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Wait, Is Saving Good or Bad? The Paradox of Thrift

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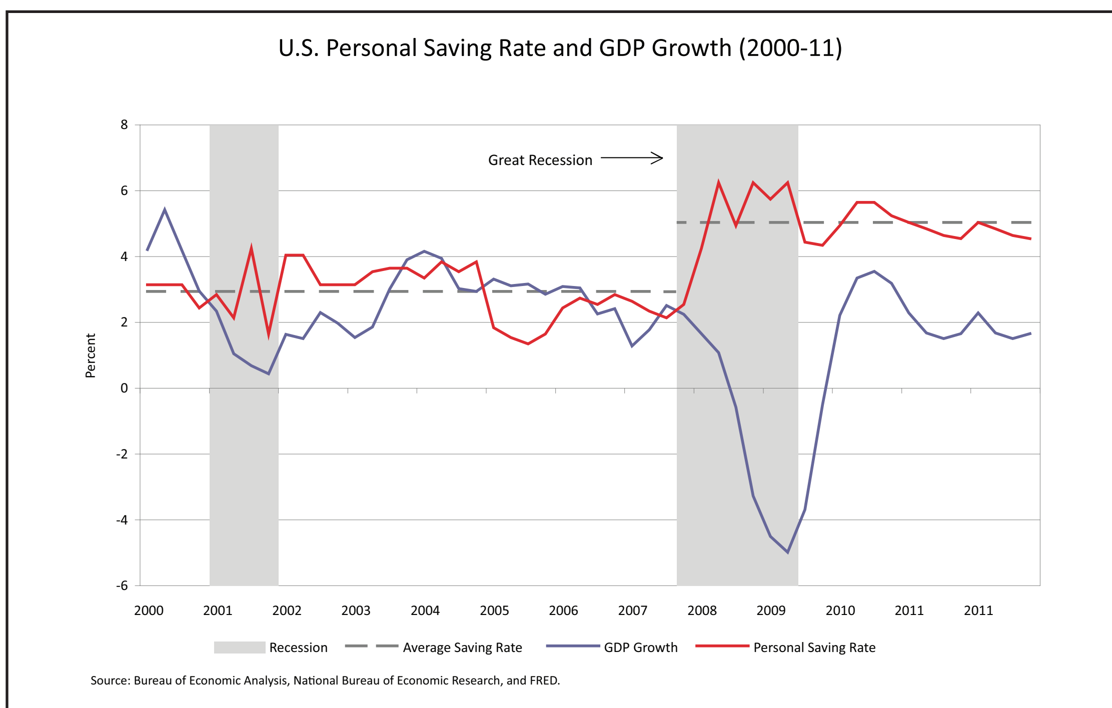
> *"[Saving] is a paradox because in kindergarten we are all taught that thrift is* always *a good thing."*[1]
> —Paul A. Samuelson, first American to win the Nobel Prize in Economics (1970)

People save for various reasons. Some save with a specific purchase in mind, such as cosmetic surgery or a Porsche, while others save just to have more money. Economists say that individuals save to buy durable goods and/or accumulate wealth to maintain a certain lifestyle during retirement or in times of financial uncertainty. These reasons all confer benefits to a saver. In the near term, the saver can finally buy the latest and greatest gadget, and in the long term, the saver can be more financially secure during retirement or unplanned unemployment.

Normally, personal saving declines during recessions because people want to maintain their existing level of consumption. During the Great Recession, though, saving increased. The chart shows the **personal saving rate**, the year-over-year growth rate of gross domestic product (GDP), and recession periods from 2000 to 2011. Before the Great Recession, the average saving rate for the typical American household was 2.9 percent. Since the recession started in 2007, the average saving rate has risen to 5.0 percent. This increase was largely driven by uncer-



tainty about future employment, efforts to reduce debt, and wide fluctuations in stock and housing prices. Although this increase in saving benefits individuals who save more, some economists argue the dramatic change in saving behavior is detrimental to the overall economy. Given the benefits to individuals, how could saving harm the economy?

John Maynard Keynes, who published his influential work, *The General Theory of Employment, Interest, and Money*, in 1936, noted saving can ultimately be detrimental to the economy because of the ***paradox of thrift***. This theory argues that if everyone individually cuts spending to increase saving, *aggregate* saving will eventually fall because one person's spending is someone else's income. Because increased saving, by definition, decreases current consumption, it stifles demand.

A simple example can illustrate this paradox. Let's assume I want a new computer, so I start saving an extra $100 each month that I would otherwise spend going out to eat. By choosing not to spend that $100, I deny the wait staff at my favorite restaurants some work hours and tips (i.e., some portion of their income). As a result, these workers also have to reduce their consumption because they are earning less. If society (as opposed to an individual as in our example) follows this saving pattern, this snowball (or **Keynesian multiplier**) effect could ultimately lead to decreased consumer spending and lower income for everyone. Consequently, Keynes argued, output would decrease and, therefore, limit economic growth/recovery until, of course, I bought my new computer with the money that I've saved.

In the Great Recession, the increase in the number of adult children (25 to 29 years of age) living with their parents is also a good example of the paradox of thrift. According to the Census Bureau's "Families and Living Arrangements" dataset, the percentage of 25- to 29-year-olds living with their parents increased from 14 percent in 2005 to 19 percent in 2011.[2] This arrangement allows them to save money on rent/mortgages, utilities, cable, and furniture. However, because the addition of just one new household contributes an estimated $145,000 to the economy when one factors in multiplier effects,[3] the rise in the number of twentysomethings living with their parents could have deprived the economy of up to $25 billion per year during this period. Even if this is accurate, it's a very small share of a $15.3 trillion economy. In the short run, then, some could argue that this choice by young adults to save slows not only the housing market, but also the retail, construction, and manufacturing industries.

These two examples illustrate that saving can have unintended consequences because one person's consumption is another person's income. During recessions, decreases in consumption could inhibit economic recovery. However, in the long run, the accumulated money from individual savers is available for capital investment, a situation where businesses borrow to purchase **capital** (e.g., machinery and technology). Thus, an increase in the saving rate increases capital investment (e.g., **investment** in machinery for production). Such increases in capital stock ultimately lead to higher levels of business productivity and growth. Because economists are largely concerned with long-run growth and economic theory notes the positive aspects of increased saving, the paradox of thrift remains a controversial concept. So ultimately, it is OK to save for that big purchase since future consumption benefits both you and society. ■

NOTES

[1] Samuelson, Paul A. *Economics*. Fourth Edition. New York: McGraw-Hill, 1958, p. 237.

[2] U.S. Census Bureau. "Families and Living Arrangements," Table A2 (www.census.gov/hhes/families/data/cps2011.html for 2011 data and www.census.gov/hhes/families/data/cps2005.html for 2005 data).

[3] Rampell, Catherine. "As Graduates Move Back Home, Economy Feels the Pain." *New York Times*, November 16, 2011.

GLOSSARY

Capital: Resources and goods made and used to produce other goods and services. Examples include buildings, machinery, tools, and equipment.

Investment: The purchase of physical capital goods (e.g., buildings, tools, and equipment) that are used to produce goods and services.

Keynesian multiplier effect: An effect where an increase (decrease) in a component of aggregate demand (i.e., consumption, investment, or government spending) produces an increase (decrease) in national income that is greater than the initial increase (decrease) in the component. This greater-than-proportional change in national income is the result of chain reactions that generate more (less) activity than the original increase (decrease).

Paradox of thrift: A controversial Keynesian economics theory, which proposes that if everyone tries to save more during a recession, then aggregate demand will fall. As a result, the theory argues everyone would grow poorer instead of richer due to the decreases in aggregate consumption, saving, earnings, and economic growth.

Personal saving rate: The ratio of personal saving to disposable personal income; the fraction of income after taxes that is saved.

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