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TARGETED INCENTIVES TO INCREASE PERSONAL SAVINGS

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TARGETED INCENTIVES TO INCREASE PERSONAL SAVINGS

THURSDAY, FEBRUARY 2, 1995

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to recess, at 9:30 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the committee) presiding.

Also present: Senators Moynihan, Pryor, Rockefeller, Graham, Moseley-Braun, Chafee, Hatch, and D'Amato.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Gentlemen, collectively, doctors, I believe we are ready.

This is a series of hearings that Senator Moynihan and I have been having on the subject of savings and investment, whether or not we need to save and invest, which was the first question.

There are some who say, no, we do not need to save more, so we do not need to get to the question of whether IRAs encourage saving or do not encourage saving; they do not feel it is necessary. I do not find that to be the prevalent economic opinion, but there is a body that comes to that conclusion.

But if we decide that we want to save more and invest more, then we are trying to figure out, what is the best way to do it? Senators Nunn and Domenici have a bill that is, for lack of a better term, basically a gigantic IRA. Whatever you save, you do not pay any tax on; whatever you spend, you do pay a tax on. If you make $100,000 and save $30,000, you pay no tax on the $30,000, which is a gigantic IRA.

Many have said the flat tax, if you could get the tax low enough, would be a fine savings incentive. If you had a flat tax at 18 or 19 percent, most people would say, fine, go ahead and pay it and we will have ample left to save. It would especially be true, obviously, at upper income brackets. You may want to comment on that.

Many people say, expand the IRAs. And I know there is a difference of opinion on our panel, and I am delighted today that there is. IRA proponents want to provide for all kinds of withdrawals prior to retirement for education, illness, buying a first home. It is kind of like a bucket of water, with how many holes can you put in it and still have any water left at the end, if your point is that you want to save it.

So, with that background, I will ask Senator Moynihan if he has any comments.

Senator Moynihan. No, except to say that I am pleased, particularly, that Dr. Kotlikoff not only knows that this is the problem, but says he knows the answer to it.

The CHAIRMAN. I might say, these are the kinds of hearings that Pat Moynihan and I particularly revel in, because we are only scheduling a panel a day and we can ask as many questions as we want. I find them tremendously educating, and we are learning what we are eventually are going to get into.

If you gentlemen do not mind, we will just take the order in which you appeared on the witness list. So we will go in order as Drs. Gale, Kotlikoff, Skinner and Wise, and then we will have questions when you are done.

Dr. Gale?

STATEMENT OF DR. BILL GALE, SENIOR FELLOW, BROOKINGS INSTITUTE

Dr. GALE. Thank you very much, Mr. Chairman. I appreciate the invitation to testify at this hearing.

My testimony is based on research that I have conducted over the past several years on IRAs, 401(k) plans, and pensions. Let me just say at the outset that I think low rates of saving and investment are one of the Nation's most important economic problem right now.

My discussion will focus on three major areas, in accordance with the outline of the session topics. The first, is the effects of IRAs and 401(k) plans on saving; second, is psychological models of saving, and the third, is on other ways to raise the saving rate.

First, do saving incentives work? The United States allows a variety of saving incentive plans, like IRAs, 401(k) plans, and KEOGH plans. I do not believe that these programs have raised the saving rate. I say that reluctantly. I would much rather be the bearer of good news concerning tax incentives, but that is not how I see the evidence.

I have three points to make here. First, the total balances in these accounts have increased by roughly $1.5 trillion since 1981. To put that number in perspective, personal saving in the U.S. is about $200 billion per year. This means that in just 13 years these accounts alone have accumulated balances worth about 7 years of personal savings, just in those accounts.

If saving incentives really do raise saving, it would not be unreasonable to expect accumulations of this magnitude to show up as increases in the personal or private saving rate. But, as is well known, rather than rising, the personal saving rate, as conventionally measured, has fallen substantially over this period.

Now, we should all be cautioned that a lot of things affect aggregate saving, but I would ask you to note that during the 1982 to 1986 period when IRAs were universal we also had a large cut in income tax rates, which should have raised saving, we also had high income growth, which should have raised saving, and we had high real interest rates which also should have raised saving. Despite all of those factors, plus IRAs, the saving rate fell.

So, point one, at a general level, was that a lot of money has poured into saving incentive accounts, but there is no evidence in the aggregate data that there has been any positive effect of these programs on saving.

Point two, is that savings incentives are poorly designed from an economic perspective. The simplest way to say this is, you do not have to save to put money in a saving incentive.

Saving more means consuming less or spending less. To put it bluntly, saving more means reducing your current standard of living. People, naturally, find that painful; nobody wants to reduce their own standard of living unless they have to.

The reason that IRAs and 401(k) plans are so popular is precisely that most of the people that use them can put the money in and get the tax break without reducing their standard of living. That is, they can make painless contributions.

How do they do that? There are three possible ways. One is they can take taxable assets that they already own and shift them into IRAs; the second, is they can take saving now or in future years that they would have done anyway and put that into an IRA; and the third way, is they can increase their debt and put that money into an IRA or 401(k).

Again, the good news for people doing these things is that they do not have to reduce their standard of living to get the tax benefits. The bad news for policy makers is, first, if this is what people do there is no increase in private saving, and, second, if this is what people do, there is a reduction in government tax revenues.

The third point concerns the evidence. There is now a very large volume of evidence. I am not going to attempt to summarize it all here, but I do want to make one point concerning the evidence.

It is sometimes said that the typical household has little saving, so their contributions to IRAs or 401(k)s must be new saving, because a typical household does not have any assets to shift away from. I believe that this is a misleading statement in the following sense.

It certainly is true that the typical household has relatively low levels of financial assets, but these households tend also not to have IRAs or 401(k)s. Households that do not have IRAs are not relevant to the issue, simply because they do not contribute.

The families that do hold IRA's and 401(k) plans also tend to have lots of other assets and other saving. And here I want to include not just financial assets, but overall net worth. In 1986, the typical household with an IRA had four times the wealth and eight times the saving of the typical household without an IRA, so these households can contribute to these plans in painless ways.

My estimates indicate that people are not stupid; that those that can contribute in painless ways do, in fact, contribute in painless ways so that the net effect on private saving is very small at best, and that the government loses revenues.

The second area I wanted to talk about briefly was psychological models of saving. Some economists now claim that psychological models are more useful than economic models in explaining how people save.

The basic argument is that saving is essentially a self-control problem, and in that framework IRAs are thought to raise saving

by giving an immediate tax benefit to people who would otherwise be very reluctant to put money into an IRA or 401(k).

Some other claims are that the heavy advertising that accompanied IRAs in the 1982-1986 period can raise saving by informing people of other opportunities for saving, or by giving them saving targets that helped convey information about how much they need to save.

I think these theories are intriguing, I think they merit further research, but I am concerned that some aspects of these theories are simply inconsistent with the data.

For example, as I mentioned before, the typical IRA contributor already has much higher non-IRA wealth and non- IRA saving than the typical non-contributor. To put that differently, somehow they seemed to have managed to solve their self-control problem without the need for IRAs.

So what that shows is that the typical household with IRAs does not need to have special incentives in order to save, and they are not unaware of the opportunities, or need, for saving.

A second claim is that IRAs can create a culture or ethic of saving, and that repeated contributions to these plans will help people save more. I would like to make two comments on that claim.

One, is again, despite all of the favorable tax policies, saving fell during the early- to mid-1980s. The second is, even by 1986 after 5 years of very visible advertising by brokerage companies about the opportunities and benefits of IRAs, only about five percent of the households in the bottom two-thirds of the income distribution made IRA contributions.

So if there is a culture of saving, it does not extend very far down in income distribution, and, as we know, it evaporated immediately when IRA deductibility was changed in 1987. So, had there really been a culture of saving, if a new ethic had been instilled in people, we would have expected saving to continue at a high rate.

The third point. What do we do about the saving rate? I think I am looking forward to Larry Kotlikoff's comments, because I think this is a very difficult problem to solve. The saving decline has occurred in many countries, in most age and income groups, over many years and for many reasons.

My reading of the evidence is, the decline is primarily related to trends like the liberalization of credit markets, the decline in wage and income growth, and increased transfers to the elderly.

My reading of the evidence is also that changes in tax policy have played a relatively minor role. To the extent that this is true, it will be very difficult to have a serious impact on savings through minor changes in the tax system.

So, first up on the list is deficit reduction. I think that is the surest way to raise national savings, with the obvious proviso that we should not reduce the deficit in a way that hurts private saving.

So, I think the obvious candidate there is Social Security reform, which could give you sort of a double payout, not only by reducing future government spending, but also by stimulating private saving.

A second reason to think about Social Security now in worrying about saving, even if Social Security is off the table for legislative reasons, is that sooner or later Social Security will have to be revis-

ited, and if the rest of the saving policy is developed with that in mind, the adjustments that are made later on with respect to Social Security might be easier to make.

In that light, I would like to focus on the private pension system. If we are going to raise the saving rate, one likely route would be through greatly expanding and simplifying the pension system.

Why do I like pensions but feel pessimistic about saving incentives? Pensions differ from savings incentives in two ways. First, participation is less optional, given one's job, and, second, pension balances are less liquid. For both of those reasons, pensions may provide bigger effects on savings than voluntary saving incentives.

There are a number of policy issues concerning pensions that could be usefully addressed. The over-funding limits were tightened in 1987, the non-discrimination rules were tightened in the mid-1980s, and, in particular, we need to find ways to enhance pension coverage, especially among low-income workers. Note that these workers currently have access to fully deductible IRAs, but do not tend to use them.

A related option would build on a paper I wrote about a year and a half ago with my then colleague Robert Litan. We discussed the idea of developing a mandatory universal pension system.

There are two great merits to this plan. One, is that it would raise the saving rate; the second, is that it would provide the ideal opportunity to start thinking about ways of reforming or integrating Social Security with private saving.

Let me stop at that point and say I would be happy to take any questions or comments.

The CHAIRMAN. I think, Doctor, we will do the rest of the panel and then we will take questions.

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

The CHAIRMAN. Dr. Kotlikoff?

STATEMENT OF DR. LAURENCE KOTLIKOFF, PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY

Dr. KOTLIKOFF. Thank you, Senator. Senators, I am honored by this opportunity to discuss with you the cause of, and remedy for, our critically low rate of national saving.

My testimony makes several points. First, the decline in net national saving, which has gone from something like 9.5 percent in the 1950s and 1960s to below 3.0 percent in the 1990s, is not due to a higher rate of government consumption, but rather to a higher rate of household consumption.

I want to stress the word "consumption" here because I think we have to really understand that the key to raising our National saving rate is by lowering our rate of household consumption. Any policy that we contemplate that does not lower our household consumption rate is not one that is going to raise our National saving rate.

The CHAIRMAN. Does that mean it would do us no good to lower the Federal deficit, which would be a Federal consumption?

Dr. KOTLIKOFF. Well, government consumption certainly could come down further, but government consumption—including Federal, State and local—is as small a fraction of net national product today as it has been at any time in the last 40 years.

So, I am not saying that there is not further room to cut; I hope you can and do. But the real story behind the increase in total consumption has to do with the increase in household consumption as a share of output.

Now, I have just completed a study with Jagadeesh Gokhale of the Cleveland Fed and John Sabelhaus of the Urban Institute, and we have tried to understand why the household consumption rate went up.

Basic economic theory says that households base their consumption on their resources. That is not just their current income or their current disposable income, but they look at their resources over an entire lifetime.

So, by that I mean their future labor income as well as the current labor income, their future Social Security benefits, their pension benefits they are going to receive, their other transfers, like Medicare and Medicaid, they may receive, as well as the taxes they are going to have to pay.

So, all these things together, when you form them in a present value, represent the resources of a household, and we have looked at how these resources have changed over time.

The government, of course, can influence the size of these resources by changing the tax and transfer system, and it certainly has in the last 40 years. We have been able to trace the increase in the household rate of consumption out of net national product to the four decade- long process by which we have been transferring from young and future generations to older generations, and we see in the data, first of all, an enormous increase in the relative consumption of older generations compared to young people as a result of this process.

We also see in the data a very substantial increase in the propensity of older generations to consume, and I think that has to do with the form in which older generations are receiving their resources, the fact that they are coming in the form of annuities which do not run out when you continue to live, which was not the case 40 years ago.

The other thing is, a lot of the resources the elderly are receiving now are coming in the form of in-kind consumption of medical goods and services through Medicare and Medicaid.

So, to give you one example, if you look at 70-year- olds relative to 30-year-olds, the ratio of their consumptions since 1960 has doubled, so the relative consumption of the elderly today is roughly twice what it was in the early 1960s.

Senator ROCKEFELLER. And the 30-year-old?

Dr. KOTLIKOFF. Yes. The 70-year-old's consumption relative to the 30-year-old is double what it was in 1960.

Senator ROCKEFELLER. The 30-year-old remained constant?

Dr. KOTLIKOFF. Well, not that they remained constant, but the ratio has risen dramatically.

You can see in Figure 1, which is two pages into the testimony, the relative consumption profiles back in the early 1960s based on a variety of sources of data, primarily the consumer expenditure surveys of the early 1960s.

You can see that the darker dotted line is the early 1960s, and the solid line is the late 1980s. There has been a quite dramatic

change in the shape of that relative consumption profile. That is also true when you look at nonmedical consumption. There has also been a dramatic increase in the nonmedical consumption of the elderly.

The CHAIRMAN. Can I just ask a question?

Dr. KOTLIKOFF. Yes.

The CHAIRMAN. On your Table 1, Saving and Spending Rates, what is Y, C, and G?

Dr. KOTLIKOFF. Y is net national product.

The CHAIRMAN. Yes.

Dr. KOTLIKOFF. C is household consumption.

The CHAIRMAN. Yes.

Dr. KOTLIKOFF. G is government consumption.

The CHAIRMAN. All right.

Dr. KOTLIKOFF. So you can see, the government consumption rate is basically where it was in the 1950s, and the household consumption rate has gone up quite dramatically.

The CHAIRMAN. Well, I apologize for interrupting, but I do not understand the chart. Total government spending, as a proportion of gross national product or gross domestic product, has gone up significantly as a percent of the gross domestic product between 1950 and now.

Dr. KOTLIKOFF. Yes. This is just purchases of goods and services.

The CHAIRMAN. Oh.

Dr. KOTLIKOFF. This is actual consumption of goods and services.

The CHAIRMAN. This does not count transfer payments then.

Dr. KOTLIKOFF. Right.

The CHAIRMAN. All right.

Dr. KOTLIKOFF. No. The transfer payments, in this analysis, are really showing up as raising C over Y, household consumption. This enormous process of transferring from younger generation to older ones has led to this increase in the relative consumption of the elderly.

And, if you look at Figure 3, you will see a very dramatic change in the relative age/resource profile, also a dramatic tilt toward the elderly. And this, again, if you trace it back, it turns out that it is very much due to our tax transfer system. And then Figure 4 is showing that the propensities of the elderly to consume have risen dramatically in recent years.

Senator ROCKEFELLER. Mr. Chairman?

The CHAIRMAN. Yes.

Senator ROCKEFELLER. I know I am out of order, but——

Mr. Chairman. No, that is fine. Go ahead. We have good time this morning.

Senator ROCKEFELLER. With the 70-year-old, what percentage of that increase is non-medical as opposed to medical?

Dr. KOTLIKOFF. Well, I would point you to Tables 3 and 4. Table 3, if you look at the middle row in that table, you will see the first number in the middle row is 0.71. And then you go to the far column, and it is 1.18. The 0.71 is ratio of a 70-year-old's consumption to a 30-year- old's consumption.

On average, the 70-year-old was consuming only 71 percent of what a 30-year-old was consuming in the early 1960s; by the late

1980s, the 70-year-old was consuming 18 percent more. That is total consumption.

Now, if you go to table 4 you look at nonmedical consumption. There you will see that the 70-year-old in the early 1960s was consuming nonmedical goods and services equalling 63 percent of the corresponding nonmedical consumption of 30-year-olds, and by the late 1980s it was 91 percent.

So, there has been a dramatic increase in the relative nonmedical consumption of the elderly as well, but not quite as dramatic as the total. So, roughly 40 percent of the increase in that ratio is due to the medical consumption.

Now, it is hard to see these kinds of numbers and not come up with the remedy. I do not think the remedy is all that mysterious. The key to raising our rate of national saving is to lower our rate of household consumption, and the key to lowering our rate of household consumption—or at least keeping it from rising because there is no reason our 2.7 or so net national saving rate cannot get lower and, indeed, go negative—or getting that saving rate to stabilize and then turn around is to limit the ongoing redistribution from the young to the old that is associated with the unchecked and extraordinarily high growth of Medicare and Medicaid expenditures.

If you look at the data for last year, my understanding is that Medicare grew at nine percent real; Medicaid, I am not quite sure what the last year numbers are, but I know the 1993-1994 number was 8.5 percent real. This is obviously a much higher rate than the economy is growing and somebody has to pay for that. The bill is really being left to the next generation.

Now, let me just make three other points. The IRAs and similar so called saving incentives are likely to raise, not lower, household consumption and lower, not raise, national saving.

This is doubly the case for proposals that would allow penalty-free early withdrawal of funds from IRAs for purposes of spending on consumption, namely education, medical care, and purchase of a house, all of which represent forms of consumption.

Now, the sixth point is—and this comes back to Senator Packwood's question—rather than tinker with this tax system through IRAs and similar devices that permit tax arbitrage, we should switch our tax structure to one involving the taxation of consumption.

So, I am a very big believer in a consumption tax, a very strong advocate of a consumption tax. I would prefer a progressive consumption tax. I like the Nunn-Domenici proposal somewhat more than some of the other proposals. Each of these proposals has some degree of progressivity in it. It is just an issue of whether the rates at the upper end of consumption rise.

The CHAIRMAN. You know, Congressman Armey has tried a flat tax and then has high personal exemptions, so he says he exempts families of four of $38,000 or under. But do you count a flat tax, properly structured, as a tax on consumption, or not?

Dr. KOTLIKOFF. Yes. The tax base is essentially consumption, with a VAT, a flat tax. The Nunn-Domenici proposal has other variants. My own favorite would be that we would have an ATM card tax. Basically, all of your consumption purchases you would

have to do with an ATM card, and the government would automatically see your monthly consumption total and it could tax that on a progressive basis and have an automatic withdrawal from your account.

The CHAIRMAN. You know, that is fascinating. I know, Pat will remember this. The last witness we had in 1986 was a young lawyer from Pittsburgh who talked about an electronic funds transactions tax, which sounds like what you are talking about.

Dr. KOTLIKOFF. Yes. There would be no forms involved at all under this tax.

The CHAIRMAN. It is a very low percentage, because the transactions get taxed 5-10 times. If you go to the gas station and buy gas with your credit cards and there is a one-tenth of 1 percent tax, and then the service station transfers it to the bank, and there is another tax, and the bank transfers it to the fed, and there is another tax, and on it goes.

Dr. KOTLIKOFF. Well, I am not advocating that, I am advocating that at the end of the month all of your purchases of goods, your consumption—not other kinds of purchases but your consumption purchases—be totaled up automatically and the government would not know the composition of those purchases, just the total, and it would assess the tax on a progressive basis.

It seems to me to get to what Nunn-Domenici will have in mind in a much simpler manner. The Nunn-Domenici proposal has some big problems with respect to people taking assets and the start-up of that system has some big evasion problems we can talk about.

Now, a consumption tax, whether it would be proportional and progressive, combines the appropriate income and substitution effects that are needed to reduce household consumption. It also places a somewhat higher tax burden on older Americans. In doing so, it would offset this ongoing redistribution I mentioned that is going through our Social Security, Medicare, and Medicaid programs.

The last point—and this really connects to something I think Senator Moynihan holds dear to his heart—has to do with informing the American public about their Social Security. I know that Social Security is going to be sending out statements.

Senator MOYNIHAN. May be.

Dr. KOTLIKOFF. Yes. May be. Oh. I thought it was definite.

Senator MOYNIHAN. It is in law.

Dr. KOTLIKOFF. I see.

Senator MOYNIHAN. But that does not necessarily follow.

Dr. KOTLIKOFF. My last idea here would be that, in addition to that statement, there should be a letter coming from perhaps the Senate Finance Committee, or, even better, from the President, suggesting to each American household, here is how much Social Security is doing for you, and here is how much we in the government think you need to do on your own in conjunction with your employer to really give people a wake-up call.

Senator MOYNIHAN. I think that is a wonderful idea. Senator Packwood will send every American a letter on how much to save next month. I think that is great.

Dr. KOTLIKOFF. That concludes my testimony.

The CHAIRMAN. Doctor, thank you very much.

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

The CHAIRMAN. Now we have Dr. Skinner, who has appeared before us before on this very subject and is convinced that the incentives for IRAs and 401(k)s work.

STATEMENT OF DR. JONATHAN SKINNER, PROFESSOR OF ECONOMICS, UNIVERSITY OF VIRGINIA, AND RESEARCH ASSOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH

Dr. SKINNER. Thank you. I am pleased to discuss the evidence about savings incentives and their potential to increase saving. In my discussion I will draw on a recent survey with Glen Hubbard of Columbia University that reviewed this evidence.

I want to focus today on three questions related to savings incentives. First, do they have the potential to increase personal saving; second, are they effective at increasing saving; and, finally, what is the best way to design a saving program?

The first question is, do savings incentives have the potential to increase aggregate personal savings? I think the answer is yes, but not by much. In 1993, IRAs, KEOGHs and 401(k) plans were about $79 billion, or more than 40 percent of personal saving in that year. But since personal saving was only four percent of disposal income, savings incentive programs add up to less than 2 percent of disposable income.

Restoring IRAs alone is not likely to increase personal saving by the 8 percentage points necessary to approach saving rates in Japan or Germany. A more attainable goal for savings incentives is to improve households' financial resources at retirement.

Just a few years of IRA or 401(k) contributions can have a large impact on the financial security of the average American household by providing a cushion against unforeseen medical expenses or other contingencies. Thus, savings incentives should be judged on more than by how much they raise the national savings rate.

Now, the second question is, are these savings incentives effective at increasing savings? Now, it is important to distinguish between the short-run effects, about which we have the most evidence, and the long-run effects.

The reason why it is important is because with short-run effects there is more potential for shuffling, for taking existing assets and tossing them into your IRA or, effectively, into your 401(k), whereas, in the long-run, the shuffling possibilities are much diminished at the margin because you have already done all of the shuffling that you can possibly do.

Now, many researchers agree that in the long run savings incentives can increase saving. For example, Dr. Gale and others used a stylized, and, as they say, speculative theoretical model that shows IRAs will increase national wealth by $4 for every $1 lost in tax revenue, and a universal 401(k) will increase national wealth by $16 for every $1 lost in tax revenues.

The CHAIRMAN. Say that again, those two.

Dr. SKINNER. In other words, the idea is, what do you get in terms of national savings per dollar of revenue that you give up? There are a number of important caveats, but the numbers that come out of their model is that national wealth rises by $4 for

every $1 loss in revenue for IRAs, and it rises by $16 for every $1 loss in revenue for 401(k)s.

The two most important caveats are that the aggregate savings effects of IRAs are still very small—they are estimated at something like a quarter or a third of one percent of GDP, although the 401(k) estimates are somewhat larger—and second of all, their long-term effects do not come for at least 50 years—so you have to be patient to wait for these, in their view—although, for a number of reasons, I think the long-term effects will come quite sooner.

Now, let me, next, consider the evidence on short-term savings effects of IRAs. Researchers remain divided on whether they increase saving in the short-term. The difficulty is that people who are most likely to purchase IRAs are also systematically different from non-contributors. They have higher incomes and, on average, they have a greater tendency to save.

Figuring out what part of their actual saving is simply due to differences in tastes and what part is due to the availability of the IRA is an extremely difficult task which has been addressed by a number of researchers, with often opposing conclusions.

I find most compelling the evidence on psychological effects of IRAs. The key word here is discipline. As Richard Thaler of Cornell University has stressed, we see many mechanisms by which people commit to saving for the future, even if they appear, in retrospect, to be irrational. By putting money aside in an IRA, even if shuffled from taxable assets in the short-term, the household sets aside wealth that is difficult to spend without substantial tax penalties.

I think that one key element in the popularity of IRAs was the ability to get the up-front deduction actually in the year after your tax year. Let me explain. Forty-one percent of IRA contributors in 1984 were actually made in the 1985 calendar year, probably as April 15th drew closer. So, clearly, these IRA contributors, while Dr. Gale may argue that they can take care of themselves, do have a problem with procrastination.

On April 15th, taxpayers would rather deposit money into their IRA and get the up-front deduction than write a check to the IRS. Once deposited in the IRA, the money is no longer so easy to spend on houses, cars, vacations, or other consumption items. Encouraging households to discipline themselves, to set aside money for retirement rather than to spend it, should be a primary goal of any savings incentive.

One final comment on front-loaded versus back-loaded IRAs. While the up-front revenue costs of front-loaded IRAs make them appear costly, the overall revenue costs are similar to back-loaded IRAs. The difference is, the revenue is just collected later.

One positive legacy of the IRA program in the 1980's is the large pool of taxable assets in IRA accounts, nearly $1 trillion, which includes 401(k) rollovers. At an average 25 percent tax rate, these IRA assets represent more than $250 billion in future tax revenue.

Next, let me briefly evaluate the short-term evidence on 401(k)s. I find that evidence more compelling for two reasons. First, I believe that money withdrawn directly from the paycheck, as in a 401(k) program, is a surer way to save than having to cough up the cash for an IRA.

Second, researchers can better test whether 401(k) programs affect saving because they can compare the overall saving rate of workers at firms that offer 401(k)s with the overall saving rate of workers at firms that do not offer 401(k)s.

It is less likely that workers at these two firms differ systematically in their taste for saving, and the evidence suggests a very strong correlation between 401(k) eligibility and saving.

The final question is, what is the best way to design a saving incentive? This is the toughest question. Let me make three points. First, the percentage of taxpaying households who contributed to an IRA was about 15 percent, even in the heydays of the mid-1980's.

The percentage of eligible workers who contributed to a salary reduction or 401(k) plan was 67 percent in 1993. Among eligible workers with salaries between $15,000-20,000, the 401(k) contribution rate in 1993 was 55 percent, substantially higher than IRA contribution rates. So 401(k) programs have the potential to reach a much broader group of households than do IRAs.

Second, there is some concern that 401(k) plans do not provide adequately for retirement. My research with Andrew Samwick of Dartmouth College suggests that the typical 401(k) plan provides better retirement benefits than the typical defined benefit plan, even when the 401(k) is subject to overly conservative investment practices or swings in equity prices.

And, while some 401(k) enrollees do spend their accumulated assets when they change jobs, they are not necessarily worse off than if they had been covered by defined benefit pension plans.

Under defined benefit pension plans, if you leave your job early the benefits largely revert to the employer, whereas, at least with 401(k)s, the employee gets to spend the money. Furthermore, the Treasury gains when workers cash out their 401(k)s and incur the substantial tax penalties.

Now, one policy change that could enhance savings behavior is to institute a mandatory rollover into an IRA account of 50 percent of your 401(k) balance, so you have to put half of your 401(k) balance into an IRA account when you change jobs. The revenue cost from this provision is likely to be very small.

The third point is, roughly half of all workers, and 40 percent of full-time workers, cannot contribute to any pension plan. Expanding the coverage of 401(k) plans can enhance the retirement security of these workers, many of whom are in low-wage jobs and who are unlikely to be saving adequately for retirement.

In principle, this coverage need not cost employers anything if they provide a simple, bare-bones salary reduction plan without matching contributions. One possible objective of a broad-based saving strategy would be to encourage financial institutions to offer 401(k) plans for small firms, and to encourage employers in smaller firms to institute 401(k) plans.

One concrete proposal suggested elsewhere is to exempt from discrimination rules firms that contribute at least three percent of income for each employee into a 401(k) plan.

To summarize, I believe there would be large gains to expanding savings incentives to improve the financial security of American

households. I suggest, in particular, a sharper focus on the nearly 50 million workers without any pension coverage. Thank you.

The CHAIRMAN. Doctor, thank you.

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

The CHAIRMAN. Dr. Wise?

STATEMENT OF DR. DAVID WISE, DIRECTOR OF HEALTH AND RETIREMENT PROGRAMS, NATIONAL BUREAU OF ECONOMIC RESEARCH, AND STAMBAUGH PROFESSOR OF POLITICAL ECONOMY, HARVARD UNIVERSITY

Dr. WISE. Thank you for inviting me to testify.

First, I want to emphasize that the cost of low saving is not only limited economic growth, which is typically what economist emphasize, but there is a personal cost as well. I think the following numbers demonstrate that.

Consider the median personal financial assets held by families on the eve of retirement: Counting IRA and 401(k) assets, the median is about $8,000. Excluding IRAs and 401(k), it is about $3,000. So, a large proportion of American families face the prospect of having very limited resources to meet any contingencies at all after retirement.

With Steven Venti and Jim Poterba, I have, for several years, been doing research on the savings effect of IRA and 401(k) plans. In my judgment, the weight of the evidence points to a substantial saving effect of these plans. That is, in my view, most of the resources that go into these plans have not come at the expense of other savings.

I would like to do two things: first, I would like to bring to your attention some of the evidence that convinces me that these plans, in fact, do work, and then I would like to say a few things about why I think they work.

A few findings: First of all, contributions to these plans at the outset of the program were very large relative to the assets of the people who were making the contributions. For example, early on in the IRA program the median level of financial assets of people making contributions was about $8,000; the typical family contribution was about $2,300.

These are people, on average, are about 49 or 50 years old. I think it is pretty clear that if your assets at that time were $8,000, you had not been saving $2,300 per year for very long.

The same sorts of numbers apply to 401(k)s. If one asks, what was the median level of financial assets of people who became eligible for a 401(k), that number was about $3,700.

The typical contribution of people who became eligible was about $1,200. Again, I think it is pretty clear that these people had not been saving at that rate, at least not for very long.

Senator MOYNIHAN. Could I ask you, Dr. Wise, you are speaking of personal financial assets. That does not include a home?

Dr. WISE. It does not include a home. And I realize that I am doing that. While in the long-run, of course, one could, I suppose, substitute housing assets for IRAs or 401(k) and any other assets, in the short-run, people are unlikely to sell a room in order to fund an IRA or to put money in a 401(k).

To me, the most compelling single piece of evidence is the following. Suppose that you consider the financial assets of families who reached retirement age (60 to 64) in 1991. These families at the mean, had financial assets of about $39,000.

Compare that $39,000 to the assets of families who reached retirement age in 1984. That is, 7 years earlier. Those people had assets, at the mean, of about $32,000.

What accounts for the $8,000 difference? The people who reached retirement age later had had more years during which they could contribute to 401(k) and IRA assets. Indeed, the entire difference in the assets of these groups is due to contributions to IRAs and 401(k)s. There is virtually no difference in the other financial assets of these families. For people who, in fact, contributed to these plans, the difference is really very substantial, about $15,000 at the mean.

That sort of comparison can be made for all age groups. For example, one can ask for the difference in the financial assets of 45-year-olds who got to be 45 in 1991 versus those who got to be 45 earlier, in 1984. Across the board, you find that the data look like the data that I have just described.

Let me then mention a third piece of evidence that I find compelling. Dr. Skinner, in fact, just mentioned it. One can compare the assets of people who became eligible for 401(k) plans with the assets of people who did not become eligible.

Now, of course, there could be differences between these two groups, but it turns out that if one controls for income—that is, one considers families with comparable income—in 1984, at the outset of the 401(k) program, the financial assets of these two groups were essentially identical. By 1991, the assets of these two groups were very different, with those who were eligible having substantially more in assets.

Finally, let me mention just one more piece of evidence that I also find compelling. One way to solve this problem of, who should you compare, that is, trying to get people who are "alike," is to compare the same people over time. Today I am probably a lot like I was a year ago, or even 5 years ago. And if I have some saving propensity now I probably had it a year ago.

If you tracked people over time and observe their saving and then observe the change in their saving when they begin to contribute to an IRA, you notice some fall in other saving, but the fall is very small. The decline in other saving is on the order of $200-300, whereas the typical family IRA contribution at that time was about $2,300.

So, in short, I think that there is substantial evidence that a very important part of what went into 401(k) and IRA plans was, indeed, an addition to saving.

Why did they work? I want to mention three things. One, is promotion, the other is the up-front deduction, and the third, is payroll deduction. You will notice that these seem to be on the psychological side. It is not that I do not think that interest rates matter—which economists would emphasize—but I think the rate of return does not explain why these things have the effect that they do.

First, the promotion: I believe that promotion had a great deal to do with contributions to IRAs. What is the evidence for that? After the 1986 tax legislation, contributions to IRAs fell by about 75 percent. Only about 25 percent of contributions were, in fact, affected by the legislation at all. Some people may have misunderstood the legislation, but another thing that happened was that the promotion by financial institutions fell off dramatically.

In parentheses, I should add here that Canada has a plan like a souped up IRA called the Registered Retirement Saving Plan. The saving rate in Canada now is about twice as high as it is in the United States.

Most of that difference can be accounted for by saving through this Registered Retirement Saving program. Indeed, in Canada, saving through that program alone is essentially as high as personal saving in the United States.

In Canada each tax filer each year receives a letter from the Minister of National Revenue advising the tax filer as to how much money can be put into a Registered Retirement Saving Plan that year. It seems to me that this surely serves to promote the program.

What about the up-front deduction? After the 1986 tax legislation, families who lost the up-front deduction essentially quit contributing altogether, even though, more or less, half of the tax advantage remained. That leads me to think that the up-front deduction is important in getting people's attention, and if you took it away it would probably matter.

Finally, payroll deduction: Again, John Skinner just mentioned this issue. Among people who are eligible for a 401(k) plan, the contribution rate is about 65 percent. Even for low-wage earners and young workers, the contribution rate is at least 50 percent. That is substantially higher than the IRA contribution rate ever was.

I think, in large part, this is attributable to the fact that the contributions are by payroll deduction, and in some sense it is out of sight, out of mind. If they take it before I see it, I am less likely to want to spend it.

Thank you.

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

The CHAIRMAN. It is interesting as I listen to you, how consistent the factual information is, forget the interpretation. Again, when we were doing the Tax Reform Act, I was fascinated to discover the much lower incidence in terms of income groups of savings in 401(k) than IRAs.

It is obvious, it is a payroll deduction and the employer had to have some non-discrimination provisions and he had to make sure the janitors were in this as well as his executives, and it seemed to work.

The other interesting thing was, after about $125,000, as I recall, IRAs were not a particularly great factor in savings. It was not enough for people in upper income groups, they needed a different way of saving, or greater way of saving.

Let me ask each of you this. If we were to go the tax incentive route and we had to make a choice between 401(k) and IRAs, which way we would we go? And I will start with Dr. Gale.

Dr. GALE. I think the 401(k) would be a preferable option, mainly because you could expand it more strongly toward lower income workers. It would also be easier to either strongly encourage low-income workers, or actually force low-income workers to save.

And, for all the reasons I talked about, integrating with Social Security, possibly, in the future, sort of establishing a pension plan for every worker would be a better route to go than the voluntary route through IRAs.

The CHAIRMAN. Dr. Kotlikoff?

Dr. KOTLIKOFF. I guess I also like the 401(k) option better than the IRAs because I like the idea of automatic deductions from your payroll. I think there is a psychological factor, I will agree with my colleagues here. Getting people to make a decision once and then to stick with it is a good idea.

The CHAIRMAN. You have the added advantage of the employer being a promoter of the 401(k).

Dr. KOTLIKOFF. Absolutely.

The CHAIRMAN. Dr. Skinner?

Dr. SKINNER. I think this may be a sweep here. I would probably pick the 401(k)s. The only suggestion would be to include some provision to make 401(k)s slightly more flexible. For example, picking up on this sudden urge on April 15th to save might be useful.

The CHAIRMAN. Dr. Wise?

Dr. WISE. Well, you can judge from what I just said, I would go with a 401(k). I think that I might try to combine that one way or another with some procedure that tends to advertise, and not just by financial institutions, by possibly by the government; that is, it is possible to do these things, and then hope that no one takes them up so there will not be a revenue cost in the short-run. But I think if one were to really push this, that it would be possible to expand the use of them and I think that would have a dramatic effect.

The CHAIRMAN. I have a second question. If our goal is to increase national savings, are we better off to go the tax incentive route—401(k) in preference to IRAs; maybe there is a better tax incentive route than 401(k)s—or are we better off to go to some form of consumption tax? I will start with Dr. Wise this time and move the other direction.

Dr. WISE. Well, in some sense you could think of an IRA in the sky or a 401(k) with no limits as going a long ways toward a consumption tax, but I think I would agree with my colleague that if it were possible to go to a consumption tax, that would, in some sense, solve this issue, at least in some part.

The CHAIRMAN. Of net national savings.

Dr. WISE. Yes. It still may not do what, for example, a payroll deduction does, but I suppose that one could combine these things and solve the problem.

The CHAIRMAN. Dr. Skinner?

Dr. SKINNER. Yes. As an economist I am very much in favor of a consumption tax, although looking at the transition rules is what gives me pause sometimes. In other words, getting to a consumption tax from where we are now without excessively double taxing people who have paid taxes on all of their previous saving, and then when they take it out they get taxed again.

I would also urge, bringing up something that Dr. Gale said, looking at credit issues.

The CHAIRMAN. Looking at what?

Dr. SKINNER. The issue is trying to do something about increases in borrowing. There have been some studies that suggested in countries where borrowing is not so easy, that savings rates are substantially higher, and Germany and Japan are two examples.

The CHAIRMAN. That seems almost a logical corollary. It does not strike me as unusual at all. If you have difficulty borrowing, if the down payment on a house is 25 percent instead of 10 percent, you are likely to save more if you cannot get a house for 10 percent down, are you not?

Dr. SKINNER. Well, that seems to be the evidence. Yes.

The CHAIRMAN. Dr. Kotlikoff?

Dr. KOTLIKOFF. Yes. I think we definitely need a consumption tax. The key, again, is restricting consumption. I think that when you bribe people to save—and that is really what the IRA and 401(k) forms are—the bribe itself will allow them to consume more.

If you think about the Nunn-Domenici consumption tax, if it were implemented correctly, people would have to register their initial holdings of assets and if they then tried to transfer them from one account to another, they would not get a tax deduction.

Whereas, with IRAs and 401(k)s, let us say you made an unlimited IRA, what you allow is this ability to tax arbitrage, to take the $20 trillion that people have in assets in this country and just move them into these IRAs and then take the deduction. So the start-up issue is quite different.

In other words, IRAs do afford consumption tax treatment of saving, but the initial deduction is quite different under an unlimited IRA versus a Nunn-Domenici type bill.

The CHAIRMAN. Dr. Gale.

Dr. GALE. Thank you. If the criteria is just saving, I would strongly prefer the consumption tax over an enhanced saving incentive, but I guess I feel the need to mention, too, that moving to a consumption tax is a major overhaul of what might be called one-seventh of the economy, if that phrase sounds familiar. I think it will raise all the political issues and problems and other issues that health care did. So, I do not think the only issue concerning a consumption tax is the saving effect.

The CHAIRMAN. The order of questioning today is in this order. Senators Moynihan, Rockefeller, Graham, D'Amato, and Pryor.

Senator Moynihan?

Senator MOYNIHAN. Thank you, Mr. Chairman. This was wonderfully clarifying testimony as regards the severity of the crisis.

Mr. Chairman, it is a form of mental laziness, but I do welcome the psychological component here. Dr. Gale, you began by speaking of scholars who argue that self-control is the heart of the saving problem. Dr. Wise, you ended your last sentence by giving ranges that might provide self-control.

There is an ethic involved here, and it changes from place to place and time to time, and is future-oriented and present-oriented. The savings bank phenomenon in the United States is an ethical, not institutional arrangement. To this day, about half of our savings banks are non-profit.

You can pretty much estimate—tell me if I am wrong—the extent of the wage system in pre-war United States by the reach of the savings banks, where typically a Methodist or Presbyterian minister would start them up; the names in New York City tell you, Immigrants Savings Bank, Seamen's Bank for Savings, things like that. To forego consumption is a future orientedness which I see in the British Postal Savings system, which the Victorians latched onto right away.

What was it said? I guess it was you, Dr. Kotlikoff, that we had a 9 percent savings rate in the 1950's and we are down to 3 percent today.

Dr. KOTLIKOFF. Yes. Slightly higher in the 1950's, and slightly lower today. I have the latest numbers for 1994, but in 1993 the national saving rate was 2.7 percent.

Senator MOYNIHAN. Where are we? You are reading from your tables, I think.

Dr. KOTLIKOFF. Right. If I look at Table 1 on page 11.

Senator MOYNIHAN. Yes. Oh. The net national savings rate went from 9.1 percent to 2.4 percent.

Dr. KOTLIKOFF. Yes.

Senator MOYNIHAN. Right next to that, however, you have something that Senator Packwood picked up that got me, that the government spending rate has not changed, it is as low as it was in the 1950's. Does the group agree with that? That is the spending rate which is procurement, the highways, bombers, and dams. So actual government spending is about what it has been. Transfer is another thing.

Dr. KOTLIKOFF. Yes.

Senator MOYNIHAN. Transfer is what we will call Social Security, Medicare.

Dr. GALE. Social Security and Medicare can account for all of the increase in total government spending since about the mid-1950's.

Senator MOYNIHAN. But they are self-financed. Those programs are still in surplus.

Dr. GALE. Right. On an annual basis, the Social Security/Medicare revenues have pretty closely approximated the outlays. If you look at the rest of the budget, what has happened is the general operating budget has stayed pretty constant as a percentage of output.

Senator MOYNIHAN. General.

Dr. GALE. And general spending.

Senator MOYNIHAN. That is the government spending rate.

Dr. GALE. Right. And general tax revenues have plummeted.

Senator MOYNIHAN. So government spending, in that sense, is not out of control.

Dr. GALE. Other than on the elderly.

Senator MOYNIHAN. Well, no. Sir?

Dr. KOTLIKOFF. First of all, I wanted to mention that these numbers are from the National Income and Product Accounts.

Senator MOYNIHAN. Yes.

Dr. KOTLIKOFF. On the point of whether this is just an issue of psychology, I do not think it is primarily an issue of psychology, I think it is primarily a problem of the government being out of control rather than the private sector being out of control.

If you look at Figure 4 in the testimony, you will see the propensities of different generations to consume. Younger and middle aged people, who have been accused, really, I think unfairly, of having a consumption ethic, have actually not risen; if anything, they are slightly lower than they were in the early 1960's.

The real change in behavior in terms of consumption propensities is of people basically over age 75. I want to emphasize that the real reason that our consumption rate has increased and our saving rate has declined is not so much a change in propensities to consume. What we have really done is increased the resources of older generations as well as some middle aged and younger generations, and left a big tax bill for future generations to pay.

So, if you look at the ratio of the resources that people have in present value—and that includes all of the transfer benefits that they are expected to receive—if you look at the resources of Americans relative to the net national product, that ratio has gone up significantly since the early 1960's.

So this whole process of intergenerational redistribution is really the fundamental reason that our national saving rate is so low, and unless you folks stop that, and it is ongoing year after year, this thing is going to get worse.

Senator MOYNIHAN. Well, that is spoken like a Boston University professor. If you had gone to Yale, you would have viewed William Graham Sumner's epic observation that state ways do not change folk ways. It echoes down from a century ago. We will see. I guess my time is up.

The CHAIRMAN. Dr. Wise, you had a comment?

Dr. WISE. Could I just add a little bit here? This is not to dispute what Dr. Kotlikoff just said, but I think it is important to emphasize that there is more at work than this. Japan, for example, has a Social Security system that is more generous than ours, also unfunded; has a pension system that is more generous than ours.

In other words, there are huge transfers to the older generation. Their saving rate, of course, is three or four times as high as it is here. That, I think, can only be explained by different tastes, or propensities, or whatever you want to call them, which makes me think that there is some potential for changing our way of thinking about that.

The CHAIRMAN. But they live in itsy-bitsy houses, all packed together. I mean, there is a different form of consumption; maybe wise, maybe not, but it is in a different form.

Senator Rockefeller?

Senator ROCKEFELLER. Thank you, Mr. Chairman. This is a great hearing.

First of all, I second, Senator Packwood, what you said on Japan. Their savings rate is much ballyhooed. It is enforced by lack of alternatives. They simply do not have things on which to spend money. That is one of the reasons they now have a Socialist prime minister, people are getting tired. They want to be able to consume some more.

They also have this rather odd problem that they are aging at twice the rate of the United States of America and they have an absolutely gigantic problem to face, which they have come up with no solution for.

I came to this hearing prepared to pursue questions about IRAs, to a certain extent. One of the questions I was going to ask was, if one of them cost $25 billion, how are we going to pay for it?

Well, that question now strikes me as irrelevant to the extent that you said—you three did not, but you did, Dr. Kotlikoff—said that the Federal deficit—I mean, this is a very strong statement and a very interesting one—is not the main problem when it comes to our low savings rate.

But if the four of you sort of agree with that, and that people are the problem, however you define psychology, the question is, how do you get people to save? If that is the larger part of the problem, how do we overcome this? In other words, do you have to do it with policy?

Now, if, as we hear these days, you have to keep changing jobs, it is not clear to me—and I hope one of you will clear that up for me—as you change jobs, what happens to the 401(k)? Does that continue, or with legislation could it continue?

When Reagan became President he cut corporate taxes, he cut income taxes. He cut income taxes because he said people will choose, as a result, to save more. He cut corporate taxes because he said corporations will decide, as a result, to invest more. Neither happened. We consume more, we invested less, we saw more mergers and acquisitions, and the rest of that, and the consumption binge happened. So that human behavior is hard to control, and it has been proven.

Now, it is generally understood in the land that we are in trouble as a Nation financially, that we have got to somehow reduce our expenditures on all fronts, and you are saying even more so on the individual front.

So then let me come to the 401(k). Tell me again why that is better. I know one reason, that is that it is simply deducted, it is used generally for retirement.

Can there be withdrawals from 401(k)s for other purposes other than retirement? Is there a penalty for withdrawal, or, if there is not, could there be a penalty for withdrawal?

Or, on the other hand, is saving for retirement the kind of saving that you want to do in that you have indicated that spending for the elderly is the spending that is going up the fastest, and only 40 percent of it is medical and 60 percent of it is non-medical?

And I do not know what the non-medical part would be because it would seem to me, as one gets 70 and beyond, there are less options except traveling. There are less assets that you need, there are less pieces of equipment that you want; you have accumulated them or you are past the point where you want to.

So, discuss the efficacy of 401(k)s for me in terms of how they would discipline national behavior, not leaving it up to the choice of Americans, and then argue to me if you think it is wrong because we have not shown in the past that we can change our behavior. Now, I have said too much. Please answer.

Dr. KOTLIKOFF. Could I respond, Senator Rockefeller, to the issue about the deficit not being the problem? I do not want to give a misleading impression of what I had in mind here. But I think that the deficit does not really summarize our true fiscal policy.

Senator ROCKEFELLER. I know. And do not apologize for it. We all put it in context. We all understand that it is still an enormous problem and it is a problem that we are responsible for. So you are not throwing us out of whack.

Dr. KOTLIKOFF. Let me just try and clarify how a pay-as-you-go system of transferring from young to the old can lower national saving. What that does is, if you start out with an economy with no pay-as-you-go programs and you take and you start up with, let us say, large benefits, they go right over to old people, they come from young people and middle aged people.

The middle-aged people realize that they are also going to get more in present value than they contribute because they are close to retirement. Younger people realize they are going to get less than present value because they could have otherwise invested their money in the market and gotten a much higher rate of return than the population growth rate and productivity, which is much lower.

So what you have here is that the existing generations, as a group, collectively have resources in present value that go up relative to the size of output, and people are consuming at not just their current income. Nobody is living hand-to-mouth, in general, in this country. They are looking into the future and considering all of their lifetime resources.

So when you run these pay-as-you-go programs, even if they do not show up in the deficit, you have a very big expansion of the resources of the existing generations relative to output. That stimulates consumption, and you get consumption relative to output going up, and you get national saving going down.

So, we can tinker around with IRAs and 401(k)s, but unless we put a halt to this redistribution from young to old, it is ongoing, it is growing, and we are going to get into worse shape.

I favor 401(k)s because I think that psychology is not everything it should be in this country, even though I do not think behaviors fundamentally change that much, from this diagram. I think that certainly the saving ethic can be improved upon, and I think 401(k)s will get people to have it happen automatically. That is why I think it is a better option.

Senator ROCKEFELLER. I apologize to the Chairman. But can you withdraw from it at any point up to your retirement, number one? And number two, if you change jobs—which we are told we are going to be doing constantly in the future—what happens to the constancy of 401(k)?

Dr. KOTLIKOFF. Well, are you asking a question about what the actual law is now, or are you asking a question about what I think it should be?

Senator ROCKEFELLER. Of what it is now.

Dr. KOTLIKOFF. What it is now.

Dr. GALE. It varies by plan. If you quit the job and you take the money with you, you can take it out with a penalty. Other plans have financial hardship provisions, things like that, so even if you do not leave your job you can take the money out in the case of a demonstrated financial hardship. But every plan is different.

Dr. KOTLIKOFF. Maybe David wants to speak to that. You are probably expert.

Dr. WISE. Yes. First of all, there is a traditional incentive effect in the 401(k), that is, the up-front tax deduction. But, in addition to that, in many firms there is a matching rate, which probably matters.

Still, even if there is no matching rate, the participation rate is very high, even among low-income people. I think, as I say, that that is due, in large part, to the payroll deduction feature of that plan. The money does go with a person. That is, a 401(k) is a personal account, it is my account. So if I change jobs, that account is still there.

The way the system operates now, if I leave one employer and go to another I would essentially have to start a new 401(k), but surely one could arrange this so you did not have to do that, you just had your personal account and you could go to another employer and put money in that same account. That does not seem to me to be difficult.

Senator ROCKEFELLER. Dr. Wise, let me come back to you. The Chairman is indicating my time is long past. Thank you, sir. It is my fault.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Continuing the discussion about the elderly. Is this phenomenon of the consumption pattern of the elderly a new phenomenon? It would seem to me it would be an inherent quality of one growing older that once they were relieved of some of the responsibilities and as they began to see the end of life approaching, that they might have a tendency to increase their consumption on those things that they had deferred earlier in their life. What degree is this a folk way, and to what degree is this a state way?

Dr. KOTLIKOFF. Well, I am not quite sure exactly what the distinction is in this context. But if you look at Figure 4, we see that there has been a change over time in behavior, so maybe this is a change in folk way, but I think it is connected to state way, too.

The elderly have more resources because of these transfers, as I mentioned, but, also, out of every dollar of those resources and present value that they have they are consuming a much larger fraction.

You have to ask yourself, why is that? Well, it could be the break-up of the family, they are less concerned about leaving bequests to their kids, it could be some change in actual psychology.

But I think what is probably behind it is the form in which they are getting their resources. If you go back to 1960, people over 75 had most of their resources in the form of net wealth.

Now a much larger fraction of their resources are coming in the form of annuities, private pension annuities, Social Security, Medicare, Medicaid. These are all annuities.

In the case of Medicare and Medicaid, they are in-kind consumption annuities, so people do not have to worry about running out of money, and, as a result, they are free to consume at a higher rate.

So, I think that is probably the number one explanation. That is really, in large part, the government's doing. The government has annuitized the elderly, in terms of their resources. There are some pluses to that because they do not have to worry about running

out. There is really a form of annuity insurance here, but I think it has had the undesirable side effect of raising their consumption behavior.

Senator GRAHAM. We have talked today about a significant structural change in the Tax Code from its current posture to one that would tax consumption, and we talked about some specific incentives that are in the current Tax Code. What is the degree to which policies that redistribute income across classes, either upward or downward, affect saving rates.

The CHAIRMAN. Bob, could you ask that question again? I want to make sure I understand it. I think it is very significant, but ask it once more so I can get it.

Senator GRAHAM. Well, the question is, to what degree do policies that, for instance, increase the overall percentage of national wealth that is held by highest income Americans, or, conversely, those that might increase the percentage of wealth held by middle- or lower-income Americans, what affect do those redistributional patterns have on individual savings rates. Would America save, collectively, more if a higher percentage of income were in one income class as opposed to the other?

Dr. SKINNER. I will give that a try. The evidence appears to be that there has been an increasing income inequality during the 1980's and I would have expected to observe a higher savings rate just because higher income people tend to save a larger fraction of their income, but this did not seem to be borne out.

One issue which I think is also important, not on the tax side but on the expenditure side, are asset-based means testing of programs like Medicaid.

When somebody is getting old and thinking about retiring and thinking about saving for, say, nursing home expenditures, there is effectively a 100 percent tax on assets because should you do the right thing and save a lot for retirement, and should you get sick and go to a nursing home, which is effectively not covered by any form of insurance except Medicaid, essentially all that saving buys you is that you remain a private pay patient for three months longer than you would have otherwise, so it is effectively taxed 100 percent by the Medicaid rules, which have very restrictive asset limits.

I think that is an important issue, not just for people who actually become eligible for Medicaid, but for people who have some chance at some point, or might think that they might some day need to go into a nursing home, the incentives to save for these sorts of things are just much less because of the structure of the welfare system.

Senator GRAHAM. Dr. Wise?

Dr. WISE. I do not know, Senator Graham, if this is directly responsive, but maybe it helps. At least it helps me in thinking about these things. There is a tendency to think that people with more money save more, and, indeed, they do, as a proportion of income. But it is also, I think, important to keep in mind that even people who have relatively high incomes in the United States do not save very much.

As an example, consider people earning $50,000–75,000, which is not wealthy but a substantial income, and are, say, 50 years old, well, those people have about $11,000 in financial assets.

So, when we are talking about any of these saving issues, while I think it is important that all people save more, we do not want to think that people who have a reasonable amount of money are saving a lot. They are not.

We need to get people who have enough money to save a lot to save much more than we do. That is, the incentives need to go, not just to the bottom part of the distribution, but well up into the distribution.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

I find it very interesting that everyone agrees that 401(k)s would seem preferable to the IRAs. Dr. Wise, would you not have to agree, everybody does not have an opportunity for a 401(k), it depends upon the employer. Is that not true?

Dr. WISE. Yes.

Senator D'AMATO. I mean, if you work for someone who does not have a pension plan, a 401(k), and that is the only plan that we permit, why, then you do not have access to a 401(k).

Dr. WISE. That is absolutely right.

Senator D'AMATO. All right. I would just like to put it in some kind of perspective. It is nice to say we all like 401(k)s and it is the plan that would be most preferable to encourage savings, but understand that 50 percent of America's businesses, or thereabout, do not provide 401(k)s. Is that right? I also find very interesting, in your figures you indicate that back in 1986 IRAs accounted for about 30 percent of the savings and then grew to something like $38 billion.

So, it would seem to me, if you look at when it started back in 1980 at something less than $5 billion, that within a 5-year period of time people began to understand the significance of using an IRA, and they were just catching on. Yours truly made sure that he put $2,000 in. It represented the only savings I ever made, but I could not afford not to do it.

Now, let me suggest to you that most Americans make, let us say, under $80,000. Over that is just a small portion. So, if you were to be somewhat generous and, let us say, go up to $80,000, $90,000, or $100,000, you would not be encouraging the truly wealthy to go into an IRA, and you would be encouraging a tremendous increase in savings that you do not have now. Yes or no?

Dr. WISE. I fully agree. When I say, if I had to make a single choice where would I put my effort? I go with the 401(k).

Senator D'AMATO. And it should not be an either/or, should it?

Dr. WISE. No. I understand. But I interpreted the question to be, I can only do so many things, so I said, if I had to make a choice that would be the choice. I fully agree with you, however. I have absolutely nothing against IRAs. Indeed, as my testimony indicated, I think they worked splendidly. They do, however, compared to 401(k)s, have this attribute that the participation rate is not as high.

But I fully agree with you, I think if we now had not abandoned IRAs in 1986, I think our saving rate would be—that is, the sort

of numbers you cited—would be noticeably higher, so I would not argue against it at all. If you said, promote the 401(k) and expand the IRA, that would be the best of all possible worlds, from my point of view.

Senator D'AMATO. Mr. Chairman, I know that it seemed to me that in 1986 we were searching for dollars so desperately to balance off the trade-offs, and I am not going to speak to the merits of it. And IRAs, it was calculated a loss of, I guess, about $25 billion.

That is why we basically eliminated IRAs for many, many people. I think it was unfortunate, myself. I just think it was. I think Senator Dodd and I offered a couple of amendments that almost passed keeping the IRAs, as you recall.

Senator PRYOR. We all voted against it.

The CHAIRMAN. Right.

Senator D'AMATO. Oh, no. We voted for it, but we came——

Senator PRYOR. Not me.

Senator D'AMATO. Oh, yes. I understand. I know that.

Senator PRYOR. The Finance Committee voted against it.

Senator D'AMATO. But we came pretty close to saving IRAs. I think we made a tremendous mistake. I absolutely do. And for the small amount of discretionary money that wealthy people, relatively speaking—because if you are really wealthy you are not worried about switching $2,000 in savings and getting the deduction.

But we took lots of working, middle class families, lots of families who would not have the incentive to save, families such as my own when you have two or three kids in college at the same time, it gets pretty tough. You made it impossible for me not to make that extra effort to put money away, so I speak from my own little experience.

I think there are lots of people out there, and I think if you want to encourage savings you have got to look for a plan. Maybe it was a rich plan. Maybe we should not have given the total deduction, maybe we should have given 50 percent on $2,000. I still think it would have been a pretty effective tool.

So, I would just like to make the point that I do not think it is an either/or. Lots of Americans do not have the ability for a 401(k), and I think that an effective IRA, maybe giving less in the way of benefits, would appreciably enhance savings. What do you say, Dr. Skinner, in the 12 seconds left?

Dr. SKINNER. Yes. But you cannot expect very large numbers in terms of aggregate effects.

Senator D'AMATO. But from 1980 to 1986 you had very large numbers. And if you put that in and let people begin to see and hear about the impact, why would you not get the same kind of growth?

Dr. SKINNER. You had a very low decline in national saving from 1980 to 1986. Keep that in mind.

Senator D'AMATO. Saved by the bell. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Pryor?

Senator PRYOR. Mr. Chairman, thank you.

I am going to expand a little bit from where Senator D'Amato left off, and ask about one whole block of the population out there who

work for small businesses. Probably 25-40 million people have no IRA, no 401(k), all they have upon retirement today is Social Security. We are talking about small businesses.

In fact, the figures, I think, have not changed in 10 years. We see only about 20 percent of the employees working for businesses with 25 employees and fewer with any kind of a retirement plan. We have also seen in mid-size businesses the figures have remained stable at low participation rules.

What can we do to remove the barriers and to prohibit some of the enormous costs that are associated with establishing a retirement program for small business; how can we target out there this massive part of the population that has nothing?

Dr. KOTLIKOFF. Well, very briefly, my suggestion is that you think about privatizing Social Security for people under 40, at least their retirement saving part of Social Security. And maybe the employee contribution continues to go to Social Security, and maybe you take the employer contribution and let people maybe raise the limit and let people put that into their private pension plans under specified diversification rules so that they cannot invest it all in risky assets or even very safe assets which rates of return are very poor. This would have the advantage of connecting people's benefits in the future with what they are paying in the present, which is very unconnected in people's minds, I think, because of the complexity of Social Security. It would also eliminate a lot of the discriminatory treatment of two owner versus single owner couples under Social Security.

A lot of problems with Social Security could be addressed for younger people without touching it off for older people. So, I am not saying eliminate the benefits or reduce the benefits or change anything for older people, just for younger people. Do not force younger people to be stuck in a system which has problems forever.

Of course, the government will have to borrow those funds back out to pay for older beneficiaries, so you will actually have a system, a transition, like what is going on in South America in virtually all of the countries down there. They are either doing it, or thinking seriously about going away from the U.S. model towards a privatized Social Security—mandatory, but privatized.

Senator PRYOR. Yes, please, Dr. Wise.

Dr. WISE. One of the problems for small companies with respect to pensions, of course, is the cost of running them, and the typical defined benefit pension plan tends to be rather expensive to operate for a small company.

In principle, an advantage of a 401(k) is that one could establish one for a very low cost. Therefore, it seems to me that there is a large potential to encourage or induce companies to adopt them.

Now, of course, you are right that many firms do not have plans, but I think if one wants to encourage a plan, the sledding is a lot easier if one is encouraging one that does not require a lot of cost to operate. So, a 401(k), I think, tends to help the problem.

Senator PRYOR. Do you have a comment on privatizing part of the Social Security?

Dr. WISE. Well, only to say that I suppose one could interpret an expansion of the 401(k) in this way. I would be inclined not to in-

terpret it that way just because I think that it raises lots of issues that I am not sure need to get raised.

But, on the other hand, I think it is useful to think of these things together. There is no doubt that Social Security is going to have to come up for discussion in the not too distant future, and it certainly does not hurt for people to start to think, maybe I better save for retirement.

So, if one wants to say this goes some ways toward privatizing, it is all right with me, since, in some sense, it does that.

Senator PRYOR. Dr. Gale?

Dr. GALE. Thank you. I absolutely share your concern about the saving of these low-income workers and small business workers. I have just a couple of things to point out.

One, most of them are eligible for fully deductible IRAs and choose not to participate. This is the same point I was making earlier, that the people that need to save through IRAs do not, and the people that do not need to save though they do.

So, what I mentioned earlier was a mandatory universal pension system, which has been talked about before, that could be implemented as to some sort of pension clearinghouse whereby the small business employee basically only had to do the withholding part and the clearinghouse took care of reporting on asset balances and allocations and things like that, kind of like a TIA-CREF for small businesses.

Senator PRYOR. I believe I am just about out of time.

The CHAIRMAN. Go ahead, Dr. Skinner.

Dr. SKINNER. I would just briefly add to this. I have been very curious about the question of, why is it not the case that financial institutions do not jump at the opportunity to sell people a steady investment, and I have been told by people in the industry that there are economies of scale problems, that it is not worth it to send one person out to four employees at the Mom and Pop grocery store. So that suggests maybe creating larger, I hesitate to use the word alliances, but some way to get around that.

Senator PRYOR. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. I just arrived. I was at the prayer breakfast this morning and I just got here, so I really would like to just pass on my question.

The CHAIRMAN. Did it go this long?

Senator MOSELEY-BRAUN. Almost. It was hard getting out of there. There were a zillion people there. It was wonderful, but there were a lot of people and the traffic was impossible to get out of.

The CHAIRMAN. I was intrigued, Dr. Wise, with Senator D'Amato's question about the growth of IRAs, I think, from $5 billion to $38 billion—this is in your testimony—from 1980 to 1986.

But the 401(k)s started from almost zero in 1980 and had grown to $50 billion in the same period of time, when only half of the employers at the outside were even providing them, which would, in my mind, indicate that there is tremendous room for expansion of the 401(k)s if they are broadened, or if they are sold, or if more employers get in, that the potential is extraordinary.

I think, for this reason, no matter how we cut it and parse it, the bulk of the money in this country is not the people who make over $75,000, it is those who make under $50,000. It is the quantity of money, and the quantity of potential savings is there.

People making $20,000 just are not going to buy IRAs. They cannot afford IRAs. They have not got any money. And people making over $100,000 or $125,000 are buying something else. It is not big enough.

But, whether you call it Dr. Gale's compulsory saving plan or tremendous inducements for 401(k)s, you can get people making $15,000-20,000 to put up money for a 401(k) because the employer sells it, and contributes to it in many cases. The breadth of potential savings is extraordinary in that income group.

I do not have any further questions.

Senator Moynihan?

Senator MOYNIHAN. It was Dr. Kotlikoff who mentioned the idea of government informing people more about their circumstances. I would mention that we do have in statute, beginning this year, that the Social Security Administration will send out statements to persons over 60 and it will work its way down. They are not expensive. The largest cost is the stamp.

But I wonder, I had thought of this in terms of making people realize that there is a Social Security system and that they do have your name and they record your contributions. But I think the majority of non-retired adults do not think they will get Social Security. Now, what will be the effect of our reassuring them that they will?

The CHAIRMAN. Did you, Pat, see the poll about six weeks ago, age cohort 20-35, by a three to one margin believe more likely in the existence of UFOs than the continued existence of Social Security?

Senator MOYNIHAN. Well, they have been listening to the Finance Committee hearings.

[Laughter.]

Dr. KOTLIKOFF. I think that information is important, so I certainly applaud your effort. I am concerned about the statement on the actual information being provided, that Social Security will be there when you are, or something to that effect, which I have read on the statement that I have requested for my own benefits.

I think that the workers need to be warned that Social Security is not a guarantee, that it can be cut and has in some years, and also increased. It is just not a certainty, and people need to save on their own.

I think if that is added and right up front, with a little message from the President, it could be two sentences, it would go a long way toward dealing with this concern that both of us share about people saying, oh, I have got this money, I can stop saving. Nobody is saving enough in this country and we all need to save more.

Again, I do not want to be repetitive, but we are taking so much from young people in taxes and handing it over to other generations, and that process is continuing and it is likely that how much we take from young people is going to get larger.

At some point you have to realize that if the young people are not left with anything from which to save, they are not going to be

able to save no matter what kind of IRA, 401(k), and other incentives we have.

Senator MOYNIHAN. I much agree. Mr. Chairman, I think that we might look into the Social Security statement question. It baffles me why that bureaucracy has resisted doing this. I mean, they were dragged kicking and screaming. They thought they would have a lot of mistakes and there would be a lot of corrections to make. It turns out there are not many mistakes.

The CHAIRMAN. It is because it has not been there before.

Senator MOYNIHAN. Yes. Yes. Well, I end up with a great deal more information, and less wisdom. I want to thank the panel.

The CHAIRMAN. Senator Rockefeller.

Senator ROCKEFELLER. I am abusing my privilege here a bit, Mr. Chairman. But, one, you save if you have money. If interest rates go up you are less inclined to save because you grow more nervous about the necessities if you are middle income, et cetera.

Now, I have never really criticized the Federal Reserve because I think they need to be independent, and I think they need to be wise, and I think they have done a pretty good job in this country. But we had six increases in interest rates, and I just want to ask for your economic views on this.

It is not on the subject. The Chairman will, I hope, forgive me, but it does have to do a little bit with savings. Wages are not going up, benefits are declining, health care is a classic example.

It is now estimated by CBO and others that, in the year 2000, only 50 percent of Americans who work will have health care benefits. It used to be in the middle 1980's, within the last 10 years.

The Wall Street Journal yesterday said, "Employment costs, a measure of workers' wages, salaries, and benefits, rose 3 percent last year, the smallest increase since the government began tracking in 1981. Increases in compensation costs generally have been slowing since 1989." Now, these are numbers are quotes, but there are people behind all of this.

Wages, as I understand it, are generally two-thirds of the cost of the product. So that would be where you would have your inflation, except it is not taking place. Energy prices have remained moderate, foreign competitors are continuing to increase their productivity, thus keeping the cost of their exported goods to this country purchased at a relatively constant rate.

I do not understand why the Federal Reserve is doing what they are doing because I think they are hurting people and they are certainly affecting savings rates. I would just be interested in the views of the four of you on the decision made by the Federal Reserve.

Dr. KOTLIKOFF. I am glad you asked that question. First of all, you are absolutely right, I do not see any strong signs of inflation over the horizon. The Federal Reserve Chairman continues to say that growth is going to generate inflation.

I think economic theory really teaches us exactly the opposite, that if we have more goods for the same amount of dollars there is going to be a lower price level rather than a higher one just because of the basics of the economics of money supply and money demand.

We have had periods in this country where we have had tremendous growth. You go from 1865, I think, to 1879, where we had a very rapid growth in the economy, like six percent per year, and we had deflation. Even though the money supply was growing over this period, we had considerable deflation during that period of time. So, there is nothing that equates growth of the economy to high inflation.

I think that the real concern is that the Fed will overdo it and that they will scare the economy, because if you look at this history of recessions in the post-war period, it is usually what people are worried about that is causing a recession. It is really, in some sense, a psychological event.

If you look at what happened in 1979 with the Volker episode, he came out and he said he was going to reduce the rate of growth of money. Well, interest rates shot way up, he reduced the rate of growth of money for about two months.

He had set these targets for 3 years in a row, and each year he missed those targets, year after year. So in terms of what he actually did, he did not do anything like what he said he was going to do, it was just that there was an entire psychological reaction, which makes a lot of sense. If you are a retailer, you have got to worry about, well, should I order those extra shirts, will I be able to sell them at the end of the day?

So, I think that the Federal Reserve can do great damage to the economy by overdoing it and by making pronouncements which do not really connect to economic theory, and they deserve to be warned, they need to be careful in this environment. We could get back in a recession and that would be very bad for national saving.

Senator ROCKEFELLER. Dr. Wise?

Dr. WISE. Two observations. In principle, the higher interest rates should increase saving, although I do not expect to see a big effect of that, but that is what most economists would think.

With respect to what the Fed is doing, I think it is perfectly possible that they are approaching the point of overdoing it. But I think also that one has to keep in mind that the Fed has a difficult problem.

They are looking at information that we see now that suggests that does not show big increases in price indices or big increases in wages. But they are trying to predict what they think will happen 9 or 12 months from now based on that data, which, of course, makes it hard sometimes to understand what they are doing.

Whether they are right or whether they are wrong, I think, is a difficult proposition and maybe we are about as far as we should go, but I think one has to understand that one cannot just observe what is happening right today and make a judgment about it. If we wait until we see inflation, it's too late.

The CHAIRMAN. Carol?

Senator MOSELEY-BRAUN. Mr. Chairman, I do not know if this has been covered already, but I would like to ask the panel, we are right now taking up in the Senate the Balanced Budget Amendment, and some of my colleagues have filed amendments or seek to change the form of the amendment as presented to the Senate with proposals to exclude Social Security altogether from our discussions in terms of how to achieve a balanced budget, or, alter-

natively, how to achieve a glide path with regard to resolving the deficit. That will no doubt be, or is, a matter of great controversy.

And, since we are talking about savings and Social Security this morning, would one of you comment on what effects, if any, you see from removing a discussion of Social Security from issues of resolving the deficit?

Senator MOYNIHAN. Would you mind if I asked a clarifying question?

Senator MOSELEY-BRAUN. Certainly.

Senator MOYNIHAN. Social Security is in surplus and we would expect it to continue for about another 15 years.

Senator MOSELEY-BRAUN. Right.

Senator MOYNIHAN. And this amendment would mean that we would have a balanced operating budget with respect to ongoing activities, plus this surplus.

Senator MOSELEY-BRAUN. That is correct.

Dr. GALE. I think I am generally in favor of any addition to the Balanced Budget Amendment that helps people understand exactly what programs are going to be cut, what taxes are going to be changed. The deficits themselves have very little direct effect on anybody's lives; government spending and taxing programs have very large direct effects on almost everyone's lives.

So, I think it is sort of a truth in labeling or truth in advertising that would be useful to couple the Balanced Budget Amendment with information about what that means.

Senator MOSELEY-BRAUN. That is another amendment.

Dr. GALE. If what that means is Social Security is exempted, that is going to make it much easier to maintain a balanced budget in 20 or 30 years, but it also removes some of the teeth, some of the meaning behind a Balanced Budget Amendment.

I think the real issue with Social Security is, with the Balanced Budget Amendment, once you amend the constitution to make day to day fiscal policy, you are severely constraining yourselves, and changes in Social Security—and we have seen dramatic changes in the forecast over the last 10 years—would put extraordinary pressure on any sort of balanced budget system if Social Security is included.

It would be easier to do the Balanced Budget Amendment without Social Security, but I am not sure it would be that meaningful to do it without Social Security.

Dr. KOTLIKOFF. Economic theory does not define the deficit. The deficit is really a function of the words the government uses to describe what it is doing. There are as many definitions of the deficit as politicians and lay people want to make up, and the real concern that I have with the balanced budget amendment is it will really start playing with the definition of the deficit in a way that will actually let us continue to avoid this redistribution across generations that has been ongoing.

Economic theory tells us that we should do something else in our terms of accounting, which is called generational accounting, which has been reported in the past three budgets of the President in past years.

Unfortunately, this year's budget will not include generational accounting, although the numbers are available, and I would be

happy to make them available to you. They will be released on Monday in a separate press release by myself and Alan Auerbach.

So the generational accounting really shows you for sure what is going on with respect to our total picture and it is not subject to this kind of manipulation.

Now, getting back to your particular question, Senator, leaving Social Security off the budget for purposes of the Balanced Budget Amendment would show up as a larger deficit over the next 25 years. Is that correct, Senator Moynihan? Because the system right now is in surplus, so there would be a larger deficit and, therefore, there would be a larger problem with respect to how to balance the deficit.

Senator MOYNIHAN. No, no, no, no. What it would do is you would have exactly the problem that Walter Heller, Kermit Gordon, and Jim Tobin encountered when they came to council in 1961, which is a full employment surplus. For the next 15 years, the government would be taking more money out of the economy than putting it in.

The CHAIRMAN. Assuming you balanced the budget absent Social Security.

Senator MOYNIHAN. That is right.

The CHAIRMAN. You then had the Social Security surplus in addition.

Senator MOYNIHAN. Yes. Is that a good idea?

Dr. KOTLIKOFF. That is a good idea because that would force us to cut back on other programs to a much greater extent than would otherwise be the case, and that is our problem. We have too much transferring going on. I am saying what you really should be doing in Congress is doing generational accounting. The program is available.

We tried to get the CBO to use it. U.S. Senators should demand from the new CBO director, that they start doing generational accounting. That is the only systematic, long-term fiscal analysis that is available; it is the one that economic theory says you should be doing. That is what you should be doing.

If you are not going to do that, then yes, I think you should take Social Security out of the balanced budget amendment because otherwise we are just playing a game with the surplus. We are basically borrowing on one account and putting the money into the trust fund, and the overall generational picture is not actually improving.

Senator MOSELEY-BRAUN. Dr. Skinner?

Dr. SKINNER. One concern is that if you put enough things off the budget, I mean, out of consideration and away from cuts, then sooner or later there will not even be $200 billion left to take away. That is, the cuts that do come would be much more draconian and perhaps completely politically unpalatable.

My concern, actually, is with Medicare, which is, I think, more likely to explode more quickly than Social Security. I think the fuse is less than 10 years.

My concern would be that if you sort of set aside Medicare and said, well, we are not going to touch that, we are not going to do anything about that, that when it does actually happen that the

Medicare trust fund runs out, that one could find oneself's hands tied.

Senator ROCKEFELLER. You need not worry. If the Balanced Budget passes, Medicare will not be excluded and the cuts in Medicare will total about $600-700 billion over 7 years.

The CHAIRMAN. So long as you understand how he defines cut.

Dr. KOTLIKOFF. Yes. Can I interject on that? I think that is very important. The American public needs to understand that the baseline that is being used in all of these discussions, going back to the health care reform debate, was one in which Medicare growth was going to grow at rates much higher than the growth rate of the economy.

When we are talking about cuts here, we are talking about reductions in exorbitant, astronomical growth rates which we are asking young and future generations to pay for through this whole system, so I am happy to hear that Medicare is finally going to be brought under control. Believe me, I am not trying to advocate that any dollar of Medicare benefits be cut.

Indeed, we could get by by allowing Medicare benefits per capita grow with labor productivity, but that is a whole lot lower than what we are actually experiencing. So we should ask the older generations to live with a Medicare system which is not giving them bigger and bigger benefits year after year by growing at leaps and bounds. That seems to be a reasonable request.

Senator MOSELEY-BRAUN. Dr. Wise?

Dr. WISE. I think I am inclined not to take it out of this balanced budget discussion, realizing that there may be a false sense of security in the short-run, but I think that it is just inappropriate to pull things out because I think that it restricts the discussion that ought to go on.

I agree with Dr. Kotlikoff, that one really ought to be looking in the long run in considering, what are our liabilities with respect to Social Security because, in fact, that is what matters. Since I believe that that probably is not going to happen in the short-run, I would rather see the discussion be a whole discussion.

Senator MOSELEY-BRAUN. Thank you very much.

The CHAIRMAN. I want to come back to the word cut, because the one answer that Dr. Reischaur gave when we were doing the health reform bill, perhaps, did more to sink it than any other single answer.

He was testifying about the President's plan and he said, if we passed it it would reduce health spending by a full percent in 10 years, from 20.5 percent of our gross national product to 19.5 percent, to which Senator Durenberger said, but it is only 14 percent now. It was hardly a cut by any stretch of the imagination, but it was going to go up dramatically.

Second, I will not quarrel specifically with Senator Rockefeller here. I do not quite agree with his totals. I saw the press scribbling down his totals, and I do not want them to think that I acquiesced in the figures that he had, because I think we can do it for less than that.

But there would be a reduction from baseline in Medicare and Medicaid under a Balanced Budget Amendment, and it would be, depending on whose definition you use, a reduction from baseline.

Senator Moynihan?

Senator ROCKEFELLER. Mr. Chairman, may I just——

The CHAIRMAN. Yes.

Senator ROCKEFELLER. Just because you popped one there, let me pop one back. As you remember during the health care debate, we all agreed that we are spending about 14 percent of the Federal budget now on health care.

There was consternation to the 20 percent figure which you referred to, and it only took it down to 19 percent. CBO is now estimating that we will go from 14 percent in the health care component——

The CHAIRMAN. The total cost in the GNP.

Senator ROCKEFELLER. No. The health component of the Federal budget will go from 14 percent to 24 percent by 1998, 3 years away.

The CHAIRMAN. That may be right. The Medicare, Medicaid, public health service, other Federal portions of health spending will go from 14 to 24.

Senator ROCKEFELLER. To 24 in 3 years.

The CHAIRMAN. In 3 years. Now, that does not surprise me. I do not know if I agree with it, but it would not surprise me at all. It is all the more reason why we ought to pass the Balanced Budget Amendment, and if we are going to exempt Social Security—I do not agree with that, but apparently we are going to—then it does mean that Medicare and Medicaid, which are the next biggest entitlement programs, are going to have to be restrained if we are going to get there.

Dr. KOTLIKOFF. Can I just interject one last thought on the Balanced Budget Amendment? What I am concerned about is the way we get to budget balance does not ensure generational balance. One way to get to budget balance and deal with Medicare growing at leaps and bounds—and, again, it grew at 9 percent real last year—is to raise payroll taxes.

So what you do then is you force younger and future generations to pay for this entire expansion, you do not limit the expansion. So, there is no guarantee that you get generational balance out of budget balance, and I think that really needs to be kept in mind in your thinking. You should have a generational balance amendment, not a budget balance amendment.

The CHAIRMAN. You know, it is interesting. I do not know what his present position is, but Milton Friedman, in the past, opposed the constitutional amendment for almost the very reason you talked about. He thinks it will raise taxes to do it. We will not cut spending.

Indeed, evidence in the States over the past 35 years would indicate that. Their spending has gone up, their revenues have gone up. They suffer a Balanced Budget Amendment if they do not like it. But it has not restrained their spending increases as a percentage of our gross national product, it is simply that their taxes have risen with it to match it.

Senator MOYNIHAN. Mr. Chairman, may I point out that at least two of our witnesses are associated with the National Bureau of Economic Research, whose economic model is known as "tax 'em." Now, do any of you wish to deny that? And I would also like to say——

Dr. KOTLIKOFF. Neither of us does. Is it tax him, or tax 'em?

Senator MOYNIHAN. That is the worst one I have heard since Bob Dole realized that the Committee to Re-Elect the President was, what, CREEP? Jay, any more?

Senator MOYNIHAN. Could I just make one statement?

The CHAIRMAN. Yes.

Senator MOYNIHAN. I am getting to that generational problem. I would have thought that the four eminent economists would have been very careful in their response to proposals that over the next 15 years the Federal Government take out about $1 trillion more out of the economy, regardless of where we are in the business cycle, where we are in the unemployment levels and so forth. That would have been——

Dr. KOTLIKOFF. I think Heller tells us that there is not a single definition of the deficit, there is basically a trillion different ones depending on how you label receipts from the public and payments from the government back to the public.

So, what you call a balanced budget, what you call a full employment budget, is completely arbitrary. That is why we need to have some accounting that has some connection to economic theory, and that is the generational accounting.

Senator MOYNIHAN. Take note, may the record show, this member of the National Bureau of Economic Research, regardless of what Martin Feldstein may think, says there are a trillion definitions of outlays and receipts. By God, the lawyers are going to love it.

Dr. WISE. Let it be noted that it was Dr. Kotlikoff who said that.

Dr. KOTLIKOFF. I am Martin Feldstein's student, but we do not agree on all things.

Senator MOYNIHAN. It shows.

The CHAIRMAN. Carol, do you have any more questions?

Senator MOSELEY-BRAUN. I am fine, thank you.

The CHAIRMAN. Jay?

Senator ROCKEFELLER. No, Mr. Chairman.

The CHAIRMAN. Gentlemen, thank you very, very much. We are adjourned.

[Whereupon, at 11:31 a.m., the hearing was adjourned.]

APPENDIX

Additional Material Submitted

Prepared Statement of William G. Gale

Mr. Chairman and Members of the Committee: Thank you for inviting me to testify at this hearing on government policies toward saving.

My testimony consists of four parts: a brief summary of the main conclusions; a discussion of the effects of IRAs and 401(k) plans on saving; a discussion of the applicability of psychological models to saving policies; and a discussion of alternative ways to raise saving.

MAIN CONCLUSIONS

- The low level of national saving and capital formation is one of the most important economic problems our country faces.
- So-called saving incentive programs, such as IRAs, 401(k) plans, and Keogh plans, are poorly designed from an economic perspective. In particular, saving incentive plans do not require people to save in order to claim the tax benefits.
- Saving is painful; it requires a reduction in current living standards. People naturally try to find the least painful way to make contributions to saving incentives. Most contributions to IRAs were made by people who could contribute painlessly, either by moving existing assets into IRAs or taking current saving they would have done outside the IRA and moving it into an IRA.
- Since 1981, balances in IRAs, Keoghs, and 401(k) plans have grown by $1.5 trillion. If these accounts represent new saving, it would not be unreasonable to expect that this increase would show up as an increase in saving rates. But the personal, private and national saving rates have fallen by substantial amounts.
- Although highly stylized research models suggest that IRAs and 401(k) plans may raise saving in the long run (35 years or more), these results should not be taken out of context and may not be a very good guide to current policy choices.
- Psychological models of saving are intriguing, but they are also speculative. In a number of cases, their predictions are not consistent with the facts.
- The surest way to raise national saving would be to reduce the government budget deficit in ways that do not reduce private saving.
- Raising private saving further through government programs may prove to be a difficult challenge, but attention should focus on the pension system.

I. SAVING INCENTIVES AND THE SAVING DECLINE

American saving rates have recently fallen to their lowest levels in decades. These declines have raised concerns that the economy may be unable to finance investment and sustain growth over the long run, and that a significant fraction of the population may not be saving adequately for retirement. As a consequence, raising the saving rate has been a frequent focus of policymakers. One popular legislative remedy for stimulating saving has been the development of special, designated saving accounts, such as Individual Retirement Accounts, 401(k) plans, and Keogh accounts. These accounts, which I refer to as "saving incentives," feature preferential tax treatment of contributions and investment earnings, annual contribution limits, and penalties for early withdrawals.

IRAs were established in 1974 for workers without pensions. In 1981, eligibility was extended to all workers. Contributions limits are $2000 for each worker and $250 for a non-working spouse. Two-earner households thus may place up to $4000 in an IRA. From 1982 to 1986, contributions were tax-deductible. For households

with a separate retirement plan, the tax deductibility of contributions was phased out in the Tax Reform Act of 1986. For households filing jointly, the phase out occurred at adjusted gross income levels between $40,000 and $50,000; for single filers, the range was $25,000 to $35,000.

Workers are eligible for 401(k)-type plans only if their employers offer the plans. Employees may make tax-deductible contributions. Employers may make independent or matching contributions to the employees' accounts. The legal annual contribution limit was $9,240 in 1994, but firm-imposed limits and non-discrimination rules reduce the limit substantially for many participants. Keogh plans are similar to IRAs but have higher limits and are directed toward self-employed persons.

These programs have been popular, but they may not have raised private and national saving. This would be true, for example, if the contributions to saving incentives were financed by shifting money from other existing assets or by redirecting saving that would otherwise have been placed in other assets.

For example, from 1981 to 1993, assets in saving incentive accounts rose by almost $1.5 trillion. Since personal saving is about $200 billion per year, saving incentive accounts, in just 12 years, accumulated balances worth about 7 years of personal saving. If saving incentives have raised the saving rate, it would not be unreasonable to expect accumulations of this magnitude to show up as increases in the personal saving rate. However, rather than rising, the personal saving rate fell by almost half over this period.

These aggregate trends should be interpreted with caution, of course. Economists are unsure about the causes of the saving decline, and many factors affect aggregate saving. Nonetheless, it is clear that saving incentives are large relative to personal saving, and that trends in personal saving show no sign that saving incentives have increased saving.

Do the Incentives Stimulate Saving?

The effect of saving incentive plans on national saving is the sum of their effect on private saving and government saving.

Private Saving: Standard economic theory indicates that raising the after-tax rate of return on *all* saving creates two effects that work in opposite directions and hence may raise or reduce saving. The obvious effect is that the higher return raises the reward to saving and thereby encourages people to undertake more saving. Economists refer to this as a price or substitution effect. The second effect is less obvious but just as real. With higher interest rates, people can save less and still reach a given wealth target. Economists refer to this as an income effect. The income effect reduces the amount that people save in response to an increase in the rate of return. For example, suppose that a worker is saving for retirement with the goal of generating retirement income equal to, some fraction (say, 70 percent) of pre-retirement income. (This is a common financial planning approach to retirement saving.) The higher the interest rate, the less the worker needs to save to reach this goal.

How would this worker respond to an increase in interest rates? For a given target level of retirement income, the worker would save less than before (the income effect). But the worker may very well raise his retirement income goal (the substitution effect). If the increase in his goal is small, the income effect will dominate and saving will fall. If the increase in his goal is large enough, the substitution effect will dominate and saving will rise. Therefore, both the size and the direction of the effect of higher interest rates on all saving is ambiguous. Most empirical estimates and realistic simulation models suggest that the response is not very big.

Saving incentives do not raise the after-tax return on all saving, only on a limited amount of contributions placed in a designated account. This may be an even less likely way to raise saving than raising the return on all saving. This is because, oddly enough, so-called saving incentives do not require that contributors save, or save more than they would have otherwise. Saving requires a reduction in current consumption; to put it bluntly, saving more requires reducing one's current standard of living. People naturally balk at reducing their standard of living unnecessarily.

One reason IRAs and 401(k) plans are so popular is precisely that people do not have to reduce their current living standards to make contributions. Rather, the contribution may be financed by transferring existing taxable assets into IRAs, by increasing debt, or by reallocating into an IRA current or future saving that would have been done outside the IRA. Unfortunately, these painless methods of contributing to an IRA or 401(k) do not raise overall private saving.

Two types of households will be most able and hence most likely to make painless contributions, that is, contributions that do not raise private saving. The first is households that have large amount of other assets. These households have more existing assets to shift, typically have more current saving to shift, and have less of a need to maintain all of their assets as precautions against emergencies. The sec-

ond is older households, who are less likely to face a binding early withdrawal penalty. In the extreme, people older than 59.5 years face no early withdrawal penalties. For each group, IRAs are good substitutes for the saving those households would do anyway, so the IRA contribution will be unlikely to represent new saving. In contrast, contributions will represent a net addition to saving only when they are financed by reductions in consumption, which will occur only when IRAs and other saving are poor substitutes for one another. This is more likely to occur for households that have lower asset holdings, and are younger.

Public Saving The effects on the government revenues are also important to consider. To the extent that contributions do not represent new private saving, saving incentive programs raise the deficit, for two reasons. First, the tax rate faced by a household during retirement (when withdrawals are typically made) is usually lower than that faced by the same household during working years (when contributions are made). Second, some tax revenues are lost on the accumulated interest because investment earnings on IRA balances are taxed only when they are withdrawn, whereas investment earnings on saving accounts, for example, are taxed every year. The long-term revenue loss may be larger than the immediate revenue loss recorded in the budget.[1]

Thus, in the absence of other policy changes, a saving incentive plan must not only raise private saving but raise it by more than the associated tax loss to the government in order to raise national saving.

Who contributed to IRAs and Why It Matters

One step toward determining the effects of IRAs on saving is to focus on the characteristics of IRA contributors. The table below shows characteristics of different types of households in 1986.[2] The table describes the median or typical household in each category. All dollar figures are in 1986 dollars.

	All Households	Households without IRAs	Households with IRAs	Households that contributed to the Limit 3 years in a row
Age	49	49	50	51
Annual Income	$21,320	$15,667	$35,000	$44,500
Non-IRA Financial Assets	$6,000	$3,000	$21,695	$41,269
Net Worth	$42,710	$25,470	$107,946	$188,943
Saving (Change in Net worth, 1983–6)	$6,129	$2,884	$23,500	$60,691

The table shows that households with IRAs are very different from households that do not have IRAs. In particular, compared to households without IRAs, the typical household with an IRA has seven times the non-IRA financial assets, four times the overall net worth, and eight times the saving. Some of these differences are due to differences in other variables like income or age, but even after controlling for these factors, there are large differences in the underlying saving behavior of households with and without IRAs that can not be explained by IRAs.

These facts have several important implications for understanding how IRAs affect saving. First, these differences complicate the task of measuring the effect of IRAs on saving. To see this, suppose there exist two groups: "large" savers and "small" savers. We would expect to see that IRA holders (where large savers are overrepresented) would save more than non-IRA holders (where small savers were overrepresented). But this would provide no information about the effects of IRAs per se unless there is a way to control for the observable and unobservable differences between large and small savers.

Second, recall that there are two groups for whom IRAs and saving should be very good substitutes and hence for whom IRAs are least likely to represent net additions to saving: those with large amounts of liquid assets, and those who are over 59.5 years old. Related data (not in the table) show that households with non-IRA financial assets over $20,000 or who were 59 or older made more than two-thirds of all

[1] For example, if the tax rate during working years is 30 percent, the tax rate during retirement is 15 percent, the interest rate is 10 percent and the holding period is 15 years, the present value of tax revenues from a dollar of pre-tax income put into an IRA is 15 cents, but the present value of tax revenues from the same dollar of pre-tax income placed in a taxable account is 54 cents. Hence, in present value terms, the government loses 39 cents. This is larger than the 1 period revenue loss that would be recorded in the budget, 30 cents. If the holding period is 30 years, the present value loss is 55 cents.

[2] The table is taken from William G. Gale and John Karl Scholz, "IRAs and Household Saving," *American Economic Review*, December, 1994.

IRA contributions in the 1983-6 period.[3] Thus, the data suggest that most *contributions* were made by households that would consider IRAs and other saving good substitutes, and thus that the overall effects of IRAs on saving are likely to be small at best.

Third, many analysts acknowledge the presence of a "transition period" after IRAs are introduced. The idea is that when IRAs are introduced, people will shift funds from taxable sources into IRAs so the contributions at first will not be new saving. After awhile, the people who contribute to IRAs may run out of funds to shift so that IRA contributions may eventually become new saving. The question that is debated is: how long will this transition period last? Some IRA proponents have reasoned that since the typical household has very little in pre-existing financial assets, the transition period will be very short: a year or less.

The logic of a short transition period is misleading for two reasons. The first is simply that the typical household in 1986 did not have an IRA, so the typical household is irrelevant to the debate about how long the transition will last. The relevant households are those that contributed to IRAs and in particular those that continue to contribute to IRAs: Did these households have many pre-existing assets that they could shift into IRAs. The answer here is a resounding "yes." The table shows that pre-existing asset balances are high among household with IRAs. The typical IRA household in 1986 had over $20,000 in non-IRA financial assets. Among households that contributed to the limit for three years in a row, typical financial asset balances were $40,000. It is clear that for these households, IRAs could be financed from pre-existing asset balances for several years without raising saving.

The second problem with the proponents' logic is even more important: it ignores IRA contributions that are financed by *current or future saving that would have been done even in the absence of IRAs.* These contributions do not represent new saving. The table shows that typical IRA households and 3-year limit contributors have extremely high levels of other saving relative to their IRA contributions and so could easily finance contributions out of saving that would have been done anyway. The median 3-year saving level for 3-year limit contributors in the SCF was $60,000. Surely, it would not be difficult for many of them simply to shift $12,000 of that into an IRA. The median 3-year saving level for the typical IRA contributor was $23,000. This is certainly large enough to fund all or most of a typical three years worth of contributions.[4] These figures suggest that among households that did contribute to IRAs, there was a large *on-going* source of funds from which IRA contributions could be financed without raising saving. There is every reason to think the transition period could take a very long time.

Evidence on the Effects of IRAs on Saving

There are two principal types of formal studies of IRAs. One type compares IRA contributors to non-contributors. The other type compares one group of IRA contributors to another group of IRA contributors.

The earliest studies of IRAs compared the behavior of IRA contributors to that of non-contributors. These studies claimed that IRA contributions raise saving. It has become clear, though, that these studies face very difficult challenges due to the differing propensities to save across different types of households. It is thus unclear whether these studies are uncovering evidence that IRAs raise saving or merely showing that people with high propensities to save tend to save more than people with low propensities to save.

For example, the degree of substitutability between IRAs and other saving can vary across households. The households that tend to contribute to IRAs (high wealth, older) are also the ones that should find IRAs to be better substitutes for other saving, and hence their IRA contributions are less likely to be net additions to saving. The households that tend not to contribute (younger, low wealth) are the ones that should find IRAs to be poor substitutes for other saving. Thus, if these households were to contribute to IRAs, their contributions would be more likely to be net additions to saving.

When comparing the 80 percent or so of the population that did not contribute to IRAs and the 20 percent that did, it is not surprising that the tendencies of the larger group dominate the estimates. That is, the estimate of substitutability *for the overall population* can be thought of as essentially a weighted average of the substitutability for the different groups and hence tends to reflect the low substitutability

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[3] Households who had non-IRA financial assets in excess of $40,000 or where the head was 59 or older made half of all IRA contributions during this period.

[4] The typical IRA household did not contribute every year: less than 1/3 of households with IRAs contributed all five years from 1982 to 1986. Half contributed all three years from 1982–4.

for the 80 percent that did not contribute. But the effects of IRAs on saving depend only on whether *the households that contributed to IRAs* found IRAs to be good substitutes for other saving. As noted above, these households differ *systematically* from the rest of the population in their substitutability of IRAs and other saving. The effects of IRAs depend in no way on whether people who do not contribute find IRAs to be good substitutes for other saving. Therefore, studies that compare contributors and non-contributors may be generating estimates that apply to the wrong group.

The second type of study has compared one group of IRA contributors to another group of contributors. The great advantage of such studies is that, by comparing one type of "saver" to another type of "saver," the studies control for *unobservable* differences between the groups in propensity to save. One such study was a paper I wrote with John Karl Scholz. Our model compared the saving behavior of households that contributed the maximum amount and those that contributed less than the maximum. We found that increases in IRA contribution limits would have resulted almost entirely in the redirecting of saving that would have been done anyway. Our paper also showed that it is statistically invalid (at least in our model) to compare contributors and non-contributors.

In another study, Eric Engen, Scholz and I look at two matched group of savers: 401(k) contributors and IRA contributors not eligible for 401(k) plans. Because the 1986 tax reform act reduced the attractiveness of IRAs, any positive effect of 401(k) plans on saving should show up in increased assets of 401(k) contributors relative to IRA participants not eligible for 401(k) plans between 1986 and 1991, controlling for other factors. We found, however, that there was no increase in assets of the 401(k) group relative to IRA contributors not eligible for 401(k) plans. This is consistent with 401(k) plans not raising overall saving. Other work that we have done and research by other scholars has produced similar results suggesting that the expansion of the IRA program has generated little in the way of new saving.

A final type of study has compare contributors over time. The idea is that, if saving incentives are raising saving, then the wealth of a typical 55 year old in 1991 should be greater than that of a typical 55 year old in 1984, because the former will have had access to saving incentives for a longer period of time. Indeed, there does appear to be evidence that the later cohorts have higher levels of financial assets, but this evidence must be interpreted cautiously.

First, measures of financial assets omit debt holdings, but contributions to saving incentives can be financed by increasing debt holdings, and the debt/income ratio rose dramatically in the 1980s. Second, contributions can be financed by choosing to invest in financial rather than non-financial assets. The comparison above omits non-financial assets, but there was a shift from nonfinancial to financial assets over the decade. Third, the analysis omits pensions, although there are obvious interactions between saving incentives and pensions. During the 1980s, non-401(k) pension coverage fell. The typical 55 year old was less likely to have a non-401(k) pension in 1991. Fourth, the 1980s saw the longest peacetime expansion since at least World War II and experienced a dramatic rise in the stock market. Some or all of the increase in financial assets my be due to these historically rare factors. Fifth, not all of IRA and 401(k) balances represent private wealth, because the 55-year old will still have pay taxes on whatever is withdrawn. The after-tax balances are probably only between two-thirds and four-fifths of the total. It is unclear how accounting for these factors would affect the conclusions.

Would Saving Incentives Work in the Long Run?

There is no necessary relation between the short-run and long-run effects of saving incentives. To examine the long-term effects, Engen, Scholz and I examined the effects of IRAs and 401(k) plans in a computer simulation model that tracks households' consumption, IRA saving, and non-IRA saving decisions over their lifetime.[5]

The results indicate that, following the introduction of an IRA, private saving falls and stays lower for a lengthy period. This occurs because people shift funds from taxable assets into IRAs and redirect into IRAs current and future saving that would have been done in taxable forms if IRAs had not existed. Thus, the model predicts that in the years following introduction of saving incentives, one would expect to see active participation in saving incentives and falling levels of other saving. As noted above, this is, broadly speaking, the pattern that has occurred in the

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[5] See Eric M. Engen, William G. Gale, and John Karl Scholz, "Do Saving Incentives Work?," *Brookings Papers on Economic Activity,* 1994:1. The model includes overlapping generations of households. In the model, people save as a precaution against income risk and uncertain lifespan. The model predicts fairly accurately a number of characteristics of IRA and non-IRA saving, but overpredicts the saving and wealth of low-income households.

U.S. since the early 1980s, and it is consistent with the reasoning above as to why the "transition period" should be thought to be lengthy.

After several years, the incentive effects of IRAs begin to dominate the shifting effects from other assets and other saving, and the private and national saving rate start rising. In the IRA example, it takes 49 years for the national wealth-to-income ratio to regain its initial value. For 401(k) plans, it takes "only" 35 years to regain the initial national wealth-to-income ratio. After 70 years, the national saving rate ends up higher by 0.2–0.3 percentage points with IRAs. For 401(k) plans, the estimated effect is somewhat larger, 0.4–1.0 percentage points.

A full understanding of these results requires a number of important qualifications. First, any result projected 70 years in the future should be regarded with caution. Second, if these saving incentives are alternatively enacted and then discontinued, saving will actually be reduced. Given the large number of changes in tax policy in recent years, there is or should be a legitimate concern about whether a result that requires a stable tax structure for 70 years and whose benefits do not appear for at least 35 years should be pursued. So unless policymakers are certain that the policy will stay in place for a long time, the model suggests that introducing saving incentives would reduce saving. Third, for several technical reasons, these results overstate the long-term effects, possibly by large amounts. Fourth, the model does not include other tax-preferred, relatively liquid assets (housing, for example) so it speaks to the effects of IRAs and 401(k)s only under special circumstances. Since the real world already has numerous tax shelters besides IRAs and 401(k)s, the real world issue is whether policymakers should add or enhance another tax shelter. The model does not address this issue.[6]

II. PSYCHOLOGICAL MODELS OF SAVING

The standard economic approach to analyzing the effects of saving incentives has come under attack in recent years from economists who argue that psychological models are better at explaining how people save. These scholars argue that self-control is at the heart of the saving problem and that households divide their assets into different types of "mental accounts," some of which they feel are available for current spending and some of which are not. Proponents of these models suggest that IRAs serve to raise saving by giving an immediate benefit (the tax deduction) to people who would otherwise be reluctant to save and by placing the IRA funds "off-limits" in a non-liquid mental account. Related claims are the heavy advertising that accompanied IRAs in the 1982–6 period can raise saving by informing people of otherwise unknown opportunities for saving, or by giving them saving targets that help convey the need to save.

These theories are intriguing, and merit further research, but many important features of the theory are inconsistent with the experience of the past ten years. For example, the applicability of these theories depends on who contributes to IRAs. If most IRA contributors had small amounts of other wealth, then the theories would be more likely to be relevant. However, as noted above, the typical IRA contributor already has much higher non-IRA wealth and saving than the typical noncontributor. It thus seems clear that the typical IRA household does not need to have special incentives in order to save, and is aware of the opportunities for and need for saving. That is, the theory just does not seem to apply to these households. The theory may apply to low wealth households, but one of the things that we have learned from the 1982-6 IRA experiment" is that these households tend not to contribute to IRAs.

Another claim based on psychological models is that IRAs and 401(k) plans can foster a culture or ethic of saving and thereby help raise the overall saving rate. This is an interesting claim, but there is already some evidence suggesting that this has not occurred over the last 12 years. First, despite expanded IRAs, most measures of saving fell from 1982-6. This occurred even though a number of other factors should have raised saving: large cuts in income tax rates in 1981, high real interest rates, and strong income growth. Second, in 1986, after five years of very visible advertising about the opportunities and benefits of IRAs, only 5 percent of households in the bottom two-thirds of the income distribution contributed to an IRA. Third, any culture of ethic of saving appears to have dried up in 1987, even though deductibility was not changed for most households, and even though 401(k) partici-

[6] A final caveat should be added. Some proponents of IRAs have tried to recast the simulation results by looking at the ratio of the change in national saving and the change in government revenues. This ratio is subject to all of the caveats above, as well as the fact that the ratio is a misleading and inconsistent indicator of the effects of the programs on saving. Specifically, a higher ratio need not imply a bigger effect on saving. It is easy to construct comparisons of policies where the ratio is higher for one policy but the effect on saving is higher for the other.

pation has expanded greatly since then. But if IRA participation instilled new values in people, one would have expected that saving would remain high and that IRA contributions would have continued.

III. RAISING THE SAVING RATE

Saving incentives are not the only alternative for raising the saving rate. The surest way to raise national saving is to reduce the deficit and in particular to reduce it in ways that raise or at least do not reduce private saving. A number of changes to the Social Security system, such as raising the retirement age faster and farther than is currently planned, would work in the right direction.

There is no painless, quick fix for the saving decline. The decline in private saving has occurred over a number of years, in most countries, and for many reasons. Economists are divided as to the relative importance of various causes of the decline. To the extent that the decline is related to the liberalization of credit markets, increased transfers to the elderly, and the decline in wage and income growth, it will be difficult to alter the course of private saving through minor changes in the tax system.

If we are to raise the private saving rate, it will most likely be through expanding, enhancing, and simplifying the nation's pension system. Pensions differ from saving incentives in that pension participation is less optional, given one's job, and pension balances are less liquid before retirement. For these reasons, pensions may provide stronger effects on saving than elective saving incentives. Policy could usefully be directed toward re-examining the overfunding rules and the non-discrimination rules, and seeking ways to enhance pension coverage, especially among low-income workers. Note that these workers currently have access to fully deductible IRAs but do not tend to use them.

Finally, many American workers may be unaware of the need to save for retirement. Some sort of realistic education program may prove useful in raising the saving rate, but is certainly not a panacea.

PREPARED STATEMENT OF LAURENCE J. KOTLIKOFF

Senator Packwood and Other Distinguished Members of The Senate Finance Committee:

I am honored by this opportunity to discuss with you the cause of and remedy for our critically low rate of national saving. My testimony makes seven points.

First, the decline in our rate of net national saving is not due to a higher rate of government consumption, but rather to a higher rate of household consumption.

Second, most of the increase in the rate of household consumption can be traced to the government's four decade-long policy of redistributing from young savers to old consumers. This redistribution to the elderly, coupled with a remarkable increase since the early 1960s in their propensity to consume, has produced a truly dramatic rise in the consumption of the elderly relative to that of the young.

Third, the increase in the elderly's propensity to consume appears to reflect the form in which the government has been transferring resources to them, namely as indexed annuities, in the case of Social Security benefits, and as in-kind consumption of medical goods and services, in the case of Medicare and Medicaid.

Fourth, the key to raising our rate of national saving is to lower our rate of household consumption. And the key to lowering our rate of household consumption or, at least, keeping it from rising, is to limit the ongoing redistribution from the young to the old that is associated with the unchecked and extraordinarily high growth of Medicare and Medicaid expenditures.

Fifth, IRAs and similar so-called saving incentives are likely to raise, not lower, household consumption and lower, not raise, national saving. This is doubly the case for proposals that would allow penalty-free early withdrawal of funds from IRAs for purposes of spending on education, medical care, and the purchase of a house—all of which represent forms of consumption.

Sixth, rather than tinker with the tax system through IRAs and similar devices that permit tax arbitrage, we should switch our tax structure to one involving the taxation of consumption. A consumption tax, whether it be proportional or progressive, combines the appropriate "income" and "substitution" effects that are needed to reduce household consumption. In placing a somewhat higher tax burden on older Americans, a consumption tax would also offset the ongoing intergenerational redistribution associated with the expansion of Medicare and Medicaid.

Seventh, an inexpensive way for the government to promote additional saving, and that may help, is for it simply to send every adult American an annual saving statement telling them how much they should be saving. The statement would in-

corporate all the information now provided in Social Security statements. But it would also indicate the additional funds households should be saving either directly on their own or through employers' pension or other saving plans.

THE DECLINE IN U.S. SAVING—SOME STYLIZED FACTS

In 1950, the U.S. rate of net national saving was 12.3 percent. In 1993, it was only 2.7 percent. The difference in these saving rates is illustrative of a dramatic long-term decline in U.S. saving. The U.S. saving rate averaged 9.1 percent per year in the 1950s and 1960s, 8.5 percent in the 1970s, 4.7 percent in the 80s, and just 2.4 percent in the first four years of the 1990s.

The decline in U.S. saving has been associated with an equally dramatic decline in U.S. domestic investment. Since 1990, net domestic investment has averaged 3.1 percent per year, compared with 8.2 percent in the 1950s, 7.9 percent in the 1960s and 1970s, and 6.1 percent in the 1980s. The low rate of domestic investment has limited growth in labor productivity and, consequently, growth in real wages. Since 1980, labor productivity has grown at less than half the rate observed between 1950 and 1979, and total real compensation (wages plus fringe benefits) per hour has grown at only one-eighth its previously observed rate.

Table 1 reports average values of the net national saving rate for the 1950s, 1960s, 1970s, and 1980s, as well as the first four years of the 1990s. The net national saving rate is defined as (Y-C-G)/Y, where Y refers to net national product, C to household consumption, and G to government spending (purchases of goods and services). The table also reports rates of government and household consumption out of output, G/Y and C/Y. In addition, the table reports my preferred measure of private-sector saving, which I call the household saving rate. It's defined as (Y-G-C)/(Y-G)—the share saved of the output left over to the household sector after the government has consumed (i.e., the share of Y-G that is not consumed by the public).

As Table 1 indicates, government spending is not responsible for reducing the rate of national saving. Indeed, the rate of government spending, G/Y, has declined since the 1970s. Furthermore, government spending in the 1990s has averaged just 21.0 percent of output—as low a rate as any observed in the five periods. The rate of household consumption spending, on the other hand, rose from 69.9 percent of output in the 1950s to 76.5 percent in the early 1990s. This increased rate of household consumption was associated with a decline in the household saving rate from 11.5 percent in the 1950s to 3.1 percent in the 1990s.

Table 2 considers the role of health-care spending in the growth of household spending. It shows that medical expenditures have increased from 3.9 percent of NNP in the 1950s to 12.8 percent in the 1990s. In the 1950s health-care spending represented less than 6 percent of household consumption. So far, in the 1990s, it has represented almost 17 percent. The increase in the rate of medical spending was associated with only a modest reduction in the rate of non medical spending. In the 1950s, non medical consumption averaged 66.0 percent of NNP. In the 1990s, it averaged 63.7 percent. Thus, although the rate of medical consumption rose by 8.9 percentage points between the 1950s and 1990s, the rate of non medical consumption fell by only 2.3 percentage points.

WHOSE CONSUMPTION HAS RISEN?

If the driving force behind the decline in U.S. saving is an increase in the rate of household consumption, it's natural to ask whose consumption within the household sector has risen so rapidly? The answer is the elderly. Figures 1 and 2 present, respectively, relative profiles by age of total consumption and non medical consumption.[1] Each figure contains profiles for the periods 1960–61, 1972–73, 1984–86, and 1987–90. The periods were chosen based on the availability of Consumer Expenditure Survey data. For each period, the average consumption of 40-year-olds is normalized to 1.

[1] These figures and the tables discussed below come from Gokhale, Jagadeesh, Laurence J. Kotlikoff, and John Sabelhaus, "Understanding the Postwar Decline in United States Saving: A Cohort Analysis," mimeo, Boston University, November 1994.

The figures document a remarkable increase in the relative consumption of the elderly. This increase is more pronounced if medical care is included in the measure of consumption, but the increase in the relative consumption of non medical goods and services is also striking. Tables 3 and 4 examine some of the numbers underlying Figures 1 and 2. They report ratios of average levels of total as well as non medical consumption of 60, 70, and 80-year-olds to the respective levels of 20, 30 and 40-year-olds for each of the four periods. According to tables, 70-year-olds in 1960–61 consumed about 71 percent of the amount consumed by 30-year-olds in 1960–61, whereas their consumption now exceeds that of 30-year-olds by 18 percent. In the case of non medical consumption, 70-year-olds consumed about 63 percent of the amount consumed by 30-year-olds in 1960–61, compared with 91 percent now. The increase in relative consumption of the elderly based on other age pairings is equally dramatic.

The striking increase in the relative consumption of the elderly has coincided with an equally remarkable increase in their relative resources. The term "resources" refers to a generation's net worth plus the present values its future labor income, pension income, and Social Security, Medicare, and other transfer payments, less the present value of its future taxes. Figure 3 examines changes across the four time-periods in the age-distribution of resources. Table 5 presents ratios of average resources of 60, 70, and 80 year-olds to those of 20, 30, and 40 year-olds. In 1960–61, the average resources of 70-year-olds were only 72 percent as large as those of 30-year-olds. In 1987–90, they were 15 percent larger than those of 30-year-olds. The resources of other older cohorts have also grown significantly relative to those of younger cohorts over the past three decades.

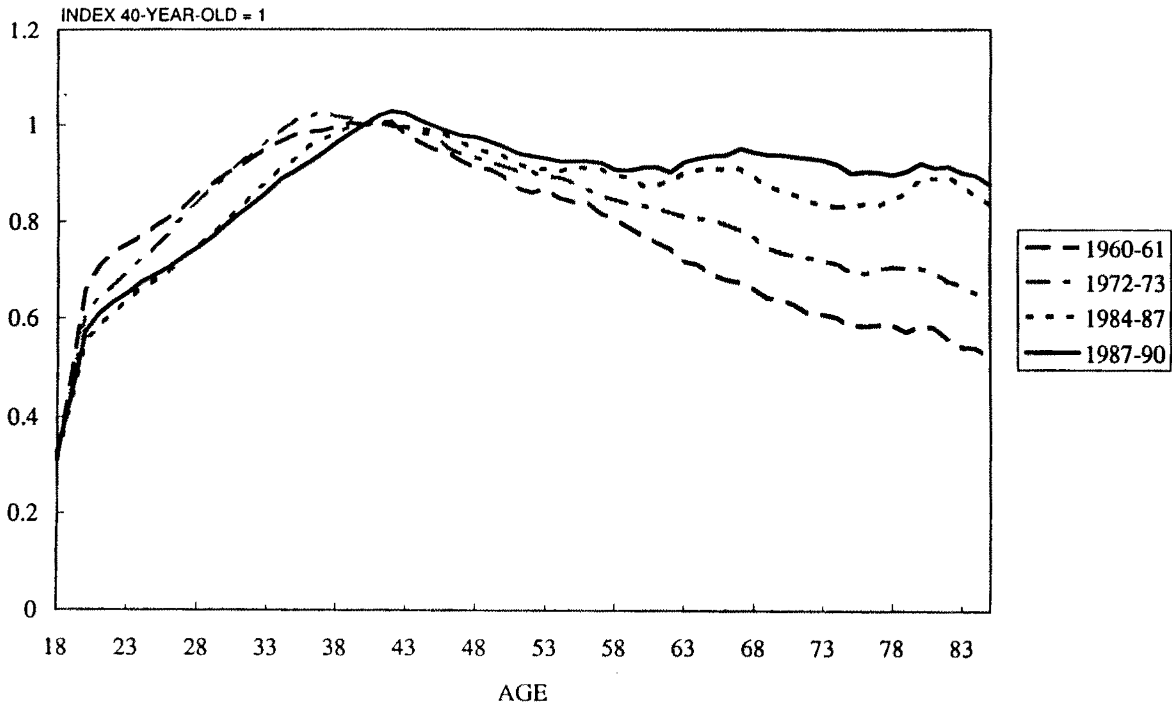
As described in a recent study,[2] most of the increase in the relative resources of the elderly can be traced to the federal government's four decade-long policy of transferring from the young and unborn to the old through pay-as-you-go Social Security and Medicare and other intergenerational transfer mechanisms.

THE INCREASE IN THE ELDERLY'S PROPENSITY TO CONSUME

In addition to the elderly consuming more because they've been handed more resources, they are also consuming more because their propensity to consume each dollar of resources has increased dramatically. This point is documented in Figure 4 which shows propensities to consume of different age groups in the four periods. These propensities are formed by dividing consumption of an age group in each period by the value of its resources in that period.

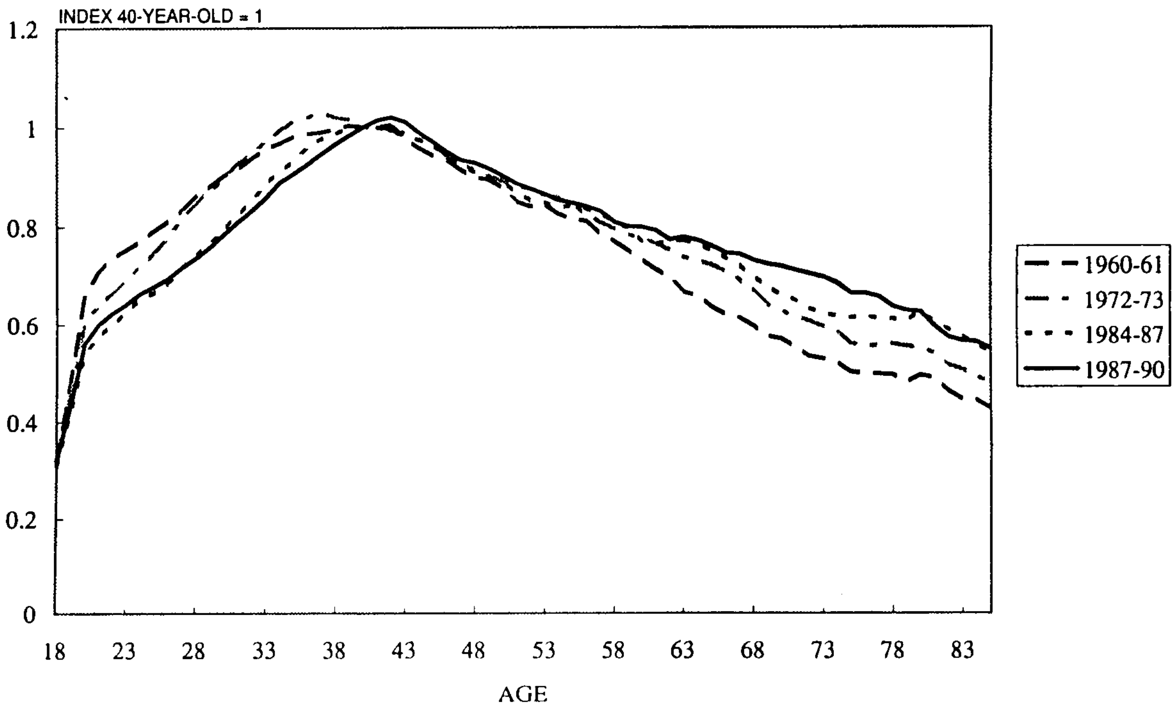
[2] Op. cit.

FIGURE 1: RELATIVE CONSUMPTION PROFILES



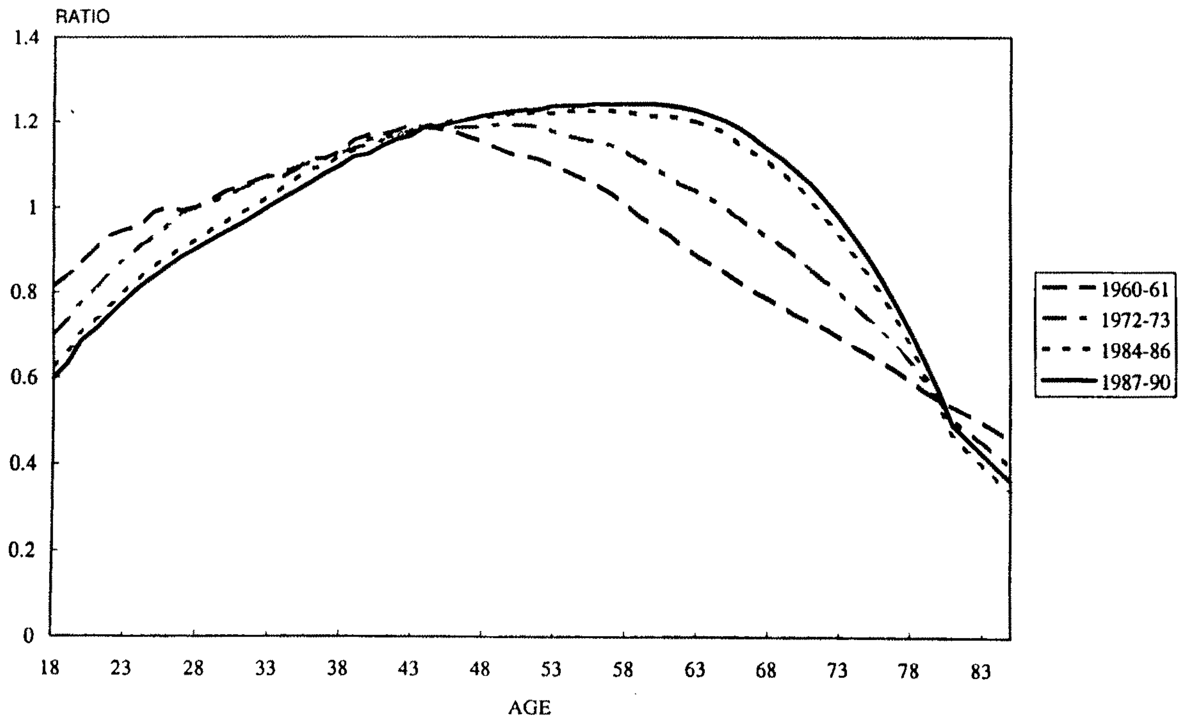
SOURCE: AUTHORS' CALCULATIONS BASED ON THE CONSUMER EXPENDITURE SURVEY.

FIGURE 2: RELATIVE NONMEDICAL CONSUMPTION PROFILES



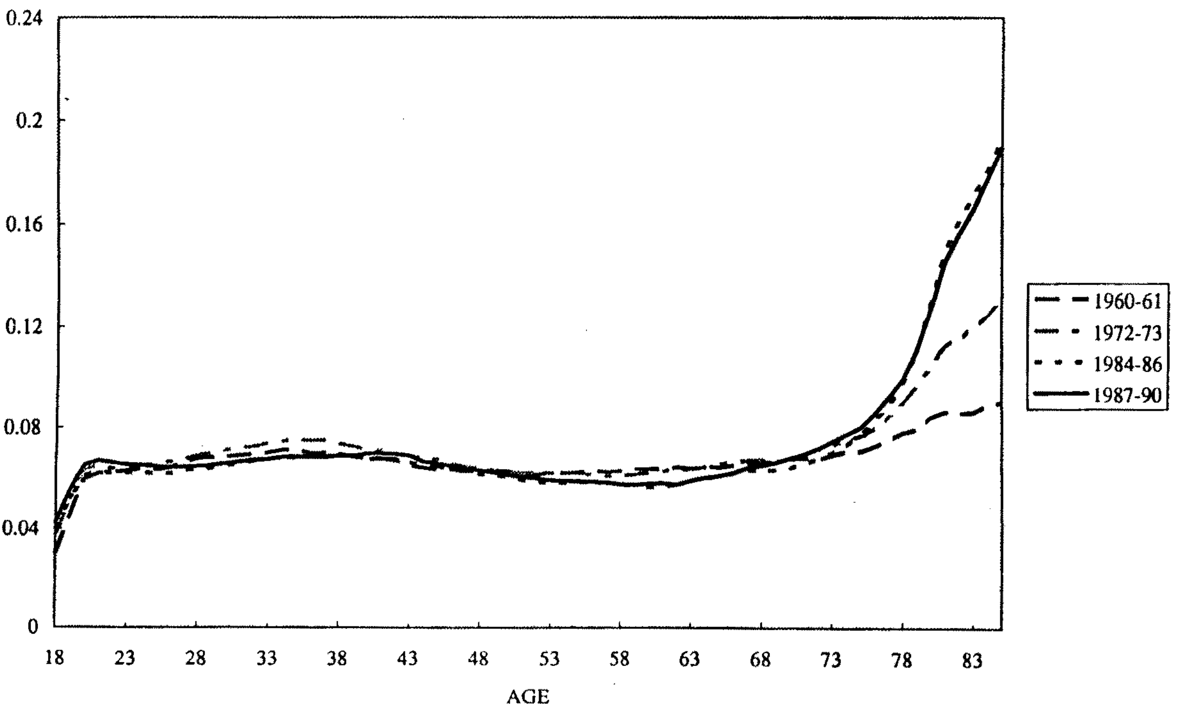
SOURCE: AUTHORS' CALCULATIONS BASED ON THE CONSUMER EXPENDITURE SURVEY.

FIGURE 3: RATIO OF COHORT RESOURCES PER CAPITA TO PER CAPITA RESOURCES



SOURCE: AUTHORS' CALCULATIONS.

FIGURE 4: AVERAGE PROPENSITIES TO CONSUME OUT OF TOTAL RESOURCES



SOURCE: AUTHORS' CALCULATIONS.

Much of the increase in the elderly's propensity to consume may reflect the form in which they are receiving their resources. The elderly's resources are substantially more annuitized now than was the case in the past,[3] which means they can consume without having to worry as much about running out of income. In addition, the medical care annuities that the government provides the elderly through Medicare and Medicaid come in the form of in-kind consumption of medical goods and services. The elderly can not help but consume these in-kind transfers.

Figure 4 also shows that there is very little change in the consumption behavior of the young and middle-aged between the early 1960s and the late 1980s. This contradicts the popular myth that the baby boom generation has poorer saving habits than did their parents when they were middle aged.

WILL IRAS AND RELATED SAVING INCENTIVES RAISE NATIONAL SAVING?

The lessen in the data just presented is that those who get more resources to spend will consume more. When we redistribute, as we have and continue to do, from young and middle-aged generations, with moderate propensities to consume, to the old, with high consumption propensities, we can expect total household consumption to rise and total national saving to fall. And when we redistribute, as we have and continue to do, from as yet unborn generations, with zero propensities to consume, to young, middle-aged, and older generations with positive consumption propensities, we can also expect total household consumption to rise and national saving to fall.

The increase in consumption of individuals or groups who receive more resources is referred to, by economists, as the "income effect." Income effects may be contrasted with "substitution effects," which refer to the change in consumption associated with changes in the incentive to consume in the present rather than the future.

Individual Retirement Accounts and similar tax-subsidized saving accounts provide an abject lesson in the need to think through the income as well as substitution effects in designing policies to lower household consumption and raise national saving. The mere fact that households place funds in IRAs and similar accounts does not mean that the funds placed in these accounts reflect either a reduction in the consumption of these households. To the contrary, these accounts permit households to reduce the present value of their lifetime taxes without reducing their consumption by a single dollar. Furthermore, in providing households with positive income effects, these accounts actually induce more current consumption and, thereby, lower national saving. The source of these income effects is well-known; IRAs and similar accounts permit tax arbitrage whereby households can reduce the present value of their remaining lifetime net taxes simply by moving money that they (1) previously had saved, (2) would otherwise have saved, or (3) have recently borrowed, from a non-tax favored into a tax-favored account.

The invitation to use these accounts to engage in tax arbitrage is available to all tax-paying segments of society, but it appears to have been fully exploited primarily by middle and upper income households. Three quarters of all contributions to IRA's are from households who contribute the maximum. that raise private saving (at least, according to the government's definition), at the very likely cost of reduced national saving.[4] For those households in income classes above $50,000, the percentage of contributions that hit the maximum, during those years when their contributions were tax deductible, was 83 percent. At the margin, households contributing the maximum end up with no change in the economic incentive they face to postpone current for future consumption. Rather, they simply experience a positive income effect leading them to consume more and work less.

For some households—those with no previous savings, no ability to borrow, and who would have saved less than the IRA maximum contribution—IRAs change saving incentives in addition to providing a positive income effect by lowering such households' effective capital income tax rates. But, as mentioned above, even for these households one would expect the income effects, from the reduced capital income tax rate, to dominate the substitution effects, from the higher after-tax return to saving, with the result that even these households would consume more and the nation would save less.

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[3] See Auerbach, Alan J., Jagadeesh Gokhale, Laurence Kollikoff, John Sabelhaus and David N. Weil, "The Annuitization of Americans' Resources: A Cohort Analysis," mimeo, Boston University, 1994.

[4] See Harvey Galper and Charles Byce, "Individual Retirement Accounts: Facts and Issues," Tax Notes, 1986.

Unfortunately, economic research has failed to focus directly on the consumption and labor supply effects of IRAs and similar accounts.[5] Instead, the research has studied the propensity of different segments of society to put money in these accounts. Indeed, not a single study to date has directly related household consumption and labor supply to the availability of IRA and similar accounts in a manner that takes careful account of the applicable income and substitution effects. The only clear fact known about household consumption and IRAs is that household consumption as a share of NNP increased precisely during the period that the use of IRAs was permitted to expand.

IRAs, SRAs, and similar accounts are symptoms of a broader schizophrenia in the U.S. tax system about whether or not to adopt an income tax or a consumption tax. Rather than make a clear choice, the U.S. has, for decades, opted for a combination of the two tax regimes, but one that permits tax arbitrage, specifically the ability to borrow at tax-deductible interest rates and lend at tax-free interest rates. While IRAs and similar accounts have received most of the concern with respect to the potential for tax arbitrage, the major means for arbitraging the tax system has been, and remains, employer-provided pension plans. These plans permit households to accumulate interest on a tax-free basis (within defined benefit pension funds and defined contribution pension accounts) on much larger sums of money than do IRAs.

The Federal Government's invitation to the American public to borrow at tax-deductible rates and lend at tax-free rates via their pension plans, IRAs, Keogh Accounts, SRAs, etc., has not gone unheeded. Rather it has produced an enormous expansion of borrowing. The expansion of borrowing was so great in the early 1980s, that the Federal government was compelled to eliminate the deductibility of consumer interest payments in the 1986 Tax Reform Act. The major vehicle for tax-deductible borrowing, namely mortgage interest, remains, however, intact, with the consequence that very significant opportunities for tax arbitrage remain to this day. The extent of tax arbitrage is so great that economists inside and outside the government have produced studies showing that the Federal government would actually increase its revenue collection by eliminating all personal capital income taxation.

Recent proposes to weaken restrictions on withdrawals from IRAs, to expand IRA limits, to permit middle and upper income households to contribute to IRAs, and that introduce IRAs which pay taxes on the contribution to IRAs, but not on the withdrawal of IRA accumulations—pose an added danger to U.S. national saving. First, they will permit more tax arbitrage by middle class and upper income households who are now precluded from transferring more of their assets into these tax favored accounts. Second, these plans will permit Americans to use their existing IRAs, prior to their reaching age 59, to finance current consumption. While the form of this current consumption will be restricted to the payment of educational and medical expenses or to the first time purchase of a home, each of these expenditures represents, nonetheless, a form of consumption, the partaking of which diminishes national saving.[6]

Third, in proposing the establishment of IRAS in which tax benefits are deferred to the future, the government is not proposing to increase the present value of anyone's tax payments, but rather to change the timing of those payments. Since the government engages in no present value bookkeeping, but continues to focus exclusively on its cash flow deficit, this proposed advancement in the timing of the government's revenues would provide a source of funds for additional spending that could be used without worsening the deficit. If such new spending were induced by the change in the timing of the government's revenues, the result would be a worsening of the government's long run financial condition. The spending itself would also reduce national saving assuming the spending were allocated to either increased government consumption or to increased transfer payments which would finance increased private consumption.

Let me point out that, although I oppose expanding IRAs or permitting penalty-free early withdrawals, I do so because of the nature of our current tax structure, which, remains, primarily an income tax. But were we to switch from an income tax structure to a consumption tax structure, which I strongly advocate, I would have no objection to any of the current IRA proposals, because IRAs are a natural

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[5] See, for example, Venti, Steven F. and David A. Wise, "Have IRAs Increased U.S. Savings? Evidence from Consumer Expenditure Surveys," *Quarterly Journal of Economics*, August 1990. For an excellent review of the literature on IRAs and an analysis of the national saving impact of these policies, see Jane G. Gravelle, "Do Individual Retirement Accounts Increase Savings?" *Journal of Economic Perspectives*, Spring 1991.

[6] In the case of new home purchases, it is not the purchase of the new home, but rather the imputed rent on the new home, that constitutes additional consumption.

component of a consumption tax structure (they afford consumption tax treatment to capital income) and within a consumption tax structure there would be no possibility for the public to use IRAs to arbitrage the tax system.

CUTTING THE CAPITAL GAINS TAX RATE

A cut in capital gain taxes is another example of a policy whose income effects would almost surely dominate its substitution effects and stimulate consumption and reduce national saving. While a capital gain tax cut would increase incentives for additional saving, it would also represent a windfall to those with accrued, but not yet realized, capital gains on past saving. Even households with no unrealized capital gains would experience positive income effects because of the taxes they would save on future realizations of capital gains.

The Auerbach-Kotlikoff Dynamic Simulation Model can provide a sense of the magnitude of the long term decline in U.S. savings and capital formation of the proposed deficit-finance cut in capital gains taxes.[7] Tables 6, 7, and 8 show the results of three simulations of the model involving reductions in the capital income tax rate from 30 percent to 29 percent that last for 4, 9, and 19 years, respectively. This represents a 3.33 percent reduction in the rate of capital income taxation, which is at the upper bound of estimates of the reduction in the effective capital income taxation associated with the Administration's capital gains tax cut proposal. Since there are no unrealized capital gains in this model, the simulation is biased in favoring of finding that a capital gains tax cut would raise saving because it ignores the positive income effects accruing to those with unrealized gains.

In each of the simulations the wage tax rate is held fixed throughout the transition at 30 percent. During the period of the tax cut the government in the model issues debt to cover its loss in revenue from the temporary capital income tax cut. At the end of the tax cut, i.e., after 4, 9, or 19 years, the model adjusts the capital income tax rate each year to maintain a zero deficit adjusted for growth.

Each of the three tax cut experiments leads in the long run to crowding out of savings and capital, lower real wages and higher real interest rates, and higher capital income tax rates. For example, in the case of the 19 year tax cut, the long run capital stock is 6.7 percent smaller, the real wage is almost 2 percent lower, and the real interest rate is 70 basis points higher than in the initial steady state. In addition, the long run capital income tax rate is .339, which is almost 4 percentage points higher than its initial steady state value of .300.

While deficit-financed reductions in capital income tax rates are detrimental to the economy in the long run, the short run effects mask the long run problems. In the very short run, the substitution effects of temporarily lower capital income tax rates induce more saving and there is a temporary crowding in of capital. But the short run increase in saving does not suffice to raise the capital income tax base enough to preclude the running of deficits. As a result, the deficit grows over time and once the period of the tax cut has come to an end, the capital income tax rate must be increased to pay interest on the debt.

The simulations indicate that, at current levels of taxation, there is no Laffer curve for the economy to exploit with respect to capital income taxation. Each of the simulations involve, after a couple of years, depressed saving rates for decades. On the basis of these simulations, one must conclude that reductions in personal capital income taxes, be they effected through capital gains tax cuts, or, for that matter, through the expansion of IRA's and similar tax-subsidized saving accounts, are precisely the wrong medicine to cure our saving problem.

ENACTING A MANDATORY DEFINED CONTRIBUTION PLAN

Another recent proposal to raise U.S. saving involves the government's enactment of a mandatory defined contribution plan (MDCP) that would cover all working Americans.[8] Under this proposal each employer would be forced to contribute a fixed percentage, say 5 percent, of his or her worker's wages to a portable defined contribution plan. In the case of the self-employed, the same contribution rate would be applied to self-employment income. The government would certify a list of private investment funds to which the contributions would be made. Workers would be free to choose the division of their contributions among the different investment funds certified by the government.

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[7] See Auerbach, Alan J. and Laurence J. Kollikoff, *Dynamic Fiscal Policy*, Cambridge University Press, 1987.

[8] Dr. Barry Bosworth, Senior Economist at the Brookings Institution, has proposed such a scheme.

Would the proposed MDCP raise U.S. saving? The answer depends on three critical issues. The first is their tax treatment. If the MDCP is accorded the same consumption tax treatment as existing defined contribution plans, it would permit more of the tax arbitrage discussed above. The positive income effects arising from this tax arbitrage would produce more, not less, consumption and less, not more, national saving. Of course, there is no requirement that the MDCP be taxed on a consumption tax, rather than an income tax, basis. If it is taxed on an income tax basis, contributions to the MDCP would not be deductible from workers' Federal income taxes.

The second issue is the extent to which existing employer-provided pension plans would simply be converted to MDCP accounts. Just over half of private wage and salary workers currently participate in employer-provided pension plans. Of these workers, somewhat over half are enrolled in defined contribution and 401K plans. The rest are enrolled in defined benefit plans (or both).[9] The contribution rates of the defined benefit and 401K plans appear to average somewhat more than 5 percent of wages. Hence, perhaps as much as a quarter of the work force could meet the MDCP requirement simply by switching the title of their defined contribution and 401K plans. However, in the case that the MDCP is taxed on an income tax, rather than a consumption tax basis, the MDCP would have less favorable tax treatment than existing defined contribution and 401K plans. In this case, one would expect fewer conversions of existing plans into MDCP accounts.

The potential also exists for firms with defined benefit plans to terminate these plans and replace them with the proposed MDCP accounts. The accrual of pension benefits in defined benefit plans measured as a fraction of wages is typically less than the hypothetical 5 percent MDCP contribution rate for younger workers and greater than 5 percent for older workers.[10] Hence, the substitution of defined benefit plans for the MDCP accounts would raise (lower) the rate of institutionalized saving for younger (older) workers in firms that currently have defined benefit plans.

A third issue is the potential for workers to respond to the MDCP by reducing their non-institutionalized saving. This can be done in several ways. Households can spend existing assets to make up for the reduction in take home pay associated with the introduction of the MDCP. Alternatively, households can save less on their personal account in response to the forced saving through the MDCP. Another method is for households to increase their long term borrowing and eventually use the assets accumulated in their MDCP account to pay off this borrowing. These and related ways of maintaining consumption levels despite the introduction of the MDCP are, of course, more likely to be used by middle and upper income households which have the assets to spend down, which are doing the discretionary saving that can be reduced, and that have the means to borrow additional sums on a long term basis. For lower income households with little in the way of accumulated assets, limited ability to borrow, and who do little or no discretionary saving, the MDCP accounts will reduce their consumption and contribute to a higher value of national saving.

While the MDCP would be most effective in forcing lower income households to postpone their consumption, lower income households are, ironically, the group that appears to have the smallest need for increased saving. The reason is that Social Security provides retirement benefits on a highly progressive basis. Consequently, its benefits replace a much higher fraction of the pre-retirement incomes of lower income households than they do of middle and upper income households. In addition to receiving more social security benefits relative to their incomes, lower income households can look forward to relying more on Medicaid to finance their old age health care than is the case for middle and upper income households.

What might be the impact on national saving of introducing the MDCP with a 5 percent contribution rate? Given the caveats listed above, any estimate must be viewed as highly speculative. But a conservative estimate might run like this. Assume that the MDCP is taxed on an income tax basis, and that the 80 percent of workers with the highest labor income are able to maintain their consumption spending, through one means or another, despite having to place 5 percent of their wages into MDCP accounts. For the 20 percent of workers with lowest earnings, let's assume that each dollar contributed to the accounts would represent a dollar less of consumption. Then the MDCP would reduce household consumption by 5 percent (the MDCP contribution rate) of 20 percent (the fraction of workers affected)

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[9] See U.S. Department of Labor, *Trends in Pensions 1992*, Washington, D.C.: U.S. Government Printing Office, 1992.

[10] See Laurence J. Kotlikoff and David Wise, *The Wage Carrot and the Pension Stick: Pension Benefits and Labor Force Participation*, Kalamazoo, MI.: The W.E. UpJohn Institute for Employment Research, 1989.

of 75 percent of NNP (labor's share of NNP). This translates into an increase in the national saving rate of three quarters of one percentage point. This would raise our current, roughly 3 percent national saving rate, to 3.75 percent. This hardly brings us back to a respectable national saving rate, but it could be a step in the right direction.

GOVERNMENT PROVISION TO HOUSEHOLDS OF PERSONAL SAVING TARGETS

An inexpensive way for the U.S. government to promote additional saving is for it simply to send every adult American an annual saving statement telling them how much they should be saving. The statement would incorporate all the information now provided (but only upon request) by the Social Security Administration. These Social Security statements detail current and past contributions and project retirement, survivor, and disability benefits. In addition to this social security information, the saving statement would stipulate how much additional funds the individual should be saving either directly on his own or through his or her employer's pension or other saving plans. The saving statement could provide tables that show how the individual's targeted saving goal depends on his or her net worth, the net worth and earnings of his or her spouse, and the number and ages of his or her children. The saving statement would be accompanied by a letter from the President spelling out the crisis in U.S. saving and stressing the need for each of us to accept more responsibility for financing our retirement years.

Obviously, the saving statement would point out that each individual's circumstances differ and that the statement's recommended saving targets might not be applicable to the particular individual. The saving statement could also include a detailed questionnaire on the individual's economic and demographic circumstances, portfolio composition, and special saving needs. Those individuals mailing in their questionnaires to the government would receive back a detailed lifetime saving plan appropriate to their circumstances.

There is, of course, no guarantee that this form of jaw-boning would induce Americans to forego current consumption in order to consume more in the future. But it might! After all, most Americans, indeed, most economists, fail to engage in any detailed planning with respect to how much to save for their retirement. Too many Americans may simply be relying on the saving done for them by the government (via social security) and their employers (via pension plans). Surely annual saving statements with specific saving targets will get Americans' attention focused on the question of how much they should save. It may also change attitudes about who is responsible—the government, the employer, or ourselves—about securing our own future economic wellbeing.

Table 1

Saving and Spending Rates

Period	Net National Saving Rate (Y-C-G)/Y	Government Spending Rate G/Y	Household Consumption Rate C/Y	Household Saving Rate (Y-G-C)/(Y-G)
1950-59	.091	.210	.699	.115
1960-69	.091	.221	.688	.117
1970-79	.085	.214	.701	.108
1980-89	.047	.213	.740	.059
1990-93	.024	.210	.765	.031

Table 2

The Growth of Household and Medical Consumption

Period	Rate of Household Consumption C/Y	Rate of Medical Consumption M/Y
1950-59	.699	.039
1960-69	.688	.052
1970-79	.701	.072
1980-89	.740	.101
1990-93	.765	.128

Table 3

Consumption of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.17	1.37	1.58	1.59
Age 70/Age 20	0.97	1.21	1.56	1.64
Age 80/Age 20	0.89	1.16	1.61	1.60
Age 60/Age 30	0.86	0.93	1.09	1.15
Age 70/Age 30	0.71	0.82	1.07	1.18
Age 80/Age 30	0.65	0.79	1.11	1.16
Age 60/Age 40	0.77	0.83	0.87	0.91
Age 70/Age 40	0.64	0.73	0.86	0.94
Age 80/Age 40	0.58	0.70	0.89	0.92

Source: Authors' calculations.

Table 4

Non Medical Consumption of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.11	1.28	1.43	1.42
Age 70/Age 20	0.86	1.04	1.22	1.28
Age 80/Age 20	0.75	0.91	1.16	1.11
Age 60/Age 30	0.81	0.86	0.97	1.02
Age 70/Age 30	0.63	0.70	0.83	0.91
Age 80/Age 30	0.55	0.61	0.78	0.80
Age 60/Age 40	0.73	0.78	0.77	0.80
Age 70/Age 40	0.57	0.63	0.66	0.72
Age 80/Age 40	0.49	0.55	0.62	0.63

Source: Authors' calculations.

Table 5

Resources of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.10	1.41	1.72	1.81
Age 70/Age 20	0.85	1.14	1.49	1.58
Age 80/Age 20	0.63	0.71	0.76	0.83
Age 60/Age 30	0.92	1.07	1.26	1.31
Age 70/Age 30	0.72	0.86	1.09	1.15
Age 80/Age 30	0.53	0.54	0.56	0.60
Age 60/Age 40	0.82	0.95	1.05	1.10
Age 70/Age 40	0.64	0.77	0.91	0.96
Age 80/Age 40	0.47	0.48	0.47	0.51

Source: Authors' calculations.

Table 6

Simulating Deficit-Financed Reductions in Capital Income Taxation
A 4 Year Cut in the Capital Income Tax Rate

Year	Capital	Labor	NNP	Wage	Interest Rate	Capital Inc. Tax Rate	S/Y
0 (Initial Steady State)	48.60	16.42	21.89	1.000	.1126	.300	.033
1	48.60	16.44	21.91	.999	.1127	.290	.035
2	48.63	16.43	21.91	1.000	.1126	.290	.034
3	48.64	16.42	21.90	1.000	.1125	.290	.033
4	48.63	16.41	21.89	1.000	.1125	.290	.032
5	48.61	16.41	21.89	1.000	.1125	.303	.032
6	48.59	16.41	21.88	1.000	.1126	.303	.032
7	48.56	16.41	21.88	.999	.1126	.303	.032
.							
.							
20	48.35	16.42	21.87	.998	.1130	.304	.032
30	48.28	16.42	21.86	.998	.1132	.304	.032
90	48.22	16.43	21.86	.997	.1133	.304	.032
150	48.21	16.43	21.86	.997	.1133	.304	.032

Table 7

Simulating Deficit-Financed Reductions in Capital Income Taxation

A 9 Year Cut in the Capital Income Tax Rate

Year	Capital	Labor	NNP	Wage	Interest Rate	Capital Inc. Tax Rate	S/Y
0 (Initial Steady State)	48.60	16.42	21.89	1.000	.1126	.300	.033
1	48.60	16.45	21.92	.999	.1127	.290	.035
2	48.64	16.44	21.92	.999	.1126	.290	.034
3	48.66	16.43	21.91	1.000	.1125	.290	.034
4	48.68	16.42	21.91	1.000	.1125	.290	.033
5	48.68	16.42	21.90	1.000	.1124	.290	.033
6	48.67	16.41	21.89	1.000	.1124	.290	.032
7	48.64	16.40	21.88	1.000	.1124	.290	.031
8	48.61	16.39	21.87	1.000	.1124	.290	.031
9	48.55	16.38	21.85	1.000	.1125	.290	.030
10	48.49	16.39	21.85	.999	.1126	.309	.030
11	48.43	16.39	21.85	.999	.1127	.309	.030
12	48.38	16.39	21.84	.999	.1128	.309	.030
.							
.							
20	48.05	16.41	21.83	.997	.1135	.310	.031
30	47.81	16.43	21.81	.995	.1140	.311	.031
60	47.61	16.44	21.80	.994	.1144	.312	.032
150	47.57	16.44	21.80	.994	.1145	.312	.032

Table 8

Simulating Deficit-Financed Reductions in Capital Income Taxation

A 19 Year Cut in the Capital Income Tax Rate

Year	Capital	Labor	NNP	Wage	Interest Rate	Capital Inc. Tax Rate	S/Y
0 (Initial Steady State)	48.60	16.42	21.89	1.000	.1126	.300	.033
1	48.60	16.45	21.93	.999	.1128	.290	.036
2	48.65	16.44	21.93	.999	.1126	.290	.035
3	48.68	16.44	21.92	1.000	.1126	.290	.034
4	48.71	16.43	21.92	1.000	.1125	.290	.034
5	48.73	16.43	21.92	1.000	.1124	.290	.034
6	48.74	16.42	21.92	1.000	.1124	.290	.033
7	48.74	16.42	21.91	1.000	.1124	.290	.033
8	48.74	16.42	21.91	1.000	.1123	.290	.033
9	48.72	16.41	21.90	1.000	.1123	.290	.032
10	48.71	16.41	21.89	1.000	.1123	.290	.032
11	48.69	16.40	21.89	1.000	.1124	.290	.031
12	48.66	16.40	21.88	1.000	.1124	.290	.031
13	48.63	16.39	21.87	1.000	.1125	.290	.030
14	48.58	16.39	21.86	1.000	.1124	.290	.030
15	48.53	16.38	21.84	1.000	.1125	.290	.029
16	48.45	16.37	21.83	1.000	.1126	.290	.028
17	48.36	16.36	21.81	.999	.1127	.290	.027
18	48.25	16.35	21.78	.999	.1128	.290	.026
19	48.12	16.33	21.75	.998	.1130	.290	.025
20	47.96	16.34	21.74	.997	.1133	.329	.025
21	47.81	16.35	21.73	.996	.1136	.330	.025
22	47.66	16.36	21.72	.995	.1140	.331	.025
.							
.							
30	46.74	16.41	21.68	.990	.1159	.333	.027
60	45.55	16.48	21.60	.983	.1185	.338	.030
150	45.34	16.49	21.58	.981	.1190	.339	.031

PREPARED STATEMENT OF JONATHAN SKINNER

My name is Jonathan Skinner, and I am professor of economics at the University of Virginia, and research associate at the National Bureau of Economic Research. I am pleased to appear before you today to discuss the evidence about saving incentives and their potential to increase saving. In my discussion, I will draw on a recent survey by Glenn Hubbard of Columbia University and me in which we reviewed much of the evidence about saving incentives and saving behavior.[1]

I want to focus today on three questions related to saving incentives. First, do saving incentives have the *potential* to increase aggregate U.S. personal saving? Second, are these saving incentives effective at increasing saving? And finally, what is the best way to design a saving incentive program?

The first question is: Do saving incentives have the potential to increase aggregate U.S. personal saving? The answer here is yes, but not by much. In 1993, Individual Retirement Accounts (IRAs), Keoghs, and estimated 401(k) plan contributions were $79 billion, or more than 40 percent of personal saving in that year. Since personal saving in 1993 was only 4 percent of disposable income, however, combined contributions to saving incentive programs add up to only 1.7 percent of disposable income. Restoring IRAs is not likely to increase personal saving by the 8 percentage points necessary to approach saving rates in Japan or Germany.

A more attainable goal for saving incentives is to improve households' financial resources in retirement. Just a few years of IRA or 401(k) contributions can have a large impact on the financial security of the average American household nearing retirement by providing a cushion against unforeseen medical expenses or other contingencies. Thus saving incentives should be judged on more than by how much they raise the national saving rate.

The second question is: Are these saving incentives effective at increasing saving? Here the evidence is more open to different interpretations, but I will try to summarize the research to date briefly.

It is important to distinguish between short-run and long-run effects of saving incentives such as IRAs and 401(k)s. Many researchers agree that in the long term, saving incentives do affect saving behavior. For example, in a Brookings Institution paper, Eric Engen, William Gale, and John Karl Scholz use a theoretical model to show that increasing the limit on IRA contributions will increase national wealth by $4 for every $1 loss in tax revenue.[2] The incremental benefits of 401(k) plans are even greater: an increase of $16 in net national wealth for every $1 loss in tax revenue. They are careful to note a number of caveats. First, the predicted impact of IRAs on the aggregate capital stock is quite small (although the predicted impact of a universal 401(k) program is larger). And second, they predict the salutary impact of these saving incentives won't come for 50 years or more. For a number of reasons, I believe the long-term effects will come considerably sooner.

It is much harder to sort out the evidence on the short-term effects of IRAs. Despite our experience with IRAs during the 1980s, researchers remain divided on whether they increased saving in the short-term. The difficulty is that people who are most likely to purchase IRAs are also systematically different from noncontributors; they have higher income and on average a greater tendency to save.[3] Figuring out what part of their actual saving is simply due to differences in tastes, and what part is due to the availability of the IRA, is a difficult task which has been addressed by a number of researchers, with often opposing conclusions.[4]

I find the psychological evidence about the beneficial effects of IRAs most compelling. The key word here is "discipline." As Richard Thaler of Cornell University has stressed, we see many mechanisms by which people commit to saving for the future, even if they appear in retrospect to be irrational. By putting money aside in an IRA—even if shuffled from taxable assets in the short-term—the household sets aside wealth that is difficult to spend without substantial tax penalties.[5]

One strong predictor of whether taxpayers make a contribution to an IRA is whether they owe money, in excess of withholding, to the IRS. That is, taxpayers would rather deposit money into their IRA, and get the up-front deduction, than write a check to the IRS. Of course, we don't know whether this is old saving or new saving; the money owed to the IRS could be simply shuffled out of a taxable account. But based on personal experience, I do know that my IRA contributions

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[1] Hubbard and Skinner, 1995.

[2] Engen, Gale, and Scholz, 1994.

[3] See Gale and Scholz (1994).

[4] For example, Venti and Wise (1986, 1988, 1990) suggest that expanding IRA limits would increase overall saving, while Gale and Scholz (1994) find that expanding IRA limits would not increase overall saving.

[5] Thaler (1990, 1994).

from 1986 were ignored in making subsequent housing or car purchases. Encouraging households to discipline themselves to set aside income for retirement, rather than to spend it, should be a primary goal of any saving incentive.

One final comment on front-loaded versus back-loaded IRAs. While the up-front revenue costs of front-loaded IRAs make them appear costly over a five year budget horizon, their overall revenue costs are equal to back-loaded IRAs (assuming that marginal rates at retirement are similar to those when the contribution is made).[6] The reason is that the up-front revenue cost is later offset by the extra revenue collected when the IRAs are withdrawn. By 1993, total IRA assets (including rollovers from 401(k)s) were nearly one trillion dollars. At a 25% tax rate, these IRA assets represent a pool of nearly $250 billion in future revenue. The true revenue costs of IRAs may be even lower once one accounts for preferential tax treatment of "taxable" assets, such as deferred taxation of accumulated capital gains, and stepped-up basis at death.

I find the short-term evidence that 401(k)s increase saving more compelling than the evidence on IRAs, for two reasons. First, I believe that money withdrawn directly from the paycheck, as in 401(k) programs, is a surer way to save than to hope that cash is available for IRAs. Second, the 401(k) program has provided a better natural experiment to test how these incentives affect saving. While one can easily argue that IRA enrollees are different from non-enrollees, it is harder to argue that workers who are eligible for 401(k)s differ systematically in their taste for saving from workers at firms without available 401(k)s.[7] The evidence suggests that net wealth among 401(k) eligible workers has risen over time more rapidly than those not eligible for 401(k) plans.[8]

The final question is: What is the best way to design a saving incentive program? This is the hardest question of all, because it relates to changing how American families view their future and their upcoming retirement. Based on the research discussed above, it appears to me that 401(k) or salary reduction plans should play a major role in any saving strategy, for the following reasons:

(1) The percentage of taxpaying households who contributed to an IRA was about 15% annually during 1982-86 when IRA eligibility was expanded. The percentage of eligible workers who contributed to a salary reduction or 401(k) plan was 67% in 1993 (see Table 1). Among eligible workers with salaries between $15,000 and $20,000, the contribution rate in 1993 was 55%, substantially higher than contribution rates among IRA contributors at that income level. Therefore 401(k) programs have the potential to reach a much broader group of households than IRAs, even if the IRA program were expanded.

(2) There is some concern that 401(k)s are inadequate vehicles for providing for retirement. However, recent research by Andrew Samwick of Dartmouth College and me suggests that the typical 401(k) plan can provide the median worker more generous retirement benefits than the typical defined benefit plan, even when the 401(k) plan is invested quite conservatively, or is subject to swings in equity prices.[9] And while some 401(k) plan enrollees do spend their accumulated assets when they change jobs, they are not necessarily worse off than if they had been covered by defined benefit plans. Under defined benefit plans, real benefits largely revert to the employer when the employee changes jobs at early ages. At least with 401(k)s, workers get to spend the money. Furthermore, there is a likely net tax gain to the U.S. Treasury if workers cash out their 401(k)s and incur the tax penalty.

One policy change that could enhance saving behavior among 401(k) enrollees is to institute a mandatory rollover into an IRA account of 50 percent of the 401(k) balance. The revenue cost from such a provision would likely be minimal, although it could reduce the demand for 401(k)s among eligible employees.

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[6] Front-loaded IRAs allow eligible households to deduct the contribution from their current taxable income, but the principal plus accumulated interest is taxed at withdrawal. Back-loaded IRAs provide for after-tax contributions, but interest and principal may be withdrawn tax-free. See Hubbard and Skinner (1995).

[7] Although see Engen, Gale, and Scholz (1994) and comments in Hubbard and Skinner (1995).

[8] Poterba, Venti, and Wise (1994).

[9] Samwick and Skinner (1994a,b).

(3) Roughly half of all workers do not have the option to contribute to any pension plan.[10] Expanding the coverage of 401(k) plans can enhance the retirement security of these workers, many of whom are in lower income jobs and who are otherwise unlikely to save adequately for retirement. In principle, this coverage need not cost employers anything if they provide a bare-bones salary reduction plan without matching contributions by employers. Why then are 401(k) plans unavailable to half of all U.S. workers even if the costs to employers may be minimal? The answer is not entirely clear; private financial institutions may not find it profitable to administer 401(k) plans to very small companies with low paid employees, workers may show little interest, or employers may fear running afoul of discrimination rules. One possible solution to this latter problem is to exempt firms from discrimination rules if they contribute a minimum of 3 percent of income to every employee's 401(k) plan.[11]

To summarize, I believe that there would be large gains from expanding targeted saving incentives to improve the financial security of Americans nearing retirement. In my testimony, I have suggested that more attention be paid to making available employer-based saving incentive plans to the one-half of all Americans who are currently not covered by any private pension plan.

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	Sponsorship Rate*		Participation Rate**	
	1988	1993	1988	1993
All Workers	**270%**	**37%**	**57%**	**65%**
	Income			
Less than $10,000	7	11	29	28
$10,000–$14,999	15	23	37	44
$15,000–$19,999	22	36	46	55
$20,000–$29,999	32	45	54	64
$30,000–$49,999	44	57	63	72
$50,000 or more	55	68	74	83

[10] Samwick and Skinner, 1994b.

[11] See for example H.R. 4534 introduced in the previous congress by Alan Wheat.

	Sponsorship Rate*		Participation Rate**	
	1988	1993	1988	1993
Age				
21–30	25	33	48	52
31–40	32	42	56	67
41–50	33	43	64	71
51–64	28	38	69	74

*Sponsorship rate is the fraction of workers whose employer sponsors a salary reduction plan for any of the employees at the worker's place of employment.
**Participation rate is the fraction of workers participating in a salary reduction plan among those whose employer sponsors a plan for any of the employers at the worker's place of employment (taken from Table 1).

Table 1: Salary Reduction (401(k)) Plans: Sponsorship and Participation by Income, 1988 & 1993

Source: Yakoboski, Paul et. al. "Employment-Based Retirement Income Benefits: Analysis of the April 1993 Current Population Survey." EBRI Special Report No. 153 (September 1994).

PREPARED STATEMENT OF DAVID A. WISE

Mr. Chairman and members of the Senate Finance Committee, thank you for inviting me to speak today about 401(k)s, IRAs, and saving.

A large fraction of American families reach retirement age with virtually no personal financial assets. The median level of all personal financial assets of families with heads 55 to 64 was only $8,300 in 1991; excluding Individual Retirement Accounts and 401(k) balances the median was only $3,000. Almost 20 percent of families had no financial assets at all.[1] Thus other than Social Security benefits, employer-provided pension benefits, and illiquid housing wealth, the typical family has very limited resources to meet unforeseen expenses. In addition to individual hardship, the low U.S. saving rate foreshadows the prospect of limited future economic growth at the aggregate level.

Two saving programs introduced in the early 1980s were intended to encourage individual saving. Individual Retirement Accounts (IRAs) rapidly became a very popular form of saving in the United States after they became available to all employees in 1982. Any employee could contribute $2000 per year to an IRA account and a non-working spouse could contribute $250. The contribution was tax-deductible. Annual contributions grew from about $5 billion in 1981 to about $38 billion in 1986, approximately 30 percent of total personal saving. Contributions declined precipitously after the Tax Reform Act of 1986, even though the legislation limited the tax deductibility of contributions only for families who had annual incomes over $40,000 and who were covered by an employer-provided pension plan. By 1990, less than $10 billion was contributed to IRAs. Whereas over 15 percent of tax filers made contributions in 1986, only 4 percent contributed in 1990.

The other program, the 401(k) plan, grew continuously and almost unnoticed, with contributions increasing from virtually zero at the beginning of the decade to almost $50 billion by 1990. In 1991, almost 25 percent of families contributed to a 401(k). Deposits in 401(k) accounts are also tax-deductible and the return on the contributions accrues tax free; taxes are paid upon withdrawal. But these plans are available only to employees of firms that offer such plans. Prior to 1987 the employee contribution limit was $30,000, but the Tax Reform Act of 1986 reduced the limit to $7,000 and indexed this limit for inflation in subsequent years. The contribution limit is $9,235 for the 1994 tax year.

By 1991, contributions to all personal retirement saving plans exceeded contributions to employer-provided pension plans. It seems evident that if it were not for the 1986 tax legislation personal retirement saving would have been much larger. Whether these programs increase net saving can be of critical importance to future generations of older Americans and to the health of the economy in general. The issue remains an important question of economic debate. In a series of papers based on very different methods of analysis Venti and Wise and Poterba, Venti, and Wise[2] conclude that contributions to these accounts represent largely new saving.

[1] Based on 1991 data from the Survey of Income and Program Participation. See also Poterba, Venti, and Wise [1994a].
[2] Venti and Wise [1986, 1990, 1992, and 1993] and Poterba, Venti, and Wise [1994a, 1994b].

Today, I would like first to summarize a few of the important findings of our analyses that convince me that these programs have indeed added substantially to personal saving. Then I will comment on the features of the plans that I believe are important reasons for their success.

1. CONTRIBUTIONS WERE MUCH GREATER THAN PRIOR SAVING

At the outset of the IRA and 401(k) programs the typical American family had almost no personal financial assets. The median in 1985 was $600. Even older families with incomes well above the median saved very little. The typical family earning $50,000 to $75,000 annually and with a household head aged 45 to 55 had a paltry $11,500 in financial assets. On the eve of retirement, the typical family aged 55 to 65 had $3,700 in financial assets. Thus when these programs were introduced, most families were saving virtually nothing and were destined to have almost no liquid financial assets at retirement.

The typical contribution to an IRA account was about $2,300. How does the contribution compare to the financial assets of families who opened IRA accounts? Although families who opened accounts had more financial wealth than families who didn't, even their assets were low relative to an annual IRA contribution of $2,300. The median financial assets of families who made IRA contributions in 1984 was $8,600. It seems clear that before they opened IRAs the annual saving of these families—whose average age was 49—had not been nearly as large as the typical annual IRA contribution.

Comparisons for families who became eligible for a 401(k) plan, and for those who contributed to a 401(k), are similar. Typical contributions to these plans were far greater than the past saving of these families. Unlike the difference between IRA contributors and non-contributors, controlling for income, the assets of persons who became eligible for a 401(k) were not very different from those who did not. The 1984 *median* non-401(k) assets of persons who were *eligible* for a 401(k) in 1984 was $3,740. The mean 401(k) contribution of eligibles in that year was $1,256. It seems evident that those who became eligible had not been saving that amount before they became *eligible* for a 401(k) account. The 1984 median non-401(k)-IRA assets of families who made 401(k) contributions in 1984 was $5,600. The mean 401(k) contribution in that year was $2,161.[3] Again, it seems clear that these families had not been saving that amount before they began to contribute to a 401(k) account. By 1991, 401(k) contributors had a median of $6,000 in that account (the mean was $15,062) and median total assets of $19,300

2. THERE IS LITTLE CHANGE IN OTHER SAVING WHEN IRA CONTRIBUTIONS BEGIN

If non-IRA saving is reduced when IRA saving is increased, then when a household that was not contributing begins to contribute that household should reduce non-IRA saving. Likewise, when a household that was contributing stops contributing, non-IRA saving should increase. But when the same families are tracked over time, there is little change in other financial asset saving when families begin to contribute to an IRA (or when they stop contributing). The Survey of Income and Program Participation (SIPP) panel data allow calculation of the change in non-IRA saving when IRA contributor status changes. This simple calculation controls directly for changes in saving behavior across families since it is based on changes over time for the same families.[4]

Table 1 shows the change in other (non-IRA) saving between 1984 and 1985 by IRA contributor status. For example, families that contributed in neither 1984 nor in 1985 saved $89 more in 1985 than in 1984. Families that contributed in both years saved $186 more in other assets in 1985 than in 1984. The key change is for families that did not contribute in 1984 but did contribute in 1985. If the new IRA saving substituted for other financial asset saving, one would expect other saving to decline between 1984 and 1985. But the table shows that the non-IRA financial asset saving of these new contributors declined by only $193 between 1984 and 1985. This decline in other saving is only a small fraction of the increase in saving from the typical family IRA contribution, about $2,300.[5] In short, these data suggest that even near the outset of the IRA program there was only a small reduction in non-IRA saving when IRA contributions began.

[3] Based on Form 5500 data.
[4] The calculations and the data set are explained in detail in Venti and Wise [1995].
[5] Indeed, the hypothesis that there is no change in non-IRA saving with change in IRA contributor status cannot be rejected. As indicated by the F-statistics.

Table 1. Change in Non-IRA Saving When IRA Contributor Status Changed Between 1984 and 1985		
	1985 Non-Contributor	1985 Contributor
1984 Non-Contributor	89.4 (102.1)	**-193.5** (413.6)
1984 Contributor	630.3 (527.2)	186.2 (303.9)
		F = 2.565

3. THE NON-IRA ASSETS OF EARLY IRA CONTRIBUTORS DID NOT DECLINE

Using 1983 and 1986 Survey of Consumer Finances data it is possible to compare the asset balances of the *same* households over time. Begin with respondents to the 1986 survey.[6] Non-IRA and IRA median balances for this group in 1983 and 1986 and the change in balances between these years are shown in Table 2, by 1986 IRA contributor status. The table also shows total assets of contributors—including both IRA and non-IRA balances.

Table 2. Survey of Consumer Finances Data Summary			
Contributor Status and Asset	Year: 1983	1986	% Change
Contributors in 1986:			
Non-IRA Assets	**9400**	13500	43.6
IRA Assets	1000	7000	600.0
Total Assets	12075	**24000**	98.8
Non-Contributors in 1986:			
Total Assets	729	1000	37.2

The non-IRA assets of contributors did not decline as IRA assets increased between 1983 and 1986, on the contrary, they increased substantially. The median 1983 non-IRA asset balance of households with IRA accounts in 1986 was $9,400. Clearly, prior to 1983, this group had not been accumulating assets at the rate of the typical IRA contribution. And clearly the $6,000 increase in IRA balances (from $1,000 in 1983 to $7,000 in 1986) was not funded by transferring funds from the 1983 balance in non-IRA accounts, $9,400.

Without the IRA program, what increase in this 1983 non-IRA asset balance would be expected over the next 3 years? In fact the observed 43.6 percent increase was equivalent to an annual growth rate of over 13 percent. IRA assets also grew, by $6,000. The median of total assets almost doubled, increasing from $12,075 to $24,000.

Without IRA contributions, would the 1983 balance of $9,400 have been expected to increase two and one-half times, to $24,000, by 1986? Assets may have been expected to increase with age and income. We have controlled for these effects by predicting 1986 assets based on the distribution of contributor assets by age and income in 1983. Adjusting for the 3-year age increase and the income increase be-

[6] Only households aged 24 to 65 are included in the analysis and households with self-employed members are excluded.

tween 1983 and 1986, the balance would have been expected to increase by about 31 percent. Including IRA contributions the actual increase was almost 100. We also find that the asset growth cannot be explained by unusually high rates of return.

Thus, judging from the SCF data, it seems to us unlikely that the IRA contributions simply substituted for saving that would have occurred anyway.

4. 401(K)S HAVE INCREASED THE SAVING OF ELIGIBLE FAMILIES

James Poterba, Steven Venti, and I have compared the financial asset saving of families who are eligible with those who are ineligible for a 401(k) plan. The results are presented in Appendix Table 1, that shows assets in three panels for 1984, 1987, and 1991 respectively.[7] The key results are for 1987 and 1991, but the data for 1984 are particularly important in judging the reliability of the method.

The inferences about the net saving effect of 401(k) contributions depend on the similarity of the saving behavior of families who are and are not eligible for a 401(k), controlling for income. It is important, for example, that the eligible group not be composed disproportionately of savers. The data show little evidence of this type of difference in saving behavior. The most compelling evidence is for 1984. In that year the two groups—eligibles and non-eligibles—had about the same level of other financial assets. Thus near the outset of the 401(k) program families that were newly eligible for a 401(k) exhibited about the same previous saving behavior as families that did not become eligible. Eligible and non-eligible families also had about the same level of other financial assets in 1991 and in 1987. These data suggest that 401(k) eligibility is indeed largely independent of overall saving propensity, given income.

Data for families with incomes between $40 and $50,000 illustrate the findings: In 1984 newly eligible and ineligible 401(k) families had almost identical non-401(k)-IRA assets—$5,027 and $5,082 respectively.[8] By 1987, eligible families had a median of $12, 588 in total financial assets, almost twice the $6,726 median for ineligible families. In 1991, the median of total financial assets of eligibles families was $14,470, compared to $6,206 for ineligible families. But, in 1991, the non-IRA-401(k) assets of the two groups were still about the same, $4,724 for eligible and $4,250 for the ineligible group. In 1987, the eligible groups had more in other financial assets than the eligible group. If families reduced saving in other forms when they became eligible for a 401(k) plan, the typical eligible family in 1991 would have accumulated less wealth in other financial assets than the typical non-eligible family. This was not the case. Looking over all income intervals, by 1991 the total financial assets of the eligible families were typically two to eight times as large as the total financial assets of the non-eligible families. The data show no substitution of 401(k) contributions for other financial asset saving.

Table 3. Conditional Median Asset Balances by 401(k) Eligibility and Income: Families with Income $40,000 to $50,000

Asset Category and Eligibility Status	Results for 1991 (1991 $s)	Results for 1987 (1987 $s)	Results for 1984 (1984 $s)
Total Financial Assets			
Eligible for a 401(k)	14470*	12588*	
Not eligible for a 401(k)	6206	6726	
Non-IRA-401(k) Assets			
Eligible for a 401(k)	4724	5663*	5027
Not eligible for a 401(k)	4250	4246	5082

*Difference between eligibles and non-eligibles is statistically significant at the 95% confidence level.

[7] In addition to income, the estimates control for age, education, and marital status.

[8] The results referred to here are conditional medians, controlling for income, age, education, and marital status.

5. IRA AND 401(K) SAVING HAS INCREASED THE FINANCIAL ASSETS OF YOUNGER COHORTS

In my view the single most persuasive evidence on the saving effect of special retirement saving plans is provided by comparing the assets of families who are the "same" except that they reached a given age in different calendar years. Hence some groups—cohorts—had longer to contribute to special saving programs (401(k) and IRA, and Keogh, plans). For example, families that reached age 65 in 1984 had had only two years to contribute to an IRA or to a 401(k) plan. But families who attained age 65 in 1991 had had nine years to contribute. This is the approach that Steven Venti and I followed in our analysis of the "Wealth of Cohorts."[9]

We find that younger families, who attained a given age in 1991 for example, had consistently larger financial assets than families who reached that age in 1984. The larger assets of the younger cohorts is accounted for entirely by more assets in IRA and 401(k) plans. There is no difference between the other financial assets of the older and younger cohorts. The results can be illustrated by comparing the assets of families who reached ages 60 to 64 in 1984 with the assets of families that attained that age in 1991.

Table 4. Summary of Cohort Effects at Age 60-64 (1991 $s)

	1984[10]	1991
Contributors:		
Percent	38	42
Median:		
Personal Retirement Assets	7575	21613
Other Personal Financial Assets	19358	17950
Total Personal Financial Assets	29847	45019
Non-Contributors:		
Percent	62	58
Median:		
Total Personal Financial Assets	2247	1691
Contributors and Non-Contributors Combined:		
Means:		
Personal Retirement Assets	4027	10995
Other Personal Financial Assets	28780	28110
Total Personal Financial Assets	32807	39105

First consider families who participated ("contributors") in personal retirement saving plans: The data in Table 4 show that the median level of total persons financial assets of families that attained age 60 to 64 in 1984 was $29,847.[11] Families that attained this age in 1991 had median total financial assets of $45,019. The median level of personal retirement plan assets of the families that reached this age in 1984 was $7,575. Those that reached this age in 1991 had $21,613. In contrast, the other financial assets of these families were about the same in 1984 and 1991 ($19,358 and $17,950 respectively). Thus there is little evidence of substitution of personal retirement saving for other financial assets. In contrast, the financial assets of families that attained age 60 to 64 in 1991 but did not participate in the personal retire-

[9] See Venti and Wise [1993].

[10] The 1984 totals exclude 401(k) assets, which were small at that time.

[11] The medians and means referred to in this section are conditional, controlling for income, age, education, and marital status.

ment plans, were somewhat lower than similar families who reached this age in 1984. Because fewer than half of families participated in these programs the median for all families is zero and is therefore not informative. The means for all families combined—both contributors and non-contributors—are informative, however, and they are reported at the bottom of the table. The mean of total financial assets of all families that attained age 60 to 64 in 1984 was $32,807; the mean of those who attained this age in 1991 was $39,105. The increase was accounted for almost entirely by personal retirement saving—$4,027 for the cohort that attained ages 60 to 64 in 1984 compared to $10,995 for the cohort that attained this age in 1991. There was essentially no cohort difference in other financial assets ($28,780 for the older cohort and $28,110 for the younger cohort).

The analysis in our paper shows that this is the typical pattern for all ages that we considered, between 45 and 70. Indeed, the analysis suggests that if current patterns persist families who reach retirement age 25 or 30 years from now will have much more in financial assets (on the order of $30,000) than families currently attaining retirement age, and the difference will be due solely to assets in personal retirement accounts. The results are illustrated graphically in Figure 1. To understand the figure, consider age 66: The cohort that reached this age in 1984 had about $5,000 less in personal retirement assets (the heavy lines) than the next younger cohort that reached that age about four years later. The difference in the total financial assets (the lighter lines) of these two cohorts is also about $5,000. But there is very little difference in the other financial assets (shown in the second figure) of these two cohorts.

6. RRSPS HAVE INCREASED SAVING IN CANADA

Registered Retirement Saving Plans (RRSPs) were first introduced in Canada in 1957. Like the IRA in the United States, an individual can make contributions to an RRSP and deduct the contributions from income for tax purposes. Interest accrues tax-free until withdrawal, when taxes are paid. The contribution limits were increased substantially in the early 1970s and RRSPs were widely promoted. Since then, they have become a very prominent form of saving. Contributions grew from $225 million in 1970 to almost $3.7 billion in 1980 to $16 billion by 1992, when they accounted for about one-third of aggregate personal saving. In 1992 about 33% of families contributed with an average contribution of $4,180. Now RRSP contributions exceed the total of employee and employer contributions to employer-provided pension plans.

Based largely on "cohort" analysis like the procedure illustrated above, Steven Venti and I conclude that taken as a whole the data suggest that RRSPs have contributed substantially to personal saving in Canada.[12] In virtually no case do the data suggest substitution of RRSP for other forms of retirement saving. In the two decades prior to the growth in RRSP popularity, the personal saving rate in Canada was typically below the U.S. personal saving rate. Since that time, the personal saving rate in Canada has become much higher than in the United States. Although it is difficult to make judgments about the RRSP saving effect based only on the trends in U.S. and Canadian aggregate saving rates, a large fraction of the current difference can be accounted for by RRSP saving.

7. WHY DO THEY WORK?

Economists are apt to proffer an evaluation of the saving effects of IRA and 401(k) plans based on the subsidized rate of return that these plans provide and based on the assumption that all forms of saving are treated by real people as perfect substitutes. The evidence suggests that neither of these assumptions provides an adequate basis for judgment I believe that the saving effect of IRA and 401(k) plans is attributable in large part to other, possibly more psychological, features of the programs.

The IRA experience suggests to me that *promotion* played a large roll in the rapid adoption of the plan. After the 1986 tax legislation, contributions and the number of contributors fell by about 75%, even though only about 25% of contributors were affected by the legislation. Some contributors could have misunderstood the new rules, but promotion seems to have declined substantially as well. In Canada, each tax filer now receives a letter each year from the Minister of National Revenue advising the recipient of the allowable RRSP contribution for the year. Although this practice was adopted because of the complex Canadian contribution limits, it is evident that the practice may also serve to promote the program.

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[12] See Venti and Wise [1994].

U.S. families with incomes above $40,000 essentially stopped IRA contributions altogether after the 1986 legislation, even though the return on assets still accrued tax free. The tax-free return accounts for possibly half of the arithmetic advantage of IRA saving over conventional saving. This suggests that the *up-front deduction* was an important motivation for contributions.

The contribution rate of persons eligible for a 401(k) is about 65%, and is at least 50% even for young employees with low earnings. These participation rates are much higher than IRA participation rates at the peak of that program in 1986. Why? Part of the explanation may lie in the employer matching rates that are common in many firms. But the participation rate is high even in firms with no matching. A likely explanation is that contributions are typically by payroll deduction and thus sheltered from current expenditures urges. The "out of sight out of mind" nature of the payroll deduction arrangement may provide self control that is not present to induce saving out of money in hand.

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Appendix Table 1. Conditional Median Asset Balances by 401(k) Eligibility and Income

Asset Category and Eligibility Status	Income <10	10-20	20-30	30-40	40-50	50-75	>75
A1a. Results for 1991 (1991 $s)							
Total Financial Assets							
Eligible for a 401(k)	2033	4045*	5499*	8683*	14470*	26093*	51080*
Not eligible for a 401(k)	1378	1997	2558	3256	6206	10080	29842
Non-IRA-401(k) Assets							
Eligible for a 401(k)	538	1138	1500	2835*	4724	8699*	18188*
Not eligible for a 401(k)	663	1063	1411	2052	4250	5437	17000
A1b. Results for 1987 (1987 $s)							
Total Financial Assets							
Eligible for a 401(k)	2061	2404	4206*	9062*	12588*	24384*	57348*
Not eligible for a 401(k)	1581	1902	2624	4605	6726	14108	30971
Non-IRA-401(k) Assets							
Eligible for a 401(k)	591	1029	1711	3398*	5663*	10776*	24044*
Not eligible for a 401(k)	799	1004	1554	2904	4246	8462	20383
A1c. Results for 1984 (1984 $s)							
Non-IRA-401(k) Assets							
Eligible for a 401(k)	561	1042	1988	3861*	5027	11683*	28824*
Not eligible for a 401(k)	754	1138	1746	3076	5082	10846	21485

*Difference between eligibles and non-eligibles is statistically significant at the 95% confidence level.

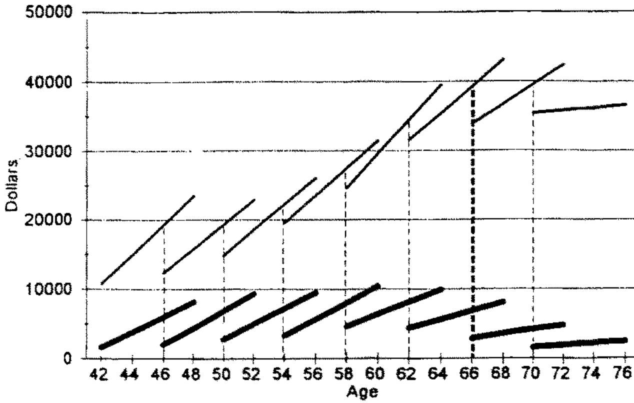
Fig 1a. Personal Financial Assets
Total and Retirement
Means--Both Contribuors & NonContributors--Indexed
Dollars
50000
40000
30000
20000
10000
0
42 44 46 48 50 52 54 56 58 60 62 64 66 68 70 72 74 76
Age

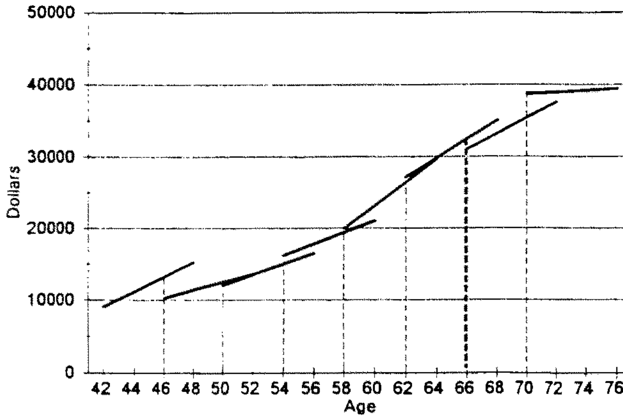
Fig 1b. Personal Financial Assets
Other
Means--Both Contributors & Non-Contributors--Indexed
Dollars
50000
40000
30000
20000
10000
0
42 44 46 48 50 52 54 56 58 60 62 64 66 68 70 72 74 76
Age

COMMUNICATIONS

CREDIT UNION NATIONAL ASSOCIATION, INC.,
Washington, DC., February 1, 1995.

Hon. BOB PACKWOOD,
Chairman, Committee on Finance,
Senate Dirksen Office Building,
Washington, DC.

Dear Chairman Packwood: The Credit Union National Association (CUNA) is pleased to submit this statement as a part of the record for the February 2 hearing in the Finance Committee on the Role of Savings in the U.S. Economy. CUNA represents most of the nation's 12,700 credit unions though our state league affiliates.

CUNA wholeheartedly supports all efforts to increase consumer savings. In fact, the credit union charter specifically states that one of the purposes of a credit union is to encourage savings.

The experience of credit unions has shown that previous versions of the Individual Retirement Account (IRA) were particularly effective incentives to consumers to save. While some of the IRA contributions initially appeared to be a shift from one form of savings to another, it became apparent that new savings were being created right about the time that the tax law was changed in 1986, after which contributions significantly trailed off. In addition, it is our contention that even though some of the IRA money did result from a shift in savings, that this was also a shift from short-term to long-term savings. The latter is a much more stable and superior form of savings, providing greater long-term benefits.

On behalf of the nation's 12,700 credit unions and their 65 million member-owners, we strongly encourage the Committee to report out some form of new savings incentives, including an expanded Individual Retirement Account.

Sincerely,

CHARLES O. ZUVER, *Executive Vice President and Director, Governmental Affairs Division.*

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