

Social Security: Tyranny of the Status Quo

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“I place economy among the first and most important of republican virtues, and public debt as the greatest of the dangers to be feared....I am not among those who fear the people. They, and not the rich, are our dependence for continued freedom. And to preserve their independence, we must not let our rulers load us with perpetual debt. We must make our election between economy and liberty, or profusion and servitude.”

— Thomas Jefferson (1816)

The status quo can be tyrannical when it focuses our thinking into known and familiar ways. Seeing only the absolute power of existing conditions, one is often led to dead-end solutions, producing no real change or way out of the current environment. In fact, it often takes a crisis to produce change, but the actions taken are typically drawn from those ideas that are lying around. So to break free from the tyranny of the status quo, good ideas are needed that are ready for implementation.

More than 40 years ago, Milton Friedman (1962, 182) wrote the following in *Capitalism and Freedom*:

The ‘social security’ program is one of those things on which the tyranny of the status quo is beginning to work its magic. Despite the controversy that surrounded its inception, it has come to be so much taken for granted that its desirability is hardly questioned any longer. Yet it involves a large-scale

invasion into the personal lives of a large fraction of the nation without, so far as I can see, any justification that is at all persuasive, not only on liberal principles, but on almost any other.

Friedman's remarks, made more than 25 years after Social Security's beginnings, still echo true. The current debate on Social Security reform, including proposals to allow for partial privatization, raise some fundamental questions about the proper role of government in administering social programs. Should government direct the collection of contributions and the financing and distribution of benefits for nearly *all* its citizens, regardless of their *need* for economic security in old age? Can one defend taxing the general population to subsidize the elderly? Should it be required that annuities be purchased only from the government? And why should the government compel individuals to use current income to purchase annuities to provide for their old age?

Milton Friedman addressed many of these questions in *Capitalism and Freedom*. As a result, several good ideas to break from Social Security's "tyranny" have been lying around for some time, and, in fact, a few have already been implemented in countries outside of the United States. This paper examines Friedman's thoughts on Social Security reform and why ideas on real change may finally be addressed.

In a sense, today's Social Security system is the antithesis of capitalism and freedom. While the United States has progressed rather nicely—its citizens are better fed, better clothed, better educated, better housed, better transported, better leisured, better etc.—the government has not, for the most part, been responsible for these improvements. To the contrary, the government has likely hindered the progress of

individuals cooperating in our free market economy.¹ And, as far as Social Security is concerned, less government involvement and more individual responsibility in planning for one's own old age appears to be the best way to get out of the current quagmire.

But Social Security reform will not happen until we understand why people seem to like the current program. Have they begun to take it for granted? Do they need to be educated about why the current program is unsustainable in the long run and that the usual justifications for the program are not at all persuasive? Or, far worse, do they reject the basic tenets outlined in *Capitalism and Freedom*?

Friedman on Capitalism and Freedom Today

Over the past 60 years, the climate of public opinion about the role of government has radically shifted. At the end of World War II and following the devastating effects of the Great Depression of the 1930s, public opinion on the role of government was predominately Keynesian. The popular view was that government intervention into the affairs of its citizens and businesses was needed in order to stabilize an unsteady and insecure economy. As a result, the growth of government exploded as many new welfare programs were started and as government took on a more paternalistic role.

But by 1980, opinion had moved away from collectivism toward a stronger belief in the free market's ability to solve our problems with limited government involvement. This change in thought was brought about mainly through experience and observation. In 1989, the visible fall of the Berlin Wall and subsequent collapse of the Soviet empire

¹Indeed, Friedman (1962, 199-200) drew this conclusion more than 40 years ago, stating, "the invisible hand has been more potent for progress than the visible hand for retrogression."

signaled an end to socialism.² Today, those who profess socialism have retreated from ownership of the means of production and now mean by it a welfare state.

Thus, even though public opinion today predominately favors free markets, this has not brought about a reduction in the welfare state, at least in the United States.³ As a result, developed economies are in danger of creeping socialism gaining momentum and reversing the tide toward giving markets a greater role and government a smaller one. In less developed economies, however, it appears that the tide continues to turn as they experience the power of free markets in creating greater prosperity.⁴

For Social Security, two separate and distinctive paths seem apparent. Down one path is creeping, or worse, exploding socialism; down the other is a return to the power of markets and individual responsibility.

A Brief History of Social Security

Social Security was established in 1935. Signed into law by President Franklin D. Roosevelt, the program was designed primarily to pay eligible individuals aged 65 or older a continuing income after retirement. Three important social, demographic, and economic changes provided impetus for this legislation: the Industrial Revolution,

²It is now taken for granted that central planning is *The Road to Serfdom*; see Hayek (1944).

³To clarify, public opinion seems to favor free markets versus socialism, but free trade and globalization versus protectionism continues to be a raging debate. Bhagwati (2004) sheds light on these distinctions and shows that globalization is part of the solution, not the problem.

⁴Gwartney, Lawson and Holcombe (1999) show that economic freedom is an important determinant to economic growth.

increased life expectancies, and the experiences of the Great Depression.⁵ In essence, these changes put political pressure on policymakers for greater government involvement to restore confidence and provide more economic security to its citizens.

Unfortunately, with the 1939 amendment, Social Security was quickly transformed from the originally-conceived funded plan—requiring workers to contribute to their own future retirement benefits through taxes paid into a trust fund—into a pay-as-you-go system, where most taxes paid into the program are immediately used to pay benefits to current retirees. A special tax is imposed on payrolls and then paid out to qualified beneficiaries with the amount determined by the age at which payments start, family status, and prior earnings. Contrary to popular belief, as well as implications made by the Social Security Administration for most of the last 65 years, contributions are not accumulated and invested in financial assets and later liquidated and converted into a pension at retirement. Rather, Social Security is an unfunded program that has provided windfall returns to the first generations of retirees since they paid little into the system relative to the benefits they received.

This “exploding” socialism mentality continued for many years as the original Social Security Act was amended several more times to provide even greater benefits without a concomitant increase in the eligibility age for old-age survivors benefits. The result is that Social Security has become the largest and most comprehensive public program in the United States. And now, Social Security’s unsustainable structure is under even greater pressure as Americans live longer and create fewer future workers through lower birth rates. The system is indeed in crisis and in need of radical reform. And the longer real reform is delayed, the costlier the fix is likely to be.

⁵See Siems (2004) for a brief summary of Social Security’s historical origins, as well as why the current program is in trouble.

Friedman on Social Security in *Capitalism and Freedom*

In *Capitalism and Freedom*, Friedman (1962, pp. 182-9) breaks Social Security into three separable elements for analysis: income redistribution, nationalization of the provision of annuities, and compulsory provision for old age. Friedman considers each element in turn to see how far, if at all, each can be justified. A brief review of his analysis is given here.

Income Redistribution

As a pay-as-you-go system, Social Security redistributes income from younger workers to those who have entered old age (at least according to the government's pre-determined designation for old age). Regardless of one's poverty or wealth, there is a subsidy paid to the old by taxing the young. As Friedman says, "the man of means receives (the subsidy) as much as the indigent." And because there is a maximum income level subject to this tax, there is a higher rate of tax imposed on persons with lower incomes. Moreover, even if we wish to help poor people, Friedman asks, "Is there any justification for helping people whether they are poor or not because they happen to be a certain age? Is this not an entirely arbitrary redistribution?"⁶

Nationalization of the Provision of Required Annuities

If income redistribution is required, then the taxing authority of the government must be used. However, if redistribution is not to be part of the program, Friedman asks, "why not permit individuals who wish to do so to purchase their annuities from private concerns?" As with most of Friedman's main arguments, individuals who are free to choose among competing alternatives will find the best solution. If the government can compete because of perceived economies of scale, then

⁶Viard (2002) investigates the intergenerational transfer of funds against three recent demographic trends: lower birthrates, the impending retirement of the baby boomers and increased longevity.

let it do so. Individual freedom and competition promote innovation, improvements, variety and diversity, and likely lower costs as well. Friedman concludes by saying that “the case against the nationalization of the provision of annuities is exceedingly strong.”

Compulsory Purchase of Annuities

To Friedman, this is the key issue: Why compel individuals to use some of their current income to purchase annuities to provide for their old age? The main argument in favor of such coercion is a paternalistic one. As Friedman says, somehow “we’ know better than ‘they’ that it is in their own good to provide for their old age to a greater extent than they would voluntarily.” The fear that a large fraction of people would not have saved enough for their old age and thus become a burden to society owes itself to the Great Depression when the unemployment rate was more than 15 percent for several consecutive years. While this was, indeed, a serious problem, the experience was unprecedented and has not been repeated since. And, it did not occur because people failed to adequately provide for their old age.

But if one believes in freedom, then one must also allow individuals the freedom to make their own mistakes. As Friedman asks, “If a man knowingly prefers to live for today, to use his resources for current enjoyment, deliberately choosing a penurious old age, by what right do we prevent him from doing so? We may argue with him, seek to persuade him that he is wrong, but are we entitled to use coercion to prevent him from doing what he chooses to do? Is there not always the possibility that he is right and that we are wrong?”

Friedman’s conclusion is that the compulsory purchase of annuities has imposed tremendous costs for little gain. “It has deprived all of us of control over a sizeable fraction of our income, requiring us to devote it to a particular purpose, purchase of a retirement annuity, in a particular way, 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 scope from one area of our life to another. And all this, to avoid the danger that a few people might become charges on the public.”

Social Security Today

Social Security is headed for problems. The pay-as-you-go structure of the system has benefited earlier generations at the expense of later generations. As a result, below-market returns from a mature pay-as-you-go scheme are inevitable as each generation is effectively forced to service the implicit “debt” issued to finance the windfall for earlier generations. This kind of structure destroys the link an individual gets between contributions (what’s paid into the system) and benefits (what’s paid out to the individual).⁷

The problems with the current program are further exacerbated by the declining ratio of workers to beneficiaries. In 1950, a decade and a half after Social Security was passed into law, the ratio of workers to beneficiaries was 16 to 1. When Friedman wrote *Capitalism and Freedom*, the ratio had already declined to about 5 to 1. Today, the ratio is roughly 3.5 to 1, and it is expected to steadily decline as the first baby boomers enter retirement. By 2030, the ratio is expected to be approximately 2 to 1 and still falling.

Declining birth rates mean that fewer workers will be available to support a growing number of retirees. Moreover, this imbalance is further aggravated as average life expectancies continued to increase even while the age to collect full Social Security benefits remained unchanged for the first 65 years of the program’s existence. When the Social Security Act was signed into law in 1935, average life expectancy at birth was 61 years, and those who reached age 65 were expected to live an additional 12 years. By 2002, average life expectancy at birth

⁷Gwartney, Stroup and Sobel (2000, 779-90) include a chapter that illuminates the problems with Social Security and alternatives to the current system.

increased by more than 16 years to 77.3 years, and those who reached age 65 were expected to live an additional 18.2 years.⁸

Consequently, the pay-as-you-go financing structure for Social Security has been under further stress as the worker-to-beneficiary ratio has declined. And now, as birthrates remain at a lower level and the baby boomers enter retirement and enjoy greater longevity, the system, in its current form, is in crisis.

Attempts to “fix” Social Security in the past have focused mainly on increasing tax rates (and earning ceilings) and cutting benefits (e.g., raising the eligibility age for benefit payments). These are “status quo” solutions (Siems, 2003), temporary patches that cannot be sustained forever. In 1937, the maximum tax that any individual paid was \$60; today it is \$9,540 (the maximum tax is \$11,160 when disability contributions are included). Future increases in tax rates (and maximum contribution levels) of such magnitudes would be economically devastating and politically infeasible (Feldstein, 1998). Instead, new thinking is needed to solve Social Security’s woes. Fortunately, Milton Friedman and other free-market thinkers have given this problem a lot of thought and see a move toward personal accounts as a viable option to “save” Social Security (Tanner, 2004a).

Why Personal Accounts Are Needed

There are only a few options available to reform Social Security: raise taxes, cut benefits, or generate greater returns on contributions. However, because of Social Security’s flawed structure and known demographic changes, neither raising taxes nor cutting benefits is a viable long-term solution. The tax increases or benefit cuts needed to keep the “unsustainable” system going would have to be very large. So the only real option available appears to be to generate higher returns

⁸For a table of life expectancies, see the National Center for Health Statistics web site at <http://www.cdc.gov/nchs/fastats/lifexpec.htm>.

by allowing individuals to manage and control their own retirement funds.

However, a move to a system that scales back transfer payments would also impose a transition cost on current generations.⁹ Current promises and protections provided to the elderly under Social Security likely need to be preserved. Moreover, the program's long-run solvency should be guaranteed. And clear incentives are needed for citizens to work and save so that returns are improved for future contributors.

Even so, transition costs should not be a show-stopper that keeps the United States from moving from a bad (and broken) Social Security system to a good one. Remaining as is, returns from Social Security will continue to decline and costs to fulfill promises to future beneficiaries will continue to escalate.¹⁰ Moreover, Social Security should not be viewed as a pure investment because it contains important social insurance elements and inflation protection.¹¹ Still, Social Security is in great need of reform and personal accounts is an

⁹Saving and Viard (2005) argue that there is no free lunch that avoids this transition cost. They cite evidence that a formal mathematical analysis reveals that the transition cost imposed on current generations must equal in present discounted value (when discounted at the pretax marginal product of capital) the gains enjoyed by subsequent generations. See also Liu, Rettenmaier and Saving (2005), Congressional Budget Office (2004) and Kotlikoff (2002) .

¹⁰Indeed, Gokhale (2005) points out that delaying changes to Social Security will likely ensure higher tax rates and more adverse reactions by financial markets in the future.

¹¹Philosophically, social insurance relies on government institutions to provide citizens with economic security. Social insurance began in Europe in the 19th century, and several European and Latin American nations already had some form of social insurance by the time it was adopted in America. While the details of social insurance programs can vary considerably, they provide insurance against some defined risk in a manner shaped by broader social objectives, rather than by participants' self-interests.

idea that has been lying around and one that appears to have great potential in increasing future returns to individual contributors.

What is needed is a system that links contributions to benefits, and personal accounts look like a viable option to accomplish this. Additionally, personal accounts give workers ownership of and control over their retirement funds. Under certain guidelines, workers would be free to choose how to invest funds and when to withdraw them, and could have a sum to leave as an inheritance. And perhaps most important, individual personal accounts would reduce workers' reliance on government and give individuals greater ownership and responsibility.¹²

Chile Got It Started

Using individual personal accounts to transform government-run pay-as-you-go social insurance plans is not a new idea. But because America's Social Security program is so popular (particularly for those who received the windfall returns from later generations), it has been labeled the "third rail of American politics"—touch it and you die. Only recently have there been any serious political discussions to reform Social Security, probably because its financial crisis is looming ever larger and drawing ever nearer, and independent think-tanks have made headway in "getting the word out."

In Chile, the pension system was reformed in November 1980 because the government foresaw that it would not be able to pay promised benefits. Chile gave each worker the choice of opting-out fully from the government-run pension system and instead putting the former payroll tax (10 percent of wages) into a privately-managed personal retirement account. Led by Jose Pinera (who got the idea from *Capitalism and Freedom*), the ideas for reform of the pension system were

¹²My favorite plan is one developed by members of Cato's Project on Social Security Choice as described in Tanner (2004b).

part of an overall vision of a free market and free society in Chile. Nearly 95 percent of Chile's workers opted-out of the government-run system and chose individual private accounts. Today, more than 6 million workers own private accounts in Chile and have earned about 10 percent annually since the program's inception (Pinera, 2004; Rodriguez, 1999).

And the Chilean economy has benefited, too. Chile's economic growth rate has doubled and total government expenditures have fallen from 34 percent of GDP to 22 percent, with about half the gains coming from social security and welfare reform (Lewis, 2004, 291-95). The reforms have also drastically reduced the proportion of people living in poverty and unleashed forces that have brought liberal democracy and the rule of law (Pinera, 2004).

Twenty-five years ago, Chile effectively transformed its pension system from the structurally flawed Bismarckian pay-as-you-go system and started a worldwide pension reform revolution. According to Pinera, eighteen countries around the world have now introduced pension system reforms. Pinera (2001) sees many benefits to individuals and governments in going to a system of privately-managed accounts. As owners of capital, workers benefit from the appreciation of assets in the long run. Workers also feel more connected to the overall performance of their country, and their interests are more in line with those of the managers and outside investors. And above all, workers find a new dimension of freedom and dignity in their lives.

Where Does the United States Go from Here?

While it is encouraging to see the President of the United States, George W. Bush, making a case for private accounts as part of his Social Security reform agenda, it is discouraging to see such opposition and misinformation circulate on this issue. If Chile and seventeen other countries can reform their pension systems, can't the United States of America? Only a market-driven solution seems capable of resolving Social Security's imminent long-run crisis. Such a change would produce

a profound and significant increase in individual liberty, and move society further away from the “slavery and socialism” that characterize the current Social Security system to one based far more on “capitalism and freedom.”

The choice is ours...and so are the consequences.

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