Personal savings need a boost

Leonard E. Burman

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America's days of economic dominance are numbered because we don't save. The government is borrowing like crazy, and households aren't doing much better. The personal savings rate -- the share of after-tax income that people set aside for a rainy day -- has been falling like a stone since the early 1980s.

Until the recession triggered an uptick, as banks cut off lending and consumers uncertain about their income postponed big-ticket purchases, the rate was hovering at less than 2 percent. That is, Americans on average save about a week's income every year for retirement, to replace the family car when it dies or to pay the mortgage after a job loss. As recently as the mid-1990s, families put two weeks' income in the bank or in retirement plans. In the 1970s, they squirreled away 10 percent of their income.

With little or no savings, families were especially vulnerable to the economic recession. Lacking rainy-day funds, spending had to fall much more than it otherwise would have when breadwinners lost their jobs. The resulting drop in demand compounded the economic carnage, triggering even more job losses.

Right now, policy is correctly zeroed in on boosting spending to try to end the recession. But when the economy recovers, we should have a strategy ready to encourage more savings. The public is likely to listen. The Great Depression created a generation of compulsive savers. Perhaps with some nudging from policymakers, the Great Recession could do the same thing.

So how can we encourage more savings? The one thing we know is that the current strategy isn't working. We spend more than $100 billion annually on tax incentives for savings -- 401(k) plans, pensions, IRAs -- and the savings rate goes nowhere but down. Indeed, it started falling in the early 1980s, at the same time that retirement tax breaks were expanded, and another round of expansions early this decade did nothing to slow the trend.

One problem is that most tax breaks are poorly targeted. The biggest beneficiaries are high-income people who would save a lot even without subsidies. Those with lower incomes, who pay little or no income taxes, gain little from tax exclusions, credits and deductions. (The Obama administration has proposed making a tax credit aimed at low-income savers refundable, which would make it more effective.)

Meanwhile, our consumer culture constantly tells us that more is better and now is better than later. Low interest rates and easy credit only reinforce the carpe diemmessage. Savings just seemed so unnecessary ... at least until the bubble burst.

One silver lining in the financial crisis may be that people once again will have to save to make meaningful down payments on houses, and credit cards may no longer drop like manna from heaven to feed our buying habits.

Some policies also have been counterproductive. The eligibility rules for means-tested transfer programs, such as food stamps and the earned-income tax credit, deter low-income people from savings. If you have too much in the bank, you can't get these benefits. Medicaid provides free nursing home care for those who can't afford to pay for it, but that punishes middle-class families who prepare by saving or buying long-term care insurance. And college financial aid formulas penalize middle-income households that save for college.

Still, not all the news is bad. Employers have learned that automatically enrolling their employees in 401(k) plans, rather than requiring employees to opt in to company retirement plans, significantly increases participation. The Obama administration would extend this thinking to many employers who do not offer retirement plans by requiring them to contribute to employees' IRAs unless the employees explicitly opt out.

I'd take President Obama's plan a step further. Starting in 2012 (if the economy has fully recovered), employers should be required to withhold a percentage of earnings from all employees for a savings account that could be used to help fund retirement, to make a down payment on a house, to cushion the blow of a job loss or to start a business. (The accounts would resemble "individual development accounts" - a small program some low-income families qualify for now.) Withholding could be integrated with payroll taxes so that employers would face little or no extra burden.

Under my plan, employees could elect to receive the withheld money at tax time, but, if they did, they would lose savers' credits and other tax breaks. Tax software and tax-return preparers would have to show users and clients how much they would lose by withdrawing the money. The lost tax breaks plus the power of inertia -- you would have to do some paperwork to get your money -- could prompt a lot of new saving.

Over time, the share of pay set aside through the new program could gradually increase to 5 percent or more.

There are other ways to boost savings. The government could require middle- and upper-income people to buy long-term care insurance. Requirements for down payments could be increased for government-sponsored mortgage programs, such as for first-time homebuyers and veterans. Asset tests for transfer programs could be relaxed so low-income working people aren't punished for saving.

And Mr. Obama should use the presidential bully pulpit. This is a teachable moment. We know now, in case we forgot, that the economy can crash. The next crash will be much easier to handle if we have money in the bank.

Len Burman is the Daniel Patrick Moynihan professor of public affairs at the Maxwell School of Syracuse University and an affiliated scholar at the Tax Policy Center.

Other Publications by the Authors

- Leonard E. Burman