

CBO TESTIMONY

**Statement of
Robert D. Reischauer
Director
Congressional Budget Office**

**on
National Saving and the
Role Played by Baby Boomers**

**before the
Subcommittee on Deficits, Debt Management
and Long-Term Economic Growth
Committee on Finance
United States Senate**

June 17, 1994

NOTICE

**This statement will not be
available for public release until
it is delivered at 10:00 a.m.
(EDT), Friday, June 17, 1994.**



**CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515**

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear here today to discuss whether national saving is high enough to enhance future living standards and, within that context, whether saving by baby boomers is sufficient to allow them to meet their expectations in retirement.

The Congressional Budget Office (CBO) has advised the Congress for some time that the low rates of national saving that set in during the 1980s pose an increasing, cumulative threat to the growth of living standards for the people of the United States. CBO and other economists have done considerable research on the issues of how saving is best measured and how it contributes to future wealth, income, and living standards. After hacking through a thicket of technical problems, we and other economists can see clearly that national saving is too low, no matter how it is measured, and that federal deficits contribute significantly to low saving. It is equally clear to us that reducing federal deficits offers the most reliable way to remove the threat that low national saving poses to the growth of living standards.

Because baby boomers loom so large in the population, many people express concern about whether the boomers are saving enough now and will accumulate enough savings to meet their expectations in retirement. It is definitely too early to say much with certainty about the financial well-being

of the baby boomers in retirement. The evidence available suggests that, even though the average income of boomers in retirement will most likely surpass that of their parents, a large proportion of baby boomers may not be able to maintain their preretirement standard of living once they retire.

Popular wisdom hints that the baby boomers played a large role in the decline of national saving during the 1980s, but the evidence suggests that the baby boomers were not responsible for that decline. In fact, as the boomers enter their high-earning and high-saving years over the next decade or two, their saving could lead to a modest increase in the personal saving rate. Higher saving rates by the boomers in the near term would lead not only to more comfortable retirement for baby boomers but also to a higher standard of living for all Americans in the years ahead. If strong action were taken to reduce federal deficits as well, the outlook would appear much brighter.

THE NATIONAL SAVING RATE IS TOO LOW

The precipitous fall in the rate of national saving--from an average rate of 7.7 percent of gross domestic product (GDP) in the 35 years to 1980, to only 3 percent between 1981 and 1993, and to only 1.7 percent in 1993--is not without consequence. It has already imposed significant costs on the people

of the United States, and until the decline is reversed, it will impose additional and even more significant costs on future generations.

National saving--that is, saving by individuals, businesses, and government--is the way a nation best provides for its future well-being. Through saving it finances the investment that adds to the stock of factories, machinery, and other types of capital that provide employment, increased productivity, and growing real income for more and more workers. From time to time, of course, national saving can fall short of investment, and inflows of saving from abroad can fill in temporary shortfalls. However, history has shown repeatedly that sustained growth in living standards is achieved most reliably through national saving. That was true for the United States during its ascendancy to world leadership and for Japan and the countries of Europe in their reemergence as industrial powers after World War II.

The Decline Is Not a Fiction

The startling size of the decline in the rate of national saving--from 7.1 percent in the 1970-1979 period to 3.8 percent in the 1980-1989 period--initially raised questions about whether something had gone awry with the way saving is conventionally measured in the national income and product

accounts (NIPA). Should some spending that is counted as consumption in the NIPA measure--such as what is spent by consumers on durable goods, by government on capital goods, and by consumers and government on education, training, and research and development (R&D)--be counted as saving and investment? Was the decline exaggerated because the NIPA measure ignores the effects of inflation and capital gains? Was it overestimated because capital consumption--the depreciation of capital that reduces national saving--was overstated?

After evaluating these measurement issues, CBO has found that national saving still declined precipitously during the 1980s, no matter how it is measured.¹ For example, including adjustments for consumer durables, government nonmilitary investment, and capital gains only makes the decline worse. The drop in the saving rate between the 1970s and 1980s--3.3 percentage points for the NIPA measure--would be between 3.6 and 9.4 percentage points by measures that include these adjustments (see Table 1).

Including other expenditures on R&D, education, and training--which NIPA ignores in part because of the difficulty of estimating depreciation--would also make the decline worse. Taken together as a percentage of gross

1. For details of the effects of the adjustments on national saving and a discussion of the issues, see Congressional Budget Office, *Assessing the Decline in the National Saving Rate* (April 1993).

domestic product, these expenditures also declined by about 1 percentage point between the 1970s and 1980s.

Finally, measures of depreciation that differ from what the NIPA methodology yields would not alter the story appreciably. Some research suggests that NIPA's estimate of depreciation might overstate depreciation and, consequently, understate saving. That could happen, for example, if capital goods last longer, or if the profile of depreciation over the assumed life of capital goods is different than the NIPA estimate of depreciation assumes. Based on the available evidence, however, CBO has determined that even under those circumstances the decline in national saving might be lessened by only about 0.6 percentage points.

TABLE 1. NATIONAL SAVING RATE ADJUSTED FOR CONSUMER DURABLES, GOVERNMENT NONMILITARY INVESTMENT, AND INFLATION-ADJUSTED REVALUATIONS (In percent)

	1960-1969	1970-1979	1980-1989
National Saving Rate	8.0	7.1	3.8
Saving Rate Adjusted for Consumer Durables and Government Investment	11.5	9.9	5.9
Saving Rate Plus Capital Gains			
At replacement prices	10.7	12.9	3.5
At prices of existing assets	12.3	9.6	6.0

SOURCE: Congressional Budget Office, *Assessing the Decline in the National Saving Rate* (April 1993), p. 17.

NOTE: Replacement prices refers to the prices of newly produced investment goods. Prices of existing assets refers to valuing assets held by corporations at the market value of corporate equity.

How Much Has the Decline Already Cost?

The decline in the national saving rate has already cost the United States a lower level of income than it might otherwise have enjoyed. That loss in income is most immediately observable in the switch from net creditor to net debtor status with the rest of the world as the United States drew capital from abroad to finance its shortfall in national saving. But it is also observable in a lower capital stock than would otherwise have been the case, which in turn lowered potential output and income.

Economists at the Federal Reserve Bank of New York have made a good estimate of these capital and income costs. Using the standard, growth-accounting approach, which provides conservative estimates of the cost, they have calculated that by 1989 the decline in national saving had already reduced productive capital by 15 percent compared with what it could have been if the national rate of saving had not fallen from its level of the 1970s. That shortfall in productive capital reduced potential output in the United States by 5 percent annually, or about \$239 billion in 1987 dollars.²

2. Ethan Harris and Charles Steindel, "The Decline in U.S. National Saving and Its Implications for Economic Growth," *Quarterly Review*, Federal Reserve Bank of New York, vol.15, no.3-4 (Winter 1991). The dollar amount is based on CBO's measure of potential output.

One can only speculate how different the situation would be if higher amounts of capital and potential income were at the United States' disposal. Would rates of labor productivity and real wage growth be higher? Would achieving low inflation have come at less cost in terms of lower levels of unemployment?

How Much Will the Decline Cost in the Future?

If low rates of national saving continue, the United States can expect lower growth of productive potential and lower real income than would otherwise occur. Those costs will pose an increasing, cumulative threat to the growth of living standards for future generations.

There is general agreement that, by raising labor productivity, increased saving and investment will enhance future living standards, although the amount of enhancement is uncertain. The conservative, growth-accounting approach that is widely used considers separately the contributions to productive capacity of labor, capital, and total factor productivity (that is everything, including technical progress, that is not labor or capital but contributes to growth). The approach suggests that a permanent increase of

1 percentage point in national saving will raise living standards 50 years hence by about 1 percentage point.

Alternative approaches, using what is termed "new growth theory," indicate that even higher increases in living standards may be possible. These approaches suggest that the contribution of capital could be larger than found through the growth-accounting approach, in part because of benefits that spill over from growing firms to the rest of the economy. Support for this view is provided by some historical studies that seem to show that investment in equipment might boost productivity more than investment in other types of capital.

Unfortunately, the new theories, though intriguing, do not yet have enough scientific support to base policy on them. The theoretical possibility of spillover benefits lacks the empirical support that would be needed to merit much confidence in it. Moreover, the finding in historical studies that equipment spending gives a disproportionate boost to growth lacks theoretical underpinnings--that is, the finding could simply be spurious. Consequently, most economists believe it is prudent to stay with the results of the established growth-accounting approach, which has a long history of scientific support.

WHAT IS RESPONSIBLE FOR THE DECLINE IN SAVING?

The main cause of the decline in the national saving rate is rampant federal deficits after the 1970s. During the 1980-1993 period, when the rate of national saving declined by an average of 3.9 percentage points from its 1970-1979 average of 7.1 percent, federal deficits as a percentage of GDP rose by an average of 1.9 percentage points. Consequently, federal deficits accounted for about one-half of the decline between the 1970s and the 1980-1993 period.

Of course, just as issues have been raised about the proper measurement of national saving, similar and related issues have been raised about the proper measurement of the deficit's contribution to the decline in national saving. How culpable would the deficit be if measures of the deficit counted government expenditures on capital goods as saving rather than consumption? What would happen if they combined federal, state, and local budgets? What would happen if changes in the market value of federal debt were accounted for? And finally, what if the inflation portion of interest payments on the federal debt were credited to repayment of principal instead of charged to interest outlays? These adjustments might reduce the contribution of deficits to the decline in the national saving rate.

Each of these possible adjustments to the standard measure of the federal deficit has its proponents and critics, and I do not want to get bogged down in the endless arguments about their merits and demerits here. Nevertheless, after looking into these possible adjustments, CBO and most other economists have found that, taking them together (which is the only legitimate way to evaluate them), the federal deficit would become even more culpable. That is, federal deficits could be responsible for between one-half and two-thirds of the decline in the national saving rate, depending on how they are measured, with a reduction of private saving accounting for the rest of the decline (see Table 2).

The exact reasons for the decline in private saving are still an unresolved matter among economists. Some of the decline may simply reflect population trends: an increasing proportion of retirees, who tend to save at low rates, and a decreasing proportion of people ages 40 to 64, who tend to save at high rates. However, those trends were also in effect in the 1970s, before the decline in overall saving rates took place. Hence, they are unlikely to have played a major role. (Averaging 26.4 percent of the population in the 1960s, the number of those ages 40 to 64 fell by 0.8 percentage points in both the 1970s and 1980s. Averaging 9.5 percent of the population in the 1960s, the number of those ages 65 and older rose by 0.9 percentage points in the 1970s and by 1.2 points in the 1980s.)

Some of the decline in private saving rates seems to have stemmed from stock market and real estate gains. Feeling richer from gains in the value of stock market equity and real estate during the 1980s, households probably

TABLE 2. CONTRIBUTION OF GOVERNMENT AND PRIVATE SAVING TO THE DECLINE IN THE NATIONAL SAVING RATE (In percent)

	1960-1969	1970-1979	1980-1989
National Saving Rate			
NIPA	8.0	7.1	3.8
Adjusted	11.7	9.9	6.0
Federal Government Saving			
NIPA	-0.2	-1.7	-3.6
Adjusted	0.7	-0.3	-2.5
State and Local Government Saving			
NIPA	0	0.8	1.0
Adjusted	1.7	1.5	1.1
Total Government Saving			
NIPA	-0.1	-0.9	-2.5
Adjusted	2.5	1.2	-1.4
Personal and Business Saving			
NIPA	8.2	8.0	6.3
Adjusted	9.3	8.9	7.3

SOURCE: Congressional Budget Office, *Assessing the Decline in the National Saving Rate* (April 1993), p. xii.

NOTES: NIPA = national income and product accounts measure of saving.

Adjustments to NIPA include those for consumer durables, government nonmilitary investment, the inflation component of interest flows, and the market value of federal debt.

cashed in some of those gains by borrowing against their wealth and using the proceeds to finance consumption.³ That helped reduce saving.

WHAT ROLE DOES THE DEMOGRAPHIC BULGE OF BABY BOOMERS PLAY IN THE DECLINE OF SAVING?

Some analysts argue that the profligate baby boomers are responsible for the recent drop in the rate of personal saving. In 1990, when the boomers were ages 25 to 44, they made up 44 percent of the population of the United States and were in the midst of the years when the lion's share of income typically goes for consumption. Low saving rates among such a large proportion of the population therefore might understandably be responsible for a substantial portion of the decline in the saving rate. However, evidence from various sources fails to support that view.

Indeed, evidence based on household surveys suggests that the drop in the personal saving rate occurred not among the baby boomers but among older workers in the 1980s, perhaps in response to increased benefits from Social Security and Medicare and capital gains on housing and other assets. One study that looked at the saving rates of households found significant declines

3. For indirect evidence that increased access to second mortgages leads to reduced saving, see Joyce M. Manchester and James M. Poterba, "Second Mortgages and Household Saving," *Regional Science and Urban Economics* (May 1989), pp. 325-346.

in saving rates among households headed by those ages 45 to 64 in the mid-1980s compared with saving rates of households headed by people in the same age group in 1963 and in the early 1970s.⁴ Only minor declines in saving rates were found for households headed by someone age 25 to 44.

A downward shift in the proportion of income saved during the 1980s by those ages 45 to 60 is corroborated in another study using a different approach and a different source of data.⁵ Such evidence reinforces the view that the cohorts that were in their 40s and 50s during the 1980s are mainly responsible for the decline in overall saving. Less saving by older workers resulted in a strong decline in overall saving because those cohorts were in the part of their life cycle when saving is highest. And recent econometric evidence suggests that the personal saving rate would have been little different during the 1980s without the baby boom.

As the baby boomers reach the peak years for both income and savings, however, their increased rates of saving out of higher incomes could lead to some modest improvement in national saving. If the profile of saving by age groups that was observed in the mid-1980s continues to apply for the next 15

4. Barry Bosworth, Gary Burtless, and John Sabelhaus, "The Decline in Saving: Evidence from Household Surveys," *Brookings Papers on Economic Activity*, no. 1 (1991), pp. 183-241.

5. Orazio P. Attanasio, "A Cohort Analysis of Saving Behavior by U.S. Households," Working Paper No. 4454 (National Bureau of Economic Research, Cambridge, Mass., September 1993).

years or so, the aging of the population will result in a 0.8 percentage point increase in the personal saving rate from 1990 to 2010.⁶ If baby boomers respond to their circumstances by saving a higher fraction of their incomes than did those cohorts in their 40s and 50s during the 1980s, an even bigger boost to national saving will result.

Of course, it is too early to tell how the baby boomers will respond to the circumstances that will confront them in the decade or two before they retire. Unforeseen changes will no doubt occur in immigration, the federal programs that provide support for retirement and health care, and the pace of economic growth. Yet these changes will have a sizable impact on the well-being of baby boomers in retirement. Moreover, it remains to be seen how the boomers will change their behavior in response to these economic factors--whether they will work more or fewer years, enjoy themselves more or less while they are relatively young and healthy, or save at a higher or lower rate during their peak earning years.

Based on what is known now, however, the degree of preparedness of the baby boomers for retirement is not a cause for alarm. The ratio of wealth to income for households headed by baby boomers in 1989 was comparable to that of their parents at similar ages before they reduced their saving rate.

6. Richard Cantor and Andrew Yuengert, "The Baby Boom Generation and Aggregate Savings" (working paper, Federal Reserve Bank of New York, April 1994).

Moreover, the levels of wealth the boomers have accumulated are comparable to what theoretical models of lifetime savings suggest is optimal.

Nevertheless, many reasons exist for concern about the outlook for personal saving. Some groups of baby boomers face a bleak future, including those who are less educated, nonhomeowners, or single. Even though it is impossible to know what will happen to national saving and economic growth over the next few decades, relatively slow growth in real compensation over the past two decades implies that the total resources available to households have not expanded as fast as might be desirable. Consequently, both the level and the rate of personal saving might be lower than would otherwise have been the case. The United States' consumption-oriented society offers many ways to expand debt, sometimes encouraged by the tax code, but it may not place enough importance on the long-term rewards of saving.

Looking forward a few decades, some analysts worry that national saving will fall further when the baby boomers retire--and that decline could be a worldwide phenomenon. National saving could fall as public and private retirement funds sell assets to provide benefits to the large number of retirees. The trust funds for Social Security are expected to be depleted by 2029, and the private pension system may become a net seller of funds at about the

same time.⁷ Providing health care and other benefits to the large elderly cohort will exert pressures on federal budgets at the same time that personal saving could fall slightly as retired boomers spend down their assets. The result of dissaving throughout the economy could be that interest rates will rise and asset prices will fall.

WHAT IS THE SITUATION TODAY?

The national saving rate may still be hovering close to the danger zone, but I am encouraged by the virtually unanimous awareness that low saving is a significant problem.

With the passage of the Omnibus Budget Reconciliation Acts (OBRAs) of 1990 and 1993, the Congress and the various Administrations made a strong initial start on the problem. OBRA-90 set out the framework for future action through caps on discretionary spending and the pay-as-you-go scorecard. OBRA-93 pushed a little further with additional spending cuts and tax increases.

7. Sylvester J. Schieber and John B. Shoven, "The Consequences of Population Aging on Private Pension Fund Saving and Asset Markets," Working Paper No. 4665 (National Bureau of Economic Research, Cambridge, Mass., March 1994).

However, those actions have given only temporary respite to growing deficits and falling national saving. I emphasize temporary because prevailing policies still imply that deficits will soon rise again and keep national saving too low to prevent further slowdown in the growth of living standards.

According to projections based on current policies, despite the actions of OBRA-90 and OBRA-93, the deficit as a percentage of GDP will begin to rise at an accelerated pace toward the end of this decade as entitlement programs consume ever-increasing amounts of resources that must be withdrawn from saving and investment (see Table 3).

TABLE 3. THE BUDGET DEFICIT OUTLOOK THROUGH 2004
(By fiscal year, as a percentage of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Revenues	18.8	19.1	19.1	19.0	19.0	19.0	18.9	18.9	18.8	18.8	18.8
Outlays	22.2	21.5	21.3	21.4	21.2	21.3	21.4	21.6	21.7	21.9	22.1
Deficit	3.4	2.4	2.2	2.3	2.2	2.4	2.5	2.7	2.9	3.1	3.3

SOURCE: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1995-1999* (January 1994), p. 29.

NOTE: GDP = gross domestic product.

Private saving has begun to improve modestly--it averaged 5.2 percent of GDP in 1993 compared with its 45-year low of 4.5 percent in 1989--but no one expects that it will improve enough to offset the drain still coming from federal deficits. For example, if private saving should rise to its 1970s' level of 8.1 percent of GDP by 2004, a projected deficit of 3.3 percent in that year would still leave the national saving rate at 4.8 percent. That would be well below its 1970s' average of 7.1 percent.

The deficit not only denies capital to future generations in order to support the consumption of current generations--a recipe for lowering the growth of living standards--but it also risks imposing huge tax burdens on future generations to maintain the financial solvency of the federal government. Economists have tried to characterize the tax burden through the methodology of generational accounting. That methodology simply tries to see what net tax rates--federal, state, and local--will have to be on future generations in order to keep the promises made under existing legislation, not only to bondholders, but also to recipients of public programs.

Given their specific economic and demographic assumptions, generational accounts estimate that future generations will face prohibitively high net tax rates--close to 80 percent--if policy continues along its current lines. And because those are net tax rates, they mean that gross tax rates--taxes as a

percentage of pretax income--would be even higher. By comparison, the generation born today will face a net tax rate averaging 40 percent over its lifetime, while the generation born in 1940 will have faced a net tax rate that averages out to 32 percent over its lifetime. The exact numbers depend heavily on the assumptions used, but the general conclusion does not: the tax burden facing future generations is an impossible one to carry. Hence, changes to prevailing fiscal policies are inevitable.

LOOKING AHEAD

We have an opportunity to make significant strides in solving the problem of low rates of national saving. Inflation remains under control, the economy seems well positioned to absorb the short-term adjustments that necessarily come with deficit reduction actions, and projected deficits under prevailing policies do not begin to rise until 1999.

If we take advantage of this opportunity and act soon, we can reap enormous benefits in the future. Feasible changes made now in taxing and spending policies will produce increasing gains in deficit reduction and increased national saving in the decades ahead.

If we fail to act soon, however, this opportunity will pass. There will be other recessions during which necessary actions on the deficit would be suspended. Moreover, even if the recessions are only mild ones, the deficit problem will continue to grow worse and the necessary changes will become more difficult to make. Not least, providing benefits and services to retired baby boomers will exert additional pressures on public programs beginning in about 15 years, which will make reductions in federal spending for these programs even more difficult to achieve. Making changes now will give boomers more time to adjust.

