After the Party conventions conclude in August, it can be expected, or at least hoped, that the presidential campaigns will turn to substantive issues like economic growth, employment, wages, taxes, and trade. If and when this occurs, the ensuing debate should address one of the most basic, as well as most important, relationships in economics: that between the savings-investment balance, on the one hand, and the trade balance (or, more accurately, the current account balance), on the other. To the extent that domestic savings fall short of domestic investment, the economy must import more than it exports. So, if the savings-investment balance is negative, then the economy’s trade balance will also be negative.

The importance of this relationship transcends that of the balance between federal government expenditures and revenues—that is, the budget deficit. The budget deficit is one among several factors influencing the savings-investment balance. Other factors include the absolute amount of government spending (quite apart from the size of the budget deficit itself), tax and regulatory incentives to save and invest, monetary policy, and demographics.

The singular importance of the balance between domestic savings and domestic investment is due to several of its consequences, including the link it provides between the domestic and international economies. This balance maps directly into changes in American holdings of assets abroad, and to changes in assets held in the United

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States by other governments, as well as by corporate and individual entities domiciled in other countries. Over time, the savings-investment balance determines whether the American economy earns more in interest and dividends from its foreign holdings than it pays to other economies on their holdings in the United States. This, in turn, determines whether the gross national product is larger or smaller than the gross domestic product. (The difference between GNP and GDP is net income received from, or paid to, the rest of the world: GNP is less than GDP when we pay more to the rest of the world than the income we receive from it, and vice versa).

Furthermore, the savings-investment balance significantly affects the growth of employment and wages, as well as the economy’s overall rate of growth. Boosting domestic savings and investment—and, in particular, boosting savings by more than investment—is also of central importance for reversing the perennial U.S. pattern of importing capital from abroad to finance the excess of U.S. imports over its exports.

For the past decade, the United States has experienced a shortfall of gross domestic savings compared to gross domestic investment. This perennial shortfall has varied between 1 and 2 percent of the GDP, averaging about $100 billion annually from 1985 through 1995. This savings shortfall is reflected by the excess of U.S. imports of goods and services over our exports. As a consequence of the cumulative shortfall in annual savings, about 18 percent (about $750 billion) of total U.S. public debt is held abroad.

To improve the performance of the American economy, policies should be pursued that will increase both investment and savings, but will increase savings by more than the increase in investment—thereby reducing or reversing the savings shortfall referred to earlier. Accomplishing this goal would mean that the current account deficit of the past decade would be replaced by a current account surplus, that U.S. exports would increase by more than increases in imports, that additional and relatively high-paying jobs would be generated (because wages in exporting industries are about 15–18 percent above average wages), and that U.S. economic growth would rise. As a consequence, U.S. import of capital would be reversed and the burden of servicing foreign-held debt would be eased. Instead, U.S. exports of capital would result in our receiving net income from
abroad, rather than incurring net servicing obligations to other countries.

So much for what needs to be done and why. The next question is how can this be done—that is, how can investment and savings be raised, while raising savings more than investment? Several options are worth considering—their respective economic merits may be uncorrelated, or even negatively correlated, with their political merits and political feasibility. One option would be a straight across-the-board reduction in marginal tax rates, perhaps by 5 percent, 5 percent, and 3 percent, corresponding to the three presently graduated marginal tax rates. The expanded tax base that such a change in marginal rates would create is likely to minimize the resulting reductions in revenue yields, and perhaps to avoid such reductions entirely.

A second option would focus more directly on incentives to save—for example, by eliminating taxation of interest and dividend income, and expanding the tax-deductibility of 401(k) contributions and IRAs (for example, to include non-working spouses as proposed in a bipartisan bill presently under consideration in Congress).

A third option is to move gradually toward an equitably-graduated consumption-based tax structure with exemptions and lower rates applying to smaller consumption outlays, and a higher rate applying to larger consumption outlays.

Some worry—not without reason—that a consumption-type system might generate a deluge of revenues, thereby tempting future Administrations and Congresses to increase spending. To ease this concern, a consumption-based system might be accompanied by automatic caps that would be triggered if revenues exceeded the standard 19–20 percent of GDP typically represented by federal government revenues over the past two decades.

Pursuing one or more of these options, while maintaining a suitably prudent set of monetary policies, will improve the economy’s performance by raising annual growth—perhaps by 0.5 percent or 1.0 percent—from, say, 2.5 percent to 3.0 percent or 3.5 percent, thereby adding $35–70 billion annually to GDP. These cumulative additions, which would total $1 trillion by 2025, are of crucial importance if the
United States is to manage the prospective surge in social spending as the baby-boom generation matures.

Postaudit

The contention of this essay—that savings in the U.S. economy are low and should be encouraged—is no less valid but is distinctly less relevant in 2002, when the economy’s growth appears to be demand-limited, than it was in the buoyant economy of 1996, when the essay was written.