

For Release on Delivery
10:00 a.m., E.D.T.
May 16, 1991

Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Finance

U.S. Senate

May 16, 1991

Mr Chairman, I appreciate the invitation to appear before this committee today. As you know, I have long been concerned about the low level of saving in the United States and am pleased that this important problem is drawing renewed attention. In my prepared statement, I will address some of the broader issues bearing on saving and investment, as well as provide a review of the available evidence on tax incentives for personal saving.

Put simply, inadequate domestic saving is impairing our economic prospects for the longer run. I say this with full recognition that the appropriate level of saving for any economy is best left to private preferences, as reflected in the marketplace. However, as a society, we have in recent decades clearly intervened in the market process through subsidies that enhance consumption at the expense of saving. And, we would be well-advised to endeavor to redress such imbalances.

Saving, of course, arises when part of the nation's current production is diverted from consumption, both private and public; it provides the funds for capital formation. Thus, by choosing to consume more now--and to save less--we are limiting our ability to expand and upgrade our stock of capital. It is the size of that stock and the new technologies embedded within it that, together with the quality of the labor force, ultimately determine our overall productive capacity and the future standard of living of our population.

The damage from low saving does not show up immediately. It is more insidious--it chips away at the productivity gains we are able to achieve over time, it gradually hampers our competitiveness in

international markets; and, after a period of years, it results in a lower standard of living than we would otherwise enjoy.

Of course, U.S. investment can be funded by foreigners, as well as by domestic residents. Indeed, since the mid-1980s, sizable inflows of capital from abroad have helped to sustain domestic investment and, thus, have cushioned the effect of inadequate domestic saving on worker productivity. But heavy reliance on foreign saving is neither a satisfactory nor a sustainable solution over the longer run. This may seem contrary to the idea that international capital markets are well-integrated and that competing rates of return will draw funds to the most productive uses anywhere in the world. To be sure, in today's world, such inflows may tend to be sustained longer than in the past. Nevertheless, the evidence for the United States and for most other industrial nations over the past hundred years indicates that large inflows have not persisted and, thus, cannot be viewed as a reliable substitute for domestic saving on a long-term basis. In other words, domestic investment, for the most part, appears to follow domestic saving in the long run.

Reflecting the large current account deficits of recent years, foreigners are accumulating claims on a sizable portion of our future output. Furthermore, we know that we will have to support a rapidly growing population of retirees two or three decades in the future. In the end, our ability to meet those commitments, while providing rising living standards to future workers, will depend on the investments that we make in capital and in new technologies in the interim.

Indeed, on the basis of our recent saving behavior, it is difficult to see how we were able to achieve the high standard of living that we now enjoy. The answer is that we have not always been a low-saving society. Granted, the statistics are problematic, but it appears that in the period following the Civil War, when the United States began to emerge as an economic power, our saving and investment rates, as conventionally measured, were much higher than those in Europe and Japan. For example, between 1870 and 1910, domestic saving in the United States averaged close to 20 percent of GNP. The best available estimates for Japan and Germany during that period place their saving rates at 15 percent or less. The saving rate in Great Britain, whose preeminence was fading, was closer to 10 percent.

The shift toward both a relatively low and an absolutely low saving rate began during the Great Depression, when the U.S. rate fell dramatically. In the decades after World War II, it stabilized at a level slightly below its pre-Depression average. Notably, between 1950 and 1979, domestic saving averaged about 16 percent of GNP--roughly the same as total investment. Budget deficits generally were small, at least by today's standards, and the private saving rate showed no discernible trend. Meanwhile, the U.S. enjoyed a positive--and gradually increasing--net foreign investment position. In the 1980s, the pattern changed markedly, as domestic saving fell well below investment, reflecting not only the enormous federal deficits, but also a large drop in the private saving rate. In recent years, U.S. saving (public and private) has totaled only about 13 percent of GNP.

Saving rates in Japan and Germany also have declined some over the past two decades, following their surge in the post World War II recovery period, but they remain substantially above those in the United States. Relative to their GNPs, the Japanese have been saving roughly twice as much in gross terms as we have, while Germany's saving rate has been about 1-1/2 times ours. Cross-country comparisons of net saving should be viewed with some caution because of differences in how depreciation is measured; nonetheless, the gap in net saving probably is even larger than in the gross measures. The high saving rates in Japan and Germany have been mirrored in rapid rates of capital formation that have helped them improve their competitiveness relative to the United States and close much of the gap in living standards.

The issue of why one nation saves a lot while another saves relatively little--or why saving behavior changes over time--is complex. It undoubtedly reflects cultural influences as well as economic forces. I suspect, however, that part of the explanation relates to how well members of a society, both individually and collectively, assess their future needs and take action in the present to meet them. Collectively, we have recognized the need to build saving and capital, and to improve our productivity performance, in anticipation of the significant increase in the ratio of retirees to workers next century. However, as last year's debate over the financing of social security made clear, we have yet to take sufficient actions to meet these needs. As you are well aware, the surpluses in the social security trusts have been overwhelmed by enormous deficits elsewhere in the federal budget.

Just as the budget deficit accounted for a large part of the fall in domestic saving in the 1980s, the surest way to raise saving in the 1990s is to get the deficit down. Last fall, you enacted a significant program of spending and tax changes and budget process reforms. Those actions set the underlying or "structural" deficit on a downward track and thus represented a strategy that is geared to the longer-run needs of the economy. I recognize that, in the near term, those savings are being swamped by the transitory effects of the weak economy. But, as the recovery takes hold, the federal sector's absorption of private saving should return to a downward trend.

The goal of a balanced budget is a good place to start. But, as I have said frequently in the past, it probably is not ambitious enough as a target for the longer run. As long as the non-social-security deficit remains sizable, we are doing little to ensure that adequate provisions are being made for the income of future retirees. Further actions must be taken to bring the rest of the budget into balance, so that the trust funds will no longer be financing current government consumption, but will translate dollar for dollar into national saving.

The federal budget deficit is only part of the story of the past decade. Saving by households and businesses also has dropped. The fall in personal saving, in particular, has been studied extensively; in large part, it appears to be associated with the sizable increases in household wealth through the latter part of the 1980s. To understand the relation between wealth and the saving rate, it is important to note that personal income, as defined in the national income and product

accounts (NIPA), measures the income from current production; it does not include the effects of capital gains or losses on assets already held by households; personal saving also ignores revaluations of existing assets. Thus, an increase in the value of an individual's stock portfolio or his house has no direct effect on his measured income. But, if he raises his spending in response to the capital gain, NIPA saving will fall.

Looking at the data, one sees clearly that the surge in the stock market between 1982 and 1987 was associated with increased consumption out of financial capital gains and, therefore, with reduced saving out of current income. In addition, the build-up of readily accessible home equity enabled many individuals to spend more out of current incomes than they would have otherwise--especially with home equity lines of credit making it much simpler to borrow against the value of one's house. The data for Great Britain in the late 1980s support a similar linkage between surging real estate prices and falling rates of saving set aside out of personal income; more recently, the British saving rate has turned up as house sales have cooled.

Analyses of the relation between saving and demographics in the 1980s also have attracted much attention; on the whole, however, the results of these studies--as well as the implications for the 1990s--are less clear-cut than one would have expected. Nonetheless, with older members of the so-called "baby boom" generation moving into their forties, the issue of retirement saving is coming to the forefront.

One way to engender more national saving, of course, is to reduce the federal budget deficit. But, we can also take actions that

should encourage individuals to save more. There is no shortage of proposals for new saving incentives. Some would function in a manner similar to that of the individual retirement accounts (IRAs) of the early and mid-1980s, which allowed workers to make deductible contributions and to defer the tax on both the principal and earnings until the accounts were cashed in. Other suggested incentives, such as the Family Savings Accounts favored by the Administration, would not allow deductible contributions up front, but would permit earnings to accumulate tax-free as long as the account balances were maintained for a specified amount of time. The plan offered by Senators Bentsen and Roth (S. 612) incorporates both approaches.

When considering these proposals, a fundamental question that must be addressed is how they are likely to affect total national saving. It is relatively easy to imagine an incentive that will raise personal saving. But unless the increase is large enough to outweigh any associated drop in tax revenues--or sufficient deficit-reducing actions are taken elsewhere--the net effect on national saving will be negative. In other words, the sum of private consumption plus public consumption as a percent of income must fall for the national saving rate to rise.

I recognize that, under the current budget procedures, any anticipated loss of revenue to the Treasury from a new tax-favored saving plan will have to be offset by increases in other taxes or by reductions in mandatory spending. This requirement should blunt much of the concern about potential drains on national saving--at least over the next five years. But, as a matter of sensible tax policy, any new

incentive must first be evaluated on its own merits and in isolation from other considerations.

Essentially two types of evidence bear on that assessment. The first is the broad economic evidence on the relation between saving and the rate of return on saving, which has been studied intensively over the years. In theory, the higher after-tax rate of return produced by an IRA or other incentive has two effects. On the one hand, it increases the amount of future consumption that each dollar of current saving will buy, thereby providing an incentive to save more now in order to consume more later. On the other hand, because each dollar of existing saving generates more after-tax income, the individual can reduce current saving and still enjoy more consumption both now and in the future. In principle, either effect could dominate, leaving the question to empirical resolution. Unfortunately, economists have not been able to develop unambiguous evidence on this score.

The second type of evidence for evaluating a new tax incentive comes from the microeconomic studies of the 1982-86 IRA experience. Clearly, IRAs were very popular, with contributions averaging nearly \$35 billion per year; this amount was equivalent to roughly one-quarter of personal saving as measured in the national and product accounts. However, at the time, many analysts believed that little, if any, of the money flowing into the accounts represented new saving--a perception that undoubtedly contributed to the scaling back of IRAs as part of tax reform in 1986. It is important to remember that in order to have increased saving, an IRA would need to have reduced consumption.

Since then, many new data have become available, and several studies of the IRA experience have been carried out. These studies provide a wealth of information, but, again, the results are inconclusive. Some essentially confirm the "conventional wisdom" that IRAs involved primarily a shifting of saving from one pile to another, without much effect on the total. But others suggest that IRAs provided a substantial boost to overall saving and that their effectiveness would have grown over time as people exhausted their opportunities to shuffle existing assets.

The lack of conclusive evidence on saving incentives makes it difficult to take a strong position either way on the desirability of a new IRA. In addition, that determination depends on how you plan to meet the pay-as-you-go requirements in the new budget procedures; the necessary cuts in spending or increases in other taxes may, in turn, have incentive effects of their own. In any event, the overall desirability of the package cannot be assessed until you specify and evaluate the offsetting elements.

In conclusion, it is important to continue to focus on the crucial need to restore saving in the United States to levels that are consistent with our longer-run economic objectives. As I noted earlier, the time is particularly opportune for exploring ways to facilitate retirement saving, given the large increase in the number of retirees that will occur within the next few decades. There may well be a role for a well-designed private saving incentive in that process. But, the historical evidence suggests that devising such an instrument will be a difficult task. In the end, substantial reductions in the federal

budget deficit are still the surest way to overcome the shortage of domestic saving and, thus, to increase permanently the supply of domestic funds available for investment.