# How to Increase America's Saving Rate

Jul 26, 2018 Martin Feldstein

Once upon a time, US policymakers believed that more consumer spending was better than higher saving. But even though officials have come to realize that a high level of saving means more investment and faster growth, legislation to encourage more personal saving has failed to reverse a sharply downward trend.

CAMBRIDGE – The United States needs new policies to raise the household saving rate. From 1960 to 1980, the household saving rate ranged between 10-13% of after-tax income, providing funds for investment in plant and equipment. Since then, levels of household saving have declined sharply. The comparable average saving rate in the past decade averaged only 5.5% and is now just 3.4%.

The cause for the decline is unclear. One plausible explanation is that working-age households may no longer feel the need to provide for their retirement years because of their greater confidence in the Social Security retirement program. Although Social Security was created in the 1930s, there was widespread fear in the 1960s and 1970s that the program would not survive politically because of conservative opposition. But when the Social Security program was about to run out of funds in 1982, a very conservative president, Ronald Reagan, rescued it. After that, it was reasonable to assume that Social Security benefits would continue to be available. Saving for health care in old age was also not necessary, thanks to the Medicare and Medicaid programs.

Whatever the cause of the current low household saving rate, it is a serious problem that requires political action. Fortunately, attitudes in the US Congress have been changing over time. In the early post-World War II years, when the Great Depression was still in recent memory, a Keynesian fear of economic slumps caused politicians to favor a decline in the saving rate. A lower saving rate, it was believed, would mean more consumer spending and therefore stronger demand and higher employment. But as policymakers came to realize that a high level of saving would actually mean more investment and faster growth, Congress passed legislation to encourage more personal saving.

The most important such response was the creation of so-called 401k accounts, which allow employers to contribute funds to retirement accounts for their employees. These 401k plans are employer-sponsored and employer-managed. Congress also created tax-favored Individual Retirement Accounts that now allow individuals to set aside up to $5,500 a year and manage their IRA in whatever way they see fit. Contributions to IRAs, up to the limit, may be deducted from taxable income, and the return on the investment in the IRA accumulates tax-free until the funds are withdrawn. Both the 401k accounts and the IRAs therefore provide a higher after-tax real return, strengthening the incentive to save.

Although both of these programs have been successful in encouraging increased saving, the cumulative effect still leaves the overall saving rate very low. One reason is that millions of small firms did not create 401k plans, owing to the cost of establishing and managing them. And

firms have been reluctant to force employees, who know that the funds will not be available until they reach retirement age, to reduce their wages by contributing to such plans.

Congress is now proposing to change the rules to get around these problems. Small firms would be able to join with others to establish 401k plans, thereby benefiting from lower administration costs. And the government would give small firms a grant to defray the cost of establishing a new plan.

Perhaps more important would be to give small businesses the opportunity to create "automatic enrollment plans," which experience shows is very effective in getting employees to join and sustain saving in 401k plans. In this scenario, employees are automatically enrolled in a 401k plan with the understanding that they may withdraw funds when they want them – that is, without waiting until they reach retirement age.

Here's why automatic enrollment is so important. When new employees are offered the opportunity to have 5% of their salary deposited in a 401k plan, a relatively small share of them choose to participate. But if the same employees are told that the company will automatically enroll them in a 401k plan with the same 5% salary reduction and that they may withdraw those funds at will, most accept the salary reduction and do not withdraw the funds.

It is not clear whether this legislation will pass in the current Congress. What is clear is that the US household saving rate is too low, and that legislative changes of this type are needed to begin moving itles back to its earlier level.

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