

National Saving and Social Security Reform

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JUST THE FACTS

On Retirement Issues

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NATIONAL SAVING AND SOCIAL SECURITY REFORM

BY ANDREW ESCHTRUTH AND ROBERT TRIEST *

Introduction

Saving is a critical component of both retirement security for individuals and the long-term growth of the nation's economy. Current trends in Social Security, 401(k) plans, and personal saving suggest that individuals will need to save more to ensure that they can enjoy a comfortable retirement. The federal government can also contribute to the nation's saving by reducing or eliminating its budget deficit. Increased saving by either individuals or the government, of course, means less consumption today. But, by providing more money for investment, additional saving boosts productivity and long-term economic growth.

Currently, policymakers are discussing possible changes to Social Security that could have significant implications for both the retirement security of today's workers and for national saving. This *Just the Facts* examines how various Social Security reforms could affect saving.

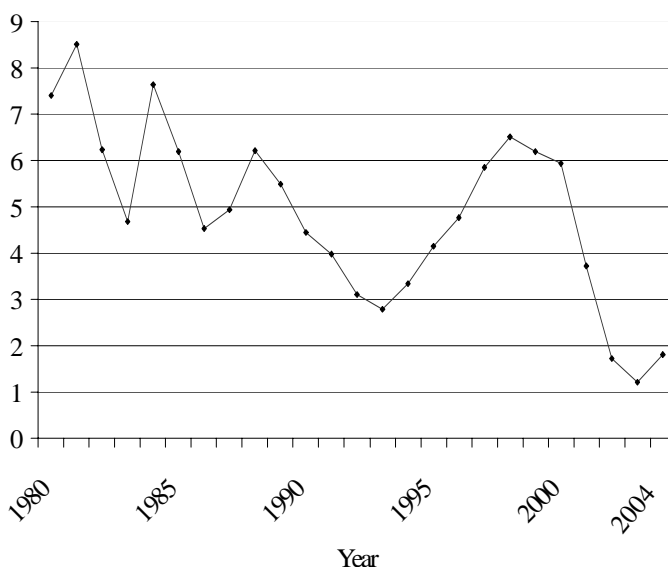
Trends in National Saving

The broadest measure of saving for the whole country is national saving, which is comprised of saving by individuals, businesses, and governments (local, state and federal). National saving has generally been declining over the past quarter century, falling from over 8 percent of the nation's gross domestic product (GDP) in 1981 to less than 2 percent today (see Figure 1).

The general decline in national saving has been driven by the behavior of both individuals and the federal government (see Table 1).¹ Saving by individuals, referred to as "personal saving" in the table, has declined consistently since the mid-1980s. The pattern of federal government saving has been somewhat more complex.

FIGURE 1: NATIONAL SAVING HAS PLUMMETED OVER PAST QUARTER CENTURY

National Saving as a Percent of GDP, 1980-2004



Source: U.S. Department of Commerce (2005), Table 1.1.5 and 5.1.

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TABLE 1: DECLINE IN NATIONAL SAVING DUE TO LESS SAVING BY INDIVIDUALS AND LARGE FEDERAL DEFICITS

National Saving by Category as Percent of GDP

Category	1980	2004
Personal	7.2%	0.9%
Federal Government	-1.9%	-3.2%
Business	1.8%	4.0%
State & Local Government	0.3%	0.2%
National Saving	7.4%	1.8%

Source: U.S. Department of Commerce (2004), Table 1.1.5 and 5.1.

Governments save when they run budget surpluses and dissave when they run deficits. The federal government has run budget deficits for most of the past forty years. Within the federal budget, analysts often distinguish between Social Security and all other federal programs.² Government deficits in the non-Social Security portion of the budget increased sharply in the 1980s. Then, in the 1990s, deficits began to decline rapidly and eventually disappeared, ushering in a brief period of surpluses. But, in 2002, large deficits quickly reemerged (see Figure 2).³ In contrast, reforms to Social Security enacted in 1983 have resulted in growing surpluses since the mid-1980s. Generally, the deficits in the non-Social Security part of the budget have swamped the Social Security surpluses, resulting in sizeable total budget deficits.

How to Raise National Saving

The actions needed to increase saving are straightforward. Individuals can consume less of their current income and instead invest in savings accounts, mutual funds, or other assets. The federal government can save more by reducing spending or raising revenues, which would reduce the government's budget deficit or, if the budget is already in balance, produce surpluses. Lower budget deficits mean that the government needs to borrow less from financial markets. This reduction frees up funds for alternative investments in the private sector because investors who would have purchased Treasury bonds instead buy other assets.

National Saving and Social Security Reform

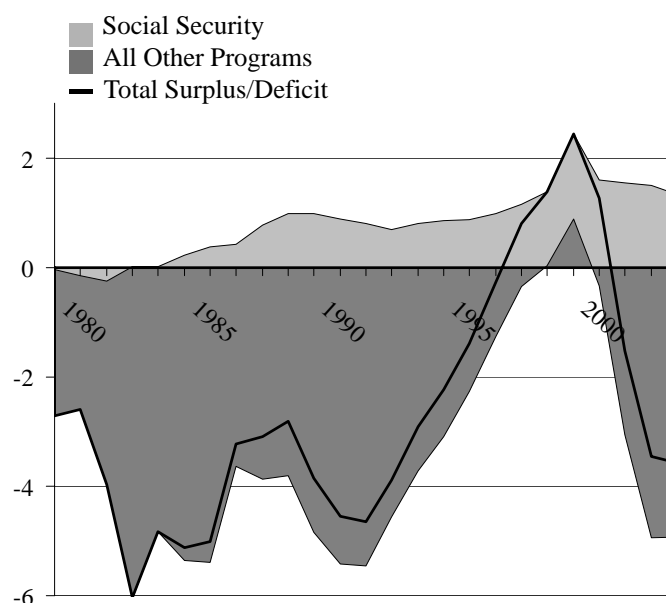
Social Security faces a long-term financial shortfall. And with expenditures of \$492 billion in 2003, the program represents a little over 20 percent of total federal spending. Given the size of Social Security, any changes could have significant direct or indirect effects on national saving.

National Saving and the Social Security Funding Shortfall

Any actions to address Social Security's financial shortfall by raising revenues or reducing benefits would tend to raise national saving by improving the federal government's financial position. These actions could take a variety of forms. For example, revenues could be increased through higher payroll tax rates or raising the payroll tax cap. Benefits could be cut through raising the retirement age or changing the indexation of benefits from prices to wages. Depending on the specific changes, the impact on saving may not occur immediately. For example, cutting benefits for younger workers would make future budget deficits smaller than they otherwise would have been, but would not reduce today's deficits.

FIGURE 2. LARGE DEFICITS IN NON-SOCIAL SECURITY ACCOUNTS HAVE GENERALLY DWARFED SOCIAL SECURITY SURPLUSES

Federal Government Surpluses or Deficits as a Percent of GDP 1980-2004



Source: Office of Management and Budget (2005), Table 1.2.

In addition to the direct effect on national saving through smaller budget deficits, cutting Social Security benefits or increasing revenue could have indirect effects. These indirect effects would depend on whether policymakers or individuals changed their own behavior in response.

On the government side, for example, improving Social Security's finances would reduce the total federal deficit. If policymakers responded by relaxing fiscal restraint in other areas — spending more on other programs or reducing income taxes — they would undercut the positive effects of the Social Security changes on national saving. The likelihood of such a response is unclear. Policy experts have long differed over how Social Security surpluses have affected other federal budget decisions. As shown in Figure 2, Social Security surpluses have partially offset large deficits in the rest of the federal budget. Some analysts believe that the presence of the surpluses has led policymakers to spend more on other programs and/or keep income taxes lower than they otherwise would have. Critics of this view counter that the surpluses have likely had little influence on other budget policy decisions and, therefore, they have effectively added to national saving.

On the personal saving side, if younger workers knew that their future benefits were to be reduced, they might respond by increasing their own saving in 401(k)s, IRAs, or other investments. Or, alternatively, an increase in payroll taxes would mean that current workers would have less after-tax money and, therefore, they might reduce their own saving.⁴ The size of the indirect effects from both government and personal behavior is unclear, but they would likely offset only a portion of the increase in saving. Therefore, resolving Social Security's financing problem, overall, would raise national saving.

National Saving and Personal Accounts

President Bush and others have suggested introducing personal accounts as part of any reform of the Social Security system. The direct impact of such accounts on national saving depends on how they would be financed. If financed through existing payroll taxes, the accounts would have little or no direct impact on national saving.⁵ They would require a diversion of money from the

federal Treasury. This flow out of the Treasury would increase the government's deficit and its need to borrow from private financial markets to finance other government spending. However, this negative effect on government saving would be offset by the infusion of funds into the personal accounts, which would boost personal saving.⁶ Thus, on balance, it is likely that personal accounts would have no direct effect on national saving.⁷

Raising national saving is crucial to the retirement security of an aging society.

The indirect effects of personal accounts funded by existing payroll taxes are somewhat complicated and could, on balance, have either a positive or negative effect on saving. First, the federal government could respond to the creation of personal accounts by increasing its own saving. The reason is that the increase in the total budget deficit resulting from the diversion of payroll tax revenue to personal accounts might prompt Congress and the President to reduce spending on other government programs or raise income taxes. This type of response would be the opposite of the case described above in which the federal government might react to improvements in Social Security's finances by spending more or taxing less in other areas.

Second, personal saving could respond to personal accounts by going up, down, or remaining the same. If the existence of personal accounts made individuals more comfortable with the notion of saving and investing, they could be encouraged to save more. On the other hand, younger workers have been particularly skeptical about whether they will ever receive any money from Social Security. By making Social Security seem more real, the personal accounts could cause workers to feel that they have less need to save through 401(k)s or other means. Or, perhaps, some workers would save more while others would save less, resulting in no net change in personal saving.

An alternative way of funding personal accounts would be through new revenue. For example, one proposal from the 1994-96 Advisory Council on Social Security called for a new individual savings account financed by an additional 1.6 percent of workers' wages.⁸ Using new revenue, instead of existing payroll taxes, would directly raise national saving. Some of this saving could be offset if individuals cut back on their 401(k) contributions or other saving in response to the new accounts. However, a variety of studies on saving suggest that this offset would be relatively small – significantly less than dollar for dollar.⁹

Conclusion

Saving more is the best way to improve retirement income security for an aging population. Both government saving and personal saving have declined substantially in recent decades. The federal government could boost its own saving by reining in large budget deficits. Individuals could cut their current consumption to set aside more for the future. Reforms to Social Security that address the system's funding shortfall would directly raise national saving by bolstering the government's bottom line. Personal accounts funded through existing payroll taxes would likely have no direct effect on saving and the net indirect effects are unclear. Personal accounts funded through new revenue would directly increase saving.

Endnotes

- 1 The focus of this brief is on saving behavior that can most directly affect individuals' retirement income. Therefore, it will examine trends in personal saving and federal government saving only.
- 2 For further details on the relationship between Social Security and the federal budget, see Eschtruth (2000).
- 3 Due to differences in accounting conventions, the federal budget surplus/deficit shown in Figure 2 differs somewhat from federal government saving in the National Income and Product Accounts.
- 4 Other, more esoteric, responses are also possible. For example, economic theory suggests that individuals might take actions specifically to counteract the longer term impact of the government's efforts. For example, if individuals believe that future spending cuts mean that their future tax levels (and, in this case, their children's tax levels) will be lower than they otherwise would be, they might decide to save less. If so, the government's efforts to improve Social Security's finances might not increase national saving if individuals reacted by saving a dollar less for each dollar reduction in the deficit. This theory, known as Ricardian equivalence, can work in reverse as well with individuals raising their saving in response to government actions that increase budget deficits. In reality, it is not clear that many individuals think in the far-sighted and complex way anticipated by the theory.
- 5 The long-run effects are less clear. The increase in government saving associated with reduced benefit payouts would be largely offset by the reduction in personal saving associated with the running down of individual account balances. But the offset would likely not be one-for-one. The effect of individual accounts on retirees' income and consumption expenditures would depend on how well they fared with their individual account investments, and also on their attitudes to spending down the account balances.
- 6 This brief assumes that the personal accounts would be classified as personal, rather than government, saving.
- 7 A potential complicating factor is the impact of personal accounts on rates of return and asset

prices. Financial markets may not view the replacement of implicit Social Security debt with explicit Treasury debt as neutral, leading to an increase in the required yields on new Treasury issues.

8 1994-1996 Advisory Council on Social Security (1997).

9 Munnell and Sundén (2004) conclude from their review of research on the effect of 401(k) plans on household saving that 401(k) plans "...increase savings for low-income earners but have little effect on savings for high-income earners." Consistent with this point, one might expect mandatory add-on retirement savings accounts to increase the total savings of low-income households, but to have less effect on high-income households. This potential outcome is also consistent with studies finding that a substantial fraction of households appear to be liquidity constrained, and have little opportunity to undo the effect of mandatory accounts see, for example, the studies surveyed by Seidman (2003).

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