

## **ECONOMICS, POLITICS, AND THE COMING COLLAPSE OF THE ELDERLY WELFARE STATE**

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Americans live in what is largely a free society, relying primarily on market price and profit-and-loss signals to motivate people to use scarce resources efficiently. Because market transactions are mutually voluntary exchanges, they are also mutually beneficial, since, by definition, each party wants what he or she is trading *for* more than what they are trading *to* the other party, and is made better off by the exchange in their own opinion. Economists term this a “positive sum game,” and it includes productive exchanges, such as employment relationships. There are minor qualifications to the claim that such transactions are intrinsically positive sum, such as when production exchanges result in air or water pollution that hurts third parties, or when the nature and quality of goods or services are misrepresented by one of the parties. One of the great justifications for the free society is the basic observation that, in the absence of such problems, mutually voluntary exchange is mutually beneficial.

This can be seen clearly by noting that forced exchanges do not have the same effect as voluntary transactions. If income is transferred at the point of a gun from citizen A to citizen B, so that B gains and A loses, we have no way whatsoever of knowing that the world is a happier place. We simply cannot compare people’s internal values and feelings.<sup>1</sup> Preventing such forced exchanges and other fraudulent, harmfully negligent, or dishonest acts by private parties (or foreign

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<sup>1</sup>We owe this point to the classic work of Lionel Robbins, *An Essay on the Nature and Significance of Economic Science* (New York: Macmillan, 1932).

governments) is one of the main reasons government is necessary, and was constitutionally established in this country. Unfortunately, people desiring to obtain such transfers, or to gain and maintain power by catering to those who desire transfers, have come to dominate governmental policy in our day, so that government itself has become the primary agent of compulsory income transfers. In an earlier period of greater personal and public honesty, such compulsory transfers would have rightly been termed thefts.

Coerced governmental income transfers may even be more costly and less justifiable than private theft. Private thieves often redistribute income dollar for dollar, without costly intermediation. The government can never take a particular sum of money from one citizen or group of citizens, and give that same amount to another citizen or group of citizens, for the very simple reason that a large fraction of the money taken must go to pay the salaries of the bureaucracy administering the transfers, and to pay for the buildings, power and equipment they use, and other overhead costs.<sup>2</sup> This payment, known as the “resource cost” of the bureaucracy, essentially measures the value of private sector production *lost* as those people and other resources are drawn from private employments into the public sector and used instead simply to redistribute a portion of the remaining aggregate output and income.

Additional real output and income is lost because the taxation to finance such transfers imposes costs on taxpayers above the revenue yielded. This includes, among other things, reducing their incentive at the margin to work, save, and invest, so that, for this reason also, fewer goods and services are produced than would be if tax rates were lower.<sup>3</sup> Recipients of the subsidies also tend to reduce their employment and earned income, thus trading part of the additional income they have received for increased leisure time, so that they have more of both.<sup>4</sup>

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<sup>2</sup>In some cases, this resource cost is known to absorb as much as 75 percent of each dollar budgeted to a redistributive agency. See Robert L. Woodson, *Breaking the Poverty Cycle: Private Sector Alternatives to the Welfare State* (Harrisburg, Penn.: Commonwealth Foundation, 1989), p. 63.

<sup>3</sup>One political scientist, summarizing many economic studies, estimated the additional costs of taxation born by the public to be 65 percent of net tax revenue. See James L. Payne, “Unhappy Returns,” *Policy Review* (Winter 1992), pp. 18–24.

<sup>4</sup>When the War on Poverty began in the late 1960s, labor force participation rates of the most affected groups fell significantly. See Charles Murray,

This also reduces real production and income, both gross and per capita, *ceteris paribus*. For these and other reasons, compulsory income redistribution is a *negative* sum game from which some people gain and others lose, but in which the sum of the losses exceeds the sum of the gains.<sup>5</sup>

### ORIGINS AND NATURE OF SOCIAL SECURITY

In the light of this background, consider the central element of the elderly welfare state: social security. It is crucial to note that this system became law only under the emergency conditions of the Great Depression. At least since the turn of the century, the institutionalization of such a program had been debated. It is understandable that there was increasing concern with care of the elderly at that time, since there were coming to be so many more of them than before. The free market was rapidly raising the living standards and health of ordinary persons, thus raising life expectancy enormously.

On the other hand, the same rising per capita incomes and living standards were making it easier than ever before for people to provide for their own retirement during their working lives. Studies in the 1920s demonstrated that there was very little meaningful problem of elderly poverty and privation to be solved by a compulsory retirement program.<sup>6</sup> With very few exceptions, the elderly simply kept working, retired on private savings or pensions (which were rapidly increasing in number and value), or were taken care of by family. Private charity was available for the two or three percent of the aged who fell through the cracks. Things were improving steadily, and the public at that time strongly opposed governmental creation of a compulsory social security system.

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*Losing Ground: American Social Policy, 1950–1980* (New York: Basic Books, 1984), in the appendix. Controlled studies such as the New Jersey-Pennsylvania and Seattle-Denver income maintenance experiments also found large labor force withdrawal. See, for example, John F. Cogan, *Negative Income Taxation and Labor Supply: New Evidence from the New Jersey-Pennsylvania Experiment* (Santa Monica, Calif.: Rand Corporation, 1978).

<sup>5</sup>For brevity, I have here omitted discussion of another major cost of redistributive politics, known as the rent-seeking cost. See Gordon Tullock, “The Welfare Costs of Tariffs, Monopolies, and Theft,” *Western Economic Journal* 5 (June 1967), pp. 224–32.

<sup>6</sup>Carolyn Weaver, “Support of the Elderly Before the Depression,” *Cato Journal* 7 no. 2 (Fall 1987), pp. 503–25.

Then came the Great Depression, with massive unemployment and distress that lasted over a decade.<sup>7</sup> In these desperate circumstances, the public accepted legal institutionalization of compulsory social security as a result of two brilliant, fraudulent appeals by its advocates, both in and out of the Roosevelt Administration. The first was that employers would be forced to pay half of the tax for workers. Since it was as true then as now that employees vastly outnumbered employers among voters, this promise of compulsory redistribution between employers and employees enormously increased public support for such a system. However, it was not true. Employee compensation is not economically arbitrary. Upper limits are set by the market value of worker's marginal contributions to the output of the firm. The employer tax simply reduced labor demand over time until wage rates were enough lower than they otherwise would have been to offset the compulsory employer contributions. But appearances are deceiving, and employees still do not realize they are bearing the entire cost.

Notice, by the way, that it does not greatly matter for the ethical character of this brilliant and successful political strategy, whether the proponents of social security themselves understood the economics of tax incidence enough to realize that virtually the entire employer burden would be shifted to employees over time. The appeal Roosevelt and his supporters made was to base human motives: to the desire to obtain something for nothing, and to class envy and resentment of employers by workers, resentment that the progressive left had long cultivated.<sup>8</sup> If, however, the initial proponents of compulsory social security really did understand the economic incidence of this type of tax (in contrast to its legal incidence), workers not only were appealed

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<sup>7</sup>For a brief explanation of the depth and length of the Depression, see James Rolph Edwards, "American Liberty in Decline, 1865–2000: The Progressive Substitution of State Coercion for Individual Cooperation," *The Montana Professor* 11, no. 1 (Winter 2001), pp. 20–21. For an excellent book-length treatment, see Robert E. Hall and J. David Ferguson, *The Great Depression: An International Disaster of Perverse Economic Policies* (Ann Arbor: University of Michigan Press, 1998). See also Richard K. Vedder and Lowell Gallaway, *Out of Work* (New York: Holmes & Meier, 1993), chaps. 5–7.

<sup>8</sup>Primarily this was done by propagating, through every imaginable forum, including the government K–12 education system that nearly everyone's children must attend, the false claim that employers in free markets systematically exploit employees through underpayment. For contrary historical and empirical evidence, see James Rolph Edwards, "Deflating the Union Mythology," *The Margin* (Fall 1992), pp. 58–59.

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to on their baser instincts for support of the program, but were successfully lied to in the process.

The second fraudulent claim was that, aside from being universal and compulsory, social security would otherwise act like a private pension or insurance plan.<sup>9</sup> Thus, advocates speak of social security “contributions,” “retirement payments,” and a “trust fund.” Yet, in no essential characteristic is social security like private pensions. In a private pension plan, not only is participation voluntary, but the contributions are invested in financial asset markets where they add to the supply of financial capital available to business for investments in physical assets or research and development, which increase productivity over time and literally generate the future income and output for future retirement payments and consumption.

Americans have been propagandized to believe that social security payments they receive after retirement constitute interest and principal on their earlier compulsory tax contributions to the system, and to this day most of them actually believe that. Yet despite an initial promise that the system would be fully funded, and endless talk since about a social security “trust fund,” the government amended the law in 1939 and began making payments to current retirees from the tax payments of contemporaneous workers, *not* from principal and interest on the retiree’s own earlier social security tax payments. Social security is a compulsory, intergenerational income transfer in which successive generations participate on both ends of the income redistribution in sequence. It is *not* a retirement fund or insurance contract in which a contributor has a property right to promised benefits. This was admitted by the U.S. Supreme court in *Helvering v. Davis* (301 U.S. 619, 1937) and *Flemming v. Nestor* (363 U.S. 603, 1960). Like all compulsory income transfers, it makes some people better off in the present only by making others worse off in the present, and is a negative sum game that makes us worse off in the aggregate, over our whole lifetimes, than we would otherwise be.<sup>10</sup>

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<sup>9</sup>The Committee on Economic Security, created by President Roosevelt in 1934 to develop a proposal for a social security bill, deliberately advocated structuring social security on the appearance of a private insurance company model, in an effort to gain the maximum possible support from a public most of the members of which had no desire to receive subsidies from taxes on other working citizens.

<sup>10</sup>One of the achievements claimed for social security about which its advocates are most proud is that it reduced the poverty rate among the elderly. See

As social security tax payments are made, all that currently accumulates in the trust fund is government bonds, consisting of promises to pay principal plus interest from future taxation. As the tax revenues obtained from current workers are received, the money is immediately paid out to current retirees.<sup>11</sup> If there is a current surplus of social security tax revenues over current payments to retirees (as there has been recently), government bonds equal in value to that surplus are added to the fund, and that extra revenue is used for *other* current government expenditures. Compare this government paper shuffling with a typical act of corporate borrowing, in which a bond is sold to a voluntary purchaser, and the funds are used to increase the productive physical assets of the firm, creating jobs and generating future production of real goods and services for sale to voluntary purchasers, and hence revenue from which to pay principal and interest on the bond. If the firm always used the funds instead to pay off past lenders, and never for investment in productive assets, we would immediately see the inherent fraudulence and bankruptcy of the process.

There are three reasons why the social security system seemed to work well in the beginning. First, both tax and benefit levels were relatively low. Second, life spans were lower than they are now. In 1935, when the system originated, mean life expectancy, though much higher than in earlier times, was only 61.7 years, which was actually *less* than the retirement age of 65 specified by the social security act. Third, the old were still a relatively small fraction of the population, so there were many workers paying into the system for each retiree drawing payments. Nevertheless, the system began reducing labor

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Federal Reserve Bank of San Francisco, *Economic Newsletter* (June 25, 1999). There are two problems with this claim. First, it could only do so by making younger workers *poorer*, a fact those advocates carefully never mention. Second, with real per capita incomes rising over time, the elderly poverty rate would have declined *without* social security, and might well have done so at a more rapid rate, given that the expansion of the regulatory welfare state (including social security) demonstrably reduced the growth of productivity in the U.S. after 1971. See Richard K. Vedder, "Federal Regulation's Impact on the Productivity Slowdown: A Trillion Dollar Drag," Center for the Study of American Business, *Policy Study Number 131* (July 1996).

<sup>11</sup>Interest is paid on bonds in the fund by adding new bonds of a value equal to accrued interest. And, of course, maturing bonds must be retired. Actually, old bonds in the trust fund are simply rolled over into new bonds of equivalent value as social security tax revenue is received and then paid out to current retirees.

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force participation immediately by motivating people to retire earlier than they otherwise would have.<sup>12</sup> This withdrawal of labor from employment, though small at first, reduced aggregate output and both gross and per capita income over time, relative to what they would have been. People who are not working—as a result of distorted incentives—are not producing.

It may be that the worst effect of this compulsory intergenerational income transfer is the least known. People's primary motive for saving is to provide for their retirement. Because Social Security provides "defined" benefits (independent of contributions), *social security taxes and benefits have reduced the national saving rate*, thereby lowering the national rates of capital formation, productivity, and real income growth over time, *ceteris paribus*.<sup>13</sup> In stark contrast to the effect of private pensions, this tends to *reduce* the nation's capacity to provide for the retirement payments and consumption of the elderly. Simultaneously, the burden of retirement payments keeps rising. As birth rates keep falling and life spans rise, both the average age and the retired fraction of the population naturally increase while the working fraction tends to fall. Add to this the increasing temptation for politicians in successive elections to buy the votes of the elderly and near elderly by raising real benefit payments, and an eventual default of the system—partial or total—becomes essentially inevitable.

Social Security is an immense "Ponzi" Scheme or compulsory pyramid. The defining characteristic of a pyramid scheme, as Brink Lindsey recently pointed out, is that investor's money is never put to

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<sup>12</sup>Jonathan Gruber and David Wise, "Social Security and Retirement: an International Comparison," *American Economic Review Papers and Proceedings* 88, no. 2 (May 1998), pp. 158–67. Gruber and Wise summarize 11 papers written by an international team of economists studying the negative effects of compulsory, pay-as-you-go retirement systems on labor force participation in America, Canada, and the European welfare states.

<sup>13</sup>See Martin Feldstein, "Social Security and Saving: New Time Series Evidence," *National Tax Journal* (June 1996), pp. 151–64. See also Isaac Ehrlich and Jian-Guo Zhong, "Social Security and the Real Economy: An Inquiry into Some Neglected Issues," *American Economic Review Papers and Proceedings* 88, no. 2 (May 1998), pp. 151–57. The non-partisan Congressional Budget Office agrees that social security reduces the saving rate. See Congressional Budget Office, *Social Security and Private Saving: A Review of the Empirical Evidence* (Washington, D.C.: U.S. Government Printing Office, 1998), p. 30.

any productive use. Instead, it is diverted to pay off earlier investors. Though nowadays, defenders of compulsory social security bitterly deny that it is a Ponzi scheme, for some time, prominent advocates of the system were proud of this fact. Consider this 1967 statement by the Keynesian economist Paul Samuelson, one of the greatest advocates of the Welfare State:

The Beauty of social insurance is that it is actuarially un-sound. Everyone who reaches retirement age is given benefit privileges that far exceed anything he has paid in. . . . How is this possible? It stems from the fact that the national product is growing at compound interest. . . . Always there are more youths than old folks in a growing population. . . . A growing nation is the greatest Ponzi game ever contrived.<sup>14</sup>

How can it have failed to occur to such an eminent economist that all pyramid schemes eventually collapse, and that this one contained the seeds of its own doom? Yes, there are always more youths than old folks in a *growing* population, but population growth had been slowing and the population was aging long before Samuelson wrote this. Did he not grasp that the provision of compulsory Social Security, by diminishing the personal perceived need for children, adds to the effect that rising per capita real income has of reducing birth rates, thus progressively reducing the working fraction of the population while the retired fraction is rising?<sup>15</sup> Such is the blindness induced by statist ideology.

### THE COMING DEFAULT

By now, the proximate factors that will bring the social security system to crisis are well known. For one, mean life expectancy has risen dramatically and retirement ages have fallen, so that people are

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<sup>14</sup>As quoted in Brink Lindsey, "Social Insecurity," *Reason* 33 no. 10 (March 2002), p. 46.

<sup>15</sup>In an underdeveloped nation, birth rates must be high precisely because infant mortality rates are high, and having progeny is the primary mechanism of retirement insurance for an adult. As markets and industry develop and real incomes rise, however, the necessity for this mechanism is reduced, and birth rates fall, eventually reducing population growth. *All* developed nations have experienced this. In fact, birth rates have actually fallen *below* the replacement level in many European and other developed nations. Compulsory, defined benefit social security systems have clearly augmented this effect.

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spending less time paying into the system and more time collecting from it. More important, while the post-World War II baby boom provided lots of workers to finance the system, it was followed by much lower birth rates and population growth. In 1950, there were 17 workers per retiree. It is now three to one, and the boomers begin retiring around 2008. By 2030, if not before, there will only be two workers per retiree, and they will not be willing to be taxed for social security at the enormous rates necessary to provide the boomers—my generation—with real benefit levels anything like those being enjoyed by the current generation of retirees. As early as 2015, the system will begin paying out more than it takes in, forcing it to sell bonds from the trust fund for money to cover the difference, and in a decade or two after that, the trust fund itself will be empty.<sup>16</sup>

A few extreme defenders of the system dispute this. Some have expressed belief that large increases in female labor force participation will provide many additional workers to feed revenue to baby boom retirees. Indeed, it is true that the number of workers per retiree has actually risen slightly since 1975, when it was only 2.7, reaching 3.0 in 1999, and entry of females into the labor force was the big factor. Black female labor force participation is still increasing rapidly, but blacks are a relatively small fraction of the population. White female labor force participation is still rising, but only slightly, and has been slowing toward a stop. Worse, both black and white *male* labor force participation rates have been *declining* for decades. As it nets out, *the overall labor force participation rate grew very little in the nineties, and not at all in the last three years of that decade.*<sup>17</sup> It is likely at or near its peak. When the boomers retire, and probably before, labor force participation and the number of workers per retiree will start declining rapidly. There is little hope in any of this for demographic salvation of social security.<sup>18</sup>

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<sup>16</sup>Because the surplus of current social security tax revenues over current expenditures is being used to provide for other current government expenditures, problems will begin immediately when that surplus disappears, if not before. The government will either have to reduce those expenditures, raise taxes, or borrow money to continue them. In the latter case, a danger is that government may monetize much of the debt and generate inflation.

<sup>17</sup>See Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 2001), table B-40, p. 322.

<sup>18</sup>The Federal Reserve Bank of Cleveland reported a few years back that Medicare, another prominent pillar of the elderly welfare state, is facing a worse

Notice that the coming default would have been precluded if the social security system had been fully funded, that is, had allowed people's payments to be privately invested like a private retirement plan. No matter how large the baby boom cohort was, their payments would have generated the real output and income for their retirement. But this was not done, and some default is now almost inevitable if we do not soon move strongly in that direction. The political economy motives behind unfunded systems is fairly clear. When Otto von Bismarck enacted the first compulsory social security system in the 1880s in Germany, he could have simply required people to save, and let private investment firms manage the money. But that would not have done his *government* any good. It was far better, as Bismarck himself made clear, to have them receiving checks from, and being dependent on, the government, to cement their loyalty to the state.<sup>19</sup> The same ideologically statist reasoning, conscious or subconscious, motivated the administration of Franklin Roosevelt half a century later, and continues to motivate the defenders of government social security to this day.<sup>20</sup>

If the current political deadlock prevents reform of social security in the next few years, we will soon learn the folly of the belief that the power to tax makes default impossible, so that government can operate a fraudulent retirement system with impunity. At that point in time, my generation will come face to face with the terrible truth. When they realize they have paid all their working lives into the system and are able to obtain only little or nothing from it, all delusions will fall away, and they will be unable to deny that they have been massively stolen from. This may precipitate the worst political crisis since the Civil War.

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crisis than social security is facing, with expenditures at that time already exceeding current income, so that the medicare trust fund was already declining, and projected to be exhausted very early in the 21st century. See Cleveland Federal Reserve Bank, "Medicare Insolvency," *Economic Trends* (May 1997).

<sup>19</sup>Lindsey, "Social Insecurity," p. 45.

<sup>20</sup>Do not interpret my discussion here as indicating that I favor governmentally coerced private saving and investment, in the sense that such a social policy would be my first option. My first option is personal freedom, and personal responsibility for the consequences of one's choices, including provision for old age, with family responsibility and voluntary charity for victims of unforeseeable adverse circumstances.

## CRISIS AND OPPORTUNITY

Fortunately, we are not the first nation to face this crisis, and we can take instruction from those who have gone before. More than 40 different nations, including Great Britain, Chile, Italy, and Singapore have already privatized their social security systems to varying degrees. Chile began the trend, privatizing almost totally, and, consequently, has had the most spectacular success. Chile's system was very similar to ours, but it reached its crisis sooner, as demographic changes caused the system's outlays to exceed its revenues. In 1981, the Chilean government began allowing private companies to compete to manage the retirement savings of dependent workers, and allowing those workers to decide within wide limits how much to contribute. Also, a minimum pension guarantee was included to reduce risk from bad investments.<sup>21</sup> Chilean workers had the option of staying in the old system, but 90 percent chose not to do so.

It is true that this was done in the context of other, similar reforms. The Chileans scrapped trade barriers, privatized government-owned enterprises, and reduced the entire government sector by more than 50 percent. In combination with private management and investment of retirement funds, this increased their saving rate to 25 percent, and raised real economic growth to seven percent per year. As a result, pensions under the new system have been enormously higher in real terms—between 51 and 57 percent higher—than they were under the old system.<sup>22</sup> This was accomplished with *lower* retirement tax rates.

President Bush rather timidly wants to allow only a small fraction of worker's social security taxes—perhaps two percentage points—

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<sup>21</sup>See Sebastian Edwards, "The Chilean Pension Reform: A Pioneering Program," in *Privatizing Social Security*, ed. Martin Feldstein (Chicago: University of Chicago Press, 1998), pp. 33–62, for a comprehensive discussion of the Chilean reform. See also Peter Diamond and Salvador Valdez-Prieto, "Social Security Reforms," in *The Chilean Economy: Policy Lessons and Challenges*, ed. Barry Bosworth, Rudiger Dornbusch, and Raúl Labán (Washington, D.C.: Brookings Institution, 1994), pp. 257–328.

<sup>22</sup>See Sergio Baeza and Raul Burger, "Calidad de las Pensiones del Sistema Privado Chileno," in *Quince Anos Despues: Una Mirada al Sistema Privado de Pensiones*, ed. Baeza and Francisco Margozzini (Santiago, Chile: Centro de Estudios Publicos, 1995), pp. 165–75. Official data show an arithmetic annual average real rate of return of 11.3 percent over the 18 years from 1981 to 1999. See Superintendencia de Administradoras de Fondos de Pensiones, *Boletin Estadistico*, no. 148 (Santiago, Chile, 1999), p. 339.

to be invested in private retirement accounts. The opposition even to this from proponents of the current system is bitter. They dogmatically oppose even a marginal rollback in the elderly welfare state, fearing the loss of their political constituency if people are allowed to experience the benefits of even partial privatization. Worse, from their perspective, if the system became fully funded and people owned their own retirement accounts (even having the right to bequeath them to their spouses and children), it would become easy to go the next logical step, and remove the compulsory element altogether, moving a large increment back toward the free society that statist liberals have worked so hard for so long to abolish.

### ***Risk and Return***

Opponents of privatization have relied primarily on two objections. One is that privatization would subject workers to risks they do not now face, since individual stock returns vary, and the whole market rises and falls randomly. To their credit, few of these opponents deny either that the stock market rises and falls around a rising long term trend, or that stocks earn higher yields than does social security.

This “risk” objection is not persuasive, for various reasons. For one, the endlessly repeated assertion that the present system has no risks associated with it is simply wrong. The risk of default on benefits promised by the government is very high. Indeed, *marginal default has already begun*. In 1983, the government began gradually increasing the retirement age toward 67, and taxing benefits for middle and upper income earners. These taxes were increased in 1993. In addition, even if all present promises are kept, the real rate of return—nominal return above inflation—that can be expected by future retirees on their tax payments is a miserably low 2.9 percent for low-wage workers, and an even worse 0.58 percent for high-wage workers. The return obtained by blacks is actually *negative*, since their mean life expectancy is lower than that of whites.<sup>23</sup>

Now obviously, the closer the probability of an adverse outcome approaches to 100 percent, the *greater* is the risk being experienced by those facing that outcome. Only someone extraordinarily ignorant

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<sup>23</sup>According to Thomas F. Siems, a senior economist and policy adviser at the Federal Reserve Bank of Dallas. See Siems, “Reengineering Social Security in the New Economy,” *SSP #22, Cato Project on Social Security Privatization* (January 23, 2001), pp. 1 and 12.

or extraordinarily dishonest would claim that *certainty* of the low returns obtained from the current system means citizens covered by that system face no risk, while citizens in a privatized system earning higher average returns with greater variability would experience risk. Yet that is precisely what is claimed every day by advocates of the current system who endlessly stress the variability of stock prices and returns while lauding the alleged “security” and stability of social security payments.

The mathematics of expected values simply settles the matter. The expected return on payments into the current system is mathematically far *less*, dollar for dollar, than that of money actually invested in the financial markets at the known, long-term levels, growth, and variability of market returns. From 1926 to 1996, U.S. stocks averaged a 13 percent nominal rate of return, even though returns varied in a normal frequency distribution all the way from -40 percent or worse (in very infrequent periods such as the great crash) to +60 percent or better, with two-thirds of the observations falling between -8 and +34 percent.<sup>24</sup> This 13 percent average return was about 11 percent net of inflation. Returns on social security payments have only averaged about 3.6 percent (and declining) in real terms. Even assuming pessimistically that the somewhat slower economic growth experienced by the U.S. since the early 1970s continues after privatization, one could conservatively expect nominal stock returns in the future to average at least 10 percent, with real returns of at least 8 percent.

The return on capital invested in the U.S. economy is greater than the rate of growth of wages, and it is the latter which determines the long-run rate of return in a government pay-as-you-go retirement system. Deducting a percentage point from market returns for administrative costs of the private retirement account managers would leave market returns earned by workers in a privatized system enormously higher than social security returns. Indeed, even were the economy to grow at far lower than normal rates in the future, the market average rate of return would still greatly exceed that of social security.<sup>25</sup>

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<sup>24</sup>Melissa Hieger and William Shipman, “Common Objections to a Market-Based Social Security System: A Response,” *SSP #10, Cato Project on Social Security Privatization* (July 22, 1997), p. 7.

<sup>25</sup>See Andrew Biggs, “Social Security: Is It a Crisis that Doesn’t Exist?” *SSP #21, Cato Project on Social Security Privatization* (October 5, 2000), pp. 1 and 30–32.

Another reason the market risk argument fails is that nobody has to be subjected to market risks they do not wish to bear. A social security reform law can simply be written to allow any workers *who wish to do so* to invest their tax contributions in private accounts, leaving others to stay with the current system if they prefer. Other protections against bad investments by particular account managers can also be written into the law. These are the things the Chileans did, as mentioned above. What is to be noted about the American defenders of our current corrupt government Ponzi scheme, is precisely their arrogant and dictatorial unwillingness to allow others to choose for themselves. Their unremitting hostility to personal freedom is central to the whole matter.

### ***Transition Costs***

The second argument used in opposition to privatization concerns the transition cost. If current workers gain a property right in their retirement tax funds, how will we then finance payments to the current retirees? This would be a temporary problem, ending when the current generation of retirees passes on, and diminishing over time as that occurs, but still the transition cost would appear at first glance to be significant for some time. Easy answers seem available, and have been offered. Some libertarians, including myself, have long advocated financing this transition cost using money gained from sales of federal assets, such as federal land in the west, or of the many subsidized lending agencies of the federal government which chronically waste huge amounts of tax money. Money could also be saved in other federal programs, so that general tax revenue was made available. We could reduce our global military interventions, for example, and foreign basing of troops, such as those in Saudi Arabia, South Korea, and Japan. This would have the added benefit of at least marginally reducing the hatred of America by people around the world.

## **CONCLUSION**

The question of financing the transition cost to a privatized retirement system is more penetrating than one might think, however, because identification of any easily available source of funds to finance that cost also identifies means of keeping the current social security system from going broke any time soon. The question then becomes, why switch to a private system at all? In those terms, however, the answer is again easy. First, we should switch because the

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negative sum game of intergenerational income transfer will be eliminated, retirees will be made much better off, and we will prosper materially as a nation from doing so as the saving rate rises, increasing productivity and economic activity. Because this effect will itself raise tax revenue over time, *there really will be no transition cost* (or rather, the gains will more than cover any such cost). Second, we should do so because government will become more honest and open by the removal of policy based on massive and deliberate deceits and appeals to base motives on the part of the public. And last, we should do so in order to restore once again, by a large increment, basic freedoms that so many Americans have allowed to be taken away from them in exchange for an illusory security.

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