

THE PROSPECT OF REAL REFORM

Peter J. Ferrara

The Washington establishment, with President Reagan in tow, enacted into law in early 1983 a Social Security rescue plan that hurts everyone:

- The elderly will see their benefits cut through a delay in the cost-of-living adjustment (COLA) and the taxation of benefits;
- Workers will have their Social Security taxes increased even further, with the burden falling particularly harshly on the low- and middle-income workers who primarily pay the payroll tax;
- Today's young people will have their future expected rate of return under the program sharply slashed, particularly through the delay in the retirement age;
- Virtually every worker in the economy will be corralled into this insatiable program against his will; and
- For the first time, massive general-revenue subsidies will be infused into the program, smashing the principle of self-financing.

Yet, for all this pain and suffering, the bailout by the Washington establishment hardly even addresses the fundamental problems of Social Security.

It was, remarkably enough, less than five and a half years ago, in December 1977, that former president Carter led the enactment of another bailout plan to save a collapsing Social Security system. The plan involved the largest peacetime tax increase in U.S. history. In 1978, the Social Security Board of Trustees proclaimed in their annual report:

The Social Security Amendments of 1977 . . . restore the fiscal soundness of the cash benefit program throughout the remainder of this century and into the early years of the next one.¹

Cato Journal, vol. 3, no. 2 (Fall 1983). Copyright © Cato Institute. All rights reserved.

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¹*Social Security Board of Trustees, 1978 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C., May 15, 1978), p. 3.

Just two years later, the 1980 Annual Report said, in less sweeping and grandiose terms:

Under all three sets of assumptions, . . . the assets of the OASI [Old-Age and Survivors Insurance] Trust Fund would soon become insufficient to pay benefits when due. . . . Accordingly, changes in the law are needed. . . .²

Now practically the same bureaucratic establishment has enacted another bailout plan based primarily on increased taxes and other palliatives that do not make any fundamental change in the program. We are again being assured that the system will be able to pay its benefits well into the next century.

Social Security's Continuing Problems

But the truth is that the program remains vulnerable to the cycles of inflation and recession that have plagued the American economy for the last 15 years. The Social Security Administration's own projections show that the program will have the same narrow margin for error for the rest of this decade that it had for the years immediately following the 1977 Carter bailout.³ Even if we have strong economic growth over the next year, if sharp inflation returns in late 1984 or 1985, thereby accelerating indexed benefit expenditures, followed by a steep recession in late 1985 or 1986, shrinking payroll tax revenues, the program will probably collapse again before the end of the decade.

This is not a unique view. The Social Security Administration's deputy chief actuary in charge of the program's short-term projections had this to say in a briefing memorandum in early April:

If actual growth is more rapid in 1983, but then restricted by another recession within the next few years, the trust funds could be in a worse financial position than indicated under [pessimistic assumptions]. . . . Depletion of the . . . trust funds would be very likely under these conditions and could conceivably occur within a few years from now.⁴

²Social Security Board of Trustees, *1980 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C., June 17, 1980), p. 5.

³Richard S. Foster, "Short-Range Financial Status of the Social Security Program Under the Social Security Amendments of 1983," Social Security Administration, April 6, 1983; Social Security Board of Trustees, *1983 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C., June 24, 1983).

⁴Foster, p. 3.

This scenario merely follows a well-established pattern. It was the inflation of the early 1970s, followed by the 1974–75 recession, that caused the program to collapse in 1977. And it was the inflation of late 1970s, followed by the 1979–82 recessions, that caused the most recent collapse.

Even if another inflation/recession cycle does not develop so soon, the program will remain vulnerable. The establishment plan counts on massive tax increases in 1988 and 1990 to move the program out of the range of vulnerability. But these tax increases will not raise the expected revenue, because they will substantially harm the economy and lower employment. Other revenue items in the recently enacted bailout plan will also fail to meet expectations based on the official static estimates. Any remaining extra revenues will probably be drained off by the Hospital Insurance (HI) portion of the program, which is still projected to collapse by the end of the decade.⁵

The trust-fund assets for the entire program will therefore remain insufficient to see it through future inflation/recession cycles. Even if the program manages to stumble through one such cycle, it will not return to its former financial balance upon recovery. The trust funds will be permanently depleted to a lower level, and the program will collapse upon the development of a later cycle.

Thus, without the general monetary, budgetary, and tax reforms necessary to end these cycles permanently—and such reforms are not yet in prospect—Social Security will probably collapse again in a few years. The Washington establishment will then be back asking for more tax increases and more benefit cuts.

Having mandated that everyone depend on Social Security for the bulk of their retirement income, the leading policy gurus of establishment Washington should have been acutely embarrassed with the system collapsing twice in the last six years. They and their bureaucratic allies had been telling us for decades that such a collapse would never occur. But, instead, they and their devotees took to the countryside to terrorize the elderly they profess to champion. In one of the most shameful chapters in American political history, they sought during the 1982 campaign literally to scare the elderly into providing money and votes for them, telling of plans to slash dramatically, or even completely cut off, their Social Security benefits. These scare tactics were used when no one was even contemplating such cuts—not President Reagan, not his staff, not congressional Republicans, not even “conservative ideologues.”

⁵Social Security Board of Trustees, *1983 Annual Report of the Board of Trustees of the Hospital Insurance Trust Fund* (Washington, D.C., June 29, 1983).

In 1980, the president had campaigned on the pledge not to reduce benefits for existing beneficiaries, and he had fundamentally kept that pledge for two years. Nevertheless, establishment campaigners, with cynical and callous opportunism, used and abused the elderly for maximum short-term political advantage. In the end, these same people were the ones who successfully advanced the one item in the bailout plan that substantially cuts benefits for today's elderly—the taxation of benefits.

Social Security faces intractable long-term financing problems as well. Official projections showing financial balance over the long run are based on unreasonably optimistic assumptions.⁶ The birth rate is assumed to increase substantially and permanently from current levels, even though the only period of fertility increase in U.S. history was produced by the back-to-back cataclysms of the Great Depression and World War II. The rate of increase in life expectancy is assumed to slow down significantly, even though we are entering a new technological age. The truly enormous deficit of the HI portion of the program is ignored. And no recessions or bouts of inflation are assumed for the next 75 years!

The truth is that paying the benefits promised to today's young workers will require payroll tax rates in the range of at least 25 to 30 percent, compared to 13 percent today. Former Social Security Chief Actuary A. Haeworth Robertson estimates that these tax rates may have to climb as high as 40 percent.⁷

Those who point with alarm at the long-term financing problems of the program are often accused of being irresponsible. But quite to the contrary, it is those who would induce today's young people to base their future on benefits that can never be paid who are irresponsible. There is nothing humane in covering up for a system that leaves the retirement security of an entire generation of Americans in serious financial jeopardy.⁸

The Burden on Young People

Nothing, however, more clearly indicates that Social Security is on its last legs than the fact that the rate of return paid by Social

⁶Social Security Board of Trustees, *1983 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*.

⁷See A. Haeworth Robertson, *The Coming Revolution in Social Security* (Reston, Va.: Reston Publishing Co., 1981). Robertson states that he still believes the tax rates may have to climb more than 40 percent, even with the latest bailout measures.

⁸For a more detailed discussion of the financing problem of Social Security, see Peter J. Ferrara, *Social Security: Averting the Crisis* (Washington, D.C.: Cato Institute, 1982), chap. 5.

Security is falling steadily, and even if all the benefits promised to today's young workers are somehow paid, the program will still be a miserable deal for these workers. This development is a natural consequence of Social Security's pay-as-you-go method of financing—taxes paid by today's workers are not saved for their own benefits but are immediately paid out to finance the benefits of current beneficiaries.

Workers retiring in the early years of the program only had to pay taxes for part of their working careers. The tax burden in those years was also quite low. The maximum annual tax, including both the employer and employee shares, was \$189 as late as 1958, and \$348 as late as 1965. But because the program is run on a pay-as-you-go basis, the benefits paid to these early retirees were not limited to what could be paid based on their own taxes. These retirees were instead paid full benefits out of the taxes of those still working. Their benefits consequently represented a high return on the taxes they did pay.

Over time, the return began to fall, as workers began paying higher taxes for more of their working careers. For today's retirees, the program's benefits still represent a good return on the taxes they paid into the system. But those entering the work force today must pay taxes of several thousand dollars a year for their entire working careers. Today the maximum annual tax is almost \$4,800 and will be almost \$8,000 by the end of the decade. Moreover, the recently enacted rescue plan sharply cuts the benefits of younger workers, particularly through the delay in the retirement age. For most of these workers, the rate of return paid by Social Security will be 1 percent or less in real terms, even if they receive all the benefits they are currently promised. For many of these workers, the real return will be practically zero.

By contrast, if these workers could use their Social Security tax money to invest in private enterprises through an Individual Retirement Account (IRA), *most workers could count on receiving three to six times the benefits promised under Social Security*, and in some cases even more, depending on income and family size.⁹ Now that the pay-as-you-go, start-up windfall is passing, this problem of inadequate returns will plague all future generations, and something must be done about it.

⁹For a more detailed discussion of the superiority of private invested alternatives for these workers, see Ferrara, *Social Security: Averting the Crisis*, chap. 5; Peter J. Ferrara, *Social Security: The Inherent Contradiction* (San Francisco: Cato Institute, 1980), chap. 4.

The Burden on the Economy

Another major Social Security problem that must be addressed is the heavy burden of the payroll tax on the economy. To the extent that the tax is borne by employers, it discourages them from hiring. To the extent that the tax is borne by employees, it discourages them from working. The result is less employment and output. The payroll tax is no more than a tax on employment, and here as elsewhere, the result of taxing something is that there is less of it.

As noted, the maximum annual payroll tax is almost \$4,800 today, and is projected to rise to almost \$8,000 by the end of the decade. For at least half of all workers covered by Social Security, the combined payroll tax is more than they pay in federal income tax. In 1982, payroll tax revenues, drawn primarily from low- and moderate-income workers, were over 80 percent greater than total federal corporate and business tax revenues. In a society deeply concerned about employment opportunities, this incredible tax burden on the act of employment is ludicrous.¹⁰

There is also the problem of the negative impact of the program on savings. The needless and confused academic debate over this issue would profit greatly from a scintilla of reality. Apart from Social Security, most workers today are providing for their retirement through private savings vehicles. Given the modern American family and cultural attitudes, the practice of having numerous children to provide for one's support in retirement is long dead. But Social Security forces workers to provide for the bulk of their retirement income through a system that creates no savings. In essence, Social Security is a form of *forced nonsaving* for retirement. It is hardly even plausible to suggest that such a system does not today substantially reduce private savings.

In any event, this dispute can be left to the academics. The relevant issue for public policy analysis is what will happen in the future as a result of various reforms. If we shifted from Social Security's mandatory, pay-as-you-go system to a mandatory, private, fully funded system, then clearly there would be a significant increase in savings. And that is a strong point in favor of such a reform when deciding whether it should be adopted.¹¹

Social Security suffers from other overwhelming problems, which cannot all be described in detail here. (a) The program's crazy-quilt

¹⁰For a more detailed discussion of the impact of the payroll tax on the economy, see Ferrara, *Social Security: Averting the Crisis*, chaps. 2 and 3.

¹¹For a more detailed discussion of this issue, see Ferrara, *Social Security: Averting the Crisis*, chap. 3, and idem, *Social Security: The Inherent Contradiction*, chap. 3.

benefit structure is haphazard and inequitable. (b) The structure includes many elements that can only be justified on a welfare rationale, yet the benefits paid through them go to too many who are not poor. (c) The program makes the retirement security of the elderly subject to the vagaries of politics. And (d) the program is harshly and unnecessarily coercive.¹²

It is easy to underestimate the vastness of the problems we are discussing. Social Security now accounts for more than one-fourth of the federal budget. Such overwhelming problems in such an enormous portion of our overgrown public sector cannot be ignored. These problems must be addressed. Social Security must be fundamentally reformed.

Toward Real Reform

The analytical key to this reform is to recognize that Social Security performs both insurance and welfare functions. It takes funds from everyone and returns benefits only when certain prestatated contingencies occur—death, disability, sickness, retirement. Yet it provides additional benefits to those who are thought to be in need. The above-described problems can be solved by splitting these functions into two entirely separate programs or sets of institutions—allowing the welfare function to be performed by a separate program explicitly and carefully designed to help the poor, and allowing the insurance function to be performed by the private sector.¹⁵

We must also recognize that we cannot achieve our reform goals by cutting Social Security benefits. We can only solve the problems of Social Security by creating the means for most of the functions of the program to be performed in the private sector. Most of the program should be moved off the federal budget entirely. That will never be accomplished by attempting to cut benefits.

We must instead lead the way in protecting the benefits of the elderly against the Washington establishment, with its perpetually collapsing program. We must guarantee to the elderly that their benefits will not be cut. In a 1960 decision, *Flemming v. Nestor*, the Supreme Court held that Congress has the power to reduce or cut off Social Security benefits to any or all of the elderly at any time.¹⁶

¹²For a more detailed discussion of these problems, see Ferrara, *Social Security: Averting the Crisis*, chaps. 6–8, and idem, *Social Security: The Inherent Contradiction*, chaps. 6–8.

¹⁵See Ferrara, *Social Security: Averting the Crisis*, and idem, *Social Security: The Inherent Contradiction*.

¹⁶*Flemming v. Nestor*, 363 U.S. 603 (1960).

The president and the Congress should make the statutory changes necessary to overturn this ruling.

At the time a worker retires in reliance on his future, promised Social Security benefits, he should receive a U.S. government bond contractually entitling him to those benefits. In accordance with an express congressional intent, this would give the retiree the same legal status as the holder of a U.S. Treasury bond. It would be unconstitutional for the government to refuse to repay such a bond holder. Similarly, it would be unconstitutional to cut the benefits of someone who had already retired on Social Security. Congress would retain authority to adjust benefits to future beneficiaries.

Second, IRAs must be expanded. The maximum annual contribution limit should be set equal to one-half the maximum annual combined Social Security tax. Nonworking spouses should be allowed to contribute the same amount as working spouses. IRA benefits should be made tax exempt, providing an immediate incentive for increased savings at virtually no cost now.

Third, the massive payroll tax increase now scheduled for 1988 and 1990 should be repealed. Neither workers nor the economy can afford these counterproductive increases.

Finally, and most important, workers must be allowed an opportunity to shift some and eventually all of their Social Security tax money into IRAs, in return for a commensurate reduction in their future Social Security benefits. There are many ways such an opportunity can be designed and implemented, and a choice among them is mainly strategic. Let us examine one plan that appears particularly attractive.

Starting on January 1, 1986, workers would be allowed to contribute to their IRAs each year, on top of any other amounts they may contribute, an additional amount up to 20 percent of their OASI taxes. They would be allowed a 100 percent *income tax credit* rather than the usual IRA deduction for these amounts. Workers could also direct their employers to contribute up to 20 percent of the employer share of the payroll tax to their IRAs, on top of any other contributions, with the employer again receiving a 100-percent income tax credit for this amount.

Workers would then have their future retirement benefits reduced to the extent they took advantage of this credit. A worker who opted for the full credit during his entire working career would have his retirement benefits reduced by 20 percent. A worker who regularly took half the credit each year would have his future benefits reduced by 10 percent. A worker who took half the credit for half his career would have his benefits reduced by 5 percent.

The rationale behind the credit is to grant workers, in effect, a rebate of part of their Social Security taxes to the extent they reduce their reliance on Social Security and increase reliance on IRAs. But since the credit is taken against income rather than against payroll taxes, the revenue base of Social Security is left intact. Payroll taxes will continue to be fully and exclusively available to pay Social Security benefits. No general revenues need to be put into Social Security to assure that benefits continue to be paid.

The credit option will, however, reduce Social Security expenditures over time. More and more workers will be relying for more of their retirement benefits on private savings rather than Social Security. Since payroll tax revenues are held in place, one important effect of this credit option is to help close or eliminate any long-term funding gap in Social Security.

If everyone took full advantage of the credit option from the start, the income tax revenue loss in today's terms would be about \$28 billion.¹⁷ But if we assume more realistically that the credit option is only half-used across the population as a whole in the first year, which is probably still optimistic, the revenue loss would be about \$14 billion.

Moreover, the increased investment through IRAs will result in increased revenues through the corporate income tax and other taxes. These new revenues, plus the reduced Social Security expenditures, will offset the revenue loss more and more over the years, eventually on net eliminating the loss entirely. Before this point, there will always be at least \$1 in increased savings through IRAs for every \$1 in lost revenue, because the income tax credit is only allowed for IRA savings.¹⁸ So even if the federal deficit is temporarily increased by the full amount of this revenue loss, and this is surely not certain,

¹⁷This would be the cost of the reform if adopted today, as calculated from Social Security Board of Trustees, *1983 Annual Report of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds*. The other estimates in this paper were calculated on the same basis.

¹⁸To avoid the danger of a mere shifting of existing savings into IRAs to obtain the credit, workers should be prohibited from withdrawing IRA amounts for which they obtained the credit and associated returns before retirement. (The assets would have to be appropriately segregated in the account for identification purposes.) This would make the IRA savings unsuitable as a substitute for nonretirement savings. Because Social Security benefits would be reduced for credited IRA contributions, the IRA savings would be needed to replace those lost benefits, and therefore would not be suitable as a substitute for other retirement savings either. As a result of these factors, any shifting of existing savings into IRAs, rather than new savings, to obtain the credit, should be negligible because such IRA savings will no longer be able to perform the function of other savings.

there will still not be any increase on net in the government borrowing drain on private savings.

Starting on January 1, 1990, workers would be allowed to contribute additional amounts to their IRAs each year for the purchase of term life insurance, up to a maximum of 10 percent of their OASI taxes. Workers could also again direct their employers to contribute up to this amount for such purchases. Both employee and employer would receive an income tax credit equal to the amount of these contributions, instead of the usual IRA deduction.

An employee with no dependents would be allowed to contribute these additional amounts for his retirement. With one dependent, the employee would be allowed to contribute half these amounts for retirement.

Social Security currently pays survivors' benefits on behalf of a deceased taxpayer who leaves behind a wife and young children, or an elderly spouse. For those under 65, private, term life insurance can entirely perform this function. Consequently, a worker will have his pre-age-65 survivor's benefits reduced to the extent he took advantage of this credit during his career.

The income tax credit is again, in effect, a rebate of Social Security taxes for those who rely more on IRAs and less on Social Security. But again it leaves payroll-tax revenues intact and requires no use of general revenues to continue paying Social Security benefits.

If every worker took full advantage of the credit from the start, the revenue loss would be at most \$14 billion in today's terms. But Social Security expenditures would also begin to decline fairly rapidly. There would not be any more new claims for pre-age-65 survivors' benefits, and once existing claims expire, these benefits would be phased out completely. All workers would then be relying on private life insurance for these benefits.

Moreover, there would be increased savings roughly equivalent to this revenue loss, as the life insurance companies would have to set aside the proceeds for each beneficiary in a lump sum. The increased investment resulting from these lump-sum proceeds would generate additional revenues. In conjunction with the reduced expenditures, such revenues would lead to the rapid net elimination of the revenue loss.

After these two steps, a substantial Social Security surplus can be expected by the mid-1990s. At that time, the maximum credit for IRA contributions could be increased to 30 percent or 40 percent, in return for further future Social Security benefit reductions. But the additional credit would be allowed against payroll-tax liabilities rather than income taxes, thus consuming the Social Security surplus.

Consequently, there would be further expenditure reductions and another surplus in the future. The maximum credit could then be increased further until it reached 100 percent of OASI taxes. To accelerate this process, some of the additional credit increases could be allowed against income taxes, as in the first two steps, rather than against payroll taxes.

Workers could then be allowed to purchase disability and old-age health insurance through their IRAs, with further credits allowed for these purchases. Eventually, workers would have the opportunity to rely on IRAs entirely, in lieu of Social Security.

Such a reform would leave the Social Security framework fundamentally in place. Workers could choose to remain in Social Security if they desired. But the Social Security structure would be expanded to allow a role for the private sector. Workers would have the option to choose the combination of public and private alternatives they preferred. Those who have confidence in the free market, however, will recognize that virtually all workers will eventually opt for the private alternatives. There would continue to be a requirement that workers choose some vehicle for retirement and insurance protection.

The Supplemental Security Income program (SSI) would continue to provide special welfare benefits to the elderly or disabled poor, and would automatically grant benefits to those who had an inadequate retirement income from their IRAs and remaining Social Security. SSI could be adapted as part of this reform to ensure that it could perform this function adequately. But for those entering the work force today, even those who earn only the minimum wage throughout their working years would be able to earn substantially more through IRAs than through Social Security—enough to make supplemental welfare benefits unnecessary.

The Advantages of Reform

The possible benefits of such a reform are compelling. Today's young workers would be able to receive full market returns on the money they paid into IRAs. They would consequently be able to earn several times the benefits promised to them under Social Security. Mandated payments into IRAs could eventually be reduced, since workers need not be legally required to provide for such high retirement incomes. Regular take-home pay would therefore be increased for those still working.

The private IRA system will operate on a fully funded basis, with enough savings always on hand to finance earned benefits. Potential financing problems will therefore be solved, as much as they can

ever be in this world. The bankruptcy crisis that still looms when today's young workers retire will be avoided.

Possibly hundreds of billions of dollars in increased savings will flow into the capital markets each year as a result of the increased savings through IRAs. Annual private savings could be almost doubled. Martin Feldstein, chairman of the Council of Economic Advisers, estimated during his academic days that Gross National Product (GNP) could as a result be increased by 20 percent.¹⁹

In the private IRA system, the numerous inequities that dominate the current Social Security benefit structure would be eliminated. Workers would be paid back what they paid in, plus interest. The waste of welfare benefits under the current system would also be eliminated, since welfare would only be paid through a means-tested system. Yet the poor would be taken care of.

With workers relying on the private sector for their benefits, total federal spending would be reduced by almost one-fourth, with total federal domestic spending (excluding defense and debt interest) reduced by almost one-half. Given that Social Security, national defense, and interest on the national debt amount to almost two-thirds of the federal budget, it is hard to imagine a substantial reduction in the federal government's claim on society without such a reform.

The reform would allow workers more control over their own incomes. They would be allowed to choose those investment vehicles that best meet their retirement and insurance needs. With each worker possibly developing a large estate through his own IRA, total national wealth would be distributed far more equally. Feldstein's calculations suggest that such a reform could reduce the concentration of national wealth by one-third.²⁰ Yet this would be achieved not by redistributing national wealth, but by providing an opportunity for the creation of new wealth, more equally distributed. Through the private IRA investments, each worker would be developing a substantial ownership stake in America's business and industry.

The reform would basically denationalize the large portion of the pension and insurance industries now operating in the public sector through Social Security. The public would characteristically be served better through the private sector and an enormous but unnecessary expansion of government would be cut back.

¹⁹Martin Feldstein, "Social Insurance," Harvard Institute of Economic Research, Discussion Paper 477, May 1976.

²⁰Martin Feldstein, "Social Security and the Distribution of Wealth," *Journal of the American Statistical Association* 71 (December 1976): 800-807.

Yet all this can be accomplished without in any way threatening the elderly. They would in fact be made much better off. Their benefits would be maintained, and indeed, constitutionally guaranteed. Political pressures to reduce these benefits will be diverted. At the same time, their children will have an opportunity for a more secure and prosperous retirement, and a chance to work in a healthy and growing economy now.

Such a reform is what the public wants in regard to Social Security. They want today's elderly to receive the present system's benefits. But at the same time the public, and especially today's young people, recognize that Social Security is not suited to the modern economy and today's workers. Individuals want expanded opportunity and control for the future. They will not long tolerate the periodic rounds of tax increases and benefit cuts and the "let them eat cake" mentality of the current Washington establishment.

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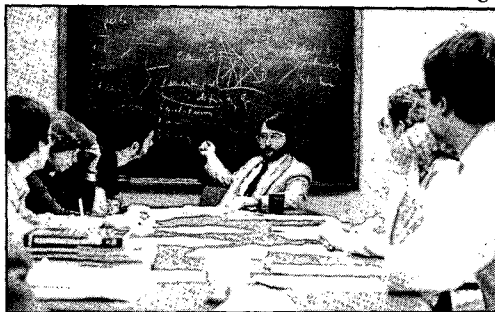
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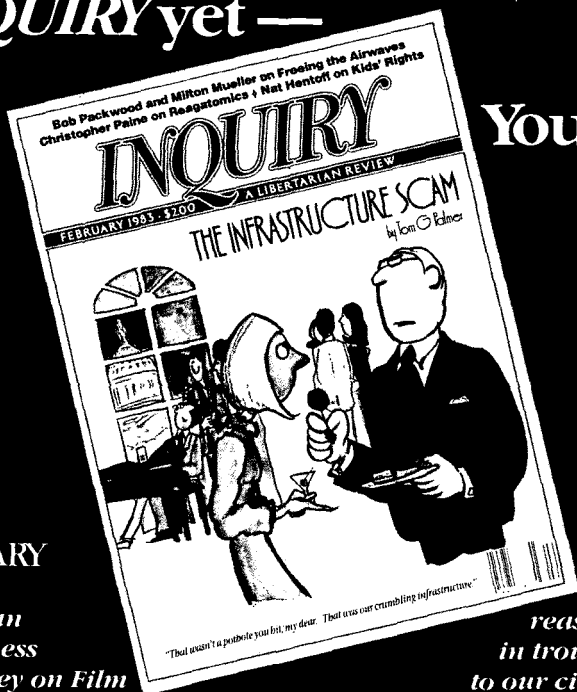
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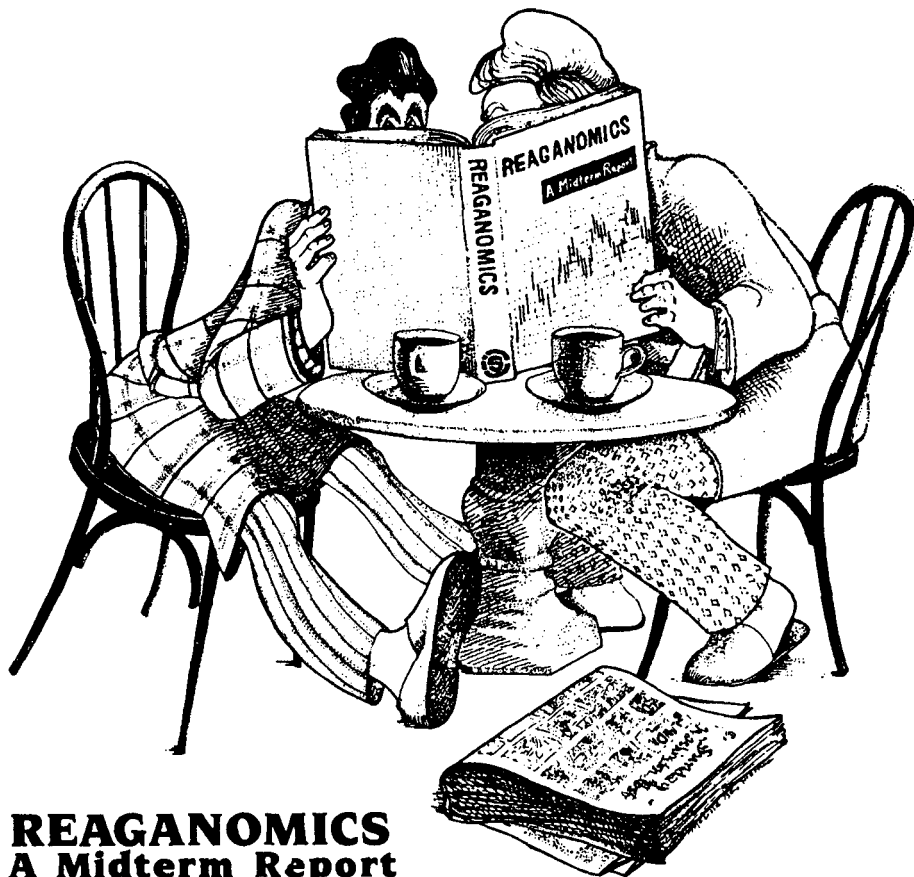
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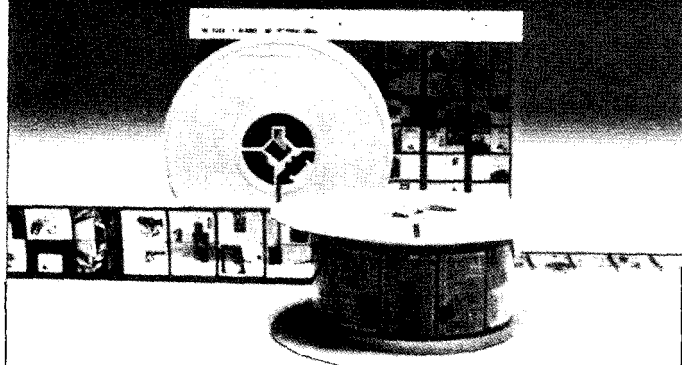
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—Carolyn L. Weaver

*The Crisis in Social Security:
Economic and Political Origins*
(Durham, N.C.: Duke University
Press, 1982), pp. 189–90.