# SOCIAL SECURITY: THE ABSENCE OF LASTING REFORM

*Richard B. McKenzie*

## Introduction

Criticisms of the conceptual basis and actual operations of the Social Security system are extensive and severe. The system is on the verge of bankruptcy. Unless projected benefits are curbed, it portends dramatic payroll-tax increases. Social Security redistributes income from those who earn their livelihood to those who do not. The system fails to adequately aid the elderly who are truly in need. It widens the tax wedge between the wage paid to laborers and the value of their labor in the workplace, thereby distorting the allocation of workers' time between productive and leisure activities. It is a fraud, a pay-as-you-go welfare system that has been and continues to be advertised to the American taxpaying public as an insurance program. The system is paternalistic. It employs government coercion, requiring people who may not wish to provide for their retirement to do what others want them to do. The system, as a set of government-established rules and procedures applicable to everyone, imposes costs and provides benefits that because of their uniformity cannot meet very well the individual needs of a diverse population.

According to its critics, Social Security reduces savings, discourages investment, dampens economic growth, and effectively imposes a tax on future generations, who are politically trapped into signing—by means of their vote—what amounts to an intergenerational social-welfare chain letter. Practically all computations of most future workers' expected rates of return on their Social Security "investment" (using the term loosely) lead inextricably to the conclusion that Social Security is a "bad" deal. Reform, therefore, is considered politically possible, since the gains from eliminating the system can in part or

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The author is professor of economics, Clemson University, Clemson, S.C. 29631.

altogether be used to offset the losses imposed on current and future net beneficiaries of the system.

In short, the Social Security system is inefficient, inequitable, and immoral. Indeed, with respect to the unethical nature of the system, we can view past and current net beneficiaries of the system as having exploited the political system to their own advantage.

Considering the extent and severity of the criticism, one must wonder how the system could possibly survive; one would think that it must simply self-destruct. Certainly, few truly doubt that Social Security can survive in its present form.

In this paper, I will consider the conceptual rather than actuarial soundness of various proposals for reforming the Social Security system. Consequently, I will remain largely unconcerned with an issue important in current policy discussion—whether or for how long reforms such as the one recently passed by Congress and signed by the president will reestablish solvency in the Social Security system. Further, I will assume for purposes of argument (if not out of conviction), that most of the criticisms itemized above and documented in detail elsewhere are reasonably accurate. This approach will allow us to focus our attention on searching for the fundamental institutional defect in our political system that has generated the existing Social Security crisis. Once we have identified the institutional defect, reform proposals can be evaluated not in statistical terms, which are always subject to change, but in terms of whether or to what extent the observed defect is remedied.

My basic conclusion is that none of the current reform proposals addresses or resolves the institutional problem that permitted the emergence of the present Social Security system. Therefore, the line of reasoning developed here suggests that current reform proposals are more sedatives than cures for our policy ills, which implies that any of the benefits that might arise from enacting the various reform proposals are likely to be short-lived. Real reform requires constitutional containment of the entire welfare state, not just of the Social Security system. Such a broad-based solution may in the end be impossible, but it is still worth considering.

Finally, my arguments on the source of the current Social Security crisis are admittedly exploratory, reflecting my conviction that available theory fails to adequately explain the political viability of Social Security. I do not wish to deny that Social Security has succeeded partly because of the bloc voting of the elderly; rather, I seek an explanation of why the individuals who do not receive checks and who appear to be net losers from the system continue to support it.

## The Critical Defect of Democracy

Democracy is a practical compromise between an authoritarian rule, in which political power is concentrated in the hands of one person or a few people, and no rule at all. Democracy disperses political and economic power by setting limits on the freedom of each and every person; it thereby diffuses and negates the tendency of each and every person, in the words of Thomas Hobbes, to obtain what he can "for so long as he can keep it."[1] The critical defect of democracy has long been recognized, namely, the less-than-unanimity, simple-majority voting rule conventionally adopted as a means of mitigating or resolving conflicts among competing interests. The central problem with such a voting rule, in the exaggerated but eloquent prose of historian Thomas Babington Macaulay, is that "institutions purely democratic will never be able to restrain a distressed and discontented majority," that in some year of scarcity the majority will "devour all of the seed corn and thus make the next year, a year not of scarcity but of absolute famine."[2]

Contemporary public-choice economists, many of whom are hard at work in the subdiscipline that has come to be known as constitutional economics, have carried Macaulay's concern with the inherent defects of democracy one step further. Arguing from conceptual and practical standpoints, they state that unless private property is constitutionally protected, the wealth of all in a democracy will be subject to usurpation by an endless and varied array of interest groups. Such groups represent minorities who, because of their concentrated interests and the latent political interests of broader majorities, choose to consume from the nation's stock of seed corn to the point that there is a net loss to society.[3] The emerging literature on rent seeking is replete with examples of how interest groups seek special privileges and in the process dissipate their profits, adding to the social loss from their monopoly power.[4] Indeed, in a majoritarian democracy, the ultimate objective of rent seekers is to use government to establish a monopoly position that will generate economic rents. Interest groups can then compete for these rents. A central thesis of Mancur

[1]Thomas Hobbes, *Leviathan*, ed. C. B. MacPherson (Baltimore, Md.: Penguin Books, Inc., 1968), pp. 185–88.

[2]Thomas Babington Macaulay, letter to Henry Stephen Randall, May 23, 1857. The letter is reprinted in Richard B. McKenzie, *Bound to Be Free* (Stanford, Calif.: Hoover Institution Press, 1982), p. xiii.

[3]This theme is more fully developed in McKenzie, chaps. 5–6.

[4]For essays in the emerging literature on rent seeking, see James M. Buchanan, Robert D. Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent-Seeking Society* (College Station, Tex.: Texas A&M University Press, 1981), especially chaps. 1–3.

Olson's new book is that political stability may be the seedbed of slower economic growth, because political stability allows larger and a greater number of interest groups to acquire benefits not from production, but from the redistributive power of government.[5]

Following this line of analysis, the defect of democracy springs from the human tendency toward predation. Democracy does little to dampen this inclination and unless properly constrained may intensify it. But democracy shifts the forum for predation from the streets to the halls of Congress. It makes predation legal and to that extent, civilized; and it establishes certain limits on predatory activity. Presumably, the resources tied up in rent seeking and destroyed by inefficient government policies in a democracy are worth less than the resources that would be lost to brute force under anarchy.

The literature on the economics of regulation vividly illustrates the tendency of interest groups to exploit democracy's critical defect.[6] Professions and trades such as law, medicine, and landscaping have secured restrictive licensing. The milk lobby has obtained from the government production restrictions and price supports. And industries such as textiles and motorcycles have secured protective tariffs, quotas, voluntary restrictions, and trigger prices. All of these measures are designed to restrict domestic supplies and increase the profits of the protected industries.

While individually such groups may represent relatively few people, their political power is disproportionately large. This stems from the fact that the per capita benefits to these groups are relatively large, while the costs of the government programs are spread thinly over a much larger number of people. In other words, the benefits are substantial and highly visible, while the costs in terms of higher taxes, higher prices, and reduced supplies are dispersed and largely hidden. The very small costs imposed on each member of the consuming public harmed by the special-interest legislation means that costly political opposition will always be limited, leaving an imbalance in the political power structure that favors the special interests.

When not constrained by constitutional restrictions on the scope, variety, and expense of its programs, democratic government—through

[5]Mancur Olson, *The Rise and Decline of Nations* (New Haven, Conn.: Yale University Press, 1982). This book builds on the theory of group behavior developed by Olson in *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, Mass.: Harvard University Press, 1965).

[6]See, for examples in this literature, Almarin Phillips, ed., *Promoting Competition in Regulated Markets* (Washington, D.C.: Brookings Institution, 1975); and Paul A. MacAvoy, *The Crisis of the Regulatory Commissions: An Introduction to a Current Issue of Public Policy* (New York: W. W. Norton and Co., 1970).

special-interest politics—will convert national income into a common-access resource. And as is the case with other common-access resources, the national income will tend to be inefficiently utilized: Government will overexpand and resources will be diverted from their higher valued uses in the private sector. When viewed this way, constitutional constraints can be analyzed in much the same way that controls on the use of other environmental resources are evaluated in environmental economics.

## Social Security in a Democracy

There is much to be gained from reading the conventional literature on the political origins of Social Security. Following closely the public-choice theory outlined here, it informs us that the elderly are a very effective voting bloc, inclined to participate in the political process to a much greater extent than younger generations, and to use their political muscle to redistribute income from the working population to themselves. It also suggests that the elderly may be supported in their rent seeking by suppliers of goods and services that are primarily designed for the elderly. These may be as general as hospital care and as specific as Geritol. The literature, however, does not fully explain an apparent contradiction—namely, why the younger working generation, especially the one just entering the work force, does not form an effective political bloc to oppose Social Security. If Social Security is as destructive as its critics claim, the net wealth gained by the younger working generation from abolishing the system would be greater than that lost by the elderly. If that is not the case, then many of the proposed reforms have no hope of ever being adopted, because they presuppose that there will be a net gain from reform. Indeed, for real reform to take place, it must be demonstrated that a mutually beneficial trade can be developed between the younger and older generations—that the older generation's claims on the Social Security system can be bought off with government bonds or claims against future government revenues, leaving some net increase in future income for the young. In understanding the breadth of political support for Social Security, I am not completely satisfied with the explanation that older people have a stronger preference for political participation than the younger generation has. I therefore seek a different perspective for evaluating Social Security.

We can expand our analysis of the widespread political acceptance of Social Security in two ways: (1) by recognizing that Social Security was originally passed as a collection of social welfare programs, including unemployment compensation and aid to the disabled and retired, that were logrolled into one system; and (2) by acknowledging that many people below the retirement age (referred to here as "younger" or "young people") have a stake in maintaining the system. Although the aims of the Social Security system may be inherently contradictory in the sense that its welfare and retirement objectives clash, the different groups that support it may make the system politically viable in the same way that the continued prohibitions against the sale of alcoholic beverages in Boone, North Carolina, depend upon a coalition of "bootleggers and Baptists." It seems to me that proposals to separate the welfare and retirement roles of Social Security are designed to divide and conquer the Social Security coalition. It will be interesting to see whether members of the supporting coalition can be outmaneuvered in the political process by opponents of the system who appeal for reform on grounds of efficiency.

The coalition supporting Social Security is probably much broader than commonly thought. Many young people may support the system because they know it relieves them from their obligation to care for elderly members of their families. The support from this sector probably has intensified as the number of workers required to support each Social Security beneficiary has increased. As the ratio of required workers to beneficiaries increases, the potential burden that is placed on younger family members by abolishing Social Security also increases, especially since intrafamily transfers would be from after-tax income. Similarly, as family size decreases, which potentially increases the burden each family member must assume if the system is abandoned, support for the system can be expected to grow among the young. In addition, young people may support the system because they see it as insurance against the erosion of their inheritance as rising living and medical expenses deplete the wealth of their aging parents. Finally, some individuals may join the political coalition of "bootleggers and Baptists" because of the intergenerational transfers of purchasing power involved in the system. How are they likely to act?

When considering democracy as an institutional form designed to promote economic efficiency as well as equity, there is no particular reason to define the relevant voting population in objective terms. Voters can be considered in the abstract. Regardless of how the voting population is defined in the abstract, the theory of public choice tells us that specialized groups will tend to further their private interest with whatever political muscle is at their disposal. If we restrict the relevant voting population to the current generation and the relevant national income to what is produced by the current generation, then it follows that all current interest groups will attempt to garner the incomes of all others via the legislative process. This will be true if the demands of individual groups are not so large that they have negative feedback effects on their own incomes.

When the relevant voting population is restricted to the current generation, the impact of shifting distributional questions to the political process becomes reasonably clear. In the context of all generations of voters, the current voting population emerges as a relatively close-knit interest group that has an incentive to redistribute income from future generations to itself. This goal, tempered by a concern for heirs, can be attained by policies that discourage investment and depreciate the nation's capital stock. Such drains on the country's capital stock and shifts of resources away from investment and toward consumption goods offer the current generation an immediate benefit. In this sense, policies that discourage investment, such as Social Security or other welfare programs, illustrate the success past generations have had in diverting consumption goods from our generation and all future generations to themselves.[7]

We should therefore expect a shift in income-allocation decisions from markets to the political process in which the current generation of voters and politicians, whose time horizons may not stretch beyond four or six years, to result in an increase in consumption and a decrease in investment. Actually, since the consumption/investment distinction may more properly be described as the ends of a continuum that runs from immediate gratification to long-term benefits, what is actually suggested by our analysis is that the payoff period for acceptable investment projects will tend to be shortened.

The negative effect of welfare programs such as Social Security on investment may be absolutely necessary to achieve the objective of the generation that enacts it. It has been widely noted that those currently approaching retirement age can obtain increases in their future retirement benefits at the expense of younger workers, who must pay higher future payroll taxes. This process can then be repeated as younger workers reach retirement age. Such "social compacts"

[7]James Buchanan, together with Richard Wagner on the subject of "excessive" deficit spending and with Dwight Lee on the subject of "excessive" tax rates, writes convincingly of the tendency of democratic institutions (specifically the election cycle) to shorten the time horizons of politicians, exploit immobile capital, and discourage investment. See James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Legacy of Lord Keynes* (New York: Academic Press, 1977), and James M. Buchanan and Dwight R. Lee, "Tax Rates and Tax Revenues in Political Equilibrium: Some Simple Analytics," *Economic Inquiry* 20 (July 1982): 344–54.

must be tenuous at best, since they depend on the bloc voting of retirees and those who may soon retire. Of course, the security of the social compact is enhanced when the ratio of retirees to taxpayers is on the increase. But one must wonder how the relatively small number of people that compose those groups can continue to constitute a winning coalition. It appears to me that the voting coalition must have a broader political base, and that people other than the direct beneficiaries of Social Security must benefit from reductions in investment. I suggest that the members of the general population who are not directly affected by the Social Security system and who place a high value on present consumption goods will lend their political support to the system. They may perceive an improvement in their welfare, because prices of consumer goods will be artificially depressed, at least in the short run.

To the extent that the preceding explanation of the survival of Social Security is correct, it would appear that future voting generations, seeking to increase their consumption, would be inclined to enact policies that would be even more restrictive of investment incentives. The net effect of such behavior, of course, would be a progressive reduction in economic growth. In Lord Macaulay's terms, at some point people may begin to eat the seed corn.

## Social Security: The Hole in the Constitutional Dike

The debate over the impact of Social Security on the nation's capital stock has, in my view, been too narrowly focused. Researchers have been concerned with how much Social Security alone has lowered the capital stock from what it would have been. However, Social Security is only one of a wide range of welfare programs that tend to reduce investment incentives. Consequently, it represents only one of the many policy outlets that keep the nation on essentially the same welfare course. Further, it should be recognized that Social Security was one of the first welfare programs and as such may have been the proverbial hole in the country's constitutional dike against government transfers. To the extent that this is the case, a portion of the country's capital stock lost to non-Social Security welfare programs should be attributed to Social Security.

Viewed in these terms, useful reform of Social Security may have to be coordinated with broader efforts to contain the entire welfare state. Containment of Social Security alone may do little or nothing to curtail the basic incentive of the current generation to direct consumption to itself and away from future generations. Any savings derived from curtailing Social Security can be largely lost in the expansion of existing transfer programs and in the initiation of new ones. For this reason, successful reform must involve a *constitutional restriction* on the overall size of government and on its power to redistribute income. Such a restriction could entail a rule that ties the transfer budget to either national income or to total government expenditures, which are tied to national income.

## Proposed Reforms

Proposed or enacted reforms of the Social Security system tend to fall into two broad categories.[8] The first type of reform seeks a short-run and politically modest objective: to make the Social Security system once again solvent by raising projected taxes, extending coverage, and/or reducing projected benefits. The Reagan administration has sought this type of reform.[9] Specifically, it pushed through Congress a proposal that

- increases the 1984 payroll tax by .3 percentage points (an increase that is a credit against federal income taxes and an indirect means of making use of general revenue) and advances a portion of the increase in the rate of payroll tax scheduled for 1990 to 1988;
- raises the Social Security tax on self-employed persons by one-third;
- extends coverage to new federal workers and employees of non-profit organizations and prohibits withdrawals by state and local governments;
- postpones for six months the cost-of-living increase scheduled for 1984;
- eliminates cost-of-living increases in benefits when the consumer price index rises by less than 3 percent;
- makes Social Security benefits of high-income earners subject to taxation; and
- raises the retirement age for future beneficiaries.

Variations on the theme of restoring short-run solvency to the system are embedded in proposals to change the indexing method used to compute future benefits,[10] shift the entire Social Security tax

[8]A number of the proposed reforms discussed below are sketched in greater detail in Peter J. Ferrara, *Social Security: The Inherent Contradiction* (Washington, D.C.: Cato Institute, 1980), chaps. 10–11.

[9]Social Security Amendments of 1983 (P.L. 98-21; April 20, 1983).

[10]See Ferrara, pp. 314–24.

burden to general revenue,[11] or increase the employer's contribution to the system.[12]

The second type of reform, advocated most forcefully by Peter Ferrara,[13] entails separating the welfare and retirement functions, now incorporated under the Social Security umbrella, into two programs. Under this type of reform the welfare function would be covered by general revenue, while the retirement function would be addressed more or less as an insurance program. Although the Brookings Institution proposes that Social Security retirement benefits be retained as a governmental function and be related solely to past wages,[14] other reformers propose that the retirement aspect of Social Security be phased out. Charles Hobbs suggests that the "debt" owed to prospective retirees can be converted into government bonds to be given to people in amounts that would yield a retirement income that could be expected from past contributions to the system.[15] Milton Friedman suggests a simpler change, one that guarantees all workers a retirement income equal to what they have been promised under current law, based on their past contributions.[16] James Buchanan proposes that the payroll tax be converted into a required purchase of government Social Security bonds that would carry a rate of interest equal to the higher of the interest rate on government bonds or the rate of growth in Gross National Product.[17] Finally, the Ferrara plan would require that people establish their own retirement accounts with any one of a number of programs approved and monitored by government.[18]

While privatizing the retirement component of Social Security is a step in the right direction, two concerns should be addressed in

[11]Joseph Pechman, Henry Aaron, and Michael Taussig, *Social Security: Perspective for Reform* (Washington, D.C.: Brookings Institution, 1968); see also Ferrara, pp. 324–30.

[12]Arthur B. Laffer and R. David Ranson, "A Proposal for Reforming Social Security," H. C. Wainwright and Co., May 19, 1977; see also Ferrara, pp. 338–40.

[13]Ferrara, chap. 11.

[14]Alicia H. Munnell, *The Future of Social Security* (Washington, D.C.: Brookings Institution, 1977).

[15]Charles D. Hobbs and Stephen L. Powlesland, *Retirement Security Reform: Restructuring the Social Security System* (Concord, Vt.: Institute for Liberty and Community, 1975); see also Ferrara, pp. 340–44.

[16]Wilbur J. Cohen and Milton Friedman, *Social Security: Universal or Selective?* (Washington, D.C.: American Enterprise Institute, 1972); see also Ferrara, pp. 348–50.

[17]James M. Buchanan, "Social Security in a Growing Economy: A Proposal for Radical Reform," *National Tax Journal* 21 (December 1968): 386–95; see also Ferrara, pp. 344–45.

[18]Ferrara, chap. 11.

reviewing the reform proposals. First, the proposals do nothing to alter the political institutions that permitted Social Security to evolve into the present crisis-ridden system that is the subject of proposals for reform. As noted earlier, a number of suggested reforms propose to divide and conquer the supporting coalition. However, if there are no effective changes in the institutional setting or the level—policy versus constitutional—at which reforms are considered, one must question the probability for success of the reform movement. Any attempt to alter the Social Security system without a corresponding constitutional limit on government spending and taxing powers will be short-lived. Without a limit on transfer spending, Congress could easily abandon, with the switch of a few seats and votes, any Social Security reform package and return to the pre-reform system. Indeed, there would be strong pressures to do so. Hence, all the energy that is used to reform the system will be misspent if it falls short of real constitutional change.

There is nothing that I can detect in the Reagan reform package to prevent future politicians from continuing the practice of promising benefits in excess of projected Social Security taxes, even at the higher tax level imposed by the current Congress. The best we can hope for out of the 1983 legislation is that Congress will hold off any *further* payroll tax increases, at least for the next several years. The legislation has not separated the welfare and retirement aspects of the Social Security program, and there is nothing to prevent Congress from treating the retirement component as a transfer mechanism if the welfare component is placed under general revenues. Indeed, if privatizing the retirement component would generate the benefits attributed to the change, it would pose a real temptation to future politicians interested in redistributing wealth and income. In short, I question whether investment will be significantly spurred by these reforms if the institutional constraints remain the same and if, as a consequence, future tax policies remain basically unchanged.

Second, by clamping down on Social Security, the transfer pressure will not have been abated; only one outlet among a multitude of conceivable outlets will have been closed, and perhaps for only a short time. Without constraints on the transfer capacity of government, the flaws observed may very well emerge somewhere else in the federal budget or regulatory ventures. Hence, the long-run effect of nonconstitutional reform of Social Security could conceivably be negative; all that might be accomplished would be to divert resources from productive purposes to efforts at reform that may not themselves be effective in reducing the costs and inefficiencies of government.

## Conclusion

The purpose of this paper has been to provide a general evaluation of the reform proposals for the Social Security system. As opposed to considering the actuarial mechanics of reform, attention was focused on what are believed to be institutional flaws in the political system—flaws that permit programs such as Social Security to become law. The main criticism leveled at the reform movement is that proposed reforms do not attempt to correct the institutional flaws. Rather, they attempt to change the course of policy, given political institutions. From the constitutional perspective developed in this paper, one must wonder whether the proposed reforms could conceivably accomplish very much in the long run. Real Social Security reform may entail constitutional restrictions on the size of the state, such as those envisioned in the balanced-budget/tax-limitation amendment currently before Congress, or overall restrictions on the size of transfer payments, or increases in the majority required for passage of social legislation. In summary, I must question whether lasting reform of Social Security is possible without a broader constitutional reform.

# "ABSENCE OF LASTING REFORM": A COMMENT

*Joseph A. Pechman*

Oddly, I agree with Professor McKenzie's conclusion that Social Security will not be altered in any fundamental respect, but—as you might expect—I arrive at it from exactly the opposite direction. Far from believing that the Social Security system is a "fraud," I believe that it is the most effective social program ever devised in this country. In 50 years, the system has accomplished what no other program could ever have done: It has raised the average income of the aged to the average income of the nonaged and it has placed a floor under the income of the elderly. It has given dignity and security to millions of Americans and has revolutionized family life in this country. McKenzie knows these facts, but his animosity to all transfer payment programs is so deep that he cannot bear to face them. So, he laments the continued popularity of the program, while I applaud it.

McKenzie lets us in on a very well known secret. The Social Security system is alive and well. It is supported by both political parties, by conservatives and liberals, and by the aged and the young. The National Commission on Social Security Reform, which consisted of political, business, and labor leaders representing all shades of opinion, opened its report with the following ringing endorsement of the system:

> The members of the National Commission believe that the Congress, in its deliberations on financing proposals, should not alter the fundamental structure of the Social Security program or undermine its fundamental principles. The National Commission considered, but rejected, proposals to make the Social Security program a voluntary one, or to transfer it into a program under which benefits

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The author is director of economic studies at the Brookings Institution, Washington, D.C. 20036.

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> are a product exclusively of the contributions paid, or to convert it into a fully-funded program, or to change it to a program under which benefits are conditioned on the showing of financial need.[1]

McKenzie's explanation of this statement is that it is another example of the "bootleggers and Baptists" again raping the public. At one point he admits that "The coalition supporting Social Security is probably much broader than commonly thought."[2] But he quickly dismisses this support on the ground that the younger generation (which he agrees is part of the supporting coalition) really does not understand that it is being impoverished by the system. McKenzie arrives at this conclusion because he believes that Social Security has reduced saving in this country. Only Martin Feldstein, however, has concluded that Social Security has reduced private saving.[3] All of the other studies—even those undertaken by highly respected conservatives—have found that Feldstein's results cannot be supported by dispassionate analysis of the data.

McKenzie is very familiar with the Brookings Institution's work on Social Security, but he has either not read or chooses to disregard Henry Aaron's 1982 study on the *Economic Effects of Social Security*. After a detailed review of all the available studies, Aaron concludes that "the evidence does not support the position that reductions in social security benefits would be effective in increasing private saving" (p. 52). He goes on to say that if we want to increase national saving, the best way is to eliminate the federal deficit—incidentally, a deficit *not* attributable to Social Security—and that raising Social Security payroll taxes or cutting Social Security benefits is not the best way to achieve that objective.

McKenzie also states that the Social Security tax has reduced labor supply, but again he pays no attention to the numerous competent studies on this subject. The fact is that the effect of the Social Security tax on labor supply of younger workers is slight. There is a difference of opinion about whether Social Security encourages people to retire early, but that is a function of the retirement test and not of the tax used to finance retirement benefits.

I want to return to the theme of the rationale for the Social Security system. In the 1968 book, published by the Brookings Institution,

[1]*Report of the National Commission on Social Security Reform* (Washington, D.C.: U.S. Government Printing Office, January 1983), chap. 2, p. 2.

[2]Richard B. McKenzie, "Social Security: The Absence of Lasting Reform," *Cato Journal* 3 (Fall 1983): 472.

[3]Martin S. Feldstein, "Social Security, Induced Retirement, and Aggregate Capital Accumulation," *Journal of Political Economy* 82 (September/October 1974): 905–26.

that I coauthored with Henry Aaron and Michael Taussig, *Social Security: Perspectives for Reform*, we concluded that Social Security is an "institutionalized compact between the working and the nonworking generations, a compact that is continually being renewed and strengthened by every amendment to the original Social Security Act" (p. 75). We devoted a complete chapter to explaining the rationale for Social Security.

The system established in the United States is intended to provide a base on which individuals can build an adequate retirement program. In our view, such a system is justified because there is "widespread myopia with respect to retirement needs" (p. 61). McKenzie does not like the use of the term "insurance" to describe this program. But here again, he does not quite use the right terminology. The system has been sold as "social insurance," not "insurance." While I agree with McKenzie that it is at least as much a "tax-transfer system" as it is an insurance system, it is clear that the American people value it as *social* insurance and do not intend to see it modified in any fundamental way.

Having said that, I must hasten to add that I believe that a lot more needs to be done to improve the Social Security system. The report of the 1979 Advisory Council on Social Security, of which I was a member, is a good starting point. That report proposed changes to improve the benefit structure, modify the treatment of working wives so that they would get more out of the system, tax half of Social Security benefits (the 1983 legislation was only a first step, since it applies only to individuals with other incomes of more than \$25,000 and married couples with more than \$32,000), and many other worthwhile changes. The changes proposed in that report would improve a program that is already operating effectively, McKenzie notwithstanding.

# ALTERNATIVE CONSTRAINTS ON SOCIAL SECURITY

*Colin D. Campbell*

As a background for my comments, let me start by summarizing the main points made by McKenzie. The paper is about the predatory activities of groups with political power (transferring income from others to themselves through the political process). The Social Security system is viewed as the result of the predatory activities of the current generation in relation to the future generation. The current generation has benefited itself by increasing its consumption at the expense of investment, thus lowering the incomes of future generations. Because predatory activities are inherent in our political institutions, McKenzie doubts that the recent amendments to the Social Security Act will have long-lasting effects, and he is skeptical of most reform proposals. He recommends constitutional restrictions on the size of government or restrictions on the size of total transfer payments.

I believe that McKenzie's approach to understanding the changes that are going on in the Social Security system is enlightening. The economic studies of rent seeking are an important contribution to economics. My comments have to do with the various types of predation in the Social Security system. What is going on is more complicated than the emphasis McKenzie places on consumption and investment. Also, in recent years the Social Security system has had financial difficulties in addition to the problems resulting from predation. These financial difficulties may have had more important effects on the system than McKenzie realizes.

My first comment has to do with who is gaining and who is losing in the Social Security system. McKenzie's analysis is almost entirely in terms of the intergenerational transfer. In his view, the current generation is the predator, and the future generation is the victim.

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The author is Loren M. Berry professor of economics, Dartmouth College, Hanover, N.H. 03755.

Although the intergenerational transfer has been very large in the past, it is steadily diminishing. This type of transfer occurs only in the start-up phase of a pay-as-you-go social insurance system. In the start-up phase elderly retirees spend only a few years paying taxes into the system, and the tax rates needed to cover the total benefits are low. As a result, the benefits that the first generation receives far exceed the value of the taxes it paid in. For young people today the intergenerational transfer is over. The taxes that many of them pay in will be larger than the value of the benefits they can expect to receive.[1] The current working generation is no longer increasing its consumption at the expense of future generations. Although there are important examples of predation in the Social Security system, McKenzie's use of the intergenerational transfer and his emphasis on consumption and investment are misplaced.

Also, the way the intergenerational transfer has diminished seems to contradict one of McKenzie's main ideas—that predatory activities are determined by the power of political groups. The intergenerational transfer has diminished not because of the realignment of political groups, but because of the nature of a pay-as-you-go social insurance system. You cannot start up such a system without greatly benefiting the first generation. Although the benefits received by the first generation probably explain much of the political support for the system, it does not explain its continued support once the system matures.

In addition to the intergenerational transfer, there are many intragenerational transfers, and there is no tendency for these transfers to diminish as the system matures.[2] Because of the spouse's benefit, there is a substantial transfer of income from single people to married couples and from working wives to nonworking women. Also, because women on the average live longer than men, there is a major income transfer from single males to single females. In addition, because of the lower tax rates paid by the self-employed, there is a transfer of income from employees to the self-employed. Also, because government employees have not been covered in their main occupations but can qualify for the relatively large minimum benefit by working just long enough in a covered job, there is a transfer from nongovernment workers to government workers. Finally, as a result of the work income test, there is a transfer from working elderly from age 65 to

[1]See table 7 in Anthony Pellechio and Gordon Goodfellow, "Individual Gains and Losses from Social Security before and after the 1983 Amendments," *Cato Journal* 3 (Fall 1983): 437.

[2]Ibid., tables 6, 7, and 8.

70 to nonworking elderly age 65 to 70. I believe these transfers are perfect examples of predation. They reflect the self-interest and political power of the groups benefited. They have little moral or any other kind of justification.

There is another type of intragenerational transfer that has not been widely acknowledged, but is mentioned by Gordon Tullock in his recent book, *Economics of Income Redistribution.*[3] This type of predation may explain the system's broad political support after the start-up phase—a question raised by McKenzie. A basic objective of Social Security is to compel all workers—whether rich or poor—to pay Social Security taxes in return for benefits in their old age. As a result, when workers become too old to work, they will not be a burden to others. From this point of view, the individuals that benefit are those who would have had to support the persons who might have reached old age without any means of support. The individuals that lose out—probably often the less fortunate—are those who are now compelled to pay Social Security taxes that they otherwise would not have had to pay.

In my opinion, McKenzie is correct in stressing the difficulty of getting rid of predatory activities. However, his focus on the intergenerational transfer is too narrow. In the future, the intragenerational transfers will be more important than the intergenerational transfer.

My second comment has to do with the system's financial problems and their effect on predation. The important amendments to the Social Security Act passed in 1977 and 1983 and the other changes made since 1974 are the result of these difficulties. These financial problems are also a reason for most of the proposals for radical reform.

The cause of the system's financial problems is not just the high levels of benefits and taxes resulting from predation. The system's earliest financial crisis was the flaw in the indexing system legislated in 1972. Although the flaw was corrected in the 1977 amendments, it required a radical revision of the benefit formula. An additional source of concern is the decline in the birthrate since 1957 and its effect on the 75-year projections of the cost of the system. It is now predicted that the cost of the Social Security system is going to increase sharply in the next century because of a rise in the ratio of beneficiaries to workers. A third problem—the immediate shortfall in revenues during the past decade—was caused primarily by the decline in the real wage differential, i.e., the more rapid rise in consumer prices than in wages. A pay-as-you-go Social Security system

[3](Boston: Kluwer-Nijhoff Publishing, 1983), pp. 113–14.

in which benefits are indexed to the consumer price index and revenues are obtained from earmarked taxes on wages soon runs out of funds if prices rise faster than wages. This problem was unexpected. Before the 1970s, wages in the United States almost always rose faster than prices, and the Social Security system was designed on the assumption that this relationship between wages and prices would continue. A fourth problem looming on the horizon is the exploding cost of Medicare. In recent years, the cost of Medicare has been rising much faster than the revenues from its share of the total payroll tax.

McKenzie argues that the only effective way to restrain predatory activities is to put restrictions on either the growth of total government expenditures or on the growth of total transfer payments. I believe the recent financial difficulties have had the same type of effect as McKenzie's proposals would have. They put constraints on the system whatever may be the efforts of the various groups that are attempting to transfer income to themselves through the political process.

The recent cutbacks in the Social Security system are more important than usually realized. The 1983 amendments include two measures that will reduce intragenerational transfers. The coverage of Social Security was extended to newly hired federal government employees and to all employees of nonprofit organizations. This will reduce the transfer of income from nongovernment employees to government employees. In addition, the payroll tax rate paid by the self-employed was raised so that it will be equal to the combined employee-employer rate. This will reduce the transfer of income from employees to the self-employed.

There have been other important cuts in benefits. The 1977 amendments reduced replacement rates—the ratio of the benefit a worker receives upon retirement to his wage just before retirement. For the average earner, for example, the replacement rate was reduced from a peak of 54.5 percent for single persons retiring in 1981 to 42 percent for those retiring in 1988 or later.[4] The 1983 amendments included a six-month delay in the cost-of-living adjustments for benefits, taxes on the benefits of persons with high incomes, a rise in the eligibility age for full retirement benefits to age 67 from age 65 and lower benefits for those who retire early, and the indexation of benefits to either the increase in wages or prices, whichever is lower, depending

[4]U.S. Senate, Committee on Finance, *Staff Data and Materials Related to Social Security Financing*, 97th Cong., 2d sess., Committee Print 97-19, December 1982, p. 49.

on the condition of the trust funds. In addition, in the 1981 Omnibus Reconciliation Act benefits were reduced for persons entitled to the minimum benefit, beneficiaries with children in college, persons receiving child-care benefits, and persons receiving the lump-sum death benefit.

These reductions in Social Security benefits have been a surprise. The 1983 amendments were considered to be a remarkable piece of legislation because they included lower benefits as well as higher taxes. The conventional wisdom has been that Social Security benefits cannot be reduced. Cuts in benefits were said to be impossible because it would be political suicide for any legislator to vote for them.

I believe that the cutbacks that have been made would not have occurred if the Social Security system had not had financial difficulties, and that these difficulties have affected the system in the same way as would setting limits on the growth of total transfer payments. McKenzie's conclusion that the recent changes will not be long-lasting is probably wrong. Predatory activities can be restrained by economic developments that adversely affect the Social Security system as well as by political limitations on total spending. The recent cutbacks, however, tend to support McKenzie's point of view that restricting the growth of total transfer payments would be an effective way to restrain predatory activities.