MISDIRECTION OF LABOR AND CAPITAL UNDER SOCIAL SECURITY

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I. Introduction

There can be no doubt that during the four and a half decades of its existence the Social Security program has had a dramatic influence on the allocation of capital and labor resources. The present paper deals with factor-market distortions caused by the program itself and with the potential distortions that may be caused by Social Security reform. As a means of keeping the subject matter manageable, the discussion will be limited to the oldest function of the Social Security program—the provision of retirement income. Limiting the discussion in this way should not be taken to imply that the other functions, which include the provision of disability and health insurance, have had allocational influences less worthy of our attention. The complexity of the Social Security program simply puts a comprehensive treatment out of reach.

The present treatment of the effects of the Social Security program draws heavily on the insights of the Austrian School.[1] Because of its emphasis on the intertemporal allocation of resources, its focus on individuals rather than on aggregate magnitudes, and its attention to the effects of uncertainties, this particular school of thought provides an appropriate framework. The following sections deal with each of these issues as they apply to the Social Security program. Section II

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[1]In recent years the term "Austrian School" has come to mean many things. It is intended here to refer to the views and insights best explicated by Ludwig von Mises, F. A. Hayek, and Murray N. Rothbard. See Ludwig von Mises, *Human Action: A Treatise on Economics*, 3d rev. ed. (Chicago: Henry Regnery Company, 1966); F. A. Hayek, *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948); and Murray N. Rothbard, *Man, Economy, and State: A Treatise on Economic Principles*, 2 vols. (Los Angeles: Nash Publishing, 1970).

distinguishes the Austrian analysis of intertemporal allocation from its neoclassical and classical counterparts. Section III argues the particular appropriateness of the Austrian approach for evaluating not only the Social Security program itself but also the proposed reforms. Because the general effect that Social Security has on the rate of saving is widely understood, the analysis is shifted at this point to focus on the allocational effects of proposed Social Security reform. Section IV calls into question the proposed special tax considerations for retirement savings. Section V argues that a tax-exempt status for retirement savings should be defended on strategic rather than strictly economic grounds. Section VI returns to the main theme of the paper and identifies distortions in capital and labor markets—distortions typically obscured by analyses that focus on aggregate magnitudes, and section VII identifies further distortions associated with uncertainties caused by Social Security. A summary assessment is provided in section VIII.

II. Time Preferences and Capital Productivity

Economists writing in the Austrian tradition deal with intertemporal aspects of resource allocation by focusing on the underlying time preferences of market participants.[2] Analysis based squarely on considerations of time preference differs from standard neoclassical analysis in terms of the respective levels of abstraction: Austrian analysis is one level more abstract than its neoclassical counterpart. And as it turns out, this difference is not inconsequential. The increased level of abstraction allows us to avoid certain analytical errors common in neoclassical theory (even more common in classical theory) and provides a sounder basis for discussions of policy and strategy.

Neoclassical economists take account of the time dimension by focusing on the market for loanable funds. The supply of loanable funds is rightly seen as a reflection of the time preferences of individual savers. The demand for loanable funds is seen as a reflection of the expected rate of return on capital. This view of the demand side of the loanable-funds market, which has some validity under restrictive assumptions,[3] masks more than it reveals. From the Austrian perspective, the demand for loanable funds is just as much a reflection of the time preferences of market participants as the supply is. The current prices of capital goods and of other factors of produc-

[2]Von Mises, pp. 483–90 and passim; also Rothbard, vol. 1, pp. 323–32.

[3]Taking the demand price in the loanable-funds market as a measure of the return on capital assumes away the heterogeneity and specificity of capital goods. Section VI suggests how such simplifying assumptions can lead to erroneous conclusions.

tion in relation to the expected market value of the consumption goods to be produced by these factors are themselves determined by time preferences. The higher (lower) the time preferences of market participants, the lower (higher) the prices of the factors of production that can yield consumption goods in the relatively remote future. The so-called normal rate of return on capital owes its very existence to this factor-price discounting due to time preference.

Further, the demand for loanable funds is not exhausted by the demand for capital—even if the concept of capital is broadened to include land and human capital. Some individuals borrow funds for the purpose of consumption spending. This component of the demand for loanable funds is clearly rooted in considerations of time preference. In the neoclassical formulation, the demand for consumer loans does not integrate well with the rest of the theory. Therefore, this component of demand is either ignored or netted out of the supply side of the loanable-funds market. In the Austrian formulation, all components of demand—whether registered by investors or by consumers—are reflections of time preferences and can be analyzed on this common basis.

The recognition that time preferences underlie both sides of the market for loanable funds helps avoid a biased view of the trade-offs and choices between consumption and investment spending. The ultimate purpose of all production is consumption. This is a fundamental economic truth that has to be recognized by economists of all stripes. Production is the means, and consumption is the end. Accordingly, the activity of production cannot be considered more important or more valuable or more virtuous than the ultimate consumption that this production makes possible. The demand for future consumption creates a demand for present investment. The interaction of supply and demand in the market for loanable funds (and in other intertemporal markets) will determine the particular terms of trade between present and future consumption. The intertemporal terms of trade are summarily expressed by the rate of interest. The market rate of interest is simply the rate at which the production activities in the economy are most closely coordinated with the preferred time pattern of consumption activities.

With this view of the relationship between production and consumption, the Austrian economist is not inclined to favor a particularly high rate of return on capital or otherwise to encourage the activity of production over consumption. The only rate of return on capital and (more broadly speaking) the only rate of interest that is consistent with the efficient allocation of resources is the market rate—the one rate that can emerge without the favor or encouragement of the economist.

The common view that policy should favor investment and capital formation has its roots in the writings of the classical economists, particularly Adam Smith, who distinguished between what he called productive and nonproductive labor.[4] Nonproductive labor is labor that immediately yields consumption services of some kind. Productive labor is labor that adds to the accumulation of capital. There is no problem with categorizing labor in this way as long as it is realized that the definitions of the two categories are purely stipulative. But "productive" and "nonproductive" are value-laden terms. It is too easy to fall into the trap of believing that productive labor is inherently or necessarily more valuable than nonproductive labor and that the former should be encouraged at the expense of the latter.

Such beliefs would certainly be in error. Both categories of labor are aimed at making consumption possible. The only substantive difference is the timing of the consumption activity in relation to the employment of the labor. Nonproductive labor permits immediate consumption; productive labor permits consumption in the future. Left to its own devices, the market will divide labor into the productive and nonproductive categories in such a way that the value of present consumption and the *discounted* value of future consumption are equal at the margin. There is no basis for judging this result to be less than optimal or for recommending policies that would bias the market outcome in favor of future consumption.

In neoclassical theory, the classical distinction between the two categories of labor is dropped, but a potential bias in favor of future consumption is maintained in the treatment of capital. It is easy to fall into the trap of believing that capital is inherently productive and that capital has a positive real rate of return simply by virtue of being capital. There is the temptation to believe that policies should be pursued that will increase the real rate of return on capital or increase the level of savings so as to take fuller advantage of a given rate of return. Such traps and temptations are a result of the failure to identify the source of the productivity of capital.[5] Accumulation of capital permits future consumption. Because of time preferences, the

[4]Adam Smith, *The Wealth of Nations*, Modern Library edition (New York: Random House, Inc., 1937), pp. 314–32.

[5]Exposing the fallacies of the productivity theories is one of the accomplishments of the Austrian School. But one of the earliest and clearest treatments of this issue is found in Frank A. Fetter, "Interest Theories, Old and New," *American Economic Review* 4 (March 1914), reprinted in Fetter, *Capital, Interest, and Rent* (Kansas City: Sheed, Andrews, and McMeel, Inc., 1977), pp. 226–55.

value of the capital is discounted with respect to the future consumption activities that the capital makes possible. The higher spot value of the future consumption activities in relation to the value of the corresponding capital may be misleadingly attributed to the capital itself, and accordingly capital may be seen as being productive in the value-laden sense.

III. Pro- and Anti-Accumulation Biases

If our current Social Security program were based on the classical vision of the economy, it might well have been designed to encourage an artificially high rate of capital accumulation. Had neoclassical theory served as the basis for the design of the program, a pro-accumulation bias might still have been present. But the Social Security program was designed at the same time that the Keynesian vision was beginning to have its effect on policy formulation. Whether or not it was consciously based on Keynesian theory, this program—along with many other Keynesian policies that were being implemented during the same period—had a strong anti-accumulation bias. By providing retirement income on a pay-as-you-go basis, the Social Security program discourages saving, which of course is the prerequisite for capital accumulation.

Fortunately, this anti-accumulation bias is now recognized by practically all economists who deal with the Social Security issue. Unfortunately, the Social Security reforms being proposed contain biases of their own. Patchwork reforms, such as those recently enacted by the present administration, accept the anti-accumulation bias in the present system and seek only to stave off the day when the inherent problems will have to be dealt with in a more serious manner. Fundamental reforms, such as those discussed and proposed by Peter Ferrara,[6] tend to go beyond the elimination of the anti-accumulation bias and establish a pro-accumulation bias instead. As suggested above, this overreaction may be the result of the biases in classical and to a lesser extent neoclassical theory. Austrian theory, which focuses directly on time preferences as they affect the intertemporal choices of market participants, invites neither an anti-accumulation nor a pro-accumulation bias. It is this unbiasedness that makes Austrian theory particularly suitable for criticizing both the Social Security program and the proposed reforms.

It is not difficult to identify the general anti-accumulation bias in the present Social Security program. Nor is it necessary to dwell for

[6]Peter J. Ferrara, *Social Security: The Inherent Contradiction* (San Francisco: Cato Institute, 1980).

long on this particular perversity. The bias is becoming more and more obvious as the program matures. Social Security withholdings, coupled with the employer's contribution, create the illusion of savings from the perspective of the individual taxpayer. The resulting false sense of security virtually ensures that individuals will not engage in as much genuine saving as they would have in the absence of the program. (Also, their disposable incomes, having been reduced by the lion's share of both the employee's and the employer's contribution, may not permit much genuine savings.) The pay-as-you-go feature of Social Security ensures that what appears to be savings from the individual perspective is in fact not savings for the economy as a whole. This absence of savings, of course, means an absence of resources with which investments can be undertaken and capital can be accumulated—hence the anti-accumulation bias.

Those who favor fundamental reform of Social Security are acutely aware of this anti-accumulation bias and of the need to eliminate it. The most straightforward means of unbiasing the system is to bring about a transition from the coercive, government-directed, pay-as-you-go program to a voluntary, market-directed, fully funded system. (If this transition were to be made, the resulting solution would constitute a "system" only in the sense that the market mechanisms that facilitate the provision of any category of goods or services constitute a "system.") But many reformers want to go a step beyond this transition. They want to give special tax considerations to all funds that are saved for retirement purposes and to interest income that is earned on those funds.[7] This extra step (apart from the strategic considerations to be considered below) has little to recommend it. If actually adopted, reforms of this sort would induce a pro-accumulation bias with the potential to create distortions that would rival the distortions created by the present system.

IV. The Economics of Tax-Exempt Retirement Savings

Most proposals for fundamental reform of the Social Security program include the provision that the funds saved privately for the purpose of retirement, along with interest earnings that accrue to those funds, be given a tax-exempt status. This provision for tax-exempt retirement savings may turn out to be a desirable feature of Social Security reform. Indeed, it may turn out to be a necessary feature—given the current plight of the existing program. But if so,

[7]A number of specific reform proposals are described in Ferrara, pp. 311–50.

the desirability or necessity of this feature will have to be based on strategic considerations and not on considerations of economic efficiency. Thus, the arguments below that such a tax provision cannot be based on sound economic reasoning are followed by a discussion of the strategic advantages (and disadvantages) of retaining this provision in reform proposals.

If a tax-exempt status for retirement savings could be taken to imply that the total amount of taxes collected by the government would be reduced by the tax revenues that would otherwise have been generated by these savings, the analysis would be more favorable to the tax exemption. Undoubtedly, gains associated with a total decrease in the tax take would more than offset the efficiency losses associated with the particular way in which the tax is taken. But the assumption that total tax revenues would be allowed to fall as a fortuitous result of Social Security reform is naive and unwarranted. It is more reasonable to assume that revenue losses to the government would be made up soon, if not immediately, by raising tax rates elsewhere. The most likely target of a compensating tax hike would be wages and salaries *not* used for purposes of providing a retirement income. If the total amount of taxes collected remains constant, the analysis must focus exclusively on the effects of the particular way in which they are collected. Adopting this perspective causes the analysis to turn against the tax exemption.

With the assumption of a constant tax take, the popular arguments in favor of tax-exempt retirement funds begin to lose their appeal. The argument is made, for instance, that individuals should receive the "full value" of the returns to investment made possible by the retirement funds.[8] But wage and salary earners who use their entire incomes to meet current expenses (or who simply choose not to save now for their retirement years) do not receive the "full value" of their labor. And if the tax rate on this category of income is increased so as to maintain the level of tax revenues, the discrepancy between the full value and the value received will be even greater. Karl Marx believed that labor income is inherently more meritorious than interest income. This belief, of course, is in error, but so is the converse. Taxes cause both laborers and savers to receive less than the full value of the production that they make possible, but there is no sound economic basis for increasing the value discrepancy for one category of income in order to decrease it for the other.

The case for the special tax considerations is further weakened by the fact that savings for purposes of retirement are to be treated

[8] Ferrara, p. 381.

differently from savings for other purposes. This differential tax treatment based on the particular purpose of savings has no basis in economic theory of any kind.[9] Should a 60-year-old individual who commits his savings to a retirement account be taxed at a different rate than a 25-year-old who is willing to have his savings tied up for 20 years (but not longer)? Recasting the distinction in terms of the duration of the savings commitment does not make it any more palatable. There is nothing inherently meritorious about making a 20-year savings commitment instead of a 5-year commitment. The market will see to it that interest is paid during the full duration of the commitment, whether long or short. And if the market has a special urgency for long-term funds over short-term funds or vice versa, the term structure of interest rates, determined by the forces of supply and demand in the loan market, will fully reflect both the direction and the intensity of the urgency. There is simply no need in this case for any special tax considerations.

The demonstration that neither the purpose-based distinction nor the term-based distinction finds any support in economic theory may cause some reformers to suggest that all savings be tax exempt, whatever the purpose and whatever the duration of the savings commitment. This modification would certainly eliminate the groundless purpose-based distinction incorporated in many proposals for Social Security reform. (And again, if such a tax exemption could be taken to imply a lower total tax take, there would be much to recommend it.) But to institute an exemption for all savings is simply to transform the income tax into a consumption tax. Those who actually believe that a consumption tax is to be preferred to an income tax should advance arguments that directly support this belief. Ultimately, the issue of which magnitude (income or consumption spending) is the more appropriate tax base cannot be resolved by appealing to economic theory. If one of these two possible tax bases is taken to be the appropriate one, then adopting the other will be seen as a source of economic distortions. The use of either tax base leads to economic distortions in relation to a third alternative in which both savings and consumption spending are tax exempt. And there are no theoretical grounds for preferring the distortions associated with one tax base over those associated with the other.

Finally, there may be a belief lying just below the surface of the arguments in favor of tax-exempt retirement savings that a

[9]Ferrara minimizes the administrative difficulties in establishing the tax status of various kinds of savings accounts, but he fails to make a theoretically sound case for the purpose-based distinction. See Ferrara, p. 358.

pro-accumulation bias is needed to help make up for the anti-accumulation bias the economy has suffered under Social Security. This belief, of course, is unfounded. It requires such a holistic view of society as to transcend both time and the individuals that make up the society. It is as if there were a goal of having some definite stock of capital at some definite date in the distant future. The economy is running behind in its progress toward that goal because of the Social Security program. Therefore, a pro-accumulation bias is needed so that the economy can make up for lost time. Surely to plainly state this belief is to discredit it. Nearly 40 years of an anti-accumulation bias can in no meaningful sense be undone by 40 years (or an infinity) of pro-accumulation bias. When the preferences of different individuals whose lives span different periods of time are appropriately taken into account, the perverse effects of the anti- and then pro-accumulation biases are seen to be compounding rather than counteracting.

Arguments based on this holistic view of society can be modified so as to apply only to the transition phase—the period of time during which Social Security is being phased out and private retirement funds are being accumulated. The one or two generations who work during this transition period must bear a double burden. They must make good on the existing obligations to which the Social Security program is committed and at the same time provide in full for their own retirement. The pro-accumulation bias created by special tax considerations may be needed to stimulate a rate of saving sufficiently high to serve both ends simultaneously. (This view implies that the government engages in heavy borrowing during the transition phase in order to pay Social Security recipients.) But if the purpose of the pro-accumulation bias is to "get us over the hump," the special tax considerations should be proposed as an interim feature of Social Security reform.

Looking behind the supply-and-demand analysis of the loan market and focusing directly on the time preferences of individuals clearly reveals the perversities of the pro-accumulation bias. As Ferrara makes clear, the tax exemptions advocated by him and other reformers would greatly increase the rate of saving. Workers earning modest incomes may have the incentive to save a million dollars or more during their working years.[10] It is difficult to believe that the true time preferences of such workers are consistent with either postponing this much consumption activity to the period beyond the 65th birthday or bequeathing a million dollars to their children. The

[10]Ferrara, pp. 141–48.

extreme future orientation of consumption activity is bound to be inferior (in the eyes of the modest-income earner) to an orientation that would have allowed for more consumption activity during the working years. The pro-accumulation bias causes workers to choose otherwise-inferior future consumption over present consumption. The extent of this inferiority constitutes the real costs of the pro-accumulation bias. And there are no economic gains to offset these costs.

V. The Strategy of Tax Exemptions

Economic analysis of the proposed Social Security reforms identifies a pro-accumulation bias in the tax-related features of the proposals. Such analysis argues against a tax exemption for retirement funds—a position that runs counter to the very spirit of Social Security reform. If economic efficiency, narrowly conceived, were the sole criterion for judging reform proposals, the spirit would simply have to yield. But reformers cannot allow themselves to be guided by considerations of economic efficiency alone. The current entrenchment of the Social Security program—an entrenchment that is itself in no way based on sound economic reasoning—requires that strategic considerations play a large role in Social Security reform. Two strategic arguments can be offered in favor of a tax exemption for retirement funds. Although both arguments identify perversities that partially offset the strategic gains, it is likely that the net strategic gains will outweigh the efficiency losses.

Ferrara proposes that current participants in the Social Security program who are under 40 years of age be allowed to opt out of the program.[11] Opting out would mean that the worker would pay no more Social Security taxes and would receive no retirement benefits. But it would also require the worker to write off all the Social Security taxes already paid as a complete loss. While the opting-out provision would be gleefully welcomed by the workers who are already aware of the program's fraudulence and bankruptcy, it would be a bombshell for those who are unaware. It would require that these workers suddenly be made aware of the true nature of the program and of the tremendous costs that the program has imposed upon them. This aspect of the Ferrara proposal may make it politically unattractive. As argued below, the tax exemption for retirement savings, which is an integral part of the Ferrara reform proposal, may by itself be a means of achieving the goals of the proposal. As usual, the increased political feasibility of this alternative strategy comes at a cost.

[11]Ferrara, p. 377.

Tax-exempt individual retirement accounts (IRAs) and Keogh accounts, which are currently available to retirement-conscious savers, are likely to result in a de facto but only partial opting out. These accounts may constitute a de facto opting out simply because the Social Security program cannot possibly make good on all present promises. It is most likely to renege in the cases in which individuals have made alternative provisions for their own retirement, such as by accumulating funds in an IRA or Keogh account. (A movement in this direction is already under way. The recent reforms make half of an individual's Social Security benefits subject to federal income tax when total income, which includes withdrawals from IRAs and Keogh accounts, exceeds a certain level. It is not difficult to predict that there will be a sequence of reforms in which the "half" is changed to "all," in which a penalty is instituted whereby the retiree forgoes one dollar of Social Security benefits for every two dollars withdrawn from private retirement accounts, and finally in which all retirees who have deposits in such accounts above a certain amount are ineligible for any Social Security benefits.) The opting-out is only partial because it affects only the benefit side of the program. The worker cannot opt out of paying into Social Security for the remainder of his working life.

The opting-out plan suggested by Ferrara makes a distinction between workers under age 40 and workers 40 years of age and older. The partial and de facto opting-out, suggested above as a likely eventuality, makes the distinction between workers who are currently sensitized to the fraudulence and bankruptcy of the Social Security program and are farsighted enough to provide for their own retirement and workers who are now oblivious to the true nature of Social Security. In effect, the tax-exempt IRA and Keogh plans will encourage prudent and farsighted individuals to save for retirement and thereby release Social Security funds that can then pay retirement benefits to imprudent and shortsighted individuals. To the extent that taxpayers foresee the government's selective reneging, there may be a dilemma for those who are now deciding whether or not to begin depositing their retirement savings in IRA or Keogh accounts. But apart from such gaming considerations, special tax treatment for such accounts will ensure that the costs of Social Security reform are borne by those who have the clearest understanding of why reform is so necessary. A tax exemption that leads to these results cannot be defended on grounds of economic efficiency. It certainly cannot be defended on equity grounds. (It should be pointed out that *predicting* that the government will renege on its promises does not imply an *endorsement* of such dishonest policies.) But at this late date, considerations of strategy may be overriding. Although the tax exemption is likely to result in an inefficient and inequitable resolution of the current Social Security crisis, it may be the only way to ensure that the eventual and inevitable reneging by the government does not result in an even greater crisis.

A second argument favoring the tax exemption on strategic grounds can be based on broader political considerations. A tax exemption for retirement savings—or for anything else—reduces the size of the tax base. It causes the government to increase the tax rate on activities that are not tax exempt, so as to maintain constant tax revenues. The rate increase has to be more than proportional to the initial shrinkage of the base, to compensate for tax-induced quantity adjustments in market activity; and the rate increase has to be greater still if government revenues are to grow. In short, tax exemptions concentrate and magnify the forces of tax opposition. As the number of tax exemptions and tax credits grows, the assumption that the total tax revenues can and will remain the same as before becomes more and more untenable. A small tax base with high tax rates is likely to give rise to a politically effective movement aimed at reducing the amount of taxes collected. While the tax-induced political process that may bring about a reduction in taxes is fraught with inefficiencies and inequities, the result may be preferable on both efficiency and equity grounds. It should be noted that these considerations of strategy have implications that transcend Social Security reform. They argue against broadening the tax base as the current supporters of the flat tax would have it, and they favor a tax exemption for retirement savings, for all other savings, and for practically anything else.

VI. Distortions Obscured by Aggregates

The Austrian School, because of its direct focus on the issue of individual time preferences, provides a sound basis for assessing the intertemporal biases of both the Social Security program and proposed reforms. Another feature of Austrian theory—its tendency to theorize at lower levels of aggregation in relation to classical and neoclassical theory—provides further insights into the misdirection of labor and capital brought about by Social Security.[12] These insights can best be put in context by reviewing the controversy about the effects of Social Security on the rate of saving.

[12]The advantages of theorizing in terms of individuals instead of marketwide aggregates are emphasized by the articles collected in Hayek, *Individualism and Economic Order*.

Martin Feldstein argues that the Social Security program tends to decrease the rate of saving.[13] The retirement income provided by Social Security on a pay-as-you-go basis reduces the incentives for individuals to fund their own retirement income through genuine saving. The government's promise to pay retirement is a good substitute—from the perspective of some individuals—for financial assets capable of yielding a similar income. This asset-substitution effect, as it has come to be called, is suggested by the most straightforward application of standard price theory.

Alicia H. Munnell has argued that some features of Social Security may actually stimulate the rate of saving.[14] Social Security provides an opportunity for early retirement but does not by itself provide a level of retirement income that would make early retirement attractive. Individuals who view the program in this way have an incentive to save more during the years that they remain in the labor force in order to be able to pad their retirement incomes. This so-called retirement effect, which is a theoretical possibility, is directly analogous to the income effect in standard price theory.

As is often the case in the application of standard price theory, two possible effects are identified and are shown to work in opposite directions. Social Security gives rise to an asset-substitution effect that decreases the rate of saving and simultaneously gives rise to a retirement effect that increases the rate of saving. The net effect on the rate of saving becomes an empirical question that must be answered by employing econometric techniques to measure the relative strengths of the two effects. It may turn out, of course, that the two effects are equally strong and Social Security is seen as having no effect at all on the rate of saving. In his treatment of this issue, Ferrara steers clear of the thorny empirical issues and offers instead a number of plausible reasons for believing that the substitution effect greatly outweighs the income effect.[15]

In the context of an analysis focused on the aggregate concept of saving, Ferrara's arguments and conclusions are satisfying. But if saving is disaggregated into its many manifestations, it becomes apparent that the two effects—even if they work in opposite directions, broadly speaking—do not cancel one another out. The very notion of a net effect is misleading. Each effect gives rise to its own

[13]Martin Feldstein, "Toward a Reform of Social Security," *The Public Interest* (Summer 1975), pp. 82–83.

[14]Alicia H. Munnell, "The Impact of Social Security on Personal Savings," *National Tax Journal* 27 (December 1974): 553–67.

[15]Ferrara, pp. 89 ff.

distortions of each individual's consumption pattern. The corresponding distortions in labor and capital markets are in no way offsetting. In an assessment of the inefficiencies of Social Security, these two effects should be added, not subtracted, regardless of what the "general direction" of each effect is determined to be. The correctness of combining the two effects in this manner should become apparent when the level of aggregation is reduced.

Consider two workers, Homer and Melvin, each reacting to the Social Security program in a different way. Homer is content with the retirement income that his government has promised him. Choosing to save very little of his after-tax income, he spends almost all of his income on consumption goods. Melvin, faced with the same opportunities, chooses to spend less on consumption goods during his working years. This choice allows him to retire early and enjoy a relatively high level of income consisting of Social Security payments plus the yield from his accumulated savings. Homer and Melvin have adopted consumption patterns that are different from those they would have adopted in the absence of the Social Security program. These altered consumption patterns give rise to corresponding alterations in the allocation of capital and labor. During the working years, labor and capital are allocated away from the production of the consumer goods that Melvin would have purchased and toward the production of consumer goods of the type purchased by Homer. After the two men retire, labor and capital are allocated away from the production of goods that Homer could have purchased had he provided for his own retirement and toward the production of goods of the type purchased by Melvin. These sequential effects on factor markets will cancel each other out only in the unlikely event that the particular goods forgone by Melvin (Homer) and purchased by Homer (Melvin) are the very same goods. This coincidence would be unlikely for any two individuals—but it is all the more unlikely for two individuals with such radically different time preferences.

Seasoned neoclassical price theorists are comfortable with the assumption of "homothetic indifference curves," which is a formal way of assuming the unlikely coincidence just mentioned. Making this assumption allows neoclassical analysis to ignore the particular manifestations of savings (the embodiment of savings in individual capital goods of all sorts) and to focus on savings as a single magnitude. Austrian analysis highlights the very differences that neoclassical analysis obscures. And by its doing so, the practice of treating the difference between the substitution effect and the income effect (in the context of Social Security or in any other context) as a net magnitude is called into question. The "net effect" obscures and understates what is more accurately viewed as a compounding of effects.

The Austrian view is reinforced by an assessment of the effects of Social Security on economic welfare. Both Homer and Melvin are worse off under Social Security than if they had been allowed to provide fully for their own retirement years. This conclusion is firmly established by Ferrara. The reduction in the welfare of both workers takes the form of alterations in their patterns of consumption spending and hence alters the particular manifestations of their savings. Any analysis that focuses on the issue of savings should seek to identify the harm done to both workers and should not suggest or imply that the harm done to one is in any way offset by the harm done to the other.

VII. Distortions Induced by Uncertainties

Compounding the general anti-accumulation bias of Social Security and the misdirection of the capital that is accumulated are further distortions in markets for capital goods—distortions associated with the uncertainties that surround the future of the Social Security program itself. Distortions identified by focusing directly on the time preferences of workers and distortions identified by adopting a less aggregative framework of analysis would characterize the Social Security program even if it were set up as a *sustainable* pay-as-you-go retirement program. But of course, the system as it now exists is not sustainable. Uncertainties about when it will collapse or about how and when it will be changed in order to stave off the collapse have their own effects on the current allocation of resources.

The general nature of these further distortions is most easily seen if it is assumed that the government makes good on its current promises for as long as it possibly can (by raising Social Security taxes and drawing from general revenues). It is further assumed that when the threat of a tax revolt becomes imminent and the prospects of continuing Social Security payments become dim, the Social Security system is allowed to collapse. Retirement incomes then fall to a small fraction of their previous level and consumption spending undergoes a corresponding change. Even if this collapse is predicted to be the eventual fate of the Social Security program, the uncertainty about the timing of the collapse would adversely affect markets for capital goods. Capital must be embodied in particular kinds of capital goods that produce particular kinds of consumption goods. But what particular kinds of consumption goods will be in demand depends to a large extent on the incomes of the different categories of consumers.

A sharp drop in retirement incomes will cause a restructuring of consumer demand and will require a corresponding change in the structure of capital goods. Unless both the collapse itself and the exact timing of the collapse are fully anticipated, the employment of capital both before and after the collapse will be less than optimal. Before the collapse, there will be a hesitancy to invest in the kinds of capital goods that produce the consumer goods and services that are demanded primarily by retirees. After the collapse, these kinds of capital goods will be in excess supply. Building up retirement communities, for instance, involves the kinds of capital that would be affected in this way. Capital withheld from such projects because of the anticipated collapse may be committed to other lines of production or may be held in liquid form. Capital that suffers a loss of value because of the collapse may be put to second-best uses or abandoned altogether. In any case, the uncertainty about the timing of the collapse means that the level and pattern of production under the assumptions set forth above are inferior to what they could otherwise be.

Distortions in the market for capital goods are reflected by the market for labor. There will be an increased demand for some kinds of labor and a decreased demand for others, depending upon the specific relationship between the particular kind of labor and the capital goods with which it is used. Whether the relationship is one of complementarity or one of substitutability, the efficiency with which labor resources are utilized will be diminished by the uncertainties created by Social Security. These distortions are compounded by considerations on the supply side of the labor market. Workers will be differentially aware of the coming collapse of the Social Security program. Those who are aware will have to make a judgment about the timing of the collapse: They will have to guess whether they will be the last generation to receive the promised benefits or the first generation to be deprived of them. The assessment that each worker makes will affect that worker's willingness to supply his services in the labor market. Some workers may retire early to take advantage of the twilight years of the Social Security program; others may extend their working years so as to hedge against an early Social Security collapse.

The assumption that Social Security benefits will be paid as promised until the program completely collapses was invoked for convenience of exposition. In all likelihood the program will undergo a seemingly unending sequence of modifications of one kind or another. Dropping the simplifying assumption complicates the analysis but does not alter the conclusion in any substantial way. There will be uncertainties about the timing of each modification and about what, in particular, the modifications will be and how they will affect individual workers and businessmen. It is not difficult to see that both labor and capital will be used with diminished efficiency in an atmosphere of such economic uncertainties.

VIII. A Summary Assessment

Econometric techniques may permit the detection of the various effects of Social Security on broadly defined aggregates such as "savings" and "the employment of labor." But when detected, such effects are likely to represent a gross understatement of the distortions caused by Social Security. Even the finding of "no effect" on these aggregate magnitudes would be no cause for comfort. Analysis that focuses on the *individuals* in the economy rather than the aggregate magnitudes reveals possibilities for distortions that are obscured by the aggregate statistics. Distortions associated with the worker's uncertain prediction of the collapse of Social Security and with his inability to tailor the pattern of consumption to his true time preferences, as well as the distortions associated with the businessman's diminished ability to forecast the pattern of future consumption demand, are impractical if not impossible to measure. Nonetheless, such distortions are real and should be taken into account in assessing the costs of the Social Security program. Politically viable reforms may involve distortions of their own, such as the distortions associated with the tax-exempt status of retirement savings. These distortions, though lamentable, may be an unavoidable feature of any successful strategy designed to hasten the end of the coercive and inefficient Social Security program.

MISDIRECTION OF LABOR AND CAPITAL UNDER SOCIAL SECURITY": A COMMENT

Gary T. Burtless

Professor Garrison has written a provocative critique of the impact of Social Security on individual economic behavior. Before reviewing the general conclusion in his paper, I would like to summarize and comment upon some of his separate arguments.

In the first two major sections of the paper, Professor Garrison lays out and defends his use of the so-called Austrian model, a model with a long and venerable history in capital theory. I will not burden you with a description of the model, not because it is uninteresting but because it is not germane to most of the paper. The main conclusion drawn from Austrian theory appears to be the following proposition: As economists we have no valid scientific grounds to favor policies that encourage capital accumulation in preference to present consumption. For this reason, Garrison firmly rejects policies aimed at boosting capital accumulation, such as policies that have frequently been proposed as substitutes for the present Social Security system. According to the author, "If actually adopted, reforms of this sort would induce a pro-accumulation bias with the potential to create distortions that would rival the distortions created by the present system."[1] Although I generally agree with this proposition, I see no way in which it differs from the conclusion one would draw using ordinary neoclassical theory. So I must admit some confusion as to the advantages of the Austrian perspective in assessing capital-accumulation policies.

The next section of the paper considers specific policies to encourage saving for retirement in addition to, or in the place of, Social

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[1]Roger W. Garrison, "Misdirection of Labor and Capital under Social Security," *Cato Journal* 3 (Fall 1983): 518.