SPECIAL CONFERENCE ISSUE

POLICY REPORT

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Has Social Security Been Saved?

by Peter J. Ferrara

Though the legislative changes in Social Security passed this spring were supposed to guarantee the system's soundness for the next 75 years, many analysts are skeptical. Remembering the same claims made for the 1977 changes, they believe that Social Security still remains vulnerable to inflation, recession, and its own inherent flaws. A number of Social Security experts gathered this spring at a Cato Institute policy conference, "Social Security: Continuing Crisis or Real Reform." They considered such issues as the long-run stability of the program, the effects of the 1983 legislation, the economic impact of Social Security, the rate of return individuals can expect on their "contributions," and the prospects for transferring at least some aspects of retirement security to the private sector. There was general (though not unanimous) agreement that Social Security's long-run financial problems have not been solved and that privatization should be carefully considered when Congress is next faced with reforming the system. This issue of Policy Report *contains excerpts from a number of conference papers, along with original articles by Peter J. Ferrara and Jule R. Herbert Jr. Complete conference papers will appear in the Fall 1983 issue of the* Cato Journal, *available for $5.00 from the Cato Institute.*

It was obvious that there would be a disaster as soon as the names of the members of the National Commission on Social Security Reform were announced. The Washington establishment was firmly in control, with only a few brave appointed tokens destined for a minority report.

In December 1977 virtually the same Washington establishment created a Social Security bail-out plan involving the largest peacetime tax increase in U.S. history. At that time, the establishment pronounced that its plan would "restore the fiscal soundness of the cash benefit program for the remainder of this century and well into the next one."[1]

Yet here they were again, just 48 months later, gathered to throw together another bail-out plan to save a once more collapsing system. Having mandated that everyone rely on Social Security for the bulk of their retirement income, the Washington establishment should have been acutely embarrassed with the system collapsing twice in the last four years. But some people apparently are beyond embarrassment. Instead, they all pronounced—citing each other as authorities—that Social Security was somehow "fundamentally and structurally sound," convinced that Americans would once again believe them.

"If high inflation returns in late 1984 or 1985, followed by a steep recession, the program will collapse again before the end of the decade."

As the 1982 elections approached, Democratic speakers fanned across the nation, taking the opportunity to terrorize the elderly into providing money and voters by telling of secret Reagan plans to slash their benefits dramatically after the election. Of course, Reagan had no such plans. Reagan had promised no cuts for existing beneficiaries in his 1980 campaign and he had fundamentally kept that promise while in office, proposing only an insignificant three-month delay in the Cost of Living Adjustment (COLA) in 1981. Nevertheless, these opportunistic establishment Democrats used the elderly for maximum short-term political advantage. In the end, it was these same establishment Democrats who advanced the one item in the bail-out plan that did substantially cut benefits for today's elderly—the taxation of benefits.

The 1983 Bail-Out

After the election, the major items of the bail-out plan enacted into law were the following: tax rate increases, partial taxation of benefits, expanded coverage for federal and nonprofit workers, a delay in the cost-of-living adjustment, military wage credits (an $18.6 billion transfer from general revenues), and a delay in the retirement age.

The plan amounts to a menagerie of desperate quick fixes designed to squeeze every possible dime out of marginal adjustments that do not make any fundamental change in the program. It clearly did all that could be done within the current program structure.

The plan ingeniously managed to hurt everyone:

- The elderly saw their benefits cut.
- Workers saw their taxes increased further, with the burden falling particularly harshly on the low and middle income workers who primarily pay the payroll tax.
- Today's young people saw their future expected rate of return under the

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Peter J. Ferrara is the author of *Social Security: The Inherent Contradiction* and an adjunct scholar of the Cato Institute.

EDITORIAL

Social Security and Minorities

One of the problems with Social Security that is rarely noted is the program's discriminatory effects on minorities and those with non-traditional lifestyles. Since Social Security is a unitary national retirement system, it must impose one pattern of taxes and benefits on all workers. At best, it will be designed to fit the needs of the "average" worker—the 47-year-old skilled worker just outside Dayton, one presumes. More likely it will be designed to benefit the most politically powerful groups in society, and even they may be ultimate losers as subsequent Congresses award benefits on an election-year cycle.

Few people, however, are "average" workers, and many have needs and preferences far different from the average. This is no problem for a free-market insurance system (or for any other industry); different companies compete to offer the kinds of plans that different consumers want. And some consumers, of course, choose no plan. But a universal, mandatory system cannot be so flexible; workers must fit the plan rather than plans being designed to fit the customers.

In *Social Security: The Inherent Contradiction*, Peter Ferrara noted some of the specific ways in which Social Security discriminates against minorities. For instance, he pointed out, "the poor pay more for less." Poorer individuals generally start working earlier in life, but this results in few if any additional Social Security benefits. The poor also tend to die earlier, so they receive fewer benefits. Even with the welfare aspects of Social Security, the poor receive a lower rate of return on their Social Security taxes than higher-income people. Finally, of course, the poor suffer most from Social Security's depressing effects on the economy.

Social Security has also discriminated against women. The system was based on a traditional view of the family, with the husband as wage earner, the wife as homemaker, and several children. As such, it has discriminated against single, working, or childless women. Some of these discriminatory effects have recently been struck down by the courts, but all those people who follow non-traditional lifestyles are still penalized and forced to subsidize those in traditional families. Again, one big system for everyone is not flexible enough to meet the needs of different consumers.

The most striking example of Social Security's discrimination against minorities is its effect on black Americans. The National Center for Policy Analysis has just released a study demonstrating that there is "a dramatic gap" between the benefits received by blacks and whites. The study reports:

> A black male born today has a life expectancy of 64 years. As such he can expect to die three years before he reaches the Social Security retirement age, which at that time will be 67.
>
> By contrast, a white male born today has a life expectancy of 70.6 years. He can expect to receive three years plus 7 months of benefits.

The difference is even more dramatic for two workers entering the work force this year at the age of 22. A 22-year-old white man today can expect to receive five years and six months of benefits. A 22-year-old black man can expect to receive *no* benefits. Yet both workers will pay the same Social Security taxes.

Also, since black women are more likely to work than white women, they suffer the double whammy of being effectively penalized by Social Security both for their lower life expectancy *and* for being working women.

Since fewer blacks attend college, the average black works—and pays Social Security taxes—for more years than the average white.

The recent "reforms" have intensified the problem. As a result of the increase in the retirement age, a 25-year-old black man lost more than 80% of his expected benefits. A 25-year-old white man lost only 22% of his.

The 13.4% payroll tax (counting both the employee's and employer's share, both of which are effectively paid by the worker) is a tremendous burden on young workers today, and the burden is even more devastating for a worker who doesn't expect ever to receive any benefits.

If workers were free to choose their own retirement plans in the marketplace, many young black workers, looking at the life expectancy tables, might well decide to purchase less retirement insurance than Social Security mandates. They might well decide that they could find a better use for several thousand dollars a year. And if they did decide to invest the full 13.4% of their income in a private plan, the money accumulated would belong to *them*. Not only could they live on the income from their own savings if they did live long enough to retire, but they could still leave the whole amount—as much as $250,000 for a minimum-wage worker or $500,000 for a middle-income worker—to their children. This may be Social Security's biggest discrimination against blacks and the poor—they are prevented from accumulating such wealth to pass on to their children. ■

Social Security (Cont. from p. 1)

program sharply slashed, particularly through the delay in the retirement age.

• Virtually every last worker in the economy was corralled into the insatiable program against their will.

• For the first time, massive general revenue subsidies will be injected into the program, smashing the principle of self-financing. Yet for all this pain and suffering, the bail-out plan hardly even addresses the fundamental problems of Social Security.

More Crises Ahead

The Washington establishment is now again assuring us that the program's problems have been solved well into the next century. But the truth is that the program remains vulnerable to the cycles of inflation and recession which have plagued the American economy for the last 15 years. Inflation causes Social Security expenditures to rise faster than expected because benefits are indexed. But recession causes wage and employment growth, and hence projected payroll tax revenues, to fall. With only a narrow safety margin, the program cannot survive back-to-back sharp inflation and deep recession. The inflation of the early 1970s (benefits increased legislatively), followed by the 1974-1975 recession, resulted in the need for the 1977 bail out. The late 1970s inflation followed by the 1979-1982 recession caused the most recent collapse.

The Social Security Administration's own projections show that the program now has the same narrow margin for error for the rest of this decade that it had for the years immediately following the 1977 bail out. This means that if high inflation returns in late 1984 or 1985, followed by a steep recession in late 1985 or 1986, the program will probably collapse again before the end of the decade.

This is not a unique view. The Social Security Administration Deputy Chief Actuary in charge of short-term projections had this to say in a memorandum distributed in early April 1983:

> If actual growth is more rapid in 1983, but then restricted by another recession within the next few years, the trust funds could be in a worse financial position than indicated under [pessimistic assumptions]. . . Depletion of the . . .trust funds would be very likely under these conditions and could conceivably occur within a few years from now.[2]

Even if another inflation/recession cycle does not develop so soon, the program will remain vulnerable. The program is not projected to move out of the range of vulnerability until massive tax increases now scheduled for 1988 and 1990 take effect. But these increases will not raise the revenue expected because they will substantially harm the economy and lower employment. Other revenue items in the bail-out plan will also fail to meet expectations based on the official static estimates. The taxation of benefits in particular will probably raise much less revenue than projected because many of the elderly potentially subject to the tax will find tax shelters, leaving them below the income thresholds triggering the taxation. The increase in the self-employment tax will result in fewer self-employed workers earning less than expected. With the Reagan reduction and freezes in federal hiring, there may be less revenue than expected from the extension of coverage to new federal workers.

Most important of all, the Hospital Insurance portion of Social Security is still projected to collapse by the end of the decade. Most likely, it will simply be allowed to consume any excess revenues from the rest of the program.

The entire program, therefore, will continue indefinitely with an insufficient margin to see it through future inflation/recession cycles. Even if the program manages to make it through one such cycle, it will not return to its former balance upon recovery. The program's financial margin will have been permanently depleted to a lower level, and the program will collapse upon the development of a later cycle.

Thus, without the general monetary, budgetary, and tax reform necessary to end these cycles permanently (and

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Social Security (Cont. from p. 3)

such reforms are not yet in prospect), one may expect another Social Security bankruptcy within 5 years if an inflation/recession cycle returns quickly, and within 15 years if the return of this cycle is delayed. Policymakers will then be back asking for more tax increases and possibly more benefit cuts.

One may argue that the problem is really with the economy, not Social Security. But Social Security itself is part of the economic problem and, in any event, the nation's retirement system should not be so vulnerable to short-term economic trends. Social Security is supposed to be the rock of Gibraltar, not a house of cards collapsing every time we have a recession. It should be noted that the recent thorough Social Security collapses have not been mirrored in the private pension and retirement savings system.

Social Security faces intractable long-term financing problems as well. Official projections showing financial balance over the long run are based on unreasonably optimistic assumptions. For example, fertility is assumed to increase substantially and permanently from current levels, though fertility has fallen steadily in the United States for the last 200 years.[3] Only the back-to-back cataclysms of the Great Depression and World War II produced a relatively brief period of increase known as the baby boom.[4]

The no-deficit, long-range projections also rely on a slowdown in the rate of mortality improvement. Yet we are entering a new technological age, with possibly dramatic medical breakthroughs in the offing. The possibility of major, life-extending discoveries over the next 50 years may produce enormous difficulties for Social Security, difficulties of unparalleled, truly disastrous proportions.

These projections also exclude the gigantic projected deficits of the Hospital Insurance portion of the program, deficits potentially four or more times as large as the supposed long-term savings from the recently enacted bail-out plan. Most incredibly of all, the projections in effect assume no recessions or further bouts of inflation for the next 75 years.

The truth is that paying the benefits promised to today's young workers will require payroll tax rates at least over 30%, compared to 13% today. Former Social Security Chief Actuary A. Haeworth Robertson estimates that these tax rates may have to climb over 40%.[5] Those incredible tax rates are politically infeasible, and so the best advice to today's young worker remains: Do not make your future financial plans on the expectation of receiving currently promised Social Security benefits.

A Bad Deal for Young Workers

There are other, even more serious problems. The most serious problem is that the rate of return the program pays is falling steadily. Even if all the benefits promised to today's young workers are somehow paid, the program will still be a miserable deal for these workers. This development is a natural consequence of Social Security's pay-as-you-go method of financing—taxes paid by today's workers are not saved for their own benefits but immediately paid out to finance the benefits of current beneficiaries.

> **"Even if all the benefits promised to today's young workers are somehow paid, the program will still be a miserable deal for these workers."**

Workers retiring in the early years of the program only had to pay taxes for part of their working careers. The tax burden in those years was also quite low. The maximum annual tax, including both the employer and employee shares, was $189 as late as 1958, and $348 as late as 1965. But because the program is run on a pay-as-you-go basis, the benefits paid to these early retirees were not limited to what could be paid based on their own taxes. These retirees were instead paid full benefits out of the taxes of those still working. Consequently, these benefits represented a high return on the taxes they did pay.

Over time, the return began to fall as workers began paying higher taxes for more of their working careers. For today's retirees, the program's benefits still represent a good deal on the taxes they paid into the system. But those entering the work force today must pay taxes of several thousand dollars a year for their entire working career. The maximum annual tax today is $4,700 and will be over $8,000 by the end of the decade. Moreover, the recently enacted rescue plan sharply cuts their benefits, particularly through the delay in the retirement age. For most of these workers, the rate of return paid by Social Security will be 1% or less in real terms, even if they receive all the benefits they are currently promised. For many of these workers, the real return will be practically zero.

By contrast, if these workers could use their Social Security tax money to invest in private enterprises through an IRA, they could regularly count on receiving two, three, and four times the benefits promised under Social Security, and in some cases even more, depending on income and family size.[6] Now that the pay-as-you-go, start-up windfall is passing, this problem of inadequate returns will plague all future generations, and something must be done about it.

Social Security and the Economy

Another major problem that remains unaddressed is the heavy burden of the payroll tax on the economy. To the extent the tax is borne by employers, it discourages them from hiring. To the extent the tax is borne by employees, it discourages them from working. The result is less employment and output. The payroll tax is no more than a tax on employment, and here or elsewhere the result of taxing something is that there is less of it.

As noted, the maximum annual payroll tax is $4,700 today and is projected to rise to over $8,000 by the end of the decade. For at least half of all workers covered by Social Security, the combined payroll tax is more than they pay in federal income tax. In 1982, payroll tax revenues, drawn primarily from low and moderate income workers, were over 80% greater than total federal corporate and business tax revenues. In a society deeply concerned about employment opportunities, this incredible tax burden on work is ludicrous. The payroll tax must be reduced, not raised.

Still another unaddressed problem is the negative impact of the program on savings. The needless and confused academic debate over this issue frankly illustrates why economic policy today is being made by former actors and divinity school students rather than academic economists. There still remains no plausible theoretical rationale as to why Social Security does not substantially reduce private savings. The fact is that apart from Social Security, most workers today are providing for their retirement through private savings. Given the modern American family and cultural attitudes, the practice of having lots of children to provide support in retirement is long gone. But Social Security forces workers to provide for the bulk of their retirement through a system which creates no savings. In essence, Social Security is a form of forced non-saving for retirement. It is hardly even reasonable to suggest that such a constraint does not today substantially reduce private savings.

Social Security suffers from many other overwhelming problems as well. The program's benefit structure remains haphazard, crazy-quilt and inequitable. The structure includes many elements which can only be justified using a welfare rationale, yet those benefits will continue to be paid to too many who are not poor. Also, the program makes the retirement security of the elderly subject to the vagaries of politics, and it is harshly and unnecessarily coercive.

These enormous problems can only be addressed by allowing workers to turn to the private sector to provide for their retirement and insurance needs. The road to such a complete reform will involve a consciousness-raising odyssey for many of those most concerned about protecting the elderly. They will come to recognize—indeed many have already begun to recognize—that the fate of the most vulnerable elements of society cannot be blindly trusted to political promises and the self-serving assurances of interested bureaucrats. Those who have seen the government mislead and lie to the people in other policy areas will come to realize that the government can, will, and has misled the people about Social Security as well. As this recognition grows, workers and the elderly will eventually join arm in arm to break the stranglehold of the haughty Washington establishment on the financial security of the entire nation. ■

[1]Social Security Board of Trustees, *1978 Annual Report of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C.: U.S. Government Printing Office, 1978).

[2]Richard S. Foster, Short-Range Financial Status of the Social Security Program under the Social Security Amendments of 1983, SSI Internal Memorandum, April 6, 1983, p. 3.

[3]The fertility rate has fallen from 7.03 in 1800 to a fluctuation around 1.80 in recent years. See Peter J. Ferrara, *Social Security: The Inherent Contradiction* (Washington, D.C.: Cato Institute, 1980), table 33.

[4]Ibid.

[5]See A. Haeworth Robertson, *The Coming Revolution in Social Security* (Reston, Va.: Reston Publishing Co., 1981). Robertson states that he still believes the tax rates may have to climb over 40% even with the latest bail-out measures.

[6]Ferrara, chap. 4; Ferrara, *Social Security: Averting the Crisis* (Washington, D.C.: Cato Institute, 1982), chap. 5.

[7]See Ferrara, *Social Security: The Inherent Contradiction*, chap. 3.

Rethinking Social Security

by Rep. William Archer

We probably are going to have to rethink Social Security continuously, certainly during my lifetime and perhaps during all of your lifetimes. I don't think we did a good job in this Congress of rethinking Social Security. The congressional package that passed is not an answer to Social Security, even on the retirement end of it, much less the Medicare end where we did little or nothing.

Rep. William Archer (R-Tex.) was a member of the National Commission on Social Security Reform.

Unfortunately, the commission disappointed me tremendously. When I was appointed to the commission, I assumed that we would make recommendations, albeit some of them controversial, that would at least chart a non-political, realistic course for the Congress to consider. As it turned out, the decision of the commission was dictated solely and purely by politics and not by the need to submit constructive recommendations for reform.

And I must say that I have taken a contrary position to Robert Ball for 10 years, and I've been right and he's been wrong for 10 solid years. He is still saying today, "Everything's going to be okay. Don't worry." That's what he said when he supported the 1972 bill which put us into the position that we're in today, and when he supported in 1977 the bill which was labeled as a solution to Social Security for 50 years. And in each instance I warned, "You're wrong."

One of the major reasons I opposed the 1977 bill was that the actuarial projection showed that inflation would decline to 4% and stay at 4% from the year 1981 for another 65 or 70 years. Now, anyone can tell you inflation is not going to stay at 4% for 65 or 70 years, and yet that is the basis on which the President told the American people we now have a solution to Social Security. Well, what have we done today? We're going right back into the same trap. The actuaries have an optimistic, an intermediate, and a pessimistic line of projections. The Congress in its wisdom

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Rethinking (Cont. from p. 5)

Rep. William Archer

accepts the intermediate and says that has to be realistic because it's halfway between optimistic and pessimistic. Although it is not publicly reported, if you press you can get a worst-case scenario, which is more pessimistic than pessimistic. And the last three years of economic experience have been *worse* than the worst-case actuarial projections. Now if the last three years have been worse than the worst case, which is worse than the only ones publicly reported, which are pessimistic, then that should also tell us that there is potentially something that is even worse than what we went through in the last three years.

So we have six possible scenarios: optimistic, intermediate, pessimistic, worst-case, actual experience and a real "worst case." And if we in Congress are ever going to look at a realistic scenario, we've got to consider that full range of possibilities.

This year, we used the intermediate assumptions again. And what do they say? They say that inflation will rise in the next couple of years to between 6 and 7%, and then it will decline in a straight-line graph to 4% in 1991, and then stay at 4% for 65 years. No regard for business cycles, no regard for any changes, just a straight line out—4% inflation for 65 years. And what will unemployment do? Unemployment will decline from what was then 10.9% on a straight line to where, in 1995, it will be 5.5% and it will stay at 5.5% for 65 years. Now today most economists say that full employment is 6% unemployment. The actuaries have then projected that for 65 consecutive years we will not only have full employment, we will have employment that will be .5% better than full employment—without variation, without change. And they're going to be wrong again. And we're going to be right back in the soup again on Social Security because we have been unwilling to work with realistic assumptions.

Individual Returns from Social Security

by Anthony J. Pellechio and Gordon P. Goodfellow

What can an individual expect to receive from Social Security? Will he gain or lose under the system? These questions are crucial in assessing how Social Security affects those paying into it.

We have analyzed the distribution of gains and losses under Social Security, both before and after the new legislation enacted last April, for both single and married men and women of various ages and incomes. We compared the amounts they can expect to get for their payments into Social Security with what they would receive if those payments were conservatively invested elsewhere. This difference can be thought of as the amount of money that Social Security would be giving or taking away today if it were all done at once rather than being spread out over a lifetime.

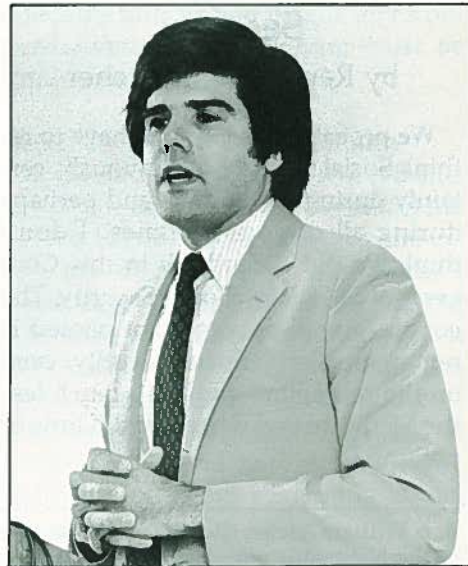
The results of our analysis make it clear that there is no direct link between the taxes an individual pays and the benefits he receives. Single men fare worst of all, incurring losses at all earnings levels, losses that rise as their earnings do. Women on the whole come out much better due to their higher survival rates; on average, they can expect to collect benefits about four and a half years longer than men.

Another striking discrepancy can be seen between single individuals and one-earner couples. For example, although a single man earning $20,000 a year at age 40 pays exactly the same taxes as a one-earner couple, he receives the equivalent of over 3 1/4 years of earnings *less* in total benefits.

One-earner couples also come out ahead compared to two-earner couples. A one-earner couple with an annual income of $20,000 receives about two year's worth of earnings more than a two-earner couple with the same total income.

There is also a great redistribution of wealth from young to old. This does not mean, however, that the burden on an individual lessens with age. A 25-year-old who is losing income today will be losing the same amount in constant dollars when he is 40 or 55, or any age.

The legislation enacted last April, which increased payroll taxes, delayed a cost-of-living adjustment, raised the retirement age, and subjected Social Security benefits to income taxation, will have the overall effect of reducing gains and increasing losses. The cost will be borne mainly by younger workers because the negative financial impact of raising the retirement age and taxing benefits grows over time.


Anthony J. Pellechio

It is inevitable that today's young will have to bear most of the burden of achieving long-range financial solvency in Social Security. Because of its great numbers, the baby boom is able to support the gains conferred on today's retirees, but its size also will preclude similar gains in retirement.

The advantages for current retirees are the result of a Social Security system, population, and economy that were expanding and growing more rapidly in the past than can be expected in the future. The 1983 Social Security Amendments mark the beginning of the end of Social Security's early abundance by reducing the returns to (and indeed imposing greater losses on) younger generations.

Anthony J. Pellechio is Deputy Assistant Secretary for Income Security Policy, and Gordon P. Goodfellow is a Senior Policy Analyst, in the Department of Health and Human Services.

The Impossibility of Full Funding

by Jule R. Herbert Jr.

The real lesson to be learned from examining the Social Security system is not that irresponsible politicians have failed, but that the present system is at bottom no different from any other government taxing and expenditure program and is subject to the same dynamics.

Social Security was sold on the basis that it was insurance paid for by the contributions put in by workers and their employers and that benefits, therefore, were not transfer payments, i.e., *welfare*, but earned rights based on some sort of social quasi-contract.

People were led to believe that the government had discovered a way for retirees to receive higher-than-market returns on relatively small premium payments with no risk. But that was not the case. The plan was an ingenious wrinkle on the time-honored practice of cementing political power by exploiting one group for the benefit of another. At the time, taxpayers were assured that a record was being kept on all this and that one day they too would get old and end up on Social Security. This innovation in tax and spending policy was one of the major steps in the coming of age of the modern welfare state.

It must be repeated, however, that in spite of the economic theories popular at the time, the government certainly had *not* discovered a new process of creating security and wealth.

Unfortunately for the serious proponents of social insurance, only a market economy generates meaningful prices, and only by adding to the existing capital structure in a *price-coordinated* way can productivity be efficiently increased. After all, conceptually, capital is a tool of economic calculation, and it can only coherently refer to market-determined monetary values of specific assets owned by particular business units. Contrary to the naive wishes of government planners, capital goods are not a homogeneous aggregate lump, and capital does not consist of cash balances that can be expanded at will by the central banking authority.

Since capital—as distinct from capital goods (produced factors of production)—has meaning only in the context of market-generated prices, there is no way for the government to rationally order the investment and capital-accumulation part of a market which has advanced beyond a primitive level of production. To assume to the contrary is as foolish as to suppose central planners could successfully direct this country's industrial production, given the current capital goods structure.

Just as a collectivist economy as a whole cannot generate meaningful prices, even a fully funded social insurance system of the size required for universal Social Security cannot find the information required to reveal the profitable capital investment choices needed to deliver what it promises. It is incapable of "knowing" in any meaningful sense what is needed for market coordination. It cannot turn its coerced savings into the economically efficient investment necessary for the required dividends, nor can it simply hold the savings in some sort of non-investment form. As Lord Keynes correctly noted in his *General Theory*, "there is no such thing as liquidity of investment for the community as a whole." Investment must ultimately consist of specific capital goods in the structure of production.

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Colin Campbell of Dartmouth College talks with Jule Herbert at conference luncheon.

Jule R. Herbert Jr. is president of the National Taxpayers Legal Fund.

Full Funding (Cont. from p. 7)

Thus, the insurmountable problem faced by an economic czar given the task of administering a social insurance scheme is where to put the money. This is the point missed by many conservative critics of the current system when they assume that Social Security could be made to work if only it were fully funded or if only benefits were more closely tied to the previous contributions of recipients.

When Social Security was first passed in 1935 it was projected that a trust fund of $37 billion would be amassed by 1980. To this, an insightful Republican Senator Vandenberg objected: "It is scarcely conceivable that rational men should propose such an unmanageable accumulation of funds in one place in a democracy." The record shows that it was not just the standard irresponsible political deviousness, but cautious political conservatism (with much input from business representatives) that led to the 1939 amendments which abrogated full funding.

The same measured process led to the expanded benefits enacted between 1950 and 1972. As with any claim to real resources, the theoretical choice to be made by the bureaucrats was between current consumption and capital investment, but the actual political alternatives faced by the government after the World War II borrowing needs had passed were: (1) spending within the system (increased benefits); (2) building up the trust fund through the purchase of government bonds (in effect, financing federal spending outside of Social Security, such as explicit welfare payments); or (3) attempting to make actual marketplace investments (the real full funding alternative). A mixture of the first two alternatives was chosen, with the more politically popular first choice eventually winning out. Is it not clear that the third choice would have led, even more so than the others, to the effective collectivization of the American private sector?

When *The New Republic* proclaims that the current system must somehow be saved because, "Social Security is our most overtly socialistic program," it is not just being refreshingly frank; it is unwittingly underscoring the actual cause of the system's ultimate failure: Resources committed to Social Security are incapable of being successfully co-ordinated with the price-determined demands of a complex market system. Social Security's managers understand this, at least implicitly. This is why the various trust funds must be invested in government bonds, unless most of industrial production is to become organized along the lines of a giant TVA under the thumb of a Reconstruction Finance Corporation, and why the "security" it produces ultimately is no more than the politicians' promise to tax somebody in the future.

Social Security was sold to most people as a system guaranteeing "mandatory prudence," so that no one would be left out of the progress seemingly automatically generated by the free market. The actual analogy given at the time was that a worker should be compelled to put his retirement "contributions" in a government piggy bank during the course of his working life. Upon his retirement, the government would break the bank and the worker would receive all the benefits of his forced savings, perhaps with imputed interest thrown in. The irony is not only that this did not and could not happen under the system as adopted, but that this is simply not how additional real wealth is generated in a free economy.

Opting Out in Britain

by John C. Goodman

About the time that Ronald Reagan was receiving voter flak over the issue, the British Labor government passed a law which allows employers to opt their employees partially out of British Social Security. What's more, the plan received little or no opposition from the socialist trade unions. Opting out of Social Security has become a part of the British way of life.

This is how the British system works: There are two types of Social Security plans; one is mandatory, the other voluntary. The mandatory or "first-level," plan pays a benefit which is like a minimum income. All workers must pay taxes into the plan, and upon retirement they all receive the same amount of benefits, regardless of their earnings and the amount of taxes they paid in.

The voluntary "second-level" plan, however, is based on earnings. The more you earn, the more benefits you receive upon retirement, which makes it comparable to a private pension plan.

Since 1978, British employers have had the option of contracting their employees out of the second-level plan. In order to do so, they must provide their workers with a private pension plan that pays benefits that are just as good, or better, than those they would have received had they remained fully in Social Security.

In exchange for giving up the right to draw a second-level pension upon retirement, workers and their companies receive a tax deduction. The average male blue-collar worker, for example, gives up an annual government pension of about $3,000 at retirement. But in exchange, his Social Security taxes are reduced by $572 each year for the rest of his working life. The system has been carefully designed to entice workers into private pension plans.

What does all this do for the Social Security crisis in Britain? In the short run, not much. Like the American system, British Social Security is pay-as-you-go. This means that the government still must collect enough taxes to pay for all the benefits that have been promised to current retirees.

But looking to the future, the plan will mean enormous improvement in the long-term health of Social Security. With fewer workers participating in the second-level plan, there will be correspondingly fewer retirees drawing benefits in the future. Over the long run, the British government has cut its liability for second-level payments in half by allowing employers and their workers to contract out.

This April marked the five-year anniversary of Britain's new Social Security system. By all accounts, it has been a smashing success. Both in terms of the number of workers contracted out and the performance of private pension plans, the system has surpassed all initial expectations.

Apparently, the success of the British system was a well-kept secret during recent debate over Social Security here in the United States. To my knowledge, the Greenspan Commission on Social Security Reform did not hear testimony from a single individual describing how the British system works. In fact, the reforms recommended by the commission and adopted by Congress move exactly in the opposite direction from the British plan.

The United States and Great Britain both have faced a crisis in Social Security financing. The British solution was farsighted while we chose a short-term solution.

In February of last year Ronald Reagan told reporters that he wondered "if there was a way to make Social Security voluntary." He should have put that question to Margaret Thatcher at the summit conference in Williamsburg. She could have told him how to do it.

John C. Goodman is president of the National Center for Policy Analysis and author of *Social Security in the United Kingdom*.

John C. Goodman

Social Security and the Young

by Peter G. Peterson

In 1977 Jimmy Carter assured us that the Social Security system would be fiscally solvent through the year 2030. Now we hear again that because of recent reforms, the system will be solvent again for the next 75 years.

But these so-called fundamental reforms don't even include Medicare. A year or two ago when we needed to borrow money, the Medicare system was part of Social Security. But when it came time to reform Social Security because the deficits were obviously getting serious, we decided to define Medicare out of the system. But it's still the most explosive part of the total system. About three-fourths of Social Security's deficits are in health insurance.

Medicare is going to crash in the latter half of the '80s. That crisis will raise questions of the most wrenching kind, because we'll be talking about how to allocate resources on a life or death basis.

Why didn't we get at some of the underlying entitlement programs and the 100% cost-of-living indexing of those programs in the first 90 days of this administration? That's when it might have been politically possible to discuss with the American people why, when we were indexing the tax system and flattening revenues, it was ethical and appropriate to also cap the indexing of programs. But doing so, of course, meant distributing pain, while the tax cuts would be distributing pleasure.

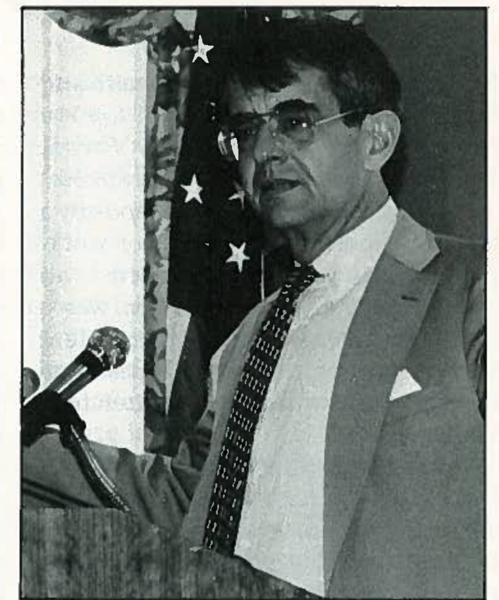
Up to now, we have avoided the issue of trade-offs in the Social Security debate. And as long as we avoid the issue of the costs of continuing the program, then obviously we won't be motivated to do much about the program.

Certainly one of the ethical issues is fairness to the young and fairness to their future—not just in taxing them heavily, but in mortgaging their future.

Perhaps young people ought to think of Social Security as the most massive transfer of wealth from the youth to the unneedy aged in the history of the world, because a lot of the money they pay in is not going to the needy aged. The truth of the matter is that most aged are not needy. The idea that there should be massive windfall benefits to those who are relatively well off does not meet my standard of appropriate use of scarce resources.

Here we sit with unfunded liabilities—one of the great euphemisms of human history—approaching $5.8 trillion; $7 trillion if you include military pensions. We are mortgaging our future $30,000 per person, leading to utterly extraordinary assumptions about the payroll taxes that will be needed to fund this system. When I asked one entitlement organization, "Why don't we tell the young people of this country that we're talking about 30-45% of pay to fund this system?," the answer came back, "You wouldn't want to do that, because if you told the young people how much taxes they'd have to pay, they wouldn't support the system." Young people will be paying the bill and yet they have no idea how big the bill will be. And we call this a democratic process. ■

Peter G. Peterson, former Secretary of Commerce, is chairman of Lehman Brothers Kuhn Loeb.



Peter G. Peterson

$69 Billion for Safety

Risk by Choice: Regulating Health and Safety in the Workplace, *by W. Kip Viscusi. Harvard University Press, Cambridge, Mass., 1983. 200 pp. $18.50.*

Risk by Choice is an excellent book by a leading expert on regulation of workplace health and safety. Viscusi, an economist at Duke University, was a regulatory reformer under President Carter. Although his book is based on his academic writings, it is written for a wide audience.

Viscusi's major contention is that there is a market for safety which operates similarly to, if more subtly than, markets for other goods. Workers are paid to take risks. The more hazardous the job, other things equal, the higher the wage necessary to attract employees. Employers will eliminate hazards only when the cost of doing so is more than offset by the reduction in wages. Costlier reductions in risk are not worthwhile to employees, and government action to require such reductions hurts employers *and* workers.

If people know the dangers they face, says Viscusi, then they should be free to face them. *Do* they know? In Viscusi's answer lies one of the book's strengths. By correlating wages with injury rates, Viscusi estimates the amount workers are paid to risk injury. He calculates the total "risk premium" paid to all U.S. private sector workers in 1979 at $69 billion, or $925 per worker. That employers must pay this sizable premium to attract employees implies that many workers know the dangers. Viscusi also presents evidence that the higher the risk of injury in an industry, the greater the number of workers in that industry who view their jobs as dangerous. While Viscusi doesn't claim workers are perfectly informed of job hazards, he shows they are much more informed than is often thought.

Moreover, Viscusi notes, the $69 billion market inducement for safety is 3,000 times the total penalties levied by the Occupational Safety and Health Administration (OSHA) in 1979. The size of this payment shows that workers' demand for safety, not OSHA, is what induces employers to make workplaces safe.

Unfortunately, Viscusi at times asserts conclusions from his academic articles without defending them. But this is a minor pitfall in a book full of valuable information and insights. I am not as enthusiastic about some of Viscusi's recommendations, particularly his proposal for an OSHA that informs workers rather than regulating workplaces. Viscusi makes a reasonable case that market incentives to provide information can be weak, but he fails to show what incentives would motivate his OSHA to benefit workers rather than to confuse them.

—David R. Henderson
Senior Staff Economist
Council of Economic Advisers

This review does not necessarily represent the views of the Council of Economic Advisers.

Policy Report Reviews

Natural Resources: Bureaucratic Myths and Environmental Management, *by Richard L. Stroup and John A. Baden. Pacific Institute and Ballinger Publishing Co., Cambridge, Mass., 1983. 148 pp. $25.00/9.95.*

The last decade has seen the rapid growth of the new academic specialty of resource economics. Much of the most innovative and challenging work in this field has originated at the Center for Political Economy and Natural Resources (CPENR) at Montana State University, leading many to label the new resource economists the "Montana School." With this book, Stroup and Baden of CPENR have produced a very readable and useful introduction to their discipline. It deserves to be read by everyone interested in environmental policy, conservation, and the efficient management of scarce resources.

The authors begin with a clear presentation of the economics of property rights, showing how "the property rights paradigm provides important analytical leverage that is useful for understanding how individuals interact in institutional contexts." They draw on the works of Harold Demsetz, Steven Cheung, Ronald Coase, and other scholars of the theory of property rights and their institutional context, supplementing this with historical examples of the evolution of property rights in the American West. Perhaps most interestingly, they note that the rigidity of the Homestead Act of 1862 usurped the efficient property rights system that was evolving independently of government. Their analysis is weakened by the assumption that somehow transaction costs are not "real" or are in some way an imperfection of the market process: "Transaction costs impose another problem for efficient market operations. Under ideal market conditions, no transaction costs would arise." One may as well say that "under ideal market conditions" no transportation, arbitrage, or, indeed, opportunity costs would arise. This is virtually meaningless, especially since there is no compelling evidence that alternatives to private property and free markets diminish transaction costs.

Property rights analysis is applied to two cases where the motivations of decision-makers are often thought to differ from the self-interest involved in market transactions, namely native Americans (supposedly historically immune to grubby self-interest) and government officials (also often believed to be motivated by purely "public" concerns). The authors show how groups of native Americans responded to incentives (on the one hand, virtually eliminating the buffalo when the costs of harvesting them declined in the absence of property rights, and on the other hand, spontaneously developing efficient property rights in beaver when demand increased) and examine the incentives faced by self-interested bureaucrats and their myriad perverse consequences (overharvesting of forests, overgrazing, reckless destruction of pinyon-juniper trees, etc.).

The two chapters by CPENR research associate David T. Fractor on ground water management and pollution control provide useful case studies of the destruction caused by lack of freely transferable property rights, as well as straightforward proposals for more efficient resource management through moves toward property rights and free markets. Unfortunately, Fractor departs substantially from the book's general thesis by defending pollution taxes ("effluent fees") rather than property rights as an alternative to present "command and control" management on the part of bureaucracies. While the defects of the latter system are well illuminated (discouragement of pollution-control innovation, inefficient income transfers within industries, subsidization of high-sulfur coal use, etc.) the difficulties with pollution taxes are ignored. Among the questions advocates of this approach should address are: Who sets the fees and how? Aren't they subject to the same perverse political incentives as command-and-control bureaucrats? In the absence of markets, how do they arrive at efficient effluent fees? And to whom do the fees accrue if not the affected third parties, and if them, then why not allocate property rights to them in the first place?

Stroup and Baden conclude with an ambitious but attractive plan to move the national forests to a system of private ownership and management, eliminating the present bifurcation between bearers of costs and reapers of benefits and replacing incentives for environmental destruction with incentives for conservation. The transition would take place through auction, the proceeds being used to finance a simultaneous transition from the current actuarily unsound Social Security system to a far more secure system of voluntary sector retirement plans.

Natural Resources is an excellent overview of the economics of resource management, challenging and informative to specialist and layman alike.

Market Reforms in Health Care: Current Issues, New Directions, Strategic Decisions, *edited by Jack A. Meyer. American Enterprise Institute, Washington, D.C., 1983. 331 pp. $10.95.*

One of the most pressing social issues of the decade is cost containment in health care. The problem of achieving economic efficiency while maintaining medical efficacy becomes even more crucial in light of the increasing average age of Americans and their ensuing health care needs. *Market Reforms in Health Care* follows up on AEI's earlier examination of the possible application of market-oriented changes to health care regulation *(A New Approach to the Economics of Health Care).* This new work looks at opportunities for implementing competitive policies in health care and the roadblocks to such proposed changes.

The volume's 16 articles were authored by a diverse group of experts—professors of economics, law, and medicine; government officials; and representatives from private sector insurers and providers, who were brought together to objectively assess the cost-saving and efficiency-enhancing potential of pro-competitive changes in health care legislation.

Part one of the book assesses the potential trade-offs should incentives-based reforms be implemented. Cost containment is juxtaposed against the risks, quality, and availability of care. Part two examines new frontiers in cost containment in Medicare and Medicaid being explored by the state and federal government as well as by private sector employees, unions, insurers, and providers. Parts three and four analyze fiscal, administrative, regulatory, and legal issues, such as antitrust legislation, relating to federal health policy reform. Free-market alternatives such as voucher systems, copayments, deductibles, employer self-insuring, and flexible benefits are discussed in the context of each of the four parts.

The views range from those of Warren Greenberg, who suggests that the removal of tax-based distortions in the purchase of health insurance will allow consumers and providers to better scrutinize the true benefits of health services, to those of Clark C. Havighurst, who posits that incorporation of private contracts should be emphasized in lieu of "appropriate professional standards" drawn from prevailing custom and now used in medical malpractice law.

The general message of the book is that cost containment will not be "free." Since, as William Swartz warns, "much of what is medically effective does not meet standards of economic efficiency," the decision to implement free-market principles, which bring marginal benefits closer to marginal costs, means treatment will not be provided to all who might benefit from it.

Although there is some repetition of ideas on legislative alternatives, each is seen from a slightly different perspective which results in a remarkably complete understanding of the benefits of market-oriented reforms. If positive changes are to be made, it will be through the adoption of these policies. ■

Coming in *Policy Report:*

Is the Dollar Too Strong?

$83 Billion for Synfuels

Does Foreign Aid Help the Third World?

"To be governed . . ."

Profiles in courage

[Ohio Governor Richard] Celeste's aides [are] trying to convince voters that his doubling of a temporary income tax surcharge, amounting to a 27 percent real increase, did not violate a campaign pledge.

"People are angry at Dick Celeste for raising taxes," said Ohio budget director Cristina Sale. "I get on a radio talk show and nine of 10 questions are on taxes. Some people think he promised not to raise taxes. He didn't, he just simply avoided the issue."

—*Washington Post*, May 29, 1983

Is that a promise or a threat?

The new buzzword among Capitol Hill Democrats this spring is "industrial policy". . . .

[Rep. John LaFalce] said the federal government already influences the American economy in a myriad of "incoherent, uncoordinated and unfocused" ways that form a national industrial policy. His aim, and those of others following the new line, is to get these varied efforts to pull together in a single policy for American industry—much as the government has done for American agriculture.

—*Washington Post*, June 10, 1983

They're just exercising their free speech

NEW ORLEANS—The city's 15 "adult" bookstore and X-rated theaters have a new feature, a uniformed police officer outside the door, who asks the name, age and address of every would-be patron. . . .

District Attorney Harry Connick said he supports the police effort. "It's not illegal, in my opinion, for a police officer to stand on public property and ask questions. He is not forcing anyone to answer the questions."

—*Washington Post*, June 27, 1983

More on democratic socialism

While most Mexican presidents of modern times have ended up with fortunes larger than their official salaries could account for, [former President Jose] Lopez Portillo seems to have been more acquisitive than all his predecessors combined. Ten years ago he was a university professor of slight means; today he is the possessor of a large—some say vast—fortune. . . .

The weekly magazine *Proceso* may have shed some light on that subject when it revealed that the federal department of public works and its engineers, *peones*, and power equipment were furiously busy on [Lopez Portillo's estate] Dog Hill during the last 18 months of Lopez Portillo's term in office. In a thought-provoking coincidence, Pipsa, the government's newsprint monopoly, temporarily cut off *Proceso*'s access to paper soon after the article appeared.

—*National Review*, July 8, 1983

Yes, but the airfield is hidden behind people in Hawaiian shirts

Then, in his so-called "Star Wars" speech March 23, the president showed an aerial photograph he described as the Grenada airfield construction and said, "The Soviet-Cuban militarization of Grenada can only be seen as power projection into the region. . . ."

In response, [Grenadan Prime Minister Maurice] Bishop said Reagan did not need to send a "spy plane" to obtain photos of the field, adding that it is "the No. 1 attraction" for thousands of U.S. tourists annually. They can roam the entire construction area and "take all the pictures they want."

—*Washington Post*, June 1, 1983

So what else is new?

Former [Chicago] Mayor Jane M. Byrne has been hired as a consultant by a company that received a $250,000 low-interest city loan in the final days of her administration, The Chicago Tribune reported yesterday. . . .

She and company president Ronald A. Kahn denied any connection between her employment and the loan.

—*Washington Times*, June 30, 1983

Notices must have been lost in the mail

For 50 years, the government has been storing 1,605 cardboard cartons containing family records and keepsakes left unclaimed in bank vaults around the country following the wave of bank failures in the early 1930s. They were someone's property, and after some assistance from Congress, the government wants to dispose of them.

The Office of the Comptroller of the Currency said yesterday it was ready to release the material.

—*Washington Post*, June 30, 1983

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