A CONSTITUTIONALIST APPROACH TO SOCIAL SECURITY REFORM

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I. Introduction

It is well known that the Social Security system embodies two basic functions: welfare and insurance. Another well-known fact, which is often ignored in popular and academic discussions of Social Security, is that the combination of the welfare and insurance functions creates an "inherent contradiction," as described by Peter Ferrara.[1] Because Social Security has always pursued welfare objectives as well as insurance goals, it operates on a pay-as-you-go basis—Social Security taxes paid into the system are not saved or invested as with real, private insurance, but instead are paid out to current recipients, as in a welfare program. As a result, the Social Security system provides insurance benefits in a very inefficient and inequitable way, imposes major negative effects on the economy, and severely restricts individual freedom. Since Social Security diverts billions of dollars in savings to the current expenses of government, capital investment is much lower than it would otherwise be, and consequently economic growth, national income, and employment are also depressed.[2] Individual taxpayers are made worse off, since they lose the interest return they would receive if their money were invested—a return much higher than that earned on tax payments and benefits financed by future generations.[3]

Cato Journal, vol. 3, no. 2 (Fall 1983).

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[1]Peter J. Ferrara, *Social Security: The Inherent Contradiction* (Washington, D.C.: Cato Institute, 1980).

[2]See, for example, Martin Feldstein, "Social Security, Induced Retirement, and Aggregate Capital Accumulation," *Journal of Political Economy* 82 (September/October 1974); and idem, "Social Security and Private Savings: International Evidence in an Extended Life-Cycle Model," in M. Feldstein and R. Inman, eds., *The Economics of Public Services* (New York: Halstead Press, 1977).

[3]It has been estimated that the rate of return provided by the Social Security system is approximately 10 to 15 percent of the return to private-sector alternatives. See Ferrara, chaps. 4 and 9.

Perhaps the most serious problem created by the Social Security system stems from its coercive and compulsory nature. Because of the welfare aspects of the benefit structure, some beneficiaries get more than they are (actuarially) entitled to, while others get less. If the system were voluntary, those getting less would opt out of the system, threatening it with bankruptcy. Because the program as it is now constructed must be compulsory if it is to survive, political decision makers insist that it must be run by the government, since the government is the only institution that has such powers of coercion. Thus, the program will always operate according to political rather than economic criteria. This politicization, in fact, is the basic cause of the program's inherent instability, as will be discussed below.

Many writers have recognized the inherent instability of the Social Security system and have prescribed various "solutions," many of which are aimed at separating the welfare and insurance functions.[4] Martin Feldstein seems to appreciate more fully than others the importance of separating the welfare and insurance elements. He has proposed placing the insurance portion of Social Security on a fully funded basis with a self-supporting trust fund. But this proposal is also bound to be disappointing, should it be adopted, for it leaves the insurance function of Social Security in the domain of the government sector and subject to the forces of political manipulation.

The objective of this paper is to explain the inherent advantages, in terms of equity and efficiency, of complete privatization or "denationalization" of the old-age insurance industry. As the title indicates, the discussion will present a "constitutionalist" perspective on Social Security reform. As in so many other areas, government's excursions into the old-age insurance industry have produced many undesirable results. I contend that this situation has come about neither because the "wrong" people were in office, nor because they were misinformed, but because our democratic institutions are constrained neither by law nor by strong traditions regarding the appropriate tasks of government.[5] Government has expanded far beyond

[4]See, for example, Joseph A. Pechman, Henry J. Aaron, and Michael K. Taussig, *Social Security: Perspectives for Reform* (Washington, D.C.: Brookings Institution, 1968); and Alicia H. Munnell, *The Future of Social Security* (Washington, D.C.: Brookings Institution, 1977).

[5]The constitutionalist perspective is most commonly linked with Friedrich A. Hayek, *Law, Legislation, and Liberty*, vol. 3, *The Political Order of a Free People* (Chicago: University of Chicago Press, 1979); and James M. Buchanan, *Freedom in Constitutional Contract* (College Station, Tex.: Texas A&M University Press, 1977). For a recent discussion of the transformation of ideas regarding the appropriate role of government in the economy, see Bernard Siegan, *Economic Liberties and the Constitution* (Chicago: University of Chicago Press, 1980).

its more limited role of protecting private property rights. It now thrives on the game of interest-group politics, whereby one group's rights are destroyed to accommodate another's in return for political support that helps keep the existing government in power. This widening of governmental powers is largely responsible for many of the destructive policies (such as Social Security) that we observe today.

The remainder of the paper will discuss the effects of the change in the constitutional setting that has allowed the nationalization of the old-age insurance industry. Section II presents some of the relevant conceptual issues from a constitutionalist perspective and discusses privatization of old-age insurance. Section III compares public and private provision of old-age insurance from a theoretical standpoint. Section IV explores the function of public advertising in the provision of Social Security and contrasts it with the role of private advertising. Section V examines the argument that compulsory governmental provision is needed because of "market failures," and section VI offers a summary and conclusions.

II. Private versus Political Provision of Old-Age Insurance: Some Conceptual Issues

The issue of whether old-age insurance is best allocated by market or by political criteria is moot to those who understand the negative consequences of the attenuation of private property rights under political resource allocation. Nevertheless, it is important to emphasize the profound differences between the market process and the political process as mechanisms for allocating resources.

The market is a process in which individuals voluntarily interact with one another in pursuit of their own interests. And with appropriately designed institutions such as well-defined, enforced, and respected property rights, freedom of contract, freedom of exchange, and the enforcement of contracts, self-interested behavior generates a spontaneous order—an order chosen by no one; yet it tends to maximize the subjective values of all the market participants. It is in this sense that the market order can be termed "efficient." The maximization of subjective values, *as individuals themselves perceive them,* is the result of the market process and is not something that can be defined or "maximized" by some outside observer. A point worth emphasizing is that self-interested behavior does provide individuals with incentives to cheat, to defraud, or to default, but as James Buchanan[6] has pointed out, laws, customs, traditions, or moral

[6]James M. Buchanan, "Notes on Politics as Process" (Paper presented at the 1983 meeting of the Public Choice Society, Savannah, Ga., March 25, 1983).

precepts have been constructed or have evolved to limit such behavior in the market. Thus an overriding function of government is to establish the "rules of the game," and to define and protect property rights, the freedom of exchange, and freedom of contract so as to facilitate mutually advantageous trade.[7] The successful performance of this function, along with generally agreed-upon norms regarding the illegitimacy of cheating and defrauding one's partners in exchange, strengthens the market process and enhances individual welfare.

By contrast, there simply are no such constraints imposed upon "political exchange." It is rare indeed that a politician is prosecuted for bribery, corruption, fraud, or dishonesty. Who would create such laws, and who would enforce them but politicians themselves? In politics, ownership rights are not respected. In fact, the state seems to operate on the notion that those within government lay claim to all property rights, and have the power to rearrange these rights as they see fit. This is not a "devil theory" of government. Politicians and bureaucrats are, as individuals, no different from the rest of us. They prefer more rights to the use of resources to fewer and are utility maximizers, just as we all are. But the utility of the politician or bureaucrat, operating in the world of "political exchange," is not necessarily enhanced primarily by ownership rights in some goods or services, as in the private market. Politicians and bureaucrats use their positions in government to bestow special rights or privileges on politically active individuals or groups in exchange for votes, campaign contributions, and other forms of political support.[8] Those whose rights are consequently abridged are usually those who are not well organized politically. The revocation or destruction of property rights is the business of modern politics, and politicians are continually seeking to expand the market for their "services." Stability in private property rights is anathema to politicians and bureaucrats, for it imposes constraints on their abilities to accumulate power and wealth.

The Social Security system currently consumes a large part of taxable income and therefore represents a significant infringement of individual rights by government. Since the system is compulsory, individuals are denied the right to control a large portion of their incomes. And, more important for our purposes, they are prohibited

[7]This is not to imply that government is necessarily the only institution that can perform these tasks. Many have argued that private courts, for example, would be superior to the present system.

[8]For a more general discussion of this phenomenon, see Michael C. Jensen and William H. Meckling, "Can the Corporation Survive?" *Financial Analysts Journal* (January/February 1978): 31–37.

from choosing other means of purchasing old-age insurance. The important point is that by its very nature, compulsory government provision of old-age insurance is "inefficient" and therefore reduces individual welfare. If old-age insurance were provided privately, the appropriate role for government would be the more limited one of protecting economic liberties in that and other markets. Currently, the government has revoked those rights—rights that many throughout society have recognized as important. As Peter Ferrara has stated:

> It should be apparent that the coercive nature of social security violates all of these rights. It forces individuals to enter into contracts, exchanges, and associations with the government that they should have the right to refuse. It prohibits individuals from entering into alternative contracts, exchanges, and associations with others concerning the portion of their incomes that social security consumes. It prevents individuals from choosing courses of action other than participation in social security, although these courses of action will hurt no one . . . The program . . . operates by the use of force and coercion against individuals rather than through voluntary consent. The social security program thus restricts individual liberty in major and significant ways. . . .[9]

From a constitutionalist perspective, it is the enforcement and protection of these rights through the rule of law that is necessary to prevent government from further abusing its power by manipulating the Social Security system for political gain. Such a rule of law may be either written or unwritten, but it will only be enforced if it has the approval of at least a majority of the electorate. In short, as argued below, what is essential to meaningfully address the Social Security dilemma is a change in the constitutional setting. Such a change would require that citizens come to realize the importance of *economic* liberties, such as the freedom to control a large portion of one's income, and to prohibit the further political plundering of these and other freedoms. For once the government extends its powers beyond the protection of basic rights and enters the realm of legislation and regulation, more and more freedoms are denied, and individual welfare is reduced.

III. The Political Economy of Privatization: The Case of Old-Age Insurance

Many taxpayers are made worse off because the old-age-insurance industry is monopolized by government. These individuals would therefore benefit if privatization were allowed. Unfortunately, tax-

[9]Ferrara, p. 275.

payers are generally poorly organized politically and will therefore find it difficult (though by no means impossible) to achieve privatization. Among the major beneficiaries of governmental control of the old-age insurance industry are Social Security Administration (SSA) bureaucrats. Bureaucrats are basically no different from other individuals; their primary objective is to enhance their own self-interest. Public employees, however, face a starkly different institutional setting than their private-sector counterparts. This difference explains why government provision of old-age insurance is likely to be more costly and of a lower quality than private provision. In the private sector, the manager (of an insurance company) who tries to minimize the cost to his customers is rewarded by profits, as cost reductions increase his price/cost margin. Profits may benefit the manager directly, should he be a part owner of the firm, or indirectly in the form of more frequent promotions and salary increases. Further, the private managers who do not strive to minimize costs and to produce a high-quality product will be penalized by the loss of profits. Managerial labor markets also promote cost minimization, because the firms that do not reward managerial talent will lose that talent (along with the profit-making opportunities) to competing firms.

The market for corporate control is yet another device that creates pressures for cost-minimizing behavior, because managers who do not strive to maximize the value of the firm (by giving the consumers what they want at least cost) run the risk of being replaced through the mechanism of a takeover bid.[10] Finally, the survivor principle dictates that the private firms that do not strive to provide high-quality products at least cost in competitive markets will, in the long run, simply not survive. In sum, private-sector institutions provide strong incentives for firms to offer old-age insurance in a least-cost way and to cater to the preferences of their customers.

By contrast, no such institutional arrangements exist in the public sector. There are no profits, by definition, in the public sector. A growing body of literature on the economics of bureaucracy[11] explains, however, that in the absence of the profit incentive, utility-maximizing public bureaucrats will pursue the objective of increasing their consumption of perquisites such as staff, travel allowances, on-the-job leisure, and so on. And all of these items are more likely to be

[10] See Henry Manne, "Mergers and the Market for Corporate Control," *Journal of Political Economy* 73 (April 1965): 110–20.

[11] See Ludwig von Mises, *Bureaucracy*, 2d ed. (Westport, Conn.: Arlington House Publishers, 1969); Gordon Tullock, *The Politics of Bureaucracy* (Washington, D.C.: Public Affairs Press, 1965); and William Niskanen, *Bureaucracy and Representative Government* (Chicago: Aldine-Atherton Press, 1971).

obtained with a larger budget for the bureau. Thus, public-sector bureaucrats such as those at the SSA are likely to act so as to maximize discretionary revenues—the excess revenues beyond the cost of providing old-age insurance—and to have a strong preference for on-the-job leisure, since the price of leisure is lower in the public sector than in the private sector. Consequently, the SSA has little incentive to make changes that will better serve the needs of its "customers." Such changes would be time consuming and costly for the SSA whereas the benefits, in terms of the probability of achieving a larger budget, would be very small. There is little, if anything, the SSA can gain by improving service to the taxpayers.

This bureaucratic attitude explains why the overall quality of government-provided services has the poor reputation it does. The SSA bureaucrats can more profitably spend their time (from *their* perspective) convincing the Congress and the public (through publications and advertisements) that government old-age insurance provides benefits far greater than what it actually provides, so as to make their own positions (and budget) more secure. These bureaucrats are among the major beneficiaries of the Social Security monopoly. Unlike private monopolists, however, they not only charge a monopoly price but also have the power to force consumers to pay it. Government has often been referred to as the monopolist par excellence, and the SSA lives up to that image.

In addition to solving the problems of bureaucratic incentives and monopoly power, a private system would be a more effective way of permitting consumers to articulate their diverse demands for old-age insurance. Each individual could purchase different amounts and types of insurance, according to his preferences. By contrast, the current system entails a tremendous welfare loss, since it imposes one set of benefit provisions on everyone. The inefficiency of this system is readily apparent. Single workers must pay for survivors insurance that they do not need—if an unmarried worker (with no children) dies, nothing is paid in his name, despite years of contributions; single people must buy the same amount of insurance as married people; people without children pay the same as those with children; those in low-risk occupations contribute as much as those who work in high-risk jobs, and so on. The list is almost endless.

A further problem is that there is no relation between (tax) prices paid and benefits received. Unlike the private sector, where consumers could trade off different types of insurance coverage and other goods depending on their incomes, preferences, and relative prices, the "price" of Social Security is determined by current benefit levels, and no tradeoffs are allowed. Furthermore, the true price of Social

Security is well hidden from the average taxpayer, who is not likely to know that he himself pays for his "employer's contribution" in the form of lower wages. Not to mention the fact that the true opportunity cost would include the (private) return he could have earned under a private system and the effects of reduced capital accumulation and economic growth.

If individuals prefer a change in the types of benefits provided by the Social Security system, they must bear the costs of becoming informed about the current system and must discover what politicians are promising to do about it. Finally, they must bear the cost of becoming part of an organized coalition powerful enough to influence legislation. These transactions costs are inordinately high compared to those in the private market, which is far more conducive to making marginal adjustments.

Government provision of old-age insurance will also necessarily result in an inequitable distribution of benefits, since the distribution will be shaped according to the preferences of the groups with the most political clout. Those who are not well organized and well financed will always be the net losers. As Peter Ferrara has shown, this group includes women, blacks, the poor, the young, and, ironically, many of the elderly, who would be better off with the right to invest their funds as they see fit. By inflicting costs on these groups, the Social Security system may very well have sown the seeds of its own demise, for beyond some point the marginal benefits to these and other groups of securing truly effective reform via privatization will outweigh the marginal transactions costs. Perhaps then politicians will finally begin to feel the heat. And as the late Senator Everett Dirksen once said, "When politicians begin to feel the heat, they begin to see the light."

IV. The Role of Public Advertising

One aspect of Social Security that has generated much criticism is the use of allegedly misleading advertising by the SSA. Advertising plays a prominent role in both the private and public sectors, although the net effects are quite different in the two settings. In the private sector, insurance companies advertise primarily to provide information regarding product quality and prices, since consumers typically have very limited knowledge of the alternative products available to them. Furthermore, the firms with the most reliable products are likely to advertise most heavily, for they have the most to gain from repeat sales.[12] There is also considerable evidence that adver-

[12]See Yale Brozen, "Advertising, Competition, and the Consumer," *Intercollegiate Review* 8 (Summer 1973): 235–42.

tising makes the economy more competitive by facilitating comparison shopping.[13] Economic research has revealed, in fact, that legislative *restrictions* on advertising tend to lessen competitive pressures and to *raise* prices. And, although much fraudulent or misleading advertising exists, as long as the consumer has the option of comparing and contrasting competing claims of advertisers he is unlikely to be continually misled or "exploited." Market competition protects the consumer from fraudulent advertising, although there are also legal restrictions on such behavior. In fact, private advertising is one of the most heavily regulated economic activities.

Is it also true that government advertising by agencies such as the SSA is on a par with private advertising? That is, does it aim to inform citizens of available alternatives? The answer to this question is an unequivocal no, since the consumers of Social Security have no market choice. Like most other services provided by government, old-age insurance is monopolized: The consumer has no choice between the SSA and a private insurance company. He must continue to pay Social Security taxes regardless of which alternative he may prefer.

Since the SSA does spend large sums on advertising, the question becomes: Are politicians and bureaucrats held legally liable for *their* promises, as they insist their private-sector counterparts should be? As Richard E. Wagner pointed out in a most original analysis of the role of public advertising:

> Politicians cannot be held liable for their promises. If a hot dog manufacturer's all-meat product turns out to be 30 percent chicken and bread crumbs, he will most likely encounter difficulty with the government, even if consumers buy the product. But when the government's comparable product turns out to be 60 percent baloney, no regulatory agency will take action.[14]

This, of course, is not to suggest that more regulation is needed. The point is that politicians and bureaucrats are not in fact held liable for false advertising, and the SSA is among the most serious offenders. In a now-famous statement from a booklet published by the SSA we are told:

> The basic idea of Social Security is a simple one: during working years employees, their employers, and self-employed people pay

[13]See Lee Benham, "The Effect of Advertising on the Price of Eyeglasses," *Journal of Law and Economics* 15 (October 1972): 337–52; and Yale Brozen, *Concentration, Mergers, and Public Policy* (New York: Macmillan, 1982).

[14]Richard E. Wagner, "Advertising and the Public Economy: Some Preliminary Ruminations," in David Tuerck, ed., *The Political Economy of Advertising* (Washington, D.C.: American Enterprise Institute, 1976), pp. 81–100.

> Social Security contributions into special trust funds. When earnings stop or are reduced because the worker retires, dies, or becomes disabled, monthly cash benefits are paid to replace part of the earnings his family has lost.[15]

Similar statements are made through government campaigns, the press, and on radio and television. As Milton Friedman has said, however, it would be hard to pack a greater number of false and misleading statements into a single paragraph. Individuals do not pay Social Security "contributions." *Contributions* are voluntary; Social Security taxes are not—and failure to pay them will result in fines, imprisonment, or both. Furthermore, employers do not pay "their share" of Social Security taxes; the burden of taxation is ultimately shifted to the wage earner.[16] The above paragraph also gives one the impression that the "special trust funds" are actually sums of money that are saved and invested much like private pension funds, rather than being immediately paid out in benefits. Finally, one also gets the impression that one's future benefits will be paid from the "trust funds" and that such benefits are guaranteed. In reality, the only guarantee is the willingness and ability of future generations to pay Social Security taxes.

Apparently, the purpose of such advertising is to mislead the public into believing that Social Security is in fact equivalent to private insurance. Perhaps that is why we are told that Social Security cards are "the symbol of your insurance policy under the federal Social Security Law."[17] Because of the absence of market constraints, and because politicians and bureaucrats themselves are "responsible" for enforcing laws or standards regarding false and misleading advertising by government, such activities can be expected to continue throughout the SSA in particular and the government generally.

Another effect of misleading advertising by the SSA stems from the fact that Social Security benefits, like the benefits of most governmental services, fall into the category of goods economists call "credence services."[18] These are services whose quality is difficult to judge. Many private services, e.g., car repair, fall into this category, and individuals can be induced to pay more for the service if they are unsure about the quality. The unsuspecting motorist who thinks

[15]U.S. Department of Health, Education, and Welfare, *Your Social Security* (Washington, D.C., June 1976), as cited in Ferrara, p. 66.

[16]Ibid.

[17]Warren Shore, *Social Security: The Fraud in Your Future* (New York: Macmillan, 1975), p. 21.

[18]Michael Darby and Edi Karni, "Free Competition and the Optimal Amount of Fraud," *Journal of Law and Economics* 16 (April 1973): 67–88.

that all he needs is an oil change has more than once been counseled into an engine overhaul, although competitive pressures make this behavior costly to the station owner and will therefore limit it. One would expect this type of fraudulent behavior to be even more widespread in the public sector, however, because of the difficulty of evaluating services *and* the absence of market alternatives.

In light of all this, just what is the function of public advertising as practiced by the SSA? Richard Wagner seems to have it right:

> [T]he principal function of public advertising would seem to be to promote acquiescence about the prevailing public policies. The purpose of public advertising would be to reassure citizens that the fact that their public goods are composed of 60 percent baloney indicates good performance.[19]

Thus, while the Social Security system impairs individual wealth and freedom and exerts a strong negative influence on the economy, the role of political advertising is to draw the public's attention away from these realities, so as to enhance the prospects for further growth of the Social Security bureaucracy. Such advertising hides the welfare aspects of the program. By emphasizing (contrary to fact) that Social Security is like an insurance program and that Social Security taxes are like insurance premiums, the SSA obscures the true costs of the program. This increases the political acceptability of the current program and provides more security not for the elderly, but for *the Social Security bureaucracy.*

V. The Provision of Old-Age Insurance: A Case of Market Failure?

There have been numerous rationales advanced for the governmental provision of old-age insurance to the exclusion of private provision, including the "forced savings" argument, welfare and redistributionist rationales, the alleged superiority of a pay-as-you-go system that must be governmentally provided, and the desirability of intergenerational transfers. All of these rationales have been widely discussed elsewhere, but yet another is of particular relevance to the privatization issue and will therefore be dealt with here. Namely, the argument has been made that government provision of old-age insurance is necessary because of market imperfections that would make private-sector alternatives unattractive or unavailable. This is the classic "market failure" rationale for government intervention. One alleged market inefficiency stems from the fact that those who

[19]Wagner, p. 97.

anticipate a long life may purchase annuities heavily, which will increase the rates charged these individuals and to others. The "average" person may therefore be treated "unfairly" or be priced out of the market and will be left without the protection provided him by Social Security. Thus it is alleged that an "adverse selection" problem exists. However, actuarial rates are based on characteristics of *groups* of purchasers, not on particular individuals. Those who are expected to live longer (i.e., women) can expect to be charged higher rates than those with lower expected life spans. *Prohibiting* such arrangements by government mandate, however, would cause what one might call a *government-induced* market "failure."[20]

Even if private markets would not emerge for certain groups of individuals (which is mere conjecture), one cannot argue for compulsory governmental provision on the grounds of economic efficiency. For in order for any change to be economically efficient, it must make someone better off without making anyone worse off. That is why voluntary trade is efficient, but it also explains why governmental provision of old-age insurance could never be, for that would require unanimous consent. In light of the fact that private alternatives would yield several times the return to Social Security, unanimous agreement to maintain the current system would be impossible. The case for prohibiting privatization can only be based on coercion, not efficiency, as conventionally defined.

A second "market failure" argument is based on the idea that since individuals do not have perfect information about market alternatives, and since information is costly, government provision is needed. Information is a public good, so it is said, so that the market "fails" in this respect to provide the optimum quantity. This particular line of reasoning commits what Harold Demsetz called the "nirvana fallacy": If one compares a world of perfection with the real world, the real world will invariably turn out to be imperfect or inefficient.[21] In fact, the market process best facilitates the use of knowledge in society.[22] No group of governmental planners at the Social Security Administration could ever make efficient use of all the constantly

[20]As a similar phenomenon, a group of women are currently suing their insurance company for charging them higher health-insurance rates than men with similar medical histories because of the fact that women live, on average, about 10 years longer than men. If this practice is ruled illegal, insurance companies will be apt to offer less medical insurance to women in the future.

[21]Harold Demsetz, "Information and Efficiency: Another Viewpoint," *Journal of Law and Economics* 12 (April 1969): 1–22.

[22]Friedrich A. Hayek, "The Use of Knowledge in Society," *American Economic Review* 35 (September 1945): 519–30.

changing information that exists *in the minds* of consumers. Only individuals themselves can make such decisions, and the private market is the only known mechanism that can facilitate this process. Once individuals decided what the "appropriate" retirement age is, when to start buying old-age insurance, etc., private firms would meet the demand. Increased demand for certain types of policies would be reflected in higher relative prices, which would induce a greater supply.

By contrast, given that personal preferences vary widely, the uniform provision of one kind of old-age insurance by the government would satisfy the preferences of relatively few. It is the government that is a major source of inefficiency in the use of information. Governmental provision, by definition, cannot accommodate the diversity of preferences that exists in the world. More important, governmental provision totally subverts the role of the price system in conveying the relevant information. It simply substitutes the preferences of bureaucrats for those of consumers, as conveyed by the price system. When one judges the efficiency of the private insurance market by a benchmark of omniscience, one is quite naturally led to the conclusion that the market "fails." But from the standpoint of reality, it is well known that the private market is much more accommodating to diversity of preferences than the bureaucracy is.

In sum, it appears that the "market failure" arguments in favor of compulsory governmental provision of old-age insurance rest on very weak ground. They are, however, rather typical products of an entire industry that has evolved, wherein welfare economists concoct an ever-increasing volume of excuses for governmental coercion to promote ends with which they personally agree. It appears that such arguments are nothing but attempts to ease the consciences of those who make them.[23]

A radical departure from orthodox welfare economics, developed by Ken Shepsle,[24] provides what I believe to be a more accurate explanation of why the insurance component of Social Security is nationalized. While much has been made of the polar distinction between public and private goods and problems of externalities and other "market failures" in discussions of the "appropriate" role of government in the economy, Shepsle notes that *all* goods are mixes

[23]For an elaboration of this view, see T. Nicolaus Tideman, "Toward a Restructuring of Normative Economics," working paper, Department of Economics, Virginia Polytechnic Institute, 1983.

[24]Kenneth Shepsle, "The Private Use of Public Interest," mimeographed (Center for the Study of American Business, Washington University-St. Louis, 1978).

of publicness and privateness, and most processes of production and consumption generate externalities. But the governmental response to these problems is generally idiosyncratic: Some externalities are regulated, others are not; some goods with attributes of publicness are provided by government, others are not; and many private goods are provided by government. In short, welfare economics has little to do with *actual* governmental decisions to intervene in private markets. Among the factors that *are* decisive, according to Shepsle, are the opportunities for coalition building by those who stand to benefit from the program, the abilities of political entrepreneurs to enact the programs (with which they hope to enhance their terms in office), and the ability to extol arguments exaggerating market failure and emphasizing the "need" for intervention.

Although Social Security has recently become somewhat of a political albatross, it was, for many years, a political gold mine. (Of course, it is still manipulated to secure votes.) For years the program has been a means of dispensing benefits to *current* voters at the expense of future generations, who of course cannot object. From the very start, the system was used by politicians to advance their political interests. Politicians convinced the public that the system would be run on a fully funded basis, but that promise was soon broken. Congress has voted benefit increases without accompanying tax increases in nearly every election year,[25] so that the system is now on the verge of financial collapse. Allowing privatization would impair the empire-building capacities of politicians; that is why the Greenspan Commission did not even consider it.

Special-interest groups have also played an important role in shaping the Social Security system, by lobbying for particularized benefits and for ideological benefits such as increased welfare spending. Of course, the most important interest group is current beneficiaries, who are arguably the strongest political force in the nation, and who provide opposition to any significant proposals for change.

Finally, as with all government programs, those who intend to run the program are the foremost lobbyists in support of it.[26] This was

[25] Ferrara, p. 253.

[26] A current example of this time-worn tradition is the crusade to revitalize Herbert Hoover's Reconstruction Finance Corporation (RFC). I recently discussed a paper of mine on that subject at the U.S. Chamber of Commerce in Washington, D.C. Judging from the Chamber's magazine and television shows, one gets the impression that it is a bastion of free-market capitalism. However, at that meeting I found that many, though not all, of the Chamber's board members, along with several former bureaucrats in attendance, were staunch advocates of more centralized economic planning "if only done correctly." Several people there offered detailed scenarios of how they, as central planners, would decide which industries should survive through government subsidization and which should not.

certainly true at the system's inception, and few would dispute the fact that the SSA bureaucracy spends much of its time and effort exaggerating the "necessity" of maintaining the status quo (but with a bigger budget) and discouraging privatization.

In summary, the market-failure arguments in support of governmental provision of the insurance element of Social Security do not stand up to close scrutiny. It is doubtful that a problem of adverse selection would be of any consequence under privatization, and even if it were, one could not argue for mandatory governmental provision on efficiency grounds, for efficiency requires unanimous consent. Nor can one claim that imperfect information is cause for governmental intervention, for private markets have proven to be far superior to government bureaucracies in the use of knowledge—knowledge that can be transmitted only via the price system. The case for compulsory governmental provision of old-age insurance is based on coercion, not efficiency or equity. In particular, the main impact of the current system is to redistribute wealth, not to provide insurance, and the motivation for this system is, I believe, that the people who benefit from the transfers want them and are adept at using the powers of the state to secure them.[27] The net losers are all those who do not receive particularized benefits but who must nevertheless continue to pay taxes and experience the effects of slower economic growth.[28]

VI. Summary and Conclusions

It does not appear that the Social Security crisis can be dealt with by manipulating the benefit structure or the tax structure every five years or so. At best, this strategy postpones the day of reckoning and permits politicians to stand on the brink of disaster, piously claiming they have saved everyone's Social Security. As discussed above, a first step toward effective reform is the complete privatization of the insurance element of Social Security. Privatization would provide benefits more tailored to individual preferences and a higher return on investment, and would stimulate private savings, capital accumulation, and economic growth.

What are the prospects for real reform? The recent actions of the Reagan administration, Congress, and the Greenspan Commission

[27]This, in fact, is the primary reason for most redistributive programs of the government. See Gordon Tullock, *Economics of Income Redistribution* (Boston: Kluwer-Nijhoff, 1983).

[28]Ferrara, chap. 6.

convey pessimism. Politics-as-usual has produced yet another short-term remedy for a long-term illness. But I am not pessimistic. The key to understanding the nature of the problem is to recognize that a major reason for this and other *government failures* is that there has been a change in the constitutional setting. A skirmish in the battle of ideas, if you will, has been won by those who prefer more centralized control over the economy and a redistribution of wealth to themselves and to other favored groups. A change in public attitutes occurred, beginning in the earlier part of this century, which allowed politicians to abandon their roles as agents whose primary task was to protect private property rights and to defend the rights of freedom of exchange and freedom of contract.[29] Instead, they became more brazen in their attempts to revoke individual rights for political gain, and the nationalization of the old-age-insurance industry was permitted to take place.

Thus, what is necessary for truly effective reform is yet another change in the constitutional setting. The value of limited government was understood by writers such as Thomas Jefferson and James Madison, as well as many of their contemporaries. Economic liberties must once again be appreciated and accorded the same respect that civil liberties seem to be given. This may not be as difficult a task as it might appear at first. As mentioned above, the tremendous costs imposed on individuals in all segments of the population by the old-age insurance monopoly will provide them with incentives to investigate and eventually advocate the privatization alternative.

A number of very distinguished authors have misunderstood or ignored this basic point, and some have even declared Social Security to be the most successful government program ever. That may be true, but it in no way means that citizens would not be far better off without it. Furthermore, it is often claimed that the existing system is successful because "it has majority approval." But as Friedrich Hayek has noted, representative democracy under majority rule, although it is our only protection against tyranny, does not produce what the majority wants. Rather it produces what each of the interest groups making up the majority must concede to the others to get their support for what it wants itself.[30] Government policy is largely determined by a series of deals with special interests, and Social Security

[29]This change in the constitutional setting has also led to many of our general economic problems caused by the government's monetary and fiscal policies. See James M. Buchanan and Richard Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977).

[30]Hayek, *Law, Legislation, and Liberty*, vol. 3, p. 11.

is no exception. In fact, Hayek further noted, majority rule is a meaningful phrase only if used to describe agreement on general rules of law, not legislation, because the amount of information necessary to make truly informed decisions about legislation (i.e., the effects of the Social Security system) is prohibitive. By contrast, individuals do have a conception of the *general* direction they would like their government to go in, and the protection of rights to life, liberty, and property is one direction that has wide acceptance. The immediate problem facing the political economist and other concerned citizens is to bring to the attention of the citizenry the fact that these rights have been revoked by the Social Security system and other governmental interventions and should be reinstated immediately.

Finally, recent events have hinted at prospects for effective reform, for Congress recently voted to place itself and a large part of the federal bureaucracy under the umbrella (web?) of the Social Security system. On this matter, the authors of *Cato's Letters* said of politicians:

> [W]hen they make no laws but what they themselves and their posterity must be subject to; when they can give no money, but what they must pay their share of; when they can do no mischief, but what must fall upon their own heads in common with their countrymen; their principals may expect then good laws, little mischief, and much frugality.[31]

I am generally proud of the fact that I do not consider myself to be an economic forecaster, but I would like to offer a political forecast. Soon after the 1984 elections, Congress will either attach an amendment to a strip-mining bill that will exclude members of Congress from Social Security, start up a "supplemental" retirement program for themselves (perhaps by altering the campaign finance laws), or seriously consider privatization. In any event, the taxpayer will benefit; for if either of the former two options is chosen, Congress itself will help to expose the Social Security system for the fraud that it is.

[31] *Cato's Letters*, letter 62 (January 20, 1721), p. 128, as cited in Hayek, *Law, Legislation, and Liberty*, vol. 3, p. 9.

EXPLAINING SOCIAL SECURITY GROWTH

Rudolph G. Penner

Conservatives have a problem. They dislike big government, especially as it intrudes on individual freedom, and they believe the American public must share their tastes, since those tastes are so reasonable. It becomes hard, therefore, to explain why government is so large. Fascinating theories of the role of special-interest groups, bureaucratic behavior, and monopolistic government advertising have emerged to explain the growth of government. DiLorenzo employs these theories to explain how Social Security got so large.

I was once quite enamored of such theories. They represent an important intellectual achievement; some are quite elegant. They also contain more than a small grain of truth. However, I have more recently made a profession of studying budget numbers, and unfortunately the theories that I used to like do not do a very good job of explaining more than a tiny fraction of what is going on. The hypothesis that most of the public likes big government and does not care much for individual freedom seems more consistent with facts.

Take the theory of special-interest groups. Certainly such groups exist, and certainly they distort government decisions. They influence spending, regulatory, and tax decisions; and I believe it is fairly clear that they distort the allocation of resources. It is somewhat more difficult to know how this affects the *level* of government spending, but I suspect it is biased upward. The questions, "How big is the bias?" and "How does it affect Social Security?" are harder to answer. I find it difficult to apply the theory of special-interest groups to explain very much of the astounding growth of Social Security, but that theory might help explain the design of the present benefit structure.

Cato Journal, vol. 3, no. 2 (Fall 1983).

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The problem with applying the theory of special-interest groups to explain the growth of Social Security is as follows. A crucial element of the theory is that special-interest groups can successfully work for programs that concentrate sizable benefits on a few individuals while diffusing the costs over many individuals, so that the latter do not find it worthwhile to get organized in opposition to the program. But this element of the theory obviously does not fit Social Security. The benefits are not concentrated on a very narrow group. Those with a direct financial interest (in the sense that the rate of return to all future payments is very high) include the 36 million already benefiting, those nearing beneficiary status, and the relatives who would otherwise have to contribute some support.

On the tax side, the costs are certainly not diffused enough that they are not burdensome. The program is financed by a highly visible, earmarked tax that has risen so much that a majority of taxpayers pay more in payroll taxes than in income taxes. Not only was there no tax revolt associated with the large increase in this highly visible and burdensome tax, but most of the public responded to opinion polls saying that more should be done for the elderly even if it meant higher tax rates. The Social Security issue was at the forefront of the 1982 election, and politicians promising to preserve benefits clearly prospered at the expense of those who did not. It would be preposterous to argue that the taxpayers who were financing the increased benefits did not know what was going on. The basic point is that most taxpayers seem quite willing to pay, as long as they expect their future benefits to be adequate.

As an aside, I note that the theory of special-interest groups may explain why government is too large, but it is hard to use the theory to explain why government has grown to its present size. What I would call programs purely for special-interest groups—programs in agriculture, the merchant marine, import aid, and so on—are taking up a diminishing share of the budget and of Gross National Product, as more popular programs (aimed at much broader groups) crowd them out. I am sure that we can all think of exceptions, but I think the expansion of programs providing very concentrated benefits and diffused costs is the exception rather than the rule. The highly concentrated grants-in-aid programs are an interesting example. Many fit the model of special-interest groups quite well, but in relation to GNP these programs were cut significantly in both the Carter and Reagan administrations.

Does the theory of bureaucracy help explain the growth of Social Security? DiLorenzo claims that bureaucrats "pursue the objective of increasing their consumption of perquisites such as staff, travel allowances, on-the-job leisure and so on."[1] They may pursue such things, but they certainly are not very successful. There is now less employment in the federal executive branch than 15 years ago, despite a vast expansion in the level of spending and the number of federal programs. (Someone will mention outside contracting, but that is not nearly as much fun as having your own staff.) Travel budgets have been cut to a level that would be considered ridiculously low in private firms with similar responsibilities. I have no evidence concerning on-the-job leisure. I suspect that it is high, but I doubt that it is growing.

What about monopolistic advertising as an explanation of the growth of Social Security? I seriously doubt that people are so naive as to believe everything they are told in government advertising about Social Security. If I believed that advertising, I would not have much confidence in private markets either. But even if one believes that the theory of monopolistic advertising is important, it does not help explain why Social Security grows so explosively while other programs, like those of NASA (with its hordes of highly skilled PR people) shrink in relation to the size of the economy and the rest of the budget.

If the above theories do not explain the growth of Social Security, how then can we explain it? If people like Social Security so much, why do they like it (given all of its faults, so excellently outlined by DiLorenzo)? Why was it invented in the 1930s, and not in the 1890s or the 1920s or the 1950s?

At this point I become very tentative, although I do believe that DiLorenzo's arguments are based on a fundamental misconception of what Social Security is all about. His paper portrays it as a compulsory system that is a substitute for private insurance sold in competitive markets. But privately sold insurance was not a major alternative to Social Security before it was invented, and I doubt that private insurance would be the main means of financing retirement today—although I admit that it would play a more important role than in the pre-World War II era.

The main technique for financing the elderly before Social Security (and indeed, since the beginning of time) was transfers from children to their parents. This was not a free-market arrangement. It was a type of social contract arrived at as the result of a collective decision-making process. Some element of compulsion, if only that emanating from social pressures, was involved. In other words, the alternative

[1]Thomas J. DiLorenzo, "A Constitutionalist Approach to Social Security Reform," *Cato Journal* 3 (Fall 1983): 449.

to Social Security has never been and would not now entirely be a private insurance market conferring complete freedom of choice. The alternative would be a system of social relationships that generated much tension between parents and children and contained many uncertainties, since the children might die before their parents, might become disabled, or might even rebel and violate the social contract.

If one sees government tyranny regarding Social Security not as an alternative to individual freedom and competitive markets but as a more secure alternative to family tyranny, it becomes much easier to understand the popularity of Social Security and its explosive growth. Indeed, when I have spoken on radio talk shows, advocating a slowdown in the growth of benefits, many of the angriest calls have come not from recipients, but from the children of recipients.

But why did the program start in the 1930s? Why did the level of retirement benefits stagnate in the 1940s, 1950s, and early 1960s? Why did the level of benefits soar in the late 1960s and early 1970s and why was it cut back in relation to income (if ever so slightly) in the late 1970s and early 1980s? I do not pretend to have reliable answers. But one can speculate that the social contract between parents and children was frequently violated during the economic duress of the 1930s, and that the state moved in essentially to enforce the social contract on a depersonalized basis.

But something else may have been going on as well. When it comes to explaining how government grows, I find the theories of E. G. West most provocative. Studying the nationalization of elementary education in the United Kingdom in the 19th century, he notes that it would have been impossible to offer state-financed education to all were it not for the fact that almost everyone was already being educated privately by free enterprise or by charitable and religious organizations. The marginal resource cost of universal education was small because the teachers, books, buildings, and so forth, were already there. If no one had been educated previously, the adjustment costs to the economy would have been enormous.[2]

It might be interesting to investigate the lifestyle of the elderly in the 1920s, to find out how they were supported and at what level. It may be that Social Security did not yield much of an improvement in the living standards of the elderly in relation to the conditions of the 1920s, although the improvement may have been significant compared to what living standards would otherwise have been in the 1930s.

[2]See E.G. West, *Education and the State* (London: The Institute of Economic Affairs, 1965).

The main point is to the extent that the system is a substitute for previous systems, it does not impose an additional resource cost. There is some additional cost because the system becomes completely universal. In return, however, it does provide a great deal more security. It now even provides protection against inflation—protection that is costly to arrange on private markets or within the family.

The bottom line, I believe, is that Social Security is a truly popular program. Ordinary people are quite willing to give up individual freedom in return for more security, in part because they place less emphasis on freedom than we intellectuals do. But more important, alternative family arrangements are not free of compulsion.

Does that necessarily mean that the system is now perfect and should not be reformed or constrained? Of course not. Earlier I belittled theories of special-interest groups and bureaucratic behavior. But there is more than a grain of truth there—benefits may have been distorted and the nationalized tax-transfer system may in some ways be less efficient than a family's tax-transfer system.

Is Social Security too large? In its absence, would children support their parents at comparable levels? Such questions very rapidly become metaphysical. Social Security has had a profound impact on our society and (among other things) has probably played a very important role in explaining falling birth rates. It is hard to imagine how the world would appear without this system. But such an exercise of imagination is unnecessary. Anyone who believes that radical reforms of the Social Security system are possible is already living in an imaginary world.