Cato Policy Report

May/June 1985 Volume VII Number 3

Social Security: Bad Deal for Young Workers

by Peter J. Ferrara

Public discussions of Social Security usually focus on the financing question of whether the program will be able to pay all its promised benefits. But more attention should be paid to a new and potentially even more destabilizing problem: while the program can still be considered a good deal for those retired today, for those now entering the work force the program will be a very poor deal, given the enormous tax burdens they must pay over their careers.

This development is a natural result of the maturing of Social Security's pay-as-you-go system, in which tax funds paid into the program today are not primarily saved for the future benefits of today's workers, but instead are immediately paid out to finance the benefits of today's elderly. The future benefits of today's workers are to be paid primarily out of the taxes of the next generation of workers.

Those who retired in the early years of Social Security's pay-as-you-go system had to pay the program's taxes for only a few years before retirement. Moreover, the taxes in the early years were quite low. The maximum annual tax, including both employer and employee shares, was $189 as late as 1958, and $348 as late as 1965. But since the program was operated on a pay-as-you-go basis, the benefits to these early retirees were not limited to what could be paid based on their own past tax payments. They were instead paid full benefits out of the taxes of those still working. Consequently, these benefits represented a high return on their own past tax payments.

> "For most young workers, the real rate of return promised by Social Security is 1 percent or less, and for many it is zero or negative."

The classic example is the very first Social Security recipient, Ida M. Fuller of Vermont, who paid Social Security taxes for only three years before she retired in 1940. By that time, she and her employer had paid a total of only $44 in payroll taxes. Yet she collected Social Security benefits for the next 35 years, until she died at the age of 100. During that time, she received $20,884.52 in benefits, an enormous return on the taxes she and her employer paid into the program.

Over the years, as workers retired who had paid higher Social Security taxes for more of their careers, the rate of return paid by the program fell, as the benefits paid naturally represented less of a return on the greater tax payments. Today's retirees are receiving much less of a good deal than the earliest retirees, but they are still receiving above-market returns.

Those entering the work force today, however, face Social Security taxes of thousands, and even tens of thousands, of dollars each year for their entire careers. The maximum annual Social Security tax is today almost $5,600 and will already be almost $8,000 by the end of the decade. Even if these workers receive all the Social Security benefits they are currently promised, the return represented by these benefits on the

(Cont. on p. 10)

Peter J. Ferrara, chairman of the advisory committee of the Independent Retirement Alliance, is editor of *Social Security: Prospects for Real Reform*, just published by the Cato Institute.

In This Issue

Conference on baby boom, political spectrum 3
New foreign policy staff 3
Cable franchising and the First Amendment 5
Rabushka and Kendrick on economic growth 6
Book reviews 14
To be governed . . . 16

Niskanen Leaves White House, Joins Cato as Chairman

Noted economist William A. Niskanen has accepted the position of chairman of the Cato Institute. Niskanen recently resigned as the senior member of the president's Council of Economic Advisers.

"The Cato Institute is doing some of the most innovative policy work in the country," Niskanen said. "It is consistent with a Jeffersonian, limited government approach, and I very much look forward to taking part in the Institute's work."

Cato president Edward H. Crane said, "The addition of Bill Niskanen as chairman of the Institute is an enormously positive development for our program. Bill is not only a first-rate economist, he is a principled advocate of the free market and a man universally respected by his peers."

Prior to his service in the Reagan

(Cont. on p. 9)

U.S.–Japan Trade: Physician, Heal Thyself

The furor and handwringing over our $35 billion trade deficit with Japan is both misguided and misinformed. So, for that matter, is the concern over the "overvalued" dollar. If the dollar is so overvalued we should be thanking the Japanese for taking dollars off our hands, rather than pillorying them for flooding our markets with their products. The fact is, however, that American exports increased worldwide in 1984, growing nearly 8 percent with Japan. How, then, is the dollar overvalued?

Well, say some, just look at the enormous growth in imports, which has resulted in a net trade deficit of some $100 billion. Surely that is evidence of the dollar being out of line with other international currencies.

Not really. The strength of the dollar is not the result of some technical aberration but rather of two fundamental trends. The first is the political stability of the United States. It is a safe place to invest in a world grown increasingly unsafe. The risk of expropriation of private property held here by foreigners is extremely low.

Second, the U.S. economy has been growing at a solid clip, led by a strong upsurge in investment spending. That economic vigor, more than the strength of the dollar, is the cause of the rapid growth in imports. Beyond that, and at the risk of contradicting conventional economic wisdom, I would argue that there is nothing inherently *wrong* with maintaining an excess of imports over exports—as, for instance, the Japanese did during their rapid development in the fifties and sixties.

Implicit in the argument that trade deficits are "bad" is the idea that imports reduce domestic employment if exports fail to keep pace. But during the past two years, when our trade deficit has grown at a record pace, employment in the United States has increased by some 7 million jobs. We live in a dynamic world economy, and our success is dependent on our ability to adapt to constantly changing conditions. We must, as David Stockman has pointed out, have *dis*-investment along with investment if our economy is going to grow. Obviously, we've done a good job of that in recent years.

Nevertheless, despite all the jobs created and superior economic growth, we hear the clamor for protectionism and trade restraints. It's as though we're looking for a scapegoat for . . . we're not quite sure what. So we picked Japan (even though our *per capita* trade deficit with Canada is twice that with Japan).

Japan-bashing has become a national pastime. From Lee Iacocca to Tip O'Neill, the anti-Japanese hysteria is spreading throughout the land. Consider, however, the fact that Japan's success in our domestic market is primarily a result of offering superior products at a low cost. Nothing more and nothing less. Trade restraints designed to limit such sales are in actuality restraints against American consumers.

Yet we witness the embarrassing spectacle of the U.S. Senate voting 92-0 to demand that President Reagan "do something" to the Japanese if they don't open more of their domestic market. In truth, Japan's import quotas and tariffs are no worse than those of most of our trading partners, and they serve primarily to harm Japanese consumers. Our concern should be with our self-imposed restraints on trade and economic growth. Let Japanese consumers worry about their own problems themselves.

Beyond the fact that we limit some of our own exports to Japan lies the more fundamental question of the detrimental impact of the huge federal government on our economy. Federal spending and taxing as a percentage of GNP are both significantly higher in the United States than in Japan. Regulation of industry is also more onerous here than for Japanese business. Our tax system has a strong bias against savings, Japan's system encourages savings.

Protectionism is wrong on several counts. It invites retaliation. It appeals to demagogues and promotes xenophobia. It leads to more government intervention in our economy. It reduces exports by reducing the number of dollars in the hands of foreigners. It has, according to the Center for Study of American Business, cost the average American $1,000 a year. It raises costs to domestic producers who are dependent on foreign inputs.

Free trade increases prosperity and leads to more peaceful relations among the nations of the world. It is another area where we would be better off if President Reagan's rhetoric were matched by action.

Ed Crane

—Ed Crane

Published by the Cato Institute, *Cato Policy Report* is a bimonthly review that provides in-depth evaluations of public policies and discusses appropriate solutions to current economic problems. It also provides news about the activities of the Cato Institute and its adjunct scholars. *Cato Policy Report* is indexed in *PAIS Bulletin*.

David Boaz .... Editor
David Lampo .... Managing Editor
Tyler Cowen, Daniel Klein, Robert Rauth Jr. .... Contributors

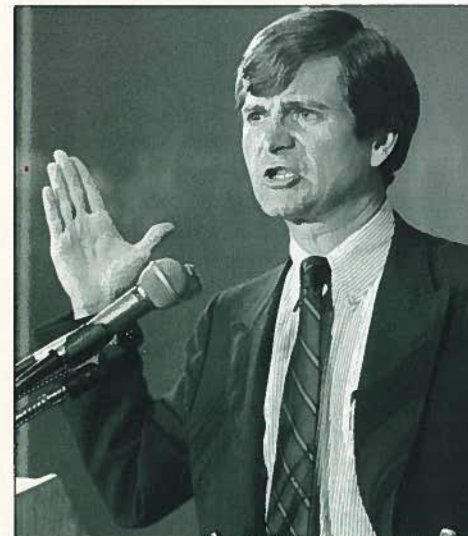
Correspondence should be addressed to: *Cato Policy Report*, 224 Second Street SE, Washington, D.C. 20003. *Cato Policy Report* is sent to all contributors to the Cato Institute. Single issues are $2.00 per copy. *Cato Policy Report* is published bimonthly by the Cato Institute, 224 Second Street SE, Washington, D.C. 20003.
ISSN: 0743-605X
Copyright © 1985 by the Cato Institute
CATO INSTITUTE

Panelists Discuss Baby Boom, New Political Spectrum

Cato News

America's political future was the subject of a Cato Institute conference, "Reassessing the Political Spectrum," in April. Many of the speakers discussed the validity of the liberal-conservative-libertarian-populist approach suggested in *Beyond Liberal and Conservative*, by William S. Maddox and Stuart A. Lilie, published by the Cato Institute in 1984.

At a well-received panel entitled "The Politics of the Baby Boom," all three speakers generally agreed that those voters born between 1946 and 1964 are on the whole more conservative on economic issues and more liberal or tolerant on social issues than older voters. Political consultant Lee Atwater, deputy director of the Reagan-Bush '84 campaign, argued that baby-boom voters share such values as social conscience; receptivity to economic and social change; and hostility to big government, big business, and big labor unions. He agreed that the Maddox-Lilie framework offers a better understanding of the political spectrum and predicted that populists will decline in number and libertarians will increase as the baby boom moves to the center of the political system.



Lee Atwater talks about how the Republicans can capture the baby-boom vote.

On the same panel Cato vice president David Boaz argued that the economically conservative, socially tolerant baby-boom voters are still up for grabs politically and concluded, "The future of American politics may be determined by whether the Democrats can liberate themselves from the grip of the AFL-CIO before the Republicans break free from the Moral Majority."

Democratic pollster Pat Caddell excoriated the Mondale campaign's failure to recognize its problems with young voters, complaining that "the Democratic party seems to have a death wish to drive this generation away." Caddell argued that the baby boomers are still essentially more liberal than conservative and that the Republicans face a serious problem in continuing to attract support and votes from the religious right without alienating younger voters.

At the conference's luncheon panel, Rep. Vin Weber (R-Minn.) argued that "the old linkage of activist government, better times, Democrat, is rapidly becoming less government, better times, Republican." Weber said that "the under-35 voting group contains the largest number of social libertarians, who may at some future date rebel against a party that takes what they consider a restrictive stand in terms of social liberty." Nevertheless, he said, for the time being younger voters seem happy with the Republicans.

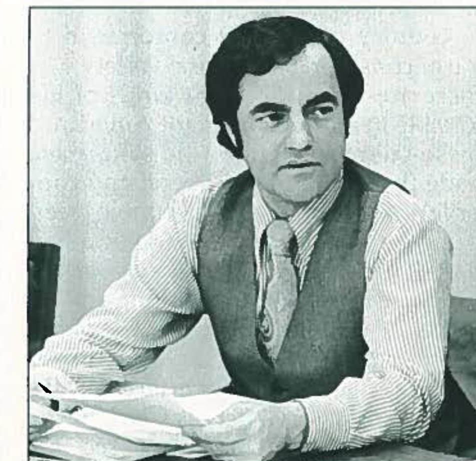
Rep. Tim Wirth (D-Colo.) maintained that the political future will be determined by which party controls the center. "Successful politicians in the United States are those who weave together the two themes of opportunity and excellence, growth and equality."

(Cont. on p. 4)

Cato Beefs Up Foreign Policy Work

The Cato Institute has recently strengthened its efforts in the area of foreign policy. Earl C. Ravenal, a board member and adjunct scholar of the Institute, has been named senior fellow. In this position, it is hoped, he will be able to work more closely with Cato staff in developing a strong research program in foreign policy and national defense issues. Ravenal, also a professor of foreign service at Georgetown University and a former Pentagon official, is the country's leading advocate of a noninterventionist foreign policy. He is currently preparing a volume of his writings to be published as *Foreign Policy in an Uncontrollable World*.

In addition, Ted Galen Carpenter has been hired as a foreign policy analyst. Carpenter, who holds a Ph.D. in American history from the University of Texas, is the author of *America and the Transformation of NATO: The "Great Debate" of 1950–51*, prepared as part of the "Ideas and Action" series directed by Prof. Walt W. Rostow. Carpenter will write and edit foreign policy studies for the Cato Institute and will work on a book dealing with the impact of an interventionist foreign policy on domestic liberty.



Earl Ravenal discusses foreign-policy issues at a Cato board meeting.

Cato president Edward H. Crane said, "We're pleased to have both these distinguished scholars more closely associated with us, which will help us expand our output of foreign policy studies. We look forward to developing a defense strategy based on the traditional American values of peace, limited government, and individual rights."

Conference (Cont. from p. 3)

On the opening panel William Schneider of the American Enterprise Institute discussed the problems of the Democrats, concluding, "The Democrats' problem is not to convince Americans that they want more government. It is to convince Americans, as Andrew Jackson did and as Theodore Roosevelt and Franklin Roosevelt did, that government is on their side." California pollster Mervin Field presented the results of applying the Maddox-Lilie framework to his California Poll data, finding that in 1980 Californians could be classified as 41 percent liberal, 19 percent populist, 14 percent libertarian, and 30 percent conservative. Former Hart pollster Dotty Lynch stressed the importance of the anti-establishment image in Gary Hart's success.

William Maddox and Stuart Lilie presented their new analysis of the political spectrum and explained some of the implications of the liberal-conservative-libertarian-populist approach. Michael Barone, an editorial writer for the *Washington Post*, talked about the shift of the United States from "a country of cultural conformism to one of considerable cultural variety. . . . There are many different kinds of life possible in affluent, tolerant America." These cultural changes, he said, have made the categories of liberal and conservative less relevant. Barone agreed that there are more libertarians today than in earlier decades, but he warned that a rise in nationalistic feeling and "a moralistic backlash against some of the libertarian trends of behavior in the last 20 years" would limit libertarian political success. Terry Nichols Clark of the University of Chicago discussed his research into fiscal problems, emphasizing the similarity of his "new fiscal populists"—urban political leaders who combine fiscal conservatism with traditional liberal social values—with Maddox and Lilie's libertarians.

In the final panel, "Ideas in American Politics," historian Paul Kleppner discussed how political leaders use ideas to rally support among their constituencies. Disagreeing with some speakers who had stressed the growth of the religious right, Kleppner said the movement's success "is likely to be fleeting, because the movement swims against the tide of social and attitudinal change, tilts at the wrong windmills, and offers an inappropriate solution—public coercion rather than private conversion." Cato president Ed Crane argued that government has grown in the United States as the intelligent lay public has been increasingly less involved in debates over the fundamental direction of government. He called for opening up the "ideas process" through competition in education and the media, abolition of the Federal Election Commission, and a limitation on congressional terms to allow more new ideas in Congress. Finally, Paul Weaver of the American Enterprise Institute delivered a wide-ranging address on the political and cultural direction of society, suggesting that America is drifting from a long-established corporatist-managerialist society to a "proto-neo-libertarianism." These two different ideas, he said, are not only struggling within society as a whole, they are at war within the Reagan administration staff.

The conference was attended by more than 100 people, including representatives of most major media. Conference sessions were nationally televised by C-SPAN. An edited transcript of the entire conference will be available soon in booklet form.

Pat Caddell talks with conference participants after his speech.

Court Fails to Protect Rights

The Supreme Court "has entered an era of aggressive majoritarianism," siding with the government and against individuals in 81 percent of the civil liberties cases decided in the 1983 Term, according to a recent Cato Institute study.

Geoffrey R. Stone, professor of law at the University of Chicago, writes, "On rare occasions, the Supreme Court fundamentally recasts its role in the American constitutional system. This has occurred at least three times in this century. . . . In the 1983 Term, the Court may have signaled a similarly historic shift in its constitutional role."

Stone concludes, "When government fails [to protect the rights of the accused], it is for the Court—the essential 'guardian of those rights'—to serve as the 'impenetrable bulwark' of our Constitution. In the 1983 Term, the Court betrayed that responsibility. And if the past is any guide, we can expect more of the same."

Stone's paper, "Individual Rights and Majoritarianism: The Supreme Court in Transition," is part of the Cato Institute's Policy Analysis series and is available for $2.00.

Book Proposes Social Security Reform

Today's retirees are receiving above-market returns through Social Security, while younger workers will receive low, below-market returns—even if all the program's promised benefits are paid. The past popularity of Social Security was due largely to the high returns it offered. In the same way, the dissatisfaction of today's young workers at the extremely low returns the program offers them will pave the way for real, fundamental reform.

This is the conclusion of Peter J. Ferrara in an important new book edited by him entitled *Social Security: Prospects for Real Reform*. It is essential reading for anyone concerned with Social Security, which accounts for one-third of the entire federal budget.

In the opening chapter Ferrara and economist John Lott of Texas A&M University analyze the benefits promised by Social Security to today's young workers, arguing that most young workers will receive a real rate of return on their Social Security "investment" of 1 percent or less. By contrast, if they put their retirement savings into a private plan, they could expect a real return of 4 to 6 percent or more. At a 5 percent return, two spouses each earning the minimum wage all their lives would have accumulated assets of $385,877 (in constant dollars), which would pay them a perpetual annuity of $19,294 and allow them to leave the entire fund to their children.

Ferrara also presents his much-discussed proposal for Super IRAs. Under this plan, today's workers would be offered the option of substituting expanded, Super IRAs for part of their present Social Security coverage. This would involve allowing workers to contribute to their IRAs each year an amount up to 20 percent of their Social Security retirement taxes, in addition to any other amounts they may contribute under current law. Instead of the usual IRA income tax deduction for these contributions, workers would receive a dollar-for-dollar income tax credit for them.

Since the Super-IRA tax credit would be taken against income taxes rather than payroll taxes, Social Security revenues would continue to flow into the program in full to finance benefit payments for today's elderly. While the program's revenues would be maintained in full, expenditures would be reduced as more workers turned to the Super IRAs for old-age pensions. Workers could freely choose between Social Security and Super IRAs, but those who chose the latter would receive much higher benefits.

Ferrara has assembled an impressive list of contributors, including former Social Security Administration chief actuary A. Haeworth Robertson, Heritage Foundation domestic policy director Stuart Butler, former Treasury Department officials Norman Ture and Paul Craig Roberts, and David Ranson of H.C. Wainwright Co.

Social Security: Prospects for Real Reform is available from the Cato Institute in a cloth edition for $20.00 and in paperback for $8.95.

Cable Franchises Violate First Amendment

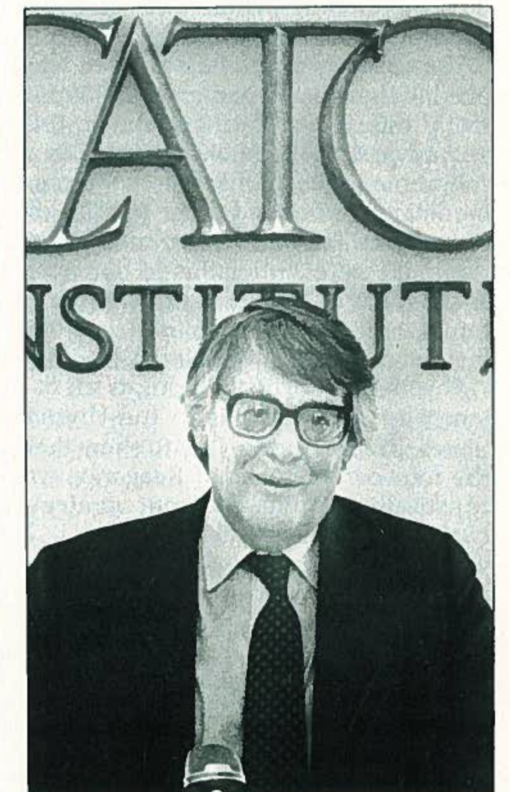
Harold Farrow, a legal expert on cable television, told a Cato Policy Forum in late March that a landmark decision in the Ninth Circuit Court of Appeals has dramatically expanded the rights of cable companies. The court ruled, on the basis of the First Amendment, that local governments cannot constitutionally exclude willing competitors from the marketplace.

Farrow, who represented Preferred Communications in its case against the City of Los Angeles, stated that it is unconstitutional for local governments to grant exclusive cable franchises. In effect, this practice is merely "a licensing of the press," bringing back "all the grief of a licensed press that we thought we were finished with in the eighteenth century."

As a result of this decision, rate controls, franchise fees, and mandatory access are all in doubt, and cities and towns will lose their leverage at franchise renewal time. This will be a much-needed change, since, in Farrow's words, "the business has clearly become, even in the smaller towns, subject to municipal extortion." Farrow noted that the "power to control the rates is the power to control the content."

A different point of view was presented by Larrine Holbrook, an attorney with the firm of Miller and Young, which represents approximately 40 cities. In Holbrook's view, invoking a First Amendment "right" to put a cable on a telephone pole is improper. She argued that most studies show that "cable will become a natural monopoly," contending that cities have dealt equitably with this situation by auctioning off franchise rights.

He argued that it "doesn't make any sense to say: because cable television might turn out to be a natural monopoly, we should make it an unnatural monopoly."



Attorney Harold Farrow discusses cable television and the First Amendment at a Cato Policy Forum.

How to Produce Economic Growth

Every month the Cato Institute sponsors a Policy Forum at its Washington headquarters where distinguished analysts present their views to an audience drawn from government, the public policy community, and the media. A recent forum featured Alvin Rabushka, senior fellow at the Hoover Institution and author most recently of From Adam Smith to the Wealth of America *(Translation Books). Commenting on Rabushka's talk was John Kendrick, professor of economics at George Washington University.*

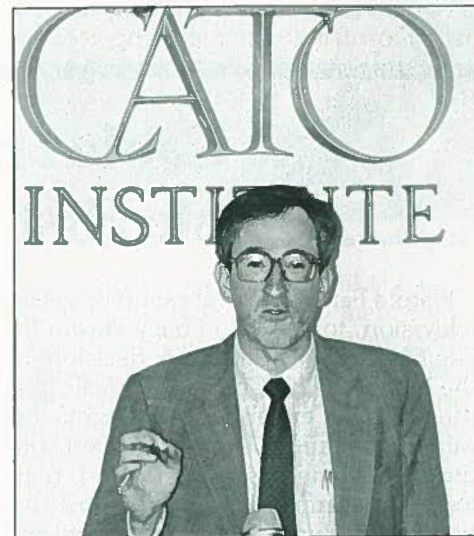
Alvin Rabushka: *From Adam Smith to the Wealth of America* spans 200 years, 6 countries, and every major region of the globe. The book attempts to show that a particular set of ideas and policies have had a dramatically beneficial result whenever and wherever they've been applied. The first part of the book attempts to show that these principles work, and that they transformed Britain in the nineteenth century from a heavily regulated and relatively poor economy into the world's most powerful industrial nation when the century closed.

The same principles have been applied in the most dynamic region of the world today—the Pacific basin. In the second part of the book I try to take a coherent look at fiscal, economic, monetary, trade, and other policies of Singapore, Taiwan, Korea, and Hong Kong. If I were writing this section over again today, I would also include the reforms currently being tried in both mainland China and in India.

The third part of the book is an attempt to apply all this to the United States. In some sense, I try to show that the four cornerstones of Reaganomics constitute a quite coherent strategy based upon historical evidence. If I wanted to convey one overriding message, it would be that it wasn't the industrial revolution that made Britain what it was at the close of the century, but the first supply-side revolution.

Consider the dilemma Ronald Reagan inherited in 1981: 21 percent interest rates, inflation approaching 17 percent on an annualized basis, middle-income brackets facing a 50 percent marginal tax rate, and a rapidly depreciating currency. The U.S. economy was in a terrible mess, and it looked like it was going to get worse. There was talk of protectionism, the zero-sum society, and national industrial policy.

But this was nothing new. Let me describe the British economy shortly after the Napoleonic War—about 1815



Alvin Rabushka: "A real supply-side revolution played a major role in nineteenth-century British economic growth."

Policy Forum

to 1820—to indicate what people confronted at that time. They were just coming out of a period when the statute book had extensive regulations of wages and working conditions for almost every class of employment. The government had told employers how much they could pay for what class of work.

There was a tariff wall—the grain and corn laws—that constituted total protection on agricultural goods. Under some circumstances the laws absolutely banned the import of grain, and in cases where it was allowed, the laws levied prohibitive duties. A tariff maze of well over a thousand specific taxes taxed literally every class of import, both finished-product and raw-material. Britain banned the export of live sheep for the sole purpose of protecting the woolen industry. As an example of the absurdity of the tariff maze in this case, it was an offense to be caught shearing sheep within five miles of the coast. There was also a ban on the export of precious metals, the idea being to keep them at home so that the country would prosper. There was a ban on the export of machinery: if you couldn't export machinery, you couldn't export competition. There was a ban on the export of skilled workers: if workers didn't go overseas, they couldn't teach foreign workers how to be productive.

The famous Navigation Acts required that goods coming in and out of Britain be carried only on British ships. (Here you begin to notice some familiar notions, but I will leave you to fill in the modern-day counterparts.) The Navigation Acts are singularly interesting because their eventual repeal in 1849 would have shocked even Adam Smith, who in 1776 wrote that he couldn't imagine the Navigation Acts ever being repealed and even thought they were a legitimate aspect of national defense.

What follows are a few commentaries written around 1815 to show how heavily Britain had been taxed. The first is from John Noble, a historian of public finance:

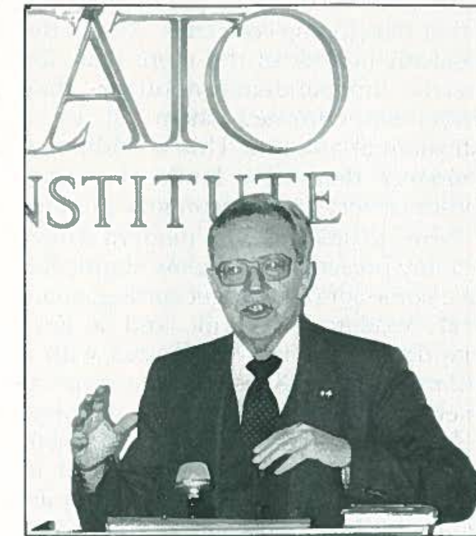
> In order to meet this growing expenditure, fresh taxes were, year after year, imposed upon the people, until, at length, there was hardly an article that could be eaten, drank, worn, or used, that was not taxed. . . . To look through the list of articles on which duties were charged excites feelings nearly akin to horror. It seems like the work of some fiendish imp of the nether regions, some demon, alike the enemy of a beneficent God and of his creature man. Everything that was useful, or good, or beautiful in nature or in art; everything that was sweet to the palate, wholesome for the body, needful for raiment [clothing], grateful to the eye, or pleasant to the taste or smell, was taxed. All the fruits of the earth, everything that was necessary to eat or drink, with some exceptions, and they were prohibited; the rich man's sauce and the poor man's vinegar, the wines that inebriate and destroy, the medicine that heals, and the poison that kills; everything that grew upon the face of the earth, or was produced from the waters under the earth, all were taxed, ruthlessly taxed—as if, by malignant and preconceived intention, it had been determined that nothing but things in the heavens above should be exempted, and, as if this were not sufficient to crush the people, a system of protection was maintained for the supposed benefit of landowners, manufacturers, shipowners, and Colonial proprietors.

Writes Sydney Smith in the *Edinburgh Review* in 1820:

> We can inform Brother Jonathan what are the inevitable consequences of being too fond of glory. [He's talking about all the taxes the British government levied to pay for the wars.] Taxes upon every article which enters into the mouth or covers the back or is placed under the foot. Taxes upon everything which it is pleasant to see, hear, feel, smell, or taste. Taxes upon warmth, light, and locomotion. Taxes on everything on earth or under the earth, on everything that comes from abroad or is grown at home. Taxes on the raw material, taxes on every fresh value that is added to it by the industry of man. Taxes on the sauce which pampers man's appetite, and the drug which restores him to health; on the ermine which decorates the judge, and the rope which hangs the criminal; on the poor man's salt and the rich man's spice; on the brass nails of the coffin, and the ribbons of the bride. . . . The schoolboy whips his taxed top; . . . and the dying Englishman, pouring his medicine, which has paid 7 per cent., into a spoon that has paid 15 per cent., flings himself back upon his chintz bed, which had paid 22 per cent., and expires in the arms of an apothecary who has paid a license of a hundred pounds for the privilege of putting him to death. His whole property is then immediately taxed from 2 to 10 per cent. Besides the probate, large fees are demanded. . . . His virtues are handed down to posterity on taxed marble, and he will then be gathered to his fathers to be taxed no more.

If you think we have a large public debt, the British public debt was so large that half of all public spending went to debt-servicing costs. In this period the British faced a monumental budget nightmare: they had a no-growth outlook, a zero-sum international recession, and the fear that postwar demobilization would produce crashing land values and rising unemployment. For the first time in a century Britain had a paper-currency economy, not linked to bullion, which had depreciated due to excess issue.

The situation in Britain between 1815 and 1820 represents every economic



John Kendrick: "The concentration of power in a command economy always represents a threat to liberty."

problem one could imagine. What happened to turn all this around to make Britain the world's greatest industrial nation? While there is a lot to be said for the role of the industrial revolution, you've got to keep in mind that it was already well in place by the late eighteenth century. So if the industrial revolution was going to turn them around, they shouldn't have been in this fix.

I would like to focus my remarks on the area of tax reduction. Supply-side economics is nothing more than the idea that incentives matter. What you had in Britain in the nineteenth century was a systematic effort to remove the impediments to enterprise, work, and initiative from the tax code. There are three heroes, three great men, in my book.

There is William Huskisson, who from 1823 to 1826 was president of the Board of Trade. He fashioned the first major assault against protectionism and high taxes and pushed in the direction of free trade. His death in 1830 in part contributed to the slowing down of the reform process.

Another story of political courage was Sir Robert Peel, a Tory landowner brought to power by the Tory gentry on the pledge that he would protect the economic foundation of Tory agriculture. He repaid his constituents by declaring free trade in grain—by completely repealing the corn laws and eliminating all tariffs, taxes, and impediments to the free movement of food in and out of Britain. He was rewarded the day after doing so by a vote of no confidence on a different bill.

The third hero is William Gladstone. He was able to virtually eliminate taxes altogether, except from a handful of items, and managed to get the British income tax down to a rate of about 1 percent when he finished his term as chancellor of the exchequer. Gladstone presided over the final phase of the process of tax cutting and deregulation; he also goes down in the annals of history as the great spending cutter. Over six years, he managed to cut all government expenditures by 10 percent, in a period of sustained and rapid economic growth when no one would have faulted him for simply spending a constant share of the increasing national income.

Stories can be told of the achievements of these three people in a number of areas. Huskisson, for example, tried his free-trade experiment on the silk industry, perhaps the most protected industry in Britain. Basically, he took out his ax and slashed away virtually the entire tariff-protected structure. The upshot was that in the following 14 or so years, silk became a vibrant, positive, booming industry. The fact that raw materials could be imported at substantially lower costs fueled an export binge tripling exports over the period 1820 to 1850. The value of imports rose five-fold. The business became efficient and stopped clamoring for protection.

Or take this marvelous anecdote. Due to a statistical slip at the British treasury, the duty on tobacco was inadvertently reduced from four shillings to three shillings. To their surprise, treasury officials discovered that receipts from customs duties of three shillings were higher than the receipts they had projected from four shillings, and the lower duty was left in place. They had discovered a rule: some items raise more revenue at lower tax rates than at higher tax rates. This rule has been

(Cont. on p. 8)

Economic Growth (Cont. from p. 7)

repackaged in modern times under the name of "Laffer Curve."

British treasury officials began to notice law-like regularity to what happens when you reduce tax rates. They found that tax reductions tend to stimulate economic activity and consumption and that low tax rates when applied to a broader base of economic activity generate higher receipts than do high rates on a smaller base of economic activity. This theme recurs over and over again in the writings of nineteenth-century analysts of British public finance. They are continually amazed that their static revenue estimates proved to be conservative. Throughout the nineteenth century, with sustained tax cuts occurring every other decade, the startling observation was that even after tax rates were reduced and lower receipts were projected as a result, the receipts came in higher than projected and usually higher than the period preceding.

Allow me to link this singularly important theme to controversies over contemporary policy during the last five years. Since 1981 we have had the following dilemma: should we cut tax rates sharply and thereby improve incentives and the strength of the economy, or should we concentrate our efforts on reducing the deficit and public debt? This dilemma was present in Britain throughout the nineteenth century, and it was routinely debated in Parliament. Although some said that reducing the national debt was most important, until about the 1860s the chancellors were determined that incentives in the British economy should be improved. On virtually every occasion of unexpected budget surplus, the decision was made to further reduce taxes rather than pay the national debt. The idea was that a constant-pound amount of debt would become smaller and smaller as a fraction of national income and thus easier to service. It wasn't until the last third of the century that they began to apply some of the fruits of sustained economic growth to reducing the debt.

There are dozens of illustrations of the beneficial economic and revenue effects of sustained tax rate reduction. The point is, a real supply-side revolution played a major role in British economic growth.

I don't have time to discuss the Pacific basin countries, except to say that Singapore, Korea, Taiwan, and Hong Kong have more closely adhered to the market model of development than any other developing countries. And in the postwar period, of the more than 130 newly independent countries, they have outperformed them all by a substantial amount. This is additional evidence that these kinds of politics produce very strong economic growth.

Now, to link this with modern America, my prescription is a low simple flat tax, some serious budget cutting, some real regulatory reform, and a gold standard. If all this is blended with a balanced budget–tax limitation amendment, I think we've fixed the country.

Why don't we do this if its sensibility has been so well documented in history? The answer is, we probably *are* going to do it. This is the great, concluding, optimistic note. Intellectual currents have changed, and institutional movements are in the right direction. We may not get there with Ronald Reagan—there was a decade between Huskisson and Peel, and another decade between Peel and Gladstone. But once the direction has been taken, I quite confidently expect it to continue.

John Kendrick: History is subject to many interpretations. It is a matter of judgment. I would certainly grant that economic liberalism did augment the rate of economic growth in Great Britain in the nineteenth century. However, I think that mercantilism wasn't as bad a policy as Adam Smith made it out to be. It perhaps served a purpose in its time by helping to build the state by pursuing policies to promote economic growth. A 1937 book by Edgar Johnson called *Predecessors of Adam Smith* made it very clear that mercantilism did try to encourage scientific advance and technological progress by encouraging immigration and promoting the development of science and the arts domestically. Even the attempt of the mercantilists to run a favorable balance of trade in order to attract gold had certain monetary implications that could be interpreted as favorable to economic growth. As Rabushka said, the industrial revolution began well before the period of economic liberalism. Strong economic growth can be consistent with other doctrines.

I, along with Rabushka, believe in classical liberal philosophy. But I am less doctrinaire about it partly because I think that such rigid rules as balanced-budget amendments and the gold standard are too inflexible and don't permit enough use of judgment, and partly because we don't know enough as economists to predict the effects of specific policy measures, particularly in a future that we can only dimly anticipate.

Regardless of whether or not a liberal economic philosophy is more advantageous to economic development and growth, and I think it is, I would favor it for its political aspect—that is, the diffusion of power that private property represents. The concentration of power in a command economy always represents a threat to liberty.

Speaking of the postwar development of the Asian countries, many other countries with far less liberal economic policies also had very strong growth after World War II. In fact, almost all the industrial countries and many less developed countries had very rapid increases in productivity and overall real growth with mixed or even socialist systems. This was due largely to recovery from the war and to the advance of American technology in many of these countries as a result of deliberate economic policy. We tried to help them to reconstruct by promoting economic development through various means—licensing, patents, exporting machinery and equipment, etc. Economic growth slowed down in all these countries after 1973 because a liberal economic policy alone wasn't enough to keep it going. When unfavorable developments occur—such as the oil shock, which slowed down growth in Japan and in some of the other oil importers more than in the United States—free market-directed economies slow down.

The last section of Rabushka's book analyzes the situation of the U.S. economy since New Deal days and then presents a recipe for prosperity. I would take issue with three of its prescriptions, in particular.

Parenthetically, I think the book was a little rough on the present administration. Rubushka points out that it took many years for Britain to establish economic liberalism, but states that President Reagan and his advisers have blown the opportunity for reform. There *is* a chance for the administration to push further ahead, even though it might take years before some of the excesses of the previous 50 years are overcome.

On the expenditure side, I would be opposed to a constitutional amendment specifying the percentage of national income or GNP that could be spent by the federal government. You never know what domestic contingencies might arise, and foreign affairs emergencies could require higher national security spending. We shouldn't spend more than we can afford—but the term "afford" is very subjective. As democratic countries become more affluent, their electorates seem to feel that they can afford more social programs, welfare programs, etc. I personally don't think we should spend so much as to impair incentives. "What we can afford to spend" is a flexible notion.

I also don't think we should have a constitutional amendment requiring a balanced budget, although I must say that when I hear Jim Buchanan advocating it, the idea seems more credible to me. Obviously, in a recession I don't think it is desirable for expenditures to be cut as much as taxes fall. There is something to the stabilization idea of an unbalanced budget in a recession. I also don't think that you should necessarily have a balanced budget over a business cycle because if private demand is strong, it might be more appropriate for the government to run a surplus, on average, over a cyclical period in order to help funnel money into savings and help bring down interest rates further than if we had a balanced budget. Rules can be circumvented in various ways. I think education—trying to promote the philosophy of the predominantly private-enterprise, market-directed economy through books such as Rabushka's—is more important than legislation.

On taxation, I'm not sure the flat tax is the answer. The idea of progressivity has a great deal of appeal as being more equitable than the flat percentage. I would suspect that we will get some kind of compromise of several rate steps if there is a "flat" tax on income with a broadened base to permit lower rates. However, an alternative that should be seriously considered is a progressive tax on consumed income. Because savings would be exempt, the problem of an increasing marginal rate providing disincentives for work and investment would be avoided.

On monetary policy, it is important to regulate the supply of money in such a way that its growth is consistent with a relatively stable price level. I don't think that a Friedmanesque monetary rule is necessarily desirable because of changes in velocity, institutions, and the nature of money. The objective should be to increase the quantity of money with due regard for velocity in such a way as to maintain relatively stable prices. It is also important to pursue a sustainable real growth rate while maintaining adequate reserves of labor and capital facilities to prevent the excesses of a "boom." I discuss this in my article "Cost Containment Prolongs the Expansion" in the May 1985 *AEI Economist*.

Alvin Rabushka: Let me begin with this 1888 commentary on the problem of cutting government spending.

> The heavy load of expenditure with which the country had been burdened, and the consequent impossibility of remitting taxation, had done much to discourage the growth of revenue. It is always so; increased expenditure and deficiency of revenue naturally go together. The necessity of maintaining heavy taxation to meet the former, depresses the latter, and prevents its expansion—a vicious circle that can only be broken by economy. On economy follows reduction of burden, and elasticity of revenue; taxation can then be lightened, and the revenue further expands.

The general theme that other countries, including those of Western Europe, enjoyed strong growth without the pure Adam Smithian world as it existed in nineteenth-century Britain or the twentieth-century Pacific basin may be true. But where Smithian principles did exist, rates were double those elsewhere. Between 1952 and 1985, Taiwan, Hong Kong, and Singapore have enjoyed an annual average growth of 9 percent. While the rest of the world economy seemed to slow down in 1974, those countries did not—they are still registering annual growth rates of 8, 9 and 10 percent yearly. We don't have any empirical evidence that they cannot continue to grow at those rates as long as they can maintain a free-market environment. ■

Niskanen (Cont. from p. 1)

administration, Niskanen had served as director of economics at the Ford Motor Company. He has also been a professor of economics at the University of California at Berkeley and at UCLA. Niskanen, who joined the Institute in April, will write and lecture on public policy issues in addition to his administrative responsibilities at Cato. ■

William A. Niskanen, outgoing senior member of the president's Council of Economic Advisers (second from right) and new chairman of the Cato Institute, talks with Sen. Steve Symms, ICC Commissioner Fred Andre, and Dudley Schadeberg at Cato reception.

Social Security (Cont. from p. 1)

enormous tax payments they face will be quite different from the returns received by retirees in the past.

Social Security Returns for Today's Young Workers

In order to analyze the returns offered by Social Security to today's young workers, economist John Lott of Texas A&M University and I examined 12 different hypothetical families.[1]

All workers in these families were assumed to start working in 1983, with incomes either low, average, or maximum. A low-income worker was assumed to earn a salary each year for his entire career equivalent to the minimum wage today.[2] The average-income worker was assumed to earn the average wage in Social Security-covered employment each year for his entire career. The maximum-income worker was assumed to earn the maximum Social Security–taxable income each year for his entire career.

Low-income workers were assumed to be 18 in 1983, average-income workers were assumed to be 22, and maximum-income workers were assumed to be 24. Nonworking spouses were assumed to be the same age as their working spouses. Married couples were assumed to be married in 1983, to have one child when the oldest worker reached 26, and to have another when the oldest reached 28. All workers were assumed to retire at age 67, which will be the normal Social Security retirement age for these workers under current law. All other assumptions were taken from the Alternative IIB set of assumptions in the 1983 Annual Report of the Board of Trustees for Social Security's trust funds.[3]

For each of these families, we calculated the amount that wage earners and their employers would have to pay in OASDI taxes throughout the workers' careers.[4] We next calculated the Social Security benefits provided each family in return. Besides expected Social Security retirement benefits, these included promised survivors benefits (multiplied by the probability of death in each year) and promised disability benefits (multiplied by the probability of becoming disabled in each year).[5] We then determined the rate of return represented by the benefits for each family in relation to the taxes paid by that family.

It should be noted that these calculations do not require any assumptions regarding the appropriate discount rate or market rate of return. They simply determine the rates of return paid by Social Security to different hypothetical families, and these returns can be compared with various market interest rates and returns.

> **"For those now entering the work force, Social Security will be a very poor deal."**

The 12 different hypothetical family combinations studied cover a broad spectrum of possibilities. The vast majority of young workers entering the work force today will receive returns from Social Security within the range of returns received by these hypothetical families.

Table 1

Social Security Real Rates of Return for Different Family Combinations

Family Combinations	Real Rate of Return
1. Single worker, earns maximum income, never marries, no children	−1.5
2. Married couple, both spouses earn maximum incomes, two children	−1.0
3. Married couple, one spouse earns maximum income, other earns average income, two children	−0.5
4. Married couple, one spouse earns maximum income, other earns low income, two children	−0.5
5. Married couple, one spouse earns maximum income, two children	0.0
6. Single worker, earns average income, never marries, no children	0.0
7. Married couple, both spouses earn average incomes, two children	+0.5
8. Married couple, one spouse earns average income, other earns low income, two children	+1.0
9. Married couple, one spouse earns average income, two children	+1.5
10. Married couple, both spouses earn low incomes, two children	+1.5
11. Single worker, earns low income, never marries, no children	+1.5
12. Married couple, one spouse earns low income, two children	+2.75

The results of our calculations are presented in Table 1, arranged from the family with the lowest return to the family with the highest. These results indicate that for those entering the work force today, all prospective families with maximum-income workers, whether such workers are single or married, whether or not they have children, and regardless of the income of any spouse, are promised zero or negative real rates of return through Social Security. Single workers of average income or greater are also offered zero or negative returns by the program. Virtually all two-earner couples are promised a real return of 1 percent or less, with only two-career low-income spouses receiving a 1.5 percent real return. Recognizing that two-earner couples will predominate among workers currently starting their careers, these results can be summarized as indicating that for most of these young workers, the real rate of return promised by Social Security is 1 percent or less, and for many it is zero or even negative.

Market Returns

These Social Security returns are far below widely available market returns. Addressing the issue of possible private sector returns on retirement investments, Martin Feldstein wrote in 1976:

> Over the past twenty-five years, the real annual yield after adjusting for inflation was 8 percent for common stocks and 3 percent for corporate bonds. A conservative portfolio with half of each would have yielded 5.5 percent.[6]

Indeed, if half the annual payments into an investment pool were invested in common stocks with an 8 percent real return and half in corporate bonds with a 3 percent real return, and the return on each half were reinvested in stocks and bonds respectively, then the real average annual yield after 41 years would be 6.5 percent.

Economist Robert S. Kaplan of Carnegie-Mellon University considered the returns on private investments relative to returns through Social Security in a paper presented at an American Enterprise Institute conference in 1977. Kaplan wrote:

> Even including the poor performance of the stock market over the past ten years, the long-term rate of return on equity investments has averaged more than 6 or 7 percentage points above the rate of inflation. Thus, as individuals are forced to provide more of their retirement income from social security, they are also being forced to invest in a program whose real rate of return is far below what could be earned through a private retirement program.[7]

Over the postwar period, 1946 to 1983, the average combined real rate of return on all stocks on the New York Stock Exchange was 6.9 percent.[8] If we go all the way back before the Great Depression, taking the period 1926 to 1983, this return was 6.4 percent.[9]

With such market returns, those entering the work force today would clearly receive several times the benefits offered by Social Security if they could invest over their careers in IRA-type vehicles the amounts they and their employers are currently required to pay into Social Security in payroll taxes. To illustrate this, we calculated the amount of such private benefits for six of our hypothetical family combinations, beginning with the amount of OASDI taxes that would be paid by each worker and his employer each year for his entire career. We then assumed that these amounts were invested in IRAs, further accumulating investment returns each year. We subtracted from the accumulated sums the value of promised Social Security survivors and disability benefits, assuming that workers would have to use some of their invested funds to purchase life and disability insurance of such value. Eventually we reached the total accumulated sum each family would have at retirement. We then calculated the retirement benefits such a sum could pay. This entire process was repeated under different assumed real rates of return ranging from 4 to 6 percent.

Some of our results are presented in Table 2. All figures are in constant 1983 dollars, so they will not be depreciated by inflation. The amount of accumulated assets at retirement in the IRA vehicle for each family is shown in the first column of data. The second column, labelled "Perpetual Annuity," shows the amount of benefits that could be paid out of the continuing returns from the assets alone, leaving the assets themselves intact to pass on to children or other heirs. The next two columns, labelled "Life Annuity," indicate the amount of benefits that could be paid if the accumulated assets were to be entirely consumed over the retirement period, leaving nothing for heirs. These annuity benefit values were adjusted to pay more while both spouses were alive than with only one alive, matching the pattern of Social Security benefits. For the two-earner couples in our hypothetical families, this means that twice the benefits would be paid with both spouses alive than with only one alive. For one-earner couples, this means that 50 percent more would be paid with

(Cont. on p. 12)

Table 2

Private-Market Benefits vs. Social Security Benefits at Different Investment Returns[1]

Family Combinations[2]	Assumed Real Return (%)	Accumulated Assets at Retirement	Perpetual Annuity	Life Annuity: Both Spouses Alive	Life Annuity: One Spouse Alive	Social Security Pays: Both Spouses Alive	Social Security Pays: One Spouse Alive
Married couple, both spouses earn maximum incomes, two children (2)	6.0	1,759,144	105,549	199,115	99,558	27,521	13,761
	5.5	1,534,130	84,377	167,917	83,958	27,521	13,761
	5.0	1,340,695	67,035	141,767	70,884	27,521	13,761
	4.5	1,174,241	52,841	119,837	59,919	27,521	13,761
	4.0	1,030,873	41,235	101,435	50,718	27,521	13,761
Married couple, one spouse earns maximum income, two children (5)	6.0	907,206	54,432	88,357	58,905	20,641	13,761
	5.5	791,803	43,549	74,220	49,480	20,641	13,761
	5.0	692,477	34,624	62,398	41,598	20,641	13,761
	4.5	606,896	27,310	52,505	35,004	20,641	13,761
	4.0	533,085	21,323	44,227	29,481	20,641	13,761
Married couple, both spouses earn average incomes, two children (7)	6.0	864,265	51,856	97,824	48,912	19,064	9,532
	5.5	746,949	41,082	81,756	40,878	19,064	9,532
	5.0	646,995	32,350	68,414	34,207	19,064	9,532
	4.5	561,742	25,278	57,329	28,665	19,064	9,532
	4.0	488,957	19,558	48,111	24,056	19,064	9,532
Married couple, one spouse earns average income, two children (9)	6.0	448,752	26,925	43,706	29,137	14,298	9,532
	5.5	388,207	21,351	36,389	24,259	14,298	9,532
	5.0	336,536	16,827	30,325	20,216	14,298	9,532
	4.5	292,386	13,157	25,296	16,864	14,298	9,532
	4.0	254,620	10,185	21,124	14,083	14,298	9,532
Married couple, both spouses earn low incomes, two children (10)	6.0	531,625	31,898	60,173	30,087	15,326	7,663
	5.5	452,334	24,878	49,509	24,755	15,326	7,663
	5.0	385,877	19,294	40,804	20,402	15,326	7,663
	4.5	330,111	14,855	33,689	16,845	15,326	7,663
	4.0	283,259	11,330	27,872	13,936	15,326	7,663
Married couple, one spouse earns low income, two children (12)	6.0	275,243	16,515	26,807	17,871	9,354	6,236
	5.5	234,282	12,886	21,961	14,640	9,354	6,236
	5.0	199,877	9,994	18,010	12,007	9,354	6,236
	4.5	170,938	7,692	14,789	9,860	9,354	6,236
	4.0	146,564	5,863	12,160	8,107	9,354	6,236

[1]Dollar values given in constant 1983 dollars.
[2]Numbers in parentheses refer to family combinations listed in Table 1.

Social Security (Cont. from p. 11)

both spouses alive than with only one alive. The last two columns show the amount of Social Security benefits that would be paid to each family.

The results indicate that at a 6 percent return, which is lower than the market returns cited above, most workers would receive through the private investments three to five times the retirement benefits promised through Social Security, and some workers would receive even more. Of course, workers would not even need a 6 percent return to do much better than through Social Security. Any private return higher than the Social Security returns discussed earlier would result in higher benefits through the private investment system than through Social Security. This is illustrated in Table 2 in the results of calculations assuming returns below 6 percent.

In addition to the private benefits noted in Table 2, the private investments would also produce new tax revenues, which would be available to finance new government goods and services or tax cuts. The private investment returns we discussed above are after-tax returns, those remaining after corporate income taxes and other taxes have been paid at the corporate level. The full before-tax real return on private capital can be estimated at around 12 percent.[10] The difference between this 12 percent and the returns discussed above is generally accounted for by taxes flowing to the government. Social Security, by contrast, produces no tax revenues to finance non-Social Security expenditures.

If we assume that only 4 percentage points of the full before-tax real return on capital goes to the government in taxes, and if those entering the work force today invested in private capital investments throughout their careers the amounts they and their employers would otherwise be required to pay in Social Security payroll taxes, then by the time these workers retired more than enough new tax revenue would be produced each year to finance an entire national defense budget of the same size relative to GNP as today's.

It seems, therefore, that even if those entering the work force today receive all the Social Security benefits promised them, they will still suffer inadequate, unfair, well below market returns on the enormous taxes they and their employers will have to pay into the system. As this becomes more widely understood, the Social Security status quo will become plainly untenable, and workers will demand basic reform.

A Proposal for Reform

The final chapter in the Cato Institute's just-published *Social Security: Prospects for Real Reform* advances a proposal to address this unacceptable unfairness to today's young workers.[11] The proposal is based on the principle of rejecting benefit cuts or tax increases in Social Security, neither of which can solve the problem. Instead, the proposed reform involves allowing workers to substitute expanded "Super IRAs" for some and eventually all of their Social Security coverage.

> "The proposed reform would allow workers to substitute 'Super IRAs' for some and eventually all of their Social Security coverage."

Specifically, the reform would begin by allowing workers to contribute to their IRAs each year an amount up to 20 percent of their Social Security retirement taxes (OASI), in addition to any other amounts they may contribute under current law. Instead of the usual IRA income tax *deduction* for these contributions, however, workers would receive a dollar-for-dollar income tax *credit* equal to the amount of such contributions. Workers would also have the right to direct their employers to contribute up to 20 percent of the employer share of the tax to the workers' IRAs, with each employer again receiving a full income tax credit for these amounts.

Workers who utilized this tax credit option would then have their future Social Security retirement benefits reduced to the extent they did so. A worker who opted for the full credit during his entire working career would have his retirement benefits reduced by 20 percent, the maximum reduction. A worker who took half the credit each year would have his future benefits reduced by 10 percent. Workers could take the credit in some years and not others, and in differing degrees each year, with a formula to calculate the resulting proportional benefit reductions. In retirement, of course, the accumulated funds in the Super IRAs would pay benefits that would more than make up for the forgone Social Security benefits.

Later, the credit option could be expanded further, until workers had the complete freedom to choose how much to rely on Super IRAs or Social Security. Workers could be allowed to purchase life, disability, and retirement health insurance through their Super IRAs in return for further tax credits and consequently cover the full panoply of benefits offered by Social Security.

Since the tax credit would be taken against income taxes rather than payroll taxes, Social Security revenues would continue to flow into the program in full to finance benefits for today's elderly. Indeed, the reform would greatly strengthen Social Security and eliminate the program's current long-term financing problems, even under pessimistic assumptions. This is because while the program's payroll tax revenues would be maintained in full, the program's future expenditures would be reduced markedly as workers relied more and more on Super IRAs rather than Social Security. With the Super-IRA option eventually expanded to the maximum, Social Security expenditures would likely be reduced dramatically, allowing room for sharp reductions in payroll tax rates.

At no time would the elderly face any benefit cuts as a result of the reform. In addition, workers would always have complete freedom to reject the Super-IRA option entirely and rely completely on Social Security as is.

Workers who chose the Super IRAs, however, could expect much higher retirement benefits, as they would be able to receive full market returns on their investments rather than the low, inadequate, unfair returns under Social Security. These benefits would also be completely equitable, with each worker receiving back in benefits what he paid in contributions, plus interest, on an actuarial basis. This is in sharp contrast to what is available through Social Security, where workers do not receive equal returns for past taxes paid into the program and where two workers paying exactly the same payroll taxes over their careers can receive widely differing benefits.

Workers would also have much greater freedom of choice and control over their own incomes through the Super IRAs. They could choose their preferred vehicles for retirement and insurance support. They could tailor coverage and investments to their individual needs and preferences. They could also choose their retirement ages with complete freedom after turning 59½ years of age.

National savings could be sharply increased through the funds paid into Super IRAs, with a fully expanded Super-IRA option potentially producing hundreds of billions of dollars in increased savings each year. Such a savings increase would in turn produce new jobs and substantial increases in economic growth, and eventual payroll tax reductions would stimulate still further job creation and economic growth. Moreover, through the accumulation of assets in the Super IRAs, each worker would be developing a substantial ownership stake in America's business and industry.

The reform would also sharply reduce federal spending as workers began relying more and more on Super IRAs rather than Social Security. With a complete option to rely on Super IRAs, federal spending could potentially be decreased by more than one-fourth. No other reform offers the potential for such a massive reduction in federal spending, not only without hurting anyone, but indeed probably making virtually everyone better off at the same time. ■

[1] Peter J. Ferrara and John R. Lott, Jr., "Rates of Return Promised by Social Security to Today's Young Workers," in *Social Security: Prospects for Real Reform*, ed. Peter J. Ferrara (Washington: Cato Institute, 1985), chap. 1.

[2] The low-income worker is assumed to start with an income equal to about what a full-time worker earning the minimum wage today would receive, and he is then assumed to receive a salary increase each year equal to the average increase in all wages for that year, basically maintaining the same income relative to other workers over his entire career.

[3] *1983 Annual Report of the Board of Trustees of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, June 24, 1983).

[4] OASDI taxes include the Old-Age and Survivors Insurance tax (OASI) and the Disability Insurance tax (DI), but not the Hospital Insurance tax (HI).

[5] For simplicity, we assumed that once a worker became disabled, he remained disabled for the rest of his life, with no change in life expectancy. In actuality, disabled workers often recover and return to work, where they not only stop collecting benefits but also start paying taxes again. In addition, disabled workers often die sooner than the rest of the population and consequently stop collecting benefits. As a result, the assumption of permanent disability without reduced life expectancy biased our estimates of the returns paid by Social Security upward to a significant degree.

[6] Martin Feldstein, "Facing the Social Security Crisis," Harvard Institute of Economic Research Discussion Paper no. 492 (Cambridge, Mass., July 1976).

[7] Robert S. Kaplan, "A Comparison of Rates of Return to Social Security Retirees Under Wage and Price Indexing," in *Financing Social Security*, ed. Colin D. Campbell (Washington: American Enterprise Institute, 1979).

[8] Roger G. Ibbotson and Rex A. Sinquefeld, *Stocks, Bonds, Bills and Inflation Quarterly Service* 1, no. 2 (July 1983).

[9] Ibid.

[10] Martin Feldstein, "National Savings in the United States," Harvard Institute of Economic Research Discussion Paper no. 506 (Cambridge, Mass., October 1976); idem, "Toward a Reform of Social Security," *Public Interest* (Summer 1975): 75–95; idem, "The Optimal Financing of Social Security," Harvard Institute of Economic Research Discussion Paper no. 388 (Cambridge, Mass., November 1974). Studies by others have found returns in about the same range. See J. A. Stockfish, "Measuring the Social Rate of Return on Private Investment," in *Discounting for Time and Risk in Energy Policy*, ed. Robert C. Lind (Washington: Resources for the Future, 1982); D. M. Holland and S. Myers, "Trends in Corporate Profitability and Capital Costs," in *The Nation's Capital Needs*, ed. R. Lindsay (New York: Committee for Economic Development, 1979), pp. 103–89; W. D. Nordhaus, "The Falling Share of Profits," *Brookings Papers on Economic Activity*, vol. 2 (Washington: Brookings Institution, 1974), pp. 169–208; J. A. Gorman, "Nonfinancial Corporations: New Measures of Output and Input," *Survey of Current Business* (March 1974); J. A. Stockfish, *The Planning-Programming-Budgeting System: Progress and Potentials, Hearings before the Subcommittee on Economy in Government*, Joint Economic Committee (Washington: Government Printing Office, September 1967), pp. 133–43.

[11] Peter J. Ferrara, "Social Security and the Super IRA," in Ferrara, chap. 11.

On April 25 the Cato Institute held a reception in honor of H. R. Gross, member of Congress from Iowa from 1949 to 1975. Gross was an inveterate opponent of excessive spending and was known as the "Taxpayer's Best Friend." Here Cato vice president David Boaz and Rep. Gross listen as Sen. Charles Grassley, who succeeded Gross in Congress, discusses today's budget issues.

Criticisms of Free-Market Theory

Free Market Economics: A Critical Appraisal, *by Andrew Schotter (New York: St. Martin's Press, 1985), 147 pp., $9.95.*

This work attempts to illustrate how economic arguments for free enterprise may founder. The author first explains free-market arguments and then applies them to hypothetical situations.

The weak link in Schotter's reasoning is his representation of the economic arguments for free enterprise. Schotter explicitly characterizes the views under consideration as libertarian, but in actual fact they have little to do with the libertarian's arguments and virtually nothing to do with his personal beliefs. Schotter's conception of free-market economic thought is taken largely from mainstream neoclassical economics, a theory of perfectly specified models that yield determinate outcomes. In neoclassical economics, assumptions are made that prevent unforeseeable factors from affecting the models, the exact nature of the knowledge of the agents in the models is specified, the welfare effects of all activity are assumed to be perfectly understood, and tastes and technology are held constant. The result is mindless agents carrying out their fate in a closed world.

With this type of economic theory, Schotter can indeed create models in which the reign of laissez-faire is undesirable. One example he gives is a market for used cars in which buyers know nothing about the quality of the cars they are shopping for, while the sellers know everything. This is a case of asymmetric information. The buyers figure that any car they look at has the average quality, but, at the price of an average car, sellers will only provide average or worse-than-average cars. Buyers realize this, figure they can never get their money's worth, and refrain from buying altogether. On the basis of this analysis, Schotter suggests that "car dealers must be licensed and car quality verified if the market is going to function properly."

This seems to be a hasty conclusion, does it not? But in the context of the model it is valid. Our intuition about the situation must be contained when we work *within* the model: no method of breaking down the asymmetry of information is allowed. A buyer cannot bring a mechanically minded friend to inspect the car, nor can he look under the hood or test drive the car. Entrepreneurs cannot purchase used cars and put them up for resale with private quality validation, which rests on reputation. Because these real-world practices of coordinating used-car buyers and sellers cannot be fit into the brittle language of neoclassical economics, Schotter does not consider them valid economic arguments. But such instances of ingenuity are typical of the arguments put forth by free marketeers.

When Schotter fabricates a model in which government intervention is "justified," he achieves no meaningful criticism of libertarianism because he is attacking a straw man. Austrian economic theory, for instance, goes far beyond the formalized notions used in model building, encompassing broader

Policy Report Reviews

notions about the nature of social interaction and about man himself. If Schotter were to incorporate the broader vision of Austrian economics into his conception of libertarian arguments, he would have a more difficult time defending the desirability of government intervention.

Not only would Austrian thought illuminate positive aspects of the market that are hidden in a neoclassical model, but it would also shed light on the inefficacy of government action. When Schotter presents a model in which free enterprise can be improved upon—cases involving externalities, the "prisoners' dilemma," public goods, or asymmetric information—he indicates that the government can effortlessly patch things up. But a sober look at American political life reveals that the efficiency and motivation of government action is drastically different from Schotter's portrayal.

Free-Market Energy: The Way to Benefit Consumers, *ed. S. Fred Singer (New York: Universe Books, 1984), 430 pp., $19.95.*

At last the nonexpert has somewhere to turn for all his energy policy questions. Eleven of the 14 articles in *Free-Market Energy* address specific energy issues, and in each case a market-oriented solution is defended with fact and analysis. Covering oil, natural gas, coal, nuclear power, and electricity, this collection of to-the-point investigations serves as a handy source of basic understanding. Here is a sampler of what the reader can expect.

Editor S. Fred Singer contributes three articles on oil. The first brings us up to date on the global history of oil production and explains the pivotal position of oil in all energy markets.

In his second piece, Singer challenges the widespread belief that oil imports should be reduced. He deals specifically with three reasons usually given for restricting imports: the economic damages produced by supply interruptions and the high cost of preparing for them (notably through the Strategic Petroleum Reserve); the outflow of dollars and its effect on the trade balance; the danger to national security. Although Singer is less critical of the arguments for import restriction than he might be, he concludes that "reliance on market forces is in most cases equally effective and much less costly."

Singer's third article (coauthored with Stephen D. Eule) treats the problem of Alaskan oil. Federal legislation prohibits the free commercial export of Alaskan oil, and, as a result, Alaskan oil is currently creating a U.S. glut, which in turn is discouraging domestic oil production. Half of Alaska's oil must be shipped to the East and Gulf Coasts at considerable cost. If export of Alaskan oil were made possible, the construction of a $2 billion pipeline from Puget Sound to the Midwest would be unnecessary. Singer is convinced that trade restrictions keep Alaska's tremendous oil and natural gas potential from greater realization.

The American natural gas industry, we learn from Connie C. Barlow and Arlon R. Tussing, has been plagued by government controls and needs to be put on a freer basis. The problems started with municipal regulation of local gas companies in the nineteenth century. Then came the Natural Gas Act of 1938, which brought long-distance gas transmission under federal control. In 1954, federal control was extended into the terms of sale between gas producers and interstate pipelines. Economic regulation culminated in 1978 with federal control of gas prices in intrastate transactions and with restrictions on the use of gas. The interventions, the authors explain, have generated the recent upheavals in the natural gas market: acute shortages in the mid-1970s, rampant price rises between 1978 and 1982, and the present artificial combination of physical surpluses and continually increasing prices.

Unlike many policy books of its length, *Free-Market Energy* is packed with meaty essays from beginning to end. While the prescriptions do not generally call for the ideal situation of complete deregulation, they probably come as close as political reality will allow.

Of Politics and Economic Reality: The Art of Winning Elections with Sound Economic Policies, *by Amar Bhide (New York: Basic Books, 1984), 246 pp., $15.95.*

Those interested in a novel perspective on the relationship between state and citizens are advised to read this book. Bhide's thesis is quite simple: the problem with modern governments is that they ignore the views of their citizens. Instead, they attempt to act "on principle" against the general will. Since the citizens know best, the result of such a stand is always chaos and economic disaster. Bhide claims that "our best hope out of the current mess lies with a modern-day Eisenhower or an Adenauer: a pragmatic, if unglamorous, politician who understands and responds to his constituents' needs and is therefore good at winning votes." Some of Bhide's specific suggestions include heavy progressive taxation, significant cuts in spending, elimination of the deficit, free trade, and entrusting the conduct of monetary policy to "experts."

The author takes great pains to show that his view, usually considered "naive," is in fact realistic and highly sophisticated. This reviewer, however, is not convinced. Bhide's complete unwillingness to discuss or even cite much of the public choice (economic theory of government) literature tends to confirm one's suspicions of naivete. In addition, his arguments contain a number of serious holes.

Bhide argues that the "citizens know best," but it is never quite clear exactly what the citizens' views are, unless we are to consider Bhide a representative citizen. Experience with questionnaires confirms the difficulties here. When questions are phrased in such a way that a respondant's answers can be inconsistent, they frequently are. In addition, specific answers will usually vary depending on how the questions are phrased. Even if we accept the premise, however, that citizens currently possess "sound" (however defined) views on economic policy, such cannot always have been the case—we have experienced too many shifts in public opinion for that. The book simply abounds with problems of this sort.

Of Politics and Economic Reality has a provocative thesis and is written in a lively style. But it is doubtful that many readers will be convinced by Bhide's arguments, even though some of his policy recommendations make perfectly good sense. ■

Economist Assails Bishops' Letter

The publication of the draft bishops' letter on Catholic social teaching and the U.S. economy last November has heightened debate over the morality of capitalism. As part of that debate the Cato Institute has published a study by Paul Heyne, an economist at the University of Washington. The bishops' social analysis, says Heyne, is "gravely deficient."

Relying on the bishops' letter, the Bible, and economic theory, Heyne provides an extensive critique within the framework of the Judeo-Christian ethic. Thus, while sympathetic to the bishops' concern for poverty and justice, Heyne challenges their reliance on biblical authority to justify their interventionist policy proposals: "The bishops' concrete recommendations for economic policy, far from being an application of the concept of justice found in the New Testament, *run directly counter to it*. The first step in the wrong direction is the very idea that the gospel presents any kind of agenda at all for government."

"Government," continues Heyne, "is fundamentally a coercive institution. The New Testament provides no agenda for government. On the contrary, it suggests to the faithful that they ought to depend very little on government. The deep suspicion of government found in so many of the radical Christian sects . . . [is] far closer in spirit to the gospel than the persistent efforts of church officials since Constantine to gain control of government for their own ends."

The call for government intervention results from a crucial misunderstanding of the nature of economic and social systems. Such systems are vastly complex and, unlike individuals, do not have goals of their own. Consequently, social systems cannot simply be instructed to place certain goals above others.

In constructing their vision of justice, the bishops also ignore the empirical consequences of past attempts to alleviate poverty. In fact, "the impression given repeatedly by the section on social reform is that the bishops are standing resolutely in the year 1964, urging that we begin the War on Poverty. Has no one called their attention to the abundance of data now available on the actual effects over the last twenty years of the various policies that the bishops recommend as if for the first time? . . . One wonders what would remain of the bishops' proposals if each member of the committee sat down and read Charles Murray's *Losing Ground*."

Heyne's essay, "The U.S. Catholic Bishops and the Pursuit of Justice," is part of the Cato Institute's Policy Analysis series and is available for $2.00. ■

"To be governed..."

Which is not to say they aren't proficient at subsidies

About 2,000 members and supporters of the American Agricultural Movement . . . cheered lustily for Jim Hightower, head of the Texas Agriculture Department, who said federal farm bureaucrats "couldn't run a roadside watermelon stand if we gave them the melons and had the Highway Patrol flag the cars down."

The farmers marched solemnly . . . to the Agriculture Department and on to the White House to demand that the administration expand efforts to keep failing farms afloat.

—*Washington Post*, March 5, 1985

A New Deal in space

When a young man suggested to Rep. Newt Gingrich (R-Ga.) that space exploration was best left to private industry and market forces, Gingrich replied, "That's exactly how Herbert Hoover took us down the wrong road."

—*Washington Post*, March 3, 1985

Fort Taxpayer, the Bronx

"In 24 hours, we can issue a permit free of charge for any public place in all five boroughs, 300 square miles," said Patricia Reed Scott, director of the New York Mayor's film office. "We don't charge [film-making crews] for police assistance, and we have 25 officers, 3 sergeants and a lieutenant who work solely on film production."

—*New York Times*, April 8, 1985

And you thought sending people to Alaska was a joke

The Pentagon was preparing to ship one of its internal critics off to Alaska until it relented yesterday under pressure from Capitol Hill.

Col. James G. Burton, who has led the drive for more stringent testing of the Army's troubled Bradley armored vehicle, was reassigned to Alaska earlier this week.

—*Washington Post*, March 15, 1985

If you're not with us, you're against us

Some FCC commissioners, echoing the free-market philosophy of the Reagan administration, indicated they would not stand in the way of a bidder, like [Ted] Turner, who already was an approved broadcaster, solely because he was making a hostile bid [for CBS]. That led to charges by some media executives, including those at CBS, that the FCC is siding with the raiders, rather than maintaining a neutral stance.

—*Washington Post*, April 6, 1985

"The only candidate certified sane"

The mayor of this Western Maryland city [Hagerstown] has said in a videotaped statement that he is convinced he can return to his job after a voluntary stay in a Baltimore hospital's psychiatric ward.

—*Washington Post*, March 19, 1985

Maybe he missed the point?

Walter F. Mondale told labor leaders today that he believes that he lost the presidential election largely because of his failure in "marketing and packaging" himself on television.

—*Washington Post*, Feb. 19, 1985

Political contributions *are* the price of big government

The Boeing Co. billed the Pentagon for nearly $127,000 in political contributions in 1982, attempting to pass along the costs to U.S. taxpayers as part of the price of building weapons systems.

—*Washington Post*, March 5, 1985

With Republicans like this, who needs Democrats?

Sen. Robert W. Kasten Jr. (R-Wis.) was adamant in protecting revenue sharing and Urban Development Action Grants. Sen. Orrin G. Hatch (R-Utah) wanted more money for the U.S. Information Agency. . . .

Sen. Slade Gorton (R-Wash.) was one of several senators who wanted to restore funds for the Export-Import Bank. . . .

Hatch . . . earlier had fought to save the Job Corps program. . . .

Sen. John Danforth (R-Mo.) . . . got some funds restored for the National Oceanic and Atmospheric Administration, as well as for multilateral banks.

—*Washington Post*, March 15, 1985

CATO POLICY REPORT
224 Second Street, SE
Washington, D.C. 20003

Nonprofit Organization
U.S. Postage Paid
Washington, D.C.
Permit No. 3571

CATO INSTITUTE