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Saving: The Challenges for Economic Policy

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Saving: The Challenges for Economic Policy

It is a pleasure to be here tonight and to address the issue of saving and the many challenges it poses for economic policy. This topic has always been important but it looms evermore important for the U.S. economy which must increasingly compete in a rapidly changing integrated world.

These proceedings certainly address many of the key questions relating to saving in the U.S. economy. Some of them were discussed in the earlier sessions today and other important issues will be examined tomorrow.

The determinants of saving are many and the issue of the effects of government policy on saving is both controversial and enormously complex. Accordingly, I cannot hope to address all of the relevant issues tonight. Interestingly, there is substantial agreement among many economists about certain principles relating to saving.

Saving is important

Most economists agree both that saving is important and why it is important. Saving constitutes the supply of capital which combined with labor form the primary inputs to production. Capital growth works to increase productivity; the more capital per worker, the higher the output per worker. With more capital per worker, returns to labor will be higher and workers' real income will be higher. The productivity-enhancing character of capital growth works to improve both overall economic growth as well as the living standards of workers.

In short, economic growth cannot occur without capital formation which, in turn, is dependent on saving. Stated simply, savings can determine which nations are rich or poor and whether living standards are high or low.

Unencumbered markets would produce an optimal savings rate

Another principle upon which there is widespread agreement among many economists relates to the operation of the market system. Specifically, economic theory argues that an unencumbered world with competitive private capital markets produces an optimal rate of saving. In such circumstances, the return to saving accurately reflects real investment opportunities. Savers determine the volume of savings according to their desire for future consumption relative to current consumption. In more technical parlance, individuals save until their subjective time discount rate matches the return to capital or equilibrium real interest rate. In short, a well-functioning price system works so as to efficiently allocate resources intertemporally. The optimal saving rate is a derivative of free choice and accurately reflects the intertemporal savings desires of the populace.

The current U.S. savings rate is low

Today there is widespread agreement that the current U.S. savings rate is relatively low and also below the above-mentioned optimal rate. Of course, there is a good deal of disagreement concerning the correctly measured level of U.S. saving. Some argue that the savings rate is so low that a crisis exists.

Proponents of this view normally refer to the personal savings rate measured by the National Income and Product Accounts. Others contend that while we do not have a crisis, we nonetheless face an important problem and a difficult policy challenge.

Of course, many measurement and definitional issues are important and lie at the root of these disagreements. Several of these issues were discussed in earlier sessions today. Recently, several important and thorough studies addressing these measurement problems have been published. The new (1989) NBER volume entitled, The Measurement of Saving, Investment, and Wealth by Lipsey and Tice serves as an excellent example. Suffice it to say that all the relevant measurement and definitional issues have not been fully resolved. But, overall, it is fair to say that the U.S. savings rate is low relative to both its earlier history and to the savings rate of most industrialized nations today.

Government policies can influence saving

Economists agree that while saving is determined by a host of factors, government policies can have an important impact on saving. Most importantly, fiscal policies, both taxation and spending, can significantly influence saving and therefore affect prospects for long-term economic growth. Of course, disagreement exists as to both the proper policies to implement in order to influence saving and the degree of influence that a particular policy may have. Nonetheless, fiscal policy is viewed as having a potentially important impact on saving. And economists

generally agree that the current low savings rate is at least in part the result of government policies.

There are many forms of distortions

There is also widespread agreement that there are numerous types of government tax and spending policies that distort behavior so as to adversely affect saving. These policy induced distortions lower saving by both increasing the cost of and lowering the reward for saving.

Tax distortions are one important form of bias

In recent years we have made important progress in reforming the tax code. Tax rates are lower and some distortions that plagued the tax system have been removed or lessened, particularly with regard to the interaction between the tax structure and inflation. But we are very far from an ideal tax system.

We recognize that the U.S. tax system is still quite biased against saving in a number of ways. The current income tax, for example encourages consumption over saving. Income that is saved is taxed twice: once when it is earned and once again when it generates additional income. Thus, there is a higher rate of tax on income that is saved and invested than on income that is consumed immediately.

But the income tax is not the only important form of tax distortion that adversely affects saving. Other forms of federal,state and local taxes also exact funds from income produced by saving and capital formation. By reducing the future

income that can be obtained by foregoing current consumption, these tax systems add to the cost of saving.

For individuals who save by purchasing shares in a taxable corporation, the income produced by the corporation is first subject to the corporate income tax. If the corporation distributes its earnings as dividends, the shareholders must pay tax on the dividends they receive, effectively resulting in a double taxation of dividends. (The U.S., incidentally, is the only country in the G-7 that double-taxes dividends.) If the corporation does not distribute dividends but retains earnings and share prices advance, shareholders must pay capital gains taxes when they sell the stock, even if share values only keep up with inflation.

In cases such as these, the interaction of corporate income taxes, personal taxes on dividends, and capital gains taxes work to substantially increase the cost of saving. Similarly, inadequate depreciation allowances on capital investment work to overstate corporate profits, thereby raising the effective corporate tax rate. Property taxes, estate, gift, inheritance as well as other wealth taxes imposed at the federal, state, or local level also amount to taxes on saving.

Government spending also serves to distort saving

But tax policy is not the only way in which fiscal policy adversely affects saving. Various government spending programs -- especially those spending programs oriented toward consumption -- can also have important distorting effects. The growth of

government consumption spending in excess of revenue growth works to adversely impact saving. This occurs because the government borrowing used to finance such spending absorbs private saving that would otherwise be used to finance more productive private investment activity. Since such government consumption spending in effect works to divert private saving to less productive public sector activity, it lowers the overall return to saving thereby discouraging saving.

Furthermore, various government welfare programs supposedly designed to provide security or insurance to workers and citizens also may adversely affect motives for saving in a more direct way. Social security, medical disability, health, and unemployment insurance, for example, all provide workers with a substitute for what historically would have been a strong motive for saving. Since these programs supposedly provide income for the retired worker, medical expenses, and unemployment benefits, workers may not save as much as they otherwise would have. Ironically, some of these programs have imposed tax burdens that have reduced both the ability and incentive for people to save while at the same time promising benefits that may have further reduced the motivation to save.

<u>Other forms of distortions also exist</u>

Similarly, other forms of governmental intervention may adversely affect saving in less obvious ways. Well-intended governmental regulations imposed on business often adversely affect returns of capital and therefore saving regardless of

whether they achieve their stated objectives. Credit allocation schemes (direct loans, loan guarantees, and credit market rules and regulations) in effect constitute implicit forms of taxation of private capital which also work to lower returns to saving.

Finally, government policies may unintentionally influence many demographic factors known to be important determinants of saving. While little research has addressed these issues, governmental policies working to change retirement ages, divorce rates, college attendance, fertility rates, and family formation may also have important effects on or implications for saving.

To summarize what I have said so far: there appears to be a consensus among economists and others on many issues pertaining to saving. They generally agree:

(1) that saving is important

(2) that an unencumbered market would allow savings to seek its optimal rate

(3) that the current U.S. saving rate is below its optimal rate

(4) that fiscal policies can influence saving and

(5) that at least part of the reason for the low U.S. saving rate is a whole host of government-policy-induced distortions that overall have an adverse impact on saving.

CONDITIONS TO SET THE STAGE FOR A SOLUTION

Before discussing specific policy proposals to improve our saving performance, some very important policy objectives should

be emphasized. An understanding of these objectives is essential to set the stage for any lasting, successful strategy to solve our saving problem.

Open trading arrangements are important

First, even if no specific action is undertaken to improve our saving performance, it is important to support policies that continue to maintain or foster both a healthy investment climate and open trading arrangements. Restrictions to capital flows should be minimized. While U.S. saving is below optimum, saving in the rest of the world may not be. If the U.S. maintains an environment fostering relatively healthy returns to investment, it may supplement its domestic saving with foreign saving to finance productive investment without necessarily endangering its future. If the U.S. economy offers higher relative returns to productive investment and attracts foreign saving, we are likely better off than if foreign saving had not migrated here. In particular, our workers will likely be more productive, earn higher wages, and enjoy higher living standards than if such foreign saving were prevented from entering. Of course, it is important to acknowledge that there are exchange rate consequences of such an approach. Despite an overall macroeconomic benefit, export and import competing industries will likely suffer as a result.

Nonetheless, just as it is important to improve our domestic saving performance, it is also important to maintain an environment conducive to both domestic and foreign investment and

to maintain and promote open trading arrangements. Offering attractive opportunities for foreign investment and saving is not only good policy, but it is a sign of strength rather than weakness. We can achieve gains from free and open trade and commerce just as we can achieve gains from removing distortions to domestic saving. Restrictions on foreign capital flows or the erection of trade barriers are not solutions to our saving problem. The best approach, of course, is to adopt policies improving our domestic saving performance while at the same time continuing to promote a healthy environment for investment and dismantling barriers to trade and capital flows.

An appropriate framework for fiscal policy is necessary

Second, it is important for policymakers to adopt an appropriate framework for analyzing the long-term effects of fiscal policy. The evidence about our saving behavior indicates that in recent decades a whole variety of fiscal policy initiatives on both the tax and spending side have (perhaps inadvertently) introduced distortions adversely impacting our saving performance. These well-intentioned initiatives were likely introduced without recognizing the adverse effects they might have on saving.

A common thread connecting fiscal policy initiatives of recent decades is that they were devised and promoted within the context of a framework which implicitly emphasized the short-term rather than the long-term effects of policy. An underlying reason for this is that the framework used for fiscal policy was

based on a theory whereby taxation and spending were intended to stabilize the business cycle, manage aggregate demand, or redistribute income but not foster long-run growth. The framework underlying this theory uses data which do not measure wealth and government budget accounting which does not acknowledge capital investment.

This theory is based on an income-expenditure framework emanating from the 1930's when the stimulation of spending was critical and saving was actually discouraged. Indeed, it is useful to remember that Keynesians promulgated the so-called "paradox of thrift"; the idea that saving is bad and consumption good for the macroeconomy. This view may have been appropriate for the peculiar circumstances of the 1930's when aggregate demand collapsed and excess supply and capacity prevailed, but it is not an appropriate framework for long-term growth.

I believe that ideas do have consequences. If we are to change fiscal policies to improve our saving performance, we need to extricate ourselves from a theory premised on the notion that saving is bad for the economy and adopt a longer-term growth oriented perspective. A framework in which the beneficial effects of saving, investment, and long-term growth receive prominent attention and in which incentives to save and invest are recognized is important. In short, a pro-growth paradigm is needed within which to frame fiscal policies intended to improve our saving performance. Until this is done it may be difficult

to properly analyze or assess our persistently poor saving performance.

A policy goal should be to remove distortions

Third, a saving-promoting public policy should have the overall objective of removing the many distortions to saving mentioned above so that saving can increase and approach its optimal level. In short, governmental policy should have the goal of fostering a system whereby the unencumbered saving preferences of the populace work to determine the actual overall saving rate. Such effects likely occur in an environment when the signals of the market system are allowed to function so as to bring about this desired result. A proper policy approach should seek to minimize the many government spending-tax related distortions and impediments which work to adversely affect saving behavior.

POLICY RECOMMENDATIONS

There is a long list of distortions working to adversely affect saving in the U.S. Correcting any one or a number of these distortions will likely work to improve our saving performance. Overall, emphasis should be placed on minimizing the taxation of saving and reducing the cost of capital. The recently outlined recommendations by Treasury Secretary Brady are consistent with such an approach and overall appear quite good. These proposals certainly move us in the right direction.

Policy should move toward a consumed income tax

My policy preference is generally consistent with recent Treasury proposals in that they involve some movement toward consumption-based taxation, or for institutional reasons, toward a consumed income tax. This, of course, is not novel. It has been recommended by a long-list of distinguished public finance experts and is the essence of the well-known Treasury proposal in 1977 entitled Blueprints for Basic Tax Reform authored by David Bradford.

The reasons for advocating consumption-based taxation are also well-known. An income tax raises the cost of saving relative to consumption, discouraging saving, investment and capital formation while a consumption tax does not. A consumption tax is neutral with respect to intertemporal consumption decisions. Consumption taxes like all other taxes do, however, continue to distort the labor-leisure choice. However, on balance, a consumption tax is more efficient than an income tax since they both produce a labor-leisure distortion.

While many good arguments do favor a value added tax or perhaps national sales tax, I do not believe they are practical or appropriate. Taxes should be clearly discernable and not disguised. Moreover, institutionally we have an entrenched income tax structure. While one can argue that such a structure is not optimal, like it or not, it does exist. Let's face it, the income tax is the mainstay of the Federal tax system and it is unlikely to change in the near future. Given this fact, the last thing we need to do is to create an additional revenue

structure or bureaucracy by imposing additional layers of taxation. Unlike old soldiers, we know that bureaucracies -- whether old or new -- neither die nor fade away; instead they seem to grow forever.

Accordingly, an appropriate alternative is to move in the direction of a consumed income tax. If an income tax is to be adjusted so as to be neutral with respect to the saving-consumption choice, it must either allow deductions for current saving while taxing all the returns to saving or it must fully exempt all income from saving while taxing current saving. Accordingly, movement to a consumed income tax would require either exempting saving or returns to saving. Thus, a practical revenue neutral approach is to expand the deductibility of saving or the returns to saving while expanding the tax base on consumption. In fact, we have already made some progress in lowering tax rates and broadening the tax base. To improve our saving performance and minimize the anti-saving bias of the tax code, however, the tax base should be broadened on consumed income rather than on saved income.

Of course, such an approach argues for IRA exemptions as well as reforming certain types of taxation such as capital gains and corporate income taxation.

Government dissaving should be reduced

Another distortion adversely affecting our overall saving performance is government dissaving. As indicated earlier, the growth of government spending -- especially government

consumption spending -- in excess of revenue growth works to adversely affect our saving performance since the government borrowing used to finance such spending absorbs private saving that would otherwise be used to finance more productive private investment activity. Such government consumption spending in effect works to divert private saving to less productive public sector activity thereby both lowering the overall return to saving and discouraging additional saving.

Increasing government saving is best achieved by reducing the growth of government consumption spending. This not only reduces the likelihood that government borrowing will absorb private saving, but reduces the likelihood of saving-distorting taxation.

Attempting to reduce government dissaving by increasing taxes is potentially counterproductive. Tax increases can lead to additional government consumption spending and also adversely affect private saving behavior.

<u>Price stabilization should be the goal of monetary policy</u>

I would be remiss if I did not say a few words about the role of monetary policy in affecting saving behavior. In particular, a credible goal of price stability would not only be associated with lower long-term interest rates because of the minimization of both inflation and risk premiums, but it would work to reduce the volatility of interest rates as well. In short, the achievement of price stability would enable the price system to work better and, accordingly, for the saving

preferences of the populace to be accurately registered in the markets and thereby impact actual saving.

One manifestation of such a smoothly functioning price system is that saving is neither destroyed by inflation nor diverted into unproductive inflation hedges. A smoothly operating price system contributes to a smoothly operating intermediation process; the uninterrupted channeling of saving into productive investment.

Thus, monetary policy is the policy tool for price stabilization and as a consequence, economic stabilization. A stable, predictable monetary policy will promote a more stable environment and in so doing should allow fiscal policy to focus more attention on capital formation and long-term growth.

CONCLUSION

Economists agree on a number of important issues relating to our suboptimal saving performance. They generally agree that fiscal policy can distort behavior so as to adversely affect the economy's saving rate. Adopting an appropriate longer-run growth framework for fiscal policy, promoting open trading arrangements, and removing distortions to saving are all important components of an overall pro-saving macroeconomic policy.

Many politicians and pundits continue to rail about our low saving rate, budget deficits, and their implications for trade deficits and long-term capital formation. Yet these same individuals normally do not address the continued distortions adversely affecting saving and they often promote policies

exacerbating these very distortions. Both tax increases and the continued promotion of the growth of government consumption spending within an income-expenditure framework characterize the policy prescriptions of many of these persons. If adopted, these policies will likely worsen rather than improve our saving performance. So long as such inappropriate policy proposals continue to be made, we should welcome rather than discourage the inflow of foreign capital.