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It's Irrational to Save

By Edward C. Prescott

There is an old maxim which states that good judgment comes from experience, and experience comes from poor judgment. I think something similar can be said of government policy, to wit: Good policy comes from experience, and experience comes from poor policy.

This bit of homespun wisdom could easily apply to all sorts of government policies over time, but it has particular relevance to tax policy and, specifically, to the U.S. Social Security system. Created during the Great Depression to guarantee that no senior citizen should live in poverty, Social Security was a good idea meant to address the growing needs of elderly Americans. However, good ideas don't always equal good policy.

Social Security was developed at a time when the number of workers paying into the system greatly outnumbered those who were receiving funds, and thus the promise made by government was easily kept. But times change while policies atrophy, and Social Security has evolved into a system that places an increasingly onerous burden on the young; the ratio of workers to elderly has shifted from 41-to-1 in the 1930s, to 3-to-1 today.

Young workers today are being told that their Social Security contributions — or taxes — may have to increase to support the burgeoning elderly population. Moreover, those young workers are being warned that the same benefits will not apply to them — that they will have to work longer and receive less than the folks they are now supporting. Such are government promises, especially those grounded on ill-founded policy.

Poor policies, though, need not persist. We really can learn from experience, and we should apply that experience and new knowledge to existing policies so those original good ideas — and government promises — can be made whole. Regarding tax policy, we have learned that labor supply is not inelastic and does indeed respond to changes in tax rates. This insight, so simple and yet so powerful, has implications for all sorts of tax policies, and one policy that would greatly benefit from an application of this insight would be our Social Security tax system.

Let's return to those three young workers who have to support that one senior citizen and who may have their benefits cut back. Would such changes in tax rates and changes in government promises affect labor supply? Theory says "yes," the statistical evidence agrees, and common sense concurs. These young workers are rational. They make labor/leisure choices on the margin, and these marginal choices add up.

So what to do? How to move from a pay-as-you-go welfare system to a self-funding retirement system that benefits from individual maximizing incentives? Again, the answer begins with the insight that labor supply is responsive to tax rates. We simply cannot keep cranking up Social Security taxes with impunity. What we need to do is turn the present tax-and-transfer system into a bona fide individual retirement system that is in line with individual incentives.

In short, the answer is to establish a system of mandatory investment accounts for retirement. Why mandatory accounts? Because without mandatory savings accounts we will not solve the time inconsistency problem of people under-saving and becoming a welfare burden.

Readers of this page will recall that I have made this proposal in a previous essay, but readers may also recall a letter that questioned an assumption I made about consumer behavior. In effect, the reader asked how, on the one hand, I consider people so irrational that they have to be forced to save, and, on the other hand, I consider people rational enough to manage their own retirement accounts.

But this question reveals a misunderstanding of the time inconsistency problem. The reason we need to have mandatory retirement accounts is not because people are irrational, but precisely because they are perfectly rational — they know exactly what they are doing. If, for example, somebody knows that they will be cared for in old age — even if they don't save a nickel — then what is their incentive to save that nickel? Wouldn't it be rational to spend that nickel instead?

So, indeed, people are acting rationally when they choose not to save. We have rational people making choices based on the rules. The trick is to get the rules right. A mandatory retirement system, properly designed, would establish effective rules. I have given additional thought to those rules, and won't take the time here to describe a new program, but suffice to say that such a proposal might involve graduated input to a retirement program that would offer investment choices. The reason for graduated input is because young workers often need their limited resources to "get started" in their adult lives; that is, they may need to make investments in human capital, like education or families, or to finance a home or a car.

Shouldn't we be worried, though, about people making bad choices with these retirement accounts and gambling all their savings on risky stocks, thereby making them wards of the state anyway? We should be no more worried about this happening then we are worried about federal workers gambling away their Thrift Plans. The reason we don't worry about federal workers playing roulette with their retirement accounts is that we don't let them — we have designed a system that allows individuals to make reasoned choices based on relatively conservative indexed options. The notion that people will be gambling away their retirement accounts on risky individual stocks is a red herring. People could make riskier choices with other investment resources; such "gambling" would simply not be an option under a rebuilt Social Security program.

The same holds true for that other red herring — that individual retirement accounts will simply line the pockets of Wall Street financial firms eager to charge exorbitant transaction fees to unsuspecting rubes. Again, we need look no further than the federal government's own Thrift Plan to see a low-fee retirement plan with conservative indexed options. And by the way, another benefit of these plans is that they allow people to manage their accounts online.

These examples illustrate another problem: No sooner did talk get serious about fixing Social Security in recent weeks than the political boo-birds went to work scaring people away from new ideas. It's rare to open a newspaper editorial page these days and not find some Cassandra screeching about evil policy-makers and cranky politicians who are trying to destroy Social Security. Why a politician from any party would want to intentionally destroy a retirement program meant to benefit the elderly is beyond me. Such political claptrap makes me glad I'm an economist. Granted, politics is a game with its own rules and incentives, and people will rationally play by those rules for political gain, but such political role-playing certainly complicates matters, at best, and makes for bad policy, at worst.

Maybe one way to help avoid ad hominem attacks and political labeling would be to recast the Social Security question from one of reform to one of reconstruction. Let's stop talking about reforming Social Security — let's rebuild it. In other words, if we could wipe the slate clean, what kind of government retirement program would we build from scratch today? It's one thing to snipe at new proposals, but it takes a plan to beat a plan, and I'm willing to bet that the best minds of both political parties, given such a charge, would not come up with a government retirement program as it currently exists.

We have had a lot of experience with our current Social Security system, and we have had a lot of experience with other tax programs. We also have new insights into the effect of tax rates on labor supply. As that old maxim suggests, it's time we put that experience and insight to use and make good policy. ■

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(See related letters: *"Letters to the Editor: A Discredited Relic Of the Statist Age" — WSJ* Jan. 7, 2004)