SOCIAL SECURITY: SAVE OR KILL

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Social Security is bankrupt, and the President's proposals will not make the system solvent. The present value of the system's future expenses exceeds the present value of future revenues under current law with reasonable economic and demographic assumptions. The shortfall is an estimated $4-11 trillion.[1] The need for reform is not at issue.

The question is how to reform Social Security. The President has offered no leadership. After a year of smooth rhetoric and heightened expectations, President Clinton announced a hodgepodge of hollow and deceitful measures that fail to address national saving, economic growth, or the solvency of Social Security. Far from saving Social Security, and even farther from reforming it, the administration's scheme offers temporary life-support. The exhaustion of the system's assets would be delayed from 2032 to 2055.

The unavoidable fact is that budgetary trouble will arrive much sooner. Within fifteen years, annual outlays of the Social Security system will exceed revenues. Even this outcome is based on unreliable assumptions and projections. The day of reckoning could arrive several years sooner. At that time, the Social Security Administration will begin exchanging Treasury securities for cash. But effectively, the government will have to raise taxes, borrow from the public, print money or divert spending from other programs to make payments to beneficiaries. This is the future that the President advocates for Social Security.

To his credit, the President has helped make public discussion of the future Social Security acceptable. To capitalize on this opportunity, reformers need to agree on the objective of reform and devise an effective means of achieving it. This process exposes the flaws and fallacies of Social Security, which many politicians are still reluctant to address, and inevitably leads to the conclusion that Social Security should be killed, not saved. The only question is how to pull the plug.

Why Didn't We Think of This Before?

The President's proposal to save Social Security has met with widespread and just condemnation. In the process of failing to "save Social Security" by any reasonable meaning of the phrase, the proposal would remove the requirement that the system be self-funding, begin socializing American businesses, and create a new entitlement program. As Martin Feldstein put it: "Resident Clinton's Social Security proposal is terrible in itself and based on a remarkable accounting sham."[2]

First, the President proposes transferring general revenues to Social Security for the first time in the program's history. The $2.8 trillion, or 62 percent of the projected 15-year cumulative surplus of $4.5 trillion, to be devoted to Social Security would take the form of Treasury securities credited to Social Security over the next fifteen years. The securities would be exchanged for cash, which would come from general revenues, to pay benefits between 2032 and 2055. After that, according to Feldstein's calculations, the payroll tax would have to be raised from 12.4 percent to 18 percent or benefits would have to be cut by more than one-third to avoid dipping further in general revenues.

Second, the proposal to invest some of the Social Security surplus in the stock market would begin the socialization of American business. The assurance that great steps would be taken to insulate investment managers from political pressure fails the credibility test. Even if proponents are sincere, and even if firewalls are erected, political dynamics are such that at some future time, the walls will begin to crumble. State pension funds provide instructive examples.

Finally, the proposal to create yet another tax-favored retirement account—this time with matching contributions from the federal government—would establish a new system of transfer payments. The costs of administering the millions of small accounts would waste scarce resources. The accounts would not change the nature of Social Security, nor even postpone its budgetary crisis.

The President's proposal misses the mark, because it fails to address the fundamental shortcomings of Social Security.

Forced Saving, Government Monopoly, and Arbitrary Redistribution

Milton Friedman, in his book *Capitalism and Freedom*, identified the three elements of Social Security that must be addressed. First, it forces individuals to provide a specified amount for old age. Second, only the federal government is permitted to provide the annuity. Third, Social Security creates an arbitrary redistribution of income. Social Security reform can focus on any one of these elements or all of them.

Why should the government compel individuals to give up current consumption for future consumption? People voluntarily save (give up current consumption) in order to invest in stocks, bonds, mutual funds or other assets. These assets provide income in the future when personal productivity and labor income decreases. The trade-off between current and future consumption is an intensely private matter that varies with circumstances and preferences across individuals. When congress, through Social Security, forces people to save a specified amount for old age, it is saying that it knows better what each of us needs than we do ourselves. Such a view is inconsistent with a free society where individuals are responsible for providing for themselves and their families. Accepting this role for government with regards to Social Security invites the trampling of individual liberties in other areas of human endeavor.

Another rationale for a compulsory system is that those who do not prepare for their less productive years create externalities in the form of a large number of indigents and potential social unrest. Government justifies mandatory participation in Social Security as a means of protecting society from these future indigents. But where is the evidence that the vast majority of Americans choose to be indigent in old age? There is none. A few of us will plan badly for our future or have some misfortune befall us in our earning years. Private charity and public welfare provide support for those unfortunates without creating adverse incentives.

In fact, Social Security may do as much to promote dependency as prevent poverty over time. A large number of retirees who are currently receiving Social Security payments would fall into poverty without those payments. But to what extent were their spending and saving decisions shaped over their lifetimes by the existence of Social Security? The payroll tax reduces discretionary income significantly, especially at low levels of income, limiting the ability to acquire claims on productive assets. The

prospects of a future payment reduces the perceived need to save. Together, the payroll tax and promised benefits have squeezed millions into dependency.

Even under a compulsory system like Social Security, why should government have a monopoly on providing annuities? Individuals could earn higher returns by investing in productive assets. And each could choose the amount of investment risk to take. The Social Security System could even offer its own array of investment products to compete with private concerns. The only significant rationale for the government to retain a monopoly is to provide more redistribution through the Social Security System. But is this a sensible way to redistribute income?

The answer is clearly no. Some individuals pay more than they will receive. Others receive more than they pay. And the redistribution is arbitrary. Presumably the intent of redistribution would be to help the old poor. Yet, Social Security payments are independent of the wealth of beneficiaries. If redistribution is a goal then the size of payments should be based on the wealth of the individual. In Washington parlance, payments would be "means tested." Other arbitrary outcomes include redistributing income from men toward women, from nonwhites towards whites and from non-college educated towards college-educated.[3] To the extent that society wishes to redistribute income, it can certainly do it in more rational ways than using Social Security.

Over 36 years ago Milton Friedman summarized the flaws of Social Security as follows:

> "Compulsory purchase of annuities has therefore imposed large costs for little gain. It has deprived all of us of control over a sizable fraction of our income, requiring us to devote it to a particular purpose, purchase of a government annuity, in a particular way, by buying it from a government concern. It has inhibited competition in the sale of annuities and the development of retirement arrangements. It has given birth to a large bureaucracy that shows tendencies of growing by what it feeds on, of extending its cope from one area of our life to another. And all this, to avoid the danger that a few people might become charges of the public."[4]

Reform: Life After Death

The objectives of Social Security reform should be to free people to allocate current income between current and future consumption and to eliminate arbitrary income redistribution. These objectives are consistent with the goals of a society build on the idea of individual responsibility and limited government.

There are a number of ways to achieve these reform objectives. One alternative is to make continued participation by workers in the Social Security system voluntary. Current enrollees could choose to remain in the system or opt out. New workers would not be permitted to enroll. Current beneficiaries would continue to receive payments according to law. Workers who stay in the system would continue to pay payroll taxes in exchange for the promise of future benefit payments. Workers who exit the system would pay no payroll taxes and leave all promised benefits behind. New workers would neither pay payroll taxes or be promised benefits.

Strong incentives exist for workers to exit the system. Both before tax and after tax incomes would rise (employers would pay higher wages and salaries in exchange for elimination of the payroll tax), and employees would have ownership and control of substantial financial assets in time. These assets would replace lost income in less productive years, and unlike promised Social Security benefits, would be passed on to family members. The system would pass away with the last current participant. The Social Security system would die but life after its death is freer and more productive.

One problem with permitting withdrawal from the system is adverse selection. Current beneficiaries would stay in the system and would be accompanied by workers who expect to (and who therefore in aggregate would be likely to) receive lifetime transfers that exceed payroll tax payments by a wide margin. The result might be to enlarge the unfunded liability that would need to be financed out of general revenues, effectively limiting the ability workers to opt out of paying for the system. In any event, the Social Security trust fund scam eventually would end, and the costs of closing it down would be borne by taxpayers in general, not just workers subject to the payroll tax.

Such a reform seems to have little political support. A second best solution is compulsory but private system without a government monopoly on investment alternatives. Many politicians have supported allowing a portion of Social Security taxes to be diverted to individual accounts that would be managed by their owners. If all of these taxes were invested in marketplace alternatives by today’s young workers, the workers would be able to purchase annuities at retirement that would generate three to four times the monthly income they would receive from the current system. Also, there would be no arbitrary redistribution. Each individual would receive the full value of his

investment. This alternative is clearly superior to the current system. A major defect, however, is that the government would still trample on individual liberty by interfering in the choices of individuals regarding the allocation of current income between current and future consumption. A transition to this type of system could be accomplished without reducing promised benefits or increasing taxes.[5]

Conclusion

Social Security cannot be saved. The system is fatally flawed. It could be perpetuated indefinitely by some combination of tax increases and benefit cuts. The President's proposal draws entirely on the first of these—substantial and disguised tax increases (i.e., the earmarking of future general revenues for Social Security)—to prolong the life of the program another twenty-three years. It should be rejected out of hand. Other measures, such as dramatically increasing immigration—especially of skilled workers—could also improve the fiscal position of Social Security. But all such measures would leave in place—even strengthen—a monstrosity. The Social Security system impinges on the most basic individual liberties, redistributes income in arbitrary patterns, impedes the accumulation of private wealth, and breeds dependency on the state. It is time to pull the plug on Social Security.

Notes

[1]Milton Friedman, "Social Security Socialism," *Wall Street Journal*, January 26,1999.

[2]Martin Feldstein, "Clinton's Social Security Scam," *Wall Street Journal*, February 1, 1999.

[3]Jagadeesh Gokhale, "Social Security's Treatment of Postwar Generations," Prepared for Submission to the Senate Budget Committee, January 19, 1999.

[4]Milton Friedman, "*Capitalism and Freedom*," University of Chicago Press, 1962, p. 189.

[5]David Altig and Jagadeesh Gokhale, "Social Security Privatization: One Proposal," Cato Institute Social Security Project No. 9, May 29, 1997.