Social Security's Coming Crash: The Certain End of Entitlement

by Doug Bandow

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The welfare state was born in Otto von Bismarck's Germany, a ploy of the famed Iron Chancellor designed to counter the electoral appeal of the rival Social Democrats. Thus, social security was created in 1889 and eventually spread, under several guises, to many nations. Here, the Old Age, Survivors, and Disability Insurance program (Social Security) was approved in 1935, an early victory for Franklin Delano Roosevelt as he rapidly and dramatically expanded government control over the economy. For FDR, Social Security's most important benefit was political: He recognized that once the American people got hooked on government benefits, they would never go back.

He was right.

Although Social Security has long been viewed as the third rail of American politics—touch it and die—it really is better seen as a symbol of America's entitlement culture. The United States lags behind Europe but nevertheless has constructed an expensive and expansive welfare state. Virtually all spending programs go up each year, regardless of which party controls Washington, and the most outlandish increases have been concentrated in the big three social-welfare systems: Social Security, Medicare, and Medicaid.

The challenge of paying for the welfare state has grown over the last year.

U.S. GDP is about $14 trillion. One year of economic output already is committed to paying off the national debt, which is now above $12 trillion and climbing fast.

Washington is running a deficit of some two trillion dollars this year and is expected to pile up another ten trillion in debt over the next decade. In fact, these estimates are low: Fannie Mae, Freddie Mac, the FDIC, the Pension Benefit Guaranty Corporation, the Federal Housing Administration, and who knows what else continue to run up big losses and will need more bailouts. So count another year's production toward the federal debt.

Then there is all of the funny money used to fund the estimated $13 trillion in bailouts doled out over the last year. Some of the cash, such as the so-called TARP money (the financial-institutions bailout that somehow was used to nationalize the auto industry), was appropriated by Congress. But between the Treasury Department and Federal Reserve there have also been loans, guarantees, and money creation. It is hard to know what it ultimately will mean in financial terms, but another year of America's economic life will certainly be lost.

Finally, there are Social Security and Medicare. Together, they have about $107 trillion in "unfunded liabilities." In real-people-speak, that is the difference between promised benefits and expected revenues. That amounts to about eight years of America's economic production and twice the world's annual GDP.

Social Security and Medicare are disastrously unbalanced for three reasons. First, "contributions" to Social Security and Medicare are insufficient to provide the promised benefits. Indeed, Social Security operates as a classic Ponzi scheme, with new contributions used to pay off earlier "investors."

Second, life expectancy is up, and fertility rates are down. The population is aging, with a larger number of elderly living longer. This is good news for people but bad news for Uncle Sam.

Third, medical outlays are increasing rapidly. In recent decades Medicare outlays have risen three percent annually above the increase in *per capita* GDP. Since the elderly consume far more healthcare services than younger Americans do, this factor compounds the impact of demography.

Even before last fall's financial crash, then-comptroller general David M. Walker warned, "The only thing the United States is able to do a little after 2040 is pay interest on massive and growing federal debt. The model blows up in the mid-2040s. What does that mean? Argentina."

Insolvency is not the only problem facing Social Security. The system is essentially stealing from those now entering the workforce.

The rate of return was good for early recipients because they had low payroll tax rates and paid in only for a few years. The very first recipient, Miss Ida May Fuller, contributed (herself and through her employer) just $49.50 in payroll taxes before she retired at age 65. She lived to 100 and collected $22,888.92 in benefits. Although not all early recipients made out so handsomely, many beneficiaries received back their lifetime Social Security "contribution" in months rather than years.

But as the number of workers per retiree has fallen—from 42-to-1 in 1940 to about 3-to-1 today, on the way to below 2-to-1—the tax rate has risen dramatically. Many people of modest means pay more in Social Security deductions than they pay in income taxes. Increasing numbers of young workers now will lose money, assuming there is money available to pay for their benefits when they retire.

Almost every proposed "reform" scheme would further drive down the system's return, increasing taxes while cutting benefits. The program has become the worst sort of fool's bargain—at least for everyone but the politicians who take credit for handing out money to a pliant population.

Last fall's stock-market collapse demonstrates that private markets offer no guarantees. But that uncertainty should be contrasted with the certain bad deal from the federal government. Moreover, the return on private investment has remained well above the levels for Social Security even when measured against major stock-market downturns. The rate of return was over three percent annually, handily beating Social Security's return these days, for even the worst 20-year period in American history, which encompasses the Great Depression.

Furthermore, Social Security's nominal rate of return needs to be discounted by its negative impact on the economy. The program reduces both the amount of money available for workers to save and their incentive to save. By diminishing the resources available for economic investment, Social Security reduces both GDP and real wages in future years. Estimates of that loss range from five to ten percent. Integrating that impact into current rates of return makes today's average return negative.

Advocates of Social Security claim that it benefits lowincome recipients, but Social Security actually discriminates against women, minorities, and anyone else with a shorter life expectancy. Moreover, the program was developed for two-parent, single-earner households. Under the current rules, two-earner couples, singles, and young divorcÃ©es—an ever-larger share of the population—are at a disadvantage.

Social Security is more than just a financial bad deal. The program undermines personal responsibility by discouraging saving and encouraging early retirement. Equally damaging, Social Security shifts the duty of caring for our elders to the government. As a result, many Americans end up dependent—a substantial number almost wholly dependent—on government.

Social Security discourages private saving in two ways. First, it takes money that otherwise would be invested in economically productive private activities and dumps it into the Treasury (the "trust fund" is a political fraud) for redistribution by Washington. This year about $560 billion is disappearing into Uncle Sam's porous pocket.

Second, creating a government retirement system makes private saving less necessary. Social Security reduces investment, economic productivity, job creation, and overall growth. Harvard's Martin Feldstein figures that Social Security "benefits replace more than 80 percent of peak preretirement after-tax income. Common sense and casual observation suggest that individuals who can expect such a high replacement rate will do little saving for their retirement." The financial crisis has exacerbated this tendency: More than one third of those between 45 and 54 have stopped contributing to private retirement accounts.

Social Security almost certainly has had a deeper social impact. The program creates a powerful incentive for earlier retirement. Obviously, people may retire whenever they desire and can afford to do so. But it is foolish for Washington to push people into retirement. The National Center for Policy Analysis reports that since the program's beginning the percentage of men over 65 who work has dropped by half. The work-participation rate fell as Social Security covered more men and delivered greater benefits.

The program also has transformed the workplace. The payroll tax directly penalizes employment, discouraging job creation. For the average family, writes Feldstein, Social Security "raises the total marginal tax rate to more than 40 percent and substantially exacerbates the distortions and waste caused by the income tax." The levy also influences choices on how many hours to work and how to structure compensation—emphasizing untaxed fringe and nonpecuniary benefits. This is a particularly perverse incentive for a government pension system funded through employment. Penalizing workers means that people will work and save less, and retire sooner. In turn, there will be fewer workers to support each retiree. This reduction in the number of workers per beneficiary is the principal reason Social Security is rapidly approaching collapse.

The change wrought by Social Security is not just economic but philosophical. Children now see the government rather than the family as having primary responsibility for providing retirement security. And retirees believe the government "owes" them their Social Security benefits. (In fact, the Supreme Court has ruled that Uncle Sam has no legal obligation to pay.)

Intergenerational ties are often difficult to maintain, but they are among the strongest bonds of community. The ultimate result of social welfare is, as Chancellor Bismarck intended, to encourage widespread dependency on the state. America's Founding Fathers feared this possibility. As Thomas Jefferson put it, "Dependence begets subservience and venality."

The imminent collapse of Social Security adds another element to the studied campaign to make people dependent. Never mind that successive presidents and Congresses have promised to protect the elderly. Never mind that policymakers have discouraged Americans from preparing for their own retirement. Never mind traditional notions of commitment, trust, and honor. Uncle Sam will leave everyone high and dry without even a glance backward.

We must confront the welfare state and the entitlement mentality that underlies it. To do that, we must transform Social Security.

The longer we wait, the more difficult it becomes to close the gap. Last year was particularly bad because of the economic crunch; the total unfunded liability for Social Security and Medicare grew by nearly six billion dollars. Reforms are hardest to apply to those who have already retired: "Delaying action until the baby boom is in full retirement insures that the next generation will bear the burden of current inaction," argue Andrew J. Rettenmaier and Thomas R. Saving of the Private Enterprise Research Center at Texas A&M University.

And that cost will be huge. David M. Walker observes that

> Failure to take steps to address our large and structural long-range fiscal imbalance, which is driven in large part by projected increases in Medicare, Medicaid, and Social Security spending, will ultimately have significant adverse consequences for our future economy and the quality of life of our children, grandchildren, and future generations of Americans. As a result, the federal government needs to engage in a fundamental review, reassessment, and reprioritization that will ultimately have to span all major spending programs and tax policies.

Perhaps economic reality will finally force Congress to act. For Social Security has become the reverse third rail of government finance: Don't touch it, and America's economy dies.