Walter Block, David Lorch, Bobby Midkiff and Keith Reed

Social Security is a paternalist measure, supposedly forcing people to save for their old-age years, based on the assumption that they are not far-seeing enough to do so on their own behalf. It is only 'supposed,' since the funds mulcted from each generation go not to finance their own retirements, but those of their predecessors. As in the case of all coercive schemes, this one cannot be shown to improve the lot of anyone (with the exception of those who do the imposing). Specifically, this measure has negative implications for family bonds, as it substitutes the state for a function previously carried out by the extended family.

Social Security reform through privatisation

The US Social Security system is in great danger. In the past 40 years, payroll taxes have increased 17 times, yet the benefits received far outweigh projected revenues by trillions of dollars. Furthermore, Social Security (SS) has become an increasingly bad deal for American workers who have to pay very high taxes with not much hope of receiving a decent income when they retire. Reductions in benefits or additional payroll taxes would address the massive long-term deficit, but only by making the system an even poorer investment for working Americans. As for raising benefits or cutting taxes, either could improve the rate of return for workers, but would place SS into bankruptcy even earlier than otherwise.

The only answer to these unavoidable problems is to privatise this system. Privatisation would not require any reductions in benefits for those who are already retired or nearing retirement. It would allow the future elderly to retire with dignity, and also would bring enormous overall benefits to the economy. Replacing the payroll tax with a system of private savings accounts would raise the low level of savings in the United States.

Despite these benefits, politicians delay proposing necessary changes simply because of the political risk attendant upon trying to reform SS. On the other hand, continuing to do nothing guarantees that the US will face a major crisis when the baby-boom generation finally retires.

The feeble state of the system

For many reasons ranging from demographics to programme design, SS is moving towards bankruptcy. In 1950, 16 workers supported each recipient. Fifty years later there are barely three workers per recipient, and by 2030 the ratio will fall to two for each. Likewise, as the baby-boom generation begins to retire, today's small surpluses will quickly become greater and greater deficits. When SS was created in the 1930s, the average life expectancy was less than 65 years of age. The designers of the system created it with standard life spans in mind. At the turn of the century there are an increasing number of Americans claiming benefits; they do so for much longer than was originally planned, and fewer workers are available to support those transfer payments.

Another problem is that payroll taxes used to fund the programme have shot up in recent decades. Both the amount of income subject to the tax and the tax rate have greatly increased. One result is that payroll taxes now rival income taxes for about 75% of taxpayers. Some believe that simply raising taxes even further could close the huge deficit, but this would of course also have a negative impact on family finances.
Using higher taxes to close the deficit would mean raising payroll taxes by at least 50%. In the past 50 years, the Social Security payroll tax has risen from 2% to 12.4%. In 1971, the tax applied only to the first $7,800 of income; now workers must pay the entire 12.4% on all income up to $65,400.7

The rate-of-return figures assume that future retirees will receive the benefits currently promised. Projected revenues, however, are sufficient to cover only about 70% of promised benefits.8 Higher taxes or benefit reductions to close the gap will make the rate-of-return figures even worse. Social Security’s one-size-fits-all approach, forcing participants to pay taxes in exchange for monthly retirement cheques, prevents the exercise of better options. For example, workers with lower life expectancies would be far better off with private savings plans that they could pass on to their children and grandchildren.9

The endgame

Ending of Social Security is not only unavoidable but also essential. If the programme remains, its unfunded liability can be made up only by tax increases and/or benefit reductions. But to do this would only render a bad situation worse. There is a solution, however, that could help: transform from a pay-as-you-go system to private savings.10

Quasi-privatisation is one way to deal with the Social Security deficit without reducing benefits in the long run. A privately based retirement system would be simple to inaugurate. Taxes could be substituted by mandatory retirement savings accounts that would be invested in stocks, bonds and other financial assets. Annual stock market returns over the past 70 years have averaged 7% in real terms, still a better deal than the negative returns of Social Security.11 Because private savings bring higher returns, this plan would allow people entering the workforce to increase their retirement income sharply, depending upon post-privatisation investment behaviour.

Pension reform is occurring in Chile, Australia, Singapore, Mexico, Great Britain, Peru, Colombia, Italy, Uruguay, Sweden, El Salvador, Malaysia, Bolivia and Argentina.12 Chile’s system is based on perhaps the purest form of privatisation and is thus the most successful. More than 90% of workers choose the private savings alternative. Even the World Bank has endorsed privatisation.13

This initiative could also help get the economy back on track. Payroll taxes hurt job creation and reduce wages.14 Social Security reform replaces a tax with private savings. Privatisation could enhance annual economic output by 5% ($350 billion) by increasing savings. Annual income for a family of four would climb more than $5,000 a year.15 The amounts accumulated in personal accounts could be used for investment in assets other than government payments and could be controlled by the contributor. According to Shipman, allowing people the freedom to invest their Social Security taxes in financial assets such as stocks and bonds produces yields three to six times higher than Social Security.16 What is even better is that the funds accumulated could be passed on to children and grandchildren. And states Hazlitt, ‘It would be hard to imagine a plan more clearly calculated [than the present SS scheme] to discourage work and production and eventually impoverish everybody.’17

Social Security is one of the biggest discouragements to the nation’s workforce and economy as a whole. According to Borden, ‘Reform is long overdue. If we fail to act soon, our children will either inherit a bankrupt system or be forced to pay an impossibly high level of taxes. Only private pensions with individual property rights to accumulated fund balances can create a secure pension system.’18

Beyond reform

It is possible, however, to go beyond mere reform, where workers are compelled to save for a rainy day, but allowed to set up savings plans on their own individual accounts avoiding the paternalism of the present system: that workers are like children, incapable of knowing what is in their own best interests. They must be forced to save, for their own (long-run) best interest, even if, given their own choice in the matter, they would do no such thing.

But this is a profoundly undemocratic sentiment.19 If adult US citizens cannot be allowed to steer their own course on this matter, how then are they to be entrusted with the ballot-box vote? There is something, too, sadly inconsistent in the spectacle of workers electing to office people who then turn around and declare their principals incompetent in matters of saving and investment. If the latter charge is true, then their own claims as legitimate office-holders are to that extent called into question. For
if they were elected by incompetents, or children, or childish adults, then they are in office illegitimately.

Implicit in the movement to reform SS through forced savings plans is the notion that the more savings there are, the better.\(^{21}\) Nothing could be further from the truth: maximising savings – spending nothing in the present period and all in the future – must of necessity lead to death, which of course obviates all future consumption and indeed life itself.

What, then, is the optimal rate of savings? It is that level which maximises the present discounted value of all income streams, present and future. And how, in turn, is this to be achieved, and what discount rate is to be employed? The answer is the subjectively\(^{22}\) chosen time preference rate\(^{23}\) of each and every individual economic actor. People with high time preference rates will maximise the value of their overall wealth by consuming more in the near periods and relatively less in the later ones. The very opposite occurs with regard to those with low time-preference rates. Thus, it is impossible that any reform plan, compelling a given rate of savings, would be able to take into account the myriad of time-preference rates of the entire citizenry. But the free market is the antithesis of the one-size-fits-all philosophy of Social Security, even in its reformed version. Under full economic freedom each individual is free to determine the allocation of resources devoted to food versus clothing, recreation versus education, and, also, consuming in the present versus consuming in the future (saving).

The worst plan for maximizing aggregate economic welfare is the extant system. Here, government forces people to save a stipulated amount, and takes charge of the investment. A vast improvement would be to force people to save at a specific rate, but allow them to invest the proceeds as they wish, as we have seen. But the best proposal of all in this regard is one of complete freedom – allow the citizens to save as much or as little (or not at all) as they wish, and also allow them to invest these monies solely on their own discretion.

But what of those who refuse to save for a rainy day? When they reach old age, they will be totally impecunious. They will constitute a burden upon the rest of us. We, then, will be called upon to make good on their youthful profligate ways. Is it not justified that we compel such people,\(^{24}\) with the force of law, to save for their futures, whether they will or no, since if we do not, they will take advantage of us later? There are difficulties with this proposal:

- It advocates a form of preventive detention. People will be punished for what they might do in the future, not for what they have done in the past. Were we to generalise from such a precedent to other areas of endeavour, all vestiges of the rule of law\(^{25}\) would disappear.
- It punishes the innocent along with the (possibly future) guilty. This aspect is, if anything, even worse, since the very basis of any rational criminal law is that only transgressors be castigated. Once allow this as a legal precedent, and all aspects of justice vanish. All that need be done with Social Security as presently constituted, is to allow all those with savings accounts (judged to be adequate by the authorities) to opt out of the system. That even this has not been done shows how far removed from rationality is this law.
- There is an implicit assumption that either the individual or the state must make provision for retirement income. Yet it is not so long ago that a third institution, the family,\(^{27}\) was far more active in this area. Then, different generations supported one another, at different points in their life cycles. Surely, this was a far preferable system.
- There is an eminently practicable solution to the threat that the economically farsighted low time preference people might one day be called upon to compensate for the near-sighted high time-preference folk: a clear announcement that the elderly will not be bailed out in their retirement years if they (or their families) fail to provide for themselves in their sunset years during their working lives.\(^{28}\) Those squirrels that do not bury nuts for the winter will either starve or throw themselves on the mercy of voluntary charity.
- SS does not deserve the honorific appellation of insurance. Rather, it is no more and no less than an elaborately conceived statist Ponzi scheme.\(^{29}\) What is the difference between the two?

An insurance policy pools risks. It gathers premiums together, now, in case a latter disaster falls: fire, flood, unemployment or a poverty-stricken retirement in the present case. Of course, the
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insurance company keeps a portion of this to defray its costs, and keeps the difference between income and outgoings as profits. Apart from this intermediation by the firm, it is as if the people themselves pool the risks; they invest money, at present, and reap the contractually agreed-upon benefits, later.

In very sharp contrast, in a Ponzi scheme the organisers (call them A) call upon the first investors (B) to give money to them (so the money travels from B to A) and then to recoup their losses, and more, by prevailing upon a third group of people (C) to make good for them (so funds now flow from C to B).

The trick is to get in and out while the going is good, for eventually economic actors at some level in this process will fail to find yet another bunch of supporters, and will be left holding the bag. They will have contributed money to others, but the same will not be done for them. In sum, Social Security is a Ponzi scheme, for those who receive benefits do so not on the basis of their own savings, but courtesy of the savings of present workers.

This is a precise description of ‘Social Security.’ The earliest recipients, A, who retired in the first few years after the inception of this scheme, recouped monetary benefits even though they did not contribute much, or at all. Their funds came to them courtesy of B, all those working during this time. And whence sprang the wherewithal to support B? From the next generation, C. Who will be left odd man out? It will be group X, who will have paid into the programme all their lives, with no benefits received upon retirement, for failure to entice yet another new generation, Y, to take part in the scheme. If the government were to follow its own laws prohibiting fraud, it would arrest all those responsible for the inception and later administration of this connivance.

Privatising Social Security

For decades, it is claimed, SS has provided millions of Americans with a stable source of income in their retirement years. The programme is also responsible for providing a steady income for individuals who become disabled or are incapable of working to support themselves owing to physical or mental problems. This creates a warm, fuzzy feeling inside most people, because it pleases them to think that everyone is and will be cared for. To economically astute individuals, however, SS is a crime against the taxpayers, the very people it is supposed to be helping.

A major problem is that the system is extremely unfair or biased against minorities. Some racial groups have life expectancies that are far shorter than the majority of recipients. In this case, individuals may work just as long as others, but draw a return for fewer years. Essentially, they pay for the retirements of those who survive them. Privatising SS would eliminate such inequality by providing minorities with the opportunity to structure their retirement to fit their needs and expectations.

Coercion and paternalism are two of the other most common complaints against SS. American citizens have no choice but to pay taxes. We are forced to pay for services, which most of us never receive. SS payments are nothing more than taxes that have been forced upon us by our government.

Every person who works in this country will have 6.2% of his salary withheld. Added to this, the employer must match this amount with an additional 6.2%. Taken collectively, this amounts to 12.4% of every working person’s salary. To put this into perspective, a person making $30,000 per year pays $3,720 per year in Social Security taxes. There are currently six taxpayers for every one Social Security recipient.

This also means that the administration is running a budget surplus by taking in more money than it is paying out. That has been the trend for the last 30 years, so one might naturally assume that there must be a huge surplus of SS funds in an account drawing interest that will take care of us all for decades to come (as when the leaders on Capitol Hill speak of the ‘Social Security Trust Fund’). However, for the last three decades, the Federal government, in its desire to intervene in the economy through the creation of more social programmes, has used this surplus of tax dollars to provide funds for new, more extravagant, ways to use our tax money. It is called a ‘trust fund’ because the government has already spent our retirement money and has given the SS administration a handful of IOUs to take its place. Therefore, we must ‘trust’ the government when it says it will repay us.

To put this in perspective, imagine being robbed by a common criminal who takes every penny you have. Exactly one week later, he steals from you again and claims that you owe him more because he has already spent the money he stole from you the
week before. Now, add to this the fact that the police agree with him and decide that he can legally rob you every week for the rest of your life. If you understand this example, you comprehend the essence of Social Security.

There are currently two main proposals to fix these problems. The first is simply to raise the age at which people become eligible to receive Social Security. This is a stop-gap measure that could have been implemented years ago. The most recent data show that the average male and female live just over 72 and 79 years, respectively. Raising the age at which one becomes eligible to draw funds would certainly help with the looming shortfall, but would not solve the underlying problem. Americans are living longer and longer because of breakthroughs in medical technology, therefore the age must be continually increased to offset the additional years of life expectancy. The second option, and more likely to be implemented, is that the Social Security tax rate will be raised from 12.4% to close to 30% to offset the reduction in the taxpayer–recipient ratio. This means that the taxpayer would take home 10% less than at present.

For the rest of us, there are options. Privatising this system would be the easiest way to solve the problem at hand. Social Security taxes would be placed into an IRA or 401(k)-type account for the individual by his employer. This account could not be touched by the employee until a specific retirement age was reached. Likewise, the employer could not use the money for any purpose as it would be property of the employee, but would receive a small percentage (1% or 2%) for managing the fund. Any shortfall of payout versus income during the transition years would be shouldered by the Federal government, not the taxpayer. Programmes that have been funded by the excess Social Security payments for the past several years would be trimmed until the government repaid what they have taken from the ‘Trust Fund.’

A more radical proposal

This proposal, radical though it may sound to some, is not fully compatible with the doctrine of economic freedom. SS was begun only in the 1930s, during the depression. What government retirement programme existed before that date? None at all. It is time, that we ‘turn the clock back’ to the era before the implementation of this programme by Franklin Delano Roosevelt.

How was retirement organised before the advent of Social Security? Everyone was free to plan for his or her own retirement in any way he or she wished, or not to plan for it at all, and bear the consequences. Some people, of course, chose to invest in retirement funds of the sort discussed above. They would still be free to do so, un der laissez-faire capitalism. Others may have put their money into commercial real estate, or stocks, or bonds, or houses or land, and then sold off bits and pieces of it as they aged. Still others may have invested in effect in their children, secure in the knowledge that they would be cared for in turn, just as they had supported their own parents.

In our present unhappiness with SS, we are all too likely to forget its role in rendering families asunder; reducing the financial and moral incentives for relatives of different generations to support one another. In bygone days, any family refusing to support grandma was a social pariah. Nowadays, such behaviour makes good (economic) sense, since if the old lady’s family refused to help her, the state would step in. It is even foolish and counterproductive from the narrow economic point of view to care for grandparents in the face of such morally debilitating welfare programmes.

What of those who refuse to save for their old ages, and either have no families at all, or have only relatives who are too poor to help them in their hour of need? There are always charities, many organised along religious lines, which will help them keep body and soul together. Even so, their economic situation will not be an enviable one. But why should a policy be erected that forces innocent taxpayers to bail them out? Why should not those who refuse to save for the future bear the responsibility for their freely chosen actions? Is the nanny state really what America is all about?

The seen and the unseen

Social Security was originally started in 1935 to provide income to people and their families during retirement or in the case of unemployment, disability or death. However, Social Security has not done that at all, let alone in an efficient and just manner. Moreover, it has set up vast difficulties concerning moral hazard and horizontal equity.
Let us consider an example to illustrate this point. John is a ne'er-do-well who had a host of itinerant jobs, and ‘saved not for a rainy day.’ Not caring about his future, he spent all of his money in Las Vegas and similar dens of iniquity on ‘wine, women and song.’ in the full knowledge that, when he retired, the government would provide for him, thanks to Bob. This latter is a retiree who worked at a low-wage mechanic job 16 hours a day for almost 60 years, and was scrupulous in his saving behaviour.

However, once John and Bob turn 65, they will both receive similar benefits. While John will continue to squander this money on alcohol, tobacco and drugs, as he has done the rest of his life, Bob will use it for medicine, food and other worthy pursuits. In truth, John has in effect and thanks to Social Security stolen a bit of Bob's income every year for 60 years. This transfer, every year, would amount to what most Americans would call a fortune. It might well have been enough for Bob to have given his children a far better education and a higher standard of living than he was in fact able to give them.

How can we expect people to raise their economic status, to strive mightily in an upward direction, if they have to give large amounts of money to parasites such as John? Bob is a hardworking American. Is it right that John, a con man who lives on the efforts of others, should be given Bob's hard-earned money? Certainly not. Rather, Bob, who earned the money, should be able to choose how it will be used.

And yet, public policy analysis too often focuses on John, the wastrel, and ignores Bob, the person who was scrupulous in his saving behaviour. But this is no more than the ‘so-called’ social security. We have, however, decided upon conventional nomenclature for ease of exposition and communication.

1. ‘Social Security’ is actually a misnomer for this programme as it is neither social (it is compulsory) nor secure (it has been heavily mismanaged). We could more accurately refer to it as ‘unsocial insecurity,’ or as ‘so-called’ social security. We have, however, decided upon conventional nomenclature for ease of exposition and communication.


Conclusion

The Social Security system has been found wanting, both economically and ethically. In the former regard, it has wasted and misallocated resources; in the latter, it is compulsory, and paternalistic. The various schemes to ‘mend, not end’ the system do not fully address either problem. None of them would make the system fully voluntary; all of them allow continued scope for government participation in retirement, which goes counter to the notion that markets can outperform governments, in terms of efficiency, thanks to the superior ability of the former to weed out, through the profit and loss system, those who cannot economise on scarce resources.

We therefore conclude that the governmentally imposed Social Security system should be ended, forthwith, and private alternatives, or none at all, be allowed to take its place.


24. One might think that all people must be so compelled since we cannot know, now, who will save for retirement and who will not. But this is not strictly true. For anyone who can show an up-to-date savings account ought to be able to receive an exemption from this law, on the ground that he patently is engaging in savings behaviour.

25. See Friedrich A. Hayek (1960) 'Why I Am Not a Conservative,' The Constitution of Liberty, Chicago: University of Chicago Press, p. 258. Criticizes building codes on this ground, stating: "... if the legislature has imposed building codes and inspections in the name of "safety," innocent builders (i.e. those whose buildings have not collapsed) are subject to unnecessary and often costly rules, with no necessity for government to prove crime or damage. They have committed no tort or crime, but they are subject in advance to rules often only distantly related to safety by tyrannical governmental bodies."

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29. In a Ponzi (or pyramid) scheme, or a chain letter, person A asks B and C to give him $1, and then to request the same amount from D, E, F, C, while A is removed from the list. This third generation of four people then enrols a fourth, consisting of 16 people, and the project proceeds in geometrical progression. Social Security resembles a Ponzi scheme not in its exponential growth, but in that one generation gives money to the previous one. Many people consider such pyramids as fraudulent per se. But social security is worse than any of them in so far as people are compelled by law to become involved in it, while entering a chain letter is a voluntary act.

30. And Medicare as well.


33. See Spooner (1870) [1966], op. cit., p. 258, criticizes building codes on this ground, stating:


35. An Investment Retirement Account (IRA) is a tax-deferred personal retirement fund. A person can contribute to his or her retirement fund, and a certain amount of the tax otherwise due on it can be deferred until retirement, when income, and hence tax rates, are lower.

36. States former governor Pete du Pont in a letter to one of the authors dated 13 September 2000: 'Would you believe that last year almost twice as many young people said they believed in UFOs as thought they’d ever get a social security check?'


Walter Block is Harold E. Wirth Eminent Scholar Endowed Chair in Economics at Loyola University, New Orleans. Bobby Midkiff and Keith Reed were students in Block’s course, Labor Management Relations, at the University of Central Arkansas, Conway, AR. David Lorch is a student at Horace Mann School in New York.