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FOREWORD

Progress Foundation's Ninth International Economic Conference, which was organized with the cooperation and co-sponsorship of the Liberales Institut, Zürich, was devoted to discussion of what arguably may be the most pressing socio-economic issue that the developed Western democracies will confront over the course of the next several decades: namely, the fate of the troubled welfare-state Social Security systems.

In virtually all of the advanced Western economies, for many decades Social Security has been a principal bulwark of the social "safety net." With few exceptions, however, financial and economic analysts have been slow to recognize the fundamental flaws in the design of Social Security as administered since its inception.[1]

As the conference papers that follow observe, Social Security in both Europe and the United States is not an "insurance program" in any conventional sense of that term. Despite the much touted "Social Security Trust Funds," Social Security has no genuine reserves against future liabilities. Rather, it is a vast income-transfer program that continues to depend on current receipts from the working population to fund benefits to the retired and disabled. As many now realize, this arrangement is viable only so long as Social Security taxes are sufficient to fund current outlays. It is inescapable that the projected dramatic decreases in the ratio of workers-to-retireds across the Western economies over the next several decades will bankrupt the various Social Security systems unless their administrations are markedly changed.

It is, of course, the question of what constitutes the most desirable course of change that has provoked greatest controversy. Currently, proposals for Social Security reform range widely. Some adherents of traditional welfare economics would introduce severe means testing for benefits — or otherwise restrict the class of Social Security recipients. In contrast, some advocates of a market-based reform would scuttle Social Security entirely by privatizing the system. There are many proposed variants that would combine elements of both such proposals.

Whatever form the eventual financial reforms may take, it is clear that — both in the United States and Europe — they will have to satisfy what understandably are broad public concerns over matters of both ethics and

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[1]A notable exception is the American Institute for Economic Research. Beginning in the 1930s, AIER's founder E.C. Harwood was a prescient critic of Social Security, which he labelled among the greatest financial frauds perpetrated by Government in human history.

equity. It is precisely this arena that Professor Meinhard Meigel addresses in his discussion of the fundamental social considerations that drive the Social Security debate.

Dr. Robert A. Gilmour observes that as a matter of both financial equity and practicality, and regardless of how theoretically attractive such proposals may be, it is unrealistic to expect that Social Security in any of the advanced economies will easily be privatized or simply "go away." On the other hand, he observes that there are far more equitable — and honest — ways to administer such programs. At the least, the public should be informed that Social Security is not insurance and that "contributions" (*i.e.*, taxes) are not savings that go into some retirement account for future beneficiaries. This in turn implies a major reform of the Social Security funding mechanism.

As in all Progress Foundation economic conferences, the views expressed by the participants are their own and do not necessarily represent the views of the sponsoring institutions. As with previous such events, however, we believe that the discussions in the pages that follow are both timely and pertinent — and will engage the reader's interest whatever his or her particular views.

About the Participants

Professor Dr. Meinhard Miegel is Leiter des Instituts für Wirtschaft und Gesellschaft (Head of the Institutes for Economy and Society) in Bonn, Germany. He is most familiar to European audiences as a frequent media commentator on German and European economic and social issues and has written and spoken widely on such welfare issues as Social Security.

Dr. Robert A. Gilmour is President and Chief Executive Officer of American Institute for Economic Research, Great Barrington, Massachusetts. He has written and lectured widely on Social Security issues, and is the author of *Swindling America's Middle Class*, AIER's 1987 cost-benefit analysis of Social Security in the United States that was among the earliest studies to compare private market performance with that of the welfare-state driven Social Security apparatus. Currently Dr. Gilmour serves as a Director of the Robert Schalkenbach Foundation in New York, as a member of the Advisory Board of the Foundation for the Advancement of Monetary Education, also in New York, and as a Trustee of Progress Foundation.

Conference Coordinators

Dr. Marcel Studer is Chairman of the Board of Trustees of Progress Foundation, Carona, Switzerland.

Professor Dr. Peter Forstmoser is Professor of Economics at the University of Zürich and Chairman of the Board of the Liberal Institute, Zürich, Switzerland.

Prospects of the Social Security Systems

Prof. Dr. Meinhard Miegel

Whoever thinks about the aspects and prospects of the social-security systems should first clarify the term "social." What does it mean? Broadly speaking, the term relates to the "interrelations of human beings in a community," including aspects of welfare. Consequently, the problem can be worded as follows: to what extent do the systems of the classic industrial countries behave in a truly social manner benefiting and promoting the communal life, systems which are aimed at providing for people having become needy because of poverty attributable to their own fault or not, or unemployment, and alternatively in case of illness, permanent need of nursing care as well as in old age?

At first glance, all of these systems seem to be highly social-minded. Our preconceived opinions presuppose the strong and powerful citizen to help the needy one with welfare, the working citizen to assist the unemployed one with unemployment aid, the healthy person to aid the sick one within the framework of health-care and nursing insurance, and finally the gainfully active population to help the old people without any gainful occupation. Otherwise expressed, aren't these systems truly social-minded and thus promoting and benefiting the interests of the community?

At a second glance, some doubts do arise. Is a welfare system really social-minded if it induces persons fully fit for work to claim its benefits and to depend on them? That such a situation really exists has been evidenced by a study made a few years ago in Bremen, according to which a substantial proportion of welfare beneficiaries had learnt how to make a living from welfare, often without actually needing it. And again: is a welfare system really social-minded, which continuously encourages a lot of fathers and increasingly mothers, too, to abandon their families in the certainty that, in final analysis, the taxpayer will provide for them? In this context, we should bear in mind that tax funds required to sustain children abandoned by at least one parent have meanwhile attained the exorbitant figure of one thousand six hundred million (U.S.: 1.6 billion) Deutsche mark per year in Germany.

We also may question the social-mindedness of unemployment insurance which sometimes incites people to quit work outright. What I mean can be gathered from an apparently secondary but typical fact. During a lifetime, almost every gainfully active person will be faced with certain interruptions of his or her remunerative occupation. Between the end of the schooling period and the beginning of remunerative activities, or between the end of one remunerative occupation and the beginning of another one,

normally an orientation or reorientation period of several weeks or even months is interposed. During the lifespan of an otherwise fully employed person, such nonoccupational periods sum up to roughly 2 percent of his or her life hours of work. However, a generation ago, almost nobody would have imagined to label these non-remunerative periods with the term "unemployment" and to apply to the local labor office for support. But nowadays, one-fifth of the unemployed persons registered by German labor offices say that they don't apply for a job, chiefly because they already have signed an employment contract for a future date. But even these people want to squeeze whatever benefits are possible out of unemployment insurance. There's no doubt: under the same fundamental conditions, the unemployment insurance is milked more widely and extensively than in former times, and it has still to meet its main challenge. That's because the future will see more and more people shuttling between employed occupations, self-employment and related activities, gainful activities in the private and the public sector and, in contrast thereto, unemployment — with every interruption providing an incentive to apply for unemployment benefits.

We may further question the social-mindedness of health-care and nursing insurance contributing to blur the boundaries between health, illness and nursing requirements, which ultimately makes disease a question of attitude or approach. It is precisely due to such attitudes that in certain professional groups in Germany, such as public service, the percentage of sick people continues to be four times as high as with self-employed people. We may ask with good reason whether, in many instances, the health insurance certificate is not tantamount to a kind of free ticket allowing the holder to burden all sorts of frustrations on the community of insured persons? Frankly speaking: everybody knows the skillful masters taking the utmost advantage of sick days and stays at health-resorts.

And again we may ask: is an old-age providence system really social-minded, which grants high benefits to one generation having paid low contributions, while it provides low benefits to another generation having paid high contributions? In Germany, those who retired in 1995, after 45 years covered by old-age retirement insurance, receive — in relation to his or her previous contributions — a pension two times higher than the one a person retiring in 2015 can expect. The situation virtually corresponds to the Bible's parable of the vineyard. Benefits and returns largely correspond to an arbitrary pattern. Can it be called social-mindedness to grant a pittance as an old-age pension to a woman who raised three children while another childless woman may expect a comfortable retirement pension just for having sold lipsticks in a boutique during her lifetime?

Please don't misunderstand me: the bulk of welfare beneficiaries are — at least relatively speaking — poor, while most unemployed are really jobless and most persons claiming health care and nursing treatment are truly in need thereof, and finally most senior citizens are undoubtedly entitled to be well provided for. But the oddities in all social-security systems are no longer shortcomings of a superficial nature to be graciously tolerated, but truly alarming drawbacks. The large majority of beneficiaries of social-security entitlements certainly are not parasitic "looters." However, the door is wide open to parasites, and it takes a lot of starry-eyed naivete not to realize it.

But let's examine the matter from a third perspective, and we will discover glaring inconsistencies which are not readily explainable. The fact now emerges that social-security systems actually do not merely muster up societal solidarity. In addition, these systems aim at cementing the State's power and at legitimating the ruling authorities.

In the abstract, such a double function does not necessarily have a shady connotation. There is only the drawback that the way of establishing and cementing power and legitimating the ruling authorities by using the instrument of social-security systems jeopardizes — at least partly — the attainment of the original objective. That's because the social-security systems no longer promote society's cohesiveness. On the contrary, they split society. In order to make this clear, it is first of all necessary to shed light, as it were, on the anthropological preconditions of the State's power, as well as on power, rule and dominion in general.

Except in a tyranny, power and dominion are always supported by several pillars. However, the one absolutely indispensable pillar consists in presents. Expressed in more precise terms: the subjects expect the ruler to give them something they cannot obtain by their own means. Even in today's welfare-oriented democracies or democratic welfare states the situation does not differ from that of the former Greek Polis. Throughout all ages, "presents" have been made in one form or other in order to establish power and to legitimate the ruling authorities. Formerly, all the involved parties — the donating rulers and the ruled beneficiaries — openly admitted this. It is only our apparently thoroughly enlightened society which tries to disguise this basic fact — and for good reason. That's because the question may arise: from which source does the ruler take his presents?

In former times, the ruler occasionally tapped his own fortune, and we are not concerned here with the way he acquired it. If the fortune was not sufficient, the ruler had to resort to the wealth of third parties, for which purpose he could choose between two alternatives. One was robbing others and distributing the booty. Secondly, he could use cunning to achieve the

same purpose. At least in our regions, distribution of robbed booty is at present out of fashion. Instead, considerable zeal is applied to acquisition by cunning.

In welfare-oriented democracies, the least amount of cunning is required for the transfer of gifts from a minority to the population's majority. For obvious reasons, such a transfer is very popular with the majority, which usually sanctions it eagerly in a democratic manner, *i.e.*, by the majority of citizens. In its turn, this act of sanctioning serves to appease the minority. Otherwise the social peace could not be guaranteed — thus the argumentation of the ruling authorities. So far, so good. But this strategy suffers from its narrow limits. Sooner or later — mostly sooner — the source for the required presents dries up, either because the minority no longer wants or is unable to be milked, or both.

The rulers have to use far more cunning for a transfer in the reverse direction: the transfer from the majority to a minority. At least within the frame-work of a democratic community marked also by transparency of media, such a transfer requires such a lot of imagination and creativity that the ruling authorities almost cannot cope with the challenge. That's why they prefer to resort to a third way of crafty procurement of presents: taking from everyone and giving to everyone — the perfect design of a welfare state's ruling mode.

Certainly, even this variant requires the taking to be carefully camouflaged, while the process of giving presents has to be publicized to the utmost degree. Because once the ruled subjects have seen through the game, they are likely to quickly lose their interest. That's precisely what the ruling parties have to prevent in the aim of preserving the pillars of their power. As instruments to achieve this purpose, they usually run the state into massive indebtedness and/or they exploit the organization of the social-security systems for their own goals.

If the State incurs debts, it borrows money from its citizens, in the aim of entertaining them in some way. Splendid fountains splash water, streets are lighted nightly with festive illumination, or certain social strata benefit from special revenues in excess of their productive achievement. The average citizen usually views all these activities benevolently, often without becoming aware that every cent to cover the cost of the show is paid out of his own purse. He continues to ignore the true situation, because the State only hands him some kind of debenture. That's why he nurtures for many years the illusion of really being able to have it both ways: plentiful presents and benefits from the State as well as substantial private savings. Once the moment of truth appears and the citizen has to foot the bill in order to cover the State's accumulated debts by paying exorbitant taxes or

some other tribute, his disappointment is huge. Enraged, he may vote the government then in charge out of office. The fact that precisely this government bears no blame does not interest him.

That's why the government's indebtedness is only the second best instrument to feign benefactions offered by the State. The best such instrument is offered by the various social-security systems. But in this instance, too, considerable skill is required, and this starts with language. An old-age pension system financed according to the "pay-as-you-go" principle and thus living practically from hand to mouth certainly does not deserve the pompous term "old-age pension," which encourages the belief that the retired citizen spends in his old age, similar to a pensioner, his own fortune accumulated during a lifetime. All the same, more than half of the German citizens insured by the public old-age pension system believe this assumption to be true. When told the truth, these people often react in an incredulous or incensed manner. Euphemistically, taxes are called "contributions" in this context. Exorbitant dues for the financing of all kinds of transfers are cozily downsized to "Pfennige", *i.e.*, "cents".

A further cloaking of the social-security systems' real nature consists in the manner of their financing. In Germany, financing occurs without exception both by contributions, *i.e.*, premiums, and by taxes. An individual involved cannot for this very reason discern the true costs thereof. The same disguising effect is achieved by allocating one half of contribution payments to the employee and the other half to the employer. This trick works. The bulk of German employees are aware only of their own half of contributions, making the cost burden appear quite reasonable, as compared with expected benefits.

It's no mere accident that the social-sphere politicians vehemently oppose the payment of employers' insurance premium contributions to the employees. They explicitly fear the occurrence of problems connected with acceptance and approval of the systems ensuring social security.

What strange offshoots may sprout from all this was evidenced a few years ago when Germany introduced so-called nursing care insurance (Pflegeversicherung). For obvious reasons the employer could not be burdened with additional higher premium payments. While appearances had to be saved, employees were explicitly required to work one day more per year without any increase in remuneration. The simple way of charging the whole premium from the beginning to employees was not held to be a feasible solution by the social-sphere politicians. In this instance, too, warnings against a dangerous precedence jeopardizing the other insurance systems were issued. But it would certainly befit a mature, reasonable society to let every citizen know the true expenditure required by the

social-security systems.

However, more decisive than the aspects of language and the financing of the social-security systems is their organization in a strict technical sense. In this area, welfare raises certain difficulties. Welfare does not actually belong to the social-security systems proper, since its financing occurs exclusively via taxes. But welfare's greatest oddity is its close resemblance to gainfully earned income. A sizable part of the population occupies just a narrow stratum above the welfare level, especially households with children. A further problem connected with welfare is the steadily increasing provision of foreigners by means of welfare, for which purpose it had not been created and consequently is not suitable.

Distinctly more problems are posed by the organization of unemployment insurance. It can only be rated as a means of providence against a general risk of life subject to certain reservations. Its main function consists in the organization of a transfer from highly skilled employees with good income and usually below-average exposure to unemployment down to low-skilled fellow employees with low income and above-average exposure to unemployment. Unemployment insurance entails a massive redistribution of income according to the principles of the welfare state. However, this fact is not disclosed. Here, too, illusions are nurtured quite intentionally.

Matters differ somewhat with respect to the statutory insurance against illness, which should more accurately be described as a complex health-care providence system kept intentionally impenetrable to a layman's understanding. However, similar to the other systems, statutory health insurance also nourishes the disastrous misconception that benefits can be obtained cheaply. That's the only reason to explain why this system is permanently overtaxed and why any attempt to reform it is immediately suppressed. Any individual feels entitled to make use of the community for every need: the State promised him or her this right. Even attempts endeavoring to slightly restrict the system's benefits provoke an outcry uttered by a large part of the community. The State fears a damaging effect on its image as a generous donor of gifts. And in every such instance, things very quickly lapse almost into their former state.

However, as regards unemployment insurance, health insurance and nursing care insurance, one must say that all these systems are fairly transparent, understandable and rational when compared with statutory old-age pension insurance. The latter one outpaces all of them with respect to obscurity, disguise, camouflaging and illusionary misrepresentations. Statutory old-age pension insurance is indeed intended to represent the true great gift the rulers make to the ruled subjects. To achieve this effect, the people are led to believe that by making provisions to guarantee retirement

pensions to old people they will also provide for their own old age. Back in the fifties, the unfeasibility of such an arrangement had already been recognized and publicized without any useful effect. Politicians were then absolutely unwilling to renounce their role as the people's benefactors and thus oblige them to be grateful. They were only interested to know the time when this concrete unfeasibility would become apparent. The answer was then: in two generations, and that was held to be sufficient. It so happened that statutory old-age pension insurance was celebrated as the great achievement of the century although, right from the start, it had obviously been built on sand. Meanwhile, this achievement of the century shows enormous cracks, and the possibility of its collapse cannot be excluded. Why?

Social old-age providence in the sense of an old-age pension plan benefiting and promoting communal life, whether or not imposed and regulated by law, always requires the same type of organization. This organizational aspect has been expertly described in a little parable written by the German poet Johann Peter Hebel in the first half of the 19th century: A wanderer meets a farmer who carries three loaves of bread on a tray, and he asks him: "Why did you bake three loaves when you and your wife can eat only one single loaf at the utmost?" The farmer replies: "Well, you're right. Together with my wife I can eat only one loaf. But I have baked a second one for my old parents living in the cottage over there. It is from them that I took over the farm, and they have achieved many things from which I can profit today. That's why I am grateful to them." "And the third loaf?" "The third one is for my children so that they may some time in future bake the bread for me when I shall live in the cottage over there." The meaning is simply: the working generation has always to bake three loaves of bread. Otherwise, no system of old-age providence will function satisfactorily, not even a statutory one imposed by law.

However, to enable the working generation to bake not merely three paltry loaves of bread, but instead three large ones satisfying the appetite of all people, the older generation must make the necessary provisions. Let me explain this by extending further Hebel's parable: the older generation has to pass on a well-kept farm with cultivated fields, seeds, healthy livestock and everything else required to run an efficient and well-functioning undertaking.

Otherwise expressed: One given generation can only make provisions for its old age by investments — investments in human capital, or let's express it in a less technical language: investments in children, in real estate, in non-monetary real capital, in productive capital and naturally also in all items of infrastructure, comprising schools and universities, the traffic network and sewage plants, as well as finally a sound environment.

That's what amounts to a successful provision for old age, and nothing else.

Given this background, the tenet so eagerly professed by many politicians and even by some economists, according to which during a specific period it is possible to do nothing else than consume and spend everything produced during that period, is indeed dangerously misleading. That's because it is a cheap pretext to indulge in idleness. Sure enough, it is correct to say that today's youngsters cannot bake the bread for their old age in our time. As to whether and how much bread will be baked henceforward, that's a problem mainly depending on today's actions, however. Decisions are made today that will determine how we will live after a generation. The dies are cast now, including those regarding the system of old-age providence and assistance, which will or will not be existing 20 or 30 years hence. The argument denying the need to take action now in order to safeguard the future of the old-age pension system, as problems likely will not arise for another 10 or 15 years — which hardly can be rated as an argument at all — is thus not only short-sighted, but absolutely foolish. That's because once problems connected with the old-age pension system become apparent, action must urgently be taken at once, and very often it is then even too late.

The quality of any old-age pension system has to be assessed using the following yardsticks: firstly with respect to its capability of truly providing welfare. In this respect, most classic industrial countries — those where industrialization began very early — deserve good marks. Secondly, there is the capability of providence. In this respect, an unsatisfactory performance is shown by all systems financed according to the pay-as-you-go principle. For "pensions" or "annuities" — irrespective of their definition — never amount to anything else than the "interest" on previously accumulated "capital".

Where this capital or principal is not formed — and it cannot be created within pay-as-you-go systems — the precondition for paying interest simply does not exist. Expressed in concrete terms: today's contributors only make interest payments on capital, understood in its broadest meaning, which they took over from the senior citizens then living. Figuratively speaking, the senior citizens take the said interest corresponding to the pensions granted them — into their grave. Consequently, contributors can no longer expect any return whatsoever. Whoever could provide it?

The more clear-sighted among us always realized these interrelations. It was the Jesuit padre von Nell-Breuning, considered as Nestor of Catholic social teaching, who wrote in the sixties: "On the strength of their contributions, the contributors have not earned their pension, but they have only

returned what has been given to them by the preceding generation. In this way, they are quits. The pension or annuity which they in their turn want to draw in future has to be earned by them through raising their offspring — and additionally by any other kind of capital formation. He who contributes nothing in this respect, finds himself in grave default. Promising pensions based merely on wages amounts to a preposterous absurdity."

However, it is precisely this absurdity that provides the foundation for the statutory old-age pension system in many countries, including Germany. In this context, the present Minister for Labor and Social Matters, Mr. Blum, asserts: "Social-security insurance cannot be equated with welfare or public relief; instead it is a system of solitary self-help based on membership and financed by contributions. Entitlement to benefits is derived from previously made contributions. With respect to the pension, the total of contributions and the period during which payments are made determine the size of the subsequent returns in the shape of pensions. Consequently, the payment is not a gift, but an old-age salary as return for contributions paid during the working life."

Should this viewpoint correspond to the truth, fortunes could be made by paying interest and settling debts, which is practically impossible. It is high time for us to face the unwelcome truth of having for considerable time baked only two loaves of bread and maybe additionally a little roll, that is one loaf for the past and another loaf for the present, while the roll is meant for the future. Such a course of action cannot succeed indefinitely — and that's what has become increasingly noticeable.

With the treacherous aim of making people believe in an easy-to-finance old-age pension system, politicians have maneuvered themselves and the population into a tricky situation with almost no escape. And the people have begun to see through the whole hocus-pocus. The fascination of former days has evaporated. In Germany, 75 percent of the age bracket below 60 years and fully 80 percent of those below 45 years no longer expect the "pension politicians" to fulfill their promise of a guaranteed adequate old-age pension. Consequently, there has been an increase in activities to get out of the existing system or at least to dodge and avoid its rules to some extent.

These activities will increase even more as soon as people realize that it is far more profitable to provide for their old age outside the statutory old-age pension insurance. A few figures will elucidate the matter. In the Western part of Germany, the unmarried new pensioner of the year 1995 received after 45 contributing years — in terms of real value — two marks in pension benefits for each mark contributed, which is not a spectacular but a fairly acceptable "yield." Under the identical conditions, however, a

new pensioner in the year 2015, will receive a pension only of one real mark for each real mark contributed. This means that his old-age providence will no longer be influenced by the interest factor. Moreover, within 20 years, the ratio contribution/benefits will be reduced by half. Another 20 years later, *i.e.*, in the thirties of the next century, a pensioner will receive in real terms only 80 Pfennig for every real mark contributed. Consequently, the contributors will see their real fortune reduced under the system of statutory old-age pension insurance.

It is at that time that the people will without fail realize that they had not taken care of a satisfactory old-age provision by making sufficient investments. They will be painfully hurt by the consequences of the above described shortcomings: due to insufficient expenditures for children, their education and schooling, for research and development, for jobs and other matters, the two pillars of the statutory old-age pension insurance consisting of demography and of the labor market start crumbling away. At that time, imploring the young generation to show solidarity with the old people will most probably be useless. What's more, it would also be unfair. Because today it's the age bracket between 45 and 65 years that shows least solidarity toward the younger citizens. This presently young generation may and will ask the older one in a foreseeable future: "How did you actually think things would work out? Is it our fault that we are so few and you so many? That's what you decided, right? Can we be blamed for the fact that we are no longer up-to-date in many areas of research and development? That's your responsibility, isn't it?" Or, returning for the last time to Hebel's parable, the young people might ask: "Is it our fault that the farm is in a run-down state and that the neglected fields have become overgrown?"

To be sure, these reproaches will be highly unjustified with respect to many older people, because many of them have made sufficient provisions for their old age. For example, if a couple with average income raises two or three children and takes care of their education, this means an investment of about one million mark. Conversely, if a couple with average income did not raise any children (and I certainly won't blame them for it) and at age 65 this couple failed to have accumulated investments amounting to at least one million mark, then it obviously had lived in an excessively grand style. As a consequence, conflicts will not only arise between young and old people, but between senior citizens themselves. There are those who, despite their own provisions, receive worse treatment from the State's old-age pension system than those who made no provisions of their own. The latter will emphasize that they shared the burden of the pension system by paying contributions, while the former ones will object that only they had effectively made provisions for their old age.

Within the framework of the statutory old-age pension insurance, this conflict can hardly be satisfactorily solved. Therefore — and this is certain even today — the statutory insurance will henceforward no longer act as a social bond benefiting and promoting the communal life, but will create disunity. What can be done in such a situation?

Firstly, tell the truth. Once again, let's hear what Nell-Breuning has to say: "Politicians must finally muster the courage to tell the population outright that everything they had told them before about the feasibility of financing the pensions had been sheer nonsense." The population must be notified in no uncertain terms that, under the present statutory old-age pension system, real provisions for old age can only take place outside the system itself. The ensuing conclusion is, secondly, that providence in the meaning of investment capability and investment willingness of the population must be strengthened by every means. As a prerequisite for this purpose, it is necessary to drastically throttle the huge social-transfer spending and consuming machine. In the fifties and sixties, at a time when things were far worse than today for people living in Germany, only about one-sixth of the gross domestic product was used for social transfers. Today, the figure is one third, corresponding to more than one billion (U.S. trillion) mark. In order to throttle the speed of this consumption machine driven by one billion (U.S. trillion) mark, it is necessary to restrict all areas of transfer: welfare, health and nursing-care insurance, unemployment insurance and above all the statutory old-age pension insurance.

The measures to be adopted for this purpose have been described so many times that I do not need to add anything. As regards medical and nursing care, the compulsory insurance systems must limit themselves to handle serious damage cases. Everyday problems can and must be reassigned to the sphere of responsibility of the individual and his family. As regards unemployment, all minor cases involving only short jobless periods of four, eight or twelve weeks have to be overcome by the individual concerned. Provided sufficient provisions have been made, the vast majority of citizens are able to do so. Of necessity, old age providence must henceforward consist firstly of a state-controlled system of basic assistance and secondly of more or less private supplementary pension plans. The times when the State could promise an old-age pension system guaranteeing a specific living standard are definitely gone. Expressed in more precise terms: in the future, a state-controlled social-security system guaranteeing a specific living standard can and will be available only for the comparatively needy citizens.

All this does not mean "social dismantling," but on the contrary restoration of the social sector. The now prevailing governmental management

of the social sector has damaged its substance and thus harmed the demographic pattern of the population, the labor market, the public budgets and many other things. It is necessary to strengthen anew the reciprocal relations between individuals. This is both possible and necessary. Due to the present organization of the social sector, society at large is far too exclusively oriented toward the present, whereas it should again be offered future-related perspectives. And that's again both possible and necessary.

To be sure, all this does not answer the question regarding the cementing of power and the legitimation of the ruling authorities. Otherwise expressed: can a democracy be ruled without making presents and without deceiving people with the mirage of a social-minded but illusionary welfare state? I can only hope so. That's because all illusions do vanish sooner or later, and it would be a real disaster if this circumstance were to jeopardize the very system of democracy. But the fact remains that illusions provide no solid foundation for society. As Abraham Lincoln put it 150 years ago: "You can fool all of the people some of the time and some of the people all of the time, but you can't fool all of the people all of the time." That's what the social-sphere politicians should keep in mind. Endeavors to maintain the social peace by means of unfulfillable promises actually destroy that peace.

The Uncertain Future of Welfare Statism: Prospects for Social Security in the United States

by Dr. Robert A. Gilmour

If I had the power to practice genuine "voodoo economics" and by some wizardry could create a better world, it would be a land absent the barriers to prosperity that have been erected by Governments everywhere in the name of providing "security" for their subjects. Indeed, there would be no need for this conference or many others like it.

In brief, it would be a land without most of the taxes that we now are forced to pay lest our property be confiscated or we go to jail. It would be a land without personal income taxes, corporate profits taxes, tariffs, subsidies, or any of the other state-imposed requirements that today burden labor and capital everywhere.

Instead, the legitimate functions of the state would be financed through a genuinely neutral tax, such as that on land values that has been widely endorsed in economic theory but seldom tried. And it would be a land where the purchasing power of the currency did not deteriorate as it has everywhere in the world today, and where all would be genuinely equal before the law.

It would be a land where Joseph Schumpeter's capitalist forces of "creative destruction" would not be feared or reviled as agents of *social insecurity*, but rather celebrated as the main engine of progress that continually raises standards of living.

It goes without saying that it would be a land where most functions now performed, or allegedly performed, by Government would be provided by market participants according to voluntary transactions — and that many of the taxes we now are forced to pay would, in the free marketplace, simply become fees that we would pay *only for the goods and services that we as individuals elect to purchase.*

It would also be a land without payroll taxes, because there would be no Social Security system. No one would be forced to provide a living for any other, and men and women would be free to decide for themselves when and how best to provide for their own retirement — or whether to do so at all. (I might note in this respect that the notion of retirement is relatively recent in human experience, and that many of the most productive in society often have expressed no wish to "retire" in any conventional sense of that term.) The point is that those who wished to accumulate resources for use at leisure would be free to do so without penalty, just as would those who had no self-imposed "need" to do so. The protection now pro-

vided through Government agencies would be provided by any number of private insurance plans, voluntary associations, annuities, and the like, and would be funded by individuals to the extent of their own choosing.

To be sure, this land would not be Utopia. Some would fall through the cracks. But it is my strong contention that their relative numbers would be far fewer than those that the policy-induced social calamities we have witnessed in the United States over the past half century have fostered. It is a senseless tragedy that in a nation of such abundance, entire generations of a portion of our population are in effect being condemned by destructive policy to lives of misery and depravity.

In the land that I would create, such would not be possible, nor would it be possible for the freedoms of the many to be trampled upon because of the shortcomings of the few. In short, liberty would triumph over naive notions of equality of result. In the long run, it is my belief that in such a land, genuine civility would be permitted to flourish — and the envy and jealousies that punctuate and confound rational polity today would be overwhelmed by the energies unleashed in an advancing civilization. Even so brief an experience as the past two centuries' on-again-off-again flirtation with a polity grounded in human freedom suggests that it is precisely in such environments that the impulse toward genuine compassion has the best chance of developing.

Alas, I am not a wizard, and this all is but a dream that almost surely will not be realized during my lifetime — or during the lifetimes of anyone in this audience. It is when we awaken from the dream that we encounter the nightmare — and which we will address in the remaining minutes today. For the inescapable likelihood is that most of the burdens we now face will endure — and those include especially Social Security.

The Mythology of Social Security

It seems unrealistic to expect that Social Security will disappear anytime soon. Although many working-age Americans apparently have become increasingly doubtful that Social Security as it currently is administered is either equitable or financially viable over the long term, intractable political support for the system continues to come from the elderly.

Almost surely, many retireds' enthusiasm for Social Security derives from narrow self-interest. But even many who may not need their benefit checks to live comfortably, and who may have ethical qualms about accepting entitlement handouts, nevertheless apparently believe that, on balance, Social Security is a compassionate program that should be maintained for the good of society.

This perception has been driven by at least one major myth: that Social Security's overreaching benefit has been in assuring there will be no recurrence of the suffering that prevailed during the Great Depression. As the president of the American Association of Retired Persons, the behemoth elderly lobby in the United States, recently exhorted AARP members: "talk with your children about Social Security's importance. Remind them that it stands as the one true pillar of our future economic security — and theirs.... For those of us born before 1930 the Great Depression defined and shaped our outlook on family, community, work, and the role of government. I was a child in those days and I still have vivid memories of neighbors losing their farms, and of daily newspaper and radio reports about growing unemployment, bread lines, and widespread homelessness.... Having experienced the hardships of the Depression firsthand... I am appalled by the continued discussion of fundamental changes [in Social Security].... More than any other program, Social Security reflects our nation's commitment to the economic security of Americans of all ages."

Its Actual Record

Powerful words and, from an economic viewpoint, powerful nonsense. Unquestionably the Great Depression was a human disaster that brought suffering to millions of people. But what ought to be apparent to anyone who gives it even passing thought, is that Social Security had virtually nothing to do with the macro-economic events surrounding it.

Social Security did not then prevent neighbors from losing farms; it did not curb unemployment; and it did not resolve widespread homelessness. Nor would it do so today. According to official statistics, homelessness has been more widespread in recent decades than ever before, despite a vast expansion of Social Security and other welfare programs. Moreover, Social Security has never protected the personal assets of able-bodied workers. Excepting the employment opportunities provided to its bureaucracy, it never has been an employment program but rather the opposite: by cutting or denying benefits entirely to those elderly who wished to continue working, it was designed to reduce the size of the workforce. And it does not provide income to out-of-work laborers. Since its inception, it has provided zero benefits to the overwhelming proportion of the millions of American workers who lost their jobs at one time or another.

Social Security *has* thwarted rather than stimulated growth in employment. For decades, the payroll taxes imposed by Social Security have raised the cost of labor and thus discouraged employers from hiring additional workers, or even retaining current ones. For many, such levies also have been either a prohibitive disincentive to entrepreneurial self-employment — or else have encouraged them to join the millions in the ranks of

the underground economy. No one can calculate the cumulative damage that has been visited on the labor economy by Social Security, but it is preposterous to describe it either as an "economic security" or a "lifetime family-protection" plan for America's workers.

Inasmuch as Social Security benefits historically have not been reduced, but often actually increased during economic contractions, in effect the system has bled American workers struggling to keep their jobs in favor of retireds, who largely have been insulated from the economic reverses that younger people must endure during these episodes. From a macroeconomic perspective, Social Security is a prescription for economic insecurity for America's workers and, on balance, would seem more likely to foster economic depression rather than alleviate it. Nevertheless, support for Social Security continues to be bolstered by a powerful legend whose blatant inaccuracy shows few signs of impairing its political usefulness.

Practical and Ethical Considerations

Beyond such mythology — economic nonsense really — there is an additional compelling factor that mitigates against the demise of Social Security anytime soon. Namely, those millions of voters of working age, whose compulsory payroll taxes have funded current Social Security benefits, have a very large stake in seeing that the system is perpetuated. This understandable interest has both practical and ethical dimensions.

The inescapable fact is that most American workers have poured tens if not hundreds of thousands of dollars into Social Security, and they regard it as a matter of equity that they receive something in return, even if that means burdening future generations with taxes to fund their benefits. According to most polls, it is mainly America's "Generation Xers" who expect Social Security to collapse (reportedly, more say they believe in UFOs than in Social Security's future ability to pay their retirement benefits). Among those age 40 and above, who represent a majority of America's voters, there is little if any measurable sentiment for actually terminating the Social Security program.

Underlying such support, almost surely, is a very practical consideration: payroll taxes have rendered discretionary saving for many Americans a virtual impossibility. Given the burden of payroll taxes, which might have provided a comfortable nestegg for most workers, most individuals' financial resources even in advanced age simply will not be great enough to finance a "retirement" of any means. In short, so long as current workers are represented mainly by those who already have "contributed" substantial payroll taxes into the system, Social Security can be expected to continue in some form, which brings me to the next question.

Can Social Security Be Privatized?

Those acquainted with the work of the American Institute for Economic Research know that we identified Social Security's principal financial and economic shortcomings many years ago. The Institute's founder, E. C. Harwood, was perhaps the harshest critic in print of Social Security from the 1930s until he died in 1980.

He labelled Social Security a Ponzi scheme, pure and simple, and ranked it among the three greatest swindles perpetrated by government in human history — a fraud that not only burdened younger and future generations in order to enrich current retirees, but also thwarted capital formation, employment, and, most important, individual initiative and responsibility. Its combined effects over the long term, he noted, could be expected not to promote, but to retard, improvements in standards of living.

He also recognized that unwinding such massive frauds is never painless — or minus new opportunities for perhaps even greater mischief. With this in mind, permit me to comment briefly on the reported enthusiasm for "privatizing Social Security" in the United States, especially among some members of the task force appointed by President Clinton to recommend ways to shore up its shaky finances.

Can Unfunded Liabilities Be Privatized?

I think there are some genuine difficulties with "privatizing" Social Security in any conventional sense of that term. Although it generally is totally ignored, the primary reason is simple: what private concern (insurance and annuity company, investment house, pension fund, etc.) would be willing to assume a multi-trillion dollar unfunded liability extending many decades into the future?

Or consider the oft-cited Chilean model, which has relied on the conversion and transfer of state-owned enterprises and undeveloped natural resources into marketable private assets to fund what had been public benefits liabilities. In the case of the U.S. Federal Government, however, what is there to sell or convert? Nevada desert property? The barren range lands of the high plains that currently are the object of concern mainly for wolves, coyotes, and cougars? How about the Tennessee Valley Authority, or any of the other Federally funded energy boondoggles? The difference, of course, is that to an overwhelming extent in the United States useful physical assets already are in private hands. Almost by definition, anyone there who acquires a government-funded enterprise or government-owned property is buying a loser (those that sometimes run in the black, such as the Postal Service, do so only because they enjoy a government monopoly).

A Strengthened Free Enterprise System...

While it is hard to see how Social Security could be privatized backward to cover existing liabilities, it clearly *could* be privatized forward to fund the future benefits of younger wage earners — albeit at the further expense of Social Security beneficiaries who otherwise would receive the funds so "privatized." For future entrants to the job market, moreover, any variety of reforms might be contemplated that would allow funds now expropriated by Social Security to be deployed by individuals as they wished — or at least more nearly as they wished. The alternatives might range from opting out of Social Security entirely, to participating in individually managed mandatory retirement accounts, to enrolling in a group investment or annuity plan comparable to those currently available through most employers. To the extent that such changes could be made *without increasing payroll taxes to offset revenue losses*, they would restore today's politicized financial flows to individuals whose financial decisions would be made through market processes, and could immeasurably strengthen the free enterprise system. But it probably won't happen that way.

Or "Mega-Scratch" for "Investment in the Public Interest?"

Rather, even a dimly aware political entrepreneur might glimpse in the initiative to "privatize" Social Security by investing in conventional financial markets an extraordinary opportunity to extend Government's reach — and the even more dimly aware media pundits seem all too ready to endorse almost any proposal along these lines. One prominent news commentator, for example, likes the idea of Social Security money going into stocks, but cautions: "If you invest [your Social Security tax money] for yourself, what saves you from 'respectable' swindles like the limited-partnership scams?" "Let's put some of Social Security's money into stocks, then distribute the gains in the traditional, safety-net way. The well-off own stocks already. It's good policy to provide the rest with a decent retirement guarantee."

It is hard to be charitable in response to this line of "thought," which may account in part for Wall Street's current skepticism about what might happen were the Social Security bureaucrats actually to become stock pickers backed by billions or trillions of tax dollars. The comments of Stephen G. Elkins of the National Association of Manufacturers are worth noting in this respect, and I quote: "As the debate over reforming Social Security proceeds, the question of government control of portfolios ought to be among the primary matters for consideration. And we can expect familiar voices to advocate 'investment in the public interest,' or some such. The prospect of *mega-scratch* available for Economically Targeted Investments under privatized Social Security will create a policy magnet

with the kind of attractive force attributed to celestial black holes."

According to another Wall Streeter, the notion that investing Social Security's trillions in the equity markets with the expectation that fabulous returns will bail out the system is a mathematical fantasy that already has pushed related Wall Street sentiment well beyond skepticism. He reports that "the most cynical people are on the very Street that stands to see a flow of fresh money.... The rest of the country seems to take sustained high returns for granted, but my Wall Street friends talk about Social Security privatization as the ultimate sign of a top.... [F]or the huge U.S. equity market, a 13 percent annualized return [like that achieved in the Chilean equity markets since its social security system was privatized] is a fantasy — we'd own the nearby planets as well as the world by the time the Generation Xers retired. There is of course a way around this mathematical impossibility — a dramatic 'correction' in the public equity markets."

In short, Social Security could become "the ultimate odd-lot investor, bound to come in at the top." It scarcely needs mention that this possibility would be immeasurably strengthened by an assiduous program of "social investing." "We could wind up," he says, "with a sort of fascistic, Washington-administered capital market."

There would appear nearly always to be such dangers inherent in enforced or mandated investing, which would seem eventually to promote wasted resources. Consider the situation of the Soviet Union in the 1960's and 1970's, for example, when it was frequently predicted that the Soviets' "high" savings rates would promote accelerated economic growth that soon would overwhelm the Western capitalist democracies. We know now how that one turned out.

The point is that is it not just the *quantity* of savings and investment, but also the *quality* of such investment that influences economic outcomes. Long experience suggests that market-directed investments — which means individuals deciding where and how much to invest — yield the most favorable outcomes.

There is, of course, a simpler way to say all this. Not too many years ago, President Gerald Ford was rebuked by his economic advisers for suggesting precisely what President Clinton's Advisory Council on Social Security recently offered as one alternative. When Mr. Ford suggested investing Social Security funds in the stock market, his advisers pointedly reminded him that Federal ownership of common stocks would constitute what economists and political scientists commonly refer to as "state-owned enterprise," "nationalized enterprise," or "socialism" — with all the consequences implied by those familiar names. One suspects they would have

found incomprehensibly bizarre the notion that one day the same scheme would instead be termed "privatization."

What, Then, Might Be Done?

I do not wish to be tedious, but I ask you to bear with me as I relate some of the technical details involved in the current calculation of Social Security benefits. If the system is to continue, as I believe it will for the foreseeable future, it is the details that may shed the strongest light not only on the system's inherent shortcomings, but also on possible avenues of useful reform.

Few people have a clear idea of how Social Security benefits are calculated or of how they are paid for. This is no accident. Rather, it has permitted the growth of perhaps the most insidious of the myths surrounding Social Security: namely, that Social Security retirement benefits are a return of the participants' "contributions," *i.e.*, the payroll taxes they and their employers paid during their working years. They envision the program as a kind of annuity plan, run by the Government but similar to the retirement annuities marketed by insurance companies or to the pensions provided by private employers. This notion is wrong on two points.

First, unlike pension funds and annuity premiums, the payroll taxes collected by the Government are *not* invested in bonds, common stocks, or other assets representing productive capital. Rather, Social Security taxes are used to pay for the benefits of *current* Social Security beneficiaries. Revenue comes in from workers and goes right back out to retirees, with the Social Security Administration acting as middleman. Consequently, when someone retires there is no fund of accrued, invested taxes waiting to be tapped for their benefits. Instead, benefits are paid for with taxes collected during their retirement, just as their taxes paid for the benefits of earlier retirees.

There is, of course, something called the Social Security Trust Fund, into which Social Security taxes are paid and out of which benefits are disbursed. For most of its history this "fund" represented little more than a working balance, but, since the last major revision of the system in the early 1980s, it has been accumulating significant "surpluses." These now amount to several hundred billion dollars. However, this money has been used to pay for Federal spending on non-Social Security programs, and the "fund" is in fact little more than a bookkeeping artifice. The "surplus" only accumulates because the taxes that the politicians have designated for Social Security recently have been larger than the payments that the politicians have designated to be paid out of the fund — some of the taxes designated for Social Security have been used to pay for other Federal

spending.

When the taxes paid in to the trust fund start to fall short of the benefits paid out, the trust fund balance will decrease. This will only mean that some Social Security benefits will be paid out of taxes not designated for the purpose. At such time, the Federal budget, which measures only overall receipts and disbursements, will fall into a widening deficit unless tax revenues are increased or non-Social Security spending is decreased — the trust fund will not reduce the cost to future taxpayers of financing future Social Security benefits. It is a myth that designating payroll taxes to pay for Social Security benefits somehow insulates the program from the rest of the Federal budget. Revenue, from whatever source, is revenue, and spending, for whatever purpose, is spending.

Moreover, unlike an annuity or many of the retirement plans sponsored by private employers, there is *no* direct link between the amount one "contributes" and the size of the Social Security benefit to which one is entitled. The amount of an individual's benefit check is related to his or her earnings history (and therefore to the amount of taxes deducted from paychecks and matched by employers, or paid directly by self-employed persons). But that relationship is mandated by legislation, which has been changed by Congress in the past and could be changed in the future. The amount of benefits is *not* determined by any sort of actuarial calculation or investment returns.

The calculation of individual benefit levels is arbitrary. The Government begins by reviewing an individual's annual earnings history, as indicated by payroll tax records, for the years prior to the individual's 62nd birthday. During the early years of the Social Security program, average annual earnings essentially were figured simply by adding up annual credited earnings and dividing the total by the number of years worked. But chronic price inflation in the postwar years took a toll on this approach; it led to vastly inflated nominal earnings from one's later working years being lumped together with smaller nominal earnings from earlier years.

When the rate of price inflation accelerated in the 1970s, Congress mandated that the calculation of average annual earnings include an adjustment for this distortion. Today, earnings for a given year (but no more than the maximum that was subject to Social Security taxes in that year) are multiplied by an "index factor" for that year. The index factors used in these calculations reflect year-by-year changes in the national average *wage* rather than the cost of living with the year before the beneficiary turns 62 (and all subsequent years) equal to 1. The most notable feature of this provision is that, because nominal wages have increased faster than prices in the postwar years, the adjustment is far more generous than one

based on price inflation. Since 1951, the national average wage has increased about ninefold, so wages from 1951 currently are multiplied by a factor of 9 to make them comparable to today's wages. During this period the consumer price index increased "only" about five and a half times.

The increase in wages relative to prices during the past 4 decades has been an increase in *real* wages reflecting higher productivity. In the business world, higher productivity is rewarded with higher wages during and after the year it occurs; past wages are not retroactively credited. In the world of Social Security, however, for purposes of calculating benefits, productivity gains boost earnings recorded perhaps 40 years before the gains were achieved.

In 1992, for example, the national average wage increased 5.2 percent. Thus a 62-year old approaching retirement saw his official earnings history for each year since he began working ratchet up 5.2 percent. This increase followed a 3.7 percent increase credited in 1991, when the national average wage increased that much. During just these 2 years, credited earnings increased 9.1 percent — even though the CPI increased only 7.4 percent.

Clearly, this generous adjustment overstates "real" earnings. Consequently, it inflates the benefits based on those earnings, and thus it makes the entire Social Security program more costly than it would be if, say, earnings were adjusted only for price inflation.

In any event, once annual earnings have been indexed to make them comparable to today's earnings, the *average indexed monthly earnings* (AIME) are calculated. In taking this average, only the 35 highest years of indexed earnings are averaged. Thus, if real earnings had increased steadily over his career, but never had been more than was subject to Social Security payroll taxes, the indexed annual average earnings would be markedly higher than actual average earnings.

Time does not permit a discussion of the procedures used to calculate the primary insurance amount (PIA), which is the basic monthly benefit amount. But it is clear that using the national average wage rather than prices as the basis for indexing prior years' earnings in the AIME calculation, has served to boost the benefits of first time claimants faster than the rate of price inflation used to index existing benefits. As a result, the benefits that can be claimed by someone retiring now will be larger than those of someone slightly older, even if the latter's earnings history prior to retirement was identical in real (price adjusted) terms. For example, that the formula credits current retirees with their most recent years' earnings (when the maximum subject to tax was far larger than it was, say, in the

1950s) means that the basic benefit (PIA) of someone who always earned more than the maximum subject to tax and who retires at age 65 is now 15 percent higher than that of a similar person 8 years older.

Actual monthly benefits paid are subject to a wide variety of factors, and probably not 1 in 10,000 recipients of Social Security understands how his or her benefits have been calculated. The complexity of the calculation of the basic benefit level, changes in methodology over the years, and the arbitrary nature of the adjustments to that basic level mean that beneficiaries have no clear idea of how, let alone why, their benefits differ from others, even those in circumstances essentially similar to their own.

In short, the ways in which Social Security benefits are calculated make a mockery of the notion that it is an insurance program (the executives of a private carrier that offered its terms would be locked up). The point is that *Social Security is an income-transfer program.* What needs to be addressed is whether it accomplishes this purpose fairly or efficiently.

Defenders of the system often argue that Social Security is "social insurance" designed to provide support for the elderly and therefore does not need to follow the same actuarial or financial principles required of private programs.

Every society has some mechanism for transferring a portion of current output to those who do not contribute to it. Support from family members is the traditional means of doing this, and it remains the main support of children and a major source of income for others who cannot provide for themselves, including disabled persons and even the elderly. Historically, there have been a wide variety of private associations that provided support for their members via a wide variety of formal and informal mechanisms.

Such mechanisms might even be deemed to include the system of property rights and financial institutions that enable individuals to accumulate savings during their working years and then use the income from such property and the property itself to support themselves when they stop working. What sets such mechanisms apart from "social insurance" is that they are voluntary. Any inequities or inefficiencies that arise are the responsibilities of the individuals involved.

In contrast, Government-mandated "social insurance" uses methods of distribution that largely are arbitrary, with little regard for the specific circumstances of individuals. Nevertheless, there seems to be a consensus that, with the smaller and less extended families and greater mobility (both geographically and occupationally) of today's population, "social insurance" in the form of income transfers should remain a major means of

supporting the elderly. There also seems to be a consensus that such payments should not be subject to any sort of means test, *i.e.*, that they should be made without any regard for the recipients' assets or income from other sources. The problem is that we will not be able to afford the current levels of payments for long, especially if we continue to make larger income transfers to those who earned the most during their working years.

What to do? Practically, an obvious approach is to make the benefit payments even more progressive than they are now. Currently, the Social Security benefit formula provides that those with a history of low earnings receive, in relation to what was paid in, much larger benefits than those with high earnings. Some argue that this bias is more than offset because those with histories of high earnings collect benefits longer (they live longer) on average, so they eventually collect as much or more in relation to what they paid in than do those with histories of low earnings.

In any event, if the goal of the program is to provide a basic level of subsistence to the elderly, the minimum payments it now provides are too low and the maximum benefit levels are excessive. ***In short, the goal of a successful reform at this time might simply be to make the benefit levels equal for everyone.*** To do this means scrapping the entire notion that the program bears any resemblance to savings or private insurance. This applies to the revenue used to pay for the benefits as well as the benefits themselves.

Moving toward equal benefits for all Social Security recipients at a level that the productive members of society can afford cannot, in fairness, be accomplished quickly. Current retirees and those nearing retirement years have planned on specific levels of benefits that should not be markedly changed overnight.

One way to make all benefits equal gradually would be to calculate all PIA amounts under current law as of a cutoff date. Thereafter, instead of computing increases in individuals' PIAs using the indexes of average wages and prices, they could all receive the same *dollar* increase. At some point not long into the next century, there would be very few individuals remaining with PIAs in excess of the minimum. Eventually everyone would get the same amount.

Abolish the Payroll Tax

Our suggested reform thus far would serve to limit the future Federal outlays under the program. It would eliminate vast amounts of bookkeeping for employers and for the Government itself, because, after the cutoff date, there would be no need to keep track of earnings histories and Social Security tax payments.

More significantly, if Social Security took its place as just another Federal spending program, there would be no need to maintain the fiction that it is "paid for by worker contributions," and the link to payroll taxes could be broken for good. If this were accomplished, the payroll tax could be examined in the light of its own merit or its lack thereof.

The most commonly noted feature of the current system of Social Security payroll taxes is that it is regressive, *i.e.*, poorer taxpayers pay a higher proportion of their incomes in payroll taxes. This is not only because the earnings subject to payroll taxes are capped, with earnings above the limit not subject to the tax, but also because property income is not subject to Social Security taxes.

Needless to say, abolishing the payroll tax would leave a gigantic void in Federal receipts. Something would be needed to replace it. Our candidate is a value added tax.

A Value Added Tax

The value added by an enterprise is the difference between its revenues or sales, and the goods and services it purchases from other firms. A value added tax essentially is a sales or turnover tax, with the important difference that a specific enterprise gets, in effect, a credit for the taxes paid by its suppliers. This means that the tax base of a value added tax includes the same base as payroll taxes (compensation of employees) *and* whatever is left over after the suppliers and vendors have been paid, which is the return to capital (interest and profits).

A long-standing objection to a value added or national sales tax is that it is regressive. However, a value added tax is a proportional (neither regressive nor progressive) tax on consumption: it is regressive only to the extent that lower-income people consume a higher proportion of their incomes. Savings are not taxed. If a family with an income of $20,000 somehow managed to save $1,000 in a year, the value added tax on their consumption of $19,000 would be a lower proportion of their income than it would for a family with an income of $200,000 that spent it all. The current payroll tax claims a higher proportion of the income of the $20,000 per year family than it does from the $200,000 family, no matter what either family does with their money.

Because it is simple, and because enterprises have a strong incentive to declare their purchases from vendors, a value added tax is comparatively easy to administer. Compliance and so-called "horizontal equity" (the objective of ensuring that those in equal circumstances pay equal taxes), generally are better than for direct taxes on income — there are far fewer gray areas subject to interpretation and dispute.

With the broadest base of any tax, the value added tax is a very robust source of revenue. Thus it is with some trepidation that we suggest the United States impose one. In some respects it makes about as much sense as, to quote a simile that P.J.O'Rourke used in another context, "giving whiskey and the car keys to teenage boys." We must stress that we only advocate a value added tax as a *replacement* for Social Security payroll taxes and, because valued added taxes fall on income from capital as well as labor, *as a replacement for the corporate income tax* as well.

Abolish the Corporate Income Tax

The corporate income tax was imposed by Congress 4 years before the passage of the 16th Amendment to the Constitution, which permitted Congress to levy taxes on individual income. Some historians believe that Congress did this because the Supreme Court had declared the individual income tax unconstitutional. If so, it would reflect an early understanding that corporations do not pay taxes, they simply collect taxes on the Government's behalf. The notion at the time may have been that, with ownership of corporate equities concentrated among the wealthy, a tax on corporate profits would fall disproportionately on the incomes of the rich and the corporate income tax may have been enacted as an "end run" around the Constitutional prohibition that was the law of the land at the time.

In any event, the corporate income tax was retained even after the 16th Amendment permitted Congress to levy individual income taxes. The significance of corporate income taxes to Federal revenues has varied greatly over the years. For some years during World War II, they accounted for nearly half of Federal receipts, but during the postwar years they have decreased in significance and recently they have amounted to less than 10 percent of receipts. The current rate is 36 percent, but the decrease in the significance of profits taxes has not been simply a function of lower rates. The *effective* corporate profits tax rate usually has been much lower than the marginal rate, because of various exemptions, credits, and methods of calculating profits (accelerated depreciation, in particular) designed to encourage corporations to behave in certain ways.

Although the corporate income tax may have been imposed in an attempt to tax the incomes of the rich, if one really believes that profits taxes come out of the pockets of stockholders, *i.e.*, that corporations reduce their dividends by the amount that they must pay profits taxes, then corporate income taxes would appear to be regressive when individual incomes are also taxed (at progressive rates). For example, taxing $100 of corporate profits at 36 percent (the current rate), increases the taxes of someone in the lowest individual bracket (0 percent) by $36, but taxpayers in the

highest bracket (39.6 percent) only pay $21.74 more. Presumably, in recognition of this possibility, Congress for many years provided for the exclusion of modest amounts of dividends on individual income tax returns (this exclusion was abolished in the 1986 tax reform).

However, the notion that profits taxes come out of the pockets of stockholders is questionable. Many economists believe that the corporate income tax is fully borne by all capital income earners (not simply stockholders), on the basis of simplified models of behavior and estimates of various elasticities and ratios. This may be the situation in the short run; however, over the long term, the data suggest otherwise.

That after-tax returns to equity capital have remained stable despite great fluctuations in nominal profits tax rates strongly suggests that profits taxes simply are shifted to and collected from customers in the aggregate and over the long term. The tax becomes another cost of doing business that becomes embedded in the selling price. The profits tax would thus appear to function, in the long term and in the aggregate, as equivalent to a sales or value added tax. This is a major reason why profits taxes should be abolished if a value added tax were levied.

In contrast to a straightforward value added tax, the profits tax is wildly capricious. Although the tax does seem to be shifted to consumers in the aggregate and in the long term, it *will* impact the shareholders of a given firm, when that firm's profits vary markedly in the short term. For example, if a hula-hoop manufacturer benefits from a revival of the fad for hula-hoops, its profits and profits taxes due will soar. If profits subsequently turn to losses, say, because the new plant comes on line just as the fad ends, the firm may be able to claim a refund for taxes paid in prior years. Perhaps more significantly, the taxes of a given corporation can vary enormously to the extent that it can take advantage of various loopholes, excuse us, "tax incentives," that Congress has built in to the law.

Thus the real mischief of a profits tax is that it opens the door for politicians to grant favors. One of the reasons the effective rate of the tax usually has been much less than the marginal rate has been that Congress often has permitted larger write-offs (for depreciation of plant and equipment, and for the depletion of mineral resources) than are indicated by financial or economic accounting, thereby reducing taxable income and profits taxes. Moreover, Congress has allowed various tax credits and various exclusions that further have reduced the tax. These have not been uniform over time or even across industries (some have been written so narrowly that they benefit only one company!).

Such "tax incentives" reflect a history of lobbying in Washington, D.C.

Some of the Nation's most talented and highly paid individuals devote their energies and talents to the work of obtaining legislation favorable to various special interests. When campaign contributions are solicited, those special interests no doubt remember which politicians have been "helpful." In addition, many more talented and highly paid individuals devote their energies to finding ways to make their clients' affairs qualify for special treatment that may have been enacted for others — finding the unintended consequences of the provisions of the tax law. Much of this fundamentally unproductive work would cease if there were no corporate income tax.

Because the tax base would be enlarged, the rate of value added tax that would be needed to replace the revenues now generated by the Social Security payroll tax and the corporate profits taxes should be lower than the 15.3 percent level of the payroll tax and much lower than the 36 percent nominal profits tax rate. A lower rate imposed on both capital and labor would not only reduce the employment disincentives of the current tax system, but also, because a value added tax would not distinguish between the returns to equity and debt capital, it would remove the current system's bias toward debt financing.

Outlook

It may be apparent from this (admittedly somewhat tedious) discussion that in my view no good purpose will be served by allowing even the most cherished visions of an ideal world to defeat what may be usefully possible in the "real world." The relatively modest reforms I have outlined here in themselves are extraordinarily radical in today's political environment, but may have some chance of at least partial adoption — and might genuinely provide an approach to weaning the Government's subjects from their current dependence.

Identifying Social Security as an income-transfer program and nothing more might go a long way toward deflating the myths that have perpetuated it. And substituting a value-added tax for today's payroll taxes and corporate income taxes would be nothing short of a tax revolution that could pave the way for the most desirable reform of all — namely, the abolition of all taxes on labor and capital. But there I go, dreaming again.

Finally, while I share both Abraham Lincoln's and Professor Miegel's view that "you can't fool all of the people all of the time," I would add the caveat that in a democratic polity where the majority rules, you don't have to! For those of us who wish to promote useful reform of Social Security, that could be a circumstance that gives our would-be rulers a large advantage.

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