

Occasional Essays on Current Policy Issues No. 13

Saving, Investment and the Surplus

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28 February 2001

Saving always equals investment. There are not many things in economics that closely resemble the laws of physics, but this is one of them. Investment is the source of growth, but adding to the productive capacity of the economy requires that someone, somewhere, put something aside. There are a several of possible sources for the needed saving, including individuals, business themselves, foreign investors, and the government. In recent years the U.S. Government has also become an important contributor to the pool of American saving. Cutting taxes in ways that fail to address the need for sufficient saving creates a risk that future growth rates will fail to live up to the levels we have now grown to expect.

The low level of domestic saving in the U.S. is a well-known problem. In recent years, individuals have saved virtually nothing out of their current incomes. Instead, resources have come from a combination of corporations, foreign capital inflows and the government. A combination factors are responsible for this pattern. First, anyone who holds equity would rather have companies save for them, creating capital gains that face a lower rate of taxation. Given the choice, individuals will always want businesses to save for them, passing on the benefits in the form of equity appreciation. The result has been that, while there may be very little direct saving out of households' labor incomes, overall wealth has increased significantly. Second, investment returns in the U.S. have dominated those in the rest of the world for some time, drawing foreign capital in at high, and possibly alarming, rates. And finally, fiscal consolidation has led to a very dramatic swing in the government's budget position.

Overall, the U.S. does not have a saving problem – at least not in the aggregate. Saving, and therefore investment, is now between 18% and 19% of GDP, the highest it has been since the mid-1980s. Decomposing this, we can see some potential dangers. American government saving is at its highest level in 40 years, representing over $\frac{1}{4}$ of the total, or 5% of GDP. Foreign investment is the highest it has ever been, at 4% of GDP. The rest, private domestic household and corporate saving, is at an all-time low – less than 10% of GDP.

The swing in fiscal policy from deficit to surplus, from draining private and foreign saving to augmenting them, came at a very important time. As government saving went from $-2\frac{1}{2}\%$ to $+5\%$ of GDP, overall investment rose by $2\frac{1}{2}\%$ of GDP. This was contemporaneous with the dramatic rise in the growth rate of the U.S. economy, from less than 3% in the first half of the 1990s to over 4% today. Of this, nearly half of the increase can be accounted for by faster real investment.

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How critical was the role of fiscal policy in the economic performance of the past decade? While the surpluses may not have been the source of the new economy, they surely helped make it possible. Without the swing in the government's budget from deficit to surplus, long-term interest rates would surely have been higher, discouraging both investment and growth. Any move to either reduce government revenues or increase spending has the potential to raise interest rates, reduce overall investment and put long-term prospects at risk.

So what how should the government react to the projections that the U.S. Treasury debt will effectively disappear in less than a decade? The Bush Administration has proposed cutting income taxes by about 1½% of GDP. This is predicated on the very reasonable argument that, without a tax cut the day will arrive when the U.S. Treasury is forced to purchase privately issued securities – something that is seems undesirable. This is likely to be sooner rather than later, given the fact that Treasury securities play a crucial role in a number of activities and so the privately held amount outstanding should never be driven even close to zero. In principle, the purchase of privately issued equity and debt is not a problem for the government, as the composition of the portfolio can be constrained to mimic broad stock and bond indices in a purely mechanical. But the very legitimate concern is that the process will become politicized.

It is important to understand that even if the Treasury was to begin accumulating assets, rather than issuing debt, it would likely be a very temporary phenomenon. The reason is that over the next 20 years the Social Security Trust fund will slowly accumulate special-issue interest-bearing Treasury debt, peaking with assets of about \$6 trillion. These assets are really an accounting fiction, as the only way to “redeem” them and pay retirees is for the U.S. Treasury to either sell debt into the financial markets, or have a budget surplus from an excess of general tax revenue. What this means is that for much of the next for the next two decades, the consolidated U.S. Government budget will have an apparent surplus, which really represents future Social Securities liabilities. Any change in fiscal policy must take account of the fact that there is no scenario under which the liabilities of the U.S. Government would disappear by 2010, even with no tax cut at all. This, and the fact that changes in Social Security are also likely to have a dramatic impact on the level of private saving, means that any change in tax cut must be considered a broader context of the overall demands on government revenues over the next several decades.

Arguing about how to cut taxes is a luxury that I could not have imagined even 2 or 3 years ago. Having gotten to this point, though, it is important that we not squander the opportunity to do it in the best way possible. The risk is that the changes in tax policy will be made with the primary aim of averting a recession in the near-term, rather than with the intent of insuring high investment and growth in the coming decades. Simple income tax cuts, that raise take-home pay, are largely spent on consumer goods not saved, and so jeopardize the pool of available investment resources. The result will likely be higher long-term interest rates and lower overall rates of growth. It is imperative that tax cuts be made in a way that provide clear enticements for households and businesses to save, thereby replacing the lost government saving. Increased incentives for retirement saving and corporate investment seem far better ways of insuring the long-term future.