THE POLITICAL FEASIBILITY OF PRIVATIZING SOCIAL SECURITY

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Butler and Germanis are concerned with the feasibility of constructing a majority coalition to phase out the Social Security retirement program and replace it with an explicit welfare program for the needy elderly. They are also concerned with the provision of appropriate government and private incentives for working Americans to save and invest privately, to ensure themselves adequate retirement income.

In one important respect, their strategy is not "Leninist" at all. Butler and Germanis seek to form a political coalition. While I am not a student of Marxist-Leninist thought, I do feel reasonably confident that Lenin gave little thought to the possibility of achieving his goal with ballots rather than bullets. Fortunately, we are blessed in the United States by the existence of well-established democratic institutions within which to work for change, and a commitment from even our most fervent reformers that democratic process is the only legitimate avenue for change.

This is not to say that democracy as we know it is flawless. The history of Social Security illustrates some of the problems. Many of us today regret the way in which the Social Security program was allowed to develop. However, we are not surprised by that pattern of development. One needs only to read Edgar Browning's classic paper "Why the Social Insurance Budget Is Too Large in a Democracy"[1] to understand the political appeal of starting a pay-as-you-go government pension program. Early generations of retirees reap tremendous windfall benefits. Future generations, who will almost unavoidably be harmed, simply are not around in sufficient numbers to vote in opposition.

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[1]Edgar K. Browning, "Why the Social Insurance Budget Is Too Large in a Democracy," *Economic Inquiry* 13 (September 1975): 373–87.

The same problem exists in reverse if we try to phase out an existing pay-as-you-go program. There are identifiable groups of current voters who will be harmed by the phase-out. Those with the most to gain—future generations—do not have any political clout. If they did, we would not be in our present quandary. Can we realistically expect a majority of voters to support a phase-out—"privatization"—at any time in the future? This question has not been adequately addressed by Butler and Germanis. It is not nearly as obvious to me as it seems to them that such a coalition is waiting in the wings. In particular, I am not convinced that expanding IRAs will help as much as they think it will.

Let me illustrate the problem as I see it with a very simple example. Suppose we start out with a fully mature pay-as-you-go pension scheme in a society that has zero population growth and zero economic growth.[2] At any point in time, there are four workers for every retiree. Each worker pays $10 in payroll tax during each of the four working periods of his or her life and receives a $40 retirement benefit during the last period. This reflects the return provided by a pay-as-you-go system that is equal to the growth rate in the economy.

This type of program would be a good deal for all individuals if the growth rate in the economy were greater than the market interest rate. However, most economists regard this as an unlikely circumstance. The analysis that follows is based on the alternative assumption that the rate of economic growth is lower than the interest rate. In this case, the first retirees in the program enjoy a windfall gain. They pay taxes over only a portion of their working lives but receive full benefits. However, the program will be a bad deal for workers who must pay taxes throughout their entire working careers before becoming entitled to a retirement benefit. This is because the implicit "return" that they receive on their tax payments is lower than the return they could have received had their money been invested in the capital market.

Despite this bad deal, political support for the government pension program will not necessarily evaporate when it reaches maturity. To illustrate the problem of achieving consensus among the currently living population, let us consider, within the context of our simple model, a proposal to phase out the pay-as-you-go system along the lines suggested by Peter Ferrara.[3] All existing entitlements will be

[2]The zero-growth assumption is purely for analytical convenience and does not affect any of the basic conclusions of the analysis.

[3]Peter J. Ferrara, *Social Security: Averting the Crisis* (Washington, D.C.: Cato Institute, 1982).

honored, but additional entitlements will be allowed to accumulate. If we take any five-person group of one retiree and four workers with the numbers 1 through 4 designating ages from youngest to oldest, their entitlements as of the period the transition begins are as follows. The retiree will receive during that period the $40 benefit to which he or she is entitled by $40 of tax contributions made during his or her working life. Worker 4 has accumulated a $30 retirement claim, worker 3, a $20 claim, and so on.

Perceived gains and losses from the phase-out may depend critically on how these residual entitlements are financed. For example, suppose we continue to collect payroll taxes as long as benefits are being paid. The payroll tax will be phased out in coordination with the benefit phase-out. Worker 4 unambiguously loses. His or her tax obligation during the last working period is unchanged compared to what it would have been if the program had continued, but that tax payment no longer adds anything to retirement income. What about worker 3? During the remaining two periods of his or her working career, tax payments are $10 and $7.50 respectively. A tax saving of $2.50 in the second period is accompanied by a $20 reduction in government-provided retirement income. The market interest rate would have to be at least 800 percent for worker 3 to avoid losing from the phase-out. We could go through similar computations for all current voters. It is entirely possible in this simple example that even though everyone is harmed by the existence of the government program in the sense that their tax obligations could be put to better use, a tax-financed phase-out that guarantees existing entitlements could do even more harm to many or all current voters at the time of implementation. Future workers would reap the benefits.

The Ferrara plan would abolish the payroll tax immediately and finance residual entitlements out of general revenues. This procedure would redistribute the tax burden within each generation as compared to the distribution arising from financing out of payroll taxes, but it is important to note that the tax distribution across generations may not change significantly. Taxes that are imposed to finance entitlements are still phased out at the same rate at which benefits are reduced. Well-informed voters may therefore find financing out of general revenues as unattractive as financing out of payroll taxes. In reality, voters tend not to be very well informed. This may lend some appeal to financing out of general revenues from a political (albeit not an ethical) perspective. Burying the costs (in the form of taxes) of financing residual entitlements in general revenue rather than making such costs explicit by continuing to rely on an earmarked tax may serve to disguise these costs. Poorly informed voters may be led as a consequence to support a proposal that well-informed voters would oppose.

Financing through bonds is an alternative approach to making the transition to a fully funded pension system. This issue has been discussed by Professor Buchanan,[4] and I will only briefly summarize the argument. The problem with financing through taxes, in terms of its failure to appeal to current voters, is that those voters end up paying twice: once for the pensions of their elders and again for their own pensions. Despite the higher rate of return to be earned with private investment, the tax phase-out does not provide capital early enough for voters to invest and come out ahead in comparison to the pay-as-you-go system. If one accepts the Buchanan model of public debt, financing through bonds can be used to shift part of the tax burden of financing residual entitlements onto future generations of taxpayers. There is an ethical justification for this, since future generations will also reap substantial benefits from eliminating the pay-as-you-go system.

My concluding comment on the political feasibility of privatizing Social Security along the lines supported by Butler and Germanis is that they need to give more careful consideration to the alternative financing options. I doubt that expanding IRAs will be enough to attract political support for their plan. Certainly they have not supported that hypothesis in any analytical sense. Some careful calculations of gains and losses under various financing schemes would be helpful.

Let me now turn to another issue that has arisen periodically in the debate over Social Security reform. Mancur Olson, Joseph Pechman, and Rudolph Penner have presented a direct challenge to the proposition that a funded private pension system is inherently preferable to a pay-as-you-go government program.[5] Their argument has two components. First, they argue that intergenerational transfers are an efficient means of providing for old age. A pay-as-you-go transfer from young to old is in line with a long and worthy tradition of children supporting their aged parents. Second, there may be some inherent advantages in collectivizing this function. We can assure individuals who do not have children or whose children predecease them that they will be provided for nonetheless. Many individuals may feel that their retirement income is more secure if provided

[4]James M. Buchanan, Comment in *Financing Social Security*, Colin D. Campbell, ed. (Washington, D.C.: American Enterprise Institute, 1979), pp. 208–12; idem, "Social Security Survival: A Public-Choice Perspective," *Cato Journal* 3 (Fall 1983): 339–53.

[5]See their comments in the *Cato Journal* 3 (Fall 1983).

through a formal government program rather than as a consequence of an implicit and unenforceable contract with their children, and so on.

This argument cannot be rejected out of hand. It is reasonably plausible, at least on the surface. However, there are some interesting issues here that need further analysis. Let me suggest two of these. First, it appears that there are some fundamental changes in people's attitudes and behavior that occur when an intrafamily activity such as income support for the elderly is collectivized. Because of this, government transfer program may not very much resemble the private process that it replaces. For example, if transfers to aged parents were purely a family decision, I doubt that those among today's elderly who have accumulated significant wealth would be willing to ask their children for a significant portion of their income. Yet these same individuals seemingly have no qualms about using their political clout to demand through Social Security what is, in an objective sense, the same thing.

My discussion of this issue is admittedly ad hoc. Perhaps careful empirical analysis will fail to support my hypothesis that this change in attitudes occurs. This is a legitimate and important research issue. Certainly, better information would be helpful in assessing the desirability of privatizing Social Security.

There is a second potential difference between a private and a collectivized intergenerational transfer that also seems worthy of some research attention. In a private system, parents have an obvious incentive to invest in the human capital of their children. A collectivized system introduces a divergence between the private and social returns to investment in the human capital of the younger generation. With a public pension program, whether a couple has children or not or how heavily they invest in the future earning capability of their children may have an insignificant effect on their potential retirement income. Even if many parents continue to receive some marginal contributions from their children, the income effect of the public pension program can be important. If all couples respond to this change in incentives, however, the potential return from the public transfer program may be sharply reduced in comparison to the average return received with a system of intrafamily transfers from young to old. Birth rates may fall and the quantity and quality of human capital investment may decline. Finally, arguments for collectivizing an activity are often based on the existence of a severe free-rider problem in a private, voluntary setting. It appears, however, that in the case of Social Security, government provision itself introduces a free-rider problem that would not exist in the voluntary setting.

PRIVATE ALTERNATIVES TO SOCIAL SECURITY: THE EXPERIENCE OF OTHER COUNTRIES

John C. Goodman

Introduction

When the Greenspan Commission on Social Security Reform took up its historic mission, the nation faced two major Social Security problems, a short-run problem and a long-run problem. The short-run problem was relatively easy to define. The Commission estimated that we would need an additional $150 billion to $200 billion over the next six years to pay for benefits that had already been promised. So in a general sense, the solution to the short-run deficit was dictated even before the Commission began its work: Somehow the government would have to raise $150 billion to $200 billion in additional taxes.

Like the short-run problem, the long-run problem of Social Security was also a financial one. But the long-run problem was much more severe. Under the "pessimistic" assumptions adopted by the Social Security Administration, we faced the strong possibility that 70 years from now between 40 and 50 percent of all taxable payroll would be needed to pay for the package of benefits that had been legislated into law.[1]

Now, extracting *half* of every payroll to support Social Security is a frightening prospect. There are two things that should make us view this projection seriously. First, the "pessimistic" assumptions used for short-run predictions in the past have tended to be much closer to reality than the "intermediate" assumptions of the Social Security Administration. Second, the "pessimistic" projection of the

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[1]See A. Haeworth Robertson, *The Coming Revolution in Social Security* (McLean, Va.: Security Press, 1981), p. 90.