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THE CHANCE FOR CHANGE:

A MEMORANDUM TO THE NEXT PRESIDENT ON A SAVINGS AGENDA FOR AMERICA

TO: President-Elect Obama
FROM: Initiative on Financial Security at the Aspen Institute
DATE: November 2008

The economic challenges that will greet you on January 20 are many. America is facing the worst financial crisis since the Great Depression. The unemployment rate is the highest in 14 years. The number of housing foreclosures is at a record high. Consumer confidence is at an all-time low. The federal budget deficit is projected to be the largest in history.

During the transition period between now and Inauguration Day, you will be crafting solutions to meet these economic challenges. An immediate economic stimulus is necessary. Putting Americans back to work is necessary. Keeping people in their homes is necessary. But none of those actions will be sufficient to forge a path to a robust, long-term economic future. And none of those actions will be sufficient to help Americans build their own long-term financial security. For that, you must address the long-term problem facing the American economy. That problem is, in a word: savings. Or perhaps more accurately, it is three words: lack of savings.

This memo outlines a strategy to address the issue of savings in America and offers a comprehensive savings agenda for you to pursue.

Savings Are Key to Long-Term Economic Growth

In macroeconomic terms, savings are only useful if they are used for investment – if the money families save in financial institutions is in turn used to finance investments that will enhance productivity. But while savings may be useful only if they are in turn invested, investment is only possible with savings. Charles Schultze, the former Chairman of the Council of Economic Advisers has written that over the long-term, “A nation can invest only what it saves.”¹

And America is not saving much. Figure 1 illustrates the long and steady erosion – an utter collapse – in the level of personal savings in the United States. In 1982, the personal savings rate – personal income minus consumption expenditures – stood at 11.2 percent of personal disposable income. Twenty-five years later, in 2007, the rate was 0.6 percent – an almost 95 percent decline. The savings rate has been hovering around zero since 2005 and, even with the expected uptick in savings in 2008, we are experiencing a period of lower personal savings than at any time since the Great Depression.² For a decade now, we have lived under the delusion that the increase in the value of our household assets – stocks and home equity – meant we could save less. The fallacy of that belief was shattered within a short two-week period this Fall.

Meanwhile, the national savings rate – which includes individual, business, and government savings (or negative savings in the case of net debt) – lags far behind most other countries of the world,³ as Figure 2 shows.

All of this has dire consequences for America's long-term economic future. Without savings, there is no domestic money for businesses to borrow and invest, to increase capital, and at the end of the day to increase productivity – all of which, in turn, lead to more job opportunities, higher wages, and higher standards of living. The only recourse to increasing national investment without increased national savings is to borrow someone else's savings – to rely on foreign countries to finance investment here at home. That is exactly the course we have been pursuing. As of September 2008, just under 50 percent of the federal government's debt held by the public was held in foreign countries.⁴ And Figure 3 shows the growth in foreign indebtedness – what we owe abroad – across both the public and private sectors. It stood at over 17 percent of Gross Domestic Product in 2007.⁵ It is no wonder that the United States has a record trade deficit.*

You will be receiving a lot of advice about the policies you should pursue in addressing the current economic downturn and for promoting economic growth. But know this: the biggest and best means of achieving long-term economic expansion is to raise the national savings rate. While the personal savings rate is only one component of overall national savings, an analysis of 2005 data found that increasing the personal savings rate among the bottom 40 percent of households by only about \$10 per week (\$500 per year) would increase the overall net national savings rate by 26 percent.⁶

Some will undoubtedly argue that individual consumption and savings decisions should be left entirely to the forces of the free market. We believe that history suggests otherwise: that only a concerted effort by the federal government to promote increased savings will result in the higher levels of savings needed to provide long-term economic security and long-term economic growth for the United States. Indeed, if done right, increased savings and investment would grow the economy to such a degree that the average American family will, within a generation, actually have more money to spend even with increased savings.⁷

* In fact, according to Schultze, "it is not a country's trade policies or those of its competitors that principally determine whether it has a trade deficit, but the relationship between its national saving and the investment demands of its homeowners and business firms." [Charles L. Schultze, *Memos to the President: A Guide through Macroeconomics for the Busy Policymaker* (Washington, DC: The Brookings Institution, 1992) 51.]

Figure 1 -- U.S. Personal Savings Rate (1960-2007)

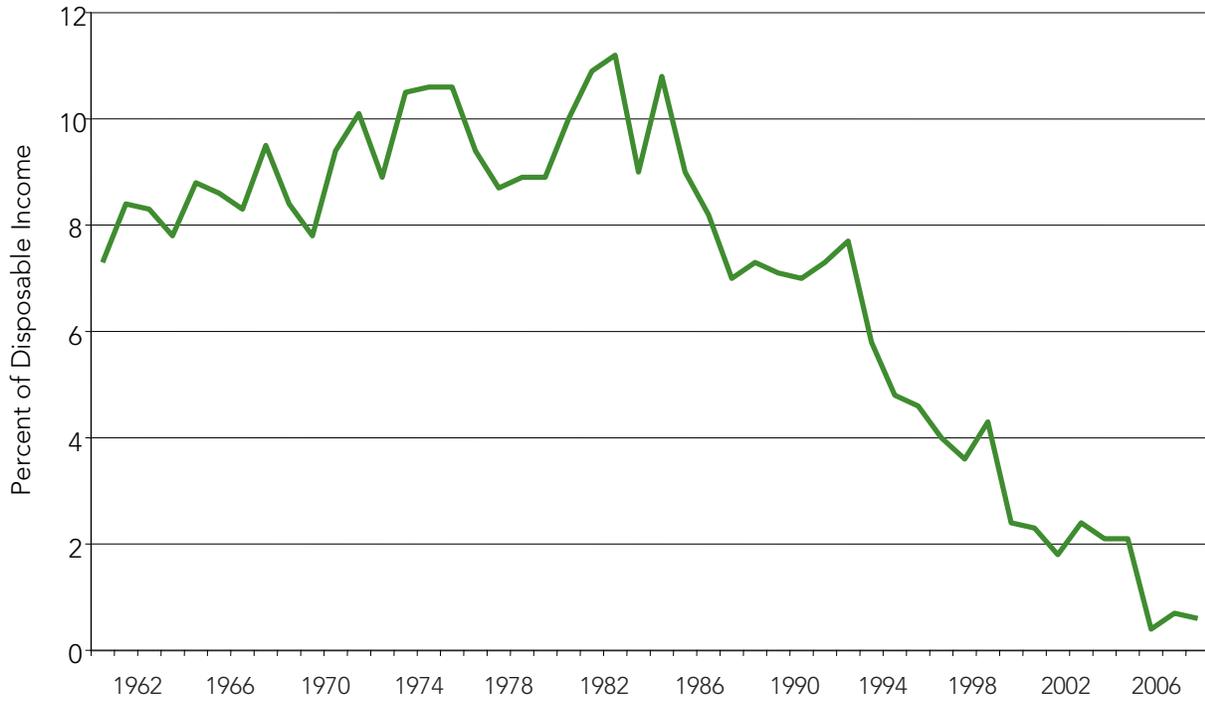


Figure 2 -- Adjusted Net Saving Around the Globe (2006)

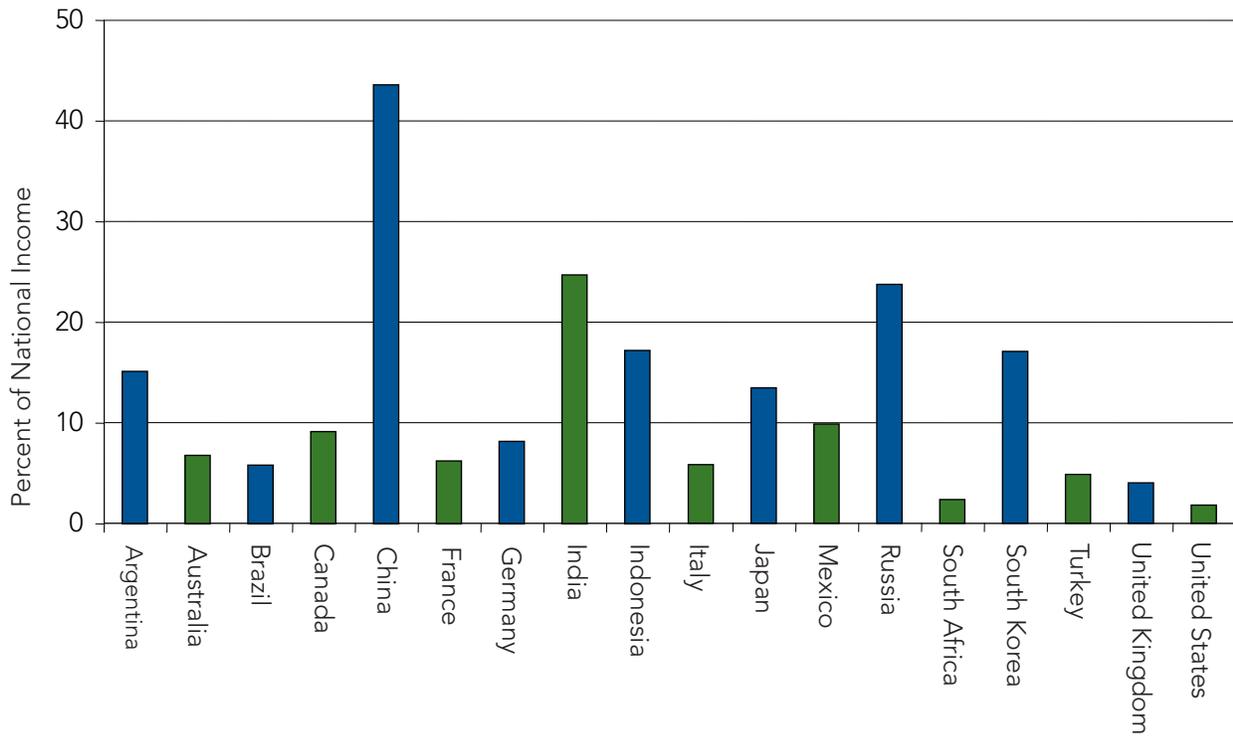


Figure 3 -- U.S. Net Foreign Indebtedness (1990-2007)

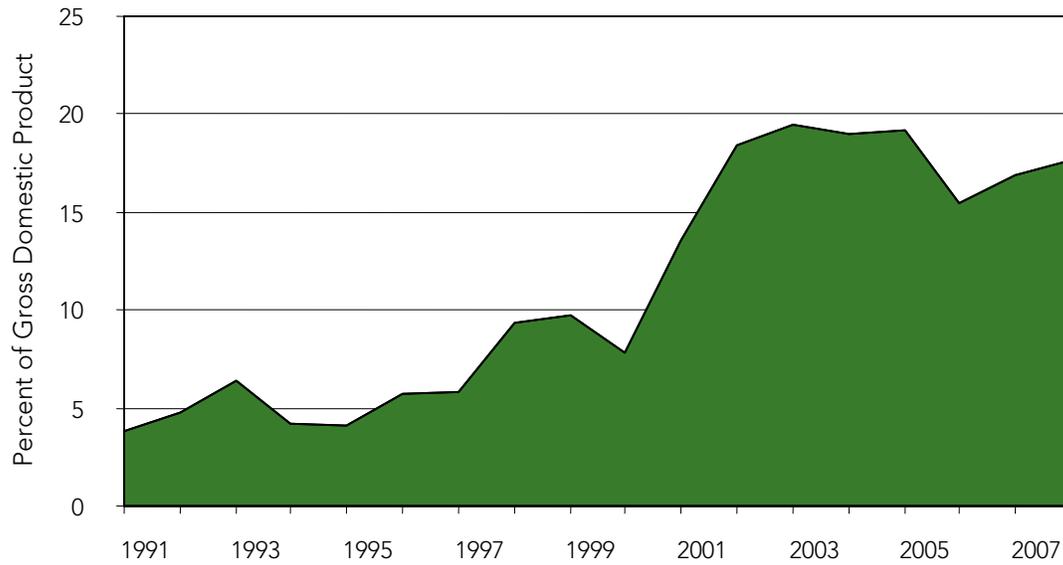
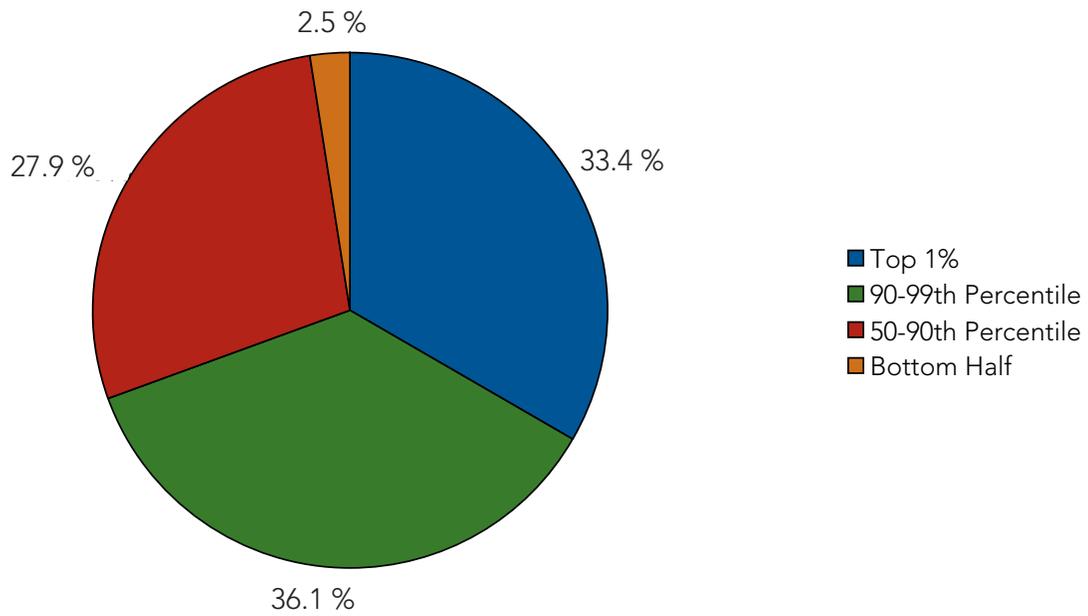


Figure 4 -- Distribution of Net Worth (Total \$50.3 trillion)



Savings Are Key to Individual Financial Security

In individual terms, savings and assets are the key distinguishing feature between those who have and those who have not. Wealthy individuals and most middle-income families have; most low- and moderate-income families have not. Today, one quarter of American households owe more than they own.⁸ Most studies of wealth distribution show not only that disparities in wealth are much larger than disparities in income, but that they have also been increasing in recent years,⁹ to the point where one-third of net worth is owned by the wealthiest one percent of Americans.¹⁰ (See Figure 4). And, in 2004 – the most recent year for which data are available – nearly 25 percent of families in the bottom quintile of income were “unbanked.”¹¹ That is, they had absolutely no connection to a private financial institution – no savings account, no checking account, no retirement account.

Washington University Professor Michael Sherraden has noted, “Very few people manage to spend their way out of poverty.”¹² Growing – and maintaining – the middle class in America requires more emphasis on savings and assets. It is the accumulation of savings and assets that fosters financial stability, creates economic mobility, and provides the ladders of opportunity for individuals to climb into and remain a part of the middle class. Studies have shown, for example, that families with greater assets tend to own homes in better neighborhoods for longer periods of time, affording children better and more consistent educational opportunities and resources.¹³ Higher levels of assets have also been shown to promote self-confidence, self-sufficiency, and civic engagement.¹⁴

But this is not just a matter of concern for the poor. This is also crucial for middle-class families, who are too often today teetering on the brink and who can no longer rely on a decent paying job to secure the family’s financial future. True, work – an income – provides what is needed to support daily existence: food, clothing, shelter, and other day-to-day needs. But for the vast majority of Americans, income alone doesn’t get your kids to college; income alone doesn’t get you a home; and income alone doesn’t get you a retirement nest egg. For that, you need savings. In addition, savings make middle-class families less susceptible to financial ruin because of unforeseen developments, such as a medical emergency or the loss of a job. For most middle-class families in America today, savings can mean the difference between a temporary setback and a plunge into poverty.

In short, income is what allows you to live each day. But wealth – savings and assets – is what allows you to secure the good life and to create opportunities for you and your children.

The False Choice of Stimulus vs. Savings

Before outlining the elements of a savings agenda, it is important to address the conventional wisdom – we call it a fallacy – that during an economic downturn, it is unwise to pursue policies that would encourage individuals to save.

Conventional economic theory holds that in times of economic slowdown or recession, the federal government should stimulate demand by pumping more money into the economy. Stimulus policies can take a variety of forms, including tax cuts, increased unemployment benefits and food stamp benefits, and government spending on public works projects. What all have in common is that all are aimed at putting more money into the pockets of people who will spend it, thus increasing demand and providing the stimulus necessary to revive the economy.*

Under this theory, policies that take money *out* of the economy – that decrease the amount of money available for spending – will not only fail to stimulate the economy but could be counterproductive by lengthening an economic downturn. Policies to encourage more Americans to save fall into this category. By its very definition, money saved is money *not* spent.

But we do not believe it is that simple. The choice is *not* between the two extremes of encouraging Americans to stockpile their savings – which could plunge us into a prolonged recession – or encouraging Americans to continue to spend beyond their means -- which could plunge us into bankruptcy. There must be a middle way. In the face of our economic straits, we need a vigorous and robust program of economic stimulus. But current economic policies should not focus *only* on stimulating consumption.

There is, in fact, no inherent inconsistency between personal savings and economic stimulus. For the most part, savings are not put under the proverbial mattress. They are deposited in a financial institution, which, as noted above, then loans and invests those savings in such activities as business capital, thereby increasing the output of the economy and creating jobs. In other words, savings itself can have a stimulating effect. Also, while it is hard to see very short-term interest rates falling much lower than current levels, increased savings do place a downward pressure on longer-term interest rates, which are more relevant for most lending and borrowing purposes.

Even if private financial institutions are unwilling to lend immediately – credit is extremely tight right now – increased savings can be borrowed by the federal government through the sale of government bonds. This would provide a domestic source of financing for additional stimulus spending or tax cuts, lessening the need to borrow from abroad.

This idea of pursuing two seemingly contradictory economic theories at the same time is not unheard of. Although it is not a perfect parallel, consider the case of World War II. The federal government's war effort involved an unprecedented – to that point and probably even since that point – economic stimulus on the American economy. Most economists believe it was this spending that finally and completely brought the country out of the Great Depression. Yet, at the same time, the federal government actively encouraged Americans to save, through public education campaigns and through the creation of a new savings product: war bonds. As a result, the personal savings rate (as a perc-

* According to popular estimates, consumer spending accounts for 70 percent of economic activity. (See, for example, U.S. Department of the Treasury, *Report to Congress on International Economic and Exchange Rate Policies*, (May 2008) 3. Available at http://www.treas.gov/offices/international-affairs/economic-exchange-rates/052008_report.pdf.)

entage of disposable personal income) was over 20 percent during the War, reaching a peak of 26.1 percent in 1944¹⁵ – again, at the same time the government was stimulating the economy.

It must also be recognized that we will not be in a perpetual recession. Eventually, the economy will rebound. An economic stimulus may address the short-term needs of the American economy, but it will at the same time leave the long-term economic needs of the United States in continued peril. Guiding us through the current economic downturn will not be sufficient to prevent a relatively flat and stagnant economy for the foreseeable future. Put another way: addressing the problems of the next two years does nothing to address the serious structural economic problems of the following 20.

We believe that you must work tirelessly on reviving the economy, strengthening the financial services sector, and restoring faith in America’s financial institutions. But, at the same time, you must lay the groundwork for long-term economic growth for when this economic recession is over. Waiting to address the economy’s long-term needs – the lack of savings in America – until after it is back on its feet, may be too late. In such a scenario, by the time personal savings is built to a level where effects have an impact on the economy, it may be time to address another short-term crisis. We fear that if you wait to address the savings crisis until later, it may never be addressed at all. There always seems to be a later.

The bottom line: if savings policy is pursued wisely and gradually, there is no inherent conflict between trying to stimulate the economy and trying to encourage Americans to save at the same time.

What You Should Do, Part One

So, what would a wise savings policy entail? And how should you pursue it?

Given the importance of increased savings to the long-term economic health of the United States, the importance of savings and assets to a strong middle class, and the importance of laying the groundwork for increased savings *now* – even in the midst of the current economic downturn – you should look to seize every available chance to start the process of instilling a culture of savings in America and of enacting policies that will encourage and provide the opportunities for more Americans to save, invest, and own.

In short, every legislative vehicle should be approached with the following question in mind: is there a way we can use this opportunity to promote increased savings? What follows are three good places to start:*

Mortgage Reform: Much of your attention in the early days of your Administration will focus on what was the cause of the current economic mess – the subprime mortgage market meltdown.

* For a more detailed discussion of these proposals, see Initiative on Financial Security, *Savings for Life: A Pathway to Financial Security for All Americans* (Washington, DC: The Aspen Institute, 2007). Available at <http://www.aspenifs.org>

There is an urgent need to address the millions of American families who have lost, or are about to lose, their homes to foreclosure because they were sold a shoddy mortgage product. But the focus cannot just be on stemming the tidal wave of foreclosures engulfing the country. Otherwise, the long-term legacy of this crisis will be a serious erosion of the fundamental value of home ownership and a slamming of the door to the American Dream of homeownership for moderate-income families. Put another way, you will have reduced consumer debt, but you will have failed to stimulate the savings needed for Americans to acquire their primary asset – a home – without resorting to questionable mortgage products. That is exactly why, in large part, we find ourselves in this mess in the first place.

Instead, you should use this opportunity to go back to the basics: purchasing a home should involve a down payment, and governmental policies should emphasize saving for a down payment.

RECOMMENDATION 1: SAVINGS FOR A HOME

- Creating tax-preferred, FDIC-insured accounts dedicated to saving for the down payment and closing costs on a first home.
- Providing individuals with incomes up to \$50,000 and couples with incomes up to \$100,000 with a 50 percent match on the amount of their own money they save in the accounts, with a \$5000 cumulative lifetime cap on the match.

Tax Reform: Between the expiring Bush tax cuts, the desire to provide some middle-class tax relief for reasons of economic stimulus, and lingering problems with the tax code (such as the alternative minimum tax and the complexity of the code itself), tax policy reform will be a centerpiece of debate in the first two years of your Administration.

Much of the current savings and asset building policies of the federal government (e.g. IRAs, employer-sponsored pension plans, and the home mortgage deduction) are done through the tax code. So, tax legislation is a natural vehicle for new savings incentives, including ones targeted at America's middle- and lower-income households. Also, including savings incentives in a larger stimulus tax bill would have the added benefit of lessening any slight short-term anti-stimulatory effect of increasing savings.

In our view, the best savings policy that could be included in a larger tax bill is one that will affect every American at the very beginning of life: a policy of child accounts. In America today, people save too little because they start saving too late. Not only would child accounts – an investment account for all children to build assets to launch them into adulthood at age 18 – increase the savings rate, they have the potential to create a culture of savings in America and, being a hands-on learning tool, are perhaps the best means of dramatically increasing financial literacy in the United States.

RECOMMENDATION 2: SAVINGS FOR EXPANDED OPPORTUNITIES

- Giving every child at birth a \$500 voucher to open an account at a financial institution, which would be saved in a fund structured for an 18-year investment horizon, have limits on account fees, be locked up until the child turned 18, and grow tax free.
- Allowing contributions to the accounts of up to \$2000 per year, with the government encouraging savings by providing, through the tax code, a dollar-for-dollar match for a family of four that makes under \$43,000 a year.

Pension Reform: The disappearance of secure retirement income through defined benefit plans, the increased reliance on defined contribution plans exposed to market risk, and the millions of working Americans covered by no plan at all are all signs that the private pension system is in need of significant reform. Despite the fact that Congress passed significant pension legislation just two years ago, most observers believe that more needs to be done. In fact, you recognized this during your campaign when you called for strengthening retirement security, including by expanding retirement savings incentives for working families – more than one third of whom will reach retirement without any private savings.¹⁶ Because saving for retirement is, by its very nature, longer-term savings, encouraging more retirement savings is precisely what is needed for the long-term growth of the economy.

However, for this to work – to encourage the necessary volume of savings to create both a long-term benefit to the economy and greater financial security for retirees – it requires more than creating millions of accounts with little savings in them. It also requires more than tax incentives for those who do not need help to save. Instead, we need to help those left out and left behind in the current pension system.

RECOMMENDATION 3: SAVINGS FOR RETIREMENT

- Creating a new IRA for those workers who do not have access to a pension plan at work and encouraging the opening of such accounts with a “starter” contribution for individuals with incomes under \$30,000 and couples with incomes under \$60,000.
- Encouraging saving in those IRAs by providing a match of up \$2000 per year for workers making under \$50,000 and married couples making under \$100,000.

While it is vitally important to find ways to increase the number of Americans with private retirement savings – and to ensure those savings are adequate for a financially-secure retirement – it is also necessary to start thinking about what happens with those savings and pension benefits once a person reaches retirement age. It does very little good for a person to have saved for retirement if he or she then outlives those savings. Given the trend away from defined benefit plans and toward defined contribution plans, this is an increasing likelihood for the 80 million Baby Boomers who will retire over the next 20 years. Most retirement planners advocate annuitizing at least a portion of retirement savings in order to ensure a steady income that you cannot outlive.

Unfortunately, the private life annuities market is underdeveloped and few Americans purchase annuities today. Knowing when and how much of an annuity to buy is a difficult personal decision for most Americans who lack confidence in and familiarity with annuities.

RECOMMENDATION 4: ANNUITIZING THE SAVINGS

- Allowing retiring Americans to use up to \$100,000 in savings and private pension funds to purchase an inflation-adjusted annuity with spousal benefits through the Social Security Administration, but underwritten by the private sector.
- Distributing the annuity payments by adding the benefit to an individual's monthly Social Security check.

What You Should Do, Part 2

As noted above, Americans have not been saving. And, with the current meltdown in the financial sector, we fear that too many Americans are now afraid to save. There is some anecdotal evidence at this point that Americans are increasingly afraid to save in financial institutions and/or are withdrawing savings from financial institutions. Saving, accumulating assets, and equity investing have, for lack of a better term, gotten a bad rap. This loss of confidence in the financial industry cannot be understated. Again, savings only work if they are available for investment – not if they are put under the mattress.

Our recommendations to stimulate more savings will not succeed if Americans are afraid to save. That is why we believe you also must make a concerted effort to restore the American people's confidence and trust in the private financial sector – to entice those who have stopped saving to return to the system and to entice those who have never been in the system to enter it – in order to make the above recommendations fully workable.

Shoring up America's financial institutions – begun under the Emergency Economic Stabilization Act – is the first step. You must continue to use the tools provided by that legislation. But staving off disaster is the short-term necessity, not the long-term solution to restoring confidence in the system.

RECOMMENDATION 5: RESTORING CONFIDENCE IN SAVING

- Replacing the patchwork quilt of financial industry regulatory schemes with a more coherent regulatory structure that includes greater protections for consumers and makes the American system for saving more inclusive.
- Encouraging the private sector to develop features in traditional equity products that would provide some guarantees to individual investors; instituting, if necessary, government back-stops and insurance for low- and middle-income equity investors with modest account balances.
- Recognizing that the place where most Americans save – the private pension system – is a key component of the American financial system and that its needs and concerns must be included in any reform effort.

Conclusion

The challenges you face are great. But with great challenges come great opportunities. The American people have turned to you to guide the ship of state through these troubling times: to stimulate the economy, to create jobs, to shore up the financial sector, and, perhaps most of all, to restore confidence in the financial markets and in the economy.

Now is the time for bold leadership. Suggesting that America cannot move forward with bold solutions because the deficit is too high or the markets are too uncertain or the country is too divided is to take the easy way out. Pursuing policies that encourage people to deplete their savings in the name of stimulating spending is to take the easy way out. Ignoring the millions of Americans who need to be encouraged to build assets so they can climb their way into the middle class is to take the easy way out.

You have the chance to think beyond your first 100 days or your first year in office or even your four-year term. You have the chance to shape the course of the American economy for a generation or more. You have a chance to give all Americans the change they need to save, invest, and own.

We urge you to be bold.

Endnotes

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