December 4, 1996

DRAFT COPY: NOT FOR CITATION

Bottom-up Government: A Theory and Preliminary Model of More Accountable Government

Introduction

A large number of Americans feel increasingly disempowered by government. The list of those feeling that government is not responsive to their needs includes the business community that sees agencies often take ideologically driven positions that increase the cost of doing business without providing significant benefits. It includes middle class voters who think interest groups have gained power at the expense of the general social, moral and economic interests that used to bind the country together. It even includes many of the beneficiaries of current social programs who must endure bureaucratic procedures that end up giving too much to those who neither need nor deserve assistance and not enough to those who do.

Dissatisfaction with the current system is not well-focused: the political left sees in it a desire to increase government's role as the guarantor of economic and social security. The right views it as a desire for the return of moral values and individual responsibility. The center is increasingly disenchanted with the candidates and platforms of both parties and often voices the desire for a socially moderate but politically conservative middle ground.

It is still unclear what the majority of Americans want. This is partly because they want different and sometimes contradictory things. But it is also partly because Americans do not yet know what they want, except that they want something else. People sense a change in the wind that threatens the familiar structure and realize that things cannot stay the same. They both welcome and fear the changes ahead. We welcome them for the opportunities and advancement in living standards that past changes have always brought. But, without familiar institutional structures to guide them, individuals have difficulty foreseeing their place in the new world. And these institutions are rapidly changing around us, leaving individuals anxious about what the future holds for them.

This paper explains why the future will force dramatic changes in the relationship between government and its people. The Democratic Party largely refuses to acknowledge the inevitability of these changes although some elements, such as the Progressive Policy Institute, have increasingly questioned the status quo. The Republican Party has taken advantage of events to call into question the logic and efficiency of government programs. But most Republicans still do not understand either the degree or the causes of coming change. Nor have they offered a new vision of the relationship between government and the people that would address people's anxieties yet at the same time be capable of outlasting the changes whose effects its seeks to moderate. Yet this new vision of government is what the public needs most.

Government will not go away in the future, but its power, in the sense of the economic and social forces that it can purposefully change in the direction it wants to, will diminish remarkably. It will be able to accomplish some important goals, but only if it focuses its efforts on simple, well-crafted programs in areas where it can make a difference. But if it tries to do too much, it will wind up with complicated programs that accomplish little for the money spent on them and that are increasingly affected by rather than affect the world around them. This paper sketches out a rough outline of what a new approach to government might look like.

Many of the paper's conclusions are driven by the belief that the collapse of existing programs is inevitable and that therefore marginal changes to the status quo or additional programs of the traditional type are not viable options. While they might conceivably keep their present names, programs such as Medicare, Medicaid, and Social Security cannot hope to keep much of their present form. Yet without major changes, these programs will dominate future government policy. Their collapse leaves a large vacuum as well as financial resources to fund the new programs that fill it.

It is also important to separate the ultimate solutions of the paper from the transitional problems involved in moving to a dramatically different system. The new system should be evaluated by whether it is better than the current one in accomplishing the goals it sets out for itself: to eliminate fiscal poverty, to give a fair opportunity for financial security to every American, and to provide both government and private citizens with incentives that encourage stable and constructive behavior. The transitional problems, dealt with at the end of the paper, should be evaluated separately according to whether they can work in practice and whether they fairly meet the needs of each person affected by changes to current programs. If the conclusion that today's entitlement programs are unsustainable is correct, then a transition of some sort is inevitable.

The Coming Democracy

Most of all, the future will be characterized by change. Society's main challenge will be to accommodate these shifts with institutional changes that channel individual freedom in socially productive ways, link the growth in individual freedom with a growth in personal responsibility, and, perhaps most important, foster a sense of community in the midst of increasing individuality and social mobility.

The analysis starts with the presumption that private markets offer the only certain path toward increased welfare. There are many reasons for thinking so. One can point to the theory of Friedrich Hayek and Milton Friedman on the workings of private markets or the theories of Gordon Tullock and Mancur Olson on the tendency of government power to be co-opted by bureaucrats and other interest groups[1]. Or we can look at the demonstrated failure of communism wherever it has been tried and the fiscal problems increasingly experienced by more socialist countries such as Germany, Japan and Sweden which find that the disparity between the demand for benefits from government and private companies and individuals' ability and willingness to make the sacrifices needed to fund them only grows over time.

But it is primarily because only the markets, with their impersonal transactions, possess the ability and incentive to change and adapt rapidly to new circumstances. As the pace of change increases, this ability grows in importance. The power of the markets is that they put the costs and benefits of individual decisions within the hands of those making decisions and provide each person with an incentive to meet the needs of others in order to meet his own. The lack of central power also makes the gains and losses accompanying change harder to stop and easier to accept. Since no one group or entity is responsible for the changes, those hurt or helped by potential change are powerless to stop it. The same is not true of government policy where legislation and regulations are the subject of fierce lobbying and the expenditure of millions of dollars.[2]

---

[1] *See,* Friedrich A. Hayek, ***The Constitution of Liberty***; Chicago: University of Chicago Press, 1960 Milton Friedman, ***Capitalism and Freedom,*** (rev. ed.), Chicago: University of Chicago Press, 1982; Gordon Tullock, ***The Politics of Bureaucracy,*** Washington D.C.: Public Affairs Press, 1965; and Mancur Olson, ***The Logic of Collective Action,*** Cambridge: Harvard University Press, 1965.

[2] This does not argue that markets work perfectly. Each person also has an incentive to try to gain for himself an unfair market advantage. There must be collective enforcement of rules that maintain freedom of competition and the ability to introduce new technology. One of government's continuing responsibilities will be to break down any barriers to competition erected by business, labor, or other groups meant to frustrate the voluntary transactions of others. Inability or unwillingness to fulfill this role explains much of the failure of private markets in developing countries.

Since the fall of the Soviet Union few would argue that private markets are the most efficient means of discovering the economic worth of goods, including labor. They should be left free to operate on their own with two major caveats. First, every market, in order to work efficiently, must operate within a set of rules set by government. The simpler these rules are, the more clearly they can be understood and the easier it will be to verify compliance. Since rules of this type usually benefit everyone, the goal should be to agree on them by consensus and then have government enforce them impartially.

With respect to labor, the market does a good job of determining a person's economic worth. In spite of increased income disparity between low-skilled and high-skilled workers, total real compensation (salary plus benefits and payroll taxes) measured in terms of the prices of the goods workers produce has closely reflected labor productivity. The rapid growth in benefit costs, especially health care, and in FICA taxes explains much of the stagnation in take home pay. In addition, the fact that the price of all things produced by workers has risen less rapidly than the price of the things they consume, has also slowed the rise in living standards over the last fifteen years.

Other than diverting more of these amounts into take-home pay, the only way to raise real overall wages is to raise productivity. Yet the market is not meant to and does not attempt to measure a worker's overall worth as a citizen. There is therefore a strong argument for supplementing the income of those with low incomes. Such redistribution can be seen as an acknowledgment that the recipient's worth to society as a citizen is much higher than the measurement of his economic worth by the impersonal forces of the market. Note that this argument for assistance is predicated on a person's broader worth to society as a citizen, parent, friend, etc. and thus implies certain responsible behavior.

Government's power is threatened by four major trends shaping the world economy. The first, and most important, is the increased pace of technological innovation. Even with constant rates of innovation, the volume of knowledge expands exponentially, as does the need for institutional changes to adapt to it. Although the pace of change has quickened, the responsiveness of our psychological and institutional mechanisms for dealing with it has not. The resulting sense of insecurity, especially among older generations used to traditional practices, should not surprise us. While we often underestimate the ability of the young to thrive in circumstances that they regard as normal, we should appreciate the psychological and practical hurdles that many adults face in adapting to change in the middle of their careers.

Commentators like Paul Erlich and Jeremy Rafkin, who complain that modern technology increases human suffering largely miss the point. It is all but impossible and almost certainly unwise to try to halt the general advance of technology. While technology is never an unblemished positive force, today's citizens would almost certainly be more unhappy if forced to return to the past. Whether past generations were happier in their simple ignorance is irrelevant. We are not them, and they did not know what we do. Technological innovation will continue and its pace will increase. The problem is how to take advantage of its possibilities and minimize its disruption.

It is largely beyond government's ability to regulate or moderate the pace of change. The increased technological innovation and international competition that have broken down previous market barriers in financial, telecommunications, and transportation industries have had two important effects. First, they have made it increasingly easy for individuals to evade government attempts to contain the effects of new technology. Each round of deregulation has increased the liquidity of investment, information, goods, and people, allowing people to relocate resources wherever they can get the highest rates of return.

Second, international competition increases the cost to countries or states that pursue social policies at the expense of economic growth. Such economies do poorly against others, a competitive disadvantage that only increases with time. The increasing pace of change shortens the time between

a government's poor policies and the inevitable economic consequences.

This leads to the second major trend: increased international competition. During the past fifteen years a number of countries have liberalized their economic and social policies and attempted to compete in world markets. The first notable case was China in the late 1970s. The fall of the Iron Curtain opened up Eastern Europe and even the former Soviet Union to market forces. During the last decade many nations in Latin America and Southeast Asia have also adopted more market-oriented policies, although some countries in these regions were ahead of the curve and others still lag it.[3] All these developments bring both opportunity and competition to American businesses. While the long-term result cannot help but be strongly positive, foreign competition places increased pressure on markets in which we have a competitive disadvantage. Low-skilled workers especially have found themselves under increased competitive pressure from abroad

The third trend is the increased complexity of modern society, including its markets. Again, even with constant rates of growth, as the size of society grows, its complexity increases at exponential rates since an increasing number of new sectors must be integrated into the existing system and connected to existing sectors and to each other.

Naturally forming complex systems demonstrate great internal diversity, with each part being different from, rather than a duplication of others. They also exhibit a great deal of structural interdependence, with each part being dependent, often in unexpected ways, on other parts. This makes central control more difficult since unintended consequences increasing frustrate the intentions of government policy. Given its large size, government's ability to intervene sensibly is dramatically reduced as markets become more complex.

Although complex these systems show a remarkable ability to adapt to new circumstances. This ability depends on the freedom of movement of their component parts. Policies that restrict the range of movement of individuals in a complex social system also restrict the system's ability to adapt smoothly to change. Since the pace of change cannot be arrested without a loss of competitiveness, this only increases the eventual cost of adaptations.

An important implication for the world economy is that continued heavy involvement in the management of economic markets is neither desirable nor, in the long-run, feasible. Increased complexity makes it harder for government to predict the effect of its own actions. Increased technological change makes it easier for individuals to evade government policy. And the presence of global competition means that national markets must continually strive to maintain competitiveness or risk falling behind. Although trade barriers can relieve this pressure for a while, they only worsen the inevitable adjustments. Trade barriers raise input costs to domestic firms, increase the price of consumer goods and cause local producers to lag behind world efficiency once they are deprived of the continued threat of foreign competition. Each of these effects slows the growth of the high-skilled jobs that are vital to increasing real wages. In spite of the supposed success that countries such as Japan and South Korea have had managing trade, the evidence is overwhelming that government trade

---

[3] The tragedy of Africa continues to defy most hopes for betterment. With the notable exception of South Africa, most Sub-Saharan countries remain mired in a state of political and economic poverty. The main ingredient missing seems to be any sense of civil society and order, the absence of which only increases the personal risk of toleration and productive activity In the absence of a tradition of civil society, the only solution may be to impose order from without in an attempt to provide the sense of security and rule of law that are necessary to allow the majority of citizens to invest and acquire wealth without the continual fear of having it taken away. Such outside intervention raises its own problems, however. Most difficult of these is the complete lack of willingness among the developed nations to incur the risk and expense of delivering such order.

barriers impose net costs on society and that these costs grow over time.[4]

Closing the economy off to the perceived threat of foreign competition is not an option. Nor are legislative attempts to limit technological innovation within markets. There will never be a shortage of interests calling for protection from market forces nor of "experts" willing to assume the power needed to enforce government policies. But in the end, such policies will increasingly become unfeasible. While transitional assistance can allow industries to adapt to external changes, temporary barriers have a way of becoming permanent and permanent barriers decrease public welfare. In the end, external changes have fundamentally changed even heavily regulated industries such as transportation, finance, energy, and telecommunications. Governments can force markets to respond to these trends in inefficient ways, but they cannot prevent the changes from eroding traditional market structures.

This loss of control leads to the fourth trend, increased decentralization and diversity. Although increased globalization will require greater international coordination, in many areas of policy national governments will increasingly lose the ability to base policy on distinctions that are not economically based. Separate laws for bond and stock markets lose their force when financial innovations produce a spectrum of instruments between them. Employment laws built on a distinction between employees and independent contractors weaken in response to the large incentives public policy creates in favor of the latter.

The growth of a middle class gives part of the nation the opportunity to look beyond current necessities and increase their demand for noneconomic goods such as increased personal freedom. New technology also threatens government's control over information. It allows people to communicate directly with each other and to find like-minded individuals within the broader population. The increased access to information allows people to compare their standard of living to those elsewhere and to discover alternative goods and ideas to those familiar to them.

The Power of Individual Demand

The desire of individuals to satisfy as many of their wants as possible is the primary force behind market economies. Money is the common currency in which these wants are typically expressed and satisfied.[5] Abraham Maslow argued that individual needs are ranked in a hierarchical order. Some needs such as basic nutrition, shelter, and security assume priority.[6] In a modern society, however, the marginal income of most individuals is spent on products that are discretionary.[7] Although these wants are shaped by existing markets, advertising, and social trends,

---

[4] There is a great deal of evidence that the economic policies of governments in countries such as Japan and South Korea, while extensive, did not play a major role in determining the success of export industries. The bureaucracies often made mistakes and propped up uncompetitive industries at great cost, while ignoring or even discouraging later successes. These policies are becoming increasingly untenable, leading to prolonged social and financial instability as the barriers surrounding protected markets are dismantled. Even if government intervention were better able to direct economic activity, it is doubtful whether the private sector in a modern society would acquiesce to the degree of political and economic control that these governments were able to assume during their early years.

[5] It would be naive to claim that all desires can be put in terms of money. Certainly, some of the most important personal goals transcend economics. This paper is primarily concerned with public policy, however. As those goals that cannot be monetized are also the ones that government has the least ability to provide to individuals lacking them, it is prudent to consider only those that can be solved with income transfers.

[6] Abraham H. Maslow, *Motivation and Personality*, (3rd ed.) New York: Harper & Row Publishers, 1987.

[7] This is true even of goods such as food and shelter since, for most people, the basic needs could be satisfied by substitutes at a fraction of the price. Most of the purchase price consists of a voluntary decision to purchase extra quality for a higher price.

they are largely the expression of individual choice. The aggregate of these individually-directed purposes drives markets. Government attempts to frustrate this force by market regulation will be increasingly difficult as the availability of alternatives allows individuals and firms to evade market barriers. It also seems likely that as individuals in advanced societies demand greater freedom of action, they will begin to disregard laws that frustrate the satisfaction of their wants unless they are persuaded that government controls are somehow fair.

Fortunately or unfortunately, individual action is based largely on self-interest. Although people are often willing to submit their desires to a sense of fairness, willingness to sacrifice for vague goals is limited. Decades of communism failed to create a new man. It is unlikely that less coercive efforts will have greater success. There is some evidence, however, that as individuals move up what Maslow termed their hierarchy of needs, they exhibit a greater willingness to engage in altruistic behavior. The increased wealth brought about by private markets may eventually allow more people to pursue spiritual rather than physical needs. But government has limited powers to guide this development.

The Role for Government Policy

Governments have limited ability to control the expression of individual desires. They can, however, establish an institutional framework that channels this force toward productive and harmonious purposes. They can also redistribute income and legal rights to ensure that everyone has a minimum amount of income. Once this level of income is attained, governments have been less successful at directing how individuals spend their financial resources. The recommendations of this paper concentrate on the limited things that government can do successfully.

The goal of this paper is to develop in some detail a policy by which government can satisfy the most important needs of its citizens. This policy does not try to address every problem. In fact, it abandons the attempt to solve most of them. It is important that government begin to distinguish between wants and needs. Although the line between the two is never clear, few things that are wanted are needed. The premise of this paper assumes that government can reasonably give each individual the means with which to satisfy his needs and his most important wants. It can do this within an institutional framework that reduces the cost of providing these means over time. But government can only do this if it carefully prioritizes the problems facing it. It must learn to concentrate on those few things that are most important and with which it can deal effectively. Other problems, and there will always be many, must be left to sort themselves out.

The Demise of Current Government Programs

In fiscal year 1996[8], Social Security, Medicare, and net interest accounted for 57 percent of all federal outlays. Since these three items also account for most of the growth in federal spending over the next several decades, an analysis of federal social spending can largely be confined to them. There should be fewer objections to replacing Medicaid and the federal government's other major poverty programs[9]—which currently account for another 13 percent of outlays—with the type of program advocated below, since these programs presumably have as their main purpose the redistribution of income. If the program proposed here is more effective at eliminating poverty, it would seem logical to replace it for current programs.

Net interest on the federal debt is typically treated as uncontrollable. This is not quite true since lower deficits and a low-inflation policy can substantially reduce future interest payments. Legislative changes will have limited effects, however. Since interest payments are not directly subject to legislative control, we must look to Social Security and Medicaid for major resources with which to fund an alternative redistribution program.

---

[8] Unless otherwise indicated, all years are fiscal years.

[9] These programs are Food Stamps, Supplemental Security Income, Family Support, housing payments, and the Earned Income Tax Credit.

This paper's task is eased by the assumption that these two programs suffer from structural problems that cannot be fixed and that will eventually lead to their collapse. The problem then is not whether to replace these programs but rather what to replace them with. This assumption also frees up the enormous sums devoted to current programs, making a large alternative program feasible.

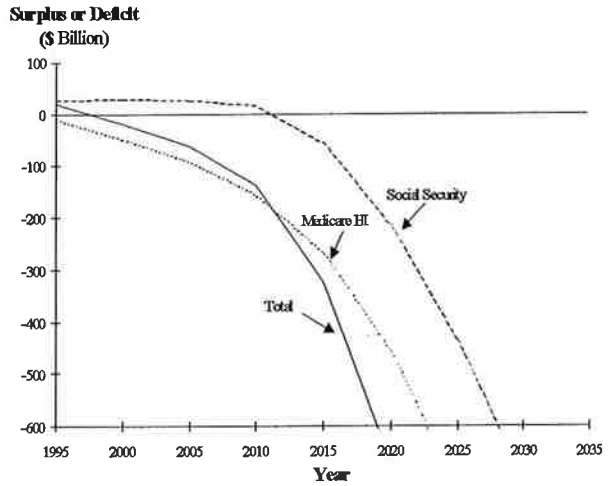
The radical departure from current programs is partly motivated by their expected failure. It is strengthened by the belief that complex, centrally-managed programs are incapable of the significant change needed to save them. The strong interdependency of various parts of a complex program mean that changes to one part inevitably create unexpected problems in other parts. The law of unintended consequences, combined with political resistance from interests that oppose change, means that, beyond a certain point, necessary changes can only be accomplished by scraping the existing system for a new, hopefully simpler one.

Social Security and Medicaid are terminally ill. Although, both are several years, perhaps even decades, from collapsing, their financing is so fundamentally unsound that they cannot hope to honor the promise of universal funding. It is not possible to keep existing promises. We must instead concentrate on redistributing burdens within and between generations in a way that is both sustainable and fair.

Entitlement Programs

In 1995 Social Security revenues exceeded payments by $27.1 billion, excluding interest earned on previous surpluses.[10] This reduced the federal government's overall deficit by an equal amount. These surpluses have succeeded in protecting Social Security from current pressures to reduce the deficit. These surpluses, are not sustainable, however. Chart 1 shows net surpluses and deficits for both Social Security and the Medicaid Hospital Insurance Trust Fund over the next several decades.

Chart 1
Net Outlays from the OASDI and Medicare HI Trust Funds: 1995-2035



Source: Annual Report of the Board of Trustees for the Old-Age and Social Insurance and Disability Insurance Trust Funds for 1996.

Two things are noticeable about this chart. The first is that by the year 2000 the total of the two trust funds adds to the deficit, and this deficit grows rapidly in later years. The two funds add $90 billion to the deficit in 2010, but over $200 billion just five years later. Since these figures include interest earned on the trust funds, they actually understate the impact these programs have on federal borrowing. Second, the combined position worsens considerably after 2010, when the first baby boomers retire. By 2025 the funds are adding almost $1.1 *trillion* to the annual deficit. Shifting the curve upwards therefore does little to delay insolvency. Instead, the slope of the curve must also be shifted horizontally. This requires long term changes to the structure of the programs. No reform that succeeds in maintaining the basic shape of these programs will preserve them for the retirement of today's young adults.

The largest obstacles to changes in Medicare, Medicaid and Social Security are transitional ones. The programs are already too large

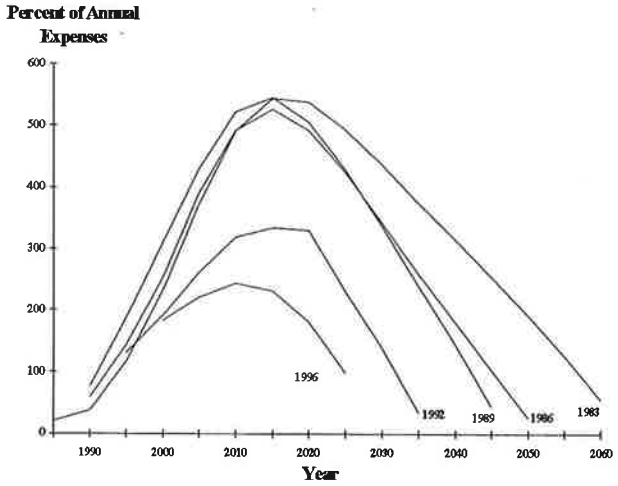
[10] Interest paid to the trust funds are intergovernmental transfers and do not affect the federal government's impact on the economy. The exclusion of interest payments is justified if one considers FICA taxes to be a substitute for higher income taxes rather than contributions.

and exert too much of an impact on other sectors of the economy to hold out much hope for a successful program of gradual reform. Pressure from special interest groups and market inertia are likely to frustrate incremental changes. Yet the sudden change to a new system will inevitably cause hardship. This is why a separate section of the paper is devoted to dealing with transitional problems.

Social Security

Unfortunately, Chart 1 is probably too optimistic. Chart 2 shows that the Board of Trustees has consistently had to revise its estimates of the fiscal position of Social Security. Almost without exception, these estimates have moved the date of insolvency forward. Given this history, it seems probable that the dates of financial insolvency will continue to move forward.

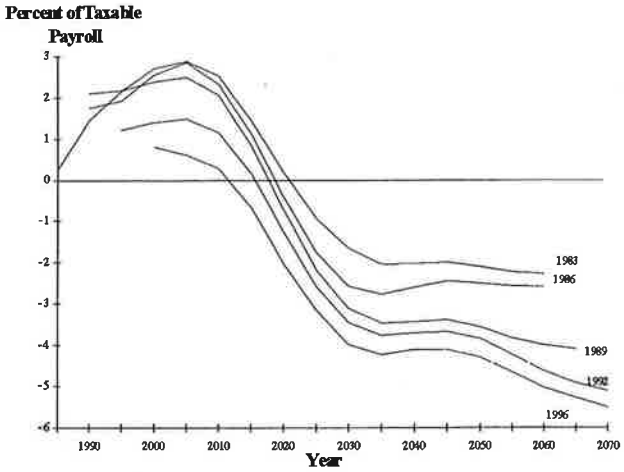
Chart 2
Estimates of the Ratio Between OASDI Trust Fund Assets and Outlays in Successive Years



Source: Annual Reports of the Board of Trustees for the Old-Age and Social Insurance and Disability Insurance Trust Fund for 1983 through 1996.

Chart 3 tells a similar tale for estimates of the net outlays for Social Security as a percent of the total taxable payroll. Both Chart 2 and Chart 3 show that the Trustees have consistently overestimated the future solvency of the Trust Fund. This strongly indicates that the Trust Fund is likely to be insolvent well before the current estimate of 2030 and that popular beliefs as to the changes needed to fix it underestimate the extent of the problem.

Chart 3
Estimates of the Annual Surplus or Deficit of OASDI as a Percent of Taxable Payroll



Source: Annual Reports of the Board of Trustees for the Old-Age and Social Insurance and Disability Insurance Trust Fund for 1983 through 1996.

Although the latest Trustees' report predicted that the Trust Fund will not be exhausted until 2030, the program's fiscal crisis is expected to hit well before then. First, given the history of actuarial projections, future reestimates are likely to move this date forward due to unforeseen circumstances. More importantly, the surpluses going into the Trust Fund are not being used to finance other government operations. As soon as the Trust Fund starts running deficits, currently forecast to begin in 2019, Social Security will begin contributing directly to the deficit. Again, this is giving the program credit for the interest earned on the Trust Fund. As Chart 1 shows, these deficits will grow rapidly. It is extremely unlikely that the program would be spared from the further deficit reduction exercises that it is largely contributing to.

Social Security has been compared to a classic Ponzi scheme. For most of its existence it attracted political support by offering to pay each generation more in benefits than it paid into the

system in taxes. Growing populations and strong economic growth made this possible for a long time, but as growth slowed and the ratio between young workers and older beneficiaries grew, like any Ponzi scheme, it was bound to collapse. The current generation of young people entering the workforce is the first in which, *under current law,* individuals will get less out of Social Security than they paid into it.

Another flaw in these programs is the means of taxation used to support them. Social Security is financed by a tax of 12.4 percent on all wages. Although half of this tax is paid for by the employer, there is ample evidence to show that the eventual cost of the entire tax is borne by workers.[11] The tax is only on wages, not on other forms of earnings, and for Social Security, the tax currently is not applied to income in excess of $65,400. As a result, Social Security now distributes income up the economic ladder, although it does this primarily between generations.[12]

Ever since the latest major revision of the Social Security Trustees forecasts in 1994, there has been an increased willingness to look at major changes to the system. Proposed changes include means testing benefits, increasing the retirement age, reducing the calculation of cost of living increases, increasing payroll taxes, and even investing some of the surpluses in the private sector where they can be expected to earn a higher rate of return. Each of these save the last would *decrease* the net benefits of Social Security for the youngest generation, which already gets less than it is expected to pay in. In light of this, any reforms are likely to reduce the system's support among younger generations. Although higher taxes could prolong the program, only a substantial reduction in benefits can solve the underlying imbalance between revenues and outlays. It is increasingly doubtful whether current generations will be willing to support a system that disadvantages them and whose expected payoffs are decades away.

Social Security's supporters admit that it suffers serious problems, but argue that periodic cuts in benefits and increases in payroll taxes can address the problem. Under current law, the average worker under the age of 30 will already receive fewer retirement benefits than he pays in over his working career. And, as explained above, there is serious doubt that the promised benefits will be there when he retires. While past payroll contributions are a sunk cost, at some point workers are likely to resist paying higher taxes in exchange for retirement benefits they no longer believe will be paid. The temptation to cut their losses will be even greater if a plan to end the program is accompanied by an immediate reduction in payroll taxes and tax incentives that make it easier to save on one's own.

The fundamental problem with Social Security is that it simultaneously attempts to serve two purposes. Some years ago economist Jan Tingenberg wrote that for every social goal the government wishes to accomplish, it needs a separate program because efforts to accomplish one goal often frustrate the achievement of other goals. By increasing the degrees of freedom available to policy-makers, multiple programs allow them to get around this tradeoff. However, when a single program tries to accomplish more than one objective, improvements in one direction will often cause problems in other directions.

One of Social Security's primary purposes is to serve as a source of minimum income to retirees. The rate of poverty among the elderly has decreased significantly over the past decades, although the floor provided by the program is still below the poverty line. A fundamental requirement of any replacement for Social Security should be that it does not allow poverty among the elderly to increase. The problem with this goal is that its' importance as a public policy is not limited to older generations. Income maintenance is just as valid a goal for young and middle-age workers as it is for retirees. And there is no inherent advantage to having a separate program

---

[11] This is true largely because the long-term compensation to labor depends primarily on its productivity measured in terms of the prices of the goods it produces.

[12] For an analysis that questions whether Social Security redistributes income within generations *see,* Robert J. Shapiro, "Rethinking Social Security," *The New Democrat,* Progressive Policy Institute, Washington D.C. September/October 1995, pp. 14-18.

for each age group. Thus accepting the government's role in meeting this goal does not necessarily require the preservation of Social Security.

Income maintenance is the primary goal of the alternative program sketched below. In fact, the approach promises to raise the standard of living of the elderly poor above that provided by current programs. However, it does so in the context of a single program, making Social Security and Supplemental Security Income not only redundant, but inferior.

The second goal pursued by Social Security is a forced savings plan. This goal justified bringing everyone into the system, even those with above-average incomes. The argument most often advanced for universal coverage is that private individuals cannot be counted on to save for themselves. In order for the government to prevent their becoming charges in the future, it should consider them charges now, and collect taxes in return for future retirement benefits. But even its most ardent admirers admit that the program was never meant to replace private savings. There is evidence that the availability of Social Security and Medicare has reduced the rate at which older generations save, increasing the very problem Social Security was meant to solve. And although younger generations recognize the need to save, current high payroll taxes make it difficult for them to do so. In fact, the negative rates of return promised to younger generations makes them even more dependent on their private savings.

The program described below does a better job of encouraging private savings by giving each individual a strong tax incentive to save on his or her own. For those receiving government assistance, it goes even further, requiring saving as a condition of assistance. This eliminates the need for a universal savings plan such as Social Security. With each person saving on their own, the rationale for making payments to individuals with above average income disappears.

Thus both of Social Security's main goals can be accomplished through alternatives that increase individual freedom and place the individual, not government, in charge of his own resources. The programs sketched below are likely to reduce poverty among all generations and increase private savings, all at a lower cost to government.

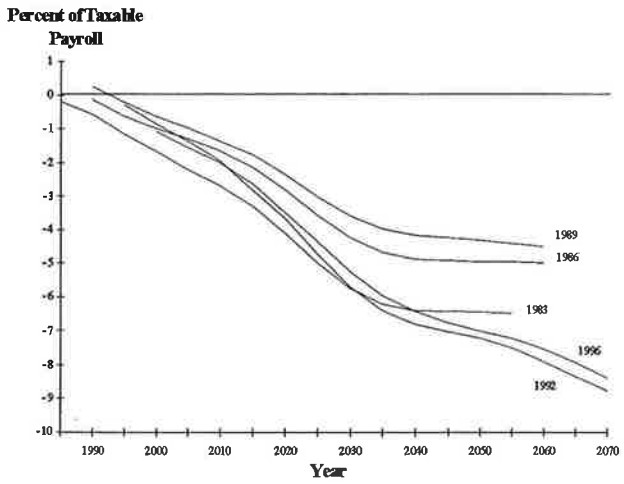
Medicare and Medicaid

Medicare and Medicaid together accounted for 18.5 percent of government outlays in 1996. This figure is expected to rise to 26.8 percent by the year 2006. Medicare is partially financed with a 2.9 percent payroll tax split between the employer and employee.

Medicare suffers from the same long-term imbalance between revenues and outlays as Social Security. The Hospital Insurance Trust Fund is already running deficits and will become insolvent by 2000. Even the changes proposed by Republicans in 1995, which Democrats have criticized as extreme, would not be enough to keep the fund solvent until 2010, when the curves shown in Chart 1 begin to steepen.

Chart 4

Estimates of the Medicare Hospital Insurance Trust Fund Surplus or Deficit as a Percent of Taxable Payroll



Source: Annual Reports of the Board of Trustees for the Old-Age and Social Insurance and Disability Insurance Trust Fund for 1983 through 1996.

Chart 4 shows past and current estimates of the net outlays over the next several decades. In this

case the projections have often gotten better as the result of policy changes and changes in the health care industry. Nevertheless, like Social Security, these figures show a growing deterioration over time.

Like Social Security, Medicare and, especially Medicaid combine two unrelated goals. First they serve as poverty prevention programs. Second, they deliver health care services to recipients. This latter goal partially explains why even the wealthiest have their health care costs subsidized. As with the case of Social Security, the goal of redistributing income can be better accomplished through a more direct program that concentrates its effort only on those with below average incomes. Concerning the second goal, government policy has actually created more problems in the health care markets than it has solved.

Medicare and Medicaid account for roughly one-third of all spending on health care in the economy.[13] Together with the income tax exclusion on employer-paid health insurance, this massive flow of subsidies into a single sector of the American economy without an effective link to the quality of care given, is largely responsible for the rapid inflation in health care costs over the past decade. Although in recent years the private sector has succeeded in reducing the rate of health care inflation to near that of the rest of the economy, the federal government has had far less success in reducing the cost of the medical services that it pays for. Nor will it as long as it continues to pay for services that others receive.

The government has a persistent problem obtaining value for the services it pays for. Both the patient and the physician have a natural interest in obtaining more services at higher fees, provided the bill goes to the government. As a result, the benefits the government purchases tend to be less valuable than those that patients would purchase for themselves, given the opportunity. This is an inherent problem with government programs.

Medicaid and the regulations surrounding it also exhaust a large amount of each state's budget and energy. When added to the cost of other welfare programs, they represent a large amount of time, resources, and energy that is going into ostensibly worthy goals, but doing so in a misguided manner that does little good and much harm.

Nursing home costs represent a looming crisis for Medicaid. They already represent 25 percent of all expenditures. These costs will continue to grow rapidly, accelerating when the Baby Boomers begin to retire. Ordinarily, middle-income workers would be expected to purchase insurance to cover the cost of nursing homes or would pay for them directly out of accumulated savings. The government would be burdened only if insurance refused to cover certain costs and these costs exhausted a retiree's savings. Given the size of nursing home expenses, however, there is a large incentive for families to transfer assets away from parents and have the government assume these costs in the last years of life. This practice is already common and government regulations can do little to stop it. Given the opportunity, families will find a way to qualify parents for whatever income tests the government devises. This practice, although done to preserve family wealth, further weakens the principle of family responsibility. The wealthier the family, the greater its incentive to engage in asset transfers and to have the children step back from the parents and let the burden fall on the government. It should be clear that government cannot hope to bear this burden for everyone.

If the efficiency of the income transfers implicit in these programs is measured by whether the federal government purchases services for beneficiaries at prices that the recipients would be willing to pay if they had sufficient income, they largely fail. As with most other income transfer programs in which the benefits are given not in the form of cash but in services, and where the government acts not as a direct transferor of income but as a third-party payer, these programs will inevitably see costs rise while quality suffers. By seeking to turn what is basically an income problem into a health care problem, the federal government has confused the source of the problem and interfered with the normal workings of the market.

---

[13] This includes the state's share of Medicaid expenditures.

The premise that every working American ought to be able to afford health care does not imply that the government should provide health care to everyone. The inability to purchase health care or health insurance is essentially an income problem. Most people in this situation also cannot afford decent housing or education. As long as there is no inherent failure in the health markets (and much of the current failure is caused by the large flow of government resources into the health care market and regulations designed to control overcharging and other abuses) there is no reason for government to intervene.

This paper accepts the idea that every deserving person ought to have sufficient income to afford normal health care and to purchase the cost of insurance against catastrophic costs. There is no inherent reason why the two goods should be purchased together or from the same company unless this leads to greater efficiency and lower prices. Given the adequacy of markets for auto insurance, disaster insurance, and life insurance, there is little reason to believe that a workable market for individual health insurance would not arise if the government made slight changes to the laws regulating it.[14]

Mandatory Programs

To understand mandatory programs it is important to reflect on the normal workings of the private market and to make two crucial distinctions. The first distinction is between wants and needs. Wants are practically infinite, whereas needs are much more limited. Although government policy cannot hope to satisfy all the wants of its citizens, it can realistically hope to ensure that every individual has enough financial resources to meet his or her needs, provided it does so through policies that are stable over time.

In poorer countries the concept of needs may be limited to those that are absolutely necessary to keep a person alive. In developed economies, needs can be more liberally defined to reflect a sense of social fairness. This blurs the distinction between wants and needs and leads to debate about where the line should be drawn. In order for the distinction to remain useful, an effort must be made to limit the concept of needs to those that society, given its current prosperity, feels that it is unfair to deny someone just because the market valuation of their labor is not sufficient to purchase them.

The second distinction is between a market failure and a lack of income. The fact that some people are unable to purchase adequate housing, health care, or education does not mean that there is a market failure. Still less does it mean that government should interfere with the market to correct the problem. In most cases, it merely means that the people lack sufficient income to purchase the goods. The proper remedy is to transfer income. In most areas of heavy government involvement such as housing, health care, agriculture, and nutrition, the underlying problem is a lack of income among the recipients, not a market failure. Government intervention in the markets is more likely to worsen the situation than to help it. The movement toward vouchers for housing and food recognizes this fact, but still limits the ability of recipients to satisfy their own needs as best they can. To get around this, a steady black market has arisen to transform these vouchers into more liquid cash.

The importance of these two distinctions can be illustrated by examining a trip to a department store by a middle-class family. Since the family is middle-class we will assume that it can afford to satisfy all of its needs and then some of its wants. The typical shopper is likely to see several goods that he or she wants in any store. Many of these goods

---

[14] Other than removing the income tax exemption for employer-paid programs as discussed below, the single most important change would be to prevent discrimination based on pre-existing conditions. This could be done simply by forcing insurers to offer insurance to everyone at the same price within each demographic group. Demographic groups should be limited to those allowed by legislation. Among the types of discrimination that should be allowed are those for age and the voluntary assumption of risk factors such as smoking. Discrimination based on sex should also be allowed, provided similar discrimination is made in life insurance where the cost advantages between the sexes are reversed.

will be offered at prices that the consumer thinks are "fair" in the sense that he or she will seriously consider buying the good at that price. Nevertheless the total price of all the goods wanted is likely to greatly exceed the person's income. The result is a balancing and prioritization of wants and a natural frustration about having to postpone or forego the purchase of goods just beyond the boundary.

Most consumers probably want a large screen television. The fact that few purchase one does not mean that they find the purchase price unreasonable or that they believe the market for large screen televisions is flawed. It merely means that they do not need the television and that in the inevitable ranking and prioritization of goods, it finishes behind other products. Notice also that if we were suddenly to double the shopper's income he would still face the same necessity of ranking and prioritizing wants, although now at a higher boundary. There would still be items that the shopper wants to buy but feels he must postpone. If the need to prioritize and forego purchases is used to define the need for government assistance than all but a few will qualify.

The result is that almost everyone is bound to feel frustration and pressure in matching wants with income. Government cannot eliminate this frustration. What it can do is to carefully distinguish between wants and needs, to calculate the amount of income that is sufficient to satisfy those needs and perhaps some wants, and to provide that income to those who contribute to society, hoping that they will spend it wisely.

A major advantage of private markets is that the benefits and costs of each decision are closely linked. Take a customer who purchases a television. The transaction is stable because the consumer bears both the cost and the benefit of the purchase. If he buys a television he gets to take it home, but he also has to give up part of his income. Similarly if he walks away from the sale, he gets to keep his money, but does not get the television. The store must engage in a similar balancing of costs and benefits. The best way to determine whether or not the sale should be made and at what price, is to ensure that both parties to the transaction share a similar balancing of interests and then to leave the final decision up to them. If in the end the customer decides that the price is too high, he may walk away disappointed but he is unlikely to feel that the nature of the transaction was unfair. For similar reasons, as long as the two parties had adequate income and alternative choices, it would be hard to say that whatever agreement they reach is unfair since it was voluntarily engaged in. Provided that the government ensures that both parties have alternative choices and that any final decision reflects their desires, it is not clear why the government should care whether the transaction is completed and on what terms.

Two points are worth noting. First, unless the good involved is one the buyer needs rather than wants, we should not feel that the decision not to purchase it is unfair. Such disappointments are inevitable. On the other hand, if the good was a need such as basic shelter or adequate nutrition, the simplest solution is to supplement the buyer's income and trust him to make the necessary purchases.

The second point is that, if someone else offers to pay for the television, the customer's opinion of what is a fair price will certainly increase. If the third party then refuses to pay this higher price, the customer will feel that the decision was unfair and will exert pressure to have it reversed. For this reason, political decisions behind income transfers are likely to be more objective if they concentrate on the more objective question of the level of income needed to satisfy an individual's wants and then deliver that income to the beneficiary, leaving to him the decision of how to spend it. Programs that attempt to deliver services directly to beneficiaries are likely to impede private markets while inefficiently raising living standards.

Entitlement programs suffer from a common structural problem. Because they treat all recipients alike, government payments tend to increase the target population. Entitlement programs usually list criteria according to which people are automatically eligible for benefits. This creates an incentive for people to alter their behavior to qualify for government aid. The beneficiaries of entitlement

programs quickly form an interest bloc that continually fights to increase the level of benefits. Because the membership and rewards of this group are far more concentrated than those of the general public, they often succeed in increasing benefits at the cost of the general welfare.

Unfortunately, entitlement programs do not match the cost of benefits with society's ability to pay for them. While there is steady pressure to increase benefits, there is little pressure to increase the taxes needed to pay for them.

In addition, entitlements usually take the form of services. Since the beneficiaries have little choice in the matter, the providers of these services have little incentive to provide quality at a reasonable price. The cost of providing the service and the benefit of receiving it are not balanced within the same person. Although food stamps and the increased use of vouchers for public housing provide a much greater range of choice, they still limit the ability of recipients to trade off different needs according to their own individual preferences.

Another flaw is that the eligibility criteria are linked to income or other status rather than to personal responsibility. The result is that people have an incentive to stay poor or remain in occupations such as farming that are eligible for benefits, even if this behavior only adds to the burden of government programs.

Because changes require affirmative action on the part of government, current beneficiaries enjoy protection against the normal workings of the market. This flaw extends to most areas of government regulation including its regulation of the transportation, banking, and telecommunications sectors. The inertial power of the status quo is politically powerful. And it is almost always used to prevent or delay the normal changes brought about by market evolution.

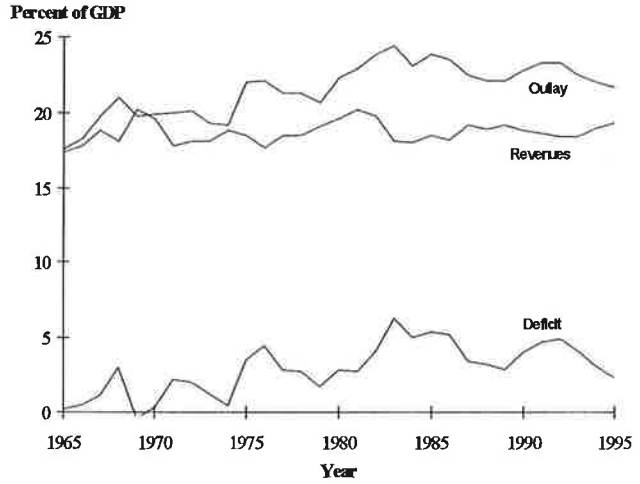
This paper assumes that the central function of government social programs should be to ensure that each *deserving* person has adequate resources to satisfy his own needs. The most efficient way to accomplish this is a straight cash transfer. The program does not attempt to save everyone, but it does offer a reasonable hope of giving each citizen the expectation of a decent lifestyle in exchange for agreeing to easily met requirements that our society generally equates with responsible citizenship.

In order to accommodate the need for increased decentralization, the program takes the form of a voluntary contract, enforceable in court, between the recipient and the federal government. In order to work efficiently and generate support both among recipients and the tax-paying public, the contract should be simple and fair.

An Overview of the Federal Budget

Chart 5 shows the historic rates of both revenues and spending. As can be seen, the total amount of revenues has remained relatively flat, averaging roughly 18.5 percent of GDP. Outlays, however, have grown.

Chart 5
Revenues, Outlays and Deficits as a Percent of GDP



Source: OMB, *The Budget of the United States Government: Fiscal Year 1997, Historical Tables*, pp. 21-22.

It is the growth of outlays in programs such as Social Security and Medicaid, rather than a decline in revenues, that accounts for the large deficits expected in the future. The Congressional Budget Office (CBO) expects total receipts to remain at roughly 20 percent of GDP through 2050 while expenditures increase from 23 percent to 28 percent

in 2020 and 40 percent in 2050.[15] Increasing revenues would likely generate political pressure to increase spending rather than being devoted solely to deficit reduction. It therefore makes sense to emphasize spending cuts when reducing the deficit. The program advocated below assumes no net increase in taxes.

The primary reason for a balanced budget is the strong positive effect it would have on a number of economic variables that affect national prosperity. These include lower interest rates, faster growth rates, and a higher rate of national savings. A number of economists from different viewpoints have agreed that the single most effective action the federal government can take to improve prosperity is to eliminate budget deficits.

The requirement for a balanced budget must take the form of a Constitutional Amendment. Because any legislation can be reversed by future Congresses, only a Constitutional Amendment can create a binding constraint within which spending priorities will be forced to compete with each other. The best alternative for such an amendment has been put forth by Senator Kyl of Arizona. The Kyl Amendment limits total spending to a fixed percent of GDP. If the wording referred to the final revision of the official GDP estimates for the prior year, Congress could, within a few months of the beginning of each new year, ascertain the exact amount of spending that was constitutionally permitted for that year.[16] Taxes would still vary according to economic conditions and would provide for some measure of automatic stabilization against the business cycle.[17] Balanced budgets would not strictly be assured, however, large deficits would be impossible to run unless there was a dramatic reduction in taxes.

The danger of Congress running large deficits by reducing taxes seems remote, however. It is also unlikely that the government would purposefully run large surpluses. Moreover, sustained moderate surpluses that were used to pay down the national debt would probably have a beneficial effect on the economy and, by lowering interest payments, would increase the proportion of later spending that could go to other programs.

One of the stronger merits of a cap on spending is that it creates explicit competition between spending priorities. Without a firm cap on spending, a sound prioritization of policies is difficult because spending on one program is not viewed as competing with spending on other programs. Since policy-makers can often resort to higher taxes or deficits, government has a tendency to support any funding that is viewed as doing some good. It should not be enough for a program merely to do some good, however. The benefits should be larger than those available from other programs and large enough to justify the reduction in disposable income that taxes imply.

Under a cap, programs must compete with each other, increasing the probability that, at least over time, funding will migrate from the least important programs to the most important ones.

One requirement of proper budgeting is the elimination of all entitlements. Entitlements are distinguished from other programs, including such necessary activities as defense, by the fact that Congress does not have to vote to appropriate an explicit amount of money to them each year. The main problem with entitlements is that the automatic

---

[15] CBO, *The Economic and Budget Outlook: Fiscal Years 1997-2006*, p 78.

[16] Any such Amendment would also have to address the problem of enforcement. Since the exact amount of permissible spending is easily verified and the appropriations process gives legislators precise control over spending, compliance should be easy. Making each member of Congress that voted for greater spending joint and severally liable for the full amount of any overspending and allowing any citizen to sue on behalf of the Federal Treasury would ensure enforcement. Of course, an escape clause should be added for times of national emergency certified by a Congressional resolution and a supermajority vote.

[17] The amendment could include a provision under which surpluses run in one year could be used to fund later deficits. This would allow for some Keynesian policy on the spending side. Surpluses would have to precede deficits, however. It is uncertain whether Congresses would possess the discipline to make use of such an option.

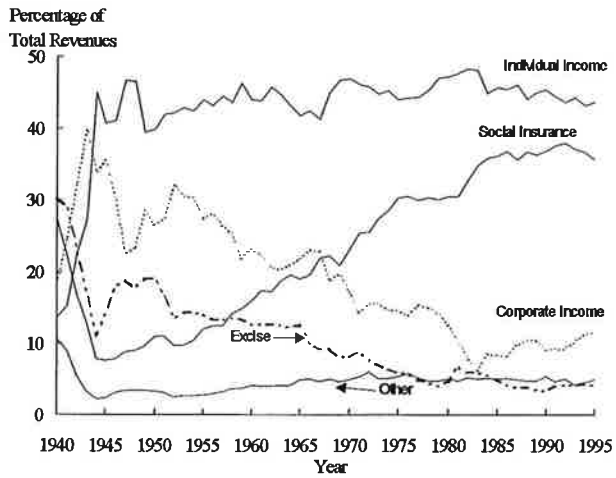
nature of their spending has allowed them to grow far beyond the intentions of their founders and has given beneficiaries rather than taxpayers the upper hand in shaping policy. The Constitutional Amendment should include a provision subjecting every penny of government spending, including interest on the national debt, to regular appropriations on an annual or biannual basis.[18] This would give Congress and the President complete control over spending and eliminate the guess work on this side of the ledger. It would also make it easier to shift funds among programs as the nation's priorities changed.

Linking total spending to GDP growth ensures that government spending increases proportionately with the nation's ability to pay for it. This gives both policy-makers and the beneficiaries of government spending an interest in supporting policies that promote growth. The result is an important change in incentives and should lead to better policy and a faster rise in incomes.

Tax Policy

The focus on spending for deficit reduction does not imply that tax law should not be reformed. Chart 6 shows the major sources of tax revenue over the last 45 years. Three trends are noticeable. First is the steady decline in the importance of excise taxes. As will be discussed below, reversing this trend may be warranted if the taxes are used to discourage activity that imposes net costs on society and and/or substitute for complicated regulations of economic markets. Second, is the decline in corporate income taxes as a source of revenue. This is not particularly disturbing since there are good reasons for avoiding the double taxation of income and concentrating instead on the distribution of corporate income to individuals. More disturbing is the growing role of payroll taxes. This regressive tax is exclusively dedicated to Social Security and Medicare, whose problems have already been discussed. The fact that revenues dedicated to programs that offer little to younger generations are almost as important to the federal government as the individual income tax is itself a strong argument for tax reform.

Chart 6
Components of Federal Revenue: 1940-1995



Source: OMB, *The Budget of the United States Government: Fiscal Year 1997, Historical Tables,* pp. 29-30.

The efficiency of tax policy would be greatly aided by a Constitutional Amendment that prohibits any legislation affecting revenues from taking effect until five years from its date of passage. This would reduce the temptation to constantly change tax legislation in order to appease interest groups or to raise political contributions from the political action committees of organizations that feel a need to protect their interests. It would also force Congress to concentrate on the long-run effects of tax legislation by designing laws that produce stable sources of revenue and impose a minimum burden on productive activity. Because individuals and firms would have time to adjust their behavior before

[18] Subjecting interest payments to appropriations need not threaten the government's credit rating. To ensure that necessary items such as interest are not held up by legislative battles, Congress could adopt procedural rules to ban amendments and limit debate on the appropriation. It should be noted that interest on the debt is a contractual obligation and creditors would find it easy to get a judgment against the United States. Finally, standard default clauses including large penalties for late payment could be used to deter Congress from paying political games with this particular appropriation.

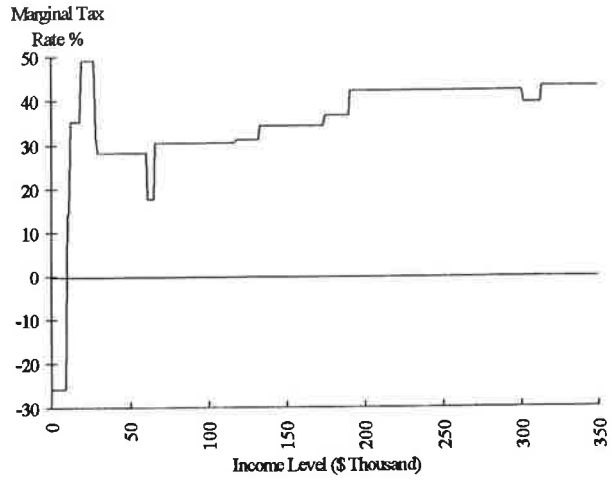
the taxes took effect, tax legislation based on largely artificial economic distinctions would be less effective.

Addressing the deficit problem by limiting total outlays to a maximum percentage of GDP does not limit the scope for tax reform. It does imply that any reform should be cost-neutral: legislation to raise taxes should be accompanied an equal amount of tax reduction.[19]

The history of tax legislation is marked by a constant struggle between efforts at tax fairness and tax simplification. The general principle that people in similar circumstances should pay the same amount of taxes does not help us find the balance between these often conflicting goals. In general people are in different circumstances. Each person's position is somewhat unique, and the attempt to address these differences in order to assess the fairest tax for each circumstance is bound to lead to complexity. On the other hand, given the complexity of economic transactions in a developed society, any simple across the board rule will certainly produce individual applications which seem unfair to many.

Tax simplification has two advantages that tax fairness does not. First, it is a more objective standard. As with spending programs, the complexity of the issues behind specific tax regulations makes it difficult for most observers to see whether they really promote tax fairness or instead deliver benefits to preferred groups. It also gives a large informational advantage to the proponents of specific provisions. Second, because simplification does not rely on continued government intervention, it does not encourage the type of rent-seeking that is so prevalent in society. The pressure of interest groups often results in government discretion benefiting those who already hold political power, rather than the disadvantaged. The avoidance of rent-seeking, together with lower administrative costs, reduces the overall burden that taxes impose on society. Finally, tax simplification imposes fewer distortions on the national economy and the effects it does impose are easier to see.

Chart 7



Effective Marginal Tax Rates 1994

Source: CBO, *The Economic and Budget Outlook: Fiscal Years 1995-1996*. pp. 56.

Chart 7 shows the effective marginal tax rates for different income tax brackets as estimated by CBO shortly after passage of the Omnibus Budget Reconciliation Act of 1993. Since there have not been any major changes to the tax laws since then, these estimates should still be accurate. The tax rates include both income and payroll taxes and show that the current system is only slightly progressive. Surprisingly there is a dramatic rise in marginal rates for those earning between $10,000 and $20,000. This large increase strongly discourages individuals from becoming independent of the government. Chart 7 also shows that any movement toward a flat tax would have to set the tax at about 30 to 40 percent of income if it wanted to replace payroll taxes.

Although tax simplification should not be pursued to its logical extreme, simpler, flatter taxes would be beneficial. Table 1 lists the annual cost of current major tax deductions and exemptions in terms of foregone revenue. Each of these tax expenditures distributes income upward and skews the underlying market in unsound ways. If eliminated, the additional income from these changes could be used either to replace roughly 60 percent of

[19] The alternative would be to apply the additional revenue to buying down the nation's debt. Such a policy could be strongly beneficial, depending upon how the additional revenue was raised.

the revenue currently produced by payroll taxes or to remove those with lower incomes from the tax rolls.

Table 1
Major Tax Expenditures for 1995

Provision	
Net Exclusion of Pension Contributions	$63.1
Exclusion for Employer-Provided Health Care	59.4
Deductibility of Mortgage Interest	48.1
Deductibility of State and Local Taxes	43.0
Step-up Basis in Capital Gains at Death	28.3
Deductibility of Charitable Contributions	23.6
Exclusion of Interest on State and Local Debt	18.6
Exclusion of OASI Benefits for Retired Workers	16.0
Total	$300.1

Source: OMB, *The Budget of the United States Government: Fiscal Year 1997, Historical Tables*, pp. 62-64.

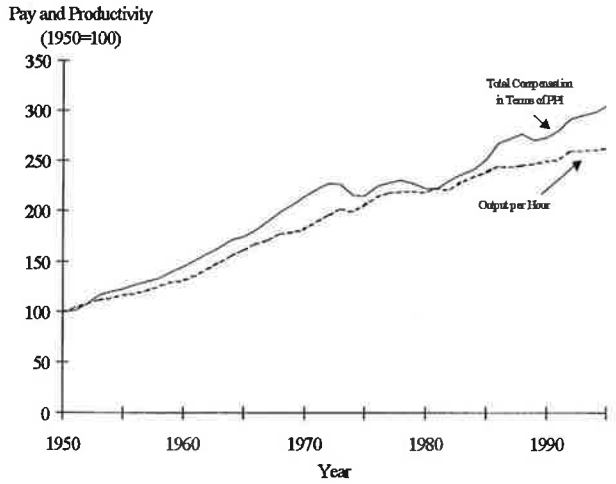
The need to raise taxes can also be used as a rough tool to guide technological and social advancement. It is a truism that whatever is taxed is discouraged. Presently, the greatest burden of taxes falls on income, especially on wages. Greater effort should go into using excise and other taxes to discourage social ills such as pollution. Placing higher taxes on the emission of effluents or the incidence of worker injuries would push behavior and technology in a direction beneficial to society. If increases in these taxes were carefully chosen and matched by reductions in the corporate income tax and a repeal of complex legislation that tries to influence behavior through regulation, the overall economic burden on the business community could even fall.[20]

[20] Efforts in this direction have been vaguely hinted at by current Secretary of Labor Robert Reich and Senator Edward Kennedy (D-MA). But their recommendations are fatally flawed by a desire to use taxes to compel specific social behavior. Attempts to draft such legislation will inevitably fail due to the difficulty of distinguishing "good" firms from "bad" and the ease with which firms can adapt their behavior without really satisfying the wishes those who draft the legislation. These difficulties largely explain why no one has proposed detailed language to follow up on these suggestions.

The use of excise taxes must be carefully thought out. Especially if their effective date was delayed by the Constitutional Amendment discussed above, there would be a strong tradeoff between their effectiveness at changing behavior and the amount of revenue raised. Taxes that were chosen because they could easily influence behavior would not raise much revenue precisely because of their effectiveness in decreasing the number of transactions subject to tax.

Once the decision is made to privatize Social Security, any policy rationale for FICA taxes immediately disappears. The loss of these taxes creates an enormous budget problem to the government, a problem that contributes to the need for the extended transition program discussed below. On the other hand, it also allows leaders to design a less regressive tax system less punishing to lower-wage workers. A transition away from FICA taxes would require higher marginal income tax rates, but need not require a reduction in take-home pay for most workers since half of the tax never shows up on workers pay checks.

Chart 8
Hourly Compensation and Output: 1950-1995



Source: Bureau of Labor Statistics.

A final point worth mentioning is that the current income exclusion of employer-paid pensions and health care benefits has strongly negative results

and ought to be eliminated. Current tax policy strongly encourages employers to provide their employees with pension and health care benefits since these benefits can usually be deducted by the employer but are not counted as income to the employee. Yet Chart 8 shows that total compensation (including benefits and payroll taxes) is primarily determined by increases in the productivity of labor measured against the price of all the things produced by labor.[21] Encouraging employers to provide benefits has not succeeded in raising total compensation, although it may have affected the distribution of this compensation among workers. Employer-paid benefits have several negative effects, however.

Both the pension and health care exemptions primarily benefit those with greater incomes These individuals are more likely to work for employers who provide benefits, they are likely to have higher benefits, and, with progressive marginal income tax rates, a greater proportion of their benefits is subsidized. These exemptions also skew the underlying health care and financial markets and make workers unduly dependent upon choices made by their employers. Finally, they often limit job mobility and unfairly disadvantage the self-employed. While the exclusions originated for sound policy reasons, their policy aims can be better accomplished in the manner explained below. Eliminating them would require a transition period and could best be done by requiring employers to offer workers the cash equivalent of current benefits and a cash-out of vested pension rights. In all probability, most workers would chose to assume responsibility for these activities themselves by taking advantage of the tax credits discussed below.

The most ingrained tax deduction is probably the deduction for interest payments on home mortgages. Although it is currently limited to loans of up to $1 million on first and second homes and $100,000 of home-equity loans, the distribution of benefits again is strongly correlated with income. Although home ownership is linked to stable neighborhoods, so is personal wealth. Demographic factors make it likely that home ownership will not be as productive an investment as it was during the last several decades. Workers saving for retirement are likely to enjoy higher rates of return if they invest in other assets. Encouraging large investments in housing may therefore be counterproductive.

There are several alternatives to the current deduction. One is to reduce the loan limit to $100,000 or $200,000. This would cover most homes and direct most of the benefits to those who need them. Another is to add a flat credit for rent or loan payments similar to the one advocated below for health care payments. This would remove the bias toward home ownership and would greatly broaden the number of people who benefit from the program. Since most of the additional beneficiaries would be on the lower end of the income scale, the redistributive effects would be strongly positive.

The preferred change would be to eliminate the deduction altogether over five to ten years. Unlike retirement savings and health care, there is little danger that individuals will not purchase housing unless given an incentive to do so. And the income contract advocated below should allow workers to afford adequate shelter. In a short period of time the resulting decline in interest rates and the reduction in property values would reduce the hurdle of buying a home and may even increase home ownership among the poor.

Toward a More Stable Tax System

The tax system proposed here is basically a flat tax with three tax credits. In each of the areas targeted for credits, there is a consensus both on the importance of the expenditure for personal well-being and on the social interest in making sure that all individuals can afford a basic level of the good. These areas are retirement saving, health care, and education. Together with the minimum income contract discussed below, these tax credits should provide each individual with access to a decent standard of living and a reasonably secure future.

Some individuals have argued that the government should require individuals to save and

[21] If workers' compensation was measured against the price of the things consumers buy, Chart 8 would show that compensation has trailed productivity since the early 1980s.

purchase health care. This paper instead stresses the principles of personal freedom to chose balanced by individual accountability. Nevertheless, the practical nature of tax credits reduces the marginal cost to the individual to zero and makes it almost certain that participation will be widespread.

With a tax credit the money either goes to the government or to the use indicated. Although there is no explicit mandate to save or to buy health insurance, the incentives created by a tax credit strongly push in that direction.

Another advantage of a credit is that it benefits all income groups equally. Tax deductions on the other hand, primarily benefit middle and upper-income individuals. In fact, as a percentage of income, credits are more important to those with lower incomes. Provided that the minimum income contract discussed below is set high enough, all participants should be able to take full advantage of each credit.

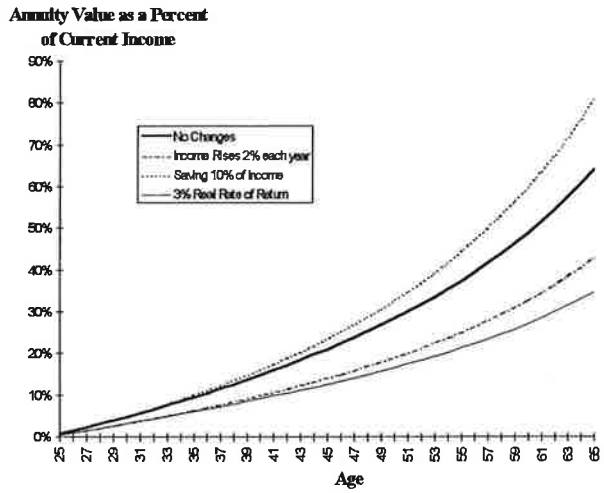
Personal Savings.--The first credit would allow each individual to place up to 15 percent of his income into an individual retirement account. Savings beyond this would not receive preferential tax treatment. Although this credit gives a higher absolute benefit to higher income people, this seems acceptable since the credit's main purpose is to allow workers to build up sufficient savings to maintain the standard of living that they enjoyed during their working years. In return for not having this portion of income taxed, the individual is commits to defer its enjoyment until retirement. If desired a cap could be placed on total annual savings to reduce the loss of revenue.

Chart 9 shows what the final annuity level would be for a worker who saved 15 percent of his income for 40 years, assuming real wage increases of 3 percent a year and a real rate of return of 5 percent on investments and a life expectancy of 90 years. Under these assumptions the worker would be able to afford an annuity equal to 60 percent of his final salary. The effect of altering these assumptions is also shown. Because a savings requirement is part of the personal contract described below, the system is designed to ensure that at some point everyone becomes free of the need for charity.

The credit for savings has several positive effects. First, it allows even the poorest individuals to acquire wealth. Because the maintenance of this wealth depends on general economic and social stability, everyone has a strong stake in the system and an interest in seeing economic growth. Just as important, it continues the democratization of corporate ownership. Many of these funds will be channeled through mutual funds to invest on behalf of workers. These funds are already well regulated. Their rapid growth has allowed them to play an increased role in corporate governance, spreading the benefits of corporate ownership more equally. Competition among mutual funds will push them to continue to insist on sound corporate policies.

Chart 9

Annuity Level as a Percent of Current Income under Different Assumptions



The savings credit should replace the current exemption for employer-paid pension plans, although payments into such plans should qualify for the credit. Since increases in worker income is largely determined by increases in productivity, pressuring employers to provide greater benefits is unlikely to raise living standards in the long run. In the end, higher benefits will come out of workers' take-home

pay.[22] As a transition, employers should be forced to allow employees to withdraw the full value of vested and non-vested pension rights, provided that they are rolled over into an IRA.

This credit, together with the credit for health care, would remove the current dependence of workers on the financial health and choices of their employer. This dependence often extends decades after retirement, exposing workers to risks beyond their control. The corresponding reduction in the need to protect workers would eliminate the need for complex regulation such as the Employee Retirement Income Security Act (ERISA) and federal insurance of defined benefit plans.

Health care.-- The second credit would allow individuals to subtract most of the costs of their health care from their taxes. The credit should be limited to a fixed amount set at a high percentage of the average cost of annual health care plus the cost of a standard catastrophic insurance plan, including nursing home care. The taxpayer should, however, bear the full cost of the last few dollars spent in order to maintain pressure on prices.

Although regular health care and catastrophic insurance are usually combined in most employer-paid health care plans, there is no inherent reason why they need to be. Technically there is a social interest only in ensuring the purchase of insurance, since people are likely to purchase health care on their own when they need it.[23] Nevertheless, in order to prevent actual taxes from rising too much when the exemption for employer-paid plans is ended, normal health care costs should also be covered, at least for a while. In the following tabulations the combined cost is tentatively estimated at $2,500.

Besides increasing individual choice and portability, the substitution of a tax credit for Medicare, Medicaid, and the tax exemption for employer-paid health plans will eliminate the strong price inflation generated by current government policy. These programs both directly and indirectly increase the amount of money flowing into the health care sector, usually with little linkage to the quality of care received in return.

Advocates of the Canadian and German plans believe the only answer to this inflation is to increase the government's control over the entire sector, based partly on the belief that the problems in the health care market are unique. The plan advocated here withdraws the government almost completely from health care, treating it as any other sector in the belief that, once everyone has sufficient income, normal market forces will produce a better outcome.

One reason often given for continuing to rely on the government and other intermediaries for the arrangement of health care is that patients cannot make intelligent choices regarding their own health care. This paternalistic attitude is wrong. Although this argument can be (and has been) used to justify government interference in other decisions involving career choice, education, and savings, it does not correspond to facts. Many patient decisions, especially those involving life or death, will be emotionally difficult. In some cases patients will choose to err on the side of buying more health care, especially as their income rises. But no one who has studied the support groups formed by women with breast cancer or the rapid growth of databases and discussion groups over the Internet can doubt that normal individuals possess the capacity to make informed decisions with the support of family and doctors. There is no reason to think that a government that lacks detailed information on the specific circumstances of each case and knowledge of the individuals involved will make better ones.

Greater personal control over health care choices is also likely to lead terminally ill patients to choose a lower level service. Although the decisions

---

[22] If workers are sacrificing current income to pay for the benefits of current retirees rather than their own benefits, a movement away from employer-paid benefits would threaten older workers and retirees. This is likely to be the case in unionized plants, where the union often negotiates pay raises and increases in benefits to retirees simultaneously. Any transition should require employers to continue honoring commitments to existing retirees.

[23] The fact that some people cannot afford normal health care costs is dealt with by the income supplement program described below.

will be difficult, few elderly will want to spend large portions of their estate for treatments that are uncertain or that will prolong life for only a short time at the cost of discomfort and pain. Although the ability to afford insurance against such costs should be guaranteed, many elderly have a sounder appreciation for the costs and inevitabilities of life than does a system that sees every death as a personal defeat.

It will no doubt strike some as unfair that this system would allow the rich to afford a better quality of health care than others. But such an outcome is inherent in the market system and is inevitable under any other health care reform proposal seriously being considered. The goal of absolute equality is unobtainable and probably undesirable, given that it is demand from the top of the socio-economic scale that usually drives market innovations. The worry of government should not be whether some people are able to afford better care than others. It should be whether everyone who contributes to society can afford a level of health care and a style of living that is generally regarded as decent.

Education.--As the twin forces of technological change and international competition combine to increase the pace of change, job insecurity among the middle and lower class will continue to exist. Eventually workers will learn to live with and even enjoy this uncertainty, taking advantage of the freedom that comes with it. Feelings of insecurity and a need for retraining will always exist, however. The minimum income contract discussed below is designed to reduce income insecurity. However, a $500 annual credit for education expenses could ensure that all workers can afford retraining. The credit should be bankable, allowing workers to save it for periods when extensive retraining might be needed.

The current educational environment overstresses the importance of a college education, contributing to rapid inflation in tuition costs. College and graduate education will always offer social and educational advantages to those willing to invest the time and financial resources needed to obtain them. And the practical demands of many professions will require such extensive education. However, for most entry level jobs, employers are likely to require little beyond the ability to read and write well, the desire to work hard in a professional setting, and the willingness to learn on the job.

Ensuring that a high school education once again implies these requirements is the single most important educational reform that can be undertaken. If accomplished, it would dramatically increase the alternatives to younger people. The goal of education should be to provide each high school graduate with the practical skills needed to enter the job market immediately and benefit from on-the-job training. Because innovations often threaten existing interest groups, dramatic improvement is unlikely to be accomplished without allowing students and their parents a greater choice between learning environments.

Although learning can never stop with high school, there is no reason to concede that it can only occur by pursuing higher education in the traditional way; paying tuition to a full-time institution. Much, if not all, learning can be accomplished on the job or by taking specific classes on an as-needed basis. The current system leans too much toward the presumption that training will only be accomplished through formal education. At the same time, labor laws and licensing requirements unnecessarily discourage on-the job training. This bias imposes a large cost on students in terms of both tuition costs and the lost income and job experience that workers would otherwise receive. People should be given more opportunities to acquire relevant professional skills through work experience rather than formal classes and employers should be encouraged to promise training in lieu of wages.[24]

---

[24] For most of this country's history, individuals could enter professions by studying at home or apprenticing to others rather than through formal courses. In many cases this was a more efficient route than the tuition and opportunity costs required by professional schools. Of course, states would still want to conduct appropriate examinations before granting a final license to ensure that an applicant was qualified.

If this shift toward basic education and training though experience were successfully accomplished, the pursuit of a college degree or even professional education would once again become an option rather than a necessity. Provided they could satisfy professional standards, students could acquire knowledge in the way that was best for them. This change would benefit those with the least income by lowering the opportunity cost of entering a profession. It would also force learning institutions to do a better job of justifying the time and money needed to attend them.

The education credit could be used to continually update skills without foregoing several years of income and job experience. Alternatively, it could be saved for several years until extensive retraining was needed.

Parents should be able to claim a similar credit on behalf of each of their children. This would allow them to begin a college fund. Even with only a 3 percent real rate of return, a $500 annual credit would total nearly $12,000 by the time a child was 18. Eventually, this credit could be merged with vouchers for primary and secondary schooling, allowing parents and children greater control of their education and an ability to spend less on primary schooling in order to save more for college.

As a worker reached retirement age, the education credit could be reduced and the health care credit increased to reflect the fact that health care costs increase with age while the need for retraining falls after retirement.

A Minimum Income Contract

Limiting outlays to 18 percent of GDP still leaves a large enough portion of national income to offer everyone a personal contract assuring the opportunity for a decent standard of living. Assuming that defense outlays and international assistance are limited to no more than 5 percent of GDP, that total government administrative costs do not exceed 3 percent, that government spending on basic research is limited to 1 percent, and that interest on the federal debt never exceeds 4 percent of GDP, that would still leave 5 percent of GDP to devote to such a program. This percentage could increase to over 7 percent as the debt burden was reduced.

The adequacy of these resources can be estimated by using actual statistics from 1994. In 1994 GDP was $6,936 billion. Assuming social expenditures of just 5 percent of GDP, this would imply outlays of $347 billion. That same year, there were just over 23 million adults living under the poverty line. Assuming conservatively that none of them were capable of earning anything in the private sector so that all of their income would have to come from the government, this would still allow expenditures of over $15,000 per person. If the reservation wage discussed below were set at $3 an hour, a minimum wage of $18,000 would be possible.

Of course, the need to phase out benefits gradually would expand the number of recipients, reducing the amount available to each person. Nevertheless, since the calculations do not include the resources freed up by eliminating current state expenditures for Medicaid and welfare programs, a properly designed program ought to be able to assure a minimum income of $12,000 to $15,000 per adult, or up to $30,000 per family. This is substantially above the current poverty line. This level of family income should also substantially eliminate poverty among children.

Of course, the problem is much larger than this, primarily because current programs are unstable, in the sense that they give recipients an incentive to maximize rather than reduce the amount of income the government transfers to them. With a fixed budget, the larger the number of people receiving government assistance, the less generous the government can be with each recipient. The key is to match the individual's incentives with that of the government: to make each person as self-reliant as possible.

Any successful program must depend on three principles. First it must target individuals rather than neighborhoods, races, or charities. Each recipient must have full freedom to achieve his potential within the circumstances surrounding him. Only the direct transfer of income and complete

freedom over how to spend it can ensure that each person has the ability to stand on his own.

Second, assistance must be linked to the personal behavior of the recipient. To be fair to recipients, the requirements should be relatively easy to satisfy and the actions required should be closely linked to personal responsibility and success. Taxpayers have a right to verify that those who receive government aid both need and deserve it. One problem with current programs is that they attract recipients that do not need assistance. This reduces the amount of resources available to those in need and diminishes the program's public legitimacy. By being slightly onerous, the requirements listed below should increase the incentive to be as self-sufficient as possible.

Third, the program should concentrate on the transfer of income rather than services. The government has the power to eliminate income as a cause of poverty. Poverty is not always a matter of income. But when it is, it is relatively easy to solve. Even where deeper problems exist, the government is far better at transferring income than it is at satisfying the physical and emotional needs of the recipients. The linkage between assistance and personal behavior partially addresses the role of the more important value questions. Finally, the guarantee of sufficient purchasing power creates a market for providers of other services and, by opening up the opportunities available to the private and nonprofit sectors to offer services in competition with the government, shifts the balance of power toward the poor.

Shifting the incentives and power relationships behind current programs is an important goal of this program. Recipients should face continuous incentives to maximize their self-reliance. Often, existing incentives do precisely the opposite, encouraging greater dependency. This dependency is sometimes fostered by rules linking eligibility to the absence of an adult male in the household or to the number of children. Just as often, dependency is instilled by the delivery of benefits through bureaucracies that provide services of poor quality and assume control over recipients' lives.

The program sketched below attempts to provide stable incentives to each recipient. It does this by linking eligibility to personal behavior through an individual contract between the recipient and the federal government. The contract is voluntary: no one needs to sign it. But its existence would be the precondition to receiving federal or state assistance. The requirements are chosen with three goals in mind. First, the contract is simple and easily verifiable. This eliminates the complexity of current programs and ensures that both recipients and taxpayers understand how the program works. Second, as a matter of fairness to beneficiaries, the requirements are easy to perform. This also ensures that others know that lack of participation is a matter of choice, not inability. Third, the requirements are limited to those aspects of behavior that are strongly linked to personal success and good citizenship.

The rigidity of the requirements must strike a delicate balance. Requirements that are too easy to comply with will attract higher numbers of beneficiaries, reducing the amount of assistance that can be given to each person. On the other hand, requirements that are too onerous would lead to charges of unfairness, whose accuracy in individual cases could not be easily verified. The hope is that the balance struck here, together with the low marginal effective tax rates (compared to those shown in Chart 7), would provide each person with both the incentive and the opportunity to earn as much as possible in the private sector.

Box 1

Personal Service Requirements

1. Work 40 Hours a Week
2. Save 15 % of Income in an IRA
3. Submit to Drug Testing
4. Do Not Have Children Prior to the Age of 21
5. Do Not Commit Crimes
6. Complete High School
7. Pay Taxes
8. Vote

Box 1 contains only eight requirements. Although additional ones could be added, they should be few in number and equally fair to both recipients and taxpayers. As expanded upon below, they offer individuals the opportunity to receive assistance in exchange for certain behavior.

Both the federal and state government should strongly encourage the general behavioral requirements listed here. The government's ability to affect behavior by stressing the morality and importance of specific behavior is seldom used to its full force. But there is a strong public consensus that each of the requirements described below not only involves a moral imperative but also strongly affects an individual's ability realize his own potential. Linking the satisfaction of these requirements to public assistance merely reflects the right of those paying taxes to demand that recipients contribute to society and strive to become as self-sufficient as possible. At the same time, the guarantee of a fair income reflects society's recognition that those who do the right things should be taken care of.

The contract should be available to every U.S. citizen once they reach the appropriate age. The two most logical ages of eligibility are 18 and 21. Either would be suitable. Payments under the contract should be made on a biweekly or monthly basis and should be fully taxed as income. Payments could be set at 90 or 95 percent of the targeted subsidy with a final year-end payment to ensure that total spending remained below the Constitutional limit. While it is possible to waste away a one-time transfer of wealth, the promise of a steady stream of income should enable each adult to afford a decent standard of living. Because the income contract is available to all adults, it should allow anyone to overcome past bad luck or unwise choices.

1. Work 40 Hours a Week —. The first requirement is that the recipient work. The initial contract should require 40 hours per week and 2,000 hours per year. In order to ensure that the program covers all who want to comply with it, there must be some assurance that everyone who wants to work can find it. This requires two main changes to current law. The first is the elimination of the minimum wage, at least for adults. The second is a requirement that each state provide every eligible worker with employment at a federally-set reservation wage. This responsibility could be assumed by local or city governments as well. The provision of jobs at the reservation wage would represent the state's role in the program and its cost would largely be covered by the elimination of the states' expenditures on Medicaid and welfare.

Again, the selection of the reservation wage requires a careful balancing. A higher wage will, of course, shift more of the burden from the federal government to the states, although it will not necessarily raise the income of workers receiving it if federal payments dropped. A higher wage will also raise the floor on wages in the private sector. On the other hand, a lower wage will shift more workers to the private sector, where their long-term prospects for advancement are likely to be greater. By reducing the number of workers carried by the state, it will also free up resources and attention for those remaining on government rolls. Since these are likely to be the workers most in need of assistance, there are strong reasons for gearing the program mainly toward them. The reservation wage could, of course, be gradually raised over time as states succeed in transferring workers to the private sector.

States should be given large leeway in matching workers to jobs, limited only by a general requirement that the work be something the recipient is physically capable of. In some cases, the state may choose to pay a worker to get retraining in order to place him in the private sector. Many of the beneficiaries left to the state will need more individualized attention, however. For those least capable, the task will be to find a role that provides meaning and some positive reinforcement in their lives. One of the most likely avenues would be volunteer work at one of the non-profits whose role is discussed below.

One important caveat that could be made to this requirement would provide that one parent staying at home to raise a child under five would be considered to qualify for the reservation wage. For poorer families this exemption would be more effective than subsidies for day care and, when added

to the avoided costs of day care, would make it possible for many mothers to remain with their children during the day. Eligibility should be limited to the first two children, however.

Another possibility would be to allow each person to spend two years in full time study while still receiving the reservation wage. Coverage should not be extended to four years, however. The burden of justifying the enormous time and resources needed for college should fall mainly on institutions of higher learning and not the government. A two-year provision, on the other hand, is one which the vast majority of workers are likely to take advantage of at some time in their lives.

2. Save 15 % of Income in an IRA —. Each recipient would be required to take full advantage of the savings credit discussed above. Thus, 15 percent of all income would be saved, roughly the same amount that is currently paid in FICA taxes. The program is designed to raise the living standard of most beneficiaries even after counting this reduction in disposable income. Chart 9 shows that, with reasonable assumptions on salary growth and real rates of return, after working 40 years most individuals would be able to afford their own retirement without suffering a significant decline in living standards. More important, the steady accumulation of wealth is likely to change the outlook and attitude of recipients, making them more independent in fact and in perception from the government. The desire to protect this wealth and to see it grow will increase the political support for sound economic policies that promote low inflation and steady growth. Adults of all ages would have the ability to remain in the income supplement program until they chose to leave it, however.

3. Submit to Drug Testing —. There is growing evidence that federal drug laws fail to reduce drug use in spite of growing expenditures. By artificially raising the price of illicit drugs, the laws actually encourage the rampant criminality that tears apart poor neighborhoods, injects a culture of violence into a large sector of society, and tempts a significant portion of the underclass into illegal activity. This pattern of behavior is strongly reminiscent of the futile effort at prohibition 70 years ago. Although many leaders view legalization efforts as condemning the nation's youth to drug addiction, they seldom acknowledge the massive diversion of resources that could be devoted to better purposes or the deadly cost of the spillover effects this war imposes on those who have the least to lose.

At the same time, drug addiction is one of the surest roads to poverty of both the mind and soul. For this reason drug testing ought to be an absolute requirement for receiving any public assistance. Failing a drug test ought to call for one of two penalties. Either a complete cessation of all assistance and placement of any children in foster care, or immediate enrollment in a drug rehabilitation program. The cost of this program should largely be borne by the person receiving assistance. If the resources currently devoted to fighting drugs were redirected, income support and the availability of counseling could increase. In addition, by linking assistance to counseling, the government supports the demand for services to which nonprofit organizations can respond.

It is extremely important that the government continue its moral war on drugs, however. The legalization of drugs should not be seen as implying that their use is ethically neutral. The country's social, economic, and political leadership should have zero tolerance of those who use drugs or sell them to others. But the need for a moral war does not justify the waste of valuable resources in an ineffective attempt to prevent willing suppliers from meeting willing buyers. If the only cost of such an attempt were scarce financial resources, the effort might be acceptable, even though the resources could accomplish more good elsewhere. But current laws actually encourage the drug trade by inflating the profit margin. In doing so, they transform private behavior that is morally destructive to individuals into a criminal problem that destroys whole communities and extend the costs of drug use to millions of others who live in neighborhoods racked by violent crime or who are tempted into criminal behavior.

Effective policy-making requires a willingness to make tough decisions involving difficult tradeoffs. Doing this wisely requires a realistic appraisal of the cost and effectiveness of alternative policies. While accepting the existence of even a small number of addicts is difficult, it has already been done in the case of alcohol and cigarettes. The history of these drugs shows that constant moral pressure can lead to declining usage over time, while intrusive government policy seldom does.

The first duty of government should be to pick goals that are accomplishable. Policy makers must occasionally engage in a form of triage. Society lacks the resources to guarantee a truly meaningful amount of income to everyone who wants it, regardless of behavior. Only by aiming resources first at those who most deserve help can leaders deliver enough assistance to make a difference. In doing so they also provide clear incentives to emulate the desired behavior. Perhaps if someday those who most deserve it no longer need public assistance, government can devote resources to those who refuse to follow the guidelines laid out here. Until then, the priority should be given to those who abide by the terms of the contract.

4. Do Not Have Children Prior to the Age of 21—.[25] The decision to abstain from having children early in life is strongly linked to increasing the living standards of young adults, especially women. Violation of this requirement should lead to the complete cessation of benefits unless the mother enters a day-study program and the father provides significant financial support. Again, the cost of such a shelter should be borne primarily by the recipients.

A balance must be struck between deterrence prior to the event and compassion after it. Without effective deterrence, this and other requirements will have little effect on those whose behavior is most likely to exclude them from effective participation in the benefits of the economy and civil society.

Children of the middle- and upper-classes may enjoy the financial resources and family support needed to overcome mistakes made in their early years. The poor seldom enjoy this margin of error. They should be given clear messages as to the rules of behavior most likely to lead to success and these messages must be strong enough to overcome whatever negative influences surround them during childhood. If a fair minimum income is linked to that behavior, then any decision to extend participation to all regardless of behavior comes at the cost of those who play by the rules.

Yet individuals are fallible and society should be forgiving where there is both repentance and an effort to reform. One way of striking a balance in this case is to restrict the freedom of the mother to a group home, both to ensure that the child receives proper attention and that the mother abides by the other requirements of the contract, especially the attainment of education. The costs of such a shelter should be borne by both the mother and the father, although the father's share should be much larger.

Another partial solution is to tighten the legal obligations of immediate family members to each other. In this case, the state ought to be able to assert a legal claim for payment against the parents and grown siblings, on behalf of both underage parents. In the case of elderly care, the state should be able to assert a claim against descendants to recover the cost of care. The role of the immediate family as the primary source for support, ahead of the government, in difficult times should be reasserted and the practice of abandoning relatives over to government care in order to preserve one's own standard of living should be seen for what it is; heartless and selfish.

5. Do Not Commit Crimes —. This requirement seems self-evident. The commission of a felony should completely disqualify a person from further eligibility for public assistance. The commission of a misdemeanor should substantially reduce assistance for an appropriate amount of time. Although this may reduce the disincentives that

[25] If the parents were married, the higher probability of proper parental care would justify lowering the age to 18.

society presents to felons not to commit further crimes, its prospective application should be a strong deterrent against first-time offenses. Moreover, it is socially unfair to use the coercive powers of government to take income from ordinary citizens and give it to those who prey off them. Occasionally clear lines must be drawn between those who would help society and those who would hurt it. Society's help should be directed solely toward the former. To do otherwise is to weaken the moral foundation of civil society and to reduce the resources available to those most deserving.

A decision must be made about crimes committed prior to the enactment of any such program. It seems probable that some type of eligibility ought to be available to those whose crimes are in the past. The passage of legislation similar to the type advocated here would represent a type of national renewal, and it is worthwhile to extend that renewal to as many as possible.

But forgiveness should not blind policy-makers to the fact that a portion of society will actively seek to prey off of their fellows, often for reasons that we cannot understand. Protection of the gains from civil society and of those most at risk in it requires the effective deterrence and isolation of such behavior. Once a reasonable income is guaranteed to all who would contribute to society, the concentration of penal officials should move from trying to understand the origins of criminal behavior, to punishing and deterring it.

6. Complete High-School —. Although the future role of a college education is often overstated, the attainment of solid reading and writing skills and work habits is critical to employment. As explained above, the goal of education policy should be to ensure that each student graduates with the basic knowledge skills needed to enter the workforce. Given the amount of money already devoted to primary and secondary education in many localities, we should expect far superior performance for most students. However, obtaining this improvement will almost certainly require reforming primary and secondary school systems to introduce competition and choice.

Possessing entry level skills will not eliminate the need for further training and learning. But it does give individuals the option of delaying or even foregoing college in lieu of other opportunities. Since much of what is learned in college is not directly applicable to a career, this ability opens up options and puts pressure on colleges to provide more than just a passport to literacy.

A solid high-school education, by providing assurance of quality to employers, could increase the number of alternatives available to graduates and expand the role of on-the-job training and night schools that offer courses on an as-needed basis.

7. Pay Taxes —. It may seem counterproductive to have the recipients of government assistance pay taxes on the same basis as nonrecipients, but there are important advantages to having every individual share the burden of collective government. First, especially if a flat tax is used, any increase in the tax rate will affect all individuals. This will place greater constraints on taxes and will reduce the temptation to pit different members of income levels against each other. Second, it is important for the recipients of government assistance to feel that they too are bearing some of the cost of government. Taxes should be withheld from income payments the same as they currently are for most workers and an annual tax return should be required. Once the full cost of the income supplement program and the various tax credits advocated above are taken into account, the final tax rate will be around 35 to 40 percent. This is only slightly above the 30.2 percent that now applies to many low income individuals once FICA taxes are included and is well below many of the effective tax levels shown in Chart 7

8. Vote —. As the final requirement, voting is meant to complete the recipient's role as a participating member of society and to ensure that, to the extent possible, their interests are represented. Over time, the impact of this vote is likely to turn more conservative as beneficiaries accrue wealth through their savings and come to regard government more as a servant than as their master. If the other

components of the program that seek to link the individual's interest with that of general society succeed, the political force of this section of the electorate could be expected to contribute to social and political stability.

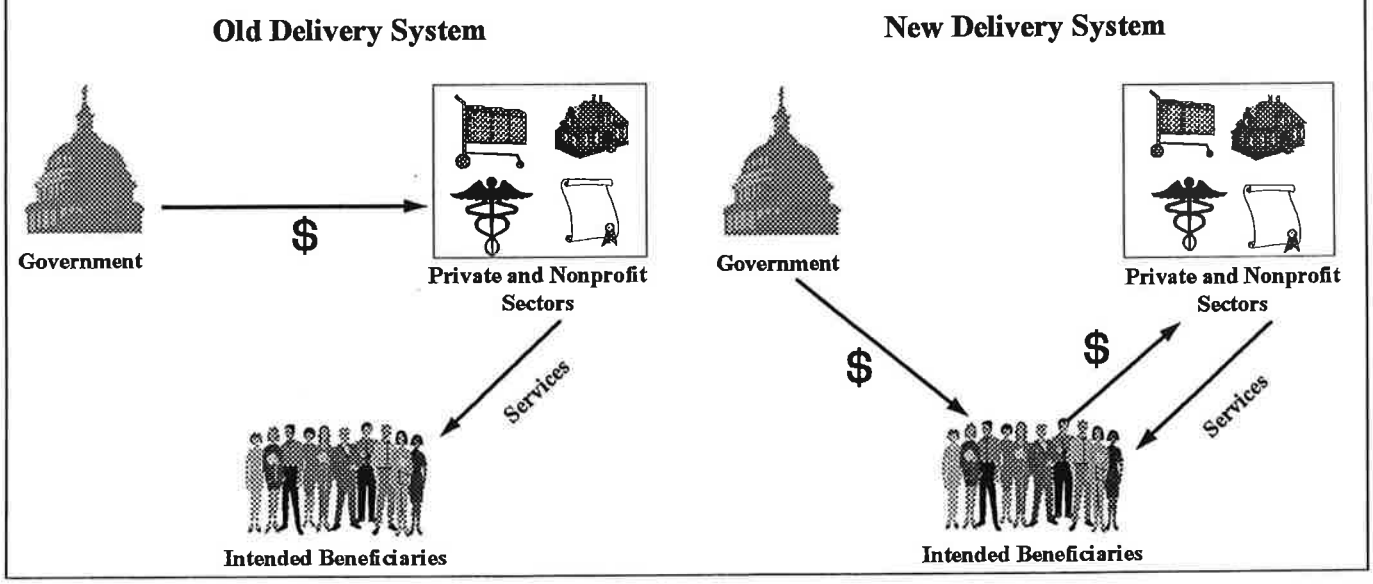
The federal government would have three major degrees of freedom in determining the support levels for each year. First it could adjust the reservation wage, changing the relationship between the federal and state governments and the private and public sectors. Second, it could increase or decrease the minimum income level given to each person. A higher minimum income would affect all workers receiving assistance, not just those at the bottom. Third, it could change the rate at which benefits are phased out. But, as discussed above, there are good reasons for keeping this rate uniform and setting it equal to the marginal tax rate paid by other workers.

The Emergence of Responsive Government: The Growth of the Third Sector.

The above program has three key aspects. First, government payments are explicitly conditioned on a reciprocal commitment from the recipient. These requirements are few, simple to understand, and popularly viewed as prerequisites for personal success.

Second, the benefits go directly to the individual. Government agencies no longer act as the exclusive deliverer of services. By giving recipients true purchasing power with which to fulfill their needs, the program elevates them to a level of equality with other consumers. This new-found freedom is likely to become the strongest evolutionary force toward a new and better form of government. Figure 1 shows the change in financial flows and purchasing power brought about by this inversion of control. Until now, government has usually operated as the exclusive servant of the majority. Unfortunately, the complexity of government programs and the presence of interest groups and bureaucracies allows agencies to stray far from what the majority would wish. By monetizing support and simplifying eligibility requirements, the program increases the transparency of government assistance. By giving resources directly to recipients, it inverts the traditional power structure of government. Now agencies must respond directly to the beneficiaries they were originally intended to serve. Moreover, because recipients have choice, the way is opened for competing public or private agencies operating at the local, state or national level, also to deliver services. The result should be a flowering of assistance agencies designed to provide help to those most in need of it.

Figure 1



Far from weakening the power of government, the above program opens the way for greater government involvement, but in a more responsive fashion. Several writers have commentated on the importance that nonprofit agencies are likely to play in the future economy, as well as on the problems of making these entities accountable. By giving recipients purchasing power, the program opens up an opportunity for any organization; local, state or federal government, non profit, or private firm to benefit from providing services that individuals really want and value. Although it opens up an opportunity for the private sector to provide these services, it does not depend upon the private sector fulfilling this role. It allows government agencies at all levels to address perceived deficiencies in the private markets by creating self-sufficient non-profits to provide services. These non-profits would have to fund themselves by either charging recipients for their services, or, in some cases, soliciting funds from donors they do now. The guarantee of a sufficient income to every eligible recipient would make the former method of funding much more viable than it is now. Dependence on voluntary business would ensure that these agencies deliver services that are truly valued by those receiving them. It would also give governments a strong incentive to develop a reputation for honesty and quality to address the distrust many harbor about existing programs and to increase its power to assist individuals who need help. Government can be an enlightening force providing the types of information and services that those most in need most. But it is only likely to do so if those in need have the economic freedom to seek other sources of help. By inverting the flow of money and choice, this program also inverts the flow of power. The result is a fundamental transformation of the relationship between government and recipient. By basing power in the individual it should also allow the government's role to evolve more easily to reflect the needs of its citizens.

The third major aspect of this program is that it is exceedingly transparent. By ensuring that all have access to an adequate income, it undercuts one of the central rationales behind the market interference involved in most government programs. The supporters of most programs justify them as responding to some perceived unfairness of market forces. But if the government deals with the central unfairness; that the market can deny adequate income to individuals for no fault of their own, then all other perceived unfairness is secondary. Once everyone has access to an adequate income, other market interventions lose a major claim to justice and become more clearly attempts to enlist the government in a struggle for income that the adherents could not win through the voluntary actions of consumers and producers.

Second, to the extent that existing programs require government resources, they compete directly with a program that should have broad public support. When measured against the program advocated here all other programs must increasingly be seen as less necessary than they were before. Once the government assures individuals that all will have access to a decent standard of living, a major objection to the reevaluation of existing programs is removed. The question then becomes one of arguing about the redistribution of income among those who already have their basic claims to fairness assured.

The Transition.

If the future insolvency of the government's major existing programs were not assured, the questions involved here would be less pressing. Many could argue that a system that works and on which people have built expectations should not be scrapped in favor of another. But once the impossibility of maintaining the status quo is admitted, then a new system must inevitably replace it. The complexity and interdependence of existing programs mean that major changes in one will often have detrimental and unforeseen effects on others. Given the size of the failing programs, the easiest and most verifiable alternative is to jump to a different system entirely. And if a different system is needed, why not one that is simple, that concentrates on those most in need and most deserving of government help, and that is stable over time because it places power directly in the hands of the recipients and provides

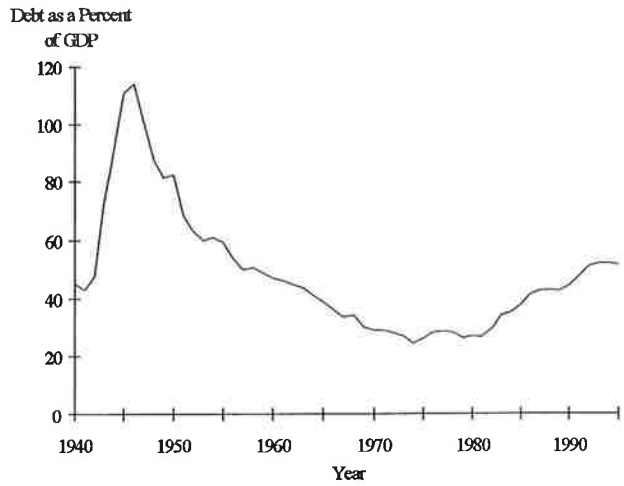
them with incentives that are closely aligned with the general welfare?

The switch from one system to another cannot occur without hardship. If, however, the need for a switch is accepted, then one is better off planning for the change as early as possible so that the hardships can be minimized and made to fall on those in the best position to bear them. Any transition to the new system should concentrate on ensuring that individuals will have the resources needed to get by under the new rules. For the young this requires relatively little since they have made few commitments that bind their future flexibility and have adequate time to take advantage of the tax credits described above. Moreover, they are unlikely to benefit from Social Security and Medicare in their current form.

Similarly, the elderly require little in the way of compensation. Payments to this group of individuals should be strictly means-tested. The new program is designed to cover the elderly poor the same as it covers all other poor. Their standard of living will not fall and should even increase. More vexing is the question of the elderly middle class. This population does not need its current payments and may be willing to give up a portion of them for a good enough cause in exchange for insurance against poverty, especially that caused by high health care or nursing home costs. Payments to this group could be made in lump-sum transfers financed through the sale of public bonds. Levels of support would then no longer be subject to later legislative changes. Although the settlement should be calculated as a lump-sum it could be paid out as an annuity subject to normal income tax and would be backed by the full faith and credit of the federal government.

Most difficult is the problem of those in their 40s to 60s. A key component of the new program is the creation of a strong incentive to save for one's future retirement. This group, even if it takes full advantage of that incentive, will not have time to generate the amount of wealth needed to replace its current income at retirement. Some form of assistance will be required to supplement the income that programs such as Social Security and Medicaid were supposed to provide. This amount should be calculated as a lump-sum based on age and, perhaps, income. The equity claim of individuals with higher income is questionable, although they will be entitled to greater benefits under the current program, they also have less need of the resources available for settling claims. The amount of settlement should be placed in an individual IRA.

Chart 10
Ratio of Federal Debt to GDP: 1940-1995



Source: OMB, *The Budget of the United States Government: Fiscal Year 1997, Historical Tables*, pp. 103-03.

The larger question is how to pay for the transitional costs of settling individual claims against the current program. Chart 10 shows that, although the ratio of federal debt to GDP has grown over the last decade and a half, it is still below the level that existed after the end of World War II. At that time federal debt amounted to 113 percent of national income. That level was substantially reduced over the next two decades through a combination of fiscal discipline and steady economic growth. The task today would be harder because long-term growth rates are likely to be lower and the debt has been issued at higher real interest rates. Nevertheless, a similar one-time expansion of the federal debt could be retired over a similar period.[26]

[26] Note that, in the period between 1947 and 1975 the federal government was in surplus only eight times. Thus the rapid reduction in the debt burden does not strictly require the balanced budgets

It may seem strange for a paper stressing fiscal discipline to argue for an unprecedented expansion of the federal debt. The justification is that in reality the program offered here represents a reduction of the liabilities currently facing the federal government. The expansion of the debt merely represents an effort to bring forward and make explicit those liabilities while at the same time substantially reducing them by paying people less than current law would entitle them to although it may be more than they are likely to ever receive given the fiscal condition of the programs.

It is likely that this large expansion of debt could be accomplished without substantially increasing interest rates, provided that the financial markets were assured of three things. First the expansion should be accomplished over three to five years and should be financed with government securities coming due within the next 20 to 30 years. Second, the payments must be used solely to satisfy future liabilities of the government created by existing programs and to satisfy them fully and finally. After this transition, government must be run on a pay-as-you go basis with future liabilities fully funded with private securities so that they truly represent stores of wealth. Finally, there must be an iron-clad commitment to balanced budgets in the future. For the next decade, the government will be exposed to the danger that higher interest rates could seriously jeopardize its financial position. The markets must never perceive a lack of commitment toward balance or a tendency to recreate the problems that the debt expansion was meant to solve. The government's exposure will be limited, however, by the fact that it will only have to roll over existing debt, not issue new debt. Since the interest payments on existing debt, including that used for the transition, will be fixed, most of the government's interest burden will be protected from sudden changes in rates. If these criteria are met, the financial markets are likely to view the debt increases as actually improving the government's long-range fiscal position. This should still allow the economy to enjoy decreasing real rates once the transition is financed.

As of October 1996, debt issued to the public was $3.7 trillion while the total gross domestic product was $7.6 trillion. Increasing the debt ratio to 100 percent of GDP over five years would raise roughly $3.9 trillion to finance the liquidation of current government liabilities. This should be more than sufficient to place every person on solid financial footing. For a period of time, higher interest payments would limit the amount of funds available for redistribution. Provided, that redistribution became the main focus of government's emphasis and that other programs were either eliminated or privatized, a sufficient amount of resources should be available to provide recipients with a standard of living above the poverty line. More importantly, this level should increase as the government's drag on the economy weakened and as the incentives contained in the program caused more individuals to graduate from government assistance.

Conclusion

Over the last six decades government has failed miserably at solving basic social problems even though it has expended far more resources in the effort than even the most ardent creators of its programs claimed would be necessary. The reason is that the programs themselves contain perverse incentives that increase the number of claims to the government's purse while reducing the resources available to pay for them. Mind-numbing complexity and the existence of a large bureaucracy accountable to higher officials but not to students, tenants, or other beneficiaries only strengthens this trend.

The above program will excite much opposition. Some of it will come from middle class beneficiaries who have succeeded in convincing the government to provide them with benefits financed by taxpayers whose income is largely near or below their own. Unless the federal government possesses a supreme ability to discover and deliver merit within today's complex economy, the justice of such programs are questionable. Greater opposition can be expected from traditional advocates of current

---

advocated above. The annual deficit exceeded two percent of GDP only three times during that period, however.

programs who claim to represent the poor and the needy but whose support of the status quo may be explained by the fact that it generally transfers wealth and power through their hands. By inverting the flow of money, and hence, power, the changes listed here would destroy the dependency of current beneficiaries on this class and ensure that whatever support they enjoyed in the future was based not on perceived political power, but on the ability to deliver services that their supposed constituencies truly value. Many of the groups who strongly proclaim the injustice of inadequate nutrition, poor housing, and substandard schooling are not inclined to provide these services themselves on a competitive basis even if the purchasing power for them exists. They would rather maintain the sinecure of funds that flows through their hands and that contributes to the dependency from which they benefit.

Opposition will also come from unions. Public sector unions such as the National Education Association will object to giving the recipients of government assistance the freedom to choose alternative providers. Both public and private unions will view the work requirement with suspicion, preferring that the poor be kept on minimal assistance than that they compete with others for jobs in the private sector.

The nonprofit sector should view the proposed program as an historic opportunity to eliminate the single largest impediment toward their helping the poor: the lack of purchasing power. With the poor assured minimum incomes, nonprofit organizations that truly care about social problems can compete to provide quality services at minimum cost. Nonprofit organizations could then look toward their intended beneficiaries rather than government and fill in whatever holes they think the for-profit sector was neglecting.

One group that is not likely to oppose this reform once it is explained to them in a way that assures them of the program's integrity and purpose, are the recipients. For it gives them true economic power and hence freedom. Not all will take advantage of it, but most will. And in exchange, they will gladly agree to the reciprocal requirements listed above and that most of them aspire to anyway. The political party that delivers this freedom to them will obtain their support and that of other Americans who feel that government's involvement in the economy should be strongly reduced but that it should still act to prevent economic hardship and strengthen the sense of community that binds us together.

Joseph Vincent Kennedy
(703) 671-8178