it is 99.98 percent. So the power of automatic enrollment is quite compelling.

Dr. BRAINARD. I would only add to that that the research suggests that it would be more powerful for low-income people, so there is a double benefit there.

Senator SMITH. Thank you all so very much.

Senator Kerry?

Senator KERRY. Thank you, Mr. Chairman. I apologize for being late and not being able to hear everybody's testimony, but I have done my best to try to get the essence of what each of you have said here, and I appreciate it.

Mr. Timmer, it is good to welcome you here from our State. Dr. Brainard, thanks for being here and for the work that we are doing on some other things.

The debt clock in New York is going to run out of digits in about 10 years if we keep going the way we are going. I guess we are at $8.4 trillion now. Fifty-one percent of our debt is owned by foreigners. I do not know if you have commented on that.

But how much does that matter? Japan being the biggest owner of debt at $600-some billion, and China next, $258 billion. What is the significance of that on America's financial well-being and future?

Mr. TIMMER. I take a slightly different take on this than my colleagues here. The last page of this handout basically, in my opinion, sums up what is going on in the world, and it is essentially globalization.

It is called the "S" curve. It is essentially a growth curve that you can apply to almost any product or technology. The U.S., as well as western Europe and Japan, are in the upper far-right corner. That means we are very wealthy and mature nations. Our GDP is high, but not growing that fast.

The vertical part of this curve shows the emerging markets, including China and India, which, of course, with 2.4 billion people combined, is a major development. To me, this sums up this whole current account imbalance situation and who owns our debt. We are basically the consumers. We are the wealthy consumers and China and India are the producers of cheap labor and goods.

So every day, every month, our dollars go abroad to purchase things, and that means these dollars end up in their reserve system. With those extra reserves, they buy our Treasuries. That was especially the case with Japan a few years ago when its economy was very much suffering, and basically China was eating its lunch in terms of their export business to us.

So what Japan did, what the Bank of Japan did, is every month they would buy tens of billions of dollars' worth of U.S. dollars in the currency market as a foreign exchange intervention, because they needed to get the yen down to compete with the Chinese economy for our business.

I think at one point, on an annual basis, they were buying something like $300 billion worth of our Treasuries and Agencies. To me, that is a mechanical activity. It is not that somebody there de-

cided, well, U.S. bonds are a great investment, I am going to buy $300 billion of them. It was basically a liquidity operation.

So I do not quite share the concern that these foreign investors are all going to dump our bonds and teach us a lesson and the dollar is going to implode and interest rates are going to skyrocket.

I think actually it is the result of the lower dollar that causes this buying of our Treasuries, and therefore our interest rates have remained low, which in turn is a stimulus to our American consumer. So, I do not take quite as dire a view on what is happening.

Senator KERRY. But when you say a stimulus to the American consumer, the American consumer is about as laden with personal debt as at any time in our history, and the American consumer has used those low interest rates to take huge equity loans out of their homes. So they are already taking their retirement equity and they are spending it today.

Mr. TIMMER. Well, homeowners' equity has been pretty stable, around 56 percent, for the last 5 years or so. What I mean is that interest rates remain low. It is a stimulus to the consumer. Debt, in absolute terms, is at an all-time high, but relative to——

Senator KERRY. But the interest rates being low are a stimulus to the consumer how? Where is the average consumer taking that stimulus?

Mr. TIMMER. They have taken it to refinance their mortgage in recent years.

Senator KERRY. Correct. And once they have refinanced their mortgage, many of them are spending the equity either on a home improvement, in some cases, but not enough. Most of them are buying RVs and second homes, cars, paying for college education. It is cash out the door. Then when they retire, with their pensions disappearing, and they will not have, most of them, 401(k)s, and so forth, where are we going to be? Because I know in your chart you have here that demographic——

Mr. TIMMER. Yes. I mentioned in my opening——

Senator KERRY. I mean, that cannot be considered to be sound. Some of the top people in the country have talked about, this is an unsustainable path we are on. Do you agree?

Mr. TIMMER. I think it is unsustainable if it continues at the rate that it has in the past 5 years, but I think that was probably somewhat anomalous because we had very low interest rates, rapidly growing home prices, so a lot of people did refinance and they did take out more equity.

But I look at consumer debt in relation to the entire balance sheet, not just on its own. Consumer debt has risen, but consumer assets have risen more. As a result, consumer household net worth is at an all-time high of $52 trillion. So, there are problems.

I just think the problems are somewhat overstated. I think the biggest issue is that people are not saving through their workplace savings program the way they should be, they are not maxing out their deferral rates. A lot of Americans do not even have coverage in a defined contribution plan. I think that is the more pressing issue.

Senator KERRY. Well, the primary consideration of this hearing is obviously, what is the impact, is there a danger or is there not, in the low U.S. savings rate? And as I think you point out, Dr.

Bosworth, in your testimony, we have long had a pretty low savings rate in the country and we have fairly strong growth, so you are fairly confident of that sustaining us. At least that is the way I read your testimony.

Dr. BOSWORTH. Not indefinitely, no.

Senator KERRY. But not indefinitely.

Dr. BOSWORTH. I would share your concerns.

Senator KERRY. I beg your pardon?

Dr. BOSWORTH. I would share your concerns. But I am not going to give you a date. I do not think we know enough to forecast the date of disaster, but continuing to run current account deficits of this magnitude with the rest of the world is not sustainable. We are running down our wealth. I think there comes a point where people will ask questions about your government, about, how high can the government debt be and still think that you are going to raise taxes to pay for it. They will begin to question you. So, no. I do not think either one of these trends is sustainable, but I do not believe they are a crisis tomorrow. That is the problem, in fact. If we had a crisis, Americans respond very well to crises. The whole difficulty today is, there is no crisis, so people say, deficits do not matter. If you can get a crisis, you can get a solution. That is a funny way of looking at it.

Senator KERRY. The question is, is it not a crisis today, except it is not being felt? Let me press you on that a little bit.

You, in the last paragraph of your testimony, say, "In the long run, the lack of export markets will prove to be very damaging to the job opportunities of American workers. Third, the situation is likely to worsen in future years as more baby boomers move into retirement."

Well, we know that is going to happen. We know we are moving, because some of you referred in your testimony, from defined benefit to defined contribution, and that is lowering people's benefits and quality of life available.

Then you say, "From a demographic perspective, the current U.S. private savings should be at an all-time peak. The international comparison suggests that demographics do have some influence on saving. It appears to be small and easily overwhelmed by other factors."

As I look at the trend line here and the overwhelming factor, you would all agree, I assume, that the fiscal choices we are making play into this very significantly.

[All witnesses nod in the affirmative.]

Senator KERRY. All heads are nodding yes.

I assume, given the fact that in the year 2000 that clock I referred to was stopped, stopped dead, if it had been recording, it would have been going backwards. But it could not record backwards, so it just stopped for 2 years. Now we are at $8.4 trillion, and if we continue the way we are going, it will be $10 trillion, and the clock cannot record any more.

So we have that staring us in the face. We have the disappearance of pensions staring us in the face. You have the disappearance of high value-added paying jobs, and the traditional manufacturing job base disappearing.

You have rising health care costs and rising numbers of people who do not have health care. You have all these people who are burdened with personal debt and have taken the equity out of their homes and will not have additional equity on which to pay their medical bills or their retirement, as they are the aging baby boomers.

But as you start adding up these trends, is there not a profound question that Congress ought to be asking itself, which is, why are we going through another big tax cut round? Dr. McCool? I mean, is that not irresponsible, in fact?

Dr. MCCOOL. That is not for me to say.

Senator KERRY. Why? You are an American citizen. You are a person who judges our economy. Why is it not for you to say? I mean, as an American citizen. Do you have kids?

Dr. MCCOOL. No, I do not.

Senator KERRY. Do you have a family?

Dr. MCCOOL. Yes.

Senator KERRY. Some wealth you hope to leave to somebody?

Dr. MCCOOL. I do.

Senator KERRY. Are you concerned about what is going to happen in terms of the choices that are going to be left behind? Is this a responsible set of choices that are being pursued in Washington?

Dr. MCCOOL. Well, I think that there are a lot of levels of responsibility, or lack of responsibility. That is, I guess, part of the issue.

Senator KERRY. Blame it on all of us, Congress. I am not trying to be partisan here.

Dr. MCCOOL. I understand.

Senator KERRY. I am just trying to get to the root of it. Does it make sense to be having a great big tax cut when we have all these issues staring us in the face, and we are adding to the debt, we are not solving the problem of retirement accounts, we are not providing added incentives for savings, we are not doing what we ought to be doing for the next workforce to come along. We are cutting after-school programs. NIH will be level-funded. R&D. I mean, just run down the list of long-term investment needs in the Nation. I am just asking you, as a citizen, do you think it is responsible?

Dr. MCCOOL. Well, again, I think, as we stated in our testimony, I think that there is a need to take action on the fiscal side and all the sides and pieces need to be considered, revenues, entitlements, and discretionary spending.

Senator KERRY. I am for cutting spending. We just never talk about the other. How can you cut spending, particularly make the choice to cut kids' after-school programs, and cut Perkins loans which give kids, underprivileged kids, the opportunity to go, hopefully, create the jobs of the future?

We are going to cut those, but we are going to give people earning more than $1 million a year $32 billion worth of tax cuts. I do not get it. It is a pretty simple question. It really is the pregnant question of this city. I am willing to cut whole departments, incidentally.

But I am also unwilling to give away some of the revenue we have today that, it seems to me, would go against the deficit, even, if not against some of these other priorities. But we do not hear

enough public opinion leaders screaming about this. I am just asking you.

Mr. Timmer, what do you think?

Mr. TIMMER. I think, if you are referring to the capital gains and dividend tax cuts, the extension of the tax cuts, the only thing I will say about that is that those are probably the two taxes that most directly affect the stock market. Of course, the stock market is ultimately what most 401(k) programs are invested in, at least at earlier ages.

Senator KERRY. You do not think 20 percent is low enough?

Mr. TIMMER. Excuse me?

Senator KERRY. You do not think 20 percent is low enough? What is it, 15 now? What do we have? Fifteen?

Mr. TIMMER. Fifteen.

Senator KERRY. Yes. I mean, that is not low enough?

Mr. TIMMER. No. But I think they are talking about——

Senator KERRY. Compared to 39 percent.

Mr. TIMMER. Are they not talking about extending the current rate?

Senator KERRY. Yes. Some people are.

Mr. TIMMER. My point is that stock investment is essentially the net present value of future cash flows. So if you tax those future cash flows at 15 percent or 30 percent, that has an immediate impact on the net present value.

So if you go from 28 to 15 and then back to 28, or whatever it is when they sunset, that will have an immediate impact on the stock market's capitalization, which will have an impact on almost everybody's 401(k) plan.

Senator KERRY. Well, you know what Warren Buffett and some very rich people tell me? They know how to make money and they certainly know how to play the market, whether it is 20 percent or whatever. Incidentally, I thought 20 percent was just fine, and I voted to put it at 20 percent.

I just do not know why this is sort of a priority after priority, again and again and again. I mean, 20 percent is better than 39, 28, or 33, which are the brackets a lot of other people are paying. If you have a better bracket there, that is pretty good incentive.

But what I am getting at is this. Would it not be better for you, for the savings rate of America, and for these long-term problems, if we grew the 401(k) capacity of workers? Or since we are shifting to defined contribution benefits, made it easier for that contribution to go into a vested, portable 401(k) so people begin to grow their own retirement capacity?

Mr. TIMMER. Yes.

Senator KERRY. Would you not do just as well versus that difference in the market?

Mr. TIMMER. I do not know what the numbers would be, but certainly automatic enrollment, automatic escalation, the use of life cycle strategies—I mean, we have studies that show that a lot of people do not have a plan. A lot of other people have a plan but do not participate. Then there are a lot more people who do not maximize the benefits.

So if we can make it easier for them to do that, through especially automatic enrollment, life cycle funds, automatic escalation,

maybe increasing the deferral rates, I think that would go a very long way to improving our retirement security, and it would be something that would be fairly easy to do.

Senator KERRY. Are you concerned, all of you, about the trend in corporations just to punch out on these pensions? I mean, this is money a lot of workers are giving away. They think it is their money, and they suddenly wake up and find it is gone. What do you think we ought to do about that? That is a form of savings.

Dr. BOSWORTH. I think that this has turned out to be a major crisis of the retirement system in the United States, the ease with which corporations can duck their responsibilities because they did not properly fund their pension programs, nor their health care programs that they promised to workers in retirement. So we need to do something about that.

I think the number one answer is, retirement saving is too important to leave to your employer. They do not make good decisions in your name. They will make decisions in their own name. Therefore, I favor the move away from defined benefit programs, which are controlled by employers and have historically been under-funded, and then they dump the problem on the Federal Government. So we should turn over to a system of defined contribution plans. I think the idea to say that every employee should automatically be enrolled is a good one.

I would go a step further. I think every employer ought to be forced to offer such a plan to their workers. Unfortunately, I do not think there is a way to raise private savings purely by incentives and nice things. If you want to make Americans save more, you are going to have to make them save more. And if they do not save, they turn out to be a burden to the rest of us in retirement.

So the government has a legitimate claim to say that every American worker should have a retirement program. There is a limited number of choices that should be made because most of us do not want to spend our life as an investment banker, so we do not want to have to make all these decisions all the time.

You earlier spoke of a great model that could be used throughout the country, and that is the Federal employee pension program. This is a very good plan. You use it yourselves. It is very attractive to you. Why do you not extend it and make it available to other Americans with the same basic idea?

Senator KERRY. Mostly because other businesses will not be as generous as we are with the American taxpayers' dollar in the employer match. It is that simple.

Dr. BOSWORTH. It is their money, not your money, I guess.

Senator KERRY. But I would love to see it happen.

Let me just close. First of all, I am delighted to hear what you just said. I think it is really important. I would like to work with the Chairman on working to do that.

Senator SMITH. Absolutely.

Senator KERRY. Because this is, I think, a huge freight train coming at us. But the only question I would have about that, if I may ask the Chairman's indulgence, wages have not been going up, but cost of education has, energy costs have, health care costs have.

So the disposable income of the average American family has gone down, or stayed about the same. It depends on where you are.

They are having a harder time making ends meet. So how are you going to get them to put this money away?

Dr. BOSWORTH. I think we have to differentiate here. The lower half of the distribution of American families has been having a tough time. The upper half of the distribution of American families has never had it so good.

Senator KERRY. Agreed. Agreed.

Dr. BOSWORTH. This economy has been growing better in the last 2 decades than at any time in our history. We are doing very well as a country. Our opposition and concern is about the distribution of the benefits.

Usually in the past, the U.S. has followed the rule, let the markets operate and allocate most efficiently as possible. If we do not like the distribution, we try to correct that with the tax and transfer system. So we ask upper-income people to pay a larger proportion of the cost of public services than people at the bottom. We do not run budget deficits.

This is not really a question of low-wage workers not having enough income. We are not redistributing the social services and the payment of the social services in a rational fashion. Those at the top are doing very well.

Senator KERRY. Does that include the Earned Income Tax Credit, conceivably?

Dr. BOSWORTH. I think the Earned Income Tax Credit is the most positive development that we have had in tax policy over the last quarter century or so, and it is the type of mechanism—it is hard to go further, but that is exactly what we need, is incentives for people at the bottom to get a job and to work.

It has been very effective in that regard, and I think it helps them, and I would encourage the expansion of it as soon as possible. But it is near its limit. You cannot do much more with the Earned Income Tax Credit than you are now doing.

Senator KERRY. Well, I appreciate all of you taking the time to testify. I appreciate the Chairman having this hearing.

Senator SMITH. Thanks, Senator Kerry.

I am intrigued, Dr. Bosworth, by your last comment. I am also intrigued by Senator Kerry's State legislature that just passed an individual mandate on health care. I know a lot of conservative commentators see that as Big Brother.

But my own sense is, if health care is a right, health care is also a responsibility. I kind of like it, and I am happy to say that. I wonder if maybe in what Massachusetts has done there is not a model for savings as well.

Maybe Senator Conrad and I are not going far enough. We are saying you can opt out, but you are automatically enrolled. Maybe there ought to be some consideration to this whole idea of, you have to participate in savings. I do not know if you have any ideas. I would love to get them from Brookings, or anywhere else, because it intrigues me.

But you all have been terrific, patient, and generous with your ideas and your knowledge. I thank you for adding measurably to my understanding of the problem, and I suspect Senator Kerry feels the same.

Eventually, the economic exigencies of our country are going to line up with our politics. I am still looking for the date when that crisis comes. So if you figure it out, let us know, because I would sure like to get something done on these great issues while I am here, however long or short that is. But thank you all so very, very much.

We are adjourned.

[Whereupon, at 3:58 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Testimony of Barry Bosworth

As requested, I would like to focus my comments on providing an international perspective on U.S. saving behavior. However, it is useful to begin with a brief macroeconomic summary of recent trends in the United States. The presentation of the data is rooted in an identity in which a nation's saving is equal to domestic investment plus net foreign investment (or what is called the current account balance in international discussions). This is of particular importance to understanding the large current account deficit of the United States on its transactions with the rest of the world. National saving can also be further divided into saving of the public and private sectors. Some countries, including the United States, go further and divide private saving into a corporate and household sector. However, the second distinction can be of questionable meaning in countries that have a large noncorporate business sector.

These concepts are shown in the summary of the U. S. saving and investment balance in table 1. After a long period of stability near 11 percent of income, the net national saving rate began to decline in the early 1980s and in 2005 it reached an astounding low of only one percent of national income. Some of this drop can be traced to the re-emergence in recent years of sustained negative saving in the public sector, but the continued decline in private saving and the negative household saving rate are particularly striking. Only the corporate retained earnings portion has held up in recent years as profits have soared since the 2001 recession.

I am not going to go into the reasons for the decline in household saving because they have been discussed at length by others and remain quite controversial. I do show in the first chart, however, the rise in the wealth-income ratio over the last two decades because it has attracted so much attention. I agree that large capital gains are part of the explanation for the reduced saving; but as shown in the chart, the correlation is not very close and saving showed no signs of recovery after the 2001 stock market crash.

On the other side of the accounts the United States continues to offer very good investment opportunities -- superior to those of most other industrial countries -- and the domestic investment rate has nearly recovered to the level of the 1995-2000 boom. The net investment rate shows some decline over the past 40 years because of a progressive shift toward shorter-lived capital with its faster rate of obsolescence, and hence higher capital consumption allowances (depreciation). However, this is offset by a larger flow of capital services per dollar of capital.

The combination of good investment opportunities and very little domestic saving with which to finance them has translated into an ever-growing reliance on the net inflow of resources from abroad. Net foreign lending (current account balance) reached -789 billion dollars in 2005, or a negative 7.2 percent of national income. This degree of reliance on foreign financing is unprecedented, but has been achieved with relatively few strains because foreigners perceive the United States as offering safe and attractive investment opportunities. The Federal Reserve has

also supported the process in recent years with a steady increase in U.S. interest rates. However, the strong demands for dollar-denominated assets have kept the value of the dollar at a high level and greatly weakened the ability of U.S. export firms to compete in global markets.

It is vital that Americans understand that this situation is a product of our own economic behavior – basically an extraordinarily high rate of consumption – and not that of other countries. We are in the midst of a domestic boom with very low rates of unemployment, and we could not possibly support our spending out of our own productive resources. We need the foreign resource inflows and foreigners perceive the expansion of our markets as the locomotive for global growth.

I have been in the process of collecting data from a variety of sources on rates of saving in other countries. Not all countries produce national income accounts with the degree of detail provided in those for the United States, and for many developing countries the data are often problematic. It is also easier to focus on rates of gross saving and investment, without correction for changed rates of depreciation; but it has little impact on any conclusions. Figures 2-5 provide a perspective on saving and investment trends in the other major industrial economies of the OECD over the period of 1960-2005. As shown in figure 2, the United States has always had a low rate of national saving compared to Europe and Japan. At the same time, a pattern of declining rates of saving is evident in all three regions. Japan's saving rate has fallen as much as that of the United States since the 1970s.

Surprisingly, the contrast among the industrial countries is actually on the investment side (figure 3). Rates of investment have fallen in both Japan and Europe in response to their markedly slower rates of economic growth; but as mentioned earlier, the investment rate has remained stable in the Untied States. As a result, differences among the industrial countries in rates of domestic investment have largely disappeared. Because rates of saving and investment have declined in parallel in Europe and Japan, they have seen very little change in their net external balance, in sharp contrast to the situation of the United States. Both Europe and Japan have much slower rates of employment and GDP growth than in the past, which contribute both to reduced rates of saving and investment. No such slowing of growth is evident for the United States. Our labor force continues to expand and we have seen a strong recovery of productivity growth over the past decade.

For the OECD countries, it is possible to distinguish public and private sector rates of saving (figures 4 and 5). The EU countries used to use strong public saving as a major source of capital financing to support their efforts to catch up to the United States in living standards. When they encountered economic problems in the 1980s, the public sector surpluses disappeared. Integration into the Euro Zone intensified pressures to reduce budget deficits in the late 1990s, but they have deteriorated again in recent years. Japan, of course, has gone through a dramatic cycle as public sector saving surged in the boom of the 1980s, but it has disappeared in the long drawn out crisis of the 1990s. The public sector saving deficit is comparable to that of the Untied States.

A focus on private saving rates yields a slightly different perspective. Except for a bulge of saving in the early 1970s in Japan, private rates of saving in Europe and Japan have declined only modestly, and they are notably higher than in the United States. The trends in private

saving have been particularly divergent since the mid 1980s. This is surprising in view of the significantly higher proportions of the population that are retired in most European countries and Japan. The United States has a comparatively young population with the surge in the aged population still almost 10 years in the future. It is also evident that Americans have long saved less than the citizens of other countries. However, the low rate of U.S. saving was not particularly damaging to economic growth. While saving less, they invested the capital very efficiently. In part, this was due to highly developed capital markets and a minimum of government interference in the allocation of saving.

We also have data on national saving, investment, and the external balance for a larger number of countries that includes most of the developing world. These data are shown in table 2 for the period of 1980-2005. Table 2a shows the distribution of current account imbalances (saving minus investment) across the major regions of the world, scaled by global GDP. The table highlights the extraordinary nature of the current situation in which the richest nation in the world is actually importing capital from all the other regions. Normally we would expect the rich to save a bit of their income and loan it to the poor. While the United States has a deficit, every other region has a surplus on its current account. With the rise in world oil prices, the surplus within the oil-producing countries of the Middle East is particularly large.

Table 2b highlights the extraordinarily large differences in saving rates across regions. Among the emerging regions, saving is notably low in Latin America and these countries have frequently attempted to borrow in the world capital market. The result has too often been financial crises. Asia, in contrast, is composed of a large number of high saving countries. It also appears that those high saving rates are concentrated in the private sector since the governments generally avoid large budget surpluses or deficits. Several explanations have bee put forth for this pattern of saving behavior. The sharp decline in birth rates has lowered the child dependency rate and encouraged adults to save for retirement since they can no longer simply rely on their children. Many of these countries do have underdeveloped public retirement systems. Second, high growth creates a virtuous circle in which rapid income growth makes it easy to save at the same time that one's standard of living is improving, and the high saving feeds back through capital accumulation to promote growth. In addition, some Asia countries have traditions of strong intergenerational linkages that may serve to promote dynastic saving and a longer-term perspective on wealth accumulation.

Table 2c shows that the cross-national variation in rates of saving and investment are highly correlated. While the situation is changing, most developing countries still find it difficult to obtain stable sources of external capital and they are often forced to rely on their own resources (saving). The situation may change in the future, but at present only one country, the United States, seems able and willing to operate with a large current account imbalance. Thus, the structure of table 2a, in which the United States has a huge external deficit and all other countries have small surpluses.

The conclusion that I would like to emphasize from this comparison is that it is the United States that is the outlier in terms of the net imbalance of saving and investment. In part, the external imbalance is good news because it is reflective of very good investment opportunities in the United States, but it is also reflective of an extraordinarily low rate of saving in both the public and private sector. Second, I do not believe the situation is a crisis. The

United States is an extraordinarily rich country which can afford to live off accumulated past wealth for a very long period. In addition, the lack of domestic saving is not particularly damaging to U.S. businesses that can obtain financing in a global market. However, the imbalance does contribute to an over-valued dollar and a situation in which firms cannot compete in the global market from a production base in the United States. In the long run the lack of export markets will prove to be very damaging to the job opportunities of American workers. Third, the situation is likely to worsen in future years as more baby-boomers move into retirement. From a demographic perspective, the current U.S. private saving should be at an all-time peak. The international comparisons suggest that demographics do have some influence on saving, but the effect appears to be small and easily overwhelmed by other factors.

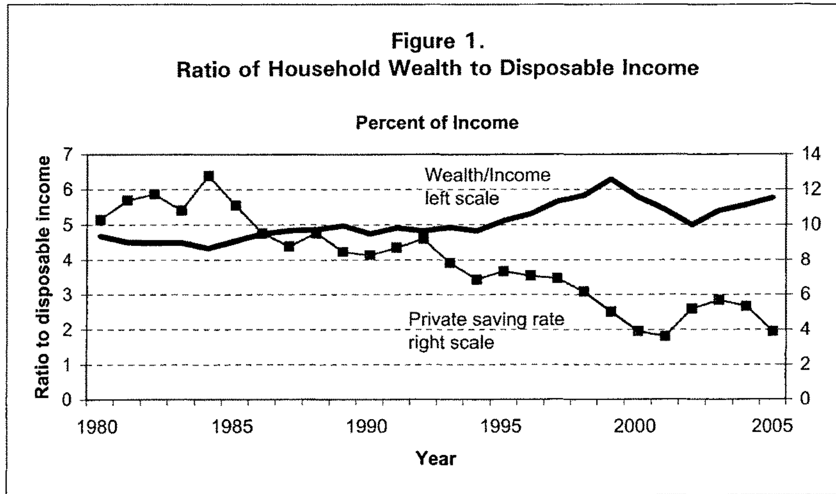
Table 1. United States Net Saving and Investment by Sector, 1960-2005

Percent of national income

Sector	1960-79	1980-89	1990-94	1995-99	2000-04	2005
Saving	11.0	7.0	4.1	6.2	3.2	1.0
Private	11.0	10.5	8.2	6.5	4.7	3.9
Household	7.0	7.5	5.5	3.1	1.7	-0.3
Government	0.0	-3.4	-4.2	-0.3	-1.6	-2.9
Domestic Investment	11.3	9.5	6.9	8.9	7.9	8.5
Private	9.2	7.9	5.5	7.8	6.5	7.1
Government	2.1	1.6	1.4	1.1	1.4	1.4
Net foreign Investment	0.5	-1.7	-1.0	-2.0	-5.1	-7.2
Statistical discrepancy	0.7	0.7	1.9	0.7	-0.3	0.4
Capital consumption	11.6	13.8	13.6	13.4	13.9	14.4

Source: Bureau of Economic Analysis, Department of Commerce, National Income and Product Accounts
Net saving excludes capital consumption allowances

Figure 1.
Ratio of Household Wealth to Disposable Income



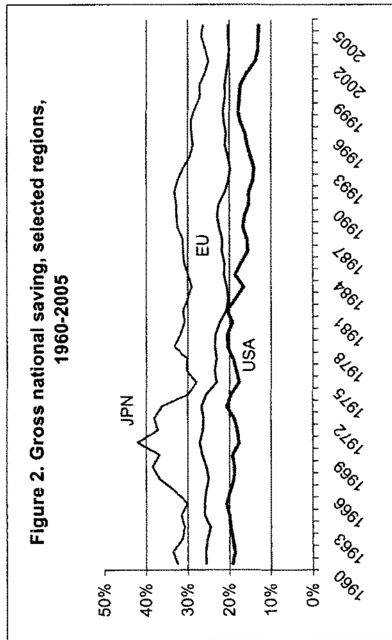


Figure 2. Gross national saving, selected regions, 1960-2005

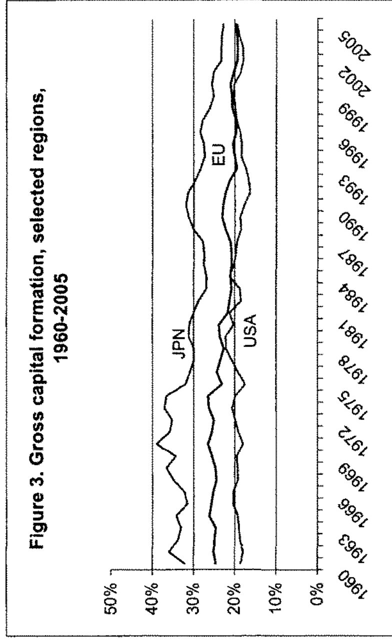


Figure 3. Gross capital formation, selected regions, 1960-2005

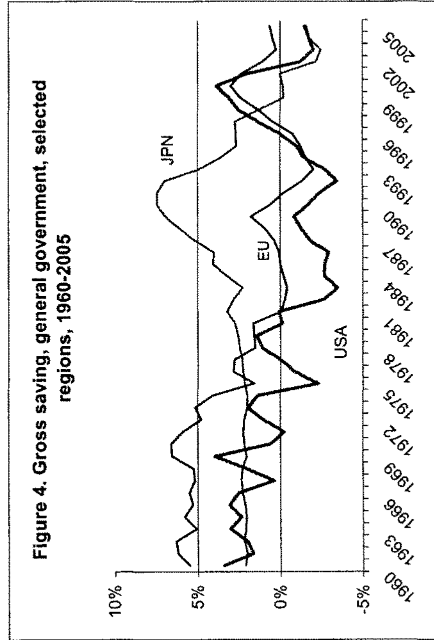


Figure 4. Gross saving, general government, selected regions, 1960-2005

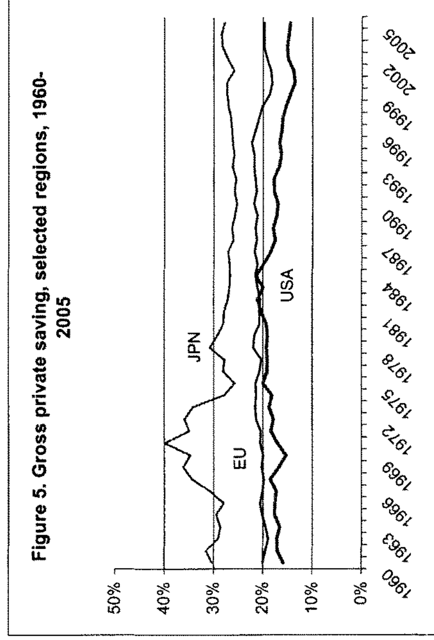


Figure 5. Gross private saving, selected regions, 1960-2005

Table 2a. Current account as share of World GDP, selected regions and years
Percent

Region	1980-89	1990-94	1995-99	2000-04	2005p
U.S.	-0.4	-0.2	-0.5	-1.4	-1.8
Japan	0.3	0.4	0.3	0.4	0.4
Europe[1]	0.0	0.0	0.3	0.2	0.2
Emerging Asia[2]	0.1	0.1	0.2	0.4	0.4
Emerging Latin America[3]	-0.1	-0.1	-0.2	0.0	0.1
Middle East[4]	0.1	-0.1	0.0	0.2	0.5

Table 2b. Gross saving as share of Regional GNI, selected regions and years

Region	1980-89	1990-94	1995-99	2000-04	2005p
U.S.	17.5	14.8	16.9	14.6	12.9
Japan	30.9	31.8	28.5	26.1	26.3
Europe[1]	21.5	20.8	21.1	20.5	20.3
Emerging Asia[2]	33.0	35.0	36.0	36.3	40.6
Emerging Latin America[3]	20.5	18.4	18.7	19.2	17.8
Middle East[4]	22.8	18.5	23.6	28.1	40.6

Table 2c. Gross capital formation as share of Regional GNI, selected regions and years

Region	1980-89	1990-94	1995-99	2000-04	2005p
U.S.	19.7	17.3	19.3	18.7	19.4
Japan	28.7	29.7	26.9	24.1	22.8
Europe[1]	21.7	21.2	20.2	19.9	19.8
Emerging Asia[2]	31.3	33.7	33.6	32.2	35.7
Emerging Latin America[3]	22.2	20.9	22.0	20.0	16.9
Middle East[4]	23.1	25.0	23.0	21.6	21.2

Source: *OECD National Accounts* Volume II, *OECD Economic Outlook, IMF World Economic Outlook,* World Bank *World Development Indicators*, various country statistical agencies.

1. Austria, Belgium, Switzerland, Germany, Denmark, Spain, Finland, France, Great Britain, Greece, Ireland, Italy, Netherlands, Norway, Portugal and Sweden.

2. China, Hong Kong, India, Indonesia, Malaysia, Phillipines, Singapore, South Korea, Taiwan, Thailand. First column average for 1982-1989.

3. Argentina, Brazil, Chile, Columbia, Ecuador, Mexico, Peru, Venezuela.

4. Bahrain, Egypt, Iran, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syria, UAR, Yemen. Data as share of regional GDP.

SAVING FOR THE 21ST CENTURY: IS AMERICA SAVING ENOUGH TO BE COMPETITIVE IN THE GLOBAL MARKETPLACE?

TESTIMONY OF LAEL BRAINARD

VICE PRESIDENT, GLOBAL ECONOMY AND DEVELOPMENT AND
NEW CENTURY CHAIR
THE BROOKINGS INSTITUTION

SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION
OF THE COMMITTEE ON FINANCE
UNITED STATES HOUSE SENATE

APRIL 6, 2006

DUAL DEFICITS: LARGE AND GROWING

Is America saving enough to be competitive in the global marketplace? The short answer is no. America is not saving enough to be competitive or secure in the fast moving global economy.

The American economy has undergone a remarkable turnaround in the last 5 years -- taking a historical surplus and turned it into record deficits. A lot of people ask, quite reasonably, "Why should that matter?" So far, we have had our cake and eaten it too, in the form of low inflation, cheap borrowing, and low interest mortgages. The question is whether it can go on. I strongly believe the answer is no.

Foreign borrowing has enabled our consumption binge. Continued addiction to foreign capital at these levels is one of the greatest risks to the global economic outlook and to America's competitiveness.

It is foreign borrowing, pure and simple, which has enabled our binge. Last year alone, the nation borrowed $800 billion or 6.3 percent of our income from foreigners. Of course, we have borrowed heavily in earlier periods. But at that time, we were still net creditors. What is different now is that we already owe a lot of debt to the rest of the world, and with the baby boom retiring, the nation should move further in that direction.

Between 2000 and 2005, debt to GDP went from 14 to 25 percent of GDP. That puts us smack in between Brazil and Argentina on the eve of their financial crises in 2001, with debt to GDP ratios of 18 and 33 percent respectively. The full awkwardness of our situation can be best appreciated in light of the historical observation that until now, hegemonic powers have been net suppliers of capital to the rest of the world, not a net drain as the US is today.

A Brooking conference concluded that there is NO historical precedent. There have been advanced economies with similarly large borrowings relative to their GDP, such as Australia and New Zealand, but none comes close to the size of the US–the world's largest economy and the world's largest borrower.

The "don't worry be happy" crowd will reply: So what is the problem? Judging from interest rates and ongoing appetite for US assets, the rest of the world seems eager to finance our borrowing.

That is true, but should not be fully reassuring. In fact, private investors' appetite for U.S. securities has cooled. The ongoing strong demand for U.S. securities – especially Treasury securities – and consequent benign interest rates owe in great part to foreign official lenders who have stepped in to maintain the enormous appetite for US securities as private investment interest has moderated. Over the last few years, there has been a big shift away from private investors in Europe and elsewhere buying US corporate securities towards central banks in Asia buying US Treasury Securities. Net private capital inflows as percentage of total net capital inflow fell from 97 to 83 percent between 2000 and 2005, while inflows of foreign official assets rose from 4 to 17 percent.

Contrary to the administration's reassurances, the US is not the best investment in the world, when you take into account the risks of substantial further dollar depreciation and the growth slowdown necessary for turning around the trade deficit.

DANGER AHEAD

So what are the dangers? Our borrowing poses risks both to our economic competitiveness and our economic security.

The hard landing scenario is the one that gets the most attention. There is a sudden rush to the exits, people dump dollar assets, the Fed is forced to sharply raise interest rates and growth both here and abroad is sharply curtailed.

But the alternative is not so good either: it amounts to delaying the pain. But time is not our friend. This course is equally troubling, although in subtler and thus perhaps more dangerous ways. If we awake to this issue later rather sooner, which is to say if foreign central banks continue to indulge our consumption binge in order to preserve their export binge, it will be much more painful to fix it. Over time, the cost of servicing the debt will eat up a larger share of our export earnings, so that it will require an even greater turnaround in our trade balance to stabilize the debt to GDP ratio. Indeed, as Nouriel Roubini and Brad Setser have shown, net debt is on track to reach 50 percent of GDP by 2008.

Now some of the "don't worry" crowd will tell you not to worry based on the logic of double jeopardy. They point out that China will be deterred from

selling by the prospect of large losses on their dollar portfolio holdings. I don't find the logic of mutual deterrence enormously reassuring in the world of international finance.

TAKING ACTION

So far, whether by default or design, the Treasury appears content to approach this problem as one for the markets to work out on their own. The current policy of leaving it to the market can be quite unsettling to the market and begs the difficult question of global burden-sharing in the adjustment process. So far, those countries with market rates – Europe, Canada, Australia, and Latin America - have taken a disproportionate share of the burden, while China and Japan have essentially taken a free ride.

If we wanted to manage the problem rather than hold our breath and react, there are several historical episodes that point the way. And the solution starts at home. The surest policy lever to materially improve U.S. national savings and lower foreign borrowing is to return to fiscal responsibility. America must commit to taking serious action on its fiscal imbalances, pressure China to act responsibly on its exchange rate, and gets commitments from Japan and Europe on stimulating domestic growth. Unfortunately instead of getting countries around a negotiating table to nail down commitments, and taking hardheaded action on the budget at home, the current policy is to hope for and plan for the best.

We stand at a time when the global competitive landscape is shifting at a breathtaking pace, when hundreds of millions of workers from low wage countries are entering into the global labor force, when even higher skilled services jobs are being buffeted by the forces of technology and trade, and when the nation's energy security is at stake. There is no doubt that Americans can compete successfully in the hyper competitive global marketplace of the 21st century. But this will require proactive policies to invest in skills for the 21st century, the game changing technologies of the 21st century, sustainable energy supplies, and a competitive health care system. Add into this mix the imminent retirement of the baby boomers, and it should be clear this is not a moment to hold economic policy hostage to sudden shifts in world financial markets, to depend on the continued indulgence of Asian central banks, or to tie our hands on making critical infrastructure, education and innovation investments because we have squandered our savings.

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Long-term Growth and Debt Reduction, Committee on Finance, United States Senate

For Release on Delivery
Expected at 2:30 p.m. EST
Thursday, April 6, 2006

NATIONAL SAVING

Current Saving Decisions Have Profound Implications for Our Nation's Future Well-Being

Statement of Thomas J. McCool, Director, Center for Economics, Applied Research and Methods

GAO-06-628T

Highlights

Highlights of GAO-06-628T, a testimony to Subcommittee on Long-term Growth and Debt Reduction, Committee on Finance, United States Senate

April 6, 2006

NATIONAL SAVING

Current Saving Decisions Have Profound Implications for Our Nation's Future Well-Being

Why GAO Did This Study

The Chairman of the Senate Committee on Finance asked GAO to testify on our nation's low saving and discuss the implications for long-term economic growth.

National saving—the portion of a nation's current income not consumed—is the sum of saving by households, businesses, and all levels of government. National saving represents resources available for investment to replace old factories and equipment and to buy more and better capital goods. Higher saving and investment in a nation's capital stock contribute to increased productivity and stronger economic growth over the long term.

What GAO Recommends

GAO does not make any recommendations but lays out a few ideas for how the federal government can help increase national saving. The only sure way for the government to increase national saving is to reduce the budget deficit, which will require a three-pronged approach: restructure existing entitlement programs, reexamine the base of discretionary and other spending, and review and revise existing tax policy, including tax expenditures, which can operate like mandatory spending programs. The federal government can also explore saving incentives and education programs to encourage personal saving.

www.gao.gov/cgi-bin/getrpt?GAO-06-628T.

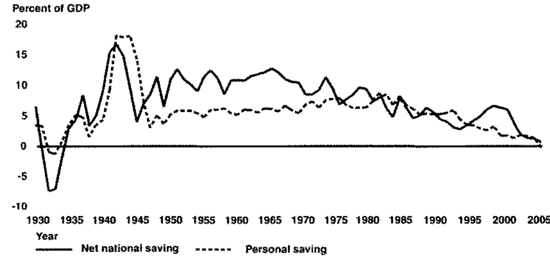
To view the full product, including the scope and methodology, click on the link above. For more information, contact Thomas J. McCool at (202) 512-2700 or mccoolt@gao.gov or Susan J. Irving at (202) 512-9142 or irvings@gao.gov.

What GAO Found

Our nation faces a number of deficits, including our nation's budget deficit, a saving deficit, and a current account deficit. Unfortunately, America has been heading in the wrong direction on all three deficits in recent years.

- In 2005 our nation's budget deficit was around $318 billion or 2.6 percent of GDP.
- For the first time since 1934, net national saving declined to less than 1 percent of GDP and the personal saving rate was slightly negative in 2005 (see figure).
- While the United States has run a current account deficit—or borrowed to finance domestic investment—over most of the last 25 years, the current account deficit hit an all time record—$782 billion, or over 6 percent of GDP in 2005.

Net National Saving and Personal Saving as a Percentage of GDP (1930-2005)



Source: GAO analysis of NIPA data from the Bureau of Economic Analysis (BEA).

Despite low national saving in recent years, economic growth has been high. However, we cannot let our recent good fortune lull us into complacency. If the net inflow of foreign investment were to diminish, so too would domestic investment and potentially economic growth if that saving is not offset by saving here in the U.S. Also, our nation faces daunting fiscal and demographic challenges, which provide even more of a reason to address our nation's low saving rates. Greater economic growth from saving more now would make it easier for future workers to bear the burden of financing Social Security and Medicare, but economic growth alone will not solve the long-term fiscal challenge. Tough choices are inevitable, and the sooner we act the better in order to allow the miracle of compounding to turn from enemy to ally.

Mr. Chairman, Senator Kerry, and Members of the Subcommittee:

I appreciate the opportunity to talk with you today about national saving and the central role it plays for our nation's long-term economic growth and future living standards. National saving—the portion of a nation's current income not consumed—is the sum of saving by households, businesses, and all levels of government. National saving represents resources available for investment to replace old factories and equipment and to buy more and better capital goods. Higher saving and investment in a nation's capital stock contribute to increased productivity and stronger economic growth over the long term.

As our 21st century challenges report notes, the United States faces serious long-term challenges in several areas, some of them unprecedented in their size, scope, complexity, and potential impact.[1] One of the primary challenges is demographics. The U.S. workforce growth rate is slowing and will continue to slow. This means that just when increasing numbers of baby boomers start to retire and draw benefits, there will be relatively fewer full-time workers to help support these retirees. What's more, people are living longer. In the very near future, our aging population will begin to put enormous strains on our nation's pension and health care systems. Other emerging trends that warrant close scrutiny are globalization, new security threats, rapidly evolving technology, and a range of quality-of-life concerns affecting everything from education and health care to energy and the environment.

Comptroller General Walker has spoken frequently about the fact that our nation faces a number of deficits, including three that are directly related to this hearing. These three interrelated deficits are our nation's budget deficit, a saving deficit, and a current account deficit. He has noted that our growing fiscal imbalance threatens our future economic growth, our future standard of living, and even our future national security. Unfortunately, America has been heading in the wrong direction on all three deficits in recent years. Nonetheless, we have a window of opportunity to turn things around, but we need to act and act soon because the miracle of compounding is currently working against us.

[1]GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005).

Today's saving and investment decisions have profound implications for the level of well-being in the future. Increasing personal saving is an important way to bolster retirement security for current workers and increasing national saving will allow future workers to more easily bear the costs of financing federal retirement and health programs while maintaining their standard of living.

In my testimony today, I will describe these three deficits and why they raise concerns about our nation's long-term growth and its ability to finance the health and retirement needs of an aging population. Finally, I will lay out a few ideas for how the federal government can help increase national saving.

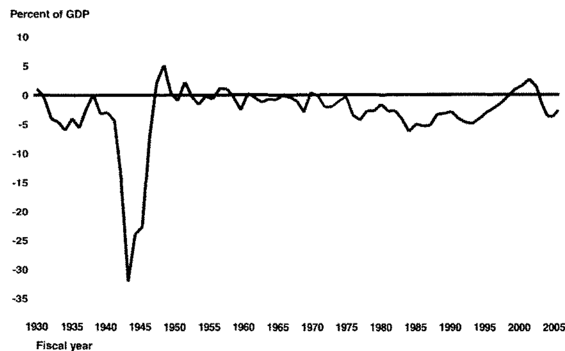
My remarks are based on our previous work on a variety of issues, including a report on national saving and GAO's work on the long-term fiscal challenge.[2] These efforts were conducted in accordance with generally accepted government auditing standards.

The Budget Deficit

The first deficit we face is the federal budget deficit (see fig. 1). In 2005 the unified federal budget deficit was around $318 billion or 2.6 percent of gross domestic product (GDP). This figure is an approximation of what the federal government absorbs from private saving. Although a single year's federal deficit is not a cause for concern, persistent deficits are. Federal deficits reduce the amount of national saving available for investment. They also lead to growing federal debt, on which net interest payments must be made by current and future generations.

[2] GAO, *National Saving: Answers to Key Questions*, GAO-01-591SP (Washington, D.C.: June 2001). See also http://www.gao.gov/special.pubs/longterm/ for information on GAO's most recent long-term simulations and http://www.gao.gov/special.pubs/longterm/longtermproducts.html for a bibliography of GAO's issued work on the long-term fiscal outlook.

Figure 1: Federal Surpluses and Deficits (-) as a Percent of GDP (1930-2005)



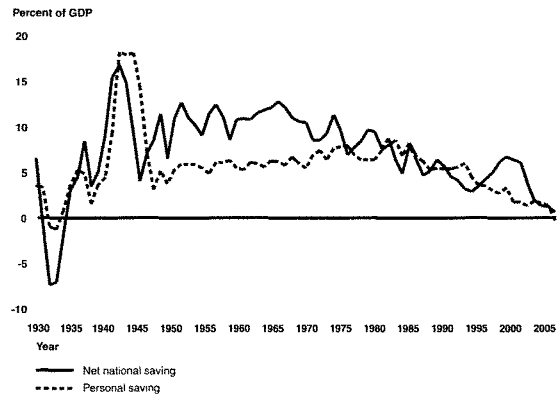
Source: Office of Management and Budget (OMB).

The Saving Deficit

A budget deficit represents dissaving by the government, but the U.S. suffers from an even broader national saving deficit. National saving is the sum of personal saving, corporate saving, and government saving. Last year, for the first time since 1934, net national saving declined to less than 1 percent of GDP and the personal saving rate was slightly negative (see fig. 2).[3] Remarkably—and unfortunately—the United States has returned to saving levels not seen since the depths of the Great Depression.

[3]Personal saving, as measured in the National Income and Product Accounts (NIPA), does not include capital gains on existing assets because capital gains reflect a revaluation of the nation's existing capital stock and do not provide resources for financing investment that adds to the capital stock. In other words, although an individual household can tap its wealth by selling assets to finance consumption or accumulate other assets, the sale of an existing asset merely transfers ownership; it does not generate new economic output.

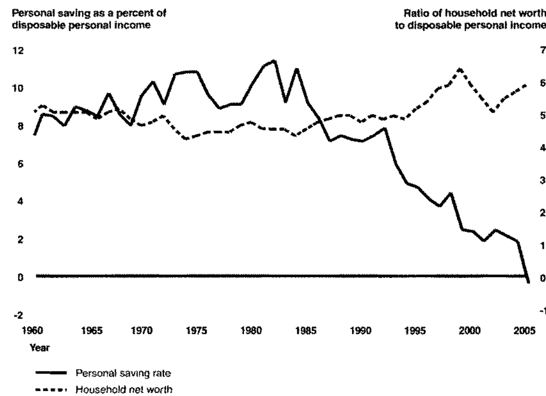
Figure 2: Net National Saving and Personal Saving as a Percent of GDP (1930-2005)



Source: GAO analysis of NIPA data from the Bureau of Economic Analysis (BEA).

A negative saving rate means that, in the aggregate, households are spending more than their current income by drawing down past saving, selling existing assets, or borrowing. No one is sure why the personal saving rate has declined. One possible explanation is increases in household wealth, which surged in the late 1990s due to the stock market boom and more recently due to the run-up in housing prices. Household wealth relative to income increased from 4.7 in 1990 to 5.8 in 2005 (see fig. 3). If people feel wealthier, they may feel less need to save. Continued financial liberalization and innovation have made it easier for Americans to borrow, particularly against their real estate wealth, which may have lead to greater consumption.

Figure 3: Personal Saving and the Wealth-Income Ratio (1960-2005)



Source: GAO analysis of data from BEA's National Income and Product Accounts and the Federal Reserve Board's Flow of Funds Accounts

Clearly, as the Comptroller General has said, many Americans, like their government, are living beyond their means and are deeply in debt. This trend is particularly alarming in an aging society such as our own. Those Americans who choose to save more will certainly live better in retirement. Those Americans who choose to save less are rolling the dice on whether they will have adequate resources for a secure retirement. While Social Security provides a foundation for retirement income, Social Security benefits replace only about 40 percent of preretirement income for the average worker. As a result, Social Security benefits must be supplemented by private pensions, accumulated assets, or other resources in order for individuals to maintain a reasonable standard of living in retirement compared to their final working years. Though the aggregate wealth-to-income ratio remains relatively high, it is a misleading indicator of financial status of the typical household because wealth is highly concentrated among a few households. While the median net worth of all families was $93,100 in 2004, the top 10 percent of the families had a median net worth of over $1.4 million and the bottom quarter of the families had a median net worth of about $1,700. Moreover, measures of

wealth are largely based on market values, which on occasion can exhibit substantial swings. This is illustrated by the sharp run-up in stock prices in the late 1990s and their subsequent decline beginning in 2000.

The only components of national saving that have not shown a long-term decline are corporate and state and local saving.[4] In fact, corporate saving is actually high by historical standards. After declines in corporate profits in 2000-2001, corporate saving has rebounded to almost 4 percent of GDP—a level not seen since the late 1960s. The state and local sector as a whole experienced a deficit from 2002 to 2004 but has since returned to a slight surplus.

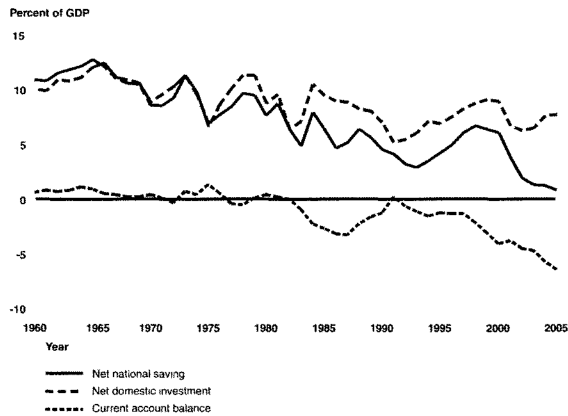
The Current Account Deficit

Now let me turn to the third deficit: our current account deficit. The current account deficit is the difference between domestic investment and national saving. That is, it is the amount of domestic investment financed by borrowing from abroad. Over most of the last 25 years, the United States has run a current account deficit, but in 2005 the current account deficit hit an all-time record—$782 billion, or over 6 percent of GDP (see fig.4).[5] That is twice what it was only 6 years earlier.

[4]Corporate saving consists of retained earnings, while state and local government saving is the difference between the sector's total current receipts and expenditures.

[5]This is measured on a NIPA basis. The current account deficit on an international transaction account basis was $805 billion.

Figure 4: Net National Saving, Net Domestic Investment, and the Current Account Balance as Percents of GDP (1960-2005)



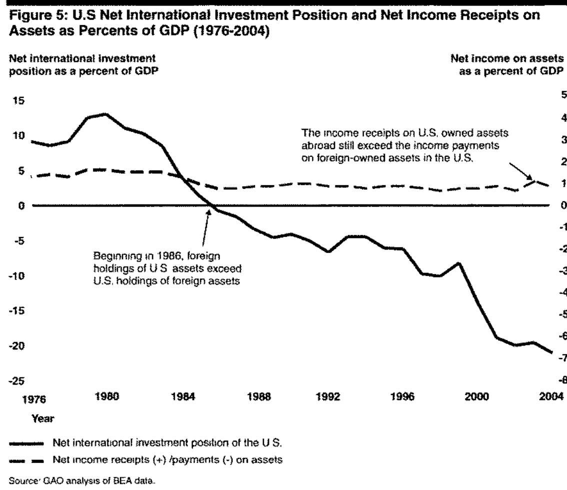
Source: GAO analysis of NIPA data from BEA.

Funds from overseas have been pouring into the United States. One explanation for these inflows is that high productivity in the U.S. raised the perceived return on U.S. assets. Moreover rising federal budget deficits and declining personal saving rates have necessitated foreign borrowing to help finance domestic investment. Another possible explanation for persistent U.S. current account deficits may be the weakness of foreign demand and the efforts of some countries to support their exports by keeping their own currencies from strengthening. Also, other countries' populations are aging more rapidly than the U.S. population and they may be investing in the U.S. in order to build up a stock of assets to prepare for their retirement spending.

Whatever the reason for high current account deficits, policymakers should be aware of the implications these financial inflows have for the nation's economic growth and for future living standards. While current account deficits support domestic investment and productivity growth, they also translate into a rising level of indebtedness to other countries.

Figure 5 shows that the net foreign ownership of U.S. assets grew to more than 20 percent of GDP in 2005. The fact that our net indebtedness to other nations is rising more rapidly than our income raises concerns that the U.S. current account balance is on an unsustainable path.

Figure 5: U.S Net International Investment Position and Net Income Receipts on Assets as Percents of GDP (1976-2004)



Source: GAO analysis of BEA data.

Despite the growth of foreign asset holdings in the United States in recent years, the United States earned more in interest, dividends, and other investment returns from other countries than it paid on U.S. assets held by foreigners. This may seem counterintuitive to the notion that U.S. assets, on average, pay a higher return than foreign assets and thus attract a large amount of foreign investment. The positive net income receipts reflect differences in the composition of foreign and U.S. investment and the higher rate of return that U.S. firms earn on their direct investments abroad compared to the earnings of foreign companies from their U.S.

subsidiaries.[6] A larger share of foreign-owned assets in the U.S. is held in portfolio investment, such as stocks, bonds, loans, and bank deposits, which pay a lower yield than U.S. direct investments abroad. A recent study by the Congressional Budget Office (CBO) attributed this to three factors.[7] First, U.S. subsidiaries abroad have generally been in business longer than foreign-owned subsidiaries in the U.S., which contributes to greater profitability. Second, investors of U.S. subsidiaries abroad may require higher returns because they face greater political and economic risks than subsidiaries of foreign-owned corporations. Finally, some observers argue that U.S subsidiaries abroad may overstate their profits for tax reasons, while foreign-owned subsidiaries in the United States understate their profits. However, given the nation's increasingly negative net international investment position, it is not clear how long the U.S. will continue to earn more on its foreign investment than it pays on foreign investment in the U.S.

The effect of large foreign borrowing on our economy also depends in part on how the borrowed funds are used. To the extent that borrowing from abroad finances domestic investment, the foreign borrowing adds to the nation's capital stock and boosts productive capacity. Thus, even though some of the income generated by the investment must be paid to foreign lenders, the investment—and hence the borrowing that financed it—augments future income. However, if the borrowing from abroad is used to finance consumption, this is not true. Short-term well-being is improved but the ability to repay the borrowing in the future is not.

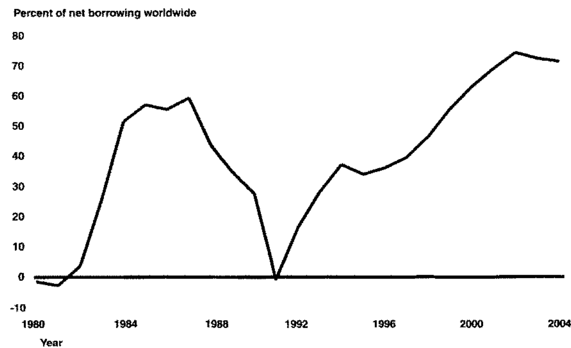
Both economists and policymakers are concerned about whether the United States can maintain its reliance on foreign capital inflows to sustain domestic investment. Investors generally try to achieve some balance in the allocation of their portfolios, and U.S. assets already represent a growing and significant share of foreign portfolios (see fig. 6). Although the United States accounts for 29 percent of global GDP, it received 70 percent of the net saving exported by countries with current account surpluses in 2004. Observers suggest that the United States' favorable investment climate, including the potential for high rates of return, may

[6]Direct investment is investment in which a resident of one country obtains a lasting interest in, and a degree of influence over, the management of a business enterprise in another country.

[7]CBO, *Why Does U.S. Investment Abroad Earn Higher Returns Than Foreign Investment in the United States?* Economic and Budget Issue Brief (Washington, D.C.: Nov. 30, 2005).

explain why the U.S. absorbs such a large share of the world's saving. However, it is probably not realistic to expect ever-increasing foreign investment in the United States. Imagine what would happen to the stock and bond markets if these foreign investors began to lose confidence and lowered their rates of accumulation, or worse yet, started to sell off their holdings. We would likely face some adverse effects in the form of higher interest rates, reduced investment, and more expensive imports.

Figure 6: U.S. Net Borrowing from Abroad as a Percent of Total Worldwide Net Borrowing (1980-2004)



Source: GAO analysis of the International Monetary Fund's World Economic Outlook Database (September 2005 edition).

Note: Calculated as the ratio of the U.S. current account balance to the sum of the current account balances of all countries that had current account deficits.

Why Does It Matter?

Economic growth in recent years has been high despite the fact that national saving was low by U.S. historical standards. This is because more and better investments were made. Each dollar saved bought more investment goods, and a greater share of saving was invested in highly productive information technology. Also, as discussed earlier, the United States was able to invest more than it saved by borrowing from abroad.

However, we cannot let our recent good fortune lull us into complacency. While the U.S. has benefited from high levels of foreign investment in recent years, this is not a viable strategy for the long run. Many of the

nations currently financing investment in the United States face aging populations and their own retirement financing challenges that may reduce foreign saving available for U.S. domestic investment. If the net inflow of foreign investment were to diminish, so too would domestic investment and potentially economic growth if that saving is not offset by saving here in the U.S. Also, our nation faces daunting fiscal and demographic challenges, which may be even more of a reason to address our nation's low saving rates. Saving and economic growth will be key factors to prepare future generations to bear the burden of financing the retirement and health costs of an aging population.

Nation Faces Long-term Fiscal Challenges

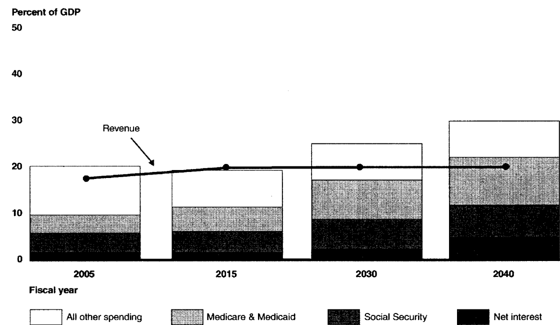
Given our nation's long-term fiscal outlook, acting sooner rather than later to increase national saving is imperative. The federal government's current financial condition and long-term fiscal outlook present enormous challenges to future generations' levels of well-being. No one can forecast with any precision what the next 75 years will look like—that would require the ability to predict changes in the economy and future legislation. However, there is a fair amount of certainty in one major driver of our long-term outlook—demographics. As life expectancy rises and the baby boom generation retires, the U.S. population will age, and fewer workers will support each retiree. Over the next few decades, federal spending on retirement and health programs—Social Security, Medicare, Medicaid, and other federal pension, health, and disability programs—will grow dramatically. Absent policy changes on the spending and/or revenue sides of the budget, a growing imbalance between expected federal spending and tax revenues will mean escalating and eventually unsustainable federal deficits and debt that will threaten our future economy and standard of living. As Comptroller General Walker has said, "Simply put, our nation's fiscal policy is on an imprudent and unsustainable course."[8]

Neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both together—would eliminate the imbalance. Although revenues will be part of the debate about our fiscal future, assuming no changes to Social Security, Medicare, Medicaid, and other drivers of the long-term fiscal gap would require at least a doubling of taxes—and that seems highly implausible.

[8]GAO, *21st Century: Addressing Long-Term Fiscal Challenges Must Include a Re-examination of Mandatory Spending*, GAO-06-456T, (Washington, D.C.: Feb. 15, 2006).

GAO's long-term simulations illustrate the magnitude of the fiscal challenges associated with an aging society. Indeed, the nation's long-term fiscal outlook is daunting under many different policy scenarios and assumptions. For instance, under a fiscally restrained scenario, if discretionary spending grows only with inflation over the next 10 years and all existing tax cuts expire as scheduled under current law, spending for Social Security and health care programs would grow to consume over 80 percent of federal revenue by 2040 (see fig. 7). On the other hand, if discretionary spending grew at the same rate as the economy in the near term and if all tax cuts were extended, by 2040 federal revenues may just be adequate to pay only some Social Security benefits and interest on the growing federal debt (see fig. 8).

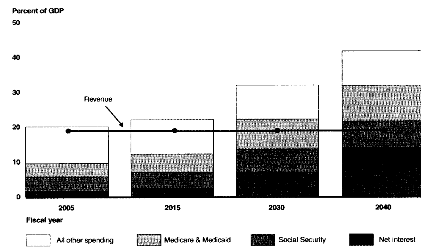
Figure 7: Composition of Spending as a Share of GDP under Baseline Extended



Source: GAO's January 2006 analysis.

Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2016 due to (1) real bracket creep, (2) more taxpayers becoming subject to the alternative minimum tax (AMT), and (3) increased revenue from tax-deferred retirement accounts. After 2016, revenue as a share of GDP is held constant.

Figure 8: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP After 2006 and All Expiring Tax Provisions Are Extended



Source: GAO's January 2006 analysis.

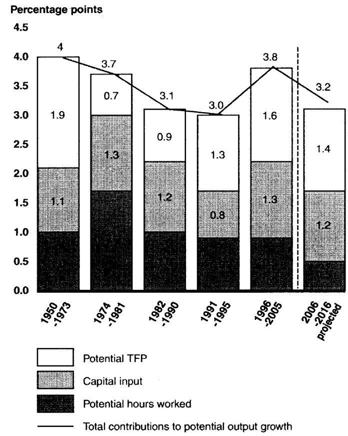
Note: This includes certain tax provisions that expired at the end of 2005, such as the increased AMT exemption amount.

GAO's long-term simulations show the squeeze on budgetary flexibility that the combination of demographics and health care cost growth will create. The burden on the budget and on the economy mean that letting current policy continue will leave few resources for investment in new capital goods and technology and result in slower income growth.

National Saving Critical for Long-term Economic Growth

There are three key contributors to economic growth—labor force growth, capital input, and total factor productivity (or increased efficiency in the use of capital and labor). Figure 9 shows the slowing in labor force growth (potential hours worked) over the next decade. Indeed, the Social Security and Medicare trustees project labor force growth to slow after 2010 and be negligible after 2020. Without improvements in managerial efficiencies or increases in capital formation, low labor force growth will lead to slower growth in the economy—and to slower growth in federal revenues at a time when the expenditure demands on federal programs for the elderly are increasing. This illustrates the imperative to increase saving and investment and explore other efficiency-enhancing activities, such as education, training, and R&D.

Figure 9: Contributions to Potential Output Growth (Nonfarm Business Sector)



Source: CBO.

Note: Numbers may not add to total due to rounding.

Greater economic growth from saving more now would make it easier for future workers to achieve a rising standard of living for themselves while also paying for the government's commitments to the elderly. While economic growth will help society bear the burden of financing Social Security and Medicare, it alone will not solve the long-term fiscal challenge. Closing the current long-term fiscal gap would require sustained economic growth far beyond that experienced in U.S. economic history since World War II. Tough choices are inevitable, and the sooner we act the better.

The Federal Government's Role in National Saving

Although there may be ways for the government to affect private saving, the only sure way for the government to increase national saving is to decrease government dissaving (the budget deficit). Each generation is a steward for the economy it bequeaths to future generations, and the nation's long-term economic future depends in part on today's decisions about consumption and saving. To address our nation's daunting long-term fiscal challenges, we must change the path of programs for the elderly and build the economic capacity to bear the costs of an aging population.

From a macroeconomic perspective, it does not matter who does the saving—any mix of increased saving by households, businesses, and government would help to grow the economic pie. Yet, in light of the virtual disappearance of personal saving, concerns about U.S. reliance on borrowing from abroad to finance domestic investment, and the looming fiscal pressures of an aging population, now is an opportune time for the federal government to reduce federal deficits. Higher federal saving—to the extent that the increased government saving is not offset by reduced private saving—would increase national saving and tend to improve the nation's current account balance, although typically not on a dollar-for-dollar basis.

Reduce Federal Deficits

As the Comptroller General has said,[9] meeting our nation's large, growing, and structural fiscal imbalance will require a three-pronged approach:

- restructuring existing entitlement programs,
- reexamining the base of discretionary and other spending, and
- reviewing and revising existing tax policy, including tax expenditures, which can operate like mandatory spending programs.

Increased government saving and entitlement reform go hand-in-hand. Over the long term, the federal government cannot avoid massive dissaving unless it reforms retirement and health programs for the elderly. Without change, Social Security and Medicare will constitute a heavy drain on the earnings of future workers. Although saving more yields a bigger pie, policymakers will still face the difficult choice of how to divide the pie between retirees and workers. It is worth remembering that policy debates

[9]GAO-06-456T.

surrounding Social Security and Medicare reform also have implications for all levels of saving—government, personal, and, ultimately, national.

Restoring Social Security to sustainable solvency and increasing saving are intertwined national goals. Saving for the nation's retirement costs is analogous to an individual's retirement planning in that the sooner we increase saving, the greater our benefit from compounding growth. The way in which Social Security is reformed will influence both the magnitude and timing of any increase in national saving. The ultimate effect of Social Security reform on national saving depends on complex interactions between government saving and personal saving—both through pension funds and by individuals on their own behalf. Various proposals would create new individual accounts as part of Social Security reform or in addition to Social Security. The extent to which individual accounts would affect national saving depends on how the accounts are funded, how the account program is structured, and how people adjust their own saving behavior in response to the new accounts.

As everyone here knows, health care spending is the major driver of long-term government dissaving. This is due to both demographics and the increasing cost of modern medical technology. The current Medicare program largely lacks incentives to control health care consumption, and the cost of health care decisions is not readily transparent to consumers. In balancing health care spending with other societal priorities, it is important to distinguish between health care wants, needs, affordability, and sustainability at both the individual and aggregate level. Reducing federal health care spending would improve future levels of government saving, but the ultimate effect on national saving depends on how the private sector responds to the reductions and the extent to which overall health care spending is moderated. For example, reforms that reduce federal deficits by merely shifting healthcare spending to state and local governments or the private sector might not increase national saving on a dollar-for-dollar basis.

Tax expenditures have represented a substantial federal commitment over the past three decades. Since 1974, the number of tax expenditures more than doubled and the sum of tax expenditure revenue loss estimates tripled in real terms to nearly $730 billion in 2004. On an outlay-equivalent basis, the sum of tax expenditure estimates exceeded discretionary spending for most years in the last decade. Tax expenditures result in forgone revenue for the federal government due to preferential provisions in the tax code, such as exemptions and exclusions from taxation, deductions, credits, deferral of tax liability, and preferential tax rates.

These tax expenditures are often aimed at policy goals similar to those of federal spending programs; existing tax expenditures, for example, are intended to encourage economic development in disadvantaged areas, finance postsecondary education, and stimulate research and development. A recent GAO report calls for a more systematic review of tax expenditures to ensure that they are achieving their intended purposes and are designed in the most efficient and effective manner.[10]

Saving Incentives

The federal government has sought to encourage personal saving both to enhance households' financial security and to boost national saving. However, developing policies that have the desired effect is difficult. Tax incentives may affect how people save for retirement but do not necessarily increase the overall level of personal saving. Even with preferential tax treatment for employer-sponsored retirement saving plans and individual retirement accounts (IRA), the personal saving rate has steadily declined. For example, although tax benefits seem to encourage individuals to contribute to these kinds of accounts, the amounts contributed are not always new saving. Some contributions may represent saving that would have occurred even without the tax incentives—and may even be shifted from taxable assets or financed by borrowing. Economists disagree about whether tax incentives have been or could be effective in increasing the overall level of personal saving. The net effect of a tax incentive on national saving depends on whether the tax incentive induces enough additional saving by households to make up for the lower government saving resulting from the government's revenue loss. The bottom line is that we have many saving incentives but very little information on whether they work and how they interact.

Saving Education

A leading obstacle to expanding retirement saving has been that many Americans do not know how to save for retirement, let alone how much to save. The need to improve consumers' financial literacy—their ability to make informed judgments and effective decisions about the management of money and credit—has become increasingly important. Congress has responded by passing legislation, such as the Savings Are Vital for Everyone's Retirement Act of 1997 (SAVER Act). In addition, in the Fair

[10] GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Examined*, GAO-05-690, (Washington, D.C.: Sept. 23, 2005).

and Accurate Credit Transactions Act of 2003, Congress created the Financial Literacy and Education Commission, which is charged with coordinating federal efforts and developing a national strategy to promote financial literacy. Also, GAO has identified financial literacy as a 21st century challenge.[11]

In a July 2004 Comptroller General forum, we discussed the federal government's role in improving financial literacy.[12] Among other things, forum participants suggested that the federal government serve as a leader using its influence and authority to make financial literacy a national priority. Some federal agencies already play a role in educating the public about saving. For example, as mandated by the SAVER Act, the Department of Labor maintains an outreach program in concert with other public and private organizations to raise public awareness about the advantages of saving and to help educate workers about how much they need to save for retirement. Also, individualized statements now sent annually by the Social Security Administration to most workers aged 25 and older provide important information for personal retirement planning, but knowing more about Social Security's financial status would help workers to understand how to view their personal benefit estimates.

Concluding Observations

Increasing the nation's economic capacity is a long-term process. Acting sooner rather than later could allow the miracle of compounding to turn from enemy to ally. This is why the Comptroller General has called for reimposing budget controls; reforming Social Security, Medicare and Medicaid; and reexamining the base of all major spending programs and tax policies to reflect 21st century challenges. As I said before, every generation is in part responsible for the economy it passes on to the next. Our current saving decisions have profound implications for the nation's future well-being.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Subcommittee may have at this time.

[11]GAO-05-325SP.

[12]GAO, *Highlights of a GAO Forum: The Federal Government's Role in Improving Financial Literacy*, GAO-05-93SP, (Washington, D.C.: Nov. 15, 2004).

Scope and Methodology

My remarks are based largely on our previous report National Saving: Answers to Key Questions and other related GAO products. We updated the information from the National Saving report with the most recent published data from OMB, BEA, the Federal Reserve Board, CBO and the IMF. We also reviewed some recently published studies and statements from academic journals, Federal Reserve officials, the IMF, CBO and other sources.

Contacts and Acknowledgments

Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. For further information on this testimony, please contact Thomas J. McCool at (202) 512-2700 or mccoolt@gao.gov or Susan J. Irving at (202) 512-9142 or irvings@gao.gov. Individuals making key contributions to this testimony include Rick Krashevski, Assistant Director; and Melissa Wolf, Senior Analyst.

Related GAO Products

21st Century Challenges: Reexamining the Base of the Federal Government. GAO-05-325SP. February 2005.

Highlights of a GAO Forum: The Federal Government's Role in Improving Financial Literacy. GAO-05-93SP. Nov. 15, 2004.

Federal Debt: Answers to Frequently Asked Questions, An Update. GAO-04-485SP. August 2004.

National Saving: Answers to Key Questions. GAO-01-591SP. June 2001.

See also http://www.gao.gov/special.pubs/longterm/ for information on GAO's most recent long-term simulations and http://www.gao.gov/special.pubs/longterm/longtermproducts.html a bibliography of GAO's issued work on the long-term fiscal outlook.

Statement of Chairman Gordon H. Smith
U.S. Senate Subcommittee on Long-Term Growth
and Debt Reduction of the Committee on Finance

"Saving for the 21st Century: Is America Saving Enough to be Competitive in the Global Marketplace?"

April 6, 2006

Good afternoon and thank you all for coming.

We're here today to discuss a topic of growing concern in America – national savings. The bottom line is Americans simply are not saving enough. This is true of both our government and our citizens. Our national savings rate is among the lowest of any other major industrialized country. And, for the first time since the Great Depression, we have a negative personal savings rate in this country.

These savings trends are especially troubling because of the dramatic demographic shift our country is about to experience. By 2030, the segment of our population over age 65 will become twice as large as it was in 2000. This shift has been described by some as an "aging tsunami."

Americans are living longer than ever before and spending more years in retirement. A person who reaches age 65 can expect to live another 18 years. And, most Americans retire before they reach age 65. If you boil it down: that is 18 years a person is consuming—medical care, housing, food, and other resources—while in retirement while not producing or contributing to the national economy. Americans are simply consuming more in retirement than previous generations.

You compound this problem with the new wave of Baby Boomers going into retirement and you have a demographic train wreck.

The first of the Baby Boomers will turn 60 this year. Therefore, over the next few years as the Boomers reach retirement age, a huge wave of Americans will be leaving the workforce. This trend will have a significant impact on our economy. Unless our immigration policy changes, it will likely result in future labor shortages. This will hurt both the competitiveness of American businesses and our economy will stagnate.

Because of the sheer number of baby boomers, we also must be concerned with a potential "brain drain." Our workforce will be losing some of our most experienced workers – many of whom have skills that simply are not replaceable.

All of these trends – the aging of our population, our increased life expectancy and the impending retirement of the Baby Boomers – will place significant strains over the next several decades on our senior entitlement programs of Social Security, Medicare and

Medicaid. While these programs have improved many Americans' lives, the reality is that they simply cannot be sustained long-term in their current forms.

Under current law, benefits will grow much more rapidly than revenues because of the increase in the number of retirees versus workers. In 1950, there were about 16 workers for every Social Security recipient. Today this ratio has fallen to about three workers per retiree. By 2030, there will only be two workers for every retiree receiving benefits.

Federal spending on entitlement programs will increase considerably over the next few years. In 2004, Social Security and Medicare spending accounted for about six percent of GDP. By 2030, it is projected to increase to about nine percent.

Reforming our entitlement programs is necessary. But, we must do so in a thoughtful manner so as to not hurt those Americans who rely on these benefits the most.

These reforms will require some difficult political decisions. I think most of my Senate colleagues realize that we must act soon to ensure that these vital retirement and health care programs are around for the next generation.

In addition to our entitlement programs, I have spent a great deal of time over the last year examining the issue of retirement savings. As I noted earlier, most Americans are saving less than ever before – and many Americans are not saving at all! This is a very disturbing trend that needs to be reversed to ensure that our seniors are financially secure during retirement.

To address our low savings rate, last June I introduced a bi-partisan retirement savings and security bill with Senator Conrad. One of the key savings proposals in our bill encourages employers to adopt automatic enrollment in 401(k) plans. In order to participate in most 401(k) plans today, employees must fill out a form and actually sign up. However, under automatic enrollment, employees are automatically enrolled in their employer's 401(k) plans unless they opt out.

Automatic enrollment has been shown to increase participation in 401(k) plans significantly – especially among low and moderate income individuals. The impact of this simple change produces amazing results!

Saving for retirement is important for all of us. Therefore, I will continue to work to encourage and assist people with preparing for retirement.

In conclusion, long-term economic growth will not occur without sacrifices. We can do two things with our money: we can buy things that we consume immediately or we can invest our money which will enable us to continue to grow our economy. Long-term savings and investment in our economy is the only way America will stay competitive and, ultimately, provide for Americans in retirement. With the aging tsunami about to hit, it is critical that we as a society begin to save and invest more of our assets.

I'd like to thank our witnesses who join us this afternoon. I look forward to hearing your testimony and what I hope to be a productive dialogue on some of the most pressing social issues of our generation.

With that, I'll turn to my colleague Senator Kerry for his opening remarks.

Testimony Before the Senate Finance Sub-Committee on Economic Growth & Debt Reduction

“Saving for the 21st Century: Is America Saving Enough to be Competitive in the Global Marketplace?"

Jurrien Timmer
Director of Market Research
Fidelity Investments

215 Dirksen Senate Office Building

April 6th, 2006
2:30 pm

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Key Points

Summary

The U.S. age wave is cresting and Americans are living longer. More and more Americans will be reaching retirement in the years ahead, and as a result will need to start drawing on their retirement savings. However, millions are insufficiently prepared for retirement, either because they do not have access to a workplace savings program, or because they either under-utilize the plan that is available to them or choose not to participate at all. As a result, a record number of Americans are working at or beyond their retirement age, a trend that may well continue for some time. Steps that could be taken to better prepare Americans for their retirement include, among others, a national small business 401(k) plan, automatic enrollment in defined contribution plans, the use of life cycle funds as a default option in those plans, simplification of the IRA model, an IRA savers credit, and programs such as Kid Save.

Demographics

A Baby Boom tidal wave is underway. In 1985, the largest segment of the population consisted of 25 to 29 year olds. Currently, the largest segment consists of 40 to 44 year olds. In 2025, it will be the 60 to 64 year old group that will comprise one of the largest segments. In fact, this segment will be the largest ever recorded on a percentage basis.

Americans are living longer. In 1955, the average life expectancy in the U.S. was 66.1 years. Today it is 74.6 years. By 2050 it is expected to be 79.9 years. In 1920, Americans aged 65 and older accounted for only 3.3% of the population. Today, this group accounts for 11.8%. In 2036, this group will account for 19.0% of the population.

The Age Dependency Ratio (the number of Americans younger than 15 and older than 65, divided by the number of Americans between the age of 15 and 64) will rise from 48% in 2005 to 64% by 2036. That means that more and more children and retired Americans will need to be supported by fewer and fewer working-age Americans (on a relative basis).

The result of all this is that more and more Americans are working longer. The labor force participation rate of 55 to 64 year olds is now 63.3%, up from 53.4% in 1986. Undoubtedly, more people are working longer because they can't afford to retire, but part of the reason may also be that would-be retirees are making a lifestyle choice to work longer based on their longer life spans. With the shortage of skilled labor that is looming as a result of the rising age dependency ratio, a continuation of this trend seems inevitable.

Household Savings

The savings rate in the U.S. is about zero, and has been declining for years. However, one could reasonably argue that the calculation of the savings rate is flawed, in that (among other things) it includes the taxes on capital gains, but not the capital gains themselves. One way to adjust the savings rate is to exclude these taxes. The other is to add back the capital gains themselves. Both these series are only available until 2003, but using CBO projections we can estimate the "adjusted" savings rate as of 2005. If we exclude the taxes on capital gains, the savings rate becomes 0.71 pct. If instead we add in capital gains, the savings rate jumps to 5.75 pct. Either way, the savings rate has been in decline for years and today would be only in the mid single digits even under the best case scenario.

However, when considering household wealth, the picture brightens considerably, because American households in the aggregate have a fairly healthy balance sheet. Household net worth stands at $52.1 trillion (an all-time high), which is 5.6 times disposable income, above the average of the past 50 years. Debt service stands at 13.9 times disposable income, the highest ever recorded but perhaps still reasonable considering that it includes both mortgage and consumer debt. Assets are 6.9 times income and liabilities are 1.3 times income. Household debt has risen in recent years, in part because homeowners have extracted more equity from their homes (56%), but also because more Americans have themselves become homeowners, and therefore carry mortgage debt. But, household assets have risen more, namely through rising home prices and financial assets.

Continued on next page

Key Points (cont'd)

Why don't Americans save more? Part of the reason may be that the recent period of very low interest rates and rising home and stock prices have created a disincentive for Americans to put away much if any of their income. Consider it a wealth effect. Perhaps now that the rise in home prices is moderating and interest rates are rising again, Americans will be more inclined to save out of their income. Either way, the financial health of American households appears to depend at least in part on the housing market, and to a lesser degree on the stock market.

Retirement Security

Over the past thirty years, defined contribution plans have taken over from defined benefit plans as the primary workplace savings program for American workers. While the number of U.S. workers has increased from 62 million to 122 million since 1975, those covered by a defined benefit (DB) plan have fallen from 29 million to 21 million. At the same time, the number of employees covered by their company's 401(k) or other DC plan have grown from 11 million to 64 million.

While the rise in DC plan participation is a very positive trend, the fact is that not every company offers a DC plan, and even within those who do, many workers either under-utilize their plan's potential or fail to enroll at all. Of the 64 million workers covered by a DC plan, 22 million do not participate. Add in the 58 million workers who are not covered to begin with, and it becomes clear that a very large number of Americans are not saving as much as they should for their retirement security.

Furthermore, research studies show that many workers who do participate in their employer's DC plan do not properly manage their plan in order to maximize their future savings. To a large degree, this is understandable. Creating a retirement savings plan when you are in your twenties, picking the right investments, maximizing your deferral rate, and then rebalancing your portfolio on a regular basis over the subsequent four decades, and all this without guidance, is something that even some professional investors have trouble with.

Suggestions

More and more Americans will reach retirement in the years ahead, yet many are not financially prepared. What can be done? Specific solutions might include the following:

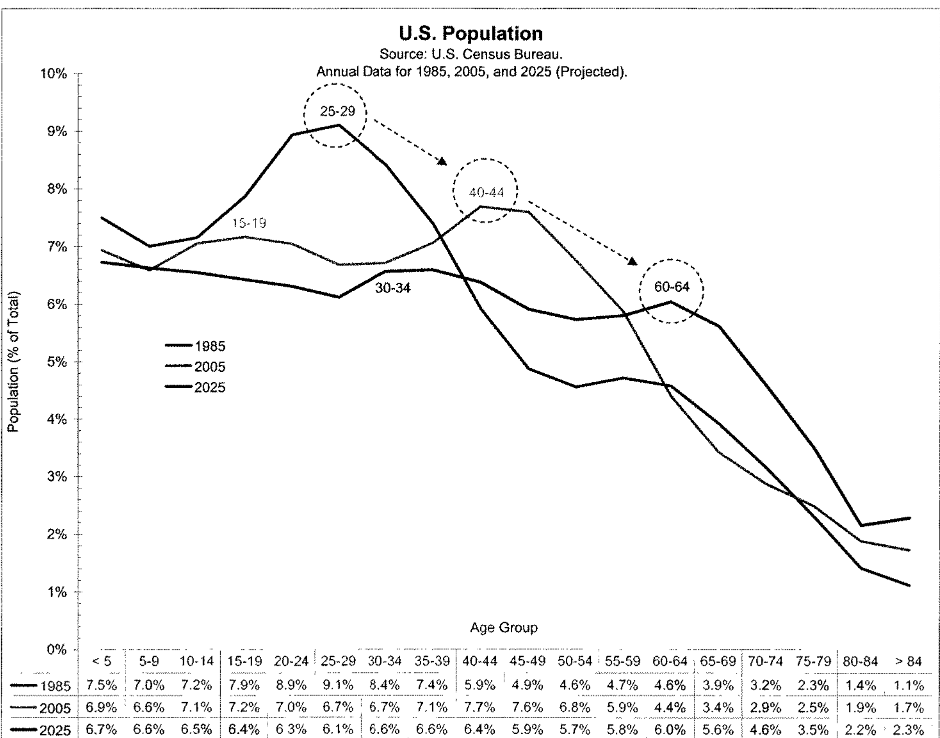
•Create a National Small Business 401(k) Plan. Many small businesses do not have a 401(k) plan because the cost of administration and reporting is too high. If these employers could outsource their plan to a central clearinghouse, their cost would be reduced while their employees would be able to access a workplace savings system.

•Encourage employers to automatically enroll their workers into their workplace savings plan. These workers could then opt-out of these plans if they so choose. Studies show that the difference in participation rates between an opt-in plan and an opt-out plan are enormous. Therefore, automatic enrollment will go a long way to helping those who are covered by a DC plan to start saving.

•Use Lifecycle funds as a default option for DC plan investors. Many workers who do participate in their company 401(k) plan do not get the most of their plan because they under-invest, don't rebalance, and don't diversify. Having these plans use lifecycle funds as a default will help workers get the most out of their plan.

•Reform and simplify the IRA system by creating fewer choices, creating saver's credits, and creating early-age programs like "Kid Save."

The Baby Boom Tidal Wave

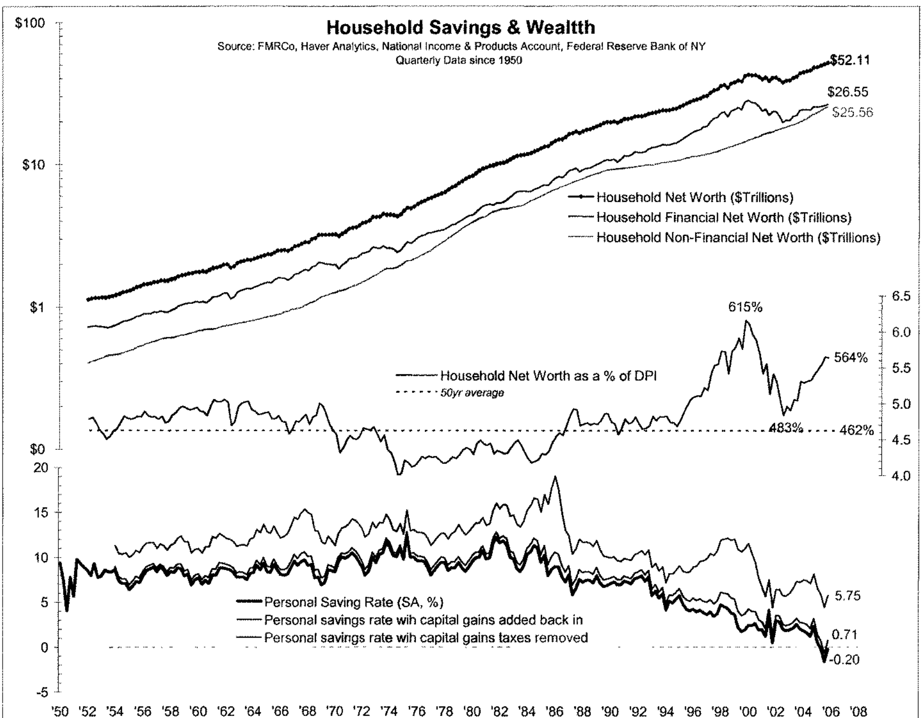


	< 5	5-9	10-14	15-19	20-24	25-29	30-34	35-39	40-44	45-49	50-54	55-59	60-64	65-69	70-74	75-79	80-84	> 84
1985	7.5%	7.0%	7.2%	7.9%	8.9%	9.1%	8.4%	7.4%	5.9%	4.9%	4.6%	4.7%	4.6%	3.9%	3.2%	2.3%	1.4%	1.1%
2005	6.9%	6.6%	7.1%	7.2%	7.0%	6.7%	6.7%	7.1%	7.7%	7.6%	6.8%	5.9%	4.4%	3.4%	2.9%	2.5%	1.9%	1.7%
2025	6.7%	6.6%	6.5%	6.4%	6.3%	6.1%	6.6%	6.6%	6.4%	5.9%	5.7%	5.8%	6.0%	5.6%	4.6%	3.5%	2.2%	2.3%

- One of the most profound demographic changes in our country's history is underway, that is, the aging of the Baby Boom generation.
- This chart shows the distribution of the U.S. population in 1985, 2005, and the projection for 2025.
- Back in 1985, the largest segment of the population was 25 to 29 years old. In 2005, the 40-44 year old segment was the largest. In 2025, the distribution from birth to 65 is about even, showing that there will be many more retiring Americans relative to the rest of the population.

•Source: U.S. Census Bureau. Fidelity Management & Research Co (FMRCo).

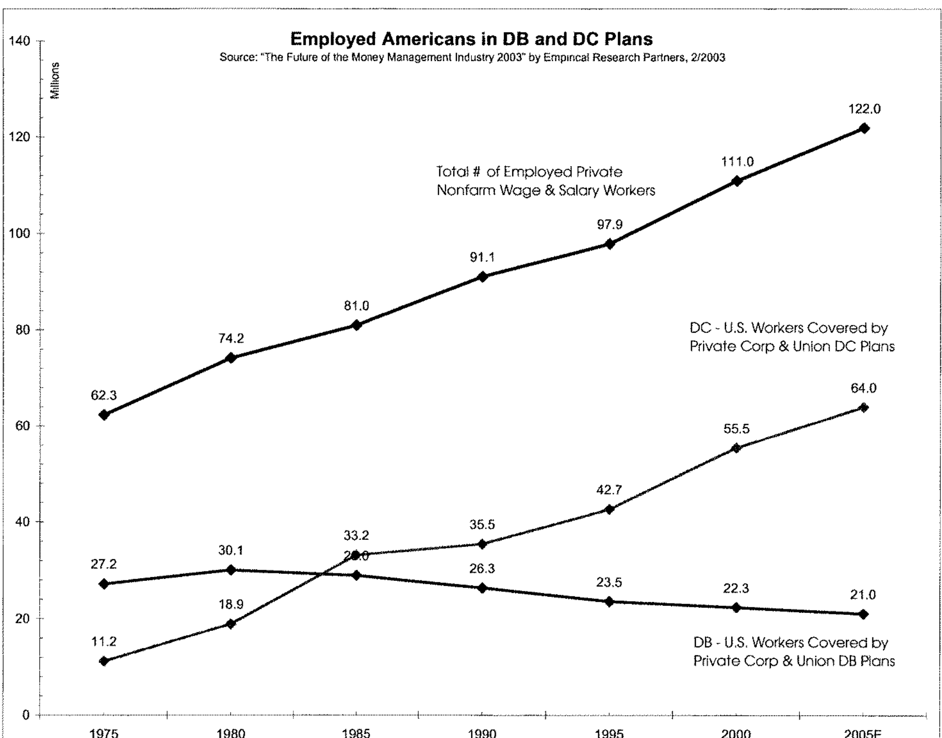
What is the True Savings Rate?



- The official savings rate in the U.S. is -0.2% and has been declining for years. However, the argument can be made that the calculation is flawed, mainly because the rate includes taxes paid on capital gains, but not the capital gains themselves.
- Furthermore, Household net worth has continued to rise, mostly as a result of rising home prices and an improving stock market.
- This prompts the question as to whether savings should only be considered as income-based or whether changes in wealth should be included as well.

•Data through 3/06. Source: Fidelity Management & Research Co (FMRCo). Based on a study by the Federal Reserve Bank of New York in 2000.

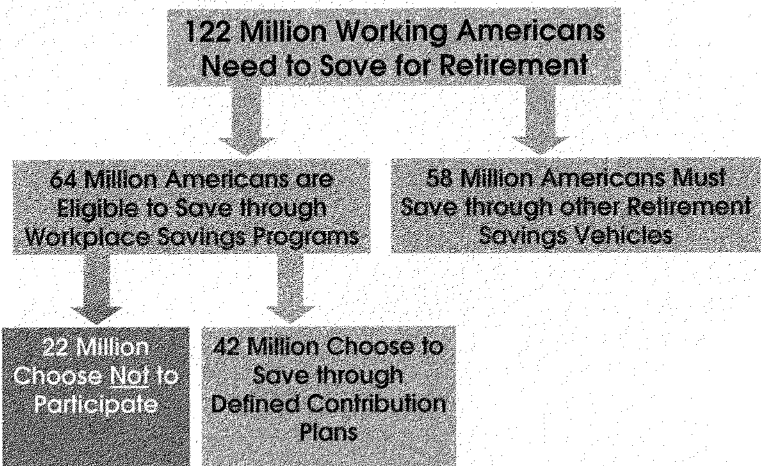
The Long Shift From DB to DC



- The longstanding trend away from defined benefit plans and towards defined contribution plans continues unabated.
- Thirty years ago, 27.2 million American workers (private non-farm) were covered by a DB plan, while only 11.2 million were covered by a DC plan.
- In 2005, only 21 million workers are covered by a DB plan, while 64 million are covered by a DC plan.
- The rise in DC plans shows that 401(k) and similar plans are the primary vehicle for many Americans to save for retirement.

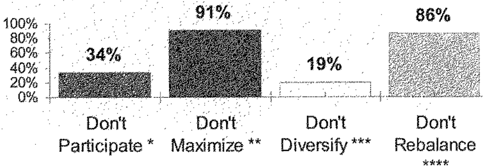
•Source: "The Future of the Money Management Industry 2003" by Empirical Research Partners, 2/2003

Inadequate Savings Options



- While DC plans are now the primary retirement saving plan for many Americans, unfortunately there are still about 58 million workers who do not have access to 401(k) or similar plan. A national small business 401(k) plan might encourage more small businesses to create plans for their employees.
- Of the 64 million workers who are covered, 22 million workers have chosen for one reason or another not to enroll.
- Making matters worse, even those workers who do enroll tend to underutilize their plan's potential. Many people do not maximize their deferral, thereby leaving matching funds on the table, many people do not rebalance and some do not diversify their holdings. Education and guidance might help workers get all the benefits they can from their DC plan.

•Sources: Building Futures Volume VI, Fidelity Investments analysis, and "The Future of the Money Management Industry 2003" by Empirical Research Partners, 2/2003



*Average among plans for which Fidelity performed nondiscrimination testing in 2004

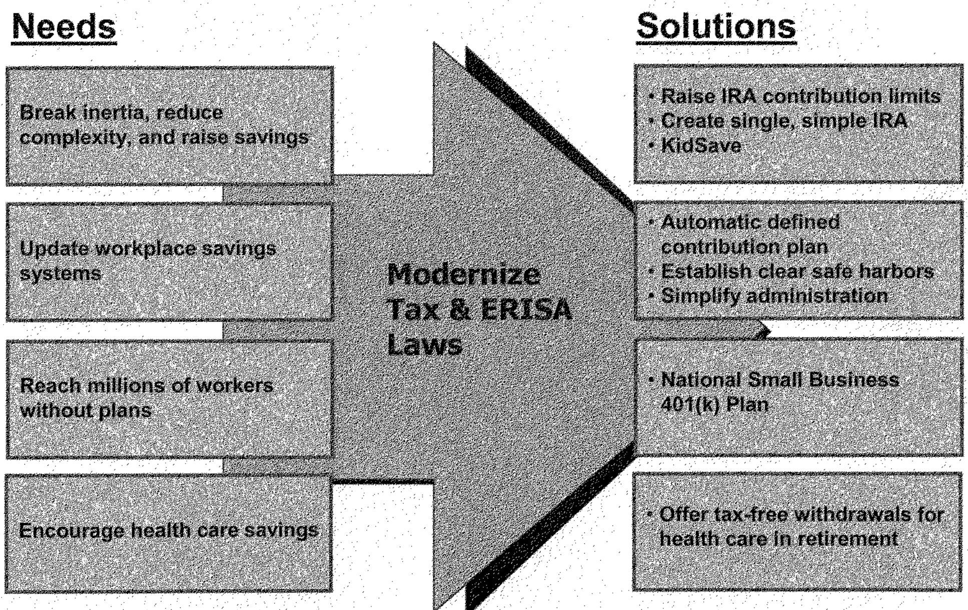
**Pre-tax deferrals were less than $13,000 402(g) limit in 2004

***Portion of all recordkeeping participants who held a single investment option other than a blended option in 2005

****Portion of recordkeeping participants present 12/31/05 who did not make a single exchange in 2005

Sources: Building Futures Volume VI, Fidelity Investments analysis.

Supplemental Charts


Solutions to America's Savings Challenges
Needs
Break inertia, reduce complexity, and raise savings
Update workplace savings systems
Reach millions of workers without plans
Encourage health care savings
Modernize Tax & ERISA Laws
Solutions
• Raise IRA contribution limits
• Create single, simple IRA
• KidSave
• Automatic defined contribution plan
• Establish clear safe harbors
• Simplify administration
• National Small Business 401(k) Plan
• Offer tax-free withdrawals for health care in retirement
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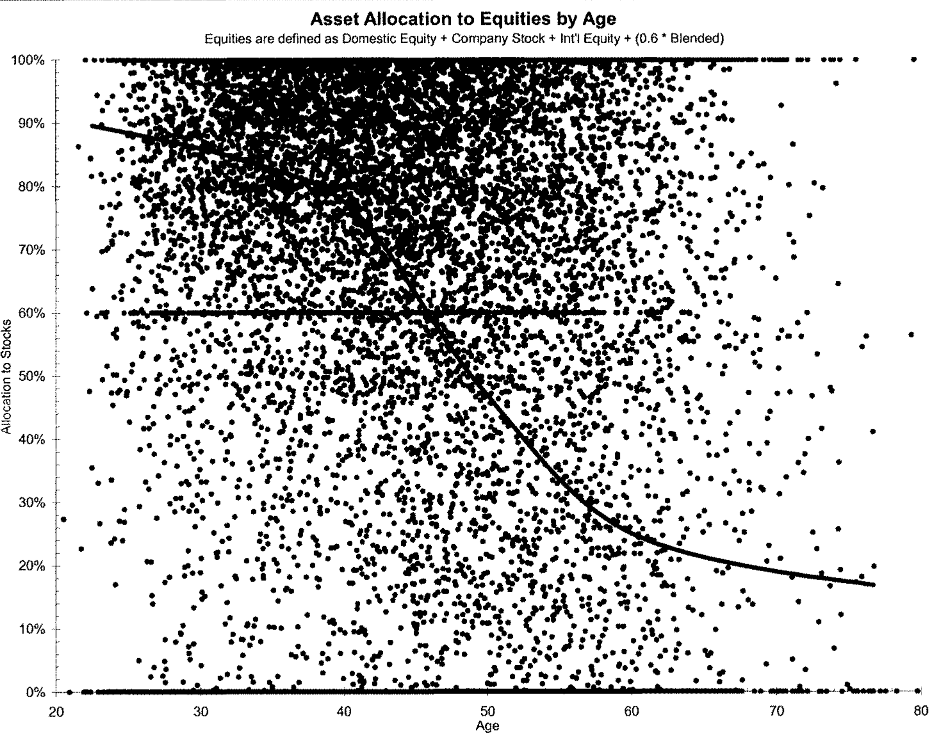
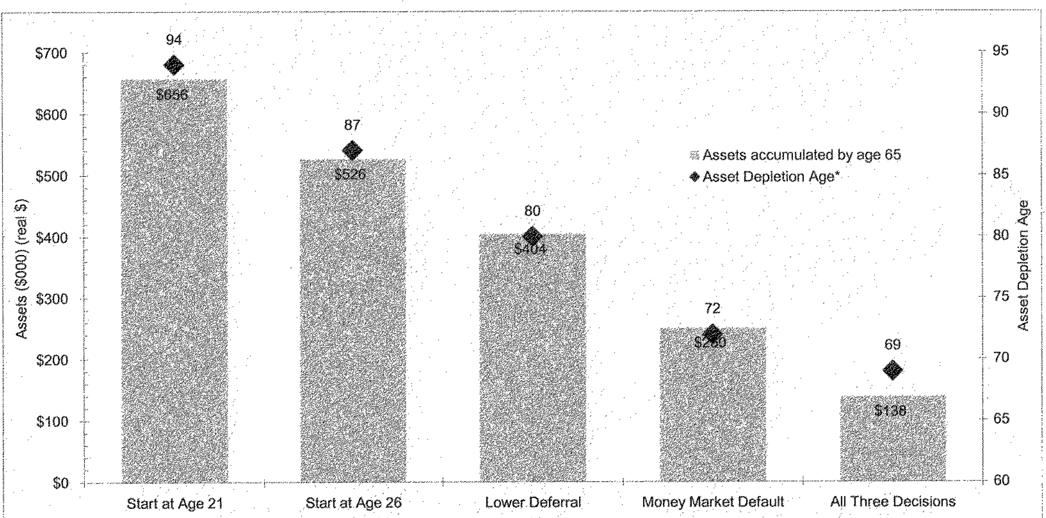
Employees Need More Guidance



- Our studies show that many American workers do not invest appropriately according to their life cycle.
- The red line shows the ideal allocation to stocks over a person's work span, from age 20 to age 80.
- The blue dots show the actual allocation to stocks. This is based on a combination of three defined contribution plan administered by Fidelity.
- The chart illustrates the need for investment guidance as well as the need for using lifecycle funds as a default option in 401(k) plans.

Source: Fidelity Management & Research Co (FMRCo).

The Cost of an Under-Utilized DC Plan



Hypothetical Illustration of a 21 year old participant in a tax deferred retirement plan with a starting salary of $30,000 that increases 3.5% a year (including 2.5% inflation). Retirement age is 65. Start at Age 21: The participant enrolls immediately, defers 10% of pay, receives a 3% company match, invests in a diversified allocation with annual nominal returns of 7%. Start at Age 26: Same assumptions, but participation starts 5 years later. Lower Deferral: Same assumptions as Right Start, but deferral rate is 5%. Money Market Default: Same assumptions as Right Start, but with annual nominal returns of 3% to reflect a 100% money market investment. All Three Decisions: Participation starts 5 years late, deferral rate is 5%, and annual nominal returns are 3% to reflect money market investment. Your own plan account may earn more or less than this example, and income taxes will be due when you withdraw from the account.

*Approximate age before assets are depleted, assuming an 80% pre-retirement income replacement ratio.

Fidelity Investments analysis. Past performance is no guarantee of future results. Neither diversification nor asset allocation ensures a profit or guarantees against loss.

No Enough Planning for Retirement

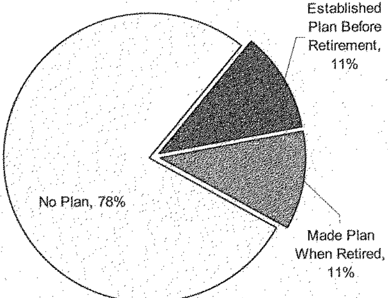
•Studies show that many people who are eligible to save through a DC plan decide not, until they get to their thirties and forties. However, in order to maximize the savings potential of DC plans, workers should start as early as possible. Automatic enrollment and better guidance could help achieve this goal.

Source: Building Futures Volume VI, Fidelity Investments Institutional Services Company, Inc., 2005

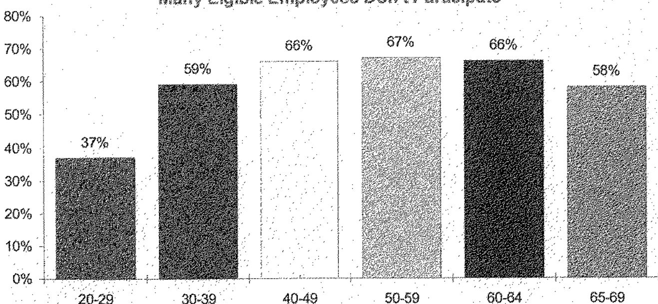
Source: LIMRA International, Inc., "Retirement Planning: The Ongoing Challenge," 2003

Retirement Preparedness

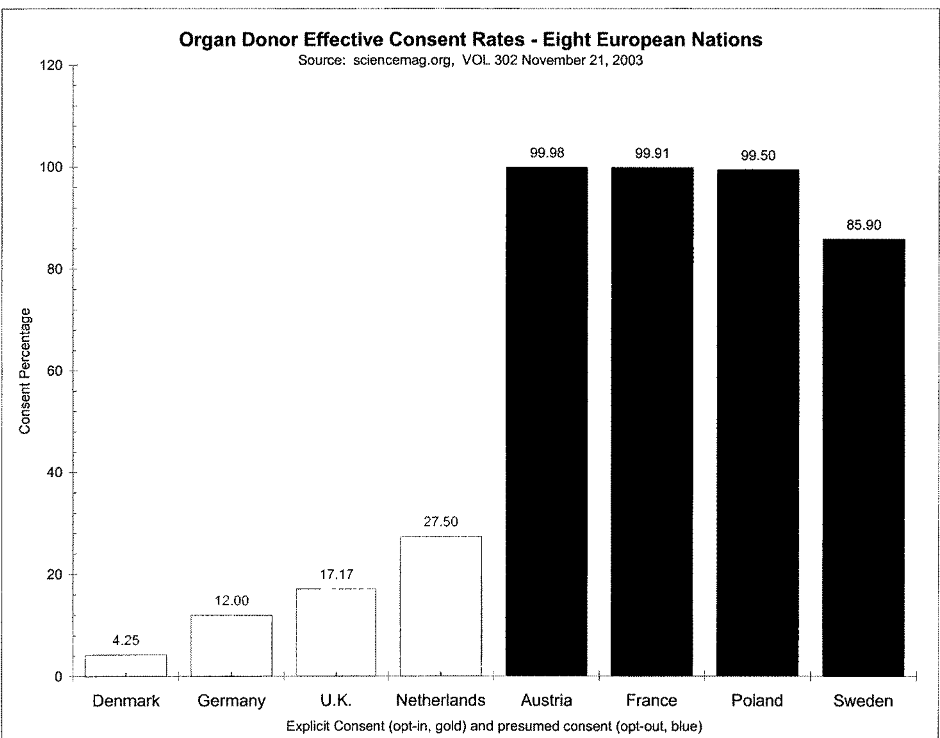
Source: LIMRA International, Inc., "Retirement Planning: The Ongoing Challenge," 2003



Many Elgible Employees Don't Participate



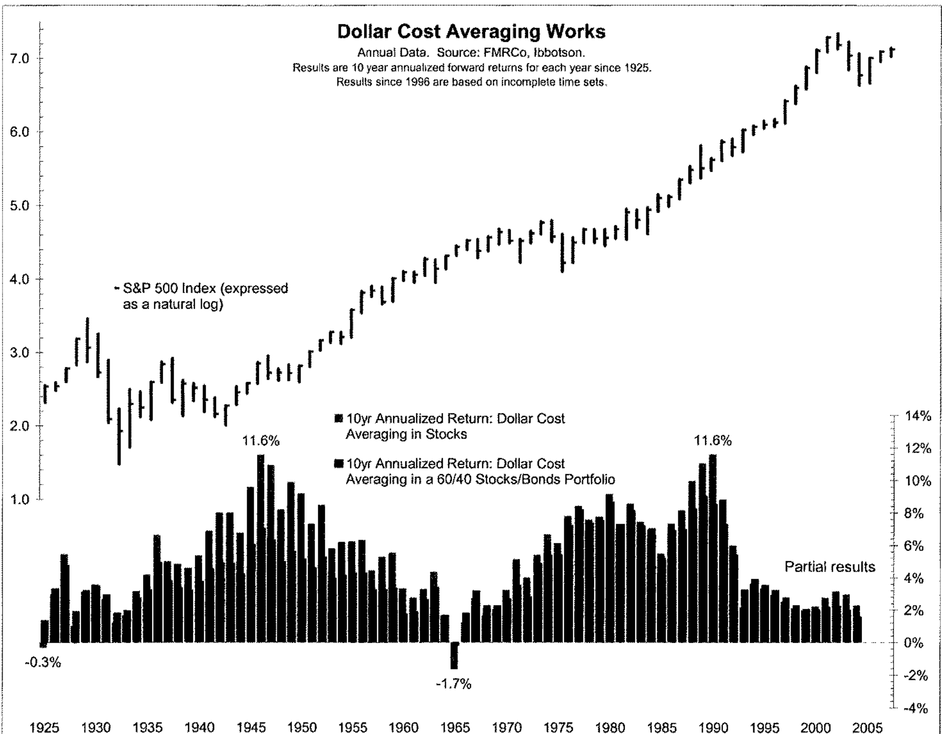
The Power of Negative Election



- Here is an illustration of the difference between an opt-in program (as 401(k) plans are currently set up) and an opt-out program (through automatic enrollment and negative election).
- In Europe, some countries have an organ donor program in which people have to opt in (gold columns, left), and some have a program where people are automatically enrolled and can opt out (blue columns, right).
- Note that Germany has only a participation rate of 12.0%, while Austria has a rate of 99.98%.
- Similar countries, totally different participation rates! Why? Automatic enrollment.

•Source: sciencemag.org, VOL 302 November 21, 2003

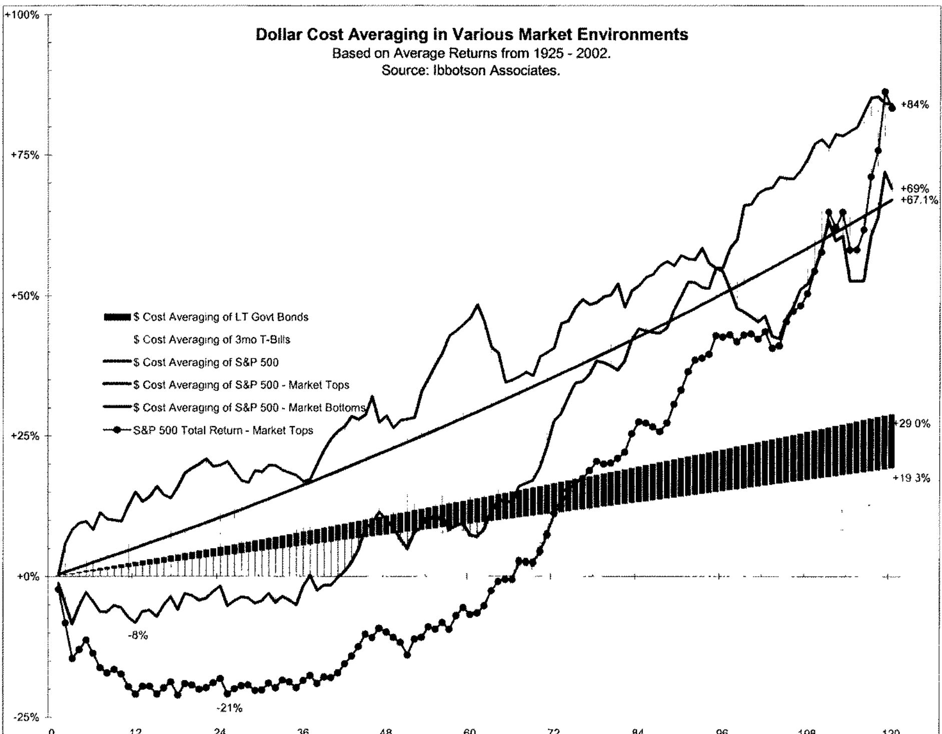
Dollar Cost Averaging Works



- The basis for any 401(K) plan is dollar cost averaging, which simply means investing small amounts of money in equal installments over a long period of time.
- Our research shows that, since 1925, a ten year dollar cost averaging plan would have netted an average annual return of 5.3% for a stock-only portfolio, and 4.4% for a 60/40 stocks/bonds portfolio.
- More importantly, the batting average over the past 80 years is 78 out of 80 (98%) and 79 out of 80 (99%), respectively.

•Data through 2004. Source: Fidelity Management & Research Co (FMRCo).

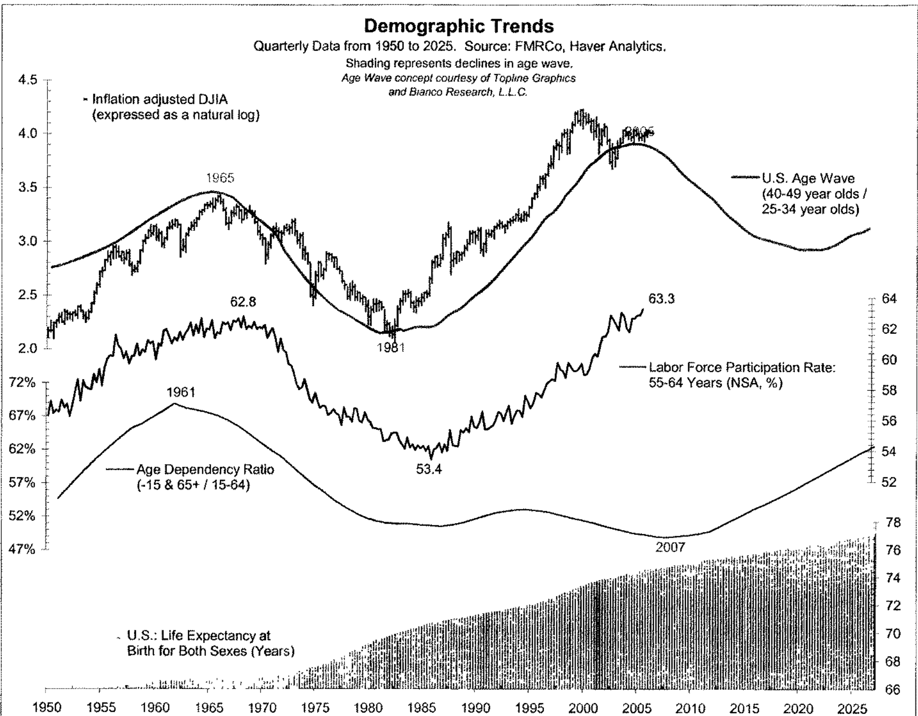
A Savings Method For All Markets



- The advantage of dollar cost averaging is that it works in most market environments, because the gradual build up of the cost basis helps to absorb market shocks.
- This chart shows that, regardless of when a dollar cost averaging program is started (typical market, top of bull market, bottom of bear market), after ten years the returns are about the same.

•Data through 2004. Source: Fidelity Management & Research Co (FMRCo).

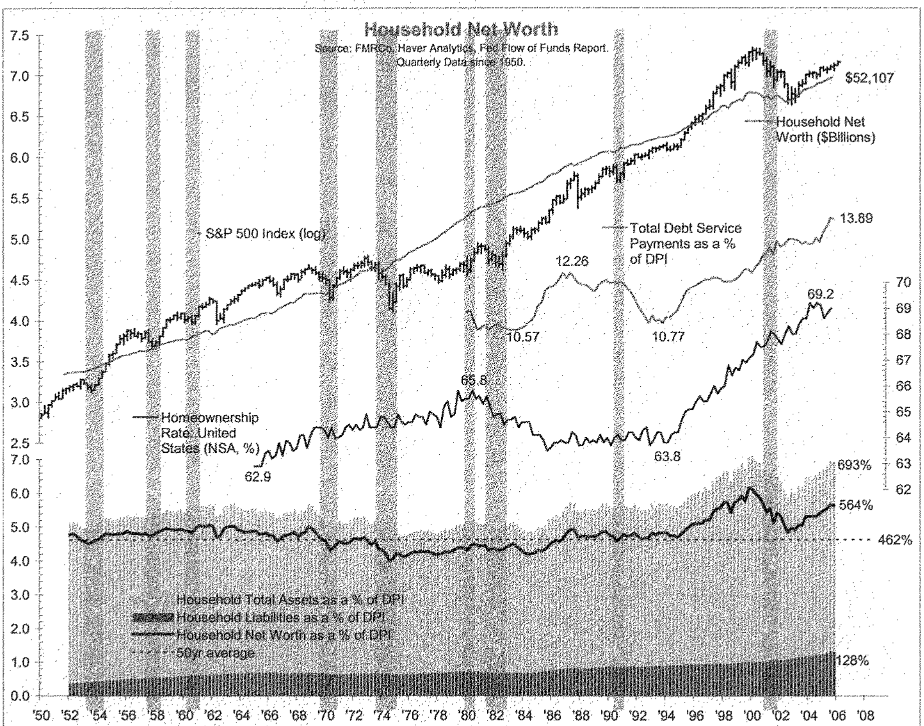
Demographic Trends



- Profound demographic changes are underway.
- Life expectancy continues to rise, and more and more Americans are working into retirement age.
- Meanwhile, the age dependency ratio will start to rise in a few years, and the age wave is peaking now.

•Data through 3/06. Source: Fidelity Management & Research Co (FMRCo), Bianco Research, U.S. Census Bureau, Haver Analytics.

Household Net Worth

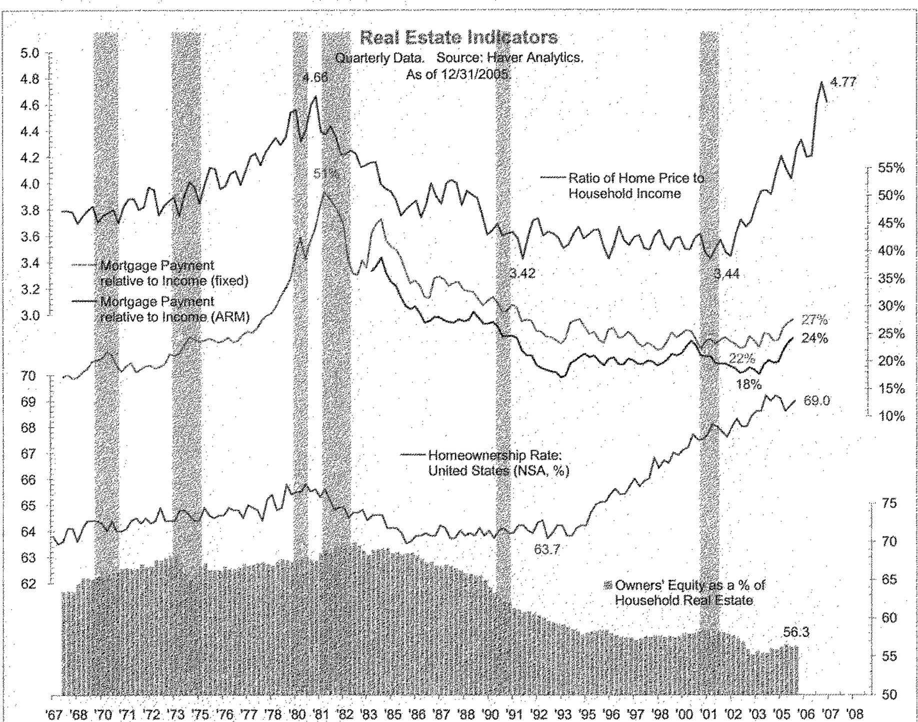


- While the household savings rate is very low, household net worth has been growing in recent years as a result of rising home prices and a rising stock market.
- Household net worth now stands at more than $52 trillion. This equates to almost six times disposable personal income (DPI).
- Debt service is at the highest level ever recorded, at 13.9% of DPI.
- Part of the rise in debt in recent years could be attributed to the rise in the homeownership rate, from 63.8 in 1994 to 69.2 in 2005.

-Data through 3/06. Source: Fidelity Management & Research Co (FMRCo).

-Based on a study by the Federal Reserve.

Is There a Housing Bubble?



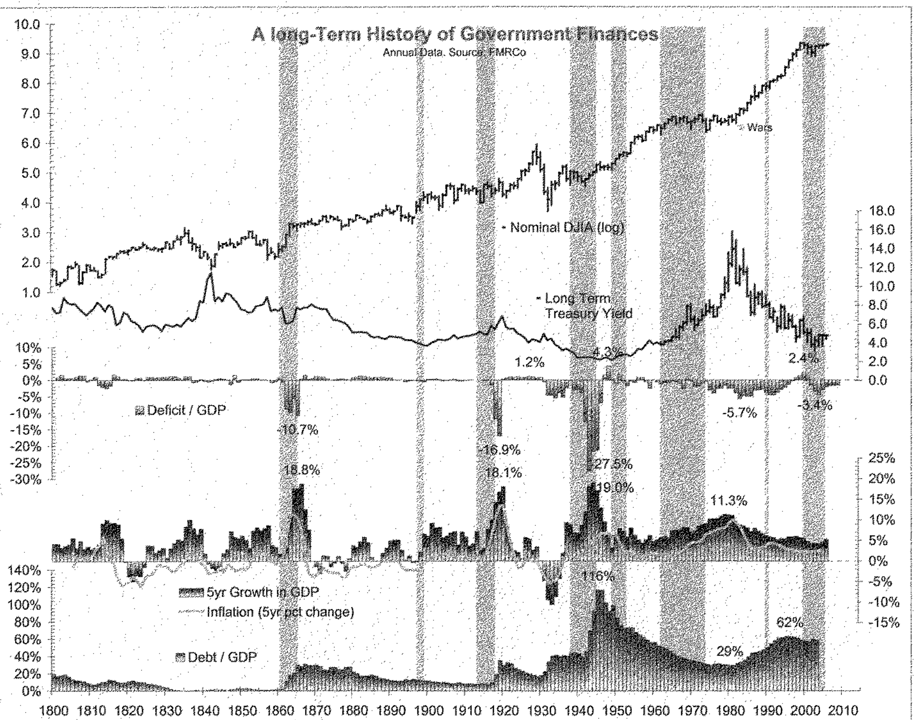
•There is a widespread belief that the U.S. housing market is a bubble that either has burst or is about to burst. Indeed, the ratio of home prices to personal income has reached a new high at 4.77 times household income.

•However, when mortgage rates are factored into the affordability of homes, the picture is not quite as alarming.

•A mortgage payment for a new house (20% down) amounts to 27% of household income using a 30 year fixed rate, and 24% using an adjustable rate. That is higher than it has been for some time, but a far cry from where it used to be.

•Data through 3/06. Source: Fidelity Management & Research Co (FMRCo), Haver Analytics.

200 Years of Government Finances

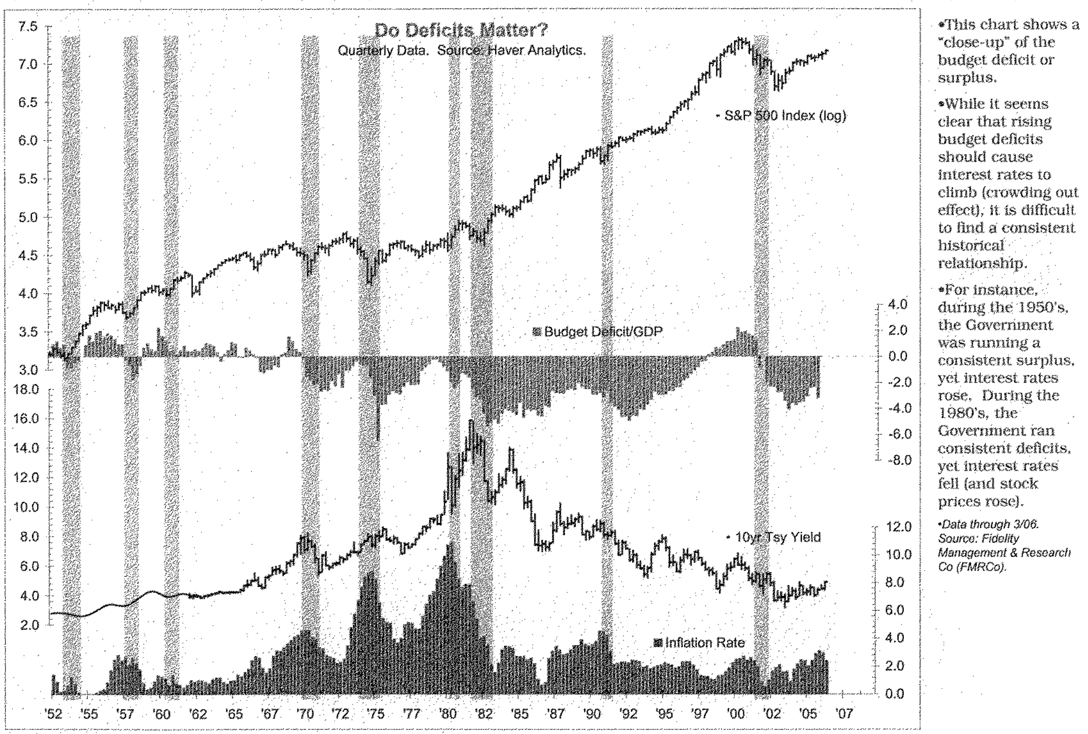


•This chart shows the U.S. Government's balance sheet since 1800.

•The vertical shadings show periods during which the country was at war. This is typically when deficits are at their highest. For example, during WWII, the budget deficit reaches 27.5% of GDP.

•Data through 2005. Source: Fidelity Management & Research Co (FMRCo), Bianco Research.

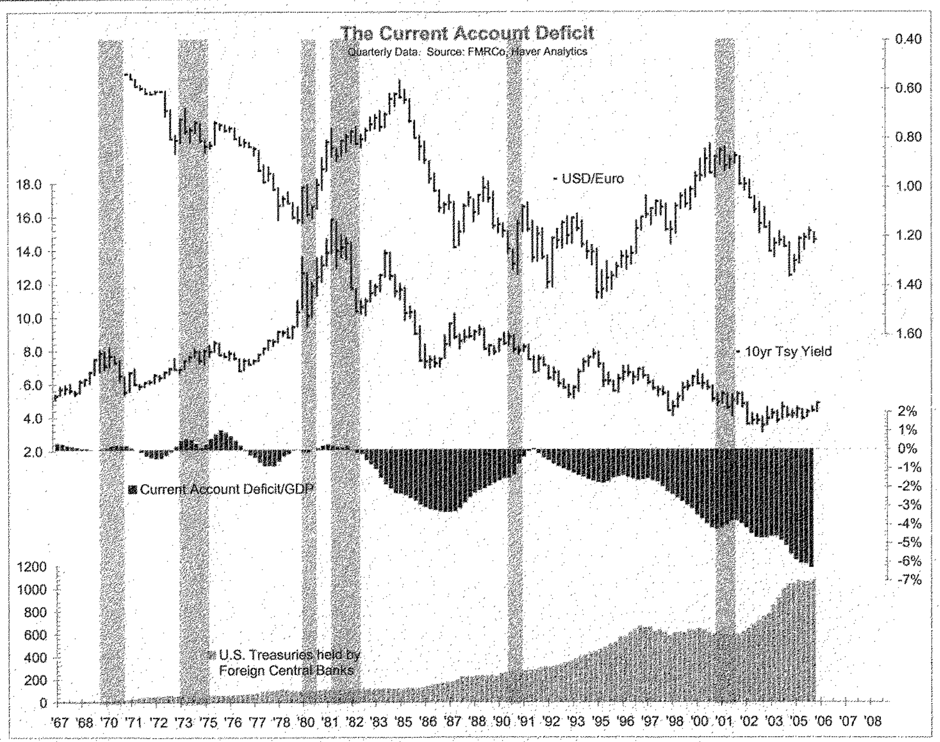
Do Deficits Affect Interest Rates or Socks?



- This chart shows a "close-up" of the budget deficit or surplus.
- While it seems clear that rising budget deficits should cause interest rates to climb (crowding out effect), it is difficult to find a consistent historical relationship.
- For instance, during the 1950's, the Government was running a consistent surplus, yet interest rates rose. During the 1980's, the Government ran consistent deficits, yet interest rates fell (and stock prices rose).

•Data through 3/06.
Source: Fidelity Management & Research Co (FMRCo).

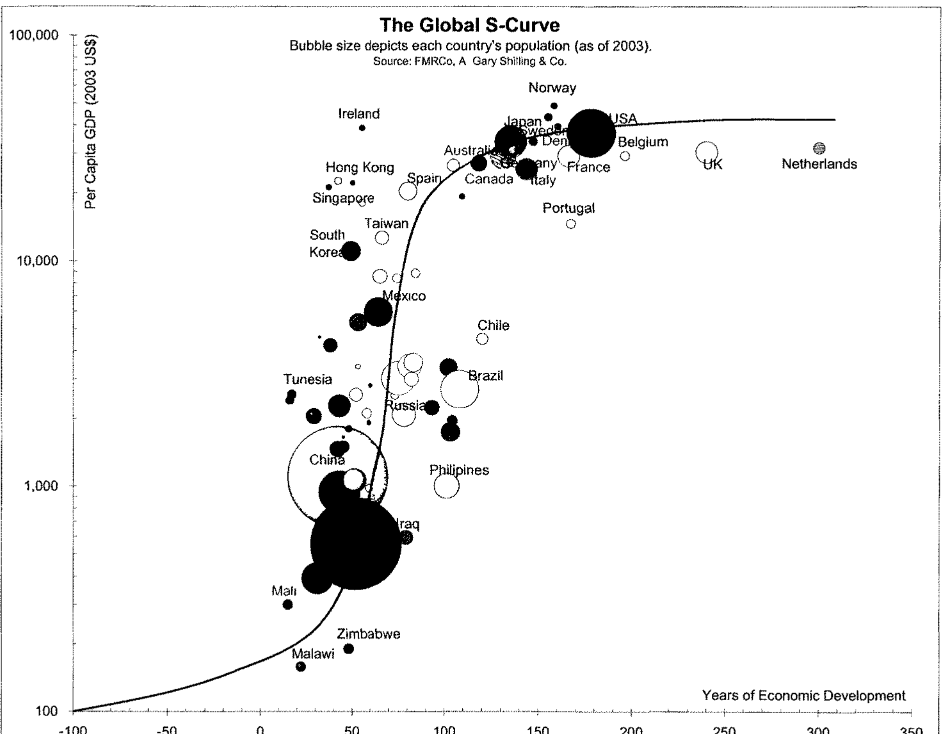
The Current Account Deficit



- In recent years, the U.S. trade deficit has ballooned ever higher (and with it the current account deficit).
- This has lead to an increased share of U.S. Government debt to be held by foreign investors, especially central banks. Foreign central banks now hold over $1 trillion in U.S. Treasuries.
- This development has lead to many predictions that either the dollar will have to fall, or interest rates will have to rise, in order to attract more investors.
- However, as the chart shows, there is little historical evidence to suggest that a widening deficit correlates with rising interest rates or a falling dollar.

•Data through 12/05. Source: Fidelity Management & Research Co (FMRCo), Haver Analytics.

Globalization: The Global S-Curve



- This chart shows where each country is on the road to economic development. This is called the "S-Curve," which represents the growth curve of each country's economy over time.
- The U.S., Western Europe, and Japan are among the richest and most industrialized countries.
- However, while levels of per capita GDP are high, their growth rates are not as high as those of emerging countries such as China, India, Brazil, and Mexico.

•Data Source: United Nations: The World Economy – Historical Statistics, A. Gary Shilling & Co. Per Capita GDP values are as of 2003.

COMMUNICATION

SAVING FOR THE 21ST CENTURY: IS AMERICA SAVING ENOUGH TO BE COMPETITIVE IN THE GLOBAL MARKETPLACE?

SENATE FINANCE SUBCOMMITEE ON LONG-TERM GROWTH AND DEBT REDUCTION

APRIL 6, 2006

STATEMENT FOR THE RECORD

SUBMITTED BY:

AMERICAN COUNCIL OF LIFE INSURERS

AMERICAN SOCIETY OF PENSION PROFESSIONALS & ACTUARIES

ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

NATIONAL ASSOCIATION OF INDEPENDENT LIFE BROKERAGE AGENCIES

NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

April 11, 2006

Senate Committee on Finance
Attn. Editorial and Document Section
Rm. SD-203
Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Chairman Smith and Ranking Member Kerry,

We congratulate both of you for drawing attention to the nation's negative savings rate by holding a hearing in your subcommittee on April 6, 20006, titled "Saving for the 21st Century: Is America Saving Enough to be Competitive in the Global Marketplace?" As the organizations representing the life insurance and employee benefits communities, we believe that Congress should encourage sound public policy that provides efficient ways for working families not only to save, but to manage financial risks and take responsibility for their lifetime financial security.

American workers share a common goal: to create financial protection and security for themselves and their loved ones. But with the changing nature of retirement and declining personal savings, today's workers face an increasing number of risks. Whether it's the financial costs from dying, becoming disabled, having inadequate saving, or outliving savings in retirement, most individuals do not have the resources to manage risk on their own.

Attached, for the hearing record, is a white paper authored by the coalition. It carries the simple message of the importance of personal financial protection and explains how the employer-based retirement system, annuities, life insurance, long-term care insurance, and disability income insurance all are an essential part of any sound financial and retirement strategy. The current employer-provided and individually purchased protection and security products are a success story worthy of safeguarding.

Respectfully,

American Council of Life Insurers (ACLI)
American Society of Pension Professionals & Actuaries (ASPPA)
Association for Advanced Life Underwriting (AALU)
National Association of Independent Life Brokerage Agencies (NAILBA)
National Association of Insurance and Financial Advisors (NAIFA)

Pensions, 401(k)s, and IRAs: Building Retirement Savings

As our national savings rate shows, convincing Americans to save is difficult. Convincing them to save on a long-term basis for retirement is even more of a challenge, especially when retirement may be decades away.

Fortunately, most working Americans have access to an attractive assortment of retirement savings vehicles designed to help them to prepare for retirement. These vehicles include employer-provided retirement plans, such as traditional, defined benefit pensions, profit-sharing plans, and defined contribution plans, including 401(k)s, 403(b)s, and 457s. For workers without access to workplace plans or for those who want to supplement savings, there are individual retirement accounts (IRAs). At least one of these options—an employment-based retirement plan or an IRA—is available to each and every working American.

The flexibility in the current retirement system provides employers—including large and small businesses, schools, and all levels of government—with the flexibility to choose the retirement savings vehicle to best meet its operational and workforce needs. This important flexibility enables employers of all sizes to offer workplace retirement plans to American workers.

Success of the Current System: Over the years, defined benefit plans, defined contribution plans, and IRAs have been incredibly successful in helping Americans build their retirement nest egg. Over 57 percent of the nation's households have retirement savings in one of these vehicles, including 73 percent of retired households.[1] These retirement savings vehicles contain more than $10 trillion, representing 17 percent of the nation's wealth. Importantly, this is a funded pool of assets that helps working Americans afford retirement without the aid of government assistance.[2]

With the decline in traditional defined benefit pension plans, defined contribution plans have become an increasingly important part of retirement security for American workers. Employment-based retirement plans have proven to be the most effective means to get moderate income workers to save. Almost 80 percent of middle income workers making $30,000 to $50,000 participate in employee savings plans.[3]

In recent years, steps have been taken by policy-makers to enhance the current system. Thanks to legislation enacted by Congress, the number of small business workers covered by a workplace retirement plan has increased by more than 20 percent over the last decade.[4] Since 2001, workers have been allowed to contribute more to their defined contribution plans and IRAs, and workers age 50 and older may make additional annual contributions to their defined contribution plan.

Current Tax Treatment: These retirement savings vehicles provide valuable tax incentives to employers and employees to encourage long-term retirement savings. An employer's contribution to workplace retirement plans on behalf of employees is tax deductible.

A worker's contribution is excludable from income and there are no taxes due on earnings until money is withdrawn. Contributions to traditional IRAs are tax-deductible and tax on earnings in all IRAs is deferred.

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[1] Bureau of Labor Statistics, Comparing the Retirement Savings of the Baby Boomers and Other Cohorts. Sharon A. Devaney and Sophia T. Chiremba. January 2005.

[2] Derived from statistics in the 2005 U.S. Statistical Abstract, with the original source of U.S. Bureau of Economic Analysis, Survey of Current Business (Table number 704, Net Stock of Fixed Reproducible Tangible Wealth in Current and Real Dollars)

[3] EBRI, 2003. (This disparity exists notwithstanding likely eligibility for the Saver's Credit.)

[4] Congressional Research Service, Pension Sponsorship and Participation: Summary of Recent Trends. September 10, 2004.

For many moderate income workers, tax deductions and exclusions make it more affordable to save. For lower income workers, an additional retirement savings tax credit (the Saver's Credit) can further reduce their tax bill.

Restrictions and penalties apply for early withdrawal of retirement savings (i.e., before retirement or disability). These restrictions exist as a trade-off for the valuable tax incentives these retirement savings vehicles provide and are designed to help ensure savings remain and grow until workers reach retirement.

Call for Action: The current tax incentives afforded employer-sponsored retirement plans and IRAs are efficient and effective ways for workers to save. The proven track record of these retirement savings vehicles simply cannot be ignored. Maintaining and strengthening the current system is the most effective way to help working Americans achieve the dream of a comfortable retirement. Further steps can—and should—be taken to ensure that more American workers have access to, and take advantage of, retirement savings in the workplace.

Issues and Trends:

- In 2004, 75 percent of employees working for large firms (more than 1,000 employees) were offered a retirement plan; 34 percent of those in small firms (fewer than 100 employees) were offered a plan.[5]
- The number of small business workers covered by a workplace retirement plan has increased by more than 20 percent over the last decade.[6]
- The number of private-sector workers covered by a defined benefit plan decreased from 30.1 million in 1980 to 22.2 mil-lion in 2000—a decline of about 25 percent, while those covered by a defined contribution plan increased from 14.4. million in 1980 to 50.9 million in 2000—an increase of approximately 250 percent over the same period.[7]
- Active participation in 401(k) plans grew from 10 million workers in 1985 to 43 million in 2004.[8]
- More than 8 in 10 eligible workers say they participate in a retirement savings plan at work (82 percent).[9]
- Low- to moderate-income workers are 20 times more likely to save for retirement through a workplace plan.[10]

Annuities: Creating Guaranteed Income for Life

Retirement today requires more planning than in previous generations. Sources of steady retirement income have changed, as fewer and fewer workers are covered by traditional employer-provided pensions that provide a lifetime benefit. In addition, advances in medicine have resulted in increased longevity—today's retirees may spend 20, 30 or more years in retirement.

Given this landscape, workers nearing retirement face an imminent crisis: how to generate a stream of income that is guaranteed to last throughout retirement. Whether workers have access

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[5] EBRI, Issue Brief No. 286, October 2005.
[6] Congressional Research Service, Pension Sponsorship and Participation: Summary of Recent Trends. September 10, 2004.
[7] EBRI, Employment-Based Retirement Plan Participation: Geographic Difference and Trends, 2004.
[8] EBRI/ICI, 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2004.
[9] EBRI, Encouraging Workers to Save: The 2005 Retirement Confidence Survey. April 2005.
[10] EBRI 2003.

to employment-based retirement plans or not, achieving stable and secure income in retirement is a challenge.

With the decline of defined benefit plans and increased popularity of defined contribution plans, such as 401(k)s, responsibility for managing savings has shifted from the employer to the individual. Unlike traditional pensions that provide a stream of payments to retirees for life, defined contribution plans typically offer a lump sum that the retirees then manage on their own.

Other than Social Security and the defined benefit system, the only means to create a guaranteed income stream in retirement is through an annuity. An annuity is an insurance contract that offers an efficient solution to what otherwise could be an overwhelming asset management task: creating a steady paycheck in retirement that cannot be outlived. Individuals without access to workplace retirement savings plans have an even greater challenge: to independently accumulate savings during their working years and manage those savings in retirement. An annuity can address both of those needs.

Success of the Product: Annuities offer solutions to both sides of the retirement equation: They provide ways to accumulate retirement savings, and then at retirement, to turn savings into an income stream that cannot be outlived.

The lifetime income option through annuitization allows retirees (and their spouses) to maximize retirement income without having to worry about payments stopping while they are alive. At the time of purchase, annuity owners are guaranteed that if they choose to annuitize at a later date, they will receive a benefit based on either the purchase rates at the time the annuity was issued or annuitized—whichever rate is more favorable to the annuity owner. Given the changes that can occur over time with respect to the economy, longevity, or an insurer's costs, this is a valuable consumer benefit.

Many insurers offer additional options—such as the guaranteed minimum withdrawal benefit, which allow consumers to create and manage income flow to meet various income needs as they age—while still offering guaranteed income for life. Other income options, which do not have a lifetime guarantee, also are available.

Annuities are popular among middle-income Americans: Two-thirds of individual annuity owners have annual household incomes below $75,000; nearly half have household incomes below $50,000; and one-third have annual household incomes below $40,000.[11]

Current Tax Treatment: By encouraging long-term savings during the working years and helping individuals manage assets during retirement, the current tax treatment of annuities promotes financial discipline.

For those who are years away from retirement, or are retired and have assets that don't need to produce income right away, a deferred annuity allows savings to build up, free of current federal income tax. When payments are received, the portion that comes from earnings is taxed as ordinary income.

There are tax penalties for withdrawals from deferred annuities before age 59½, in addition to the income tax due on earnings, to encourage long-term savings for retirement. The tax penalty is not applied to certain lifetime payouts, death benefits, or payments made if an annuitant becomes disabled. Other exceptions may apply.

The current tax treatment has served as an effective savings incentive: 77 percent of individual annuity owners report that they have set aside more for retirement than they would have if the

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[11] Committee of Annuity Insurers, 2005 Survey of Owners of Non-Qualified Annuity Contracts. (Conducted by The Gallop Organization and Mathew Greenwald & Associates)

tax-deferred growth of annuities was not available. A large majority cite the tax treatment of annuities as a "very" or "somewhat" important reason for their purchase.[12]

Call to Action: An annuity can help American workers meet the challenges of the changing landscape of retirement. In fact, eight out of 10 individual annuity owners say they will use their annuity savings for retirement income.[13] With the shift from defined benefit to defined contribution plans and increased longevity, policy-makers should explore ways to encourage more Americans to turn to annuities for guaranteed lifetime income.

Issues and Trends:

- Over the past 10 years, contributions to individual annuities have grown 8 percent annually.[14]
- Sixty-six percent of individual annuity owners have household incomes below $75,000; 48 percent have income below $50,000; 34 percent have incomes below $40,000.[15]
- Eight out of 10 annuity owners say they will use their annuity savings for retirement income.[16]
- During 2004, payments into annuities increased 4 percent to $301 billion.[17]
- Americans deposited $172 billion in individual annuities, up 4 percent from 2003.[18]
- Individual annuity owners received $35 billion in benefit payments in 2004.[19]

Life Insurance: Providing Financial Protection

Life insurance is a key component of Americans' ability to take individual responsibility for the financial futures of their families and businesses. It is unique in guaranteeing the delivery of financial security at precisely the moment it is needed, while contributing significantly to the nation's storehouse of savings and investment capital.

A big fear for many American families is the death of a wage-earner or provider, leaving the family unable to cope financially. Life insurance offers peace of mind through immediate financial protection for families and dependents.

Life insurance enables individuals and families from all economic brackets to maintain independence in the face of financial catastrophe, helping relieve pressure on government entitlement programs. For this reason, there has been strong public support for continuation of current tax policy for life insurance products.

By providing tools for self-protection and savings, life insurance is an efficient way to promote personal responsibility and foster less dependence on government programs. A recent survey showed that three-quarters of Americans agree that life insurance is a critical part of a financial plan.[20]

Success of the Product: According to the most recent census, there were approximately 105 million households in the United States. Life insurance data shows that in 2004, there were 167

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[12] *Ibid.*
[13] *Ibid.*
[14] ACLI, Life Insurers Fact Book 2005.
[15] Committee of Annuity Insurers, 2005 Survey of Owners of Non-Qualified Annuity Contracts. (Conducted by The Gallop Organization and Mathew Greenwald & Associates).
[16] Ibid.
[17] ACLI, Life Insurers Fact Book 2005.
[18] *Ibid.*
[19] *Ibid.*
[20] ACLI, Monitoring Attitudes of the Public. 2004.

million individual life insurance policies in force providing $9.7 trillion of protection. Fifty-six percent of the individual life insurance policies issued in 2004 were permanent policies.[21]

Life insurance protects families from financial loss from the death of a loved one. It enables families to pass on more assets from one generation to the next, providing a source of reliable liquid assets when the need arises to pay for death-related expenses or to offset estate tax and inheritance tax liabilities. Very few Americans can self-insure the risk of premature death through their own financial means. Life insurance makes managing this risk affordable through the pooling of risk.

Permanent life insurance has an additional advantage—it is guaranteed to remain in force for one's whole life, regardless of age. By design, the level premiums of permanent insurance are used to both pay for the term cost of a policy's face amount and to create a savings component (cash value), which helps cover the rising cost of insurance as one gets older. If an insured's needs change and death benefit protection becomes less acute, the policy's cash value can be used to pay various expenses, such as those for tuition or long-term care. Or, the cash value can be converted into a retirement income producing annuity that can guarantee regular payments for life or for a specified period of time, an option also available to beneficiaries of life insurance policies. Some policies allow an insured to collect all or part of the death benefit if he or she becomes terminally or chronically ill.

Businesses use permanent life insurance to protect against financial uncertainty and secure their employees' futures. By owning life insurance on key employees, businesses have a secure funding source to pay for important employee and retiree benefits and to protect jobs and families from financial loss and instability that can result from the death of an owner or key employee.

Current Tax Treatment: Policy-makers have long-recognized the important social policy served by encouraging individuals and families to protect themselves against financial risks, rather than depend on government to do so. Since its inception in 1913, the tax code has provided that death benefits—and the cash value in permanent life insurance—are not subject to income tax.

Premiums are paid with after tax dollars—there is no deduction for premiums paid. Earnings on a permanent life insurance policy's cash value are not taxed as long as the policy remains in force. However, if a policyholder gives up his or her insurance protection, earnings in excess of the total premiums paid are subject to tax.

The protection afforded by life insurance is an important societal benefit that public policy has consistently validated. This policy has been reviewed several times over the last century, and each time Congress has chosen to preserve the current tax treatment of permanent life insurance.

Call to Action: The current tax treatment of permanent life insurance encourages individuals, families, and businesses to efficiently manage risk and prepare for long-term financial needs, despite a general environment that focuses more on the short-term. Any changes to public policy must not limit or disadvantage the critical protection only permanent life insurance can provide.

Issues and Trends:

- The financial plans of 69 percent of American families include life insurance.[22]
- These families are covered by life insurance policies and group certificates that provide $18 trillion worth of protection.[23]

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[21] ACLI, Life Insurers Fact Book 2005.
[22] Federal Reserve Bulletin, January 2003, "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances."
[23] ACLI, Life Insurers Fact Book 2005.

- In 2004, there were 167 million individual life insurance policies in force, providing $9.7 trillion in protection.[24]
- Of all the individual policies issued in 2004, 56 percent were permanent insurance policies.[25]
- In 2004, beneficiaries of life insurance policies received $52 billion in death benefits.[26]

Long-Term Care Insurance: Protecting Retirement Savings

Long-term care insurance is a crucial component of retirement planning. It protects retirement savings from being depleted by the steadily growing costs of long-term care, and provides consumers with the dignity of choice by covering a wide range of services in a variety of settings. At the same time, private long-term care insurance eases the burden on public programs.

Many Americans will require long-term care in a nursing home or by an in-home provider. Of those individuals who are currently 65, about 44 percent will use a nursing home at some point. And a sizable percentage will require such services for an extended period of time—with women more at risk than men.[27]

Such care can easily deplete savings or impoverish a family. Since 1990, the price of nursing home care has increased at an average annual rate of 5.8 percent—almost double the overall inflation rate.[28] Today, the cost of a nursing home stay averages nearly $70,000 annually for a private room. Most Americans cannot save enough to cover these high costs on their own. That's where long-term care insurance comes in.

With the aging baby boomers and the increasing cost of care, total spending on nursing home care is expected to more than triple over the next 25 years and to increase more than five-fold in the next 45 years. These increases will place heavy burdens on government programs, and ultimately on taxpayers. Long-term care insurance can protect individuals and families from financial crisis and at the same time alleviate the strain on state and federal budgets.

Success of the Product: Private long-term care insurance is already meeting the needs of millions of Americans every day. Since its introduction to the marketplace in the 1980s, more than 9 million policies have been purchased.[29] In 2003 alone, carriers paid $1.6 billion in long-term care insurance benefits.[30]

Government studies show that people who bought long-term care insurance are glad they did so: claimants typically found it easy to file a claim (70 percent) and an overwhelming majority (86 percent) are satisfied with their policy.[31]

Since its introduction to the marketplace, long-term care insurance has evolved to meet the ranging needs of consumers, covering a variety of services that help individuals receive care inside or outside the home. Today's policies also handle the multifaceted challenges of family caregivers, from easing physical and emotional stress to reducing job disruptions. Hybrid products that link long-term care coverage with life insurance or annuities offer additional options to meet a wide array of financial needs.

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[24] *Ibid.*
[25] *Ibid.*
[26] *Ibid.*
[27] Spillman and Lubitz (2002).
[28] U.S. Department of Labor, Bureau of Labor Statistics.
[29] AHIP, Long-Term Care Insurance in 2002. June 2004.
[30] ACLI tabulation of 2003 NAIC data.
[31] ACLI, Passing the Trust to Private Long-Term Care Insurance. 2003.

Long-term care is available on an individual basis, or through a group plan sponsored by an employer or association. An increasing number of group employers—including the federal government and more than 20 state governments—recognize the importance of long-term care insurance in retirement planning and offer it as part of their employee-benefit packages.

Current Tax Treatment: Long-term care insurance premiums are paid after-tax; a portion of premiums and out-of-pocket expenses may be deducted from federal income taxes as part of medical expenses, but this deduction is severely limited to amounts in excess of 7.5 percent of annual income. Twenty-three states provide either a tax deduction or tax credit for long-term care insurance premiums. Long-term care insurance benefits are not taxable as long as the benefits received do not exceed certain limits.

Call to Action: In 2006, Congress paved the way for the expansion of the highly-successful long-term care partnership program, providing more Americans the opportunity to protect their assets and stay off Medicaid. With rising demand and soaring costs for long-term care services, it is crucial that policy-makers continue to encourage Americans to plan for their future long-term care needs through private-sector solutions, such as long-term care insurance.

Issues and Trends:

- Currently, about 55 percent of those 85 and older require some form of long-term care and about 19 percent of all seniors suffer some degree of chronic impairment.[32]
- By 2050, it is estimated that up to 5.4 million seniors will need the services of a nursing home—the most costly form of long-term care—and another 2.4 million will require home health care.[33]
- More Americans are buying long-term care insurance before age 65. From 1998 to 2002, the average purchasing age in the individual market fell from 72 in 1990 to 60 in 2002. The average age of employees who purchase long-term care insurance in the workplace remained fairly constant at 45 since 1990.[34]
- In 2003, carriers paid $1.6 billion in long-term care insurance benefits.[35]

Disability Income Insurance: Providing Paycheck Protection

A serious illness or injury can harm more than one's health—it can have an impact on an individual's ability to work and pay living expenses. A disability also can disrupt one's retirement planning.

The likelihood of long-term disability for persons between ages 35 and 65 is quite high—about 45 percent.[36] In the event of a serious illness or injury, the benefit from employer and government programs—such as sick leave, short-term disability, and Social Security—may not be enough to meet all of one's financial needs. Disability income insurance provides critical income protection for working-age people who are unable to work due to illness or injury.

Success of the Product: Disability income insurance enables individuals to meet ongoing living expenses—such as rent or mortgage payments and groceries—and avoid depleting long-term savings for retirement by providing a portion of earned income until they are able to return to

[32] Congressional Budget Office (2004)
[33] ACLI, Long-Term Care Insurance or Medicaid: Who Will Pay for Baby Boomers' Long-Term Care, 2005.
[34] AHIP, Long-term Care Insurance in 2002. June 2004.
[35] ACLI tabulation of 2003 NAIC data
[36] ACLI, Protectors and Investors. 2005.

work. Some policies also include return-to-work provisions, such as rehabilitation, retraining, and modifications to the work environment.

Disability income insurance can be purchased on an individual basis and is increasingly available as part of an employee benefit package in the workplace. Carriers are providing more flexibility for consumers to 'scale up' or 'scale down' benefits to meet their changing needs.

Current Tax Treatment: Benefits received from an individual disability income insurance policy typically are not subject to income taxes. Benefits are taxed, however, if an employer pays for the coverage.

Call to Action: As Americans live longer, work longer, and assume more financial obligations—such as funding education and parental care, in addition to saving for retirement—it is important to foster public education about how long-term disability income insurance can help Americans continue to support their families, maintain their independence, and avoid depleting their long-term savings for retirement should a disabling event occur.

Issues and Trends:

- People in their early 30s are three times more likely to suffer a disability lasting three months or longer than they are to die.[37]
- 36 percent of full time workers have a long-term disability policy provided by their employer—43 percent employed by medium to large firms and 17 percent employed by small firms.[38]
- Almost 1 in 7 individuals will become disabled for 5 years or more prior to age 65. This number increases to nearly 1 in 5 for individuals between the ages of 35 and 65.[39]

[37] 1985 Commissioner's Individual Disability Table A.
[38] Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States. March 2005.
[39] 1987 Commissioner's Group Disability Table.