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ECONOMIC SCENE

Americans Save So Little, but What Can Be Done to Change That?

By ROBERT H. FRANK

THE single-cell paramecium is about the size of the period at the end of this sentence. In many species, mature cells divide daily into two daughter cells. In schools around the world, this feature has made the paramecium a favorite vehicle for illustrating the miracle of compound interest.

Left unchecked for 64 days, a single paramecium would become a colony of 9,223,400,000,000,000,000 members. Since 125 paramecia lined up shoulder-to-shoulder would span about an inch, this means a string spanning more than 1,164,600,000,000 miles - over 6,000 round trips between the Earth and sun.

The story is less dramatic, of course, for growth rates much smaller than the paramecium's. Even with relatively small growth rates, however, the gains are impressive. Money invested at 7 percent interest, for example, will double every 10 years, which means that $1,000 deposited at that rate by Benjamin Franklin in the late 1700's would be worth more than $3 trillion today. The same $1,000 invested in 1945 would be worth more than $64,000.

Given the miracle of compound interest, our ability to invest at even modest rates of return represents an extraordinary opportunity. Yet Americans have largely squandered it. Our savings rate, always low by international standards, has fallen sharply in recent decades.

Almost a fifth of American adults have net worth of zero or less. Even more troubling, it is now common for families to pay $1,800 and more in annual interest on revolving credit card balances. Those families experience the miracle of compound interest in reverse.

The savings shortfall threatens not just those who face retrenchment in retirement living standards, but also the country's economic prosperity. With little of Americans' own savings to finance domestic investment, the United States has been borrowing more than $600 billion each year from foreigners.

The mushrooming foreign debt, now almost one-fourth of gross domestic product, has already weakened the dollar and threatens far more serious harm.

Why do Americans save so little? Lack of self-discipline is one reason. If that were the only problem, families could solve it by simply committing a portion of each year's income growth into a payroll savings account, placing it out of temptation's reach.

But the savings shortfall also stems from a second source, one less amenable to this solution. The basic idea is captured in the following thought experiment:

If you were society's median earner, which option would you prefer?

¶You save enough to support a comfortable standard of living in retirement, but your children attend a school whose students score in the 20th percentile on standardized tests in reading and math; or

¶You save too little to support a comfortable standard of living in retirement, but your children attend a school whose students score in the 50th percentile on those tests.

It is an unpleasant choice, to be sure, but most people say they would pick the second option.

Because the concept of a "good" school is relative, this thought experiment captures an essential element of the savings decision confronting most families. If others bid for houses in better school districts, failure to do likewise will often consign one's children to inferior schools. Yet no matter how much each family spends, half of all children must attend schools in the bottom half.

The savings decision thus resembles the collective action problem inherent in a military arms race. Each nation knows that it would be better if everyone spent less on arms. Yet if others keep spending, it is too dangerous not to follow suit. Curtailing an arms race requires an enforceable agreement. Similarly, unless all families can bind themselves to save more, those who do so unilaterally risk having to send their children to inferior schools.

People in other countries also face temptation and collective action problems. Why do they save more than we do? One explanation is that both problems are made worse by income disparities, which have widened much faster in this country than elsewhere.

A collective agreement that each family save a portion of its income growth each year would attack both sources of the savings shortfall. Such an agreement might specify that one-third of income growth be diverted into savings until a target savings rate - say, 12 percent of income - was achieved. A family whose income did not rise in a given year would be exempt from the agreement.

Such an agreement would put the magic of compound interest to work for retirement savings, a benefit that the current Social Security system completely misses. Most of the money currently taken from workers in payroll taxes gathers no interest in the decades before their retirement. Instead, it is paid directly to current retirees, who spend it on rent and food. We have a pay-as-we-go system because the program was started in the Great Depression, when there was simply no money to create a fully financed system.

The good news is that Americans now have ample wealth to support such a system. Some have praised President Bush's proposal to privatize Social Security as a move that will create a fully financed program of retirement savings. It is no such thing. Under his proposal, the transition to private accounts is to be financed with borrowed money. The interest earned on private accounts would thus be offset by the interest paid on the money borrowed to create them, leaving the system right where it started.

Many would object that requiring families to save a portion of each year's income growth would be an infringement of individual liberty. Yet it is the very absence of such a requirement that currently prevents most American families from saving as much as they wish to. Just as nations find it advantageous to restrict their options by signing arms reduction treaties, families may have a similar interest in limiting their freedom to engage in bidding wars for houses in top school districts.

It is clear, in any event, that the failure to save entails risks of its own to freedom. America's rapidly rising debt to foreigners now threatens the economic prosperity on which so many of our cherished liberties depend.

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Hey, Big Saver

Thanks to compound interest, those who save aggressively fare better when it comes to retirement and also have more money to spend in the years before. Here is an example of the total consumption of "high spenders" vs."high savers" both making $50,000 a year for 45 years with no pay increase.

High spenders

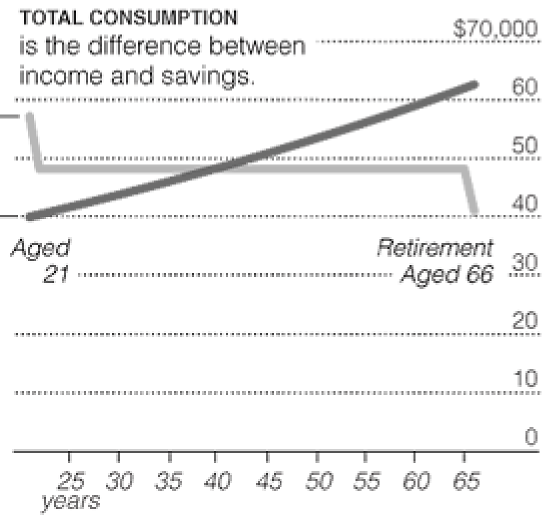
Save nothing. At age 21, in addition to their income, they make a $9,000 credit card purchase. Thereafter, they pay 20% interest, or $1,800 a year, on this purchase until the year they retire, when they pay it off.

SAVINGS ACCOUNT BALANCE AT RETIREMENT: $0

High savers

Save 20% of their total income (including the 5% interest income on their savings) each year.

SAVINGS ACCOUNT BALANCE AT RETIREMENT: $564,811



Source: Analysis of income and spending patterns by Robert H. Frank, Cornell University

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