SOCIAL SECURITY: THE ABSENCE OF LASTING REFORM

Richard B. McKenzie

Introduction

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

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

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

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

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

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

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

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

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

The Critical Defect of Democracy

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Social Security in a Democracy

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

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

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

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

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

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

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

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

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

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

Social Security: The Hole in the Constitutional Dike

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

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

Proposed Reforms

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

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

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

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

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

[10]See Ferrara, pp. 314–24.

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

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

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

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

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

[13]Ferrara, chap. 11.

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

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

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

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

[18]Ferrara, chap. 11.

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

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

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

Conclusion

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

"ABSENCE OF LASTING REFORM": A COMMENT

Joseph A. Pechman

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

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

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

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

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