

**PRESENT LAW AND BACKGROUND
RELATING TO TAX INCENTIVES FOR SAVINGS**

Scheduled for a Public Hearing

Before the

HOUSE COMMITTEE ON WAYS AND MEANS

on February 12, 1998

Prepared by the Staff

of the

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on February 12, 1998, on reducing the tax burden. This hearing will focus on the tax treatment of capital gains and savings, including interest and dividend income.

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of present-law tax treatment of savings and background information on savings in the United States. A separate staff document,² which was issued previously, provides a description of present law and background on the taxation of capital gains.

Part I of this document is a description of present law relating to the taxation of savings. Part II provides background information on savings in the United States.

¹ This document may be cited as follows: *Present Law and Background Relating to Tax Incentives for Savings*, (JCX-11-98), February 11, 1998.

² Joint Committee on Taxation, *Present Law and Background Relating to Taxation of Capital Gains* (JCX-4-98), February 6, 1998.

I. PRESENT LAW

In general

Dividend and interest income is taxable under present law. However, present law also contains a number of provisions which permit individuals to save on a tax-favored basis. These include provisions relating to individual retirement arrangements, tax-qualified retirement plans and similar employer-sponsored arrangements, tax-sheltered annuities, annuity contracts, life insurance, and medical savings accounts.

Individual retirement arrangements (“IRAs”)

Deductible IRAs

Under present law, an individual may make deductible contributions to an individual retirement arrangement (“IRA”) up to the lesser of \$2,000 or the individual’s compensation if the individual is not an active participant in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to \$2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

If the individual (or the individual’s spouse) is an active participant in an employer-sponsored retirement plan, the \$2,000 deduction limit is phased out for taxpayers with adjusted gross income (“AGI”) over certain levels for the taxable year.

The phase-out limits for a single individual who is an active participant in an employer-sponsored retirement plan are as follows: for 1998, \$30,000 to \$40,000; for 1999, 2000, 2001 and 2002, the limits increase by \$1,000 each year, so that the limits by 2002 are \$34,000 to \$44,000; for 2003, \$40,000 to \$50,000; for 2004, \$45,000 to \$55,000; and for 2005 and thereafter, \$50,000 to \$60,000.

The phase-out limits for a married individual filing a joint return who is an active participant in an employer-sponsored plan are as follows: for 1998, \$50,000 to \$60,000; for 1999, 2000, 2001 and 2002, the limits increase by \$1,000 each year, so that the limits by 2002 are \$54,000 to \$64,000; for 2003, \$60,000 to \$70,000; for 2004, \$65,000 to \$75,000; for 2005, \$70,000 to \$80,000; for 2006, \$75,000 to \$85,000; and for 2007 and thereafter, \$80,000 to \$90,000.

In the case of a married taxpayer filing a separate return, the deduction is phased out between \$0 and \$10,000 of AGI.³

³ A couple is not considered married for purposes of the IRA deduction rules if the individuals file separate returns and live apart from one another at all times during the taxable

The maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, is phased out for taxpayers with AGI between \$150,000 and \$160,000.

Amounts held in a deductible or nondeductible IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to \$10,000.

Roth IRAs

For years beginning in 1998, individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of \$2,000 or the individual's compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA in the same taxable year. As under the rules relating to IRAs generally, a contribution of up to \$2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with AGI between \$95,000 and \$110,000 and for joint filers with AGI between \$150,000 and \$160,000.⁴

Taxpayers with modified AGI of \$100,000 or less may convert an IRA into an Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that if the conversion occurs in 1998, the income inclusion is spread over 4 years.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the 5-taxable year period beginning with the first taxable year in which the individual made a contributions to a Roth IRA, and (2) which is made on attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

year; each spouse is treated as a single individual in such a case.

⁴ It was intended that the phase-out range for married taxpayers filing separately be \$0 to \$10,000. A technical correction is necessary so that the statute reflects this intent. See Title VI (sec. 605) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

Nondeductible IRAs

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to an IRA. Distributions from a nondeductible IRA are includible in income and subject to the 10-percent early withdrawal tax to the extent attributable to earnings.

Legislative history

The individual retirement savings provisions were originally enacted in the Employee Retirement Income Security Act of 1974 (“ERISA”). Individuals who were active participants in an employer-sponsored retirement plan were not permitted to make contributions to an IRA. The limit on the deduction for IRA contributions was generally the lesser of (1) 15 percent of the individual’s compensation for the year, or (2) \$1,500.

The Economic Recovery Tax Act of 1981 (“ERTA”) increased the deduction limit for contributions to IRAs and removed the restriction on IRA contributions by active participants in employer-sponsored retirement plans. Beginning in 1982, the deduction for IRA contributions was generally the lesser of (1) 100 percent of the individual’s compensation, or (2) \$2,000. An individual was entitled to make a deductible contribution to an IRA even if the individual was an active participant in an employer-sponsored retirement plan.

The Tax Reform Act of 1986 (“1986 Act”) added the restrictions on deductible IRA contributions for an individual (or the individual’s spouse) who is an active participant in employer-sponsored retirement plan. For years 1987 through 1997, if a single taxpayer or either spouse (in the case of a married couple) was an active participant in an employer-sponsored retirement plan, the maximum IRA deduction was phased out between \$25,000 and \$35,000 of AGI. For married taxpayers, the maximum deduction was phased out between \$40,000 and \$50,000 of AGI. In the case of a married taxpayer filing a separate return, the deduction was phased out between \$0 and \$10,000 of AGI. In addition, the 1986 Act added the present-law rules permitting individuals to make nondeductible contributions to an IRA.

The Small Business Job Protection Act of 1996 (“1996 Act”) modified the rule relating to the maximum deductible IRA contribution by permitting deductible IRA contributions of up to \$2,000 to be made for each spouse (including a spouse who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

The Taxpayer Relief Act of 1997 (“1997 Act”) (1) increased the AGI phase-out limits for deductible IRAs, (2) modified the AGI phase-out limits for an individual who is not an active

participant in an employer-sponsored retirement plan but whose spouse is, (3) provided an exception from the early withdrawal tax for withdrawals for first-time home purchase (up to \$10,000), and (4) created a new nondeductible IRA called the Roth IRA.

Employer-sponsored qualified retirement plans

In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though the contributions are not currently included in an employee's income. Contributions to a qualified plan are held in a tax-exempt trust.

Employees, as well as employers, may make contributions to a qualified plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified plan. Pre-tax employee contributions (e.g., contributions to a qualified cash or deferred arrangement (sec. 401(k) plan)) are treated the same as employer contributions for tax purposes.

The tax treatment of contributions under qualified plans is essentially the same as that of deductible IRAs. However, the limits on contributions to qualified plans are much higher than the IRA contribution limits, so that qualified plans provide for a greater accumulation of funds on a tax-favored basis. The policy rationale for permitting greater accumulation under qualified plans than IRAs is that the tax benefits for qualified plans encourage employers to provide benefits for a broad group of their employees. This reduces the need for public assistance and reduces pressure on the social security system.

The qualification standards and related rules governing qualified plans are designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as highly compensated employees. They also define the rights of plan participants and beneficiaries and provide some limits on the tax benefits for qualified plans.⁵ Certain of the rules relating to qualified plans are designed to ensure that the amounts contributed to qualified plans are used for retirement purposes. Thus, for example, an early withdrawal tax applies to premature distributions from such plans, and the ability to obtain distributions prior to termination of employment from certain types of qualified plans is restricted.

⁵ Qualified plans are subject to regulation under Federal labor laws (Title I of Employee Retirement Income Security Act of 1974 (ERISA)) as well as under the Internal Revenue Code. The ERISA rules generally relate to rights of plan participants and the obligations of plan fiduciaries.

Types of qualified plans

Qualified plans are broadly classified into two categories, defined benefit pension plans and defined contribution plans, based on the nature of the benefits provided.

Under a defined benefit pension plan, benefit levels are specified under a plan formula. For example, a defined benefit pension plan might provide an annual retirement benefit of 2 percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan. Benefits under a defined benefit pension plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation ("PBGC"), a Federal corporation within the Department of Labor.

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Profit-sharing plans and qualified cash or deferred arrangements (called 401(k) plans after the section of the Code regulating such plans) are examples of defined contribution plans.

Limits on contributions and benefits

Under present law, limits apply to contributions and benefits under qualified plans. In the case of a defined benefit pension plan, present law limits the annual benefits payable under the plan to the lesser of (1) 100 percent of the participant's average compensation for his or her high 3 years, or (2) \$130,000 (for 1998).⁶ Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) \$30,000. Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The dollar limits are increased for cost-of-living adjustments in \$5,000 increments.

An overall limit applies if an individual is a participant in both a defined contribution plan and a defined benefit plan of the same employer. The Small Business Job Protection Act of 1996 repealed this overall limit for years beginning after December 31, 1999.

Taxation of distributions

Under present law, a distribution of benefits from a qualified plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed

⁶ Annual benefits may in some cases exceed this dollar limitation under grandfather and transition rules contained in the Tax Equity and Fiscal Responsibility Act of 1982 and other legislation.

represents the employee's investment in the contract (i.e., basis). Special rules apply to lump-sum distributions, distributions rolled over to an IRA, and distributions of employer securities.

Early distributions from qualified plans generally are subject to the same additional 10-percent early withdrawal tax that applies to early distributions from IRAs. However, certain additional exceptions to the tax apply. For example, the early withdrawal tax does not apply to distributions made to an employee after separation from service after attainment of age 55.

Qualified cash or deferred arrangements

As mentioned above, a qualified cash or deferred arrangement is a type of qualified plan. Thus, such arrangements are subject to the rules generally applicable to qualified plans. In addition, special rules apply to such arrangements.

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is \$10,000 for 1998. This dollar limit is indexed for inflation in \$500 increments. An employee's elective deferrals must be fully vested. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements. Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are also subject to a special nondiscrimination test.

SIMPLE retirement plans

Under present law, certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least \$5,000 in compensation during the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an IRA for each employee or part of a qualified cash or deferred arrangement ("401(k) plan"). If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules generally applicable to qualified plans (including the top-heavy rules) and simplified reporting requirements apply. Within limits, contributions to a SIMPLE plan are not taxable until withdrawn.

A SIMPLE plan can also be adopted as part of a 401(k) plan. In that case, the plan does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified plan rules continue to apply.

A SIMPLE retirement plan allows employees to make elective contributions which cannot exceed \$6,000 per year. The \$6,000 dollar limit is indexed for inflation in \$500 increments. The employer is required to satisfy one of two contribution formulas. Under the

matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation. Under a special rule applicable to a SIMPLE IRA, the employer can elect a lower percentage matching contribution for all employees (but not less than 1 percent of each employee's compensation). In addition, a lower percentage cannot be elected for more than 2 out of any 5 years.

Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a 2 percent of compensation nonelective contribution on behalf of each eligible employee with at least \$5,000 in compensation for such year, whether or not the employee makes an elective contribution.

In order for the employer to lower the matching percentage, (in the case of a SIMPLE IRA), or to make a nonelective contribution for any year, the employer has to notify employees of the applicable match within a reasonable time before the 60-day election period for the year. The 60-day election period is the period within which each eligible employee can elect to participate in the SIMPLE plan and modify any previous elections regarding the amount of contributions. The 60-day period is the 60-day period before the beginning of any year or the 60-day period before an employee first becomes eligible to participate.

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE plan. All contributions to an employee's SIMPLE account must be fully vested.

Contributions to a SIMPLE plan generally are deductible by the employer and excludable from the employee's income. Early withdrawals from a SIMPLE plan generally are subject to the 10-percent early withdrawal tax. However, in the case of a SIMPLE IRA, withdrawals of contributions during the 2-year period beginning on the date the employee first participated in the SIMPLE IRA are subject to a 25-percent early withdrawal tax.

Simplified employee pensions ("SEPs")

Under present law, certain employers (other than tax-exempt and governmental employers) can establish a simplified employee pension (SEP) for the benefit of their employees. A SEP is an IRA which may receive contributions from the employer in an amount that is greater than the normal IRA deduction limits. The employee is always 100-percent vested in employer contributions. SEPs are generally subject to the same rules that apply to IRAs. In addition, certain other rules apply. An employee satisfies the participation requirements if the employee (1) has attained age 21, (2) has performed services for the employer during at least 3 of the immediately preceding 5 years, and (3) received at least \$400 (for 1997) in compensation from the employer for the year. An employee can participate even though he or she is also a participant in one or more other qualified retirement plans sponsored by the employer. However, SEP contributions are added to the employer's contribution to the other plans on the participant's behalf in applying the limits on contributions and benefits (sec. 415).

Effective for taxable years beginning after December 31, 1996, employers can no longer establish a salary reduction SEP ("SARSEP") under which the employees can elect to have contributions made to the plan or to receive the contributions in cash (sec. 408(k)(6)). However, employers may continue to make contributions, under rules in effect prior to January 1, 1997, to SARSEPs that were established before 1997. In addition, employees hired after December 31, 1996, may participate in SARSEPs established by their employers prior to January 1, 1997.

Tax-sheltered annuities

Tax-sheltered annuities are another form of employer-based retirement plan that provide the same tax benefits as qualified plans and IRAs. Employers may contribute to such annuities on behalf of their employees, and employees may contribute on a pre-tax basis through salary reduction. Tax-sheltered annuities are subject to rules similar to some of the rules applicable to qualified plans. Tax-sheltered annuity plans may be maintained only by certain types of organizations, in particular, tax-exempt charitable organizations and educational institutions.

Annuity contracts

Present law provides that income credited to a deferred annuity contract is not currently includible in the gross income of the owner of the contract nor is the income taxed to the insurance company issuing the contract. No deduction is provided for, and no dollar limits are imposed on, amounts used to purchase annuity contracts. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under or secured by the contract) are includible in gross income as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. In addition, a portion of each distribution received after the annuity starting date is treated as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

A 10-percent additional income tax is imposed on certain early withdrawals under an annuity contract. This additional tax does not apply to any distribution made after the owner of the contract attains age 59-1/2, receives annuity payments under the contract, or satisfies certain other requirements.

Life insurance

Under present law, the investment income ("inside buildup") earned on premiums credited under a life insurance policy generally is not subject to current taxation to the owner of the policy or to the insurance company issuing the contract. This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract. The contract must satisfy the statutory definition of life insurance by meeting either of two statutory tests: the "cash value accumulation" test, or the "guideline premium/cash value corridor" test.

No deduction is provided for, and no dollar limits are imposed on, amounts used by an individual to purchase life insurance contracts.

Death benefits paid under a life insurance contract are excluded from income, so that neither the policyholder nor the policyholder's beneficiary is ever taxed on the inside buildup if the proceeds of the policy are paid to the policyholder's beneficiary by reason of the death of the insured.

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income only to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income. In the case of a modified endowment contract, however, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances.

Medical savings accounts

Under present law, eligible individuals covered under a high deductible health plan may have a medical savings account ("MSA"). In general, eligible individuals are individuals employed by a small employer and self-employed individuals. Within limits, contributions made by an individual to an MSA are deductible, and contributions made by the individual's employer are excludable from gross income. Earnings on amounts held in an MSA are not currently includible in income. Amounts withdrawn for medical expenses are not taxable. Amounts withdrawn for nonmedical purposes are includible in income and subject to an additional 15-percent tax unless the distribution is made after death, disability, or age 65.

While MSAs are not available to all individuals, when used for nonmedical purposes, MSAs provide the same tax benefits as IRAs and qualified plans. When used for medical purposes, they provide greater tax benefits, because withdrawals are tax free.

II. BACKGROUND RELATING TO TAX INCENTIVES FOR SAVING

A. Role of Saving in the National Economy

Investment and economic growth

When an economy's rate of investment increases, the economy's stock of capital increases. A larger capital stock permits greater production of goods and services. Because a larger capital stock means more productive workers, investment also leads to higher wages and salaries. Thus, increases in investment lead to future increases in a nation's standard of living.

It is important to distinguish gross investment from net investment. Gross investment includes investment in new capital as well as investment that is undertaken to replace depreciated or worn out capital. Net investment⁷ measures increases to the capital stock.

In the short run, increases in gross investment will increase the capital stock. As the capital stock increases, worker productivity increases and the economy will experience a higher rate of growth. In the long run, any given rate of investment will just be sufficient to replace the existing, though larger, capital stock as it depreciates. Thus, in the long run, an increase in the level of investment increases a nation's standard of living, but may not increase a country's long-run rate of growth.

It is possible that a higher investment level can lead to a higher growth rate even in the long run. Even if there is no growth in net investment, investment to replace depreciated capital may still enhance economic growth to the extent that the replacement capital embodies improved (and more efficient) equipment and technologies. The higher the gross investment rate, the more new capital is purchased each year, and thus the rate at which new technologies get adopted may be higher.

Sources of investment funds

Investment involves a trade-off between consumption today and consumption tomorrow. Investment can either be financed by national saving, or by foreign borrowing (saving by foreigners). A basic accounting identity of the national income and product accounts states that:⁸

⁷ Net investment is equal to gross investment less depreciation.

⁸ The national income and product accounts measure the flow of goods and services (product) and income in the economy. Two common measures of the size of the economy are the gross domestic product ("GDP") and the gross national product ("GNP"). GDP measures the total value of the output of the American economy. GNP measures the total annual value of goods and services produced by Americans, their gross income. GDP is greater than GNP by the payment of factor income to the rest of the world (such as profits to foreign owners of U.S. based

$$\text{Investment} = \text{Private Saving} + \text{Government Saving} + \text{Net Foreign Borrowing}$$

Many analysts in the past ignored the foreign sector, primarily because at the time it was small relative to the U.S. economy. These analysts interpreted this basic relationship as saying that national investment must equal national saving, where national saving is the sum of private saving and public saving.

However, national investment need not equal national saving if foreigners can invest in the United States. The experience of the 1980s, when investment in the United States greatly exceeded national savings, demonstrates how important this source of funds can be. When demand for investment funds in the United States outstrips the supply of national savings,

businesses), but is less than GNP by the amount of factor income received from the rest of the world by Americans (such as wages paid to Americans who work abroad). Examining the income measure, GNP, is useful in understanding the trade-off between consumption today and consumption tomorrow. GNP may be measured in several ways. One way is to measure GNP by expenditure on final product in the economy. By this measure,

$$(1) \text{ GNP} = C + I + G + (X-M).$$

Equation (1) is an accounting identity which states that gross national product equals the sum of consumption expenditures (C), investment expenditures on plant, equipment, inventory, and residential construction (I), governmental purchases of goods and services (G), and net exports (exports less imports of goods and services or X-M).

An alternative is to measure GNP by the manner in which income created in the economy is disposed of. By this measure,

$$(2) \text{ GNP} = C + S + T.$$

Equation (2) is another accounting identity which states that gross national product equals the sum of consumption expenditures, saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less domestic transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity,

$$(3) I = S + (T-G) + (M-X)$$

This is the basis for the statement that national investment equals private saving (S), plus public saving (T-G), and net imports (M-X).

interest rates rise in response. Increases in interest rates attract foreign capital to the United States, and the excess of investment over national saving is financed by foreigners' saving.

Foreign investment in the United States also is related to the value of the dollar and the trade deficit. To take advantage of high interest rates in the United States, foreign investors first must convert their currencies to dollars. This increases demand for the dollar, thereby increasing the dollar's exchange rate relative to the foreign currency. A stronger dollar makes imported goods relatively cheaper and our exports relatively more expensive. As a consequence, net exports fall and the trade deficit increases. A further accounting identity states that:⁹

$$\text{Net Foreign Borrowing} = (\text{Imports} - \text{Exports})$$

When net foreign borrowing increases, the trade deficit (the difference between imports and exports of goods and services) also increases. Thus, many people have blamed the trade deficits of the 1980s on the low national savings rate during that period.¹⁰

Is the United States' saving rate too low?

Consequences of a low saving rate

The consequences of a low saving rate depend on the mobility of international capital. If capital is not mobile, then, as discussed above, investment is equal to national savings. When the saving rate is low, so is the investment rate. Historically, there has been a strong relationship between a country's rate of investment and its rate of saving.¹¹ Although this relationship has become weaker over time,¹² it is still true that countries with high saving rates also generally have high investment rates.

If capital is mobile (that is, if foreigners can invest in the United States at low cost and without a lot of added risk), then investment will not decline as much when the saving rate falls.

⁹ This ignores the relatively small amount of unilateral transfers to foreigners. For a more detailed discussion of foreign trade and domestic saving and investment, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

¹⁰ For instance, see Hatsopoulos, Krugman, and Summers, "U.S. Competitiveness: Beyond the Trade Deficit," *Science*, 15 July 1988, vol. 241, pp. 299-307.

¹¹ See, for instance, Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," *Economic Journal*, vol. 90 (June 1980) pp. 314-29.

¹² See Phillippe Bacchetta and Martin Feldstein, "National Saving and International Investment", in Douglas Bernheim and John Shoven (eds.), *National Saving and Economic Performance* (Chicago: The University of Chicago Press), 1991.

Instead, investment will be financed by foreigners, either by direct foreign investment in the United States or by foreign lending to American investors. When domestic saving rates are low, foreign financing of domestic investment results in a higher rate of investment than would be possible if investment were financed by domestic saving. Foreign investment in the United States does increase the productivity of American workers. However, the profits generated by foreign investment flow abroad, since the United States has to pay interest on the funds it borrows. Furthermore, eventually the debt will have to be repaid, so the net wealth that is left to future generations of Americans is smaller than it would be if the investment were financed by domestic saving.

Trends in national saving

National saving is generally divided into private saving and public saving. Private saving is comprised of household or personal saving and business saving. Households save by not spending all of their disposable income (i.e., after-tax income). Businesses save by retaining some of their earnings. Public saving reflects the extent to which the Federal, State, and local governments run combined budget surpluses or deficits. Table 1 presents data on the components of net national saving in the United States. In interpreting these data, it is important to note that "personal saving" generally includes saving via an employer's pension plan contribution made on behalf of the employee. For example, in 1994, of the \$189.4 billion of personal saving, \$80 billion, or 42 percent, was attributable to employer pension contributions. The 1994 experience is somewhat anomalous, as over the past two decades, employer pension contributions accounted for between one fifth and one third of total personal saving.

Table 2 presents net saving by component as a percentage of gross domestic product ("GDP"). As the table demonstrates, the personal saving rate, the net business saving rate,¹³ the total net private saving rate, and the public saving rate were all lower during the 1980s than in the 1960s or 1970s. As a result, the net national saving rate was lower in the 1980s than in the 1960s or 1970s. The personal saving rate has continued to decline in the 1990s. As a result, the total net private saving rate and the net national saving rate are also lower in the 1990s than in the three previous decades. However, declines in dissaving by the public sector recently have contributed to an increase in the net national saving rate. The net business saving rate also has been higher over the past three years than over the prior 15 years. Figure 1 displays the arithmetic relationship of the total net private saving rate, the public saving rate, and the net national saving rate.

Some analysts suggest that because households save out of their disposable income (i.e., after-tax income), it is more appropriate to examine personal saving relative to disposable income than to examine personal saving relative to GDP. Table 3 presents personal saving as a percentage of disposable income. Generally, the same trends observed in Table 2 are evident in

¹³ Tables 1 and 2 present net saving, which equals gross saving less capital consumption (depreciation).

Table 3. The personal saving rate of 3.8 percent of disposable personal income in 1997 is the lowest computed by the Commerce Department since 1939. Some analysts attribute recent low personal savings rates to strong stock market performance. Growth in asset values in the stock market increases the wealth of many households and may lead households to conclude their need for saving to meet future goals is reduced.

Prior to 1980, domestic saving generally financed domestic investment as well as providing funds for Americans to be net investors abroad (negative net foreign investment). During the 1980s, net savings fell short of domestic investment as a share of GDP. Domestic investment declined from its 1984 peak and net foreign investment provided for the difference in domestic savings and investment. Thus, although the decline in saving was coincident with a decline in investment, this decline was not as severe as it might have been had there not been foreign investment.

Comparison of saving rates in the United States and other countries

The United States' national saving rate is low when compared to that of other nations. Table 2 showed that the United State's net national saving averaged approximately 5 percent of GDP in the 1980s. The net national saving rate of Canada during the 1980s averaged 7.3 percent of GDP. For Japan, the comparable rate was 17.9 percent; Germany, 9.2 percent; Italy, 8.3 percent; France, 6.7 percent; the United Kingdom, 4.5 percent; and Australia, 3.4 percent.¹⁴ Table 4 presents a comparison for household or personal saving. As Table 4 indicates, the household saving rate of the United States during the 1980s was below the household saving rates of Canada, Germany, and Japan.¹⁵

Generally, saving rates of all nations have declined from the rates of the late 1960s. In percentage terms, the decline in the national saving rate of the United States between the late

¹⁴ Organization for Economic Co-Operation and Development, *National Accounts, 1960-1989*, vol. 1, 1991.

¹⁵ The data on international saving rates in the text and in Table 4 are not directly comparable to the data in Tables 2 and 3 because such data are not always compiled consistently across nations. For example, in computing household saving rates, the OECD subtracts household interest expense from income to determine U.S. household disposable income. The Bureau of Economic Analysis does not make a similar adjustment in defining household disposable income. Also, while the source of the international comparisons draws on data from the OECD, which attempts to provide data on an internationally comparable basis, the data are not fully comparable. For example, in computing household saving rates, the definition of the household sector is not identical across all countries. In particular, except in Japan, France, and Italy, private nonprofit institutions are included in the household sector. See, Andrew Dean, Martine Durand, John Fallon, and Peter Hoeller, "Saving Trends and Behaviour in OECD Countries," OECD, Economics and Statistics Department Working Paper, No. 67, June 1989.

1960s and 1989 is greater than the decline in the saving rates of Japan and Germany, but comparable to the decline of the saving rates of France and Italy.

Although many people have pointed to the low saving rate in the United States as a cause of declining productivity, others argue that the United States has long been a relatively low-saving nation, and yet has enjoyed substantial economic growth. They note that many of the nations with higher saving rates were nations which needed to rebuild after the destruction of war on their own territory.

Furthermore, some argue that the low saving rate in the United States may be a product of demographics, and that the saving rate will increase as the baby boomers enter their forties and fifties, typically the years during which people do much of their retirement saving. However, others note that in the past, demographic changes have not been very successful at predicting saving rates.

In general, the decline in private saving rates is not well understood. It is likely that demographic changes, capital market liberalization, increased insurance availability, increased asset values, and increased social security benefits have all contributed to the decline. However, these factors have not proved significant enough to account for the total decline in the saving rate. Similarly, there is no convincing explanation for why saving rates have declined in other nations as well.

B. Adequacy of Personal Saving¹⁶

Because social security coverage of workers has increased over time,¹⁷ and because the labor force participation of women has also been increasing, current workers are more likely to be covered by social security than current retirees. Similarly, pension coverage of current workers is also substantially larger than that of current retirees.¹⁸ Although coverage by pensions and social security is expected to be higher for current workers than it is for current retirees, the saving rate of current workers may be lower than the rate at which current retirees saved during their working lives. This would imply that although one source of retirement income, retirement benefits, is expected to be higher for current workers, another source, income from savings, may be lower.

¹⁶ For a more complete discussion of adequacy of personal saving, see Joint Committee on Taxation, *Analysis of Tax Proposals Relating to Savings and Investment (Capital Gains, IRAs, and Estate and Gift Tax)* (JCS-5-97), March 18, 1997.

¹⁷ For a discussion of the legislative history of social security coverage, see Committee on Ways and Means, *Overview of Entitlement Programs* (WMCP 102-9), May 7, 1991, pp. 105-106.

¹⁸ *EBRI Databook on Employer Benefits*, 1990, p. 75.

The measure of personal saving used in the National Income and Product Accounts attributes all corporate pension contributions and earnings to the household sector. Thus, the increased pension coverage is already included in the measure of household saving. Table 2, above, shows that personal saving has been declining over the past 15 years. Private saving, which includes the saving of business, and which may provide a better measure of total households saving since businesses are ultimately owned by households, exhibits the same downward trend. Thus, the saving of the current generation of workers for their retirement seems to be low relative to the past.

In a recent study, the Congressional Budget Office ("CBO") reported that while the saving rate of current workers appears low relative to the past, this may not imply that the level of savings is inadequate for retirement. That CBO study concludes that the so-called "baby boom" generation appears to be accumulating assets at a rate equivalent to that of their parents who are currently retired. The CBO concludes that the continued increase in real wages, the fact that baby boomers are more highly educated than their parents, and the increased participation of women in the labor force portend "increases in household incomes of baby boomers in retirement."¹⁹ Some have criticized the conclusion of this study as too optimistic. Critics note that finding that baby boomers have accumulated approximately the same amount of assets as had their parents at a similar age does not bode well for retirement income. Having the same amount of assets would imply only the potential for the same amount of income as experienced by current retirees, and as incomes grow this would imply future retirees would be less well off compared to the rest of society than are current retirees. Critics also note that current retirees benefited from increases in social security benefits and unexpected capital gains on housing that the baby boomers may not reasonably expect to experience.²⁰

Finally, it is possible that the need for retirement income is increasing over time. Increases in life expectancies and trends toward earlier retirement increase the number of years in retirement and therefore, increase the need for saving. Furthermore, the normal retirement age for social security was changed in 1983. In 1995, the normal retirement for social security (the age at which retirees receive full benefits) is 65. By 2010, normal retirement will be 67 years. If the increase in the normal retirement age means that individuals will be working more years, then current saving need not adjust. However, if the historical trend toward earlier retirement continues, then the increase in normal retirement age for receipt of full social security benefits means that individuals should increase their retirement saving.

¹⁹ Congressional Budget Office, "Baby Boomers in Retirement: An Early Perspective," September 1993, p. xiv. Also see, Joyce Manchester, "Baby Boomers in Retirement: An Early Perspective," in Dallas Salisbury and Nora Super Jones (eds.), *Retirement in the 21st Century: Ready or Not?* (Washington: Employee Benefits Research Institute), 1994.

²⁰ B. Douglas Bernheim, "Adequacy of Savings for Retirement and the Role of Economic Literacy," in Dallas Salisbury and Nora Super Jones (eds.), *Retirement in the 21st Century: Ready or Not?* (Washington: Employee Benefits Research Institute), 1994.

C. Tax Incentives for Saving

Present law contains various tax incentives for savings. Tax incentives are provided to encourage taxpayers to save for certain purposes and to encourage taxpayers to save in certain forms. Saving for the purpose of education and retirement is subsidized through the tax treatment of certain Treasury bonds and of certain retirement plans. Incentives are also provided for people to save in the form of investments in housing, life insurance, and municipal bonds.

Tax-favored treatment of assets does not always increase the rate of return on saving. If the supply of a tax-favored asset is limited relative to the demand for that asset, much of the benefit of the tax treatment will be realized by the initial owners of the asset, rather than by the subsequent holders of the asset. For instance, holders of municipal bonds may not receive a higher after-tax rate of return than holders of taxable bonds because, even though the earnings are tax exempt, municipal bonds offer lower rates of return. The issuers of municipal bonds receive a tax benefit because they can pay lower interest rates than the rates paid on other securities.

The tax benefits of IRAs and pension funds, however, are not limited to particular assets. Because investors in IRAs and pension funds can invest in a wide range of assets, and because the amount of funds permitted to be invested through these tax-favored vehicles is limited (the demand is small relative to the supply of assets), investors in IRAs and pension funds do receive a higher rate of return than that available through other investments, and thus do benefit from the tax-favored treatment.

Enactment of additional saving incentives would be expected to alter taxpayers' choices among various taxable and tax-preferred assets. Because the income earned on assets held in IRAs effectively is exempt from tax, the taxpayer maximizes the benefit of the tax preference by directing the investment of IRA contributions in assets which are not otherwise tax preferred. The benefits of tax preferences for assets that are tax preferred to one degree or another are maximized when such assets are held outside an IRA.

Some argue that tax incentives for saving are appropriate because the income tax system taxes the return to income that is saved, thereby lowering the return to saving. This lower return on saving affects both the national saving rate, as well as the assets that taxpayers accumulate for particular purposes. There is some disagreement about whether the goal of tax incentives for saving should be to encourage saving for particular purposes or to increase national saving. A tax incentive might induce more personal saving, or personal saving for a specific goal, and reduce national saving. As discussed above, national saving is the sum of private saving and public saving. Personal saving could increase, but if the tax incentive reduces Federal receipts, public saving may decrease. The net effect could be a decline in national saving even as personal saving increases. However, these purposes are not mutually exclusive; if sufficiently effective, incentives to save for particular purposes will increase national saving. Oppositely, general saving incentives will not necessarily fulfill more specific goals. Whether new tax

incentives for saving should be aimed at increasing national saving in general, or increasing retirement saving, depends on the perceived adequacy of each type of saving.

Table 1.--Components of Net National Saving, 1959-1997

Year	Gross Domestic Product (\$ billions)	Net Private Saving			Net Public Saving			Net National Saving (\$ billions)
		Personal Saving (\$ billions)	Net Business Saving (\$ billions)	Total Net Private Saving (\$ billions)	Federal Government Saving (\$ billions)	State & Local Net Saving (\$ billions)	Total Net Public Saving (\$ billions)	
1959	507.2	24.3	13.9	38.2	2.6	9.6	12.2	50.4
1960	526.6	23.3	12.7	36.0	7.4	9.9	17.3	53.3
1961	544.8	28.3	13.0	41.3	2.9	10.4	13.3	54.6
1962	585.2	29.5	18.7	48.2	2.8	11.7	14.5	62.7
1963	617.4	28.6	21.2	49.8	5.4	13.0	18.4	68.2
1964	663.0	35.5	24.4	59.9	0.9	14.7	15.6	75.5
1965	719.1	37.8	29.9	67.7	3.4	15.1	18.5	86.2
1966	787.8	39.1	31.7	70.8	2.6	17.3	19.9	90.7
1967	833.6	48.9	28.9	77.8	-8.3	17.3	9.0	86.8
1968	910.6	46.8	26.3	73.1	-2.8	20.0	17.2	90.3
1969	982.2	46.9	22.6	69.5	8.7	21.1	29.8	99.3
1970	1,035.6	61.0	17.7	78.7	-14.1	20.8	6.7	85.4
1971	1,125.4	68.6	27.3	95.9	-25.3	21.7	-3.6	92.3
1972	1,237.3	63.6	34.5	98.1	-20.5	32.2	11.7	109.8
1973	1,382.6	89.6	37.6	127.2	-11.1	33.4	22.3	149.5
1974	1,496.9	97.6	21.5	119.1	-16.9	30.5	13.6	132.7
1975	1,630.6	104.4	40.1	144.5	-73.9	27.6	-46.3	98.2
1976	1,819.0	96.4	47.0	143.4	-57.2	35.9	-21.3	122.1
1977	2,026.9	92.5	53.4	145.9	-46.3	44.7	-1.6	144.3
1978	2,291.4	112.6	62.0	174.6	-31.7	52.6	20.9	195.5
1979	2,557.5	130.1	53.5	183.6	-18.4	52.3	33.9	217.5
1980	2,784.2	161.8	23.0	184.8	-61.0	54.4	-6.6	178.2
1981	3,115.9	199.1	33.3	232.4	-57.8	55.4	-2.4	230.0
1982	3,242.1	205.5	26.3	231.8	-134.7	51.3	-83.4	148.4
1983	3,514.5	167.0	54.3	221.3	-174.4	64.9	-109.5	111.8
1984	3,902.4	235.7	91.0	326.7	-156.0	86.9	-69.1	257.6
1985	4,180.7	206.2	92.9	299.1	-162.9	91.0	-71.9	227.2

Year	Gross Domestic Product (\$ billions)	Net Private Saving			Net Public Saving			Net National Saving (\$ billions)
		Personal Saving (\$ billions)	Net Business Saving (\$ billions)	Total Net Private Saving (\$ billions)	Federal Government Saving (\$ billions)	State & Local Net Saving (\$ billions)	Total Net Public Saving (\$ billions)	
1986	4,422.2	196.5	54.2	250.7	-177.5	94.9	-82.6	168.1
1987	4,692.3	168.4	75.7	244.1	-128.9	83.8	-45.1	199.0
1988	5,049.6	189.1	103.3	292.4	-121.3	85.9	-35.4	257.0
1989	5,438.7	187.8	76.2	264.0	-113.4	95.1	-18.3	245.7
1990	5,743.8	208.7	77.2	285.9	-154.7	80.1	-74.6	211.3
1091	5,916.7	246.4	86.0	332.4	-196.0	75.8	-120.2	212.2
1992	6,244.4	272.6	88.9	361.5	-280.9	86.3	-194.6	166.9
1993	6,553.0	214.4	103.3	317.7	-255.6	94.9	-160.7	157.0
1994	6,935.7	189.4	123.2	312.6	-190.2	99.7	-90.5	222.1
1995	7,253.8	294.3	140.6	434.9	-161.7	95.0	-66.7	368.2
1996	7,636.0	239.6	142.8	382.4	-110.5	105.3	-5.2	377.2
1997	8,124.3	208.2	156.1	364.3	-10.8	111.4	100.6	464.9

Note: 1997 figure is annualized figure for the third quarter of 1997

Source: Department of Commerce, Bureau of Economic Analysis

**Table 2.--Components of Net National Saving as a
Percentage of GDP, 1959-1997**

<u>Year</u>	<u>Net Private Saving</u>			<u>Public Saving as a Percentage of GDP</u>	<u>Net National Saving as a Percentage of GDP</u>
	<u>Personal Savings as a Percentage of GDP</u>	<u>Net Business Savings as a Percentage of GDP</u>	<u>Net Private Saving as a Percentage of GDP</u>		
1959	4.79	2.74	7.53	2.41	9.94
1960	4.42	2.41	6.84	3.29	10.12
1961	5.19	2.39	7.58	2.44	10.02
1962	5.04	3.20	8.24	2.48	10.71
1963	4.63	3.43	8.07	2.98	11.05
1964	5.35	3.68	9.03	2.35	11.39
1965	5.26	4.16	9.41	2.57	11.99
1966	4.96	4.02	8.99	2.53	11.51
1967	5.87	3.47	9.33	1.08	10.41
1968	5.14	2.89	8.03	1.89	9.92
1969	4.77	2.30	7.08	3.03	10.11
1970	5.89	1.71	7.60	0.65	8.25
1971	6.10	2.43	8.52	-0.32	8.20
1972	5.14	2.79	7.93	0.95	8.87
1973	6.48	2.72	9.20	1.61	10.81
1974	6.52	1.44	7.96	0.91	8.86
1975	6.40	2.46	8.86	-2.84	6.02
1976	5.30	2.58	7.88	-1.17	6.71
1977	4.56	2.63	7.20	-0.08	7.12
1978	4.91	2.71	7.62	0.91	8.53
1979	5.09	2.09	7.18	1.33	8.50
1980	5.81	0.83	6.64	-0.24	6.40
1981	6.39	1.07	7.46	-0.08	7.38
1982	6.34	0.81	7.15	-2.57	4.58
1983	4.75	1.55	6.30	-3.12	3.18
1984	6.04	2.33	8.37	-1.77	6.60
1985	4.93	2.22	7.15	-1.72	5.43

<u>Year</u>	<u>Net Private Saving</u>				<u>Net National Saving as a Percentage of GDP</u>
	<u>Personal Savings as a Percentage of GDP</u>	<u>Net Business Savings as a Percentage of GDP</u>	<u>Net Private Saving as a Percentage of GDP</u>	<u>Public Saving as a Percentage of GDP</u>	
1986	4.44	1.23	5.67	-1.87	3.80
1987	3.59	1.61	5.20	-0.96	4.24
1988	3.74	2.05	5.79	-0.70	5.09
1989	3.45	1.40	4.85	-0.34	4.52
1990	3.63	1.34	4.98	-1.30	3.68
1991	4.16	1.45	5.62	-2.03	3.59
1992	4.37	1.42	5.79	-3.12	2.67
1993	3.27	1.58	4.85	-2.45	2.40
1994	2.73	1.78	4.51	-1.30	3.20
1995	4.06	1.94	6.00	-0.92	5.08
1996	3.14	1.87	5.01	-0.07	4.94
1997	2.56	1.92	4.48	1.24	5.72
Average 1960-69	5.086258594	3.199308258	8.285566852	2.419703499	10.70527035
Average 1970-79	5.519417944	2.376650284	7.896068228	0.218632553	8.114700781
Average 1980-89	4.752048703	1.562120438	6.314169141	-1.299618765	5.014550376
Average 1990-97	3.443630221	1.687444976	5.131075197	-1.124656988	4.006418209

Note: 1997 figure is annualized figure for the third quarter of 1997

Source: Department of Commerce, Bureau of Economic Analysis

**Table 3.--U. S. Personal Saving as a Percentage of Disposable
Personal Income, Selected Years, 1929-1997**

Year	Personal saving as a percentage of disposable personal income
1929	3.2
1939	2.6
1944	25.1
1949	3.9
1954	6.3
1959	7.0
1964	7.7
1969	7.0
1974	9.3
1975	9.0
1976	7.6
1977	6.6
1978	7.1
1979	7.4
1980	8.2
1981	9.1
1982	8.8
1983	6.6
1984	8.4
1985	6.9
1986	6.2
1987	5.0
1988	5.2
1989	4.8
1990	5.0
1991	5.7
1992	5.9
1993	4.5
1994	3.8
1995	4.7
1996	4.3
1997	3.8

Source: Department of Commerce, Bureau of Economic Analysis.

Table 4.--Net Household Saving as a Percentage of Disposable Household Income in Certain Countries, Selected Years, 1972-1995

<u>Country</u>	<u>1972</u>	<u>1976</u>	<u>1980</u>	<u>1984</u>	<u>1988</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>Average 1986-1995</u>
United States	7.5	7.6	8.4	8.6	5.3	5.2	5.8	5.7	4.7	4.2	4.9	5.2
Japan	18.2	23.2	17.9	15.8	13.0	12.1	13.2	13.1	13.4	12.8	13.0	13.2
Germany	14.4	13.3	12.8	11.4	12.8	13.8	12.9	12.9	12.2	11.7	11.6	12.5
Canada	8.7	11.8	13.6	15.0	9.7	9.7	9.9	10.3	9.6	7.6	7.0	9.4
Australia	11.8	11.1	10.8	9.9	6.1	6.9	5.2	4.6	3.3	3.2	2.6	5.1

Source: Organization for Economic Co-Operation and Development, *OECD Economic Outlook*, 60, December 1996.

**Figure 1.--Components of Net National Saving as a Percentage of GDP,
1959-1997**

