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Growing old expensively

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Abstract (Article Summary)

At issue is whether older people are responsible for America's falling savings rate. Two dramatic trends stand out in a provocative new study. For a start, the elderly now hold a much bigger share of total "wealth" than they did a generation ago. As well as having more money, the elderly are spending more of it, especially relative to younger people.

Full Text (1047 words)

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[Headnote]

Are old people responsible for America's falling savings rate?

AMERICANS, particularly older ones, love to reminisce about the golden years of the 1950s and 1960s, when the economy boomed and living standards rose swiftly. Their nostalgia is understandable: nowadays, output per worker is growing less than half as fast as it was a generation ago, after allowing for the vagaries of the business cycle. Yet, while America's elders are quick to lament this deteriorating performance, few of them realise that their own behaviour may be one of its main causes.

Of the many factors that have caused America's growth to slow, one widely cited cause is a long-term decline in the country's investment and savings rates. The share of its output which the United States invests (net of capital depreciation) has more than halved since the 1950s, from 8.2% to less than 4% today. Savings rates have fallen even more dramatically: the net national savings rate--defined as total national output minus what households and the government consume-- was a promising 9.1% in the 1950s and 1960s. In the first half of the 1990s it was a meagre 2.7% (see chart).

Explanations for this collapse abound: punitive taxes on savings, the distorting effects of Social Security, less

concern for the future and so forth. Choosing among these suspects is tricky. In a provocative new study*, Jagadeesh Gokhale of the Federal Reserve Bank of Cleveland, Laurence Kotlikoff of Boston University and John Sabelhaus of the Congressional Budget Office try to do just that, with striking results.

To sort out what is happening, they divide America's aggregate consumption according to different age groups, or "cohorts", of consumers. They then break down the changes in the savings rate into a combination of five factors: a change in the rate of government spending on goods and services, a change in the savings rates of the people within each cohort, a change in the size of the different cohorts, a change in the share of wealth owned by the different cohorts, and the extent to which current generations are spending future generations' money.

All of this seems sensible enough. But in order to disaggregate changes in the savings rate this way, the three economists first tried to measure savings properly. This is not as easy as it sounds. If you assume that people are rational, and that they want to keep their pattern of consumption as smooth as possible over time, then savings rates do not depend simply on today's income but on the total income that a person can expect over his lifetime. To estimate this, the economists had to add up people's financial assets, the future income they could expect to earn from their jobs, and the future benefits they could expect to receive from the government, net of taxes.

From lenders to spenders

Once all these numbers are crunched, two dramatic trends stand out. For a start, the elderly now hold a much bigger share of total "wealth", as defined by the authors, than they did a generation ago. The biggest contributors to this increase are government entitlement programmes such as Social Security and Medicare (which provides health care to old people), which take more in taxes from the young (and from future generations), and pay more in benefits to the old, than they used to do.

As well as having more money, the elderly are spending more of it, especially relative to younger people. In the early 1960s, for example, the typical 70-year-old consumed only 71% as much as a 30-year-old. By the late 1980s he was consuming almost 20% more. You would expect some increase in consumption, because America as a whole has aged. Based on demographics alone, the elderly's share of total American consumption would anyway have increased by 16% between the early 1960s and the late 1980s (because there were more old people in the late 1980s). In fact, their share grew by almost 70%. Even if you exclude the consumption of medical services, the elderly have been spending furiously: in the early 1960s, non-medical spending by 70-year-olds was only 63% of that of 30-year-olds; in the late 1980s it was more than 90%.

Why have the elderly become so profligate? Again, government transfers appear to be the reason. Both the amount of money the old have been handed by the government, and the way they have received it, are to blame. In deciding how much to consume, elderly people may be influenced either by fear or by generosity. If they are afraid of outliving their wealth, or if they want to leave some to their children, they may consume less of it than they otherwise would.

America's government transfer programmes may have altered their behaviour in two ways. Because Social Security benefits are paid every year, regardless of how long you live, they reduce the fear of running out of money. And by paying benefits "in kind" (you get a specific good or service, rather than cash), Medicare reduces the incentive to be frugal in order to bequeath. If the elderly do not use medical care, they do not thus save money that can be bequeathed to their children; they save cash for the taxpayer instead.

According to Messrs Gokhale, Kotlikoff and Sabelhaus, these two trends—for the old to have more money, and to spend more of it—lie behind America's plummeting savings rate. Without these factors, they reckon, the country's national savings would be roughly 312 times as large as it is.

Despite these dire numbers, however, there is a glimmer of hope. As it turns out, younger and middle-aged people are saving more of their wealth than in the good old days. If these younger generations had consumed their wealth at the same rate in the 1980s as their predecessors did in the 1960s, America's national savings rate would have fallen even further, hard as that feat sounds.

The authors make some bold assumptions to arrive at these estimates. Yet the story that emerges seems to make sense. A radical redistribution from young savers to old spenders lies at the heart of America's saving collapse. Those Americans who yearn for the "age of affluence" their parents enjoyed should, at least in part, blame their parents for its demise.

Happy consumers

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