Another Penny Saved

The Economic Benefits of Higher US Household Saving

EXECUTIVE SUMMARY

OXFORD ECONOMICS

A report sponsored by: AARP, American Society of Pension Professionals & Actuaries, the Aspen Institute, Bank of America Merrill Lynch, Financial Services Roundtable, John Hancock Financial, LPL Financial, Natixis Global Asset Management, the New England Council, Putnam Investments, the US Chamber of Commerce

Foreword: A message from our Steering Committee

Economists of every school have always recognized savings as the source of investment that fuels an economy's long-term growth. Nations whose citizens and leaders have acted on this insight have gained powerful competitive advantage over time. Saving, in short, can ultimately translate into rising living standards and a more stable economic environment.

Too often in recent years, however, American policy-makers and media pundits have treated savings as a mere "leftover"—after deducting consumption from a nation's total output. And many remain worried about saving as a potential drag on growth, fearing what John Maynard Keynes called "the paradox of thrift" —a downward spiral driven by falling consumption.

Policies that foster saving are ultimately aimed at prosperity—not austerity. Nations that adopt well-crafted saving policies stand to win over time, through their citizens' personal solvency and independence, as well as the investments those citizens' savings fund. America's own retirement savings system, for example, based mainly on workplace payroll deductions, has played a major role in creating the world's deepest and most liquid capital markets.

Policy-makers in Washington have been tempted in recent years to simply cut back saving incentives in our tax code. They mistakenly treat saving deferrals as a pure "tax expenditure," even though some revenues are captured when retirees draw down their balances—and they fail to realize that private savings today means less government spending on safety net programs in the future. Based on this serious category error, multiple proposals have been made to curb or even eliminate saving incentives in order to capture more revenue for the government.

This misguided line of thinking effectively pits Americans' personal solvency against national solvency—even as we face the widely acknowledged risk of a retirement savings shortfall for millions of workers. Given currently low US saving rates, any move to reduce saving incentives would not only risk a rise in elder poverty, but undercut America's long-term growth potential.

By contrast, as you will learn in this report, policies that succeed in raising household savings can enhance America's ability to finance its future, lift potential growth rates, and contribute multiple trillions of dollars in added output—and higher living standards—over coming decades.

Oxford Economics' study, *Another Penny Saved: The Economic Benefits of Higher US Household Saving*, offers dramatic evidence that raising America's household savings should be a policy imperative—with benefits to both Americans and America's economy.

This project has brought together an extraordinary, widely diverse group of sponsors drawn from the financial services, non-profit and policy-analysis communities, representing tens of millions of Americans. We are proud to be part of this project, which we hope will spur a lively national conversation—and action—to raise America's household saving and help secure a more prosperous future.

Another Penny Saved is produced by Oxford Economics in conjunction with a group of financial and public-policy organizations that have come together to encourage an open debate and positive action on increasing saving to renew America's economy. Supporting companies and organizations include AARP, American Society of Pension Professionals & Actuaries, the Aspen Institute, Bank of America Merrill Lynch, Financial Services Roundtable, John Hancock Financial, LPL Financial, Natixis Global Asset Management, the New England Council, Putnam Investments, and the US Chamber of Commerce.

The importance of saving

Americans have fallen out of the saving habit. According to the Bureau of Economic Analysis, the household saving rate, which topped 13% in the early 1970s, is just 3.8% today,[1] and over 75% of Americans do not have enough saved to cover six months' expenses,[2] whether the need arises because of job loss or other unexpected life event. Projecting the current rate forward, and adjusting only for the aging of the population, we found that the saving rate will fall to an extremely low 3% in the 2030s.

Unless they can boost their saving during their working years, as they approach retirement age many US households will have to choose between working much longer, accepting a lower standard of living in old age—or running out of money altogether. And inadequate household saving is also a critical issue for the nation as a whole: with businesses expected to spend down their existing cash hoards, and government unlikely to run a fiscal surplus for years to come—if ever—a larger portion of national saving to finance business investment will need to come from households. Otherwise, undersaving will place the economy and government on a slow growth path as domestic investment in productive assets slows to match domestic saving, or the nation may be cast onto an unsustainable path as current investment levels persist but are financed with ever-increasing external debt with potentially adverse consequences for economic stability and the value of the dollar.

Nations that work to encourage and nurture saving stand to gain a competitive advantage over time, along with rising standards of living for households.

Policy-makers should view saving incentives as promoting individual long-term economic security and national long-term economic prosperity. But in practice, they often focus on reducing incentives to meet short-term goals. Caught up in successive efforts to stimulate consumption, reform the tax code, and reduce the deficit, Congress in recent years has entertained a series of proposals that would curb or cut back tax-based saving incentives.

Instead of retrenchment, the retirement saving system needs to be enhanced to address the challenges it presents to potential savers. Many employers, for example—especially small and medium-sized businesses—still do not offer 401(k) plans or other opportunities for their employees to save through payroll deductions.

Working with a group of partners drawn from the financial services, non-profit, and policy communities, we conducted a rigorous study of US saving patterns and their impact on both household financial security and the prospects for the nation's economy as a whole. Our research drew on original macroeconomic analysis of saving patterns, the impact of lower saving on households and the larger economy, and the potential impact of a shift to higher saving rates. Through our research, we found that:

- **The saving gap is large for many households—especially lower-income individuals and families—and filling it will be a struggle.** We analyzed the latest modeling results from the Employee Benefit Research Institute to determine the extent to which US households are currently undersaving. These numbers reveal that the saving gap—the difference between their projected lifetime savings and the

1 US Department of the Treasury, U.S. Economic Statistics—Quarterly Data. http://www.treasury.gov/resource-center/data-chart-center/monitoring-the-economy/Documents/quarterly%20ECONOMIC%20DATA%20TABLES.pdf

2 http://money.cnn.com/2013/06/24/pf/emergency-savings/

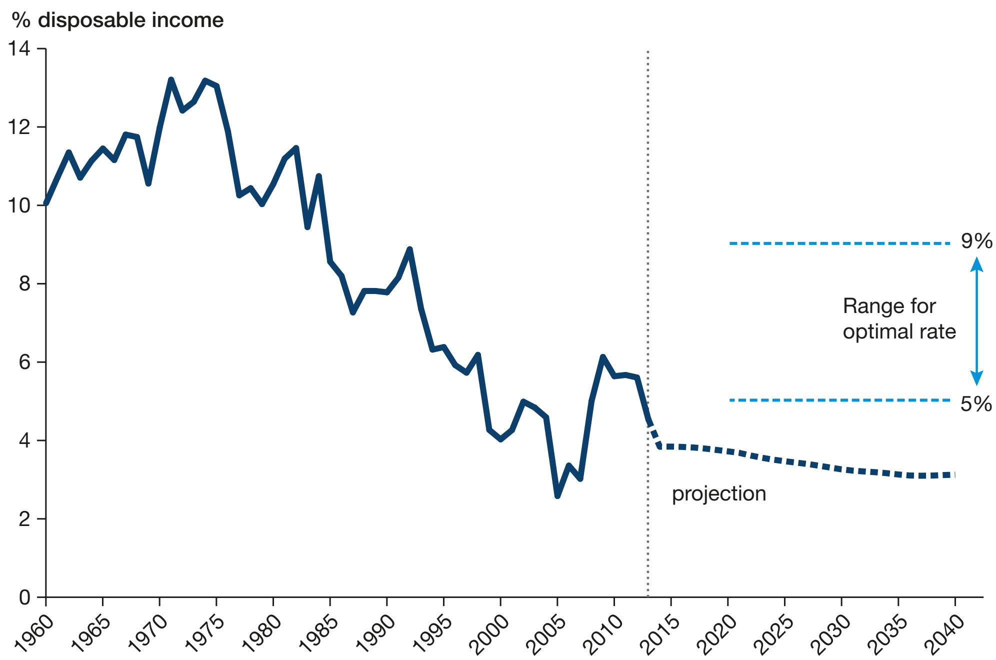
amount they would need to support an adequate lifestyle in retirement—is a scant 0.15% for the top 25% of households by total income. Those in the bottom quartile, however, need to save about 21% more of pre-tax income than they already do, on average, and even those in the second-lowest quartile will need to save an additional 4%, more than doubling the current average saving rate for households.

- **An optimal, or healthy, range of investment for the economy as a whole would equal 20%–25% of GDP.** Until recently, the US had no problem staying within this range—but only by borrowing increasingly from overseas investors, reflected in a large current-account deficit. Unless the household saving rate increases, getting back to that healthy range for the long term will mean relying even more heavily on foreign capital, resulting in greater exposure to capital flight and currency volatility. To achieve a more sustainable profile for the US' net foreign borrowing, the household saving rate will have to increase by one to five percentage points over current levels, or to between 5% and 9% of GDP (see Fig. 1).

To produce a more balanced mix of investment capital, household saving will have to increase by one to five percentage points over current levels.

Fig. 1: Estimating the optimal household saving rate

US: Personal saving rate forecasts*



*Profile based on projected demographic trend

Source: Bureau of Economic Analysis, Oxford Economics

- **A boost in saving would make the US less dependent on foreign capital, make households more secure, and strengthen long-term economic growth.** If investment rose to average 22.5% of GDP in the long run—the midpoint of our healthy range—matched by higher household savings, we found that GDP would be about 3% higher in 2040, equivalent to about $3,500 per person in today's prices. Incrementally, the additional GDP would amount to a net present value of $7 trillion—equivalent to about half of US GDP today. Not only would the US generate greater household wealth, but the economy would be better insulated from international capital shocks.

The importance of government policy in encouraging saving

Underlying the US retirement saving framework, however, is a complex interplay between government incentives, household decision-making processes, and employers' decisions whether to offer savings plans and payroll deductions in the first place. The most powerful factor encouraging greater saving is the opportunity to save for retirement through payroll deductions at work—and the willingness of employers to offer these plans.

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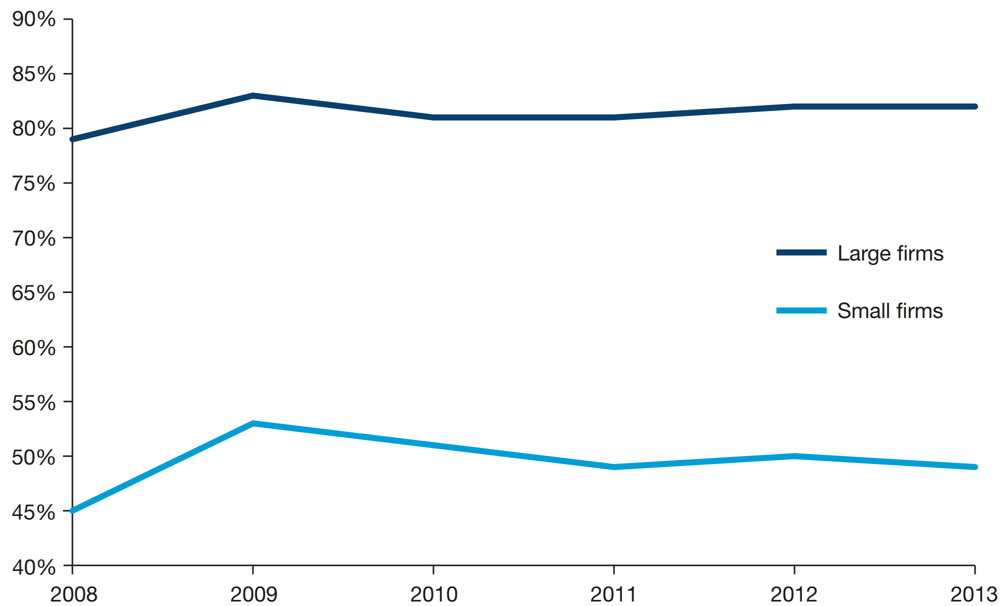
Employers must be supported so that they can provide a plan for their employees. While 401(k)s and similar plans have become widespread among larger employers, small firms are currently much less likely to offer them because of the costs involved (see Fig. 2). Extending these opportunities to save at work through payroll deduction could get millions more workers to save. It's important, then, that lawmakers and regulators, at a minimum, don't make the rules governing workplace plans more onerous.

Fig. 2: Smaller companies are less likely to offer retirement saving plans

Access rates to any retirement (DB or DC) plan for employees of small (≤100 employees) and large (≥100 employees) firms



Source: BLS National Compensation Survey

Once a workplace plan is established, employees must be encouraged to take it up. Incentives come in three principal types—two of them behavioral, one financial:

- **Nudges** rely on workers' intuitive judgments and educated guesses to take a specific action, rather than financial rewards. In one study, when randomly selected workers received an email asking them to sign up for the company's 401(k) plan and included a high savings goal example, their saving rose by up to 1.9% of income.[3]

3 James J. Choi, Emily Haisley, Jennifer Kurkoski, Cade Massey, "Small cues change savings choices." NBER Working Paper No. 17843 (2012).

- **Passive incentives** set default options that encourage an individual to save unless she specifically opts out. The most common passive incentives are automatic enrollment and escalation.[4]
- Matching contributions from the employer are an example of an **active incentive**, pushing the individual to take specific actions to obtain financial rewards.

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Evidence suggests that behavioral approaches—passive incentives and nudges—have a more powerful effect on saving practices for most employees than active incentives. Active incentives target active savers, who tend to be wealthier and more financially savvy. But because plan sponsorship by employers is voluntary for the US system, the impact of active tax incentives on the voluntary sponsorship of these plans by employers is extremely important. Smaller-business owners tend to be active savers, and active incentives are needed to ensure that this group provides work-based plans to all of its employees.

Active and passive incentives, nudges, and the availability of options geared to a long-term asset-accumulation strategy, such as target-date funds, can be combined to create a retirement saving framework that provides adequate retirement income—with automatic participation, steadily growing contributions, and a long-term, consistent investment strategy.

From debt to saving—key strategies

Achieving a pro-saving, pro-growth policy set within the boundaries of a private-sector system will require government, employers, and financial-services providers to work together. Public policy, therefore, should never pit personal solvency and national solvency against each other in a misguided quest for fiscal savings.

- **Existing saving incentives and vehicles should be preserved and restructured** to maximize savings, both in aggregate and among the groups currently least able to save, including the large proportion of workers not covered by workplace plans. Matching contributions and other enhanced incentives to support saving by low-income Americans, such as refundable tax credits, should be considered.
- **The success of workplace payroll saving plans should be recognized as the prime driver of asset accumulation for working Americans.** Employers should be encouraged to automate features and direct participants to more appropriate deferral rates.
- **Working households have a role to play in this process as well**. Employees can push for other workplace opportunities that their employers may have overlooked. The person who is self-employed or between jobs can urge her elected representatives to broaden access to tax-advantaged saving vehicles, or to liberalize rules governing contributions.

4 Schlomo Benartzi and Richard Thaler, “Heuristics and biases in retirement savings behavior,” *The Journal of Economic Perspectives* (2007): 81–104.

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