Saving is a Virtue

When I was a kid, my parents taught me the importance of saving. I was brought up in the Great Depression when saving was even more a sacrifice than it is now. Then, as now, it's attractive to live modestly and be humble—two virtues that are the result of spending only that which we really need and using the rest for savings and charity.

There are many reasons why people in our times should save more than our parents. Let me enumerate some of these.

I would be remiss not to mention the great debt burdens many people have now. A debt is a negative investment. A debt consumes interest and does not produce it. Few people now can earn a higher interest rate on their actual investments than the interest rates they are paying, especially for consumer loans and on credit card balances. It takes higher savings to both pay off interest on loans as well as to contribute to a retirement savings plan. Having to make a choice between paying off a loan and add to savings, it's almost always better to forsake savings and pay off loans, other than perhaps very low interest mortgages and to at least get the free matching funds from an employee savings program.

Many people think that their home is their best retirement resource. In a way it is, because a debt free home means no more mortgage payments. On the other hand, we have to ask if we really need a home that may be twice as big as our parent's. There are several ways to get retirement income from a home: (1) downsize and save the proceeds and future lower home-ownership costs, (2) get a home equity loan, (3) obtain a reverse mortgage or (4) rent out some rooms. Both the home equity loan and a reverse mortgage put people back into debt again, so the better choices are downsizing (preferably as soon as practical) and renting out some rooms. But if people are reluctant to do one of these things, then they have to rely on saving more of their wages.

Savings were over 20% of disposable income (income after income tax) during World War II when the stores had few consumer goods, restricted food supplies, and no appliances or new cars were available. Gasoline was rationed so that people drove very little—either to stores or for recreation. Both spouses worked: the wife in the defense industry and the husband in the military. Savings equals after-tax income less spending, so with spousal income up and consumption down, savings were great.

After World War II, savings leveled off to about 9% of disposable income. Then starting in 1985, we got on a consumption binge buying larger homes, lots of electronics and things beyond our parents ken. Savings continued to drop until 2005 when the savings rate actually went negative. It has come up since then but only to about 6%. From 1985 until now, the amount of savings lost is greater than the current national debt—and it's literally impossible to gain it back without World War II type living and savings standards for the next two decades.

What makes this worse is that over that same period from 1985 till now, employers started dropping pensions for their employees. Few companies today offer pensions. Pensions, like Social Security, offered lifetime benefits for both the worker and spouse. So instead of a 9% savings rate, we should have savings approaching 15%. At the same time as pensions were being dropped, employees were getting mobile and moving from job to job. This greatly reduces the benefits of a pension because a significant pension requires long-time employment.

Employers started offering 401(k) (or equivalent) and cash balance plans in lieu of a pension. These took the burden off the employer and put it on the employee to provide retirement benefits. They sweetened the plans by offering some matching funds. But even with matching funds, people were so hooked on consumption, they often didn't even take advantage of the free employer contribution.

Now interest rates are so low that it takes significantly more savings to produce the same income as previous retirees. Many of those currently dependent on interest income have had to drastically cut expenses, often at the expense of necessary health care or health care insurance. At some point, interest rates will have to go up, but when interest rates go up, the principal value of a bond goes down (until it reaches maturity). Hence, those who have bond funds will be back where they started: higher interest rates but a smaller value in the fund to generate the income.

Then there's the fact that people are living longer. When Social Security was started in the Great Depression, the normal retirement age to get Social Security benefits was 65. Yet life expectancy (the average age to die) was less than that. This meant that less than 50% of the people even would reach the age to start Social Security. Now life expectancy is in the eighties with a fairly high probability that one spouse will live into the nineties or better. So our retirement savings have to last longer, and, shy of a decades long bull market, we have to save more to support the longer life.

The longer life span comes partly at the expense of ever increasing health care costs. Even those who enjoy good health to the end have to pay higher premiums for Medicare and Medigap policies. Those who have to go to a nursing home are facing charges of $80 thousand dollars per year of care.

Coincident with the increased life spans is the aging of our population as a whole. Birth rates are far lower than they were in the past. So we are going to see a great increase in the number of retired people relative to those who are still working. After the Great Depression, there were about five workers per retiree. Now there are about three workers per retiree. The forecast for future generations is two workers per retiree. That puts a horrible burden on the young people who have to fund the ever-growing entitlements such as Social Security, Medicare, Medicaid, and government pensions. Some people think that the past taxes they paid to support these programs will be available for their own use. Not so, entitlements will be funded out of then current tax revenues.

There is still another reason though why the coming generations will need more savings. That's the exponential growth of national debt. Unless the Congress and a willing President would agree to cut government spending by draconian amounts as well as to increase taxes and let inflation increase at a faster rate, unless all of these happen, we will be facing an unsupportable $60 trillion national debt (in today's dollar values) within twenty years, up from our current $15 trillion. Only the very best savers and wisest of investors will be able to sustain a "normal" retirement under these conditions.

So, if savings ever were a virtue, they are going to be even more virtuous in the future. That means living more modestly and humbly than in the past. Without savings, people will live VERY modestly and VERY humbly, not by choice, but of necessity.

Henry K. Hebeler
12/23/11
www.analyzenow.com