Retail Therapy

Using Retirement Savings As A Fiscal Tool

By John Crudele and Walter J. Williams

ERIC SWANSON/VEER

Think of the mechanism for keeping the United States economy on a growth track as a bicycle – a two-wheeler, as we used to call it. The wheels are conventional monetary policy and fiscal policy. Low interest rates grease one wheel, while a combination of tax cuts and government spending lubricates the other.

But, as any kid can tell you, there's a problem with two-wheelers. If something unexpected upsets the bike's balance – a pothole in the road, a neighborhood bully who jams a stick in the spokes – it can end up in a ditch.

This country's economy is still upright, and it could very well be moving at a good clip when these words reach print.

Still, there's little doubt that a variety of shocks – not to mention the malevolence of terrorists – have made our economy wobble in the past few years. And this makes us wonder what obstacle lies in wait down the road.

So maybe it's time to improve the stability of our economy by adding a third wheel.[1] In addition to cutting interest rates or taxes, Washington could offer people limited-time-only access to their retirement savings accounts without penalties or tax consequences when the economy is in need of a boost. This would augment private spending when the economy needs it, increasing demand directly for consumer goods and indirectly for new productive capacity.

And what works in one direction could work in the other. When the economy is overheating, Washington could increase the tax incentives for retirement plan contributions. This would give account owners a reason to spend less and save more, slowing the economy in the process.

We'll flesh out these ideas below. First, though, an acknowledgment: Some people with brains and/or political clout won't like the proposal. Wall Street won't be thrilled if money is coaxed out of stocks, potentially reducing the value of equities. And those who are (justifiably) worried that Americans aren't saving enough for retirement will fret that the plan will give families one more reason to ignore future needs.

But at a time when macroeconomic policy options have narrowed, all plausible means of offsetting the vagaries of the business cycle deserve exploration. Moreover, the downside isn't as disquieting as one might imagine.

Here's where our two-wheeler[2] has gotten us today.

The Federal Reserve has gone about as far as it can go with easy credit. Short-term interest rates – the rates controlled by Greenspan & Company – are as close to zero as is practical. Indeed, at its January 2002 meeting, the Fed's Open Market Committee explored what "unconventional policy measures" might be available in the event more aggressive recession-fighting measures were needed. Fearing the onset of a Japanese-style deflationary spiral, the Fed discussed options such as buying stocks with newly created money.

Congress has done its part, too – albeit for its own political reasons – by providing a heavy dose of fiscal stimulus. Americans have been treated to about $200 billion in tax cuts




IMAGE SOURCE/VEER

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[1] *Patience; we're almost done with the metaphor.*

[2] *OK, OK; we're almost done with the metaphor.*

over the past two years. One consequence, though, is that the federal deficit has risen to a record level.

Under normal circumstances, interest rates at an all-time low and a full-speed-ahead, damn-the-deficits fiscal policy would be enough to keep the American economy afloat. But the times are apparently not normal. Despite policies that might have been expected to add 200,000 to 300,000 jobs a month, we seem to be in the midst of a jobless recovery.

Chief executives are keeping an especially close eye on payrolls so Wall Street doesn't have an excuse to turn against their stocks (or their compensation). And even if they weren't so focused on cutting costs these days, a combination of technologically driven productivity change in service industries and the new enthusiasm for exporting service-sector tasks to places like India, Russia and Ireland would be slowing job growth. Then, too, there is the intangible issue of business confidence – executives' fear that sticking their necks out by adding employees could put them in sight of the guillotine.

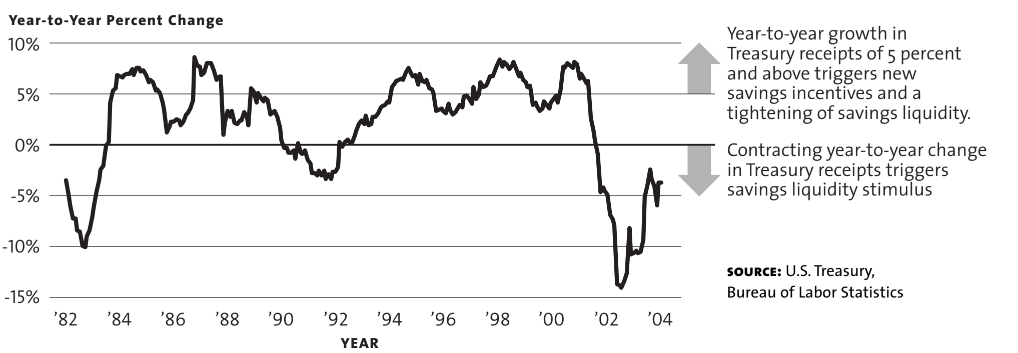
The trouble is, there isn't a bigger confidence buster than the failure of the fiscal and monetary bullets that have already been fired to slay the recession beast.[3] And more disappointing employment figures in the months ahead would undoubtedly deepen the gloom.

That brings us back to the idea of putting retirement cash in play. People don't have to feel especially confident to be induced to

[3] *Hey, at least it's a fresh metaphor.*

U.S. TREASURY RECEIPTS

12-MONTH MOVING AVERAGE, ADJUSTED FOR INFLATION



SOURCE: U.S. Treasury, Bureau of Labor Statistics spend. They just have to be convinced that the temporary tax advantages offered by the plan made it worthwhile to accelerate purchases they would otherwise have deferred. Conversely, when spending needs to be dampened, the carrot of more generous tax breaks for folks who were prepared to delay spending and sock away cash for retirement could make a big difference.

TAPPING INTO $10 TRILLION OF PENSION RESERVES

Why focus incentives on retirement accounts? To paraphrase Willie Sutton, because that's where the liquid assets are. Private pension and retirement accounts represent the single largest unencumbered asset group held by families, and account for one-third of all financial assets. More than $10 trillion sits in these accounts; roughly $4.5 trillion of this is

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in various sorts of defined-contribution plans built on tax-deferral incentives.

According to the Federal Reserve's 2001 Survey of Consumer Finances, 52 percent of families – some 39 million families in all – own some form of retirement account. And a separate study by the Congressional Budget Office estimated half of the work force in 1997 actively participated in tax-deferred retirement savings plans.

But the use of retirement accounts to shelter savings varies sharply according to income. The Fed estimated that only 13 percent of families in the lowest fifth of the income distribution had retirement accounts. The figure for the next quintile was 33.3 percent, while fully 88 percent of families in the top quintile took advantage of the big tax break. The CBO study showed that tax-deferred plan participants were generally married, were over the age of 30, and had incomes exceeding $22,500.

In broad outline, we would allow families to tap tax-deferred retirement savings to some specified maximum (perhaps $20,000 annually) with no tax consequences when the economy hit pre-specified recession triggers. If it proved practical, we would limit the use of the money to job-creating activities – that is, spending it rather than reshuffling it to other savings vehicles. Since those without retirement savings to cash in would lose out, the plan would ideally include a flat refundable tax credit of, say, $500, for those below some modest income threshold.

When the time came to slow the economy down – again, according to a pre-specified trigger – the amount of money that families could contribute to retirement plans would be ratcheted up. If stronger incentives to reduce spending were warranted, the plan might allow those who had previously made tax-free withdrawals to return the funds and claim a fresh tax deduction.

IMAGE SOURCE/VEER

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The bad news here, of course, is that the poor would miss out on the benefits from incentives keyed to retirement savings – which is why it would be wise to supplement the plan with alternative spending incentives at the low end. The good news is that retirement account holders have the means to make high-ticket purchases if the incentives are right.

With regular individual retirement accounts and 401(k) accounts, most money contributed by the earner is deductible from taxable income. No taxes are due on the principal or account earnings until funds are withdrawn. If the withdrawals are made before age 59½, they are not only taxed at regular rates, but also subject to a 10 percent penalty. Contributions to Roth IRAs are not tax-deductible, but withdrawals after five years are tax-exempt. Early withdrawals still are subject to the 10 percent penalty.

Our plan would eliminate both tax and

IMAGE SOURCE/VEER

penalty consequences for early withdrawals up to $20,000 per family per year, so long as the trigger mechanism was signaling recession ahead. Account holders could replenish their retirement nest eggs without further tax reduction. Additional incentives, however, could be offered to help accelerate the process. Roth IRAs would be replenished by allowing full tax deductibility of the replenished amounts.

There are already precedents for giving retirement plan participants limited penalty-free access to funds for a variety of uses – among them, first-time home purchases, higher-education expenses, health insurance premiums and medical emergencies. Our plan would sweeten the incentives by eliminating all tax liability on withdrawals when a recession was in the offing.

STIMULUS WITHOUT DEFICIT TEARS

We estimate that allowing up to a $20,000 per individual tax- and penalty-free withdrawal would lead to a savings liquidation of roughly $100 billion annually. This added spending could increase aggregate demand by roughly 2 percent as it worked its way through the economy. Although the figure is in the ballpark of recent tax cuts, there is good reason to expect that a greater percentage would be spent rather than saved – implying that it would generate more stimulus, dollar for dollar, than the Bush administration's tax cuts.

Further, unlike a tax cut, this stimulus would not lead to higher budget deficits in the year of the trigger. Since these are funds that generally would not have been touched otherwise, the immediate impact on tax revenues would be nil. Indeed, the approach would increase near-term budget revenues for two reasons. First, it would increase economic activity, and thus total income subject to taxes. Second, it would lead to a net reduction in deposits to tax-sheltered retirement accounts, and thus broaden the tax base.

THE VIRTUES OF AN AUTOMATIC PILOT

Congress and the president always have the discretion to change the rules governing retirement accounts. But it would not be practical to leave decisions about the activation of countercyclical retirement account incentives to the politics of the moment. What is needed to help regulate the timing is a trigger that responds automatically to changes in economic conditions, thereby providing a stable planning environment for savings and spending decisions.

A prior effort at fashioning an automatic economic trigger was used in conjunction with the Gramm-Rudman-Hollings Act of 1985, which forced Congress to balance the budget unless the economy was in recession. The recession trigger: two consecutive quarters in which real GDP fell.

But GDP figures go through a series of revisions, and using the first set of numbers could be problematic. For example, GDP growth for January through March of 2001 was initially estimated in April 2001 to be 2 percent. Fifteen months later, that figure was revised into negative territory, belatedly recognizing that the economy was already in recession in the first quarter of 2001. Other widely used data, like payroll employment, also go through regular revisions and suffer from sampling and methodological issues.

What is required is a hard number that directly reflects underlying economic activity. U.S. Treasury receipts, which largely consist of tax collections and are reported monthly, are such a measure.

The figure shows monthly the year-to-year change in the 12-month moving average of Treasury receipts, adjusted for inflation. If negative year-to-year change were used as the trigger, the savings liquidity stimulus would have been activated during the double-dip recession in the early 1980s, the 1990-91 recession and the 2001 recession, generating trigger signals in July 1990 and August 2001 in the latter two periods. While the figure is not adjusted to remove the effects of changes in the tax laws, such adjustments could be made with little effect on the demonstrated trigger pattern.

The periods of economic boom, when tax deferral incentives could be increased to help prevent economic overheating and related inflation, appear to be delineated by year-to-year inflation-adjusted growth in Treasury receipts exceeding 5 percent.

IMAGE SOURCE/VEER

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WALL STREET REACTION

Critics may fret that the withdrawal of cash from retirement savings accounts could trigger a slide in equity prices. But we believe that Wall Street really has more to gain than to lose from the plan, particularly if the savings stimulus action gets a sluggish economy moving.

Individual holdings of stocks and mutual funds outside of retirement accounts are

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double those inside retirement accounts. Accordingly, the greater concern on Wall Street should be that a sagging economy will trigger broader selling of equities. By the same token, if one believes that the markets are rational – that the value of equities is driven by the expected profits earned by corporate America – any effective countercyclical plan that increases corporate earnings should increase stock prices.

BUT WE DON'T SAVE ENOUGH AS IT IS

It is conventional wisdom that Americans save too little. So, wouldn't a program to liquidate savings make a bad situation worse?

First, take a closer look at the premise that Americans don't save enough. Savings statistics from the primary source, the Bureau of Economic Analysis' National Income and Product Accounts, are based on a tower of assumptions. Moreover, comparing the numbers for U.S. personal saving rates against the rest of the world requires another host of assumptions.

In a November 2003 study of baby boomers' retirement prospects, the Congressional Budget Office took apart the traditional analysis of the personal saving rate. It noted that baby boomers, who had been blamed for the declining saving rate, actually were saving as much as their parents had saved at comparable periods in their lives. Moreover, alternatives to the NIPA measure of savings suggest that Americans are far thriftier than generally supposed.

In any event, the effects of the stimulus side of our proposal on savings would be temporary and reversible. Taming the business cycle should have a positive effect on saving in the long-term, since enhanced tax incentives for retirement savings would be provided in better economic times.

A SYSTEM PUSHING ITS LIMITS

Recent tax cuts and spending increases have injected demand into the economy and stimulated growth – but at the cost of sharply increasing the federal budget deficit. Concerns that the deficit is now "structural" rather than cyclical – that the budget would be far out of balance even if the economy were operating at peak capacity – have also been a factor behind the recent rise in long-term interest rates and weakness in the dollar. What's more, the Fed has pretty much run out of conventional monetary policy responses to promote growth.

That's why Washington needs another policy instrument – and preferably one that serves as an automatic stabilizer to lean against the winds of recession and overheating. We don't pretend to have worked out the inevitable kinks in our proposal to harness retirement account liquidity to the task. But we are convinced that it is a promising direction to explore if we are to sustain economic growth in these uncertain times. M

IMAGE SOURCE/VEER