

THE ECONOMICS AND POLITICS OF THE EMERGENCE OF SOCIAL SECURITY: SOME IMPLICATIONS FOR REFORM

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Introduction

Over the past 15 to 20 years, economists have offered a wide range of proposals for “radical” reform of Social Security, where “radical” is taken to imply either the explicit financing of the public debt implied by the system or else the partial or complete return to private supply. In one of the first of these proposals, offered by Buchanan and Campbell,¹ government bonds would have been issued to the trust funds in the full amount of the system’s unfunded liability—its “covert” debt obligation. People would then have been permitted voluntary participation. Later, Buchanan developed a proposal to replace the payroll tax with a requirement for the compulsory purchase of Social Security bonds.² Individuals would then have been granted the option to purchase such bonds in the private sector, provided they carried a comparable return. More recently, Feldstein has argued for moving toward a fully funded system while maintain-

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This paper reflects the views of the author and does not necessarily reflect the views of any member of the Senate Finance Committee.

¹James M. Buchanan and Colin D. Campbell, “Voluntary Social Security,” *Wall Street Journal*, December 20, 1966, p. 14.

²James M. Buchanan, “Social Insurance in a Growing Economy: A Proposal for Radical Reform,” *National Tax Journal* 21 (December 1968): 386–95.

ing the government monopoly over the supply of Social Security.³ Friedman, by contrast, endorses the complete privatization of the insurance functions of Social Security, a concept embraced by Ferrara and Wooten.⁴

The common theme of these reform proposals is that the compulsory, pay-as-you-go nature of Social Security in this country has resulted in significant efficiency losses for the citizenry—losses of both choice and wealth. Each of the proposals is an attempt to rationalize a seemingly irrational system; each is an attempt to put present and future generations in the position of benefiting from the fruits of their own savings and the economic growth that could be fostered.

At one level, it would seem, the political and economic climate has never been as fertile for proposals such as these. For the better part of a decade, the financing of Social Security has been in a shambles, and confidence in the long-term viability of the system is at an all-time low. If we know anything about the operation of pay-as-you-go systems and the probable course of mortality and longevity, the financing difficulties and confidence problems will only become more acute in the years ahead.⁵

At another level, particularly after the enactment of the 1983 Social Security Amendments—perceived by some to have been the loss of a great opportunity for “real reform”—it is easy to fall prey to a certain fatalism. The politics of a pay-as-you-go system, or the inability to terminate or significantly scale back such a program once under way, seems so ineluctable.

³Martin Feldstein, “The Social Security Fund and National Capital Accumulation,” in *Funding Pensions: Issues and Implications for Financial Markets*, Conference Series no. 16 (Boston: Federal Reserve Bank of Boston, 1976). See also Michael J. Boskin, “Social Security: The Alternatives Before Us,” in Michael J. Boskin, ed., *The Crisis in Social Security: Problems and Prospects* (San Francisco: Institute for Contemporary Studies, 1977), p. 175; and Daniel Orr, “Toward Necessary Reform of Social Security,” *Policy Review* 2 (Fall 1977): 47–65.

⁴Wilbur J. Cohen and Milton Friedman, *Social Security: Universal or Selective?* (Washington, D.C.: American Enterprise Institute, 1972); Peter J. Ferrara, *Social Security: The Inherent Contradiction* (Washington, D.C.: Cato Institute, 1980); and James Wooten, testimony, Hearings before the Social Security Subcommittee, National Commission on Social Security Reform Recommendations, U.S. Senate, 98th Cong., 1st sess., February 24, 1983, pp. 330–53.

⁵This theme is developed in Carolyn L. Weaver, *Understanding the Sources and Dimensions of Crisis in Social Security: A First Step Toward Meaningful Reform* (Washington, D.C.: Fiscal Policy Council, 1981); idem, “The Long-term Outlook for Social Security—Continued Political Turmoil” (paper presented at a symposium sponsored by the McCahan Foundation for Research in Economic Security, Bryn Mawr, Pa., 1982); and idem, *The Crisis in Social Security: Economic and Political Origins* (Durham, N.C.: Duke University Press, 1982), pp. 175–93.

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In this paper I will argue that the conventional wisdom about pay-as-you-go systems—which is basic to understanding the growth and evolution of Social Security—is inadequate for explaining the emergence and, by inference, the reform of the system. The transitional “gains” to be made from enacting a social insurance program financed on a pay-as-you-go basis, like the transitional “losses” occasioned by reform, are no more significant to real policy outcomes than are the *expectations* that those gains or losses will materialize.

In the midst of the economic and political upheaval of the Great Depression, uncertainty of payoff in the distant future under the new pay-as-you-go social insurance system, compared to the status quo, underlay the failure of Social Security to emerge prior to 1935. The same factor—uncertainty of the alternative—will be a significant barrier to reform, now that the status quo is Social Security. However, real reductions in the expected payoff to perpetuating the system are already observable, as are the increased uncertainties of payoff. These forces will increase the comparative attractiveness of reform.

The paper begins by presenting the conventional wisdom on pay-as-you-go systems. The economic and political origins of Social Security are then carefully examined, as they provide insight into the potential for radical reform in the coming years.

The Conventional Wisdom on Pay-As-You-Go Systems

A public retirement system financed on a pay-as-you-go basis is one in which there is essentially no accumulation of reserves; instead, benefits to the retired generation are financed by a compulsory tax levied on the working population.⁶ The benefits that can be paid under such a system, which determine the rate of return on taxes paid, vary in a predictable way over the life of the system. For analytical purposes, it is useful to distinguish two periods: the “start-up” period (during which time workers pay into the system over only part of their work lives) and the “mature” state (during which time the working population spends its entire work life under the system).

⁶See Edgar K. Browning, “Social Insurance and Intergenerational Transfers,” *Journal of Law and Economics* 16 (October 1973): 215–73; Joseph A. Pechman, Henry J. Aaron, and Michael K. Taussig, *Social Security: Perspectives for Reform* (Washington, D.C.: Brookings Institution, 1968); and Paul A. Samuelson, “An Exact Consumption-Loan Model of Interest with or without the Social Contrivance of Money,” *Journal of Political Economy* 65 (December 1958): 467–82. See Edgar K. Browning, “Why the Social Insurance Budget Is Too Large in a Democracy,” *Economic Inquiry* 13 (September 1975): 373–88, for the seminal work on the politics of pay-as-you-go systems.

Given any rate of taxation, and holding everything else constant, the rate of return on tax payments is extraordinarily high for generations near retirement at the time of the adoption of the system. Furthermore, during the transition to a mature state, the rate of return remains well above that payable in the long term. All of the revenues collected by the government—a simple function of the tax rate and taxable wages in the economy—can be paid out to people as they retire, although they may have contributed to the system for only a brief period.

The older the system and (thus) the longer people will have paid taxes before receiving benefits, the lower the rate of return on tax payments. Ultimately, under a mature system, the average real rate of return payable is limited to the growth rate of the wage base as determined by labor productivity and employment in the economy. At least theoretically, this long-term sustainable rate may or may not compare favorably with the rate of return on private investments as determined by the productivity of capital in the economy.⁷

Once in place, the incentive to expand such a system is significant. The higher the tax rate imposed in this period (or the larger the group that is compulsorily covered), the higher the benefits payable and thus the rates of return, for all of the currently retired, those nearing retirement, and those who will not be subject to the higher tax for their entire working life. Unlike under a funded system, a decision to increase the tax rate represents a collective decision to alter the distribution of rates of return between generations—transferring income from the future generations to the present—rather than simply a decision to “save” more at a given return. In effect, expansions in the program postpone the maturing of the system and perpetuate the gains made possible during the transition.

The incentive to eliminate such a system, by contrast, is nonexistent. Once again, unlike a funded system in which accumulated reserves would be sufficient to pay off any accrued liability, eliminating a pay-as-you-go system, or setting the tax rate equal to zero, is equivalent to paying no further benefits to anyone, now or in the future. Everyone alive who has paid any taxes at all would receive a rate of return equal to minus 100 percent and would rationally oppose any such effort. Any reduction in the tax rate would likewise reduce returns.

⁷According to estimates made by Martin Feldstein, the long-term rate of growth of the wage base is unlikely to exceed 1 to 2 percent, whereas additional investment in the corporate-sector capital stock would yield a real pretax return of about 12 percent. See Feldstein, “The Social Security Fund,” pp. 43, 46–47.

Taken literally, this simplistic presentation of the operation of a pay-as-you-go system implies the following.

- It always pays to create a pay-as-you-go system, although such a system may or may not make sense in the long term;
- It generally pays to expand a pay-as-you-go system; and
- It never pays to eliminate the system, regardless of how poor the return becomes.

So goes the conventional wisdom.

As a method of analyzing the evolution and growth of Social Security, this simple model has great explanatory power. As a method for analyzing the present "crisis" in Social Security, this model is equally useful. Much of the political tension today results from nothing so much as the inevitable deterioration in returns resulting from the maturing of the system, exacerbated by adverse economic and demographic changes. Coverage is nearly universal, the ceiling on taxable earnings now exceeds the earnings of the vast majority of the population (93 percent), and the only way to maintain or improve returns in the face of historically low real wage growth is to further increase taxes. But for nearly half the taxpaying population, Social Security taxes already take a bigger bite out of earnings than federal income taxes.⁸ Given the significant redistributive elements of the system, rates of the return look especially low for young, higher-income people.⁹

As a model for explaining the emergence of Social Security in this country, however, something is evidently missing from the analysis. Under the original Social Security bill, retirement benefits were payable to people 65 and older who had contributed to the system

⁸On the basis of 1979 data, the Social Security Administration found that 24 percent of households paying Social Security taxes, or 18 percent of all households, paid more to Social Security than to the Internal Revenue Service—and this is only if the employee tax is considered. If it is assumed that the employee pays the employer's share too, in the form of lower wages, 51 percent of taxpaying households pay more in Social Security than income taxes. "Family Social Security Taxes Compared with Federal Income Taxes, 1979," *Social Security Bulletin* 44 (December 1981): 12–18. See also Joseph A. Pechman, "The Social Security System: An Overview," in Boskin, ed., *The Crisis in Social Security*; and Roger Leroy Miller, "Social Security: The Cruellest Tax," *Harpers*, June 1974, pp. 22–27.

⁹See, for instance, Michael D. Hurd and John B. Shoven, "The Distributional Impact of Social Security," National Bureau of Economic Research, Working Paper no. 1155, June 1983; and Orlo R. Nichols and Richard G. Schreitmüller, "Some Comparisons of the Value of a Worker's Social Security Taxes and Benefits," Actuarial Note no. 95, HEW Pub. no. (SSA) 78-11500, April 1978. Both of these studies were conducted prior to the 1983 legislation, which by taxing benefits, raising the retirement age, and increasing taxes, further reduced returns for young, high-income workers.

for as few as four years. Administration estimates at the time projected that everyone retiring during this century could receive unearned benefits under the proposed distribution of taxes and benefits, with the aggregate amount of unearned benefits amounting to \$500 million a year (in 1934 dollars).¹⁰

Yet Social Security, or more specifically, compulsory Old-Age Insurance (OAI), emerged from Congress in 1935 against a backdrop of significant and broad-based political opposition.¹¹ Already six years into the Great Depression and with nearly 20 million people on direct government relief, the program was challenged at every step of the legislative process. When the Social Security Act was finally passed, some 46 years after OAI had emerged in Europe, the United States became the last industrial country in the world to enact a national scheme to aid the elderly.

It is not as though Congress and the public were uninterested in the well-being of the elderly or unaware of social insurance as a mechanism for redistributing income. On the contrary, considerable attention was accorded the elderly and the problems of retirement-income security. Even before the Great Depression, 13 states established commissions to study the financial condition of the elderly and report on the advisability of public action.¹² Proposals to make cash transfers to the elderly poor were debated by most state legislatures.

In part, this interest was a response to the marked demographic changes taking place at the turn of the century. For some 40 years (between 1880 and 1920), the elderly population grew faster than

¹⁰See *Report of the U.S. Committee on Economic Security*, Hearings before the Committee on Finance on S.1130, U.S. Senate, 74th Cong., 1st sess., January 22–February 20, 1935, pp. 1334–36; and Edwin Witte, “Old-Age Security in the Social Security Act,” in Robert Lampman, ed., *Social Security Perspectives: Essays by Edwin Witte* (Madison: University of Wisconsin Press, 1962).

¹¹See Edwin Witte, *The Development of the Social Security Act* (Madison: University of Wisconsin Press, 1963); Arthur Altmeyer, *The Formative Years in Social Security* (Madison: University of Wisconsin Press, 1968); Paul Douglas, *Social Security in the United States* (New York: McGraw-Hill, 1939); and Carolyn L. Weaver, “On the Lack of a Political Market for Social Security Prior to the Great Depression: Insights from Economic Theories of Government,” *Explorations in Economic History* 20 (1983): 294–308. See Weaver, *The Crisis in Social Security*, for a thorough development of the argument made here and the historical perspective provided.

¹²See New York Commission on Old-Age Security, *Old-Age Security*, Leg. Doc. no. 67 (Albany: J. B. Lyons, 1930), pp. 48–49, 312–24, 220–70. See also “Old-Age Pensions and Relief,” *Bulletin of the U.S. Bureau of Labor Statistics*, no. 439 (1927), pp. 431–36; “Old-Age Pensions and Relief,” *Bulletin of the U.S. Bureau of Labor Statistics*, no. 491 (1929), pp. 529–32; and Abraham Epstein, *Insecurity: A Challenge to America* (New York: Random House, 1938), pp. 532–50.

the overall population, and during the 1920s alone, it grew at twice the rate of the overall population (reaching 5.4 percent of the total population in 1930). For the balance of the population, the median age rose from 22 to more than 26 in the period from 1890 to 1930, and the probability that a young worker would live to age 65 increased from 41 percent to 60 percent—the odds exceeding 50:50 for the first time at the turn of the century. The amount of time the young worker could expect to spend in retirement was thereby doubled.¹³

Equally important, there was an active core of advocates for the elderly in the early social insurance movement. Originating at the turn of the century with the founding of the American Association for Labor Legislation (AALL), the social insurance movement was led by social workers, social scientists, socialists, and other progressives who banded together in the name of “worker security.” Workmen’s compensation, national health insurance, unemployment compensation, and compulsory old-age insurance were all a part of their agenda. Designed to provide “low-cost insurance” to wage earners through a compulsory tax-transfer scheme, compulsory old-age insurance was a mechanism, said proponents, for substituting income security in the public sector for the uncertainty inherent in the private sector.¹⁴

The Failure of the Early Movement for Social Insurance

In this country the response to proposals for social insurance and other collective welfare schemes was poor.¹⁵ Compulsory insurance was described by the Massachusetts Commission on Old-Age Pensions (in 1910), for example, as “unthinkable and distasteful.”¹⁶ For

¹³U.S. Bureau of the Census, *The Statistical History of the U.S. from Colonial Times to the Present* (New York: Basic Books, 1970); U.S. Department of Commerce, *Historical Statistics of the U.S. from Colonial Times to 1970* (Washington, D.C.: Government Printing Office, 1976); and Michael Darby, *The Effects of Social Security on Income and the Capital Stock*, Study no. 227 (Washington, D.C.: American Enterprise Institute, 1979), pp. 23–26.

¹⁴See, for instance, Barbara Armstrong, *Insuring the Essentials: Minimum Wage Plus Social Insurance—A Living Wage Program* (New York: Macmillan, 1932); Isaac Rubi-now, *The Quest for Security* (New York: Henry Holt, 1934); and Epstein. For an informative recent piece on the early social insurance movement, see Roy Lubove, *The Struggle for Social Security: 1900–1935* (Cambridge, Mass.: Harvard University Press, 1968).

¹⁵See Weaver, *The Crisis in Social Security*, pp. 39–41, and idem, “On the Lack of a Political Market.”

¹⁶Lubove, *The Struggle for Social Security*, pp. 118–19; New York Commission, *Old-Age Security*, pp. 48, 312–13; and Hace Tishler, *Self-Reliance and Social Security: 1870–1917* (Port Washington, Wis.: Kennikat Press, 1971), p. 88.

the Pennsylvania Chamber of Commerce (in 1924), compulsory public schemes to aid the elderly were “un-American and socialistic and unmistakably earmarked as an entering wedge of communist propaganda.”¹⁷ And for Samuel Gompers (in 1917), president of the American Federation of Labor, social insurance was “in its essence undemocratic.”¹⁸ In 1916, he vowed to assist in the “inauguration of a revolution against compulsory insurance.”¹⁹ On the eve of the Great Depression, only one out of the 21 reports that had been commissioned by state legislatures endorsed compulsory insurance.²⁰

Predictably, the onset of the Great Depression in 1929 and the election of Franklin Roosevelt in 1932 revived interest in social insurance and indeed in a wide variety of proposals for using the coercive powers of the federal government to redistribute income. Advocates fueled the notion that the depression was the failure of a “wage-based” economy or, in the president’s words, the product of a “disintegrating system of production and exchange.”²¹

The collapse of private banking and savings institutions and sustained high rates of unemployment, particularly acute among the elderly, threatened two vital means of financial support for persons of all ages. Between 1929 and 1933, one-fifth of all commercial banks failed, and unemployment rose to 25 percent of the labor force. Between September 1929 and June 1932, the real value of all stocks listed on the New York Stock Exchange fell nearly 80 percent, and by 1934 real personal savings had fallen by \$33 billion. As late as November 1934, some 19 million persons, or 15 percent of the population, were receiving emergency or work relief from the various levels of government.²²

Yet as the depression worsened, Congress was no more inclined to enact Social Security than in earlier years. The legislative response to poverty among the elderly was more direct—toward subsidization

¹⁷Cited in Lubove, p. 139.

¹⁸Samuel Gompers, “Not Even Compulsory Benevolence Will Do,” *The American Federationist* 24 (1917): 48.

¹⁹Cited in Lubove, p. 168.

²⁰New York Commission, *Old-Age Security*, pp. 312–24.

²¹Speech delivered March 5, 1934, to a meeting of the National Recovery Administration, cited in *Congressional Record*, June 22, 1935, p. 9906.

²²Milton Friedman and Anna Schwartz, *A Monetary History of the United States: 1867–1960* (Princeton: Princeton University Press, 1963), pp. 299–419; U.S. Department of Commerce, *Survey of Current Business*, no. 8 (January 1933), p. 105; and *Survey of Current Business: Annual Supplement*, 1932, p. 33; U.S. Bureau of the Census, *Historical Statistics*, p. 266; *Supplement to the Report of the Committee on Economic Security*, Hearings before the Committee on Finance on S.1130, p. 40; and U.S. Social Security Board, *Trends in Public Assistance: 1933–39*, p. 6.

of poverty assistance programs at the state and local level rather than the imposition of a tax on young people, many of whom were poor, in order to transfer income to the elderly, high and low income alike. The depression was putting great strains on the old-age assistance (means-tested welfare) programs sprouting up across the nation. Between 1930 and 1934 alone, the yearly cost of old-age assistance rose from \$2 million to \$32 million, nearly twentyfold in real terms, and the number of recipients increased from about 11,000 to 235,000.²³

By 1934, federal assistance to the elderly poor had become a major campaign issue. Organized labor and the Democratic party were joined by business organizations and the Republican party in endorsing such legislation. In that year, a bill (the Dill-Connery bill) authorizing federal aid to the states gained unanimous support in both the House Labor Committee and the Senate Finance Committee.²⁴ Still, no bill calling for compulsory OAI had even been introduced into Congress.

Why So Much Resistance to Social Security? Further Thoughts on Pay-As-You-Go Financing

Understanding the widespread reluctance to enact Social Security requires taking the conventional view of pay-as-you-go systems a step further—to account for uncertainty. Opposition to the creation of the new system may well have been the rational response to the extreme uncertainty of payoff, *ex ante*, for most people.²⁵ Certainly those who were already elderly or near retirement in 1935 could plan, with a relatively high degree of confidence, on receiving net transfers from Social Security. Unearned benefits were typical of the start-up phase of retirement programs throughout the world, and indeed even in most private systems. And of course, with benefits likely to be payable after only minimal time under the system, the risks were low. Recognizing these factors, it should come as no surprise that when the elderly emerged as a political force in their own right in the 1930s, as epitomized by the “Townsend movement,”

²³“Experience Under State Old-Age Pension Acts in 1935,” *Monthly Labor Review* 34 (October 1936): 830–36; “Congress Faces the Question of Old-Age Pensions,” *Congressional Digest* 14 (March 1935): 72; and *Supplement to the Report of the CES*, Hearings before the Committee on Finance on S.1130, pp. 50–51.

²⁴See Epstein, pp. 533, 546; Douglas, pp. 10–11; Witte, *The Development of the Social Security Act*, pp. 5, 7; and American Association for Old-Age Security, “Both Major Parties Promise Social Legislation,” *Bulletin of the AAOAS* 8 (June/July 1934): 5–6.

²⁵This section draws on Weaver, “On the Lack of a Political Market,” and *idem*, *The Crisis in Social Security*, pp. 49–51.

transfers much larger than those in the Social Security bill were sought.²⁶

For younger workers, by contrast, an intergenerational transfer scheme was only potentially profitable and the stakes were very high. The potential profitability lay in the fact that since social insurance programs were not fully funded, retirees could earn an extranormal return on their taxes for many years as income was transferred intergenerationally. Social insurance offered another potential for profit that could prevail over time. The expected returns for similarly situated workers in any particular generation were politically determined—returns did not have to be equal, since they were not constrained by market forces. Thus, depending on one's income class, or family or marital status, the return earned by particular classes of retirees could be even higher than that earned on average.

All of these benefits, however, were *contingent* upon the initially agreed-upon institutional arrangement actually coming to pass at the time of retirement—a point generally neglected in current discussions of the “gains” to be made from pay-as-you-go systems or the “losses” resulting from reform. Under an unfunded social insurance scheme, a decision at some time in the future to lower taxes or reduce benefits would lower rates of return not only for current retirees but also for all the workers who had already paid into the system. The same problem would result from any decline in the growth of tax revenues, such as that caused by an adverse economic or demographic change, only the effect on returns would be permanent. A simple decision—to tilt the benefit formula toward high- or low-average earners, or to cap benefits, tax benefits, lengthen eligibility requirements, or apply offsets for other pension income—could generate huge windfall losses for certain retirees. In relation to the status quo, extranormal (or even positive) returns required the assurance of political control over time and thus the ability to raise taxes to buttress returns at the time of retirement. Evidently, without legally enforceable contracts, there was no certainty of payoff, in an *ex ante* sense.

The experience that workers had with underfunded schemes—including public retirement systems for state and municipal employ-

²⁶The Townsend Plan would have provided payments to the elderly of \$200 (\$1,500 in 1982 dollars) monthly, provided they quit work and spent the entire check in the month received. The Townsend movement was said to have 3.5 million paid supporters by 1935. See Committee on Old-Age Security, *The Townsend Crusade* (Washington, D.C.: Twentieth Century Fund, 1936); “Is the Townsend Plan for ‘Old-Age Revolving Pensions’ Sound?” *Congressional Digest* 14 (March 1935): 92–94; and Douglas, pp. 69–74.

ees, some company and trade-union pensions, and many of the life insurance companies that failed in the late 1800s—all clearly revealed a high degree of risk in this regard.²⁷ Overexpansion of benefits in the early years, when assessment rates were deceptively low, produced too high a structure of future tax rates as well as an unwillingness on the part of younger workers to continue benefit payments. Benefit reductions and outright default in such plans were commonplace. In trade-union plans, there were ongoing struggles between retirees and active workers over benefit levels as compared to assessment rates, with no clear pattern of resolution. While compulsory participation at the federal level could add permanence to an intergenerational transfer scheme by preventing voluntary exit by the young, this would be true only to the extent that younger workers lacked political control.

What did social insurance mean for organized labor? It meant a relatively certain tax on its membership (already sharply declining), in exchange for uncertain future benefits. It also meant the probable termination of their own pension plans, over which they had direct administration and control, in exchange for shared political control. As of 1928, some 1.6 million workers, or 41 percent of all trade unionists, belonged to unions providing old-age benefits.²⁸ At least during the pre-depression years, these benefit plans were perceived as both member-attracting and member-sustaining features.

Surely the Great Depression had a profound effect on the risk that people assigned to the status quo and the uncertainty associated with various social insurance alternatives. As sources of retirement income, labor earnings and private savings became considerably riskier for certain individuals—particularly those already in retirement or close to it. As a countervailing pressure, however, the shifts in political power bases occasioned by the Great Depression must have increased the uncertainty associated with the payoff under any particular social insurance proposal (with no more security than could be offered by an intergenerational “compact”). With the median age of the population just 26 (in 1930), a large proportion of the population could have made the quite rational judgment that the risk of losses under

²⁷“Public Service Retirement Systems in the U.S.,” *Bulletin of the U.S. Bureau of Labor Statistics*, no. 491 (1929), pp. 542-47; “Public Service Retirement Systems: U.S., Canada, and Europe,” *Bulletin of the U.S. Bureau of Labor Statistics*, no. 477 (1929), pp. 1-170; Murray Latimer, *Trade Union Pension Systems* (New York: Industrial Relations Counselors, 1932); and Paul Studensky, *The Pension Problem and the Philosophy of Contributions* (New York: Pension Publishers, 1917).

²⁸Latimer, pp. 113-16. See also William C. Greenough and Francis P. King, *Pension Plans and Public Policy* (New York: Columbia University Press), pp. 40-42.

a pay-as-you-go system, when compared to the status quo, offset the potential for gains in the distant future.

The Shift in Political Power toward Social Insurance

Given this environment, there was an extraordinary shift in political power in 1934 that proved to be decisive for the enactment of Social Security. In that year, President Roosevelt intervened to take the political momentum behind old-age assistance to propel his own program of Social Security. As described by Paul Douglas, an active proponent of social insurance: “[T]he President wanted to delay Congressional action [on the Dill-Connery bill] in order that he might make the program his own. . . . The President’s desire to combine old-age pensions with a general program of social security and his belief that a unified program should be worked out were, therefore, powerful factors in preventing Congress from passing the Dill-Connery bill.”²⁹ The old-age-assistance bill died in the 72d session of Congress, having failed to gain the president’s support.

Shortly thereafter, on June 8, 1934, Roosevelt addressed Congress on the general issue of Social Security. Calling for reconstruction measures to create adequate housing, jobs, and “some safeguards against the misfortunes which cannot be wholly eliminated in this man-made world of ours,” the president announced his intention to formulate a comprehensive plan to “provide at once security against several of the disturbing factors in life—especially those which relate to unemployment and old-age.”³⁰

Three weeks later, by executive order, the president created the Committee on Economic Security (CES). Entrusted with the responsibility of fully exploring the question of Social Security during the remainder of the year, the CES was instructed to report to Congress with a definite program of action in January. At the top of the policy group were five cabinet members: Frances Perkins, secretary of labor; Harry Hopkins, federal emergency relief administrator; Henry Morgenthau, secretary of the treasury; Homer Cummings, attorney general; and Henry Wallace, secretary of agriculture—with Perkins named chairman. Subordinate to the committee was a technical board selected by the CES and composed exclusively of individuals from federal departments and agencies, an executive director selected by the CES, and an advisory council selected by the president. Arthur Altmeyer, assistant secretary of labor, was appointed head of the tech-

²⁹Douglas, pp. 11, 26.

³⁰Text of speech in *Congressional Record*, June 8, 1934, pp. 10769–71.

nical board; Dr. Edwin Witte, member of the Economics Department of the University of Wisconsin, was selected as executive director. Under the chairmanship of Dr. Frank Graham (president of the University of North Carolina), the advisory council was established to represent "the public" at large. Social reformers and other advocates of social insurance were well represented at all levels in this administrative organ of the president.³¹

The final report of the CES, transmitted to Congress on January 17, 1935, was far-reaching. Proposals for a tax-offset system of unemployment compensation and federal grants to states for mothers' pensions, care for dependent and crippled children, and public health programs were included, along with proposals for federal grants to the states for old-age assistance, a voluntary annuities program, and old-age insurance—the latter being the only compulsory and entirely federal program.³² Each of the proposals was consolidated into a comprehensive bill, "the economic security bill," which was introduced into Congress two days later.

Despite the enormity of the bill before Congress (members had 2,500 pages of expert testimony and 12 volumes of technical materials used by the CES to peruse), there was no point in the ensuing legislative process during which the proposal for OAI failed to generate sharp opposition.³³ No feature of the proposal went without criticism; no fallacy went unnoticed. As Altmeyer (who would hold Social Security's top appointed position from 1937 to 1953) recounted, leading members of the House Ways and Means Committee approached the president "to tell him it would not be possible to get a favorable vote on this feature of the bill."³⁴ According to Witte, "it seemed probable" that the "OAI titles would be completely stricken from the bill."³⁵ On the House floor, with the Democrats out-

³¹See Witte, *The Development of the Social Security Act*, pp. 201–2; Charles McKinley and Robert W. Frase, *Launching Social Security: A Capture-and-Record Account, 1935–1937* (Madison: University of Wisconsin Press, 1970), pp. 9–10; Douglas, pp. 27–28; Altmeyer, *The Formative Years*, pp. 7–29; and Frances Perkins, *The Roosevelt I Knew* (New York: Harper and Row, 1946), pp. 278–301. For a comprehensive legislative account, see Robert Stevens, ed., *The Statutory History of the United States: Income Security* (New York: Chelsea House, 1970), pp. 59–88.

³²*Report of the Committee on Economic Security*, Hearings before the Committee on Finance on S.1130.

³³For more on this, see Witte, *The Development of the Social Security Act*; Altmeyer; and Douglas.

³⁴Altmeyer, pp. 12, 34.

³⁵Witte, *The Development of the Social Security Act*, p. 90.

numbering Republicans by three to one, an amendment to strike the OAI program mustered a third of the votes cast (65 to 128).³⁶

On the Senate side, opposition to the administration's proposal was no less intense. On the floor of the Senate, where Democrats held a two-to-one margin, an amendment was adopted (by a vote of 51 to 35) which, if enacted into law, would have been the death knell for Social Security as envisioned by Roosevelt. Under the Clark amendment, employers were granted the option to contract out of the public system if they provided comparable retirement protection.³⁷ As one opponent said, this was the equivalent of the government "inviting and encouraging competition with its own plan which ultimately would undermine and destroy it."³⁸ In conference, it was an unresolved issue over OAI, and in particular the question of whether Social Security would be competitively supplied, that delayed the final passage of the entire Social Security Act. Despite all this, Social Security was law by summer, signed by the president on August 14, 1935.³⁹

The Politics of the Legislative Agenda

Difficult indeed would be the task of finding a better example of the force of an all-or-none offer (short of the summer of 1981, when the powers of the reconciliation process were used so effectively to cut federal spending and taxes). Information was controlled by advocates, alternatives were restricted, and programs were bundled so as to preclude anything approaching a competitive political outcome. These, it is argued—not the potential "profitability" of the system—were the decisive factors in the enactment of Social Security in 1935.⁴⁰

Information Control

In an atmosphere of crisis, social insurance advocates secured a measure of control over the outcome by simply dominating the information presented to Congress and the public on such issues as the "failure" of private savings and insurance institutions, the extent and

³⁶Douglas, pp. 109–10.

³⁷See *Congressional Record*, June 17, 1935, p. 9442; June 18, 1935, pp. 9510–36; and June 19, 1935, pp. 9625–33. See also Witte, *The Development of the Social Security Act*, pp. 88, 102–08, 157; and Douglas, pp. 120–25, 252–65.

³⁸*Congressional Record*, June 18, 1935, pp. 9532–33.

³⁹Witte, *The Development of the Social Security Act*, pp. 159–62; *Congressional Record*, August 9, 1935, pp. 12793–94; and Altmeyer, p. 42.

⁴⁰This section draws on Weaver, *The Crisis in Social Security*, pp. 71–76.

causes of poverty among the elderly, and “viable” institutional alternatives. In part, this was an outgrowth of having a stronger incentive than opponents to invest in acquiring and disseminating information on alternative social policies. The rewards to the advocate who exhibited active support for Social Security and helped see it through to enactment went beyond the shared benefit of having improved the world for all advocates. A job in the newly created bureaucracy, a staff position in Congress, an expanded realm for an existing agency, and jobs for students and colleagues, as well as expanded research and consulting possibilities, were but a few of the spillovers that could accrue to the advocate. Then too, advocates were frequently engaged in the types of employment (such as government agencies, social work, or universities) that facilitated (or funded) research in support of government programs.⁴¹

Opponents had a difficult time competing. Since proposals for compulsory old-age insurance were not seriously entertained before the economic security bill, there was little incentive to invest in acquiring and disseminating counter information and drafting alternative proposals. Likewise, there were no well established congressional committees or subcommittees to oversee such studies. On the basis of time alone, once the CES had been appointed and its staff of experts organized, opponents simply could not compete—in the span of just five months—in turning out the volume and quality of documentary support for their proposals. At the same time, individuals had little ability to capture the benefits of costly research and lobbying. For example, since effectively blocking OAI would secure benefits for all insurance companies, or all young people, whether or not they had participated in sharing the cost, each opponent was motivated to free-ride on the activities of the other opponents.

In essence, even if the CES had not been created to supersede Congress and had not presented Congress with a complex tied package of institutions, competing sources of information were likely to have been outweighed by the information made available by proponents of social insurance. They were the ones with the time, the

⁴¹On uncertainty and information manipulation, see Gordon Tullock, *Toward a Mathematics of Politics* (Ann Arbor: University of Michigan Press, 1967), pp. 100–32; and Randall Bartlett, *Economic Foundations of Political Power* (New York: The Free Press, 1973), pp. 70–75. On the economics of lobbying, see Peter H. Aranson and Peter C. Ordeshook, “A Prolegomenon to the Theory of the Failure of Representative Democracy,” in R. D. Auster and B. Sears, eds., *American Re-evolution* (Tucson: University of Arizona, 1977); and for a similar model, see Tullock, “The Paradox of Revolution,” *Public Choice* 11 (Fall 1971): 89–99; and Richard Auster, “The GPITPC and Institutional Entropy,” *Public Choice* 19 (Fall 1974): 77–83.

funds, the expertise, as well as the ability to capture the rewards of their activities.

Agenda Control, Tie-In Sales, and All-or-Nothing Offers

President Roosevelt then bypassed Congress to establish a committee that would draft its own legislation. Staffed by an array of carefully selected cabinet members and advocate "experts," the CES had a vested interest in expanding the role of the federal government and in advancing programs with specific institutional features. The CES responded to the emerging demands for old-age security not with proposals for changes in legal, tax, or direct financial incentives for pensioning firms, for example, but by advancing a compulsory federal old-age insurance program, along with an entire array of federal/state welfare programs.

Of what significance was all of this? If the CES had simply been one of many freely competing suppliers of proposals, there would have been little significance to who drafted the bill and the particulars of the bill. But, by creating, staffing, and funding the CES with the purpose of formulating a Social Security program outside of Congress, elements of monopoly were created in the agenda formation process. The CES was federally subsidized to produce a bill and to produce a bill of a certain type—one that satisfied Roosevelt's expressed demands for a comprehensive, unified, and permanent program of Social Security, and one that was consistent with the objectives of its members.

These subsidies produced a type of power that could not be eroded by the existence of competing suppliers. Once the CES report was on the agenda, reasonable counterproposals were extremely costly to submit. In many cases, these costs would have been borne directly by participants rather than diffused through taxpayer support. And as suggested earlier, the creation of a competing proposal would have been analogous to the production of a public good for opponents. The power of the CES via subsidized information was thereby compounded by the pervasive problem of an undersupply of proposals.

More important to the nature and timing of the legislation, however, was the administration's use of standard monopoly practices, including the tie-in sale and all-or-nothing offer.⁴² The tie-in sale, in

⁴²For models of agenda control in the public sector, see Charles Plott and Michael Levine, "A Model of Agenda Influence on Committee Decisions," *American Economic Review* 68 (March 1978): 146-60; Robert J. Mackay and Carolyn L. Weaver, "Commodity Bundling and Agenda Control in the Public Sector," *Quarterly Journal of Economics* (forthcoming 1983); idem, "Agenda Control by Budget Maximizers in a Multi-Bureau Setting," *Public Choice* 36 (Winter 1981): 325-52; and Thomas Romer and Howard Rosenthal, "Political Resource Allocation, Controlled Agendas and the Status Quo," *Public Choice* 33 (Winter 1978): 27-43.

this context, was the exchange of the legislator's vote for a bundle of programs. The right to "purchase" one activity over which the government maintained a monopoly (such as emergency relief funds) was tied to the purchase of some other activity (namely, OAI). Rather than being able to register opposition to OAI by voting against it, the legislator had to weigh the losses associated with its enactment against the losses that would be incurred by voting down the bundle and with it, federal relief funds. By increasing the number of politically appealing welfare programs (aid to mothers, the blind, and orphans) in the bundle, the president simply increased the likelihood of swinging opposition votes.

As an effort to restrict the scope of the legislative agenda, the ultimate check on this practice would have been a separate legislative vote on each title of the bill. Effectively utilizing the tie-in thus required the additional control over the agenda provided by the all-or-nothing offer. An all-or-nothing offer, in this context, was the implicit exchange of a legislator's vote for all items in the bundle or none at all. The legislator was thereby placed in the position of supporting the entire package as long as he assessed his position to be better than with none of the programs at all. As described by Abraham Epstein, a leading figure in the early social insurance movement, the omnibus nature of the legislation

presented a real dilemma for earnest members of Congress. . . . They could not physically find the time to master the details of the many subjects involved in the bill. Nor could they place themselves in the same category with the anti-social members of Congress in opposing the entire bill. . . . Since their choice was all-or-none, they voted for all and left it to the Supreme Court to separate the good from the bad.⁴³

The power behind the all-or-none offer lay in Roosevelt's clearly stated position (or threat) that the economic security bill was to be considered as a "unified," "comprehensive" bill and that the extension of welfare to the needy aged would be unacceptable without

On the practice of tie-in sales in the public sector, see James M. Buchanan, "The Economics of Earmarked Taxes," *The Journal of Political Economy* 71 (October 1963): 457-69 and Richard Wagner and Warren Weber, "Competition, Monopoly, and the Organization of Metropolitan Areas," *Journal of Law and Economics* 22 (December 1975): 661-84.

See also Gordon Tullock, *The Politics of Bureaucracy* (Washington, D.C.: Public Affairs Press, 1965); William A. Niskanen, *Bureaucracy and Representative Government* (New York: Aldine-Atherton, 1971); and Ludwig von Mises, *Bureaucracy* (New Rochelle, N.Y.: Arlington House, 1969).

⁴³American Association for Old-Age Security, "Social Security Bill Impractical," *Bulletin* 9 (June/July 1935): 11.

the creation of the permanent social insurance program. This was made clear at several key points, such as when leaders of the Ways and Means Committee met with the president to determine whether (given the opposition to OAI) the omnibus character of the bill had to be kept intact: “The President informed them he wanted the whole bill passed and that OAI must stay in the bill.”⁴⁴ When the Clark amendment was pending in the Senate, the White House assigned expert advisors to each of several key senators in order to influence the vote, then threatened to veto the entire Social Security bill in the event the amendment was adopted.⁴⁵ Witte assessed the situation:

I doubt whether any part of the social security program other than the old-age assistance title would have been enacted into law but for the fact that the President throughout insisted that the entire program must be kept together. Had the measure been represented in separate bills, it is quite possible that the old-age assistance title might have become law much earlier. I doubt whether anything else would have gone through at all.⁴⁶

In sum, the decisive factors for the emergence (the timing and the nature) of Social Security were: (1) an administration committed to the program and willing and able to use the powers of the office to see it enacted; (2) a network of advocates throughout the government and at the highest levels (such as Hopkins and Perkins), well schooled in social insurance and capable of doing the necessary “spadework”; (3) the presence of a popular and time-sensitive political commodity—relief funds for states and localities—the “sale” of which the administration could tie to compulsory old-age insurance; and (4) an economic crisis working to increase the uncertainty attached to the status quo—continued employment and private insurance as mechanisms for providing retirement income.

Some Implications for Reform

Admittedly, the huge wealth transfers effected by Social Security over the years have created two real obstacles to reform—a dependence among the elderly on the present system and perceptions among younger workers that high rates of return are sustainable. While these conditions tend to raise the cost of reform (particularly in the near term), they do not make reform impossible or even unlikely in the longer term. The “facts of the case” are what will condition long-term pressures for reform, and the relevant facts for evaluating Social

⁴⁴Altmeyer, pp. 12, 34.

⁴⁵Witte, *The Development of the Social Security Act*, p. 161.

⁴⁶*Ibid.*, pp. 78–79.

Security as a vehicle for providing for one's retirement are that rates of return *are* falling and that the uncertainty of payoff in the distant future *is* increasing. Recent examples abound (the taxation of benefits and the increase in the retirement age, for example) whereby cuts in Social Security have been possible despite their apparent unprofitability for huge segments of the population.

In 1968, Buchanan suggested that given the opportunity to choose between the present system, with its "pie in the sky" features, and genuine insurance, the individual might well

opt for a genuine insurance scheme which allows for considerably greater certainty about rates of return on what is genuine investment, both for the individual contributor and for the group of contributors collectively. He may do so even if he fully understands and accepts the argument that . . . the intergenerational tax-transfer mechanism may possibly secure for him a net advantage. The uncertainties may outweigh the differential in possible returns.⁴⁷

Uncertainties, in other words, are what will make reform possible, even at a cost. Reforms that draw on now-familiar methods of supply (such as the expanded use of IRAs) will be particularly attractive.

In our present situation, radical reform of the social insurance system will require a committed administration and core of advocates. As revealed over the past three years, our governmental institutions and the people who staff them are considerably more responsive to revolutionary ideas when they expand the realm of government than when they contract it. Who is to say, however, that there will not be a confluence of forces that promote real reform? If the extreme (and costly) uncertainty about one's financial security in old age is recognized by an administration that has concrete ideas for expanding the options for young people, then—despite the transitional cost of reform—we could see real changes in our social insurance system.

⁴⁷Buchanan, "Social Insurance in a Growing Economy," p. 389.

“THE ECONOMICS AND POLITICS
OF THE EMERGENCE
OF SOCIAL SECURITY”:
A COMMENT

Edgar K. Browning

Professor Weaver's paper, and even more so her book, *The Crisis in Social Security*, contains a wealth of information on the political factors that led to and shaped the Social Security system.¹ One of the most fascinating conclusions of her work is that Social Security did not emerge out of a broad-based public demand for a federal retirement policy. Quite the contrary: Weaver shows that Social Security had its origins on the supply side of government and was hardly able to secure legislative approval. Despite having started from a position of little popular support, however, it is today regarded by the public as one of the most successful and popular social policies.

Social Security is far from unique in being a policy that the public was at first reluctant to accept and yet later embraced enthusiastically. The public school system is a similar example. As Professor E. G. West has shown, public schools were not initially demanded by the public; the pressure came from teachers who wanted security and favorable pay.²

Both the Social Security and the public-school examples—and others that could be mentioned—raise serious questions about the workings of the political marketplace. There is great political support for these policies today, yet there was little at their inceptions. Are

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¹*The Crisis in Social Security: Economic and Political Origins* (Durham, N.C.: Duke University Press, 1982) is a very informative and insightful study that contains much more supportive evidence for Weaver's position than could be included in her brief paper.

²See Edwin G. West, "The Political Economy of American Public School Legislation," *Journal of Law and Economics* 10 (October 1967): 101–28.

these cases in which monopolistic public supply has created its own demand and thereby perpetuated itself? Or are these cases in which public supply, once in place, has demonstrated its superiority to private alternatives and has thereby come to win public approval? Both these positions are defensible, but the former—that public policies gain approval by virtue of being part of the status quo—raises the more serious roadblocks to meaningful reform. It suggests that policies become entrenched by creating powerful constituencies, making reform difficult. Weaver's work, I believe, tends to support this disheartening position.

Now let me turn to a consideration of some of the specific points raised in her paper. She begins by describing what she calls the "conventional wisdom" regarding the politics of Social Security. (As an aside, I would quibble with this characterization, because I think only a small minority of people accept this explanation of the way political factors influence the system.) The conventional wisdom is essentially a demand-side view of the political determination of policy: It holds that individuals weigh the benefits and costs they expect from Social Security and decide to support the system if they perceive net benefits. Thus, the conventional wisdom will take widespread voter support for the system to be sufficient explanation for its existence.

The most interesting implication of the conventional wisdom is how it explains rational political support for the system even if it harms most people over the long run. The key to understanding this paradox is the fact that with a pay-as-you-go system it is always in the interests of older persons to continue or to expand the system. A person already retired, for example, will benefit from simultaneous increases in benefits and taxes (because retired persons will pay none of the taxes), even if that course harms all subsequent generations. And the later generations, when they grow older, will also favor continuation of the system. Society can become locked into perpetuating this chain-letter type of arrangement—no one wants to stop the process when he gets near the payoff (that is, as he grows older).

This is the conventional wisdom. Although Weaver acknowledges that the conventional wisdom "is vital for understanding the growth and evolution of Social Security," she argues that it "is inadequate for explaining the emergence, and, by inference, the reform of the system."³ In other words, the system did not begin because of self-interested political pressure from voters, although that factor later played a role in the development of the system.

³Carolyn L. Weaver, "The Economics and Politics of the Emergence of Social Security: Some Implications for Reform," *Cato Journal* 3 (Fall 1983): 363.

In tracing the emergence of Social Security, Weaver first documents the lack of popular support for the program and then shows how supply-side forces—bureaucrats, reformers, social workers, and so on—ultimately triumphed in 1935. I find this a generally convincing account of the thesis that supply-side factors played an important role, but I do not agree that those were the only factors involved. To develop this point, consider why there was so little public support for Social Security before 1935. Weaver finds the explanation in the “extreme uncertainty of payoff.” People (especially younger people) were not really convinced the government would deliver the promised benefits. There is probably an element of truth in this, but I believe it is only part of a more general story. Remember that the 1930s were a period that saw the introduction of many government programs besides Social Security. That period was, in fact, the beginning of the welfare state. I think it is necessary to look for a general explanation for the growth of government in this period, and not just an explanation related exclusively to the specific characteristics of the Social Security program.

The explanation I prefer emphasizes two factors beyond those that Weaver stresses. First is the general leftward drift in ideological beliefs that took place in the early decades of this century. At that time, although the general public continued to believe in the principles of limited government and individualism, socialism and other doctrines critical of free enterprise became predominant in intellectual circles. This trend created a core of people in influential positions who were sympathetic to a more activist role for government—although they lacked the popular support necessary to put their ideas into practice. But then came the Great Depression. That traumatic experience further undermined the public’s faith in free enterprise, and made people willing to accept almost any experiment that held out some promise of improvement.

So in the 1930s we had an intellectual climate favorable to expansion of government, combined with an economic catastrophe that conditioned the public to be receptive to drastic measures. It is easy to understand why Social Security (as well as a host of other government initiatives that would have previously been dismissed out of hand) secured legislative approval in this environment. My explanation is not offered as an alternative to Weaver’s, but as a supplement to her analysis—neither uncertainty of payoff nor supply-side factors alone are sufficient to explain the emergence of Social Security. However, it seems clear that whatever the true cause of the emergence of Social Security in the 1930s, the conventional wisdom helps

account for its rapid growth and its enthusiastic acceptance by the public.

What are the prospects for reform? At the end of her paper, Weaver is cautiously optimistic about the prospects for fundamental change. She emphasizes that the rate of return to Social Security is decreasing as we move out of the start-up phase and that uncertainty about future benefits is increasing, perhaps due to the demographic changes expected in the early part of the next century. However, according to the conventional wisdom, neither of these factors would lead to a rejection of the system. The “reduced returns” are average rates of returns over a lifetime—currently they include the windfall gains of early retirees. The relevant return from a political point of view, however, is the marginal return to changing the size of the system, and that return will remain very high for older people regardless of a (predictable) decline in the lifetime average return. For example, although future retirees may receive a low lifetime return, they will continue to support the system because curtailing it would have a negative marginal effect on their well-being.

Likewise, the uncertainty about future benefits does not appear to be important enough for the public to seriously consider radical reform. Much of the uncertainty has little factual foundation. Many people have been alarmed by talk of possible bankruptcy of the system, believing that in such a case benefits would cease altogether, but such an outcome is not possible. The problem is in mismatched revenues and outlays, especially in the next century, which will require a moderate (or substantial, under pessimistic assumptions about the future) reduction in benefits and/or increase in taxes. While the prospects are not rosy, they do not justify the fear that no benefits will be paid. Hence it is unlikely that the public will become fearful enough of benefits ceasing to support jettisoning the Social Security system.

In conclusion, the reasons given by Weaver for cautious optimism regarding the prospects for real reform are unsatisfactory. In conjunction with the general climate of opinion regarding the role of government in our society, the political forces that the conventional wisdom focuses on still operate too powerfully to allow us to achieve real reform.

SOCIAL SECURITY: POLITICAL HISTORY AND PROSPECTS FOR REFORM

Edward J. Harpham

The past, historians remind us, holds the key to understanding the present. This is particularly true of the current problems confronting Social Security. The economic and political crisis that has undermined confidence in the Social Security system did not spring up overnight. It is the result of a long history of decisions that have been made over the past 50 years. To grasp the full significance of the problems confronting Social Security and the obstacles to real reform, it is essential that we understand the origins of the existing Social Security program.

Carolyn Weaver's paper provides us with an interesting perspective on this past. It attempts to explain why a pay-as-you-go system did not exist prior to 1935, and tries to account for those factors in the decision-making process that led to the creation of Social Security in 1935. Her paper, however, has certain limitations that weaken its usefulness as a guide to the political past of Social Security. By pointing out these limitations, I will try to provide additional insight into the political history of Social Security and the prospects for reform.

Uncertainty of Payoff

According to Weaver, "uncertainty of payoff" was one of the major reasons that a pay-as-you-go Social Security system did not emerge in the United States before 1935. In an unstable political and economic environment, workers had no guarantee that their participation in a pay-as-you-go system would pay off. Thus, Weaver argues, workers could have accepted the status quo (i.e., no social insurance

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program) simply by calculating that the risk of losses in the present under the pay-as-you-go system more than offset the potential for gain.¹

There is a certain appeal to Weaver's argument. One would expect that the issue of the uncertainty of payoff should have played a major role in undercutting support for a pay-as-you-go system. Such an explanation, however, does not fully account for why the United States did not have a Social Security program by the early 1930s while almost all other industrial societies did. By focusing on the issue of the uncertainty of payoff, Weaver tends to underestimate and even ignore other factors unique to the American experience that played a much more important role in preventing the emergence of a pay-as-you-go system.

For example, Weaver fails to consider important institutional barriers that prevented Social Security from being put on the agenda of the federal government prior to the Great Depression. One of the most important barriers was a limited constitutional government kept in check by a strong judiciary. Prior to the passage of the Social Security Act of 1935, welfare policy was an area traditionally left to the state and local governments. With relatively few exceptions, the federal government had refused to enact welfare legislation in the first 30 years of the 20th century and had left initiatives in such important areas as old-age pensions, workers' compensation, and unemployment insurance up to the states.² Many felt that Congress did not have the constitutional authority to enact such social insurance programs. Indeed, as late as 1937 many key policy makers believed that the Supreme Court would declare important portions of the Social Security Act unconstitutional. When the entire act, including the Old-Age Insurance program, was declared constitutional, policy makers were pleasantly surprised. Whatever the wisdom of the Supreme Court's final decision, the fact remains that it was not simply uncertainty of payoff that prevented the emergence of a pay-as-you-go system prior to 1935. Governmental institutions themselves were working under a set of rules and assumptions that tended to undercut and mute political support for such programs at the federal level.

Weaver also fails to consider how certain aspects of the political process affected the way in which voters' preferences got translated

¹Carolyn Weaver, "The Economics and Politics of the Emergence of Social Security: Some Implications for Reform," *Cato Journal* 3 (Fall 1983): 371-72.

²For a discussion of early welfare and social insurance initiatives at the state level prior to 1935, see Roy Lubove, *The Struggle for Social Security: 1900-1935* (Cambridge, Mass.: Harvard University Press, 1968).

into public policies in the early decades of the 20th century. In order to understand why a particular policy was or was not enacted by the federal government, one needs to know not only voter preferences but also how interest groups tended to translate their self-interest (preferences) into concrete policy proposals. In this regard, the political position of organized labor on Social Security is particularly revealing. Surprisingly, organized labor did not play a major role in the passage of the Social Security Act. Indeed, the American Federation of Labor (AFL) did not have a fixed position on social insurance issues until the early 1940s. From its establishment in the late 19th century until the 1930s, the leadership of the AFL was committed to “volunteerism”—the belief that employment issues were settled best by collective bargaining free from government interference. While the AFL did support the passage of the Social Security Act of 1935, it did so with little enthusiasm.³ Much like the question of constitutionality, organized labor’s commitment to volunteerism tended to work against the emergence of a political coalition in favor of any social insurance programs.

One could argue, of course, that the issues of constitutionality and of labor volunteerism simply contributed to the uncertainty of payoff confronting rational voters deciding whether to support a pay-as-you-go system of social insurance. This line of argument, however, points to what is perhaps the most disturbing aspect of Weaver’s paper: The assumption that a pay-as-you-go Social Security program was an issue that confronted both voters and policy makers prior to 1935. Such an assumption is difficult to accept, particularly in light of the political controversies surrounding the actual passage of the Social Security Act. The pay-as-you-go system that exists today did not emerge in its final form until 1950—15 years after the passage of the original Social Security legislation. It was the product of a long history of debate among policy makers as to how Social Security should be funded over the long run.

The Debate over Financing

The Committee on Economic Security (CES) originally considered both “full reserve” and “pay-as-you-go” approaches to financing Social Security.⁴ Under the full-reserve approach, initial benefits being paid

³See Martha Derthick, *Policymaking for Social Security* (Washington, D.C.: Brookings Institution, 1979), pp. 110–13.

⁴See Derthick, pp. 228–30; Jerry R. Cates, *Insuring Inequality: Administrative Leadership in Social Security, 1935–54* (Ann Arbor: University of Michigan Press, 1983), pp. 40–44; Arthur J. Altmaier, *The Formative Years of Social Security* (Madison: University of Wisconsin Press, 1968), pp. 10–11; Edwin E. Witte, *The Development of the Social Security Act* (Madison: University of Wisconsin Press, 1963), pp. 146–61.

out would have been low and based on contributions to the system. In addition, a reserve of \$50 billion to \$60 billion would have been accumulated to meet future payouts. Under the pay-as-you-go approach, on the other hand, initial benefits would have been high and financed over the long run by supplementing payroll taxes with general revenues. The reserve would have been kept at a minimum.

The final plan recommended by the committee to Roosevelt was a modified-reserve approach that provided for the accumulation of a "partial contingency" reserve of \$10 billion and for higher initial benefit payments for older workers. Younger workers, meanwhile, were to receive benefits based upon their contributions to the system as if the system operated fully on actuarial principles.⁵ The committee recognized that by 1965, general revenues would have to be used to supplement payroll taxes. However, the committee argued that because the need for the Old-Age Assistance Program (a state/federal program included in the Social Security Act) would have dwindled to almost zero, general-revenue monies would be available for subsidizing the social insurance program.

It is significant to note that considerable confusion surrounded the benefits provisions in the original CES proposal. As Edwin Witte, the executive director of the committee, pointed out: "[N]o member of the committee understood that payments in excess of contributions would be made not only to workers already approaching old age, but to substantially all workers who entered employment prior to 1957."⁶ It appears that Roosevelt also suffered from such a misconception. Initially Roosevelt believed that the committee's plan contemplated higher benefits only for those workers approaching old age who did not have the time to build up adequate old-age credits. When he discovered that his understanding of the program did not conform with the actual proposed program and that the large deficits projected after 1965 were to be funded with general revenues, he demanded that new tax rates and benefit formulas be developed to make the program self-supporting.⁷ In the end, the committee's proposals were amended to be more along the lines of the full-reserve approach. The initial tax rate was to be 1 percent on employers and employees from 1937 to 1939 and was then to rise .5 percent every three years, until a maximum of 3 percent on both employers and employees was

⁵See Cates, p. 42; Theron F. Schlabach, *Edwin E. Witte: Cautious Reformer* (Madison: State Historical Society of Wisconsin, 1969), pp. 126–28.

⁶Witte, pp. 148–49.

⁷*Ibid.*; see also Cates, pp. 40–44.

reached in 1949. Initial benefits were to be lower than in the original plan. Actuaries calculated that under this arrangement the system would accumulate a reserve of approximately \$50 billion and would be self-supporting at least until 1980.⁸

Interestingly, Roosevelt found himself backing off from the full-reserve method within four years.⁹ Almost immediately after the passage of the act, a heated partisan debate developed over the financing of the Social Security program. Some critics protested the initial low benefits provided retirees. Others criticized the payroll-tax mechanism. Still others were fearful of the large accumulation of funds in the hands of the federal government. The debate culminated in the passage of the Social Security Amendments of 1939. The amendments effectively shattered the linkage that had been forged between taxes and benefits in the original full-reserve program. They provided for supplemental benefits for dependents and survivors of covered workers, the beginning of benefit payments in 1940 rather than 1942, and the basing of benefit rates upon monthly wages rather than cumulative wages. They also postponed the .5-percent payroll-tax increases scheduled for 1940 until 1943.

In short, the Social Security Amendments of 1939 transformed Social Security from a self-supporting insurance program based in large part on a full-reserve approach into a system of transfer payments geared to present welfare concerns. The amendments did not, however, formally establish the pay-as-you-go system that we are familiar with today. Throughout the 1940s, the payroll-tax rate remained frozen. Few in Congress were willing to support tax increases whose current need could not be demonstrated. Little attempt was made to grapple with the question of the long-term financing of the program. Not until 1950 was a new linkage actually forged between payroll taxes and benefits. This linkage was qualitatively different from what was originally envisioned by either the CES or Roosevelt.

In light of this brief history of Social Security, Weaver overstates the argument that uncertainty of payoff played a primary role in explaining the reluctance of many individuals to support a pay-as-you-go system of social insurance. Such an issue could not be raised in any coherent manner until the long-term financing of Social Security had been resolved in 1950. However important the issue of the uncertainty of payoff in a pay-as-you-go system is for workers today, it is a mistake to believe that it was an issue of paramount importance in the early decades of the 20th century.

⁸Witte, p. 151.

⁹For a more detailed discussion of what follows, see Derthick, pp. 237-44.

There were important political questions surrounding the financing of an old-age retirement system that were of vital importance to workers and voters. Moreover, some of these were closely related to the question of certainty of payoff. For example, Roosevelt favored a contributory system of social insurance financed through the payroll tax because he believed it would make the payment of benefits more certain. Individuals would feel that they had earned a right to Social Security benefits through their payroll-tax contributions, and the government would be placed under a certain obligation to make sure that those benefits were paid. Significantly, Weaver has analyzed some of these political questions in her excellent book, *The Crisis in Social Security: Economic and Political Origins*.¹⁰ Unfortunately, by focusing her discussion in this paper on the larger theoretical implications of the pay-as-you-go model, she has failed to discuss such concrete historical issues in sufficient detail.

Despite the limitations of Weaver's general discussion of uncertainty in the pay-as-you-go model, the paper has much to teach us about the policy-making process that gave us the Social Security system. Weaver points out how social-insurance experts were able to control the flow of information into the policy-making process and as a result, how they were able to dominate the agenda with their own proposals. She also explains how the comprehensive approach (to problems of welfare) found in the Social Security Act of 1935 made the passage of particular programs, such as the Old-Age Insurance program, easier. In short, she outlines the conditions that made Social Security possible at a time when many individuals were hostile to any federally sponsored social insurance program.

The Limits on Reform

Do the conditions exist for a substantive reform of the Social Security system? This question, which follows from Weaver's discussion of the passage of the Social Security Act, is of vital importance to us today. Although Weaver believes that such reform is possible, I believe that her paper suggests why it is not. In sharp contrast to 1935, no one group of individuals controls either the information going into the decision-making process or the agenda. The virtual monopoly that social-insurance experts and advocates have had over Social Security policy making since 1935 has been challenged on various fronts since the early 1970s. Far from leading to more open policy making, however, the opening up of the debate over Social

¹⁰(Durham, N.C.: Duke Press Policy Studies, 1982).

Security appears to have overloaded the decision-making process. Legislators do not seem to be very interested in substantively reforming Social Security; rather they seek to suppress meaningful reform and defuse the issue until the next election is past. If the 1983 reform package is any indication of what is to come, there is little hope for more than marginal changes in the Social Security system.¹¹

The likelihood of fundamentally restructuring Social Security thus does not appear great in the near or the foreseeable future. This does not mean that the issue of Social Security reform will go away like some bad dream. Indeed, it might return to haunt us time and again over the next 45 years. The 1983 reforms provided only a small reserve margin to get through the late 1980s. Even a brief economic downturn could throw the entire issue of funding Social Security back into the public arena. Moreover, potentially massive liabilities face the Medicare program if nothing is done to cope with rising health costs in the next few years. Finally, despite the modest benefit cuts of the 1983 reforms, the long-term problem of an aging population still looms.

¹¹For a larger discussion of the significance of the 1983 reforms, see Edward J. Harpham, "Fiscal Crisis and the Politics of Social Security Reform," in Anthony Champagne and Edward J. Harpham, eds., *The Attack on the Welfare State* (Prospect Heights, Ill.: Waveland Press, 1984).