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Early Withdrawal Does Not Negate 401(k) Importance

The annual contribution flow to 401(k) savings programs now exceeds \$100 billion. More than 35 million workers are participating in these plans offered by their employers. In **Pre-retirement Cashouts and Foregone Retirement Saving: Implications for 401(k) Asset Accumulation** (NBER Working Paper No. 7314), NBER Research Associates **James Poterba**, **Steven Venti**, and **David Wise** consider the effect on retirement income of pre-retirement withdrawal of 401(k) assets when workers change jobs. Such "cashouts" typically reduce average 401(k) assets at age 65 by only about 5 percent, they find. This is largely because most households who are eligible for a lump sum distribution when they change jobs choose to keep their accumulated 401(k) assets in the retirement saving system. They either leave their assets in their previous employer's 401(k) plan, or they roll the assets over to another retirement saving account, such as a new 401(k) plan, or an Individual Retirement Account.

Most of those who do withdraw assets have very small accumulated balances. So, for households headed by individuals now 39 years old and reaching retirement age in 2025, the authors predict that average 401(k) balances will be between 5 and 10 times as large as they are today. For these future retirees, 401(k) balances will represent one

Predicting average 401(k) balances two or three decades into the future, the authors note, is "necessarily fraught with uncertainty." There could be systematic changes in household attitudes toward saving, or reforms of the Social Security system that alter the basic structure of financial preparation for retirement. The average retirement age could increase,

"Cashouts typically reduce average 401(k) assets at age 65 by only about 5 percent."

half to two times average "Social Security wealth" (the present actuarial value of future Social Security benefits) of \$103,400. For households with heads retiring in 2035, the authors predict that 401(k) balances will be three quarters to two-and-a-half times Social Security wealth. To place the findings in context, the authors note that the expenses charged by the financial institutions administering 401(k) plans have a larger effect in reducing 401(k) balances at retirement than pre-retirement withdrawals do.

boosting retirement assets. The authors assume that the increase in the rate of 401(k) participation will continue to rise for all age groups. Today's young and middle aged households have much higher 401(k) participation rates than current retirees did at similar ages. Those retiring in 2015 will have a participation rate 50 percent higher than those 55 years old in 1993 and retiring in the next several years, they predict.

—David R. Francis

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The Japanese Banking System is in Transition

Japanese banks are among the largest in the world, yet they are some of the least profitable. Burdened by recent bank failures and the poor performance of the economy, the Japanese banking sector is in transformation. In **The Japanese Banking Crisis: Where Did it Come From and How Will it End?** (NBER Working Paper No. 7250), **Takeo Hoshi** and **Anil Kashyap** predict a shift in Japanese banking to a new steady state. The authors suggest that there will be a substantial decline in the prominence of Japanese banks as the financial markets become as liberalized as U.S. markets.

An important force behind this transformation is deregulation, a process that began more than 20

estimates of bad loans in Japan remain large, at roughly 7 percent of GDP (several times the size of the U.S. crisis). This crisis has included the first significant Japanese bank failures since the end of the U.S. occupation of Japan. The banking problem is not just a reflection of poor performance of the economy as a whole. Hoshi and Kashyap present evidence that banks' performance was worse in the 1990s than would be expected on the basis of macroeconomic conditions. They also find that the banks most at risk of losing customers to the capital markets underperformed others. Both results indicate the importance of deregulation.

The Japanese government during the 1990s has taken steps to address the financial problems: a private loan

will start following the route already taken by the large firms and will cut their dependence on bank loans. The Japanese allocation of savings and investment financing patterns will move further towards the patterns seen in the United States. The authors present estimates showing that this impending shift implies a massive contraction in the size of the traditional banking business in Japan.

The speed of adjustment depends on three factors: how fast corporations modify their financing, how fast households shift their funds out of bank deposits, and how fast the banking industry is reorganized. The authors expect the adjustment on the corporate side to be complete within 10 years. The most significant elements of the liberalization of savers' options have started only recently, but even a modest shift in this aspect would be substantial because the savers' dependence on deposits has been extremely high.

Lastly, the speed of reorganization depends on the government policy actions toward bank failures. According to the authors, the Japanese government is taking initial steps to address the bad loans problem. Once the restructuring begins in earnest, it will take several years for doomed banks to exit, but reorganization should be complete within the 10-year period. Importantly, the recently announced mergers among several of the largest Japanese banks should only be viewed as progress if the mergers help these institutions to reduce their size: merely combining banks without eliminating redundancies will only postpone the inevitable down-sizing. Ultimately, the transition to the new regime for the banking industry should be almost complete by the end of the next decade. —Marie A. Bussing-Burks

“There will be a substantial decline in the prominence of Japanese banks as the financial markets become as liberalized as U.S. markets.”

years ago. The reform program, commonly referred to as the “Japanese Big Bang,” represents the conclusion of the deregulation process. Deregulation allowed large bank customers to quickly shift from bank financing to capital market funding. Hoshi and Kashyap show that large Japanese firms, particularly manufacturers, are now almost as independent of bank financing as comparable U.S. firms. Deregulation was less favorable for savers, and they continued to deposit their money with banks. Japanese banks were not permitted into new lines of business; consequently, their new loans primarily flowed to small businesses and expanded real estate lending. Both actions proved unprofitable.

A result was the immense banking crisis in the Japanese economy. The

purchasing company to purchase non-performing loans, the establishment of a bank to take over failed credit cooperatives, reorganization of the supervision authority for banks, and the provision of funds for bank reorganization and capitalization. Nevertheless, the authors believe that a recurring problem with the Japanese government attempts to overcome the crisis has been a lack of a clear vision for the future of the Japanese banking industry.

By 2001, when the Big Bang is complete, banks, securities houses, and other financial institutions will be competing on a level playing field. At that time, Japanese financial markets may even be less regulated than U.S. markets. Once financial deregulation is complete, the authors say that even relatively small firms

Social Security Increases Wealth Inequality

In **Simulating the Transmission of Wealth Inequality Via Bequests** (NBER Working Paper No. 7183), **Jagadeesh Gokhale, Laurence Kotlikoff, James Sefton, and Martin Weale** find two things that run contrary to popular belief. First, most U.S. inheritances may be unintended. Second, were it not for Social Security, inheritances would probably mitigate, rather than exacerbate, U.S. wealth inequality among married couples reaching retirement.

Absent Social Security, unintended inheritances can reduce wealth inequality because their receipt is random, depending on when parents pass away. But this wealth equalizing aspect of inheritances—that the parents of high income children may die late and those of low income children may die early—is undone

by Social Security. The reason is that Social Security differentially disenfranchises the children of low and middle income families from receiving inheritances. It does so by annuitizing a much larger share of the economic resources of those parents than of rich ones.

“Social Security differentially disenfranchises the children of low and middle income families from receiving inheritances.”

In addition to Social Security, other factors contribute to wealth inequality. The most important of these is inequality in lifetime earnings, because high earners will save more for retirement than low earners. A second critical factor is the degrees of assortative mating (choosing a spouse based on earnings potential), since this process exacerbates inequality in total household earnings.

The authors' analysis assumes a

life span of 88 years, divided into distinct economic and socio-demographic phases. The calculations closely approximate the degree of inequality in the actual U.S. data. For example, in the authors' calculations the richest one percent of retirement households own 32.8 percent of total

wealth, compared to an actual figure of 30.4 percent according to the Survey of Consumer Finances (SCF).

All told, the factors that the authors examine through their simulation model are capable of reproducing much of the observed wealth inequality in the United States and closely match the SCF data.

—Lester A. Picker

Corrupt Governments Receive No Less Foreign Aid

International programs to alleviate poverty include bilateral aid from rich countries to poor countries, multilateral aid from international organizations, grants below market interest rates, technical assistance, and debt forgiveness programs, such as the World Bank/IMF's Highly Indebted Poor Country initiative. The World Bank, in particular, increasingly has focused in its aid programs on issues of good governance, and on the

level of corruption among the politicians and bureaucrats of countries that receive aid.

Critics of foreign aid programs argue that aid often supports corrupt governments and inefficient bureaucracies. Supporters of foreign aid programs, on the other hand, argue that aid not only can help to reduce poverty but also is a way of rewarding good policies and honest government. A crucial question is therefore whether good governments receive more foreign aid than cor-

rupt governments. An NBER Working Paper by **Alberto Alesina** and **Beatrice Weder** shows instead that corrupt governments receive as much aid as honest ones.

In **Do Corrupt Governments Receive Less Foreign Aid?** (NBER Working Paper No. 7108), Alesina and Weder find that—based on some measures of corruption—the more corrupt the government is, the more aid it actually receives. According to no measures of corruption that they use do less corrupt govern-

ments receive more aid. Also, they conclude that there is no evidence that an increase in foreign aid reduces corruption.

In terms of bilateral donors, the researchers find that Scandinavian

aid leads to increased corruption is the most difficult to answer, Alesina and Weder find. Data on corruption are not only imperfect by their nature, but only have been collected for a large number of countries in

levels of corruption. They find no evidence that foreign aid reduces corruption levels in recipient countries.

Alesina and Weder also show that the private sector pays significantly more attention to corruption than official donors do. Foreign direct investment (FDI) flows behave differently from aid flows, because of the negative effects of corruption on investment. A low level of corruption is by no means the most important determinant of FDI flows. But these researchers conclude that, when it comes to corruption, the private sector is significantly more discriminating than official donors.

—Andrew Balls

“Based on some measures of corruption—the more corrupt the government is, the more aid it actually receives.”

countries (the most generous in per capital terms) give more aid to less corrupt governments; Australia also gives less aid to countries with high levels of corruption. The United States, in contrast, stands out for giving more aid to more corrupt governments, other things equal.

The question of whether increased

recent years. This makes it difficult to measure changes in the level of corruption following changes in the flow of aid. While warning that the results need to be treated with caution, the researchers find evidence of a weak “voracity effect” of foreign aid, meaning that countries that receive more aid tend to have higher

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