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

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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 provided 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.