

# COMMENTARY

## SOCIAL INSECURITY: A COMMENT ON BOOKS BY SHORE AND DRUCKER

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### I. INTRODUCTION

Like ants, which expend their energies gathering and storing food for the winter, Americans are obsessed with retirement security. Unlike the ants, however, we expect government to provide for us if we fail to save enough.<sup>1</sup> Although we sacrifice current income to provide funds for our retirement years, we need not pay the full price of our security. Because of the miracles of actuarial science and compound interest, we have to collect and store away only a small portion of the amount we will need for retirement.

An annuity program depends on those who live shorter than average lives to provide the funds to sustain those who live longer. The risk of longevity is spread over the whole group of insureds. In addition, insureds benefit from the investment return on the funds they contribute before their retirement. An employer or an insurance company contracts to pay a fixed monthly retirement income to the insured upon his retirement. The current contribution, whether by the employer or the employee or both, is the amount needed to produce the promised retirement income if the actuarial and interest assumptions prove accurate. A plan is said to be "fully funded" if it requires the payment of the full contribution necessary to provide the promised benefits according to conservative actuarial and interest assumptions.<sup>2</sup>

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1. In Aesop's fable when the grasshopper asked the ant for food to save him from starvation during the winter, the ant replied, "What were you doing . . . this last summer?" 'Oh,' said the Grasshopper, 'I was not idle. I kept singing all the summer long.' Said the Ant, laughing and shutting up his granary: 'Since you could sing all summer, you may dance all winter.' "AESOP'S FABLES 123 (The Century Co. 1911). A popularly elected government is not likely to be that unresponsive to those who fail to provide for their retirement.

2. An ant colony could use actuarial science to calculate how much food each ant must store away to feed the number of ants who usually survive the winter. There must be an adequate supply of food to store from the beginning, however. Although no individual ant would need to provide a full winter's supply for himself, there is no imaginable method by which the ants could earn interest on the stored food. To ensure an adequate future supply of money, the Employment Retirement Income Security Act of 1974 sets minimum funding standards for most pension plans. See 29 U.S.C. §§ 1003, 1081-1086 (Supp. V 1975).

By contrast, the Social Security system operates on a “*self-supporting, current-cost financing* arrangement.”<sup>3</sup> Thus, taxes currently imposed on workers and employers provide the funds to pay those who are already retired. Social Security retirement benefits are not “funded.” Retirees have not purchased their benefits directly by their contributions. Their claim for benefits is a moral, not a property, right.<sup>4</sup> Unlike annuitants, Social Security recipients often receive more than they paid for, because benefits are not limited to the actuarial value of the contributions. In such a system, if a generation of employers and employees is both prosperous and compassionate, the retirees will be treated well; if not, their benefits may be reduced or eliminated.

Two recent books explore the prospects for retirement security in light

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3. SENATE COMM. ON FINANCE, 94TH CONG., 1ST SESS., REPORT OF THE PANEL ON SOCIAL SECURITY FINANCING 4 (Comm. Print 1975).

4. The Supreme Court has refused to characterize the interest of a person in benefit payments as an “accrued property right” subject to the protection of the due process clause. *Flemming v. Nestor*, 363 U.S. 603 (1960). It has been argued, but so far ineffectively, that a claim to Social Security benefits should be treated more like a contractual or property right. *See id.* at 622-25 (Black, J., dissenting). *See also* Reich, *The New Property*, 73 YALE L.J. 733, 785-86 (1964). The Court has held that, although benefits are not contractually promised, they “must be distributed according to classifications which do not without sufficient justification differentiate among covered employees solely on the basis of sex.” *Weinberger v. Wiesenfeld*, 420 U.S. 636, 647 (1975); *Accord*, *Califano v. Goldfarb*, 430 U.S. 199, 209 (1977). Although no covered employee has a right to benefits because of his tax contribution, male and female taxpayers are entitled to nondiscriminatory treatment with respect to benefits provided for their beneficiaries. Seven members of the Court accepted this view in *Wiesenfeld*, but only four did so in *Goldfarb*. In *Goldfarb*, Mr. Justice Stevens concluded that the statutory provision requiring proof of dependency by widowers but no proof of dependency by widows was unconstitutional because of sex discrimination among beneficiaries. Four justices had found the provision discriminatory on that basis as well as on the ground that it discriminated against female taxpayers. According to Mr. Justice Stevens:

At the same salary level, all workers must pay the same tax, whether they are male or female, married or single, old or young, the head of a large family or a small one. The benefits which may ultimately become payable to them or to a wide variety of beneficiaries—including their families, their spouses, future spouses, and even their ex-wives—vary enormously, but such variations do not convert a uniform tax obligation into an unequal one. The discrimination against this plaintiff [a widow] would be the same if the benefits were funded from general revenues.

*Id.* at 217-18 (Stevens, J., concurring). Although it appears that the government could reduce or abolish Social Security benefits across the board, it does not have carte blanche to do so selectively with respect to classes of beneficiaries, or, despite Justice Stevens, taxpayers. Obviously, the government would encounter much more political resistance to across-the-board changes in benefits than to selective ones.

of some alarming demographic projections. Warren Shore examines the condition and future of the Social Security system in *Social Security: The Fraud in Your Future*. Peter F. Drucker analyzes the private pension system and its impact on the nation's economic future in *The Unseen Revolution: How Pension Fund Socialism Came to America*. Both authors are alarmed because the ratio of retirees to workers will increase substantially in the near future<sup>5</sup> and neither pension system is prepared to accommodate such a change. The Social Security system will be forced to increase the tax burden on workers to produce the retirees' required income;<sup>6</sup> private pension plans, although funded to a considerable extent, will be forced by the demographic change to hold more income-producing assets and reduce their growth investments.<sup>7</sup> Those plans that are not fully funded will become insolvent unless the employers or workers contribute more than is now required. Although the two authors agree on the nature of the problem, their perspectives and proposed responses differ substantially.

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5. Shore says:

Bureaucrats willing to give away more than they were willing to tax have created an unfundable burden. Where in 1947 one out of every seventy-one Americans received Social Security benefits, today one in every seven collects. By 1990 the ratio is expected to worsen to one benefits recipient for every six Americans.

Although Social Security Administration birthrate analysts have seemed not to notice, we are producing more beneficiaries than we are people to pay the bills. In 1955, seven U.S. workers paid taxes for every person collecting benefits. Today, fewer than three workers "pool" their "contributions" for each Social Security beneficiary. By early next century, only two Americans will be working for every one collecting a check.

W. SHORE, *SOCIAL SECURITY: THE FRAUD IN YOUR FUTURE* 39-40 (1975).

Drucker writes of a "demographic sea change" that has created

both a very large group of "middle-aged" people, that is, people past the age of family formation and child-rearing yet still fully capable of working, and a smaller but still very large group of people surviving (by and large in fair health) into "old age," that is, past "retirement." Together these two groups, for whom pensions are a major concern, form a near-majority of the adult population in all developed countries.

[T]he number as well as the proportion of people older than traditional retirement age will still grow for at least a decade. In the United States, people over sixty-five numbered in 1975 around 22 million—a little less than 10 percent of the population. They will number 30 million by the mid-eighties—almost 12 percent of the total population, 20 percent of the adult population, and 30 percent of the labor force. And from then on, they will stay at around that percentage unless there is another "baby boom" . . . .

P. DRUCKER, *THE UNSEEN REVOLUTION: HOW PENSION FUND SOCIALISM CAME TO AMERICA* 31-32 (1976).

6. W. SHORE, *supra* note 5, at 40-41.

7. P. DRUCKER, *supra* note 5, at 75.

## II. SHORE

Initially, Shore establishes an indisputable premise: our government has consistently and blatantly misrepresented the nature of the Social Security system. Specifically, his complaint concerns the government's description of the trust funds as reserves for policyholders<sup>8</sup> and its assertions that workers are buying "insurance" by their FICA contributions.<sup>9</sup> The funds have served not as actuarial reserves but as a cushion for those years in which, because of economic conditions, benefits paid exceed contributions.<sup>10</sup> Although the system clearly has been misrepresented, it is uncertain whether comparing Social Security to "insurance" constitutes fraud. Social Security performs the function of insurance even though benefits are not contractually promised or funded. In addition, the government has always met its commitments and has increased benefits considerably in recent years.<sup>11</sup>

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8. W. SHORE, *supra* note 5, at 5-14.

9. *Id.* at 19-22.

10. The original Social Security Act did observe, in some respects, private insurance principles:

Emphasis was placed on the principle of "individual equity"—that workers should get out of the system at least as much as they had contributed to it. A large reserve fund was deemed desirable and was to be accumulated by deferring benefit payments until 1942 and basing them on total lifetime earnings. These similarities to private insurance should not be exaggerated. No attempt was made to fund the entire liability of the system on a private insurance actuarial basis, and the benefit formulas favored the low earner from the beginning. Nonetheless, the system as originally enacted differed fundamentally from the system as it operates today.

J. PECHMAN, H. AARON, & M. TAUSSIG, *SOCIAL SECURITY: PERSPECTIVES FOR REFORM* 32-33 (1968). By 1939, however, the system had moved strongly in the direction of the welfare function and away from insurance principles. Amendments enacted that year provided that benefits would begin in 1940 rather than 1942 and that benefits were to be tied to average earnings during a minimum period of coverage rather than to lifetime earnings. The direct relation between lifetime earnings and benefits was thus eliminated. In addition, the amendments adopted the pay-as-you-go financing system and abandoned the idea of a large trust fund. The trust funds now serve as a cushion against severe recessions. *Id.* at 33-34.

11. "Even after adjusting for inflation, benefits have increased by 102% in the last decade. This expansion of benefits has occurred at an even faster rate during the most recent five years. Real benefits rose 56% during these years while real GNP rose only 10%." *Hearings on Financing the Social Security System Before the Subcomm. on Social Security of the House Comm. on Ways and Means, 94th Cong., 1st Sess. 379-80 (1975)* (statement of Martin Feldstein) [hereinafter cited as *1975 Hearings*]. These benefit increases were accompanied by substantial increases in the Social Security tax. The maximum tax increased from \$348 in 1965 to \$1650 in 1975. *Id.* at 380.

Shore compares the amount paid in Social Security tax to the premium that would be paid for an insurance policy having comparable benefits, but limits his examples to young workers. A young worker may get much better coverage from a private insurer for the same amount of money that he pays in Social Security tax because he is paying for current retirees' benefits.<sup>12</sup> The tax is not based upon the actuarial cost of future benefits for today's workers but upon the cost of benefits for today's retirees. When the system began, there was a large pool of retirees and persons nearing retirement for whom no provision had been made. Social Security was designed to provide income for those already retired and to encourage others nearing retirement to give up their jobs to unemployed young workers.<sup>13</sup> Social Security thereby extended coverage to a class of persons who had not contributed to the fund. The original plan was to fund the liability for benefits to noncontributors over a long period of time by collecting slightly more than the actuarial cost of benefits from those subject to the tax.<sup>14</sup> In return, the system conferred an immediate benefit on some members of the tax-paying class—jobs of newly retired workers.

In recent years, the trust funds have declined substantially as new benefits, including a system for indexing cost of living increases, have

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12. The question is far more complex than Shore indicates. Income level and sex are examples of other factors that affect the tax-benefit ratio. One's attitude with respect to whether young workers are overburdened depends largely on one's willingness to assume at least a moderate increase in taxes and benefits over the years. See J. BRITAIN, *THE PAYROLL TAX FOR SOCIAL SECURITY* 151-52 (1972). Using a model of the Social Security system as it presently exists and projecting the growth of both taxes and benefits, Britain concludes that "most participants will fare much better than investors in fixed-dollar claims have in recent decades but much less well than long-run investors in equity capital." *Id.* at 152.

13. One of the reasons for making retirement a condition to the receipt of benefits by the aged was to open up jobs for the younger workers. See P. DOUGLAS, *SOCIAL SECURITY IN THE UNITED STATES* 171 (1939).

14. Under the original bill to establish the program, the payroll tax was expected to provide enough income to cover benefits being paid out until about 1965. Under the bill that passed, a larger reserve was provided and estimates indicated that no additional revenues would be needed until at least 1980. With the 1939 amendments, the size of the reserve was reduced and it was estimated that benefits would exceed revenues by about 1955. That estimate proved conservative. By 1950, the reserve was almost \$12.9 billion. The Senate Finance Committee had estimated a reserve of about \$6.9 billion for the end of 1955 and the House Ways and Means Committee estimate had been \$7.8 billion for 1955. See Crowley, *Financing the Social Security Program—Then and Now*, reprinted in SUB-COMM. ON FISCAL POLICY OF THE JOINT ECONOMIC COMM., 93D CONG., 2D SESS., *STUDIES IN PUBLIC WELFARE: ISSUES IN FINANCING RETIREMENT INCOME*, 21, 24-29 (Comm. Print 1974).

been added.<sup>15</sup> Although Social Security makes no contractual commitment to pay benefits, it creates expectations that it does not fund. Today's worker is encouraged to believe that he will receive, upon retirement, benefits equal to or greater than, those being paid to current retirees. Based upon these expectations, Shore notes with alarm the current estimates of the system's unfunded liability. He charges that the liability to future beneficiaries amounts to \$2.9 trillion (possibly as high as \$4 trillion) while reserves are only \$44.5 billion, and that Social Security's reserve fund is less than one percent of promised benefits while the fund maintained by private life insurers is ten percent.<sup>16</sup> The Wall Street Journal engaged in similar scare tactics by alleging in an editorial on Social Security that: "The government has . . . promised to pay out in benefits over the next 75 years \$4 trillion *plus interest* more than it expects to receive in revenues."<sup>17</sup> Such hysteria is unwarranted and deceptive. According to Robert Ball, former Commissioner of Social Security, nearly half of the estimated actuarial deficit would disappear if the "double indexing" that resulted from an ill-conceived cost-of-living indexing system enacted in 1972 were eliminated.<sup>18</sup> Most commentators

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15. In 1972, benefits were increased by 20% and the "level cost" actuarial forecasting system was replaced by a new system. The "level cost" system, which was used for long-run predictions, assumed that neither benefits nor wage levels would change. This meant that with steadily rising wages and a fixed percentage tax, reserves would accumulate until Congress acted to increase benefits. Short-run forecasts were made on the assumption that wage levels would rise but that there would be no change in the law that set the limit of the tax base. It was assumed that revenues would increase because the wages of those who earned less than the maximum amount subject to the tax would increase, but it was not assumed that Congress would raise that maximum amount. The new system provided for automatic cost-of-living benefit increases, financed by automatic increases in the tax base. This eliminated the anticipated actuarial surpluses under the "level cost" system, that would result from Congress' failure to enact benefit increases. These increases would have expended the additional revenues produced by rapidly increasing wages. Although the new system automatically adjusts revenues to finance cost-of-living benefit increases, it requires the enactment of increases in the tax or the rate base to finance additional benefit increases. *Id.* at 53-65.

16. W. SHORE, *supra* note 5, at 11.

17. Wall Street J., May 26, 1976, at 22, col. 1.

18. 1975 *Hearings*, *supra* note 11, at 603-05. According to Professor Martin Feldstein: As the law now stands, inflation will affect current and future workers in two ways. When prices and wages rise, the "average monthly earnings" on which social security benefits are based will also rise. In addition, the current method of indexing also raises the benefits at each level of average monthly earnings. Thus, inflation raises benefits in two cumulative ways.

This "double-indexing" makes both the value of benefits and the required tax rate hypersensitive to the rate of inflation. A useful way to measure benefit levels is the "replacement ratio," *i.e.*, the ratio of benefits at age 65 to the earnings

agree that "double indexing" is irrational and must be eliminated.<sup>19</sup>

Even if the alarming predictions are borne out, the government has a number of options available: taxes can be increased, benefit increases can be halted or slowed, and later retirement can be encouraged or mandated. Consequently, it is absurd to speak of an insolvent Social Security system because the government has the power to make whatever adjustments are necessary. The issue is when and what kind of adjustments must be made.<sup>20</sup>

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immediately before retirement. The actuaries of the Social Security Administration have estimated the effects of different rates of inflation on the replacement rate for a "typical" married retiree who had previously had the median level of earnings. During the 25-year period from 1948 through 1973, real wages grew at approximately 2 percent while prices increased about 2.4 percent. With this rate of growth of real wages and a 2 percent rate of inflation for the 75 year forecast period, the "typical" retiree would receive benefits that replaced 63 percent of what he was earning just before retirement. If prices rose 4 percent instead of 2 percent, the replacement rate would be increased from 63 percent to 95 percent. With an even higher rate of inflation, an individual's social security benefits could substantially exceed what he had earned before retirement. This haphazard behavior of the replacement ratio is clearly undesirable.

*Id.* at 381. John Brittain of the Brookings Institution has expressed a similar view. *Id.* at 370-71.

19. *Id.* at 381, 601. In his plan to improve the financing of Social Security, President Carter recommended decoupling "in a way that maintains the current ratio of retirement benefits to pre-retirement wages." 123 CONG. REC. S7229-30 (daily ed. May 9, 1977).

As this commentary goes to press, both houses of Congress have recently passed bills making major revisions in Social Security financing. Final passage in the House of Representatives occurred on October 27, 1977. 123 CONG. REC. H11,659-60 (daily ed. Oct. 27, 1977). The Senate passed a somewhat different bill on November 4, 1977, and insisted on a conference. 123 CONG. REC. S18,844-45 (daily ed. Nov. 4, 1977). Both bills contained decoupling provisions. See 123 CONG. REC. H11,533-34 (daily ed. Oct. 26, 1977); 123 CONG. REC. S18,385-86 (daily ed. Nov. 1, 1977).

20. The Carter Administration proposed a gradual increase in the wage base ceiling for the employee tax and elimination of the wage base ceiling for the employer tax by 1981. The Administration also proposed increases in the payroll tax rate and general revenue financing to replace revenue lost during periods of high unemployment. 123 CONG. REC. S7229-30 (daily ed. May 9, 1977).

The bill that recently passed the House of Representatives provided for a substantial, but equal, increase in the tax base for employers and employees and an increase in the tax rate. The bill included a provision that would permit the trust funds to borrow from the Treasury when they fall below certain levels. 123 CONG. REC. H11,533 (daily ed. Oct. 26, 1977). The Senate-passed bill provided for an increase in the employer tax base to \$50,000 in 1979 and to \$75,000 in 1985 while the employee tax base would increase gradually to achieve equality with the employer base by 2002. The bill also included tax rate increases. 123 CONG. REC. S18,383-85 (daily ed. Nov. 1, 1977).

The Conference Committee agreed on substantial but equal increases in the tax base for employers and employees, adopted decoupling provisions, rejected general revenue financing, and approved a higher schedule of payroll taxes than either bill provided. 123

Shore leaps from his premise that the system has been misrepresented to the conclusion that it should, therefore, be made to conform to the representations. It is equally logical to consider changing the representations. The Social Security system combines insurance and welfare concepts. Like a private insurer, it pays benefits only to persons (and their dependents) who have contributed to the fund. In a sense it adjusts the premium to the risk, but it does so to a lesser extent than a pure insurance system would. Higher income earners pay higher Social Security taxes and receive higher benefits because benefits are related to past earnings. Social Security thus charges more in premiums for the higher level of protection. Unlike insurance, however, Social Security does not classify individuals according to the likelihood that a loss will occur. Specifically, no insurer would write an annuity for a fifty-year-old man at the same premium it would charge for a thirty-year-old. Social Security does.<sup>21</sup>

Social Security benefits, like those in a welfare system, are adjusted to need to a considerable extent. There is, however, no general needs test. Indeed, the absence of such a test is thought to be one of the virtues of the system; benefits based upon contribution rather than need are less de-

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CONG. REC. S19,498-501 (daily ed. Dec. 15, 1977). The Conference Report was adopted by both houses on December 15, 1977. *Id.* at S19,518 and H13,000. The President signed the measure on December 20, 1977, and, on the same day, proposed a major program of tax cuts and revisions to offset, at least in part, the economic effect of the Social Security tax increase. N.Y. Times, Dec. 21, 1977, at 1, col. 8; *id.* at 41, col. 3.

In addition to changes in the tax law, the 95th Congress will probably enact legislation that will reduce the number of people who retire at age 65. Present law permits employers to establish 65 as a mandatory retirement age. Legislation passed by the House on September 23, 1977, and by the Senate on October 19, 1977, would prohibit mandatory retirement for most employees below age 70. 123 CONG. REC. H9967-85 (daily ed. Sept. 23, 1977); 123 CONG. REC. S17,272-304 (daily ed. Oct. 19, 1977). Because of differences between the bills with respect to exemptions for certain employees, the effective date, and provisions with respect to federal employees, the legislation was referred to a conference committee. 35 CONG. Q. WEEKLY REP. 2249 (1977).

21. The premium charge for an installment annuity would be actuarially equivalent for the thirty-year old and the fifty-year old. The thirty-year old pays premiums for a longer time and they earn interest over a longer period before the benefits begin. This would be equalized either by charging the younger person a smaller premium or by contracting to pay him a larger annuity. See S. HEUBNER & K. BLACK, JR., LIFE INSURANCE 117-23 (1972). Social Security taxes rise more than proportionate increases in earnings, up to the maximum income subject to the tax. Above that maximum, neither taxes nor benefits are affected by the higher earnings. Social Security is simply not like an insurance system which actuarially equates benefits to contributions. Once a covered employee works the minimum number of quarters, he becomes eligible for benefits that may bear little relation to the actuarial value of his contributions. See G. REJDA, SOCIAL INSURANCE AND ECONOMIC SECURITY 93-105 (1976).

meaning, much easier, and less expensive to administer. Nevertheless, a number of restrictions on the receipt of benefits are related to presumed need. The lowest income workers receive benefits in a greater proportion to their past earnings than the higher paid workers. The underlying rationale is that no benefit recipient should get less than a certain minimum.<sup>22</sup> Perhaps the most controversial provision related to need is the post-retirement earnings restriction. It is related to earnings, not to income generally, and was designed to distinguish retirees from those still employed.<sup>23</sup>

Shore, and other critics who argue for abolition of the earnings restriction, are unrealistic. Why should we compel people to insure for their retirement, if they do not need the coverage?<sup>24</sup> In a welfare system, only needy retirees would receive benefits. In an insurance system, anyone who has paid the required premiums receives benefits according to the policy criteria. With respect to annuities, the principal criterion is attainment of a specified age. Social Security uses a combination of age and retirement, and the test for the latter is the reduction of earnings below a specified level. Since benefits do not depend on proof of actual need, retirees are conclusively presumed to be needy. Only retirees receive benefits because for the vast majority of workers, retirement, rather than

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22. The benefit formula is designed to provide "socially adequate" benefits to the lowest wage earners. G. REJDA, *supra* note 21, at 95. In addition, long time earners of low wages in covered employment are now guaranteed a minimum benefit amount that may exceed the sum computed under the formula that bases the benefit amount on the average monthly wage. *Id.* at 96. *See also* Califano v. Jobst, 98 S. Ct. 95, 98 (1977) (Social Security "is designed to provide the wage earner . . . and his or her family with protection against the hardship occasioned by his loss of earnings; it is not simply a welfare program generally benefitting needy persons.") (citing Califano v. Goldfarb, 430 U.S. 199, 213-14 (1977)(Brennan, J.)).

23. G. REJDA, *supra* note 21, at 102. The popular misunderstanding and resentment of the earnings test are aptly illustrated by a passage from a recent novel:

"Social Security's a terrible thing though, you got to admit it, Aunt Sally. You pay all your life, and then when you retire it ain't enough to live on, and if you get a job you ain't eligible for your own damn money. It's dollars down a rat-hole."

"Oh, *Lewis*," Ginny said.

"Well, it's true, sweet-hot." He spoke gently, eyebrows lifted, not insisting on the point, just appealing to common sense.

"What's true has nothing to do with it," she said.

J. GARDNER, *OCTOBER LIGHT* 127 (1976).

24. Professors Blum and Kalven have suggested, in another context, that there is a "traditional presumption against sumptuary legislation." Blum & Kalven, *Public Law Perspectives on a Private Law Problem—Auto Compensation Plans*, 31 U. CHI. L. REV. 641, 678 (1964); Blum & Kalven, *Ceilings, Costs, and Compulsion in Auto Compensation Legislation*, 1974 UTAH L. REV. 341, 355.

attainment of a specific age, is the event likely to result in need. If the test were abolished, a substantial increase in Social Security taxes would be necessary to provide benefits for people who have reached a certain age, but who are not retired and therefore have no need to replace earnings.<sup>25</sup>

There are two possible rationales for a system that compels people to insure regardless of their specific needs. The first is paternalism: some people will not have private pension plans, savings, or private annuities at retirement, unless they are compelled to provide for their retirement while they are employed. The second rationale is that unless people are forced to provide for retirement, they will burden their children, or, ultimately, society during their retirement years.

Compulsion is needed only for those who are unable or unwilling to provide for their retirement. Few people, except the very poor, will purposely consume all current income and rely on family or society for support in old age. Most workers, because of the pervasiveness of private union pension plans, will not even have the opportunity to do so. Those who fail to provide for retirement, if employed, will pay considerably higher taxes during their working lives as a result of their failure to use tax-sheltered retirement plans. Tax shelters, of course, are of little value to the poor. Only the lowest paid workers cannot afford to sacrifice current consumption to provide for the future. Yet Social Security forces them to do so. In fact, one of the principal objections to the current Social Security system is that it is financed by a regressive tax that unconscionably burdens the poor.<sup>26</sup>

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25. See G. REJDA, *supra* note 21, at 118-19. The earnings restriction is also somewhat helpful in opening job opportunities for young workers during periods of high unemployment. *Id.* at 119. The argument is often made that the earnings test discriminates in favor of the rich because it permits them to keep income from capital. If the test were based upon income rather than earnings it would be a true needs test. The earnings test excludes those who have not retired without penalizing retirees who sacrificed consumption to save or to contribute to a private pension fund. It is consistent with the idea that Social Security is a basic retirement program upon which one may build. *Id.* at 121-22.

Despite the practical utility of the earnings test, it is one of the most unpopular features of the Social Security program. The recently enacted legislation provides for major tax increases, but it also eases restrictions on earnings by benefit recipients over 65 and eliminates the restrictions entirely for those aged 70 and 71 beginning in 1982. Persons 72 and over were already exempt from the restrictions. Social Security Financing Amendment of 1977, Pub. L. No. 95-216.

26. See 1975 Hearings, *supra* note 11, at 377-78. Congress had recognized the burden of the payroll tax on low-income groups. The recently enacted "earned income credit" provision of the income tax law "in effect, rebates more than 85 percent of the combined employer-employee tax on earners making \$4,000 or less and gives progressively smaller

There is considerable confusion about the function of the Social Security system. It serves a basic welfare function by providing minimum income to all retirees. On the other hand, it is an insurance mechanism that cushions the shock of retirement by providing a reduced, but steady, income in excess of a minimally adequate amount.<sup>27</sup> In fact, the system now performs both functions imperfectly. People who are most concerned about the poor would prefer to move in the direction of a purer welfare system. They would provide higher minimum benefits to needy retirees by denying benefits to others, and would make the tax progressive to reduce the burden on the poorer workers. People who believe that the great majority require the cushioning effect of compulsory protection would not only prefer to have benefits relate more closely to the actuarial value of contributions, but would also have the benefits funded and contractually promised.<sup>28</sup>

Shore simply perpetuates the confusion over the function of Social Security. In his plan to save the system, "The New Generation Compact," workers would be permitted to choose between compulsory private insurance coverage and Social Security. Benefits apparently would be fixed at present levels. Each worker who chose private insurance would be required to pay the actuarial cost of insurance coverage plus a surcharge that would be used to pay benefits to one person who retires a year later. In other words, the private insurers would pair young workers with those on the verge of retirement. The insurance company would start with an equal number of retirees and workers, but the ratio of workers to retirees would increase automatically as the retirees died. According to Shore, the amount now being paid by workers under forty

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rebates up to the \$8,000 level." *Id.* at 378. The credit does not rebate the entire payroll tax to any wage earner and is not available to earners who have no children. The credit could be expanded to further reduce the burden of the payroll tax on the poor. The effect would be to shift the cost of Social Security benefits for such low income workers to the general fund. The proposal is obviously contrary to the contributory nature of the insurance system Shore and others desire, but even the existing "relationship between benefits and taxes is . . . a loose one . . ." *Id.*

27. See J. PECHMAN, H. AARON, & M. TAUSSIG, *supra* note 10, at 55.

28. P. DRUCKER, *supra* note 5, at 102-06. Drucker suggests that Social Security will soon be left with the welfare function of providing for those who are not covered by private pensions and that benefits will be related even more closely to need. He sees the private pension system, with some modifications, ultimately providing for the basic retirement needs of most people. Although millions of workers, especially the lowest paid, now have no private pension or an inadequate or unfunded one, Drucker's vision seems much clearer than Shore's. If we desire to have a funded pension system, why not build on what exists?

would be sufficient to provide for their own coverage as well as benefits to the paired retirees.

Those who did not choose the private insurance plan, presumably older workers and retirees, would remain in the Social Security system. Eventually, everyone would be switched to the private system either by choice, or by pairing with a young worker at retirement. The Social Security system would continue its present operation until its long-term obligations were liquidated. This would occur when all retirees and workers had switched over to the new system, or when unfunded liability had been reduced to a point at which it could be funded by a single transfer from general revenues.<sup>29</sup>

Shore's plan is intriguing. It would gradually convert Social Security from an unfunded to a funded system while maintaining an insurance system appearance. Obviously, the system would retain welfare aspects. It would be compulsory, and workers would pay a premium exceeding that required to pay the actuarial cost of their own benefits. Given these two critical facts, the question is whether Shore's proposal is the best response to the demographic crunch.

Unfortunately, Shore sketches his plan inadequately and fails to indicate any weaknesses in his approach. The plan is subject to several major criticisms. First, he prefers an insurance rather than a welfare system. He believes that only contributors should collect retirement benefits; that the benefits should be fixed contractually based upon actuarial and interest assumptions; and that benefits should be fully funded. He summarily rejects the suggestion that the welfare function of Social Security be performed by a purer welfare system and that the insurance, or cushioning function, be performed by the existing private pension system. He argues that a new insurance system will permit the gradual funding of the currently unfunded liability. If the government collects premiums greater than actuarial cost, the excess can be allocated to fund the debt.

There is an alternative to Shore's system: general tax revenues could be used to fund the existing liability and honor the commitment to those who have made substantial contributions to Social Security. New workers would be covered by a basic welfare system, financed by general tax revenues, in combination with the existing, or an improved, private pension system. The government could further encourage, or require, employers and workers to arrange private pension plans. Shore says that

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29. See W. SHORE, *supra* note 5, at 130-37.

“[a] \$3 trillion debt, accumulated over forty years, cannot suddenly be added to the burden of the U.S. Treasury.”<sup>30</sup> That statement is simplistic and misleading. Once the problem of “double indexing” for increases in the cost of living is resolved, the debt will be reduced by half. In addition, the debt is not a current obligation, but a projected obligation to beneficiaries over the next seventy-five years.<sup>31</sup> A portion of each year’s general tax revenues could be allocated to pay the benefits due and begin to fund the future liability. In fact, it seems more reasonable to use income tax revenues rather than the regressive payroll tax for this purpose.<sup>32</sup> Although Shore urges that contributions to either Social Security or the “New Generation Compact” be deductible from the income tax,<sup>33</sup> such a deduction will be of little value to the poor.

Shore’s system would employ private insurers as the custodians of the fund because of an apparent belief that they are more responsible in actuarial and fiscal management than government. In addition, the funds will be more economically productive if held by private companies.<sup>34</sup> Yet his system provides a fixed contractual benefit which would become very unattractive in the event of long-run inflation. If this occurs, there will be extreme pressure for liberalization of benefits whether the retirement fund is held by private insurers or by government.

The assumption that the capital will be more productive in private hands is economically unsound. With Shore’s plan, the Social Security trust funds that are presently invested in Treasury obligations will increase substantially. If they are held by a government agency, the government will be able to sell more of its debt securities to the agency and will have a reduced need to seek buyers in the private capital market. This would depress interest rates and free large sums of money for private business, municipal bonds, and other investments.<sup>35</sup> Thus, the private capital market would benefit from the change to a funded system whether the government or private insurers hold the money. In addition,

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30. *Id.* at 129.

31. *See* notes 18 & 19 *supra* and accompanying text.

32. Brittain says: “It is generally assumed that, in an economy in which saving is determined by the aggregate of individual decisions, a reduction of income inequality must be paid for by a contraction of saving and of the rate of growth.” J. BRITAIN, *supra* note 12, at 258. He goes on to argue, however, that the inequitable and regressive payroll tax could be gradually replaced by income tax revenues without seriously damaging the economy. *Id.* at 258-60.

33. W. SHORE, *supra* note 5, at 127-37.

34. *Id.* at 136-37.

35. *See 1975 Hearings, supra* note 11, at 387.

the capital could be made available to the private market in two ways Shore apparently has not considered. A government operated insurance fund could invest in private business rather than government securities. Alternatively, an expanded and improved private pension system could increase its investment in private business, subject, of course, to the problems of pension fund socialism discussed in Section III.<sup>36</sup>

Shore's plan is also unacceptable because it conflicts with political reality. As long as inflation continues, there will be tremendous pressure for increased retiree benefits. His plan cannot accommodate this eventuality. Although he contends that we cannot be secure without funding, in reality, we cannot be secure even with funding. A fully-funded system, as Shore suggests, would work perfectly thirty or forty years from now *if* the economy is stable and prosperous and *if* retirees continue to have political influence. Funding will not protect us from rampant inflation, from economic calamities, which could destroy even soundly-managed insurers, or from a government that lacks compassion for the aged. An insensitive government could simply tax the benefits directly or indirectly by permitting, or fostering, inflation. Under either a pay-as-we-go or a Shore system, retirement security will be contingent largely upon the long-run health of the economy and the political strength of the retirees.<sup>37</sup>

### III. DRUCKER

Peter F. Drucker, an economist and management consultant, is the author of several books on management.<sup>38</sup> His thesis in *The Unseen Revolution* is that management, labor, and government must confront the arrival of "pension fund socialism," that is, worker ownership of the means of production through pension fund trusts. He notes:

employees of American business today own at least 25 percent of its equity capital, which is more than enough for control. . . . Within another ten years the pension funds will inevitably increase their holdings, and by 1985 (probably sooner), they will own at least 50— if not 60—percent of equity capital.<sup>39</sup>

The largest funds already control (defined as ownership of one-third of the equity capital) nearly all of the one thousand largest corporations. In

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36. See notes 40-52 *infra* and accompanying text.

37. For Drucker's views on the potential for expropriation of pension benefits by government, see note 50 *infra* and accompanying text.

38. The most recent is P. DRUCKER, *MANAGEMENT: TASKS, RESPONSIBILITIES, PRACTICES* (1974).

39. P. DRUCKER, *supra* note 5, at 1.

short, Drucker alleges that American workers have a greater degree of ownership and control of the means of production than workers in any other nation.<sup>40</sup> Of course, we have socialism in its purest form—a decentralized market socialism—that does not yet involve an organized effort to force companies to operate for the benefit of their worker-owners. Drucker attributes this to worker ignorance of their ownership interest, and union unwillingness to use pension fund power to participate in management.<sup>41</sup>

Drucker's point that workers, through their pension funds, own a substantial share of American business is important and valid. His claim that their ownership amounts to control is misleading, however, because even if workers were aware of their ownership, they could not exercise control over any specific business. Numerous pension funds would have to pool their votes to affect management or corporate policy. Although one-third of the voting power in a corporation could be enough for control if the votes were cast as a block, corporate management is more likely to exercise this kind of control than a group of unorganized pension fund trustees. The importance of worker ownership through pension funds, therefore, arises not from their possible exercise of direct company control but from worker awareness of ownership, which may indirectly influence company management and affect the way workers perceive macroeconomic issues.

The same demographic changes that concern Warren Shore suggest to Drucker several problems for the future of pension fund socialism. Drucker is primarily concerned with the macroeconomic effects of the increasing dependency ratio—the ratio of retirees and other nonproductive persons to workers. Whereas Shore worries about the effects of the pay-as-we-go Social Security system on the availability of capital,<sup>42</sup> Drucker recognizes that the private pension system also affects the capital formation problem. He points out that the private pension funds will soon be paying out more than they are taking in:

By 1990 . . . [the pension funds] will have become transfer mechanisms. . . . Indeed, by that time the pension funds are likely to bring about negative capital formation. As more and more of the beneficiaries age and, begin to draw retirement benefits, the funds will increasingly need cash income rather than capital gains. They

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40. *Id.* at 2-4.

41. *Id.* at 4, 97-98, 139-47. For more discussion of the role of labor unions under pension fund socialism, see notes 47-50 *infra* and accompanying text.

42. W. SHORE, *supra* note 5, at 37-38.

will need dividends . . . and will have to put pressure on the companies they own to increase dividend pay out and to decrease retained earnings—and with them capital formation.<sup>43</sup>

Negative capital formation will be most serious in those sectors of the economy affected by unfunded or underfunded pension plans. Industry-wide plans (as opposed to company plans) and public plans exemplify this problem. New York City's financial crisis can be attributed largely to its failure to fund pension benefits that are now due.<sup>44</sup>

If the economy is to grow, Drucker believes government must encourage larger contributions to pension funds and increase investment incentives by high interest rates, higher profits, and lower corporate taxes.<sup>45</sup> Saving must be encouraged to provide the needed capital and thus workers must be convinced of their capital ownership and consequent stake in profits. Although Drucker recognizes that workers perceive the inflation problem as secondary to unemployment, he believes the same demographic change that is causing problems for the pension funds will diminish unemployment and change the country's political balance.<sup>46</sup>

Labor unions may be the principal focus of the tensions caused by the rising dependency ratio. Young workers are primarily concerned about current net earnings whereas older workers, especially those already retired, are more interested in increased pension benefits. Unions represent both groups; if they continue with an "us against them"—workers against owners—theory of labor relations, they hurt workers' interests as owners of businesses. If they use the pension funds to exert some control over companies, they will blur their traditional role<sup>47</sup> and aggravate the conflict of interests between their older and younger members.

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43. P. DRUCKER, *supra* note 5, at 75. Shore's desire to improve capital formation is not fulfilled by his "New Generation Compact." His plan will have the deficiencies Drucker now perceives in the private pension system. In particular, funds held by trustees, whether they are private or governmental entities, are not likely to be available as risk capital. Drucker is concerned about the starvation of "the new, the young, the small, the growing business." *Id.* at 71. Trustees are not able to invest in such enterprises because of their duty to be prudent in minimizing risk to their beneficiaries. Drucker suggests that the large pension funds commit a significant portion of their assets to such risk investment for the good of the economy. *Id.* at 71-74.

44. The problems of the Teamsters' Central States Fund are well known. *See id.* at 16-27. For a brief summary of the development of the New York City pension problems, see F. FERRETTI, *THE YEAR THE BIG APPLE WENT BUST* 50-51 (1976).

45. DRUCKER, *supra* note 5, at 79-81.

46. *Id.* at 197-205.

47. *Id.* at 139-47.

Labor leaders traditionally have actively represented both the old and the young. This strategy has contributed to inflationary pressures, however, because management has been forced to grant both pay increases to young workers and improved pension benefits to older workers. The settlements require price increases and occasionally exceed management's capacity to pay.<sup>48</sup>

This problem is especially acute in the public sector of the economy, and New York City is an illustrative case. To keep labor peace, the city increased both wages and pension benefits without funding the latter. Both groups of workers are now suffering the consequences. Many young workers have been laid off while those who are working have had to increase their contributions so that the pension fund could meet its current obligations. At the same time, the older workers have watched their pension fund invest in debt securities to bail the city out of possible bankruptcy.<sup>49</sup> Drucker fears that the pressure for such bail-out arrangements will increase and, as a consequence, many workers have only illusory pension security.<sup>50</sup>

Drucker envisions increasing social conflict between the "welfare state" and the "welfare society." The "welfare state" provides benefits to those who cannot provide for themselves, while the "welfare society" provides for former workers and their dependents.<sup>51</sup> If both classes of beneficiaries are to be cared for, the producers, those who are currently working, must create a surplus of real wealth. If the economy fails to grow sufficiently, the result will be either inflation, which will hurt both groups, or competition between the two groups for the limited surplus. Because of the demographics, a political struggle between the groups probably would result in a victory for the retirees and their dependents.<sup>52</sup>

Drucker is optimistic that a new political coalition will be built around the pension funds. He predicts that the dominant class of people, those

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48. *Id.* at 56-58.

49. F. FERRETTI, *supra* note 44, at 399. An additional development, even more important to workers in the long run, is that they now are subject to a control board that has authority to freeze wages and even to redraw contracts. *Id.* at 413.

50. P. Drucker argues: "Outright expropriation of pension claims by government is most unlikely to come to pass. . . . But expropriation by compulsory misinvestment under government pressure or by government fiat is a real threat." P. DRUCKER, *supra* note 5, at 152. He urges that pension rights be treated as property subject to due process protection against government appropriations. *Id.* at 153.

51. *Id.* at 180.

52. *Id.* at 181.

who are or soon will be retired, will unite to force government to reduce welfare spending on those who cannot be productive, to improve the productivity and profitability of business, and to curb inflation.<sup>53</sup> Such a major shift in attitudes, however, seems less likely than a continuation of our present drift towards a welfare state or even state socialism. Workers will be uncomfortable viewing themselves as capitalists and, if they are unable to do so, we may be forced to rely increasingly on government activity to provide capital for economic growth. Drucker believes this is a distasteful, and inefficient, alternative.<sup>54</sup>

The problem of capital formation will not be solved by awakening the worker-capitalists. The sector of the economy most susceptible to rapid growth will be unable to obtain capital from the pension funds, despite Drucker's hopes, because worker awareness of their capital ownership may make trustees even more conservative in selecting investments. Government will have to direct capital to the small and the new businesses by investment in industries—like housing—that are not dominated by large enterprises, or by requiring some pension fund capital investment in such areas. An awakening of worker-capitalists might make it possible for the largest companies to build up capital, but even Drucker acknowledges that capital will not be allocated to growth areas. For additional reasons, it is also unlikely that it will be available where the public need for increased capital is greatest.<sup>55</sup>

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53. *Id.* at 199-205.

54. If we have to resort to compulsory levies to form the minimum of capital needed, the "decentralized market socialism"—and democracy altogether—will have failed; and the private pension system will go down the drain with them. But compulsory capital formation by a dictatorial, if not a totalitarian, régime is the last resort if all else fails.

*Id.* at 81.

55. Professor Galbraith divides the economy into two major sectors: the market system and the planning system. The planning system consists of the dominant large corporations, which are able to generate capital internally by retaining earnings and by selling shares to investors, including pension fund trustees. The market system consists of the small and the new businesses, which have great difficulty raising capital for growth. He regards government intervention as necessary to promote the growth of market system industries, and cites agriculture as an example of an industry that would not have developed without active government support. Other areas of public need, like housing, also need government support if they are to grow. Galbraith, like Drucker, is not afraid to describe as "socialism" what he thinks is happening in the economy. He views government ownership of business as necessary to remedy underdevelopment in the market system, and to control overdevelopment in the planning system.

The foregoing necessarily inadequately summarizes the views expressed in J. GAL-

## IV. CONCLUSION

Drucker's book offers a provocative and quite perceptive analysis of the future. Although Shore errs in focusing too narrowly on the Social Security system, Drucker overextends his thesis. Worker ownership of the means of production does not necessarily mean worker control. Even if it did, there is no guarantee that workers would mirror Drucker's perception of their interests. His faith in management's ability to be more responsive to worker-owners, and in the efficacy of such responsiveness, is almost certainly unjustified.

Both Shore and Drucker ignore the interests and political power of the poor, especially the dependent poor; they seem to have forgotten Watts, Detroit, and Hough. Shore makes concessions to relieve some of the burden of the Social Security tax on the working poor, but advocates a funded, contributory retirement system that requires them to sacrifice funds from their inadequate current incomes. Drucker, on the other hand, predicts that Social Security will move toward a pure welfare system for the dependent poor with the working poor gradually absorbed into the private pension system. He believes the dependent poor will lose a political struggle with retirees for the limited surplus of wealth. Because of the political power of a frustrated minority, and the compassion of some of the non-poor, he may be wrong.

Shore and Drucker differ with respect to the investment strategy that workers should adopt for their retirement security. Shore's plan uses a fixed annuity and will be seriously affected by long-term inflation. Drucker, on the other hand, advocates the variable annuity. This would enable workers to invest part of their retirement fund and thus take advantage of the growth of the economy and, at the same time, try to keep pace with inflation. Drucker's prescription of variable annuities is not far removed from the pay-as-we-go Social Security system which assumes that economic growth will enable the government to continue and improve benefits to retirees.

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BRAITH, ECONOMICS AND THE PUBLIC PURPOSE (1973). In particular, see ch. 27, *The Socialist Imperative*. *Id.* at 274-85.

Galbraith is much less concerned than Drucker about the loss of liberty which may result from increased government intervention in the economy. He sees a "choice between a private bureaucracy and a public bureaucracy," *id.* at 277, and domination of the economy by large, bureaucratic corporations, virtually autonomous from their owners. He has faith, possibly unjustified, in public control of government. Drucker, by contrast, has faith, probably unjustified, in owner control of business.

If the forecasters are right about the demographic changes that will occur in the next thirty years, both Social Security and the private pension system will have to endure major upheavals. They must be coordinated and operated in a way that will best serve the long-run economic health of the nation. Capital formation must be enhanced and inflation curbed if we are to enjoy the secure and comfortable retirement for which we are sacrificing current income.

Simplistic solutions like Shore's will not save us, nor can Drucker or anyone else foresee all of the developments that will require adaptation. Neither the founders of the Social Security system, which is just over forty years old, nor the architects of the private pension system, which is twenty years younger, foresaw the combination of zero population growth, double-digit inflation, and high unemployment.

Both authors would do well to consider the counsel of two economists who looked into the future with somewhat more humility. Keynes said:

It would be foolish, in forming our expectations, to attach great weight to matters which are very uncertain. It is reasonable, therefore, to be guided to a considerable degree by the facts about which we feel somewhat confident, even though they may be less decisively relevant to the issue than other facts about which our knowledge is vague and scanty. For this reason the facts of the existing situation enter, in a sense disproportionately, into the formation of long-term expectations; our usual practice being to take the existing situation and to project it into the future, modified only to the extent that we have more or less definite reasons for expecting a change.<sup>56</sup>

The creators of the Social Security system, operating in the depths of the depression, did not create a system well-adapted to our present situation. Economist, later Senator, Paul Douglas noted in a book on the Social Security legislation published shortly after it was enacted:

Behind all these attempts to attain security within our present system lies the question as to whether our social and political structure will itself prove secure. It is menaced today by business depressions and by war. If it is not able to prevent these twin scourges from assuming virulent form, it will inevitably be changed and transformed. But in the intervening period, life is likely to be extraordinarily insecure. The real struggle for security may therefore be carried through upon a larger stage . . . .<sup>57</sup>

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56. See J. KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* 148 (1936).

57. P. DOUGLAS, *supra* note 13, at 243-44.

We must adapt to developments as they occur. That adaptation may be achieved by comprehensive legislation, like the Social Security Act, or by private innovation like the pension system. Both approaches will probably be necessary. Perhaps the only certainty about the future is that in major respects our forecasts will be wrong.

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