At These Rates, Why Bother to Save?

By Kerry Pechter *Thu, Mar 5, 2020*

Negative real interest rates have become a disincentive to personal savings, especially among lower-income Americans who will rely heavily on Social Security and Medicaid anyway, this team of economists from Stanford suggests.

Responding to last week's stock market plunge—when fear literally went viral—the Federal Reserve lowered its benchmark fed funds rate by 50 basis points. The central bank was signaling that investors should… what, exactly? Is the message:

1. Remain calm and stay invested, because liquidity will remain cheap and abundant, or
2. Don't bother saving, because safe assets won't yield enough to make delayed-gratification—the very essence of saving—attractive.

The answer may depend on how much you earn per year and what you think your retirement will be like. For people in households with incomes under $62,000 a year and below-average health, the answer is likely to be "2," according to a new paper from Stanford University economist John Shoven and three of his top former students.

If people behave rationally, as classical economists assume, then they are bound to notice that the return on government bonds is now less than the inflation rate. They may therefore decide to spend freely in early retirement rather than save their money until later, when it will buy less and when they might not be able to enjoy it.

"We find that for many, perhaps most, people in the bottom half of the lifetime earnings distribution, it is optimal to spend out their retirement wealth well before death and to live on Social Security alone after that. Very low earners may find it optimal to not engage in retirement saving at all," they wrote in "Can Low Retirement Savings Be Rationalized?" **NBER Working Paper 26784**, February 2020.

Shoven and his co-authors—Jason S. Scott, Sita N. Slavov of George Mason University and John G. Watson of Stanford—challenge at least two major assumptions about retirement planning. One is the life-cycle hypothesis, which says that people want their consumption to be fairly constant over their entire life-cycle. The second, which is related, is the idea that people will need to 65% to 85% of their pre-retirement income in retirement to avoid feeling a decline in living standard.

This might apply to affluent people, the paper says. But people for whom Social Security will replace a large percentage of their pre-retirement income, and who expect to rely on Medicaid if they live long enough to need long-term care, have more reason to behave like the grasshopper in Aesop's fable than the ant.

John Shoven

"Today, the real rate of interest is negative," Shoven told *RIJ* this week. "So if you set aside money today, you'll be able to afford lower consumption in the future than today. There are significant consequences to this era that we're living in. For many people, their return on savings is less than zero. Bank accounts pay a quarter of a percent. They're basically offer a minus two percent yield.

"If you said today, 'Boy, I want to consume $30,000 per year when I'm 80,' you realize that with today's low rates you'd have to save a lot more to have $30,000 when you're 80," Shoven told *RIJ* this week.

"You might say, with rates so low, I'll change the tilt of consumption. You'll take that trip to Europe at age 70. We're saying that declining consumption during retirement can be attractive—given the market rewards for patience. You might feel differently than you did fifteen years ago when you could get 2.5% real return if you invested in safe assets. the safe real rate of return was 2.5%."

Shoven was asked if conserving money against the fearful possibility of big medical bills in old age would be rational. "With respect to high medical expenses, particularly with the cost of long term care, it is so expensive that it's difficult to provide for," he told *RIJ*.

"Many people who need long-term care will be supported by Medicaid. They'll get about the same level of care whether they go into care with $50,000 in savings or if they have zero."

[For people in the bottom half of the income distribution], "any achievable goal will be so small compared to the size of the need, that they lose by hoarding. They say, 'I could be frugal and save $50,000, or I could enjoy myself now.'" If you spend your last $50,000 on long-term care, "You're basically helping Medicaid instead of yourself," he added.

While there's an old saying about saving for a rainy day, Shoven suspects that people feel little motivation to save for tomorrow if they believe they will be sick tomorrow and won't feel like vacationing.

"A representative sample of individuals are asked to imagine there is an even chance that they are in good or poor health at age 80," the paper said. "They are then asked to how they would allocate a $10,000 windfall between those two possibilities. Would they prefer to have all, most, some or none of the windfall in the healthy or unhealthy state? Of interest for our work is that the answers, while volatile, tended to allocate wealth between the unhealthy and healthy outcome at an approximately 1:2 ratio." A healthy day is worth twice as much as a sick day.

It's not likely, Shoven added, that low-income savers will respond to low yields by taking more risk. "The model says, 'Declining consumption is optimal, given the way the market fails to reward delayed consumption," he said. "In other words, whatever resources you have, you'll spend more in your younger years.

"We don't address the possibility that, in the face of extremely low interest rates, some people will say, 'I'll take more risk with my investments.' We didn't go into that. Typically, as people get older, they want to be in safe assets."

If correct, this paper's conclusions clash with more than one of the basic rules of thumb for retirement planning. The paper suggests that it doesn't make much sense for people in the bottom half of the income distribution to defer Social Security benefits until age 70 or to buy life annuities.

"The considerations in this paper may help to explain the lack of demand for private annuities," the authors wrote. "Spending liquid assets for annuities whose payout pattern does not correspond with optimal consumption isn't particularly attractive. It is well known that private annuity markets suffer from adverse selection [the tendency for people with long life-expectancies to buy annuities]. Adding a sub-optimal pattern of payouts [with constant rather than declining consumption] further reduces the attractiveness of annuities, especially for those in the lower part of the income distribution."

The paper's reliance on the concept of ***homo economicus***—the assumption that ordinary people think like economists—might raise the eyebrows of behavioral economists who believe that many people exhibit "irrationality" or "**bounded rationality**" when dealing with money.

"There could be a criticism of our approach in the sense that people might behave with rules of thumb rather than completely rationally," Shoven conceded. "This is a rational approach. Like a lot of economists, we assume rationality on the part of the investor. The simple, rational model that economists use doesn't argue for a constant standard of living as you age."