

# RESEARCH BUZZ



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## Is There a Revolution in American Saving?

By John A. Tatom

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The personal saving rate has spiked up to an unusually high level in recent months, prompting many observers to suggest that the financial crisis has created a new thrift ethic, reversing decades of decline in U.S. saving to near zero. Time magazine (2009) captured the spirit of the new American in a cover page special report, "The New Frugality," noting: "The recession has changed more than just how we live. It's changed what we value and what we expect—even after the economy recovers." Kansas (2009) is slightly more questioning, but concludes that the "newfound fondness for thrift will persist." The depth of the recent financial and economic crisis has prompted many to believe that there has been a sea change in attitudes toward regulation, independence and personal responsibility and that a permanent rise in saving behavior has taken place. There are many reasons for personal saving to have surged recently, however, and most of them are very temporary, so it is not likely that the personal saving rate will persist at a higher level. Betting on fundamental changes in behavior is a risky, dare we say foolish business in the absence of fundamental change in the economic environment or incentives.

### The personal savings rate has risen sharply

Personal saving climbed to 5.1 percent of personal disposable income in April 2009, the highest pace since February 1995 (see Chart 1). The personal saving rate has been volatile over the past year. It surged to 4.8 percent in April 2008 from near zero, then declined to 0.8 percent by August 2008 and then began to climb. It averaged 4.3 percent from December 2008 through March 2009. The recent performance of personal saving is striking in light of the quarter-century trend of decline in the personal saving rate to near zero levels in recent years. Indeed in a couple of quarters (October 2001) and August 2005) the personal saving rate was negative, meaning that consumers, as a group, spent more on consumer goods than they received in disposable income.<sup>1</sup>

The recent reversal would represent fundamental change if it persists and if it extends to overall saving in the economy, but neither development is likely to be the case. Since last August, and also in April-May 2008, there have been significant, but temporary, changes in the economic environment that point to temporary increases in the personal saving rate, so that a reversal of the surge in personal saving is likely. As explained below, temporary tax cuts and the recession itself have played key roles in the temporary increase in the personal saving rate. More importantly, the surge in the personal saving rate is a small part of overall saving developments in the country and the surge has arisen, in part, because of more significant and adverse government saving developments, or put more directly, personal saving has surged, in part because of a sharp rise in the U.S. government deficit. And, unfortunately, the budget deficit increase is growing and is not a temporary development. Indeed, official estimates point to budget deficits of over \$3 trillion dollars

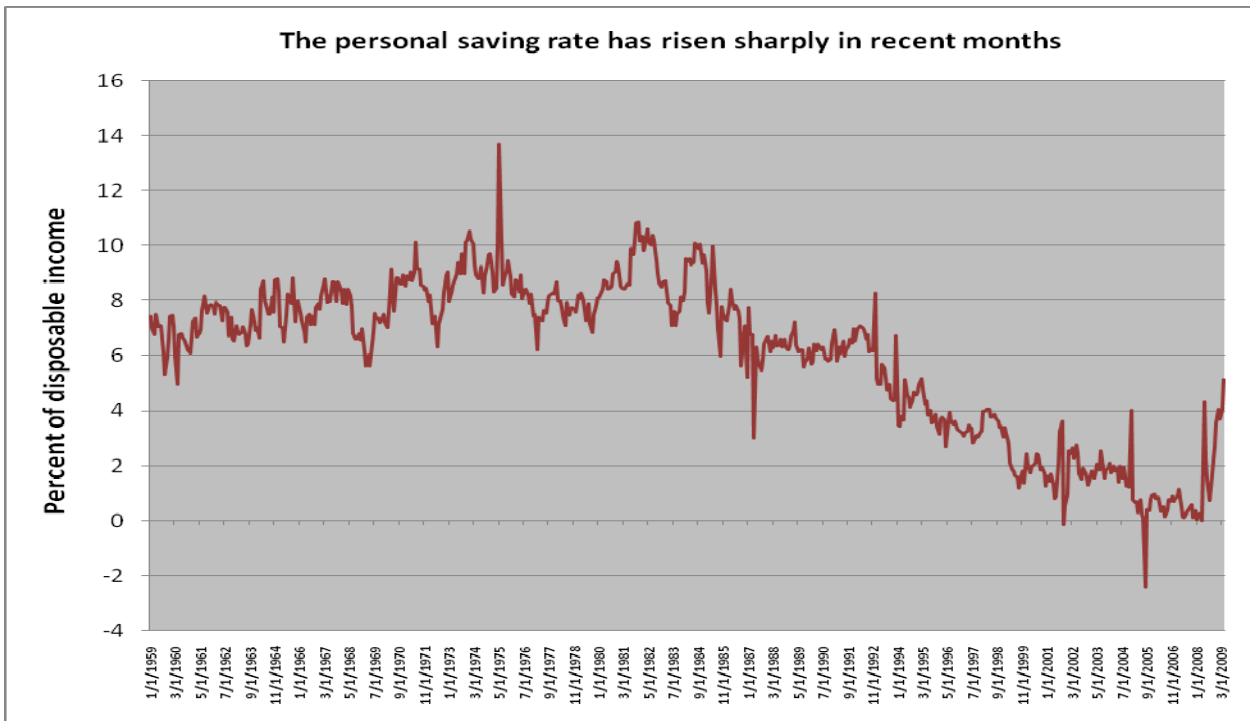
over the next three years (2010-2012), while the deficit was about one trillion dollars at an annual rate in the first quarter of 2009 and headed up to \$1.8 trillion for the year as a whole.

There are two main reasons for the improvement in the personal saving rate recently. The first is tax cuts. In April and May 2008 there were large one-time tax rebates to most individuals of \$300 per person/\$600 per joint return. These resulted in little or no change in consumer spending because the tax cut was temporary.<sup>2</sup> Tax cuts that are expected to be temporary are used to pay down debts, or saved, instead of increasing consumer spending, according to the permanent income hypothesis. The Obama tax cut is also temporary and took effect in April 2009, boosting the personal saving rate. The personal saving rate rose from 4.1 percent in February 2009 to 5.1 percent in April 2009, while current personal taxes fell from 11.9 percent of disposable income to 10.8

percent in April 2009, nearly matching point-for-point the rise in the personal saving rate. In the most recent case of a temporary tax cut, the cut is \$400 per person per year/\$800 per joint return for 2009-10. This rebate lasts longer, but is also a one-time tax cut that can be expected to boost saving temporarily.<sup>3</sup>

The second major factor boosting personal saving recently is the recession, especially after August 2008 when the real incomes actually began to fall rapidly. In a recession, real income falls because of lost employment. Most unemployed workers recognize such an income loss as temporary and lasting only so long as the unemployment spell persists. Consequently individuals do not reduce consumer spending in line with the temporary income loss. Instead, temporarily unemployed workers tend to reduce assets or increase debt in order to finance consumer spending. This is another aspect of the permanent income hypothesis.

**Chart 1**  
**Personal saving appears to have reversed its 25-year trend decline**



Source: Bureau of Economic Analysis

When income falls temporarily, as in a recession, if consumers maintain their pace of consumer spending then saving must fall. Recessions are typically characterized by such developments, although consumer spending is not constant during recessions. Real expenditures on services and non-durable goods, a closer measure of true consumer spending because it excludes durable goods purchases that are conceptually largely saving and investment, does not usually decline in recessions, presumably because permanent income does not decline.

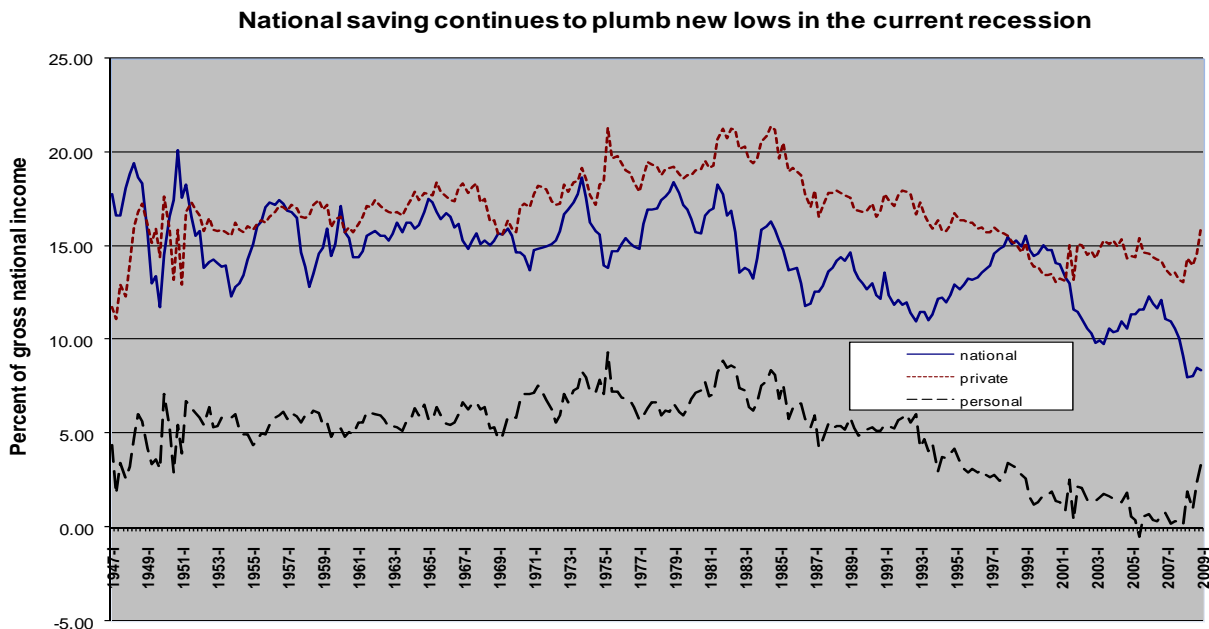
When there are supply shocks, such as large increases in energy price, however, the cyclical (and temporary) decline in income and employment overlay an underlying permanent loss in income. In the current recession, the surge in energy prices in 2007 to mid-2008 presumably lowered permanent income so that consumer spending fell and by more than is usual. Real consumer expenditures on nondurable goods and services declined 1.3 percent from April 2008 to April

2009, much more than in the earlier energy-shock related recessions in 1973-75, 1980 and 1981-82, when it was essentially unchanged, falling by less than 0.11 percent in the worst and only 12-month period of decline in each case. In the other smaller energy-shock related recessions in 1990-91 and 2001, this measure of consumer spending did not decline. Since energy prices are in the process of largely reversing their earlier rise, the permanent effects of the energy price shock could also be expected to reverse, so that any effect of the loss in permanent or transitory income on the saving rate is likely to disappear.<sup>4</sup>

**Overall saving has declined**

There are three components of national saving in the U.S. accounts: personal saving, business saving and government saving. This is tricky because business saving, which comprises undistributed cash flow arising from profits and depreciation cash flows, is really part of individual income, but is not accounted as such in the National Income and Product Accounts. Instead, when

**Chart 2**  
**National saving has declined in the latest recession**



Source: Bureau of Economic Analysis

business and personal saving are added together the total is referred to as private saving. Finally government saving, which is really negative saving or dissaving, is better referred to as the government budget deficit.

Note that the private saving rate is much higher than the personal saving rate, reflecting the large amount of saving “at the office,” as stockholders reinvest their undistributed cash flow directly back into their businesses instead of taking the cash flow as income and then lending or purchasing new stock in their businesses with the proceeds. National saving is usually smaller than private saving because the government does not save, instead it has negative saving that reflects what it must borrow in order to finance its economic activity.

At the last cycle peak in the fourth quarter of 2007, the national saving rate was 10.1 percent, but the national saving rate has been lower throughout the recession, registering 8.0 to 8.4 percent in the latest three quarters. Thus, while personal saving and private saving have risen during the recession, overall national saving has not. The budget deficit increases have exceeded the rise in private saving, pushing national saving to the lowest pace since 1947.

The secular decline in the national saving rate reflects a sharp slowing in inflation that had earlier reduced wealth and forced individuals to save in order to maintain the purchasing power of cash balances, a decline in tax rates on income, and a fall in the real rate of return to capital. All three factors boosted wealth relative to income and depressed saving. The decline in household and non-profit institutions assets since the third quarter of 2007, immediately before the business cycle peak, has been \$13.7 trillion or 16.2 percent, reaching \$65.7 trillion in the last quarter of 2008. Moreover the size of current and future deficits, as well as expected further increase in government spending and budget deficits, suggest that wealth will decline further. As wealth falls, individuals will

want to rebuild wealth relative to income by increasing saving. Thus, while saving has not risen so far in the recession, it is likely that current wealth trends will lead to a boost in private saving that surpasses the growth of the government deficit so that overall national saving returns to higher levels. Of course, higher saving to rebuild lost wealth is not a positive outcome if the alternative were to maintain wealth and a slower pace of saving. In any event, national saving is at record lows and there are growing efforts to boost saving. One of the latest efforts is the drive to improve the effectiveness of financial education and savings programs (see Lusardi 2009).

### Conclusion

Recent increases in personal saving are impressive relative to the secular decline of personal saving, but the increase has been driven by temporary factors that are likely to reverse soon, especially tax cuts and recessionary declines in income. Moreover, the rise in personal saving has been surpassed by increases in the government deficit so that available national saving to finance investment and growth has actually declined sharply relative to the nation’s income. Thus, it is a little early to cheer a rise in saving. There are reasons to believe that saving could rise—rising inflation, tax rates, and government spending—as wealth declines and individuals attempt to restore their wealth. Forced saving to rebuild wealth is not exactly the path to higher saving that most individuals would prefer.

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#### Endnotes

1. The August 2005 saving rate was pushed down by a massive one-time capital loss reflected in rental income from property destroyed by Hurricane Katrina. The October 2001 negative saving reflected a large and temporary rebound in consumer spending from the depressed 9/11 related spending the month before, which had also shown up in an unusually large spike up in the saving rate.
2. See Feldstein (2008) for an explanation and evidence of the ineffectiveness of the 2008 tax cut for boosting consumer spending.
3. An earlier example of such an extended one-time tax change is the 10 percent income tax surcharge in 1968 and reduced to 5 percent in 1969-70. The saving rate fell with the passage of the tax hike in June 1968 and began to rise in February 1969. It did not return to its May 1968 level until about April 1970 when the surcharge was phasing out and the economy was in the midst of recession. Consumer spending was not affected despite the 27-month surcharge, somewhat longer than the 21-month Obama tax cut. Other examples of temporary swings in taxes causing large temporary swings in the personal saving rate see in Chart 1 are the tax rebate in May 1975, sharp temporary shifts in taxes in April 1987, May-October 2001 and of course April-May 2008, and 2009.
4. The latest recession was accompanied by a large increase in the relative price of energy that led to a decline in real per capita consumption expenditures, which has only been

in earlier energy-price related recessions, such as in 1973-75, 1980, 1981-82, 1990-91 and 2000-01. In the latest recession, the surge in energy prices has been largely reversed so that any transitory effect of the change in transitory or permanent income should disappear.

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## Social Security and Medicare Reports Underline Increased Urgency

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On May 12, 2009, the Social Security Administration released the "2009 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds" (2009 OASDI Report), which outlines the current and future financial status of the trust funds. Insured workers are eligible, upon attaining the mandated retirement age, to receive a basic monthly income to support them in retirement, though the OASDI fund provides for a broader set of benefits. It consists of two components, namely, the Old-Age and Survivors Insurance (OASI) for retirees and survivors of deceased workers, and, Disability Insurance (DI) for disabled workers and their families.

On the same day, the "2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds" (Medicare), was also released. Medicare has two components. "Hospital Insurance, or Medicare Part A, helps pay for hospital, home health, skilled nursing facility, and hospice care for the aged and disabled. Supplementary Medical Insurance consists of Medicare Part B and Part D. Part B helps pay for physician, outpatient hospital, home health, and other services for the

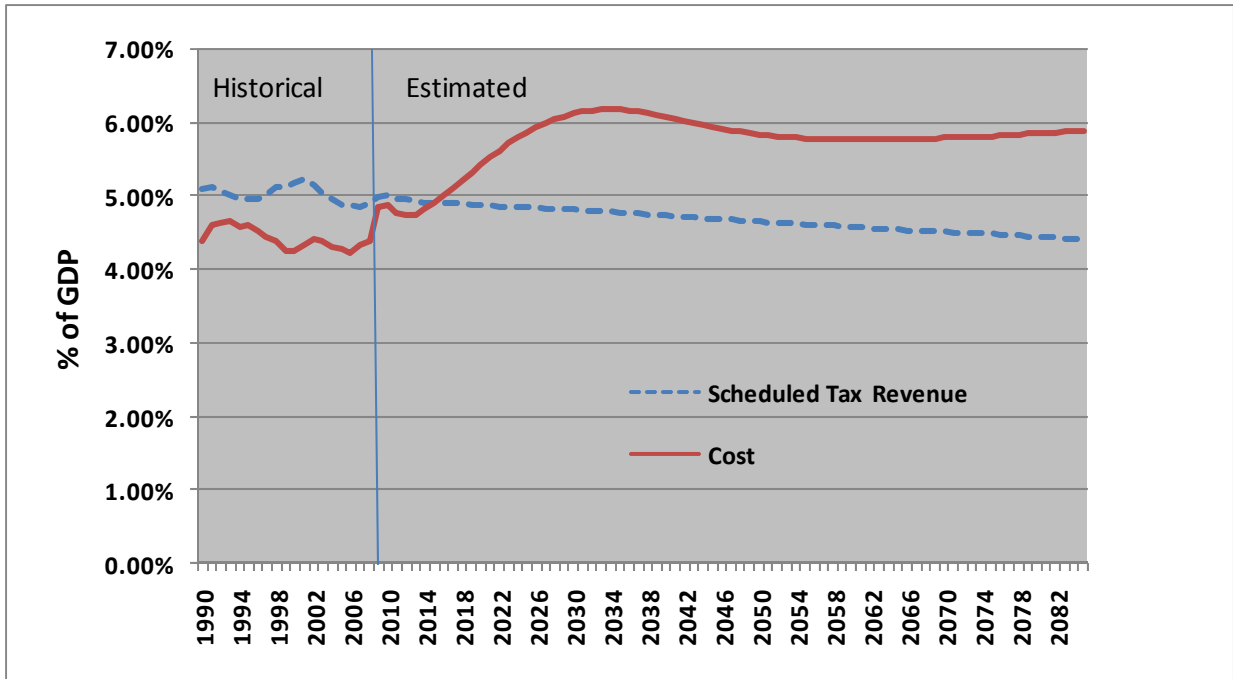
aged and disabled who have voluntarily enrolled. Part D provides subsidized access to drug insurance coverage on a voluntary basis for all beneficiaries and premium and cost-sharing subsidies for low-income enrollees. Medicare also has a Part C, which serves as an alternative to traditional Part A and Part B coverage. Under this option, beneficiaries can choose to enroll in and receive care from private “Medicare Advantage” and certain other health insurance plans that contract with Medicare.”

Social Security and Medicare’s continued existence are threatened by some major problems. Increased life expectancy rates and an increasing number of baby boomers who are retiring will exert pressure on the scheduled payments of social security benefits. These factors, together with a birth rate that is expected to remain at levels below the baby boom era, ensure that the number of beneficiaries will rise at a faster rate than the labor force. While there were about 3.2 workers for every OASDI beneficiary in 2008, this is projected to be 2.2 by 2030. Actuarial estimates

indicate that the actual OASDI costs will exceed tax income from 2016 and the trust fund assets covering the deficits will be exhausted in 2037. Individually, the report expects the DI fund to pay full benefits up to 2020, while the fund will last until 2039. This means that within the next 10 years, it will be necessary to either reallocate the payroll tax from OASI to DI as a stop gap, or to come up with a more permanent solution. The current recession has also led to adjustments in the projections. The 2016 estimate is a year sooner than last year’s projection while the 2037 estimate is four years sooner than was anticipated a year ago. These recessionary effects have also increased the actuarial deficit from 1.70 percent of GDP in last year’s report to 2 percent over the 75 year period to 2083.

The report further states that if no major changes are made to change this situation, then either one of the following scenarios could be used to keep Social Security solvent for the next 75 years.

**Chart: OASDI Cost and Scheduled Tax Revenue as a Percentage of GDP**



Source: 2009 OASDI Report

1. Raise the OASDI payroll tax to about 16.26 percent at the point of trust fund exhaustion in 2037 and continue to about 16.74 percent in 2083 (It is currently 12.4 percent for employers and employees combined).
2. Reduce benefits to a level that is payable with scheduled tax rates in each year beginning in 2037. Under this scenario, benefits would be reduced 24 percent at the point of trust fund exhaustion in 2037, with reductions reaching 26 percent in 2083.

An earlier proposed solution would require smaller increases and/or reduced benefits.

Ochieng (2008) covers some proposals on changes that need to be made to the Social Security dilemma. There are two broad categories being floated to handle this situation. One option is to privatize it. There are various proposals on how privatization should be done without affecting those using the current system. Two, amend the current system by raising the payroll tax or reduce benefits. Again, there are various proposals on how, and the extent to which this can be done. Considering the increasingly dire projections, a solution will need to be reached sooner rather than later. It is no wonder that the social security dilemma is often considered the third rail of politics.

The Medicare report, on the other hand, depicts an even more dire need for a solution. This is the third consecutive year that a "Medicare Funding Warning" has been triggered, a mechanism used to signal that at least 45 percent of Medicare outlays will come from primary general reserves. This also requires a presidential proposal to curb spending, prior to releasing his budget. Tax income and other revenue for Hospital Insurance (HI) is, going forward, expected to be less than expenditure. It is projected that HI trust fund assets will be depleted in 2017, two years earlier than last year's report, due to recessionary effects. Barring any changes to current law, taxes would cover 81 percent of estimated costs in 2017 and only 29 percent at the end of the long range

period (2083). Since HI is primarily financed by payroll taxes, bridging these deficits could require substantial increases in taxes, reductions in expenditure, or both.

Medicare's other component, Supplementary Medical Insurance (SMI), is largely reliant on transfers from the general fund of the Treasury and by beneficiaries' premiums paid toward the total cost. Another source of revenue is interest generated by the securities held in the SMI trust fund. Future expenditure is expected to rise drastically and, although premiums and transfers from the general fund are reset each year to match costs, alternative solutions are needed fast to match the rising expenditure. As in the Social Security report, earlier implementation of solutions to the Medicare problem will allow for adequate adjustments by affected parties-including health care providers, beneficiaries, and taxpayers.

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