Old age - Economic problems

Address on

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To be given by

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THE THEORETICAL FRAMEWORK

The purpose of this paper is to consider the nature of some of the more important effects of our system of Old Age and Survivors' Insurance upon the distribution of income, the allocation of resources, and the major determinants and aggregative components of the national income. Since this meeting - and, indeed, the entire Centennial Conference - is devoted to problems of an aging population, it is well to bear in mind that the economic impacts of the institutional provisions for the support of the aged will, in the absence of other changes, assume increasing quantitative significance with the passage of time. By and large, Old Age and Survivors' Insurance can be regarded as a communal response to the problem of increased dependency which is associated with our aging population, and, to some extent, as we shall see presently, the institution itself tends theoretically to increase the magnitude of the problem. In the concluding section of the paper, however, I shall suggest for your consideration some changes whereby the operation of the Insurance program might tend to offset the trend to increased dependency without impairing its efficiency in implementing its fundamental purpose.

Before proceeding to this overambitious agenda, however, it is in order to discuss the possible helpfulness of subjecting a social institution, such as Old Age and Survivors' Insurance to economic analysis. At the risk of omission and oversimplification, I shall summarize the useful end-products of such analysis under three heads: (1) the test for consistency, (2) the test for neutrality, (3) the evaluation of social cost. Let us define and elaborate upon these cryptic terms:

(1) By the test for consistency, I mean merely the attempt to discover whether the responses of the economic mechanisms in the community will permit the institution

in question to achieve its stated objective, or whether, on the other hand, it is self-defeating in its working-out. If, for example, it could be demonstrated that the enactment of a legal minimum wage would result in the unemployment of all people who had been employed previously at wages below the minimum, such legislation could be considered unworkable. Or, to take another hypothetical case nearer home, if it could be established that, under any system of financing, a system of old age insurance ultimately must result in lower real income for the beneficiaries, one would have to conclude that the inevitable result of the plan's operation is to frustrate its purpose. If, on the other hand, it cannot be demonstrated, either empirically or on a priori grounds, that such inconsistent results would obtain, the modest requirement of consistency has been satisfied.

(2) By the test for neutrality, I mean the determination of whether the institution in question - or important parts thereof - elicits any characteristic responses from the economic system. If the institution is neutral economically, the merits of the case can be considered without resort to the arbitrament of economic analysis. Sometimes the economic neutrality of an institution is a matter of dispute; the vigorous controversy over the respective merits of the reserve fund and of pay-as-you-go as methods of financing Old Age and Survivors' Insurance is a case in point. Under the reserve plan, tax collections will exceed disbursements to beneficiaries in the earlier years in the interest of actuarial soundness. Under pay-as-you-go, current receipts need cover only current disbursements. Thus, in this early period, social security revenues would be less under pay-as-you-go than they would be under the reserve system. On the other hand, revenues would increase steadily under the former arrangement as an increasing number of older persons became eligible for benefits, while, under an actuarially sound reserve, current revenues could remain at a constant level over time. Actually, however, there is less to this difference than meets the eye. Under the

reserve plan, any excess of collections over receipts is invested in government securities; the Fund, in effect, holds public debt and surrenders cash obtained in collections in payment for its newly acquired securities. If the securities bought by the Fund are newly issued - an addition to existing public debt, the Treasury can use the proceeds from their sale for current government expenditures - and thus the excess social security collections pass back into the economy. The same result obtains, if the Government is operating under a surplus and is not adding to its debt. Then the Fund acquires securities previously held by other creditors of the Government, and again the excess of collections over current disbursements is returned to the public. Thus, although current collections under the reserve system might exceed current collections under pay-as-you-go, net current withdrawals on account of Old Age Insurance are the same under both methods of financing. Furthermore, the lower social security taxes under pay-as-you-go would have to be supplemented by other taxes - or borrowing - in order to finance those government expenditures which, under the reserve plan, could be met from the proceeds of securities sold to the Fund.

Nor would the situation differ if, at some future date, it should be necessary for the Fund to sell government securities (if current benefit payments exceeded current receipts). The Treasury would then have to raise the funds required to redeem its securities from the Fund by additional taxing or borrowing; and the total taxing - for social security and for general revenue - and borrowing under a reserve plan would equal the taxing for social security alone under a current-cost system.

To this extent, then, one can hold that the choice among the two methods of financing is of little import economically. It is alleged, however, that there is one significant difference between the two methods. Under the reserve plan, the purchase of government debt by the fund results in a saving of interest to the

Government. If benefits should exceed receipts, it might be possible for the Fund to make up the difference by paying out to beneficiaries interest which its securities had produced. In order to pay interest to the Fund, the Treasury would have to resort to taxation. But, if the Fund held no securities - or if there were no Fund, and the system were financed on a current-cost basis, an amount equivalent to the interest would also have to be raised by taxation. And if securities were not held by the Fund, they would be held by private investors, so that an equal amount would have been taxed to pay interest to the latter, in addition to the taxes required for the excess old-age insurance benefits over receipts. Hence the reserve system results in a reduction in taxes; or, as Harris expressed it, "Larger taxes today reduce in perpetuity the tax burden of the future." While this is undoubtedly true, it is really no more relevant than the earlier distinction between higher current taxes under the reserve system and lower current taxes under pay-as-you-go in the initial stage of the system. For, just as total current receipts and expenditures are balanced under the reserve system, so they are balanced when the government raises by taxation an amount which it subsequently disburses as interest to holders of its securities. Indeed, there is no necessity to finance the extra interest payments (which would be required under a pay-as-you-go system) by taxation; the necessary amount could be raised by borrowing.

Another example of a difference which is significant institutionally but not economically is suggested by the reserve system of financing Old Age and Survivors' Insurance. Costs (benefit disbursements) can rise either because of a reduction in birth rates or because of an improvement in life expectancy; both of these phenomena (among others) characterize our aging population. A rise in costs which is brought about by a rise in the birth rate occasions no embarrassment to an actuarially sound reserve fund: since each age group should pay into the fund an amount sufficient, when its interest earnings are included, to cover its later benefits, the fact that fewer younger workers will enter the system in subsequent years is a matter of no importance. But if a rise in costs is occasioned by "an <u>unexpected</u> reduction in the number of deaths," the solvency of the Fund is jeopardized, for "less than the discounted value of future benefits imputed to the present time will be going into the reserve fund." When we pass from actuarial considerations to economic problems, however, this distinction vanishes. For, as we have seen, the economic burden of one generation in a closed community (in the absence of foreign debt) cannot be passed on to another. Actuarially, each generation should pay for itself; economically, each year pays for itself. Thus, the fact that, with each year, an increasing proportion of the population becomes eligible for benefits, constitutes an economic phenomenon which is unaffected by the nature of the demographic or institutional factors responsible therefor. The burden of dependency is a growing one. The problem was stated succinctly by the British Chancellor of the Exchequer in his recent Budget speech: "It is well known that in the next 20 years there will be a larger and larger number of elderly persons, who, if they retire from work, will have to be supported by the efforts of a group of workers more or less constant in number."

(3) If an institution passes our tests of consistency and neutrality - that is, if its stated objectives are possible of achievement and if it does "make a difference" economically, it should be possible for the economist to assess its impact upon the economy in terms of alternatives sacrificed in its favor. For economics, the dismal science, is concerned with the allocation of scarce resources among alternative ends. When the consumer, with a limited income, increases his purchase of one commodity, he reduces perforce his purchase of others - assuming that alternatives are available on the same terms as before. Similarly, when the country decides to place more of its resources at the disposal of a certain group of its citizens - in this case, those eligible to receive Old Age and Survivors'

Insurance benefit payments, these resources must be drawn from alternative employments or destinations. It is presumably the function of economic analysis to acquaint society with the precise nature of its proposed choice. Thus it is valid procedure to subject a social institution such as Old Age and Survivors' Insurance to economic analysis. It will not do to take as our point of departure the requirements of the institution alone, since, in satisfying these requirements, the community foregoes or abridges the satisfaction of other social objectives (which include the gratification of the wants of individual consumers).

On the other hand, the present state of development of economic analysis cannot justify resorting to the other extreme, that is, judging the social desirability of an institutional arrangement solely according to its impact on the economy. In the first place, economic analysis has denied to itself more than a rigorously restricted competence to pass judgment in cases involving alternative dispositions of resources. I shall extend my remarks on this point in discussing the effects of Old Age and Survivors' Insurance upon the distribution of income, the allocation of resources, and the supply of labor; it suffices now to point out that the only criterion which welfare economics can provide is that of efficiency, not equity. In the second place, economic analysis is not yet sufficiently developed as a scientific discipline to perform in many instances its avowed function of determining the precise nature, magnitude, or direction of the economic effects of institutional (and other outside) disturbances. Although "many economic processes can be explained only in terms of the actual magnitudes of ...factual relationships," economic analysis, still obliged to rely upon "general reasoning" (i.e. the deduction of general conclusions from general principles) cannot supply the required numbers. This is particularly distressing from our own point of view, when the direction of change is in question and when it is the resultant of opposing forces. A brief consideration of the effect of the old-age insurance scheme upon the volume of investment will illustrate this point. Insofar as the operation of the reserve fund tends to reduce the rate of interest (which is the price which businessmen pay for capital), investment is encouraged. But insofar as the system tends to reduce consumer spending, profit prospects are dampened, and investment is discouraged. Since it is impossible to determine by how much investment is encouraged by the tendency to reduce the rate of interest and by how much it is discouraged by the tendency to reduce consumption, it is impossible to predict the outcome - whether investment, in the final analysis, is stimulated or inhibited by the operation of our system of old-age insurance.

Since there is good reason, therefore, for taking neither the requirements of the institution itself nor the requirements of the economic system in which it operates as our point of departure, it is, perhaps, wisest to steer a middle course. In the absence of distinctly economic criteria of evaluation and of important information concerning the economic impact of the institution, we are justified in assigning high priority to the essentials of the institution. At the same time, we should bear in mind the nature - so far as we can determine it - of the institution's impact upon the economy. This middle-ground approach will enable us to suggest, if necessary, such modifications of the institution as will minimize undesirable effects upon the economic system, provided, however, that they are not inconsistent with the essential features of the institution itself. This procedure, it should be noted, does not leave us without economic relief; if the economic effect of the institution appears to be undesirable and if the institution itself cannot be altered without impairing its essential purpose, "equal and opposite" disturbances might be produced in the economy which would tend to neutralize the undesired institutional impact.

Given this point of departure, then, it would be well to specify the essential requirements of our system of Old Age and Survivors' Insurance before considering some of its economic implications. The purpose of this institution has been well stated by Professor Witte; it is "to assure a minimum income sufficient for a decent existence in old age..." Two features of Old Age and Survivors" Insurance which are regarded as essential to the implementation of its purpose for extra-economic reasons are (1) the reserve-fund system of financing and (2) the present system of obtaining revenue from the proceeds of an income tax on workers in covered employments and an excise tax on payrolls.

II. Some Economic Effects of Old Age and Survivors' Insurance

1. The Distribution of Income

It is obviously intended that our system of Old Age and Survivors' Insurance accomplish the objective set forth above by effecting a redistribution of income in favor of its beneficiaries. From which groups in the community is income really diverted in favor of the eligible aged? In general, it can be held that the ability of any individual, group, or institution to shift a tax burden elsewhere is limited by the range of nontaxed alternative employments available to it.

Workers in covered employments definitely assume part of the burden; half of the tax receipts are collected from them as income taxes, and such taxes cannot be shifted to other groups with any appreciable degree of success. The employees cannot charge more for their services, for there is no increase in the aggregate demand for those services (or for the final products which they are hired to make) as a result of the combined process of withdrawals of funds by taxation and disbursements to beneficiaries.

The excise tax upon employers, however, can be shifted, to some extent. The business firm is both a buyer of resources and a seller of products. To the extent that it can succeed in raising the price of its product, it shifts the tax forward to the consumers; to the extent that it can lower wages, it shifts the tax backward on labor. The extent to which prices of <u>all</u> products (assuming complete coverage) can be raised is problematical, for aggregate consumer money demand throughout the economy must be increased in order to permit the consumption of the same amount of goods and services at higher prices. This increase can be accomplished only through an expansion in bank credit, and it is by no means certain that profit prospects will always be sufficiently bright to induce businessmen to seek additional short-term loans, the expenditure of which will produce the necessary expansion in the money supply. To the extent that prices can be raised, however, the excise tax is shifted to the consumer. It should be noted that, since the beneficiaries are consumers, part of the tax burden is borne by them; their real benefit is reduced.

If prices can't be raised sufficiently to cover the increase in unit costs attributable to the tax, however, employers' net proceeds from sales are reduced. Since sales proceeds determine the money value of employees' services to their employers (the marginal value product), assuming that their contribution to the productive process remains unchanged (the marginal physical product), the decline in net proceeds will be reflected in a decline in the demand for labor. This, in turn, will result in a lowering of wages, and thus some of the tax cost to the employee will be absorbed in lower wages - or, if we make the more realistic assumption that money wages tend to rise over time, in a slowing down in the rate of increase of wages. Trade unions, of course, might continue to press for higher wages, but labor presumably would still pay the cost in the form of reduced employment opportunities. The higher labor costs induced in the first instance by the imposition of the payroll tax, furthermore, might be expected to stimulate the adoption of labor-saving devices and techniques, which might constitute another depressing effect upon wages.

Nevertheless, it is not possible for the business community to shift the entire burden of the tax; firms making profits above the competitive level (and, under perfect competition, zero profits are earned) will not be able to avoid paying at least part of their tax costs out of profits. Since the sum total of profits depends on the volume of output, and since the higher unit costs after the tax induces firms to restrict output, profits will be curtailed as output and employment are reduced.

Finally, the rentier groups bear some of the costs of this social insurance and will continue to do so as long as tax collections exceed benefit payments and the Fund continues to purchase government securities with its excess receipts. Since the Fund, under these conditions constitutes an additional source of demand for government securities, it tends to raise (or support) the price of such securities and therefore to reduce interest rates (or to retard their rise). This would tend to reduce the incomes of investors.

It must be repeated that the economist cannot, as an economist, tell us whether the redistribution of income caused by old age insurance constitutes a net gain or a net loss in the country's economic welfare. If it could be demonstrated, when income was taxed away from one group and handed out to another, that the loss in "welfare" or "utility" to the taxed group was less than the gain to the subsidized, one could hold that the new distribution of income was preferable to the old since the total of utility, or welfare, in the community had increased. But it is impossible either to measure utility or to compare one man's estimation of a dollar's worth of utility with that of another. As a result the welfare economist has been obliged to define an optimum position as one in which no individual's welfare could be increased without impairing the welfare of another. There may be many such positions, or income distributions, and one cannot choose among them. A. P. Lerner wrote that, "If there is some good general reason for incurring debt, the redistribution can be ignored because we have no more reason for supposing that the new distribution worse than the old than for assuming the opposite." By parity of reasoning, we might ignore the redistribution of income caused by Old Age and Survivors' Insurance, and the "good general reason" in this case is the requirement of the institution in question.

It should be added that, while neither the economist's blame nor his approval can be attached to a redistribution of income brought about by the taxing and spending activities of the government, redistributions which are effected by the imposition of price rigidities - raising or maintaining the incomes of the favored groups by raising or maintaining above the competitive level the prices of the goods or services which they sell - can generally be condemned as uneconomical. Put formally, such price-setting by public authority results in a situation in which it is possible that an alternative policy such as taxing and spending could improve the economic welfare of some sectors of the economy without deteriorating that of those remaining. Since OASI does not tamper with the price mechanism, therefore, it is a preferable <u>method</u> of redistributing income.

2. <u>The Allocation of Resources</u>

Redistribution of income in favor of the eligible aged results in the production of relatively more of those goods and services which they characteristically prefer and of relatively less of those products which are characteristically preferred by those groups upon whom the burden of the redistribution falls. We should note, in this connection, that there is no basis for judgment here, for reallocations which follow from redistributions of income of the type occasioned by this institution are merely responses to changes in the pattern of consumer demand. The principle of "consumer sovereignty" is not violated, for that principle merely holds that resources be allocated in accordance with consumer preferences, <u>given the distribution of income</u>.

In this respect, however, it might be pointed out that incomplete coverage under OASI <u>would</u> tend to distort the allocation of resources. For resources will tend to move from covered and taxed to noncovered and untaxed employments. This movement of resources is not made in response to changes in consumer demand and is therefore undesirable. Here, then, is an instance in which the requirements of the institution (complete coverage) and of the economy coincide. For the same reason our governmental system of old-age security is superior to a regime of private retirement pensions. Since under the great majority of private plans, the employee loses all accumulated pension rights upon termination of his employment prior to the time in which he would be eligible to his retirement pension, this lack of "vesting" constitutes an obstacle to the mobility of labor in response to changing patterns of consumer demand.

3. The Magnitude of National Income

In order to discuss the influence of Old Age and Survivors' Insurance upon the size (in contrast to the distribution) of the national product, we must consider its impact upon the major determinants of the economy's capacity to produce: (a) the supply of labor, (b) the stock of capital, and (c) the state of the industrial arts.

(a) The Labor Supply. The payment of retirement benefits is in itself an inducement to earlier retirement. Professor Slichter described this influence very succinctly:

> ...if the best age for retirement is the age at which the return from working merely compensates the cost of working, the arrangements in the community for providing income for retired workers are themselves an important determinant of the best age of retirement. The more liberal the pensions or old-age assistance payments, the lower will be the age of retirement at which the returns from working merely compensate for the costs of working.

Given the age-distribution of the work force, a rise in retirement age constitutes, other things being equal, a reduction in labor supply. Thus do the benefit provisions of OASI tend to reduce - or to brake the rate of increase in - the community's supply of labor. Theoretically, the income-tax provisions of the system might also tend to restrict labor supply. Although as I have mentioned in a previous section, it is generally considered that the income tax cannot be shifted from the taxed individual, it might remove some of his incentive to work by reducing the value of his pecuniary return. This tax-effect of OASI on the supply of labor, while it probably would not result in the withdrawal of younger workers from the labor force, might be reflected in increased absenteeism and lower productivity in piece-rate establishments. Probably it is of negligible importance at existing and contemplated levels of taxation; it does, however, reinforce the benefit-effect of the system upon the propensity to retire of those eligible to receive benefit payments.

This tendency of OASI to reduce labor supply and, therefore, national product does not result in a loss of economic welfare to the community. This conclusion holds even if the institutionally induced decline in the supply of labor should result in an absolute reduction in the output of goods and services. Welfare is a function of leisure as well as income, and, since it is possible to alter the ratio of the two components of the total, no loss is involved in substituting leisure for income. Indeed, since the substitution is made because the older workers <u>prefer</u> to forego income in favor of leisure (assuming that a retired worker's benefit payment is less than his compensation in industry), a net gain in welfare is involved. Under these conditions, notwithstanding some allegation to the contrary, there is no "waste of manpower."

(b) <u>The Supply of Capital</u>. The higher the ratio of capital to labor, the higher the output per worker, and, given the size of the labor force, the greater the annual product. In order to add to its accumulation of capital, it is necessary for the community to divert resources which might otherwise have entered into the production of consumer goods and services to the production of plant and equipment. The smaller the proportion of a given national income devoted to consumption the larger the proportion whih is saved and which can be invested. Let us consider briefly some of the effects of OASI on these relevant variables: consumption, saving, and investment. Since these variables are themselves interrelated - both directly and indirectly via their relations to the level of income, and since even some of the more obvious effects exerted upon them by the institution in question differ in direction from one another, it will be possible to do little more than indicate the nature of the changes which might be induced by OASI.

Let us consider first some of the effects upon consumption and saving, assuming provisionally that the Fund is built up so that tax receipts are equal to benefit payments. In that case, funds would be diverted to beneficiaries from workers in covered employments by means of the special income tax and, to the extent that it is shifted backward by employers to these wage-earners, of the excise tax as well. This transfer would probably have little effect upon the total volume of consumption since both the taxed and the subsidized are groups with high propensities to spend. But it is theoretically possible that the marginal propensity to save of the taxed workers might be decreased because they would feel under less compulsion to save on their own account for their old age. Hence, less of their incomes after tax would be saved and aggregate consumption would be increased. There are, however, views to the contrary which hold that compulsory taxation for old-age insurance has an educational effect which tends to stimulate private thrift. To the extent that the excise tax could be shifted forward by producers so that prices rise, all income groups would be affected as consumers. Since the upper-income groups especially might be expected to reduce their saving in order to maintain their standard of living, total consumer spending would tend to increase. To the extent that the tax falls on profits, this tendency would be reinforced.

During the period in which tax collections exceed receipts as the Fund is built up, the effect upon consumption is largely dependent upon the ultimate destination of the excess receipts. Under deficit spending by the government, these receipts, taxed away in considerable part from groups with a high propensity to consume are invested by the Fund in new issues of public debt and might well be disbursed by the Treasury to groups with similar spending habits. To the extent that excise taxes fall on consumers and profit recipients, consumption would also be increased, as described in the preceding paragraph. But if the government is operating under a surplus, the Fund purchases government securities from investors, and forces making for a reduction in consumer spending appear. Income taxes and, ultimately, a portion of excise taxes that is shifted backward on wage earners result in a withdrawal of income from high-consumption groups; purchases by the Fund of government obligations divert that income to low-consumption investors. On the other hand, the purchase of securities by the Fund tends to lower the rate of interest and, to reduce the incomes of the rentiers (unless an offsetting increasing occurred in private investment). If we assume that saving is an increasing function of the rate of interest, the lower interest rates would tend to reduce rentier saving. On the other hand, it can be urged that, to the extent that saving is performed in order to achieve a capital sum of given magnitude within a stated period of time, a fall in the rate of interest would necessitate an increased rate of saving. (This argument is essentially identical with that used to support the contention that the worker in covered employment will save less because of the institutional provision for his period of retirement.)

When we consider the possible effects of OASI upon investment, we find once more that the outlook is "mixed", as the financial journalists would put it. On the one hand, lower interest rates (characteristic of the period in which reserves are being accumulated) represent reduced costs of borrowing and act as an inducement to businessmen to increase their spending on new plant and equipment and thus to increase net "autonomous" investment. But, on the other hand, to the extent that OASI tends to reduce consumption, that part of investment spending which is "induced" by changes in consumption is inhibited.

If our (literally) balanced judgment is that OASI, in the period of accumulation of reserves, tends to result in a reduction in the proportion of income which is consumed and in a corresponding proportionate increase in investment, we find that, once more, we can make no value judgment in comparing this new allocation of resources with the old. One theory of consumer behavior, however, might furnish justification for the belief that the new proportioning is superior. Consumers, according to this theory, tend, in true grasshopper fashion, to attach too little importance to their future wants and to overvalue their present satisfactions. Since this is not rational procedure, the total volume of savings resulting from such an underestimation of the future is less than the optimum. An institutional arrangement, therefore, which tends to reduce aggregate consumption (i.e. to increase saving) and to encourage capital formation (investment) is socially desirable. Thus, it is possible that the induced reallocation of resources as between consumption and investment is a happy by-product of the operation of OASI in its formative period. It is, however, a transient boon, which will disappear once the system achieves actuarial maturity.

(c) <u>The Rate of Technological Change</u>. Changes in technology increase national product, <u>given</u> the supplies of the "original" factors of production - land, labor, and capital. It is difficult to establish any causal relationship between the operation of our old-age insurance system and the rate of innovation. But it has been urged that, to the extent that trade unions resist efforts of employers to shift the excise tax backward in the form of an equivalent reduction in wage rates, unit labor costs will rise by the amount of the tax and employers will find an incentive to develop labor-saving innovations.

4. The Utilization of Resources

It is now necessary to make explicit an assumption which underlies our optimistic comment on the possible salutary effect of an immature old-age insurance system upon capital formation and the growth of national income. Granted that consumption can be reduced and savings increased, it does not follow that sufficient investment will be forthcoming to offset the increased spending. We have relied on a relative reduction in interest rates, caused by the emergence of the Fund as an additional market for government securities, to induce sufficient business spending, but this inducement might not prove adequate to the task. The interest rate is but one element in business costs (and one whose importance is the subject of considerable debate), and investments are made only if anticipated revenues exceed costs - that is, only if the outlook for profit is bright. If profit prospects are poor and if the decline in consumption induces disinvestment, the net new investment might be insufficient. Since income is equal to consumption plus investment, if the reduction in consumption effected by OASI is greater than the increase in investment, there will be a tendency for income and employment to fall. This tendency might be offset if a decline in the price level induced people to reduce their cash balances and thus, in effect, make up for the deficiency of investment activity with an increase in consumption. But it might equally well be aggravated by expectations of a continued fall in prices, which would induce consumers and businessmen to postpone their buying and thus aggravate the depression. Furthermore, the very growth in national product resulting from present investment activities requires that future spending by consumers and businessmen increase sufficiently to absorb the output of the additional productive capacity. Thus any increased investment induced by OASI today requires a greater increase in total spending tomorrow. As a matter of fact, it is apt to require an even greater increase in future <u>investment</u> spending, for, as Harris has pointed out, as the stock of capital is increased by investment, capital becomes cheaper relative to labor. As a result there is a tendency to substitute capital for labor, which results in a redistribution of income in favor of the capitalist class, which, in turn, decreases the community's propensity to consume. Thus, the original decrease in the propensity to consume will be magnified, and the increase in net investment which might have been induced by the institution will become inadequate even if it is sufficient to equal in volume the original decline in consumer spending.

Fortunately, there is no element of the inevitable in these gloomy speculations. But it should be obvious that the ratio of consumption to saving can help to determine not only the economy's capacity for growth, but also the degree to which its present resources are utilized. In a surging investment boom, the transition from consumption to investment might be made without undesirable repercussions - and with socially beneficial results; but in the absence of strong profit prospects, a reduction in consumer spending might contribute to unemployment and a decline in income.

In our discussion of the effect of OASI upon the supply of labor, it was indicated that a reduction in income, accompanied by an increase in leisure, is not incompatible with an increase in the economic welfare of the community. It need hardly be pointed out that a decline in income incident to a depression does not fall in the same category. The difference between the two is the difference between leisure, which is desired as an end in itself, and unemployment, which is definitely undesired. Without hesitation, the economist could point to a combination of lower income and unemployment as inferior to a combination of higher income and full employment (or less unemployment).

III. The Present Situation and Some Proposals

It is obvious that the community's "total welfare" (to employ Pigou's phrase) is more inclusive than its economic welfare, but it is generally presumed "that qualitative conclusions about the effect of an economic cause upon economic welfare will hold good also of the effect on total welfare" - or, in more homely language, what is good for the former will be good for the latter. But that this is not necessarily true becomes apparent once it is realized that national defense is an element in total welfare, and that "Injury to economic welfare may need to be accepted for the sake of defensive strategy." Since economic welfare is defined only with respect to the individual (or to the community regarded as no more than the sum of its individual members), what is really meant is that the individual's welfare position is reduced in the interest of the community's defense, but that this reduction is accepted as a superior alternative to the welfare position in which he ultimately would find himself if the community were undefended. If we view economic welfare as a function of both leisure and income, the voluntary sacrifice might be made in either or both of these components. As a matter of fact, both will probably suffer some reduction, but, since official and popular sentiment regard it as desirable that total output be increased and that the curtailment of civilian production be minimized in the defense effort, it is probable that there is more willingness - or less unwillingness - to sacrifice the community's stock of leisure than to reduce its annual purchasing of goods and services. This decision is reinforced by the requirements of modern warfare according to which expansion of certain sectors of the civilian economy - notably the capital-goods industries - add to, rather than subtract from, the sinews of war. Thus our economy, for the indefinite future, will be judged less by its capacity to maximize some combination of output and leisure time than by its annual physical product.

As a result of the community's increasing provision for defense, deficiency of aggregate demand and unemployment is no longer a clear and present danger to our economic welfare. But the stability of the economy is a precarious thing, and

and an excess of demand has replaced deficiency as an economic problem. On the other hand, since welfare is now measured almost exclusively by annual product, the problem of deficiency emerges on the side of supply. Under the old welfare definition, the economist was incompetent to pass judgment on idleness (as long as it was desired by the idler); now he can join Poor Richard in condemning it as vice.

What can be said about the place of Old Age and Survivors' Insurance in this new - and it is to be hoped, transient - order of things? Let us reconsider OASI's effect upon (1) aggregate demand, (2) the supply of labor, and (3) the demand for labor.

(1) Aggregate Demand. What might have been poison in the past might prove meat in the future. The deflationary effects of OASI, in its period of accumulation of reserves, no longer threaten the maintenance of full employment (or tend to intensify existing unemployment); now they are welcome as a mechanism for the reduction of inflationary pressures. On the other hand, the depressing effect upon interest rates - recently welcome, with reservations, as a possible stimulus to investment - must be re-examined, for private business spending, like private consumer spending, must be held in check. The importance of high interest rates as a deflationary device might indeed be questioned, for the same reason that we questioned the importance of low interest rates as an expansionary measure. Nevertheless, the recent debate between the Treasury and the Federal Reserve Board on this subject should prompt us to suggest that an alternative method of selling government securities to the Fund be considered. We have seen that, if the Treasury does not operate under a deficit - and the adoption of a tax program sufficient to achieve this result is highly desirable - the Fund purchases securities with its excess collections from holders of existing government debt. Thus the excess collections are returned to circulation; the sellers of these securities

might either increase their spending for consumption or purchase private issues. In the latter case, interest rates would fall, with presumed inflationary consequences. It should, however, be possible for the Treasury to sell special issues to the Fund and then to impound, or "sterilize", the proceeds. In this manner the excess of collections over benefit payments would constitute a net deflationary effect.

(2) The Supply of Labor. Since it is desirable to maximize output, the aging of our population now presents a problem in addition to the social question of an increased burden of dependency. It is desirable to increase participation in the labor force, but the increasing proportion of the aged in the population, together with the trend to earlier retirement, has resulted in a situation in which the proportion of those over age 65 in the labor force has not increased. We have observed that the provision of old-age insurance is a factor which tends to support the movement to earlier retirement. Under the conventional definition of economic welfare, the economist can find nothing to condemn in this effect, even if it should ultimately result in a decline in output. Under the new definition, however, it is desirable to check and, if possible, to reverse this trend.

One method whereby participation in the labor force might be encouraged without impairing the fundamental nature of OASI - indeed, I believe that the purpose of the institution would be furthered - would be to eliminate the test of retirement, whereby any individual under 75 years of age who receives a wage income in excess of $50 in any month forfeits the entire benefit for which he and any of his dependents would otherwise have been eligible. In advancing a modified version of this proposal, the Advisory Council on Social Security pointed out that a provision such as this "may in some instances mean that a beneficiary has a smaller total income when he works than when he remains unemployed or does a small amount of work." Under such conditions, the work clause is a direct incentive either to retire or to remain out of the labor force. It might also be pointed out that a beneficiary might even prefer not to work when the monthly wage which he could earn as an employee exceeds the total benefit-payments which he and, possibly, some dependents receive: the greater leisure time at his disposal in retirement might outweigh, in his judgment, the higher income which he would receive in return for surrendering that leisure (i.e. working).

Elimination of the test of retirement would go far in removing these anomalies. The older worker would no longer be confronted with the choice between benefit income-plus-leisure and wage income. With the additional benefit income assured to him on reaching the eligible age, it is true that the worker might be willing to work less than if no old age insurance system were in effect at all, and it is possible that, if the only employment opportunity available to him were conditioned upon his working a stated number of hours per day or days per week, he might prefer not to work at all. Nevertheless, it is certain that his willingness to work at a given wage rate would be greater under an insurance scheme without a work clause than it is under the existing law.

(3) The Demand for Labor. Although, in the aggregate the demand for labor might be expected to exceed the supply at the existing wage level, it is nevertheless true that the number of older workers seeking work, at existing wages, exceeds the demand for their services. The problem of inducing employers to hire older workers is a greater one than the problem of inducing the latter either to remain or to reënter the labor market. To the extent that employer reluctance to hire is based upon belief that older workers are less efficient and "not worth" the same wage paid to younger employees, an efficient wage-control policy might alleviate the problem. For if employers would be willing to pay younger workers wages higher than the legal maximum, they might be willing to hire older workers at the existing wage "ceiling", if the price level were appropriate. To the extent that reluctance

to hire older workers flows from unwillingness to burden private retirement annuity systems (since annuities are determined by past earnings), it is desirable that such plans be superseded by Old Age and Survivors' Insurance.

Furthermore, if it is held desirable to concentrate entirely upon the demand side of the problem, a modification of the contribution features of OASI might be suggested which, in conjunction with existing retirement provision, would tend to induce more hiring of older workers, although it would not induce older workers to remain in or to reenter the labor force to an important degree. It is suggested that the retirement test be retained, but that, upon attainment of age 65, no more excise and income taxes be paid into the Fund on the worker's account. Thus, at the same wage rate, the cost of hiring older workers would be less than the cost of hiring younger men. It is also contemplated that computation of the employee's average monthly wage for benefit purposes take account only of wages earned and employment in the period during which taxes were paid. Thus, upon eventual retirement, the eligible worker would receive the same monthly benefit to which he would have been entitled had he retired at age 65. Under the present system, if an older worker's monthly earnings decrease, his average monthly wage is reduced, and he is, in effect, penalized for remaining at work after his maximum earning capacity has been reached. Thus, this provision, by eliminating that inequity, affords a worker less incentive to quit work - and even more incentive to return to work from retirement, since he need not fear that his future retirement benefits would be reduced below their present level. (Some additional incentive is offered by the elimination of the older worker's income tax.)

It might be desirable to effect a compromise between the two proposed modifications of OASI. Instead of eliminating the work clause altogether, as proposed under section (2) above, provision might be made for a reduction in the worker's benefit in proportion to the excess of his earnings over some minimum figure. This would still afford some incentive to work. However, in order to offer employers some special inducement to hire older workers, taxes should be reduced in some stated proportion to the reduction in benefits.

(4) The Cost of Living. It might be urged that the changes which I have submitted for your consideration, insofar as they are intended to make older people more willing to work, are really nothing more than offsets to the tendency of OASI to make them more willing to retire, and that a more efficient manner of obtaining greater participation in the labor force of those over 65 is to eliminate the institution itself or suspend it for the duration of the emergency. Indeed, for the benefit of the squeamish executioner, a guillotine is built into OASI. For, since the maximum "average monthly wage" is established at $300 for the purposes of computing benefits, the primary insurance amount cannot exceed $80, nor can total monthly benefits exceed either $150 or 80 per cent. of the insured's average monthly wage, whichever is lower. Furthermore, once the worker has retired, he, and, possibly, his beneficiaries are recipients of absolutely fixed incomes. If the price level continues its upward drift, the real value of OASI benefit payments will steadily shrink until the purpose of the institution is effectively frustrated and the elderly are no longer provided with "a minimum income sufficient for a decent existence." The volume of contributions, it is true, will increase proportionately to the rise in wages, for the income and excise taxes are levied as a percentage of payrolls. Furthermore, since cost estimates are based on a level-wage assumption, future increases in wages and payrolls will yield sufficient income for the fund so that future monthly benefits could be increased to the point where they would bear the same proportion to future earnings as present benefits bear to present earnings. However, while the Fund's income is placed on an escalator basis, benefit levels are not. The Congress could afford to legislate increased benefits if wages and prices rise, but they could also afford to reduce or eliminate planned increases in - tax rates. And, even if benefits are increased

in response to inflationary pressures, the action taken will inevitably be delayed.

If we do not desire to inflate the institution to death, we should insert a cost-of-living clause into our contract with the aged as an earnest of our good faith. And it is imperative that we should not allow Old Age and Survivors' Insurance to become a casualty of the cold war. In the first place, there is no compulsion to throw out the baby with the bath; any undesirable effects of the institution upon the defense economy are probably quantitatively unimportant and, furthermore, can be offset by countervailing measures - including alterations in the institution itself which do not frustrate its essential purpose as defined by Dr. Witte. In the second place, OASI throws off some economically beneficial by-products; it constitutes, in its present stage of development, an effective deflationary device, and, moreover, it affords us a potential means of lowering worker costs on the aged relative to those on younger men and women. But most important is its significance as a weapon for democracy in the cold war. Authoritarianism justifies its existence on the grounds that a decent minimum of economic security must be obtained and that it must be purchased with individual freedom. If it can be demonstrated in the world market of ideas that free men can make themselves reasonably secure against economic vicissitude, the decisive battle will be won.