// POLICY REPORT

VOLUME I NUMBER 1 A PUBLICATION OF THE CATO INSTITUTE JANUARY 1979

Social Security: Has the Crisis Passed?

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In 1977 it was announced that the Social Security program had "unexpectedly" accrued a deficit of $4.3 trillion, triggering the widely held belief that there existed a "crisis" in Social Security. Elimination of this deficit would, it was suggested, require massive tax increases. Payroll tax rates projected in 1972 to peak at 11.9% early in the twenty-first century were projected only three years later to reach nearly 30% by the year 2050. To this state of affairs, past Secretary of Treasury William Simon was prompted to say, "The future prospects of the system as we know it are grim."[1]

According to the "official" perspective, which saw the crisis as essentially financial, the 1977 Amendments should put the claims of impending bankruptcy to rest and mark the passing of the crisis. The indexing provision that overresponded to inflation was modified, and tax rate and taxable earnings schedules were adjusted upward so that projected deficits as a percent of taxable payrolls were slashed from 8% to 1.46%. In the words of the Acting Commissioner of Social Security, the system is, once again, "sound and will remain so." For President Carter, these "tremendous achievements" represent the most important amendments to the law since the program's inception in 1935.

From an actuarial perspective, of course, an average deficit of 1.46% of taxable payrolls is still quite substantial. Even with the 1977 Amendments, which entailed the largest peacetime tax increase in U.S. history, it is anticipated that the average deficit for the OASDHI system will rise from $800 million in 1980 to $1.7 trillion in 2025, and reach $7 trillion in 2050, when expenditures are projected to reach 24% of taxable payrolls. The annual tax payment (employee plus employer) for individuals earning more than the taxable maximum is scheduled to rise from $2,140 in 1978 to $4,580 in 1983, reaching $6,550 in 1988. When the college students of today retire, moreover, people who are working at that time will be expected to saddle themselves with 24% tax rates to finance Social Security alone. How can it be said that the financial crisis in Social Security is behind us, particularly when it is remembered that the cost projections used by Congress to expand the program in 1972, just prior to the onset of the "fiscal crisis," actually projected that the system was *overfinanced*? Some wariness in embracing the "official" view about Social Security seems prudent.

Politics and the Social Security Crisis

But is the Social Security crisis simply financial in nature? Do the fundamental sources of this crisis lie in such recent and "unexpected" problems as double-indexing, cyclical recessions, and declining fertility rates? Long before any of these problems materialized, the cost of Social Security grew at an increasingly rapid rate. From a limited-objective, old-age insurance program designed to distribute monthly benefits to retired workers, Social Security grew in just 43 years to encompass four compulsory social insurance programs—old-age, survivors, disability, and hospital insurance—distributing monthly benefits on a pay-as-we-go basis to more than twenty beneficiary categories. Between 1940 and 1977, the number of beneficiaries grew from 222,000 to 33 million who, on average, now receive a monthly cash benefit of nearly $200. While this expansion took place, the combined employee-employer tax rate rose from 2% paid by 35 million taxpayers to 11.7% paid by more than 100 million taxpayers, and the real maximum individual tax payment grew by more than 600%. Social Security has become the largest domestic government program in the United States, spending nearly $100 billion a year.

Since Social Security has developed within a political rather than a market setting, perhaps the crisis in Social Security is at base political rather than financial. Perhaps the current financial difficulties are just visible expressions of what is essentially an evolving political crisis. Accordingly, the historical evolution of Social Security may simply be the natural outgrowth of institutional weaknesses embedded in the early program, so that truly effective reform will require excision of these central weaknesses. To examine this alternative perspective, some details of the evolution of Social Security must first be presented.

As enacted in 1935, the Social Security program consisted of only one compulsory federal program, old-age insurance, which appeared to be simple and relatively narrow in scope, possessing some attributes of private insurance.[2] There was only one beneficiary category, the eligible retired worker. Monthly benefits, which ranged from $10 to $85, were to be paid to worker-taxpayers only, and were to be directly related to their earnings. Coverage was limited to 60% of the civilian work force and was generally concentrated in lower-income occupations. Finally, the system was intended to be fully funded, with tax rates rising from 2% to a maximum combined rate of only 6%.

Similar to private insurance, benefit tables had been designed to ensure that every worker received at least what he had paid in taxes (employee's share only) plus interest, and, importantly, that all workers with the same earnings histories were entitled to exactly the same monthly benefits. While the benefit formula tended slightly to favor workers with lower incomes, the program was primarily designed to supplement private sources of retirement income in a "systematic and safe" way, while relegating the relief of old-age poverty to the newly created old-age pension (means-tested) program.

These features of the original Act provided a set of institutional constraints on the size of the program and its redistributive potential. There was little ability to finance program expansion by postponing tax costs

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Complex Solutions for a Simple Problem: Mr. Carter's Crusade Against Inflation

Inflation results when the supply of money expands. The control of inflation is one of the simplest problems in economics, no more difficult than the arithmetic of losing weight. While a lack of self-discipline or motivation may make it difficult actually to lose weight, there is no mystery about what is required. The control of inflation is equally simple—monetary expansion can be curtailed. Although there is much scope for reducing tax and regulatory disincentives to production, inflation will not be controlled without curbing monetary expansion.

Yet, Mr. Carter's program for controlling inflation is hardly simple. It took him 30 minutes just to sketch it briefly for us. Since the President claimed "there is no single solution for inflation . . . only a number of partial remedies," a wide variety of remedies will be tried. Some of these will involve the federal government: Hiring will be cut, a limit placed on pay increases, and "unnecessary" regulation eliminated. But since "we know that government is not the only cause of inflation," private citizens will also be drafted into the crusade. We will have a period of "voluntary" wage and price controls, controls which we are sternly told are for "everyone," and we are reminded that there is "no excuse" for noncompliance. No one, apparently, is responsible for inflation, so putting an end to it is a task for everyone. Like a virus, it just seems to have been in the air and to have infected us. With only various "partial remedies" to choose from, everyone must be involved in what appears to be a complex, uncertain adventure.

The contrast between the simplicity of the problem and the complexity of the proposed "solution" is striking. Why does this contrast exist? It is certainly convenient to attribute it to economic ignorance. But the economics of inflation is just too simple for this explanation to carry much weight. There must be another explanation. Perhaps academic economics provides the wrong perspective from which to gauge Mr. Carter's program. Mr. Carter is, after all, a practical politician, not an academic economist. The choice of complex solutions that cannot work might indicate, not economic ignorance, but an awareness that creating money can be politically expedient. Since inflation promotes the self-interest of those in political control, there may be little desire to control money creation. This lack of desire, however, cannot (in our political setting) be openly acknowledged. Thus a complex program is developed that, while doing many things, does not control money creation but serves as a form of rationalization for its continuation.

Under our present institutional order, inflation must be understood politically as well as economically. Money creation serves some people's interests; inflation has a constituency. While inflation has been defined as a general state of rising prices, some prices will rise more rapidly than others, as the Inflation Monitor illustrates. If all prices rose at the same rate, money creation would serve no political purpose, and there would be no inflation. The variation in prices is the raison d'être of the politics of inflation. Those who gain by inflation are the initial recipients of the newly created money, while the losers are people who occupy later positions in the chain of transactions. A pervasive feature of politics is the development of economic policies to create and to reward supporting constituencies. The ability to finance such policies through money creation provides an additional instrument of political strategy, the result of which is inflation.

This variation in prices, which provides the political reason for money creation, is also a source of economic disruption. Inflation distorts the information content of market prices, thus increasing economic mistakes. Some investments will be made and lines of business expanded that eventually, in the absence of an accelerating rate of inflation, will prove unprofitable. The economic readjustments thus made necessary by the inflation will weaken our economy. "Stagflation" is no mystery; it can result from inflationary policies chosen to advance particular political interests. Some of these interests, moreover, appear to be promoted by a transfer of power to government as an institution. Inflation, and the attempts to combat it through complex policies, can promote these desires. For instance, will General Motors now dare to announce a 10 percent raise in the price of Chevrolets?

Different options for reform cannot be considered in this short space. This will be the task for future articles. Since inflation results from political action rather than ignorance or happenstance, any search for solutions must likewise be understood and approached as a problem of politics and political order. Mr. Carter's economics is glaringly faulty, but he is not so dumb as he sounds. It is far more believable that controlling excessive money creation is contrary to Mr. Carter's sensed political interest than it is that he cannot fathom the simple economics of inflation. So long as the control of inflation is treated simply as a problem of economic ignorance, without recognizing how it is rooted in political conduct, opposition to inflation seems destined to be ineffectual.

—Richard E. Wagner

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to future generations, because funding would ultimately require each generation to fully meet the tax obligation implied by its future benefit promises. Moreover, by restricting compulsory tax and benefit coverage to lower-paid workers, by placing a ceiling on taxable earnings (initially set at $3,000), and by restricting benefits to worker-taxpayers only, the ability to employ the program as a means of redistributing income between beneficiaries was quite limited.[3]

Major Flaws in the Act

Nonetheless, the original law contained two serious flaws. First, the new Social Security Act created an apparatus through which coalitions of voters could potentially vote for transfers to themselves to be made good by claims on other workers' incomes. Since any "rights" bestowed under the Act were statutory rather than contractual, the political process could be used as effectively to rescind them as it had been used to bestow them. The likelihood that political demands for income transfers would emerge was enhanced by a confounding of the objectives of the old-age insurance program with those of the old-age welfare program. The original benefit formula, which was weighted downward to benefit the near-elderly, was at the same time weighted toward lower-income workers. In effect, these workers would be provided benefits as a "right" under the earnings-related insurance program, even though they had not fully contributed to their cost. This precedent would certainly encourage the growth of demands for larger unearned benefits as a matter of "right" or "social adequacy," thereby obscuring further the relation between a person's benefits and tax payments.

Second, the Act simply removed broad-scale old-age insurance from the traditional realm of voluntary, private sector activity and, in so doing, took an important step toward monopolizing the provision of old-age insurance. The introduction of the compulsory old-age insurance program compelled purchase from a single supplier, the federal government. By eliminating voluntary patronage flows among insurance carriers as an indicator of social value, this step sharply curtailed the information- and efficiency-generating forces of competition.[4] Moreover, any inherent advantages of private companies in providing insurance to the poor and near-elderly were destroyed by the introduction of redistributive features into the benefit formula.

This initial granting of monopoly power to the public supplier, along with the consequent stifling of competing sources of information, ultimately led to a disproportionate weighting of the interests of social insurance advocates and bureaucratic suppliers. These advocates, who had invested heavily in amassing political support for the original bill, were installed in the newly created bureaucracy, where they evaluated the bureau's performance, disseminated information, and drafted legislation. They were in the position of determining not only which issues would be studied internally and which results would be communicated, but also which ones would not. By controlling the production of information relevant for political decisions, Social Security bureaucrats were in a position to use their influence to expand the size and scope of the program.[5]

And this they did. Only four years after the enactment of the original law, and before any monthly retirement benefits had been paid, the new bureaucracy and its carefully selected "citizens' advisory council" engineered a radical redirection of the program. The 1939 Amendments eliminated the fund for a pay-as-we-go system, abandoned individual equity for the goal of social adequacy, and legislated large windfall gains to most workers who would retire in the early years of the program.

Two of the changes enacted in 1939 would prove crucial to the program's future course: changes in the distribution of benefits, and changes in the means of financing. First, modification of the benefit formula and the introduction of benefits for survivors and dependents tilted the pattern of returns not only more in favor of lower-income workers and early retirees, but also in favor of workers with survivors and dependents. In so doing, the distribution of benefits was made to differ increasingly from the distribution that would have arisen in a competitive setting, thus buttressing the monopoly position of the bureau and eliminating the individual equity benchmark as a means of evaluating future changes.

Full Funding Rejected

Second, the intention of building up a funded system was rejected in favor of a pay-as-we-go system of finance, a decision of monumental importance. Under a funded system, each retiring generation would have earned a market rate of return on its tax payments. By requiring that assets ultimately be maintained sufficient to finance all accruing liabilities, this would have been accomplished without imposing burdens on, or making decisions for, future generations. Under the new pay-as-we-go system, on the other hand, benefits would not be financed from accumulated reserves. Instead, benefits paid to the currently retired would be financed by taxes imposed on the currently productive. Rather than being determined by the productivity of investment within the market process, therefore, the rate of return on Social Security payments would come to be determined after 1939 by the relatively unconstrained operation of majority rule.

This change in method of finance would have a dramatic impact on the incentive for beneficiary groups to lobby for program expansion. Under a funded system, beneficiaries would have been able to increase their benefits only by saving more during their working years through the imposition of higher taxes on themselves. Under a pay-as-we-go system, however, beneficiaries would be able to acquire higher benefits by imposing higher taxes on those currently working. Such windfall gains could also be captured by simply expanding the number of people forced to pay the tax.

These types of pressures on the new pay-as-we-go system could only intensify as the proportion of elderly in the voting population increased and as politicians became more responsive to their demands. At the same time, the incentive and ability of taxpayers to monitor the ensuing growth and evolution of the program would be dulled by the broad dispersion and misunderstood incidence of tax costs, and by the Social Security Administration's monopoly on information, particularly with regard to such issues as the actuarial status of the program and the rates of return payable in the distant future. As a result, the interests of beneficiary groups, politicians, and bureaucrats would become increasingly coincidental and, moreover, an increasingly dominant force in shaping the evolution of the new system.

The ultimate power of these groups to determine the future course of the program would derive from the ability of a pay-as-we-go system to make current decisions binding on future generations. Regardless of how high the tax rates or how large the gratuitous transfers to current beneficiaries might become, the system, and therefore benefit payments, would not be able to be terminated or even curtailed once under way without imposing uncompensated losses on all those persons who had paid taxes up until

that time. Incredibly, this massive institutional restructuring of incentives and constraints that took place in 1939 was, at the same time, obscured by the formal introduction of insurance terminology (insurance, fund, contributions, trustees) into the Social Security law and into the vocabulary of the Social Security bureaucracy. Could such a system have been characterized by anything short of fiscal irresponsibility?

Expansion and Redistribution

In the years that followed, the redistributive potential of the pay-as-we-go system was achieved. New beneficiary categories were introduced and eligibility requirements were reduced, thus increasing the proportion of beneficiaries whose tax contributions were well outweighed by their redistributed gains and whose livelihoods had historically fallen within the auspices of old-age welfare. Repeated increases in the ceiling on taxable earnings during the 1960s and 1970s raised the maximum individual tax payment from $288 to $2,141. Expansion of compulsory coverage to nine out of ten workers during the 1950s increased the number of claims on the system while helping to finance an 875% increase in real expenditures over the decade. In other words, each of the program's three originally defined objectives—benefits to worker-taxpayers only, limited coverage, and full funding—were abandoned as the institutional constraints implied by those objectives were eroded by the political process.

Today, currently retired couples enjoy real rates of return well in excess of a market rate, replacement rates of roughly 66%, and annual benefits of up to $8,415, at the same time that the system rapidly approaches a "mature" state.[6] A mature state refers, of course, to the time when these transitional financial gains have been fully captured by beneficiaries through prior, unsustainable rates of increase in the taxable wage base. As population growth declines, the real return on Social Security tax payments—which is determined by the rate of growth of the taxable wage base—must then fall, approaching the rate of growth of labor productivity, or roughly 2%. Taking into account the redistributive elements of the benefit formula, this real return for future retirees will be even lower for higher-income earners.

Toward Meaningful Reform

The prospects for reform of Social Security will be determined, to an important extent, by the views that are generally held on the program's history and current operation. As the foregoing discussion reveals, there are at least two quite distinct views of the crisis in Social Security and, consequently, two possible futures for the system. For those who maintain the view that the crisis is basically financial in nature, simply eliminating long-run imbalances in fiscal accounts—through marginal adjustments to tax rates, taxable earnings, benefit schedules, or eligibility requirements—will imply an elimination of the "crisis." For them, moreover, "reform" of the system will simply constitute an expansion of the program, perhaps to yet uninsured risks, while maintaining balance in fiscal accounts.

The types of proposals generated by the proponents of this view fail, of course, to recognize the possibility that the crisis in Social Security is political in nature and that the same set of institutions being marginally adjusted are those that are coercing a growing proportion of young workers to abide by a program that is making them increasingly worse off than they would have been in its absence. Moreover, their proposals fail to recognize that the system has created a loss even larger than that attributable to the visibly rising proportion of one's income devoted to Social Security. By transferring resources from those planning for retirement to those already retired, the system transfers resources from savers to spenders,

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thus ultimately depressing the nation's capital stock and wealth, and reducing the well-being of everyone. Since there is no real saving and, therefore, no real investment of tax receipts under the current system, the choice of a pay-as-we-go system has implied the sacrifice of an opportunity to enjoy a real return on savings, as determined by the productivity of capital, of roughly 12%. Estimates by Martin Feldstein in 1975 suggest that this loss is hardly inconsequential, having translated into a reduction in Gross National Product of potentially $285 billion.[7] In short, to view the crisis as essentially financial in nature is to fail to recognize that the losses associated with young workers forgoing the opportunity to invest in private markets and the losses associated with this never-achieved wealth both fundamentally derive from the loss of choice in 1935.

To view the crisis, instead, as essentially political in nature and as having evolved predictably from institutional weaknesses in the early program, points to the clear need for truly radical reform of the system. Reform, from this perspective, implies the introduction of choice, voluntarism, and competition into the provision of Social Security as the only effective constraints on the future course of the program.

But how can choice be reintroduced into Social Security? At this point, of course, simply permitting individuals the choice between Social Security and private insurance cannot be done without defaulting on promises already made. By nature of a pay-as-we-go system, all current beneficiaries, and many workers who have already paid taxes into the system, would be made worse off by such a change. As young and higher-income workers left the system in search of better private investments, the tax base would be eroded, and benefit payments curtailed. Simply put, a pay-as-we-go system cannot survive in a competitive setting.

A Program for Transition

How, then, can the transition to choice and competition be made without threatening the continuation of outstanding benefit promises? One possibility is to accumulate a funded system of Social Security and, in so doing, place the public supplier on a more equal footing with private insurers. Since under a funded system there is no significant relationship between the total number of participants and individual benefit levels, the accumulation of a fund would assure all those who wished to remain under the public system that their benefit payments would be met even if the number of younger workers subject to the tax declined. Once funded, therefore, the need would be eliminated to coerce others to remain in the system simply as a means of protecting one's own expected income.

While the problems of financing the huge unfunded liability in the transition to a funded system cannot be ignored, the various means that might be chosen seem to be, at least at this time, of considerably less importance than an understanding of their likely impact on the future of Social Security. In an institutional environment in which people are permitted free choice between the public suppliers and competing private suppliers of retirement income, each worker-taxpayer could be assured—even without contractual agreement—that the return on his payments to Social Security would be no less favorable than in the market. By eliminating the potential for discriminatory income redistribution, the funded system with competitors would, therefore, introduce a lower bound on returns which, being determined by the productivity of investment in the economy, would well exceed the return ultimately payable under the pay-as-we-go system. In addition, the type of information on alternative price-output bundles that would be generated automatically by voluntary patronage flows between competing suppliers of old-age insurance would serve as an effective means of monitoring both private and public suppliers alike.[8]

That this suggestion constitutes a truly radical reform proposal today only attests to the extent to which Social Security has been

INFLATION MONITOR

A regular feature of *Policy Report*, the "Inflation Monitor" reports on the effects of inflation as a monetary phenomenon and demonstrates its distorting influence on the structure of relative prices in the economy.

PERCENTAGE CHANGE (ANNUAL RATE)

	1 month to 9/78	3 months to 9/78	6 months to 9/78	12 months to 9/78
M-1	15.1	9.5	10.8	8.4
M-2	13.3	10.8	9.9	8.5
PRICE OF GOLD	27.16	57.24	29.63	41.78
CPI—URBAN WAGE EARNERS	8.50	7.78	9.91	8.21
COMMODITIES, LESS FOOD	9.57	7.36	7.02	6.50
FOOD	4.48	2.62	11.08	10.58
SERVICES	9.55	9.51	10.45	8.84
FINISHED GOODS	9.83	5.14	8.36	8.25
CONSUMER GOODS, FOOD	19.88	–.96	6.43	10.25
CONSUMER GOODS, NON-FOOD	6.47	8.09	9.31	7.18
CAPITAL EQUIPMENT	7.18	5.83	7.40	8.26
PRODUCER PRICES, BY STAGE OF PROCESSING				
COMMODITIES				
Crude materials, non-food	12.02	11.39	11.80	14.98
Intermediate materials, less food	7.72	7.07	6.61	6.62
Capital equipment	7.18	5.83	7.40	8.26
Consumer finished goods, less food	6.47	8.09	9.31	7.18
FOOD				
Farm products	19.35	–7.33	8.47	18.28
Consumer foods	19.88	–.96	6.43	10.25

All figures are taken from the *Chartbook on Prices, Wages, and Productivity* (U.S. Department of Labor), *Monetary Trends* (Federal Reserve Bank of St. Louis), and the *Wall Street Journal.*

redirected since its inception in 1935, and the extent to which the initial choice of bureaucratic supply has tended to put, in the words of Hayek, a "straitjacket on evolution."[9] In 1935, an amendment that was offered to the original Social Security Act to permit individuals free choice between the new public program and private suppliers actually won majority approval in the Senate and went on to stalemate the Congressional conference committee. The failure to reconsider such "radical" reform of Social Security in the 1970s may well mean the acceptance of "the ineluctable lesson of recent events that Social Security can no longer be a positive sum game where everybody wins and nobody loses."[10]

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FOOTNOTES

[1]William Simon, "How to Rescue Social Security," *Wall Street Journal*, November 3, 1976.

[2]For a more thoroughly argued and documented reexamination and reinterpretation of the evolution of Social Security, *see* Carolyn L. Weaver, "The Emergence, Growth, and Redirection of Social Security: An Interpretive History from a Public Choice Perspective," (Ph.D. diss., Virginia Polytechnic Institute and State University, 1977), or "Competition in the Provision of Social Security: An Old Idea Revisited," in *Deductive Reasoning in the Analysis of Public Policy*, ed. Gordon Tullock and Richard E. Wagner (Lexington, Mass.: D.C. Heath and Company, 1978).

[3]This should not be taken to imply that the program was broadly supported by the electorate in 1935. To the contrary, had it not been for the prolonged duration of the Great Depression and the ability of program advocates to tie the creation of a series of popular poverty-relief programs to the enactment of federal old-age insurance, it is extremely unlikely that the compulsory program would have gained passage in the 1930s. This is witnessed, in part, by the fact that a proposal to eliminate the old-age insurance program from the Social Security Act altogether mustered nearly 30% of the votes cast in the House. In addition, the one amendment to the Act that was passed by the Senate and ultimately stalemated the conference committee was a proposal to permit private insurance plans to contract out of the public program if they could provide at least as generous cost-benefit bundles as the federal government.

[4]*See* Friedrich A. Hayek, "The Use of Knowledge in Society," *American Economic Review* 35 (1945): 519-30, for the seminal discussion of the role of markets in the production and dissemination of information.

[5]For an exceedingly insightful early discussion of the problems that would plague the program, *see* Friedrich A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1954), pp. 285-305; and for a similarly insightful discussion of bureaus as information monopolies, *see* Ludwig von Mises, *Bureaucracy* (New Rochelle, N.Y.: The Arlington House, 1969).

[6]A replacement rate is the ratio of the retired worker's initial benefit payment to his gross earnings in the year prior to retirement.

[7]Martin Feldstein, "Social Security, Induced Retirement, and Aggregate Capital Accumulation," *Journal of Political Economy* 82 (1974): 905-25.

[8]To simply accumulate a fund within the present monopolistic framework would in no sense constitute a "halfway" measure. The possibility of the federal government accumulating huge reserves to be invested in private capital markets runs the very real risk of extending its existing monopoly power to yet other markets. The monopolization of credit in the United States is likely to present a far more serious problem than does the current system.

[9]Hayek, *Constitution of Liberty*, p. 304.

[10]Gene Koretz, "The Social Security Bomb Is Still Ticking," *Business Week*, January 9, 1978.

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