Mandated Saving and the Fallacy of Aggregation

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Social security promises more than current taxes can deliver. Because social security spends tax collections almost immediately, rather than putting them aside to fund future retirement costs, it is believed by many to reduce net national saving at a time when other private and public saving are considered too low. This low savings rate coincides with a matured private pension system that does not provide much in the way of benefits for about half the population. These considerations have led many, including myself, to consider whether government ought to mandate that deposits be made to private saving accounts.

Think of the social security tax as nothing more than a mandate to make deposits to a retirement fund, except that for the most part deposits are immediately spent on current retirees. Suppose now that we were to adopt a mandate that forced saving to be put aside for the future rather than spent immediately. In the simplest case, individuals would treat these mandated savings as similar to deposits to a government thrift account or an individual retirement account. In a more complex case, the money might be used to build up the social security trust funds much more than under current law.

This type of mandated saving can take many forms. The money might come out of the existing social security tax, or a new mandate might be added on to the existing tax. Benefits to future retirees under the current, mainly unfunded, social security system would also likely be changed. And so on. Here I wish to concentrate on one of the most basic and fundamental issues, but one that often is glossed over: will this type of mandate increase net saving in the first place?

The answer is that the mandate probably will increase net societal saving, but by substantially less than the amount collected under the mandate. Many discussions of mandates and of "privatization" of social security fail to make the distinction between changes in gross deposits and additions to net saving. They fall prey to what I call the "fallacy of aggregation." Under the fallacy of aggregation, one assumes that every additional dollar put into some account or fund increases net societal saving by the same amount.

In point of fact, there are strong theoretical, as well empirical, reasons to believe that this type of simple aggregation is unlikely. How do analysts, including many highly trained economists, fall prey to this fallacy? Well, they make the simple assumption that "all other saving behavior does not change." If you or I put additional money into a mandated account, they assume that we simply consume less to pay for the mandate. Or if government puts aside another dollar into a fund, then it won't change its other spending and taxing decisions, while we, the public, will not change our own saving in response to the new government activity.

Suppose that an individual is required to make deposits to a retirement saving account. For instance, 5 percent of pay might be required as deposits to a social security supplementary account. One of the first reactions that we might expect from an employee subject to this mandate is that she would adjust other retirement saving to take account of the mandate. For instance, if she were putting 5 percent of pay into retirement saving -- say, a 401(k) plan -- then she might easily treat the 5 percent mandate as simply an alternative way of making the same deposit. In this case, one type of saving account simply substitutes for another one.

A change in deposits to other employee retirement saving accounts, therefore, is the first and most easily identifiable adjustment to a new mandate. The issue gets more complex when dealing with employer plans that promise benefits related to final pay of the employee, but do not keep separate individual accounts for each employee. Here individuals save indirectly by receiving lower wages to help pay for these employer pension funds. Such employer "defined benefit" plans have developed over the years as a consequence of many types of considerations: the desire of the employer to ensure that individuals have income in retirement; the pressure of unions and other employee groups to receive compensation in the form of

employee benefits; plan amendments to integrate more closely with social security laws; and so on.

Despite the multiple forces affecting the design of these employer pension plans, reductions in pension deposits and benefits are still a likely reaction to a new mandate. If the plan is set up to reach a given target level of saving by retirement, for instance, that target is now easier with the mandate. Many plans might be amended to take into account income available from mandated saving accounts. Perhaps even more important, a new mandate threatens to immediately reduce the take-home pay of employees. If they still demand the same cash pay as before, then employee benefits must fall to make up the difference. In other words, the money for the mandate must come from somewhere -- and much of it is likely to come from those types of saving that are the closest substitutes for the mandate itself.

The fallacy of aggregation, however, goes deeper. A new mandate may not cause you or me to adjust our saving, but that still doesn't mean that societal saving increases. If you don't believe me, just look in your wallet or purse at all those credit cards that weren't there two or three decades ago. Consider also all the "secondary" mortgages now available. Net mortgage borrowing -- the increase in mortgage borrowing in society -- has grown considerably relative to the amount of net new housing investment. All of this borrowing comes from somewhere -- namely the gross saving and gross deposits made by depositors in society. Indeed, mortgage and credit borrowing has been made possible in part by the growth in private pension deposits in society. Net investment, however, has not tended to increase by the same amount as past increases in net private pension saving.

A few years ago, I analyzed government saving behavior as well. In the first couple of decades after World War II, federal debt was falling rapidly relative to the size of the economy. At the same time, private borrowing took off -- without large increases in net saving and investment in the economy. As government saved more and borrowed less in private markets, the deposits of individuals became increasingly available to other private borrowers. Those borrowers included both investors and consumers.

Finally, even if new gross deposits to individual saving accounts or government funds initially do increase net saving, the long-term effect is still uncertain. In general, additional saving in society yields additional returns down the road, but those returns are shared by both labor and capital. Indeed, the ratio of total returns to capital and total returns to labor shows a remarkable constancy over time even when saving rates differ. Much of the gains to new saving are garnered by labor because more capital makes labor more productive, but labor often will decide to spend most of the returns that it receives. Meanwhile, the rate of return to all saving is liable to fall, which, in turn, may feed back to reduce incentives to save and offset some of the initial gains in saving.

As the debate over privatization and mandated saving takes off, therefore, watch out for the fallacy of aggregation. There is a number of good reasons to favor mandated saving, but one should not exaggerate the extent to which it will increase net saving in society.

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