

Social Security Privatization

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Property Rights The Hidden Issue of Social Security Reform

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Executive Summary

One of the most enduring myths of Social Security is that a worker has a legal right to his Social Security benefits. Many workers assume that, if they pay Social Security taxes into the system, they have some sort of legal guarantee to the system's benefits. The truth is exactly the opposite. It has long been law that there is no legal right to Social Security. In two important cases, *Helvering v. Davis* and *Flemming v. Nestor*, the U.S. Supreme Court ruled that Social Security taxes are simply taxes and convey no property or contractual rights to Social Security benefits.

As a result, a worker's retirement security is entirely dependent on the political decisions of the president and Congress. Benefits may be

reduced or even eliminated at any time. Given the program's looming financial crisis, benefit cutbacks are increasingly likely. Therefore, the entirely political nature of Social Security places workers' retirement security at considerable risk. Indeed, Congress has already arbitrarily reduced Social Security benefits of some groups of workers. Moreover, because Social Security benefits are not a worker's property, they are not inheritable.

In contrast, a privatized Social Security system, based on individual accounts, would provide workers with the benefits and the safeguards of true ownership. Benefits could not be arbitrarily reduced or taken away by the government. In addition, workers could pass their benefits on to their heirs like any other property.

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Introduction

One of the most enduring myths of Social Security is that there is a right to Social Security benefits. Many workers assume that, if they pay Social Security taxes “into the system,” they have some sort of legal right to benefits “out of the system.” That is not surprising. Much of the language surrounding the Social Security program is designed to convey that impression. For example, payroll taxes are called “insurance contributions” under the Federal Insurance Contribution Act. Social Security monies are placed in a “trust fund” to pay “Old-Age and Survivors Insurance” benefits.

In reality, however, all those terms are misleading to the point of dishonesty. The U.S. Supreme Court has ruled that payroll taxes are not “contributions” but are taxes like any others. Social Security has nothing to do with “insurance” contracts or any other type of contract, and nothing to do with segregated “accounts.” Paying Social Security taxes does not give rise to any contractual right to Social Security benefits. In the Social Security Trust Fund, no property is held in trust for any worker or collection of workers.

In *Flemming v. Nestor*, decided in 1960, the Supreme Court ruled that Social Security is an umbrella term for two schemes that are legally unrelated.¹ One is a taxation scheme, the other a welfare scheme. Workers and their families have no legal claim on the tax payments that they make into the U.S. Treasury or that are made on their behalf. Those funds are gone, commingled with the general assets of the U.S. government. This decision rested on a previous case, *Helvering v. Davis*, in which the Court ruled that Social Security was *not* an insurance program.²

As a result, a worker’s retirement security is entirely dependent on political decisions made by the president and Congress. Benefits may be reduced or even eliminated at any time. Indeed, Congress has already arbitrarily reduced the benefits of some groups of workers. In contrast, a privatized Social Security system, based on individual accounts, would provide workers with the protections and the safeguards that go with true ownership. In addition, under the current system, because Social Security benefits are not the worker’s property, they are not inheritable. But under a privatized system,

workers would be able to pass their benefits on to their heirs as they would any other property.

What Is Property?

When legal scholars discuss “property,” they are, in fact, discussing not a physical object but a bundle of rights.³ If there are no rights that are enforceable in some court, then, for all intents and purposes, there is no “property.” The law generally puts property into one of three general categories: real property, tangible personal property, and intangible personal property. It is the last category that is at issue in Social Security.

An example of intangible personal property is the classic “nonvariable” private annuity “contract” issued by an insurance company. The insured pays a premium to the insurance company in exchange for a promise to make periodic payments. That enforceable promise is called “insurance.” The premium belongs to the insurance company and is subject to the claims of its creditors. The premium does not exist as a separate entity, nor is it segregated. Instead, it is commingled with the general assets of the company. In return, the insured individual receives a contractual promise of benefits. Because that promise is enforceable in the courts, it is property.

Another example of intangible personal property is a bank account. That also is a contract. The deposited funds belong to the bank and are subject to the claims of its creditors. In return, the depositor possesses the bank’s enforceable promise to pay interest and principal as agreed. In other words, the bank is a debtor and the depositor is a creditor. The bank’s contractual promise (i.e., the “account”) is property.

Private property is a bundle of rights. Accordingly, “the dichotomy between personal liberties and property rights is a false one. Property does not have rights. People have rights.”⁴ Thus it is said, “The right of property is the guardian of every other right, and to deprive a people of this is in fact to deprive them of their liberty.”⁵ Were the U.S. government to own all the printing presses, the First Amendment would not be worth the paper it is printed on. We would be a citizenry of supplicants, constrained in our political expression by

the whims and the predilections of politicians and state bureaucrats.

The bundle of private rights we call property is the guardian not only of our civil rights but also of our physical welfare. Thus, a public retirement benefit scheme under which the state, rather than its citizens, has untrammelled ownership of all the underlying property is a scheme that allows the state to reduce benefits or eliminate them altogether. Social Security, as currently structured, is such a scheme because under it “participants” have no legal right to any future benefits.

Social Security Involves No Property Rights

For some time, it has been law that workers have no property rights in Social Security. Two key Supreme Court decisions established that.

The first was the 1937 case of *Helvering v. Davis*, which began as an action by a shareholder of the Edison Electric Illuminating Company of Boston, Massachusetts, to restrain the corporation from making payments and deductions called for by the Social Security Act pending adjudication of the act’s constitutionality. The federal district court declined to issue an injunction. *Helvering*, the Edison shareholder, appealed to the Circuit Court of Appeals for the First Circuit. The court of appeals held that the welfare component of Social Security was void as an invasion of powers reserved to the states or to the people by the Tenth Amendment. Accordingly, the taxation component of Social Security “collapsed” with the welfare component. The government appealed, and the Supreme Court agreed to hear the case.

One of the key issues facing the Court was whether Social Security was an insurance program or simply a welfare program. Although at the time the federal government’s authority to operate a welfare program was under debate (indeed, the plaintiffs in *Helvering* challenged that authority), it was generally agreed that a federal insurance program would be unconstitutional. As Edward Witte, executive director of the research staff of the Committee on Economic Security and one of the fathers of Social Security, warned supporters, “The only hope . . . is that the Court will find [the Social Security Act] does not, in fact, establish an old-age insur-

ance program.”⁶ In fact, the Social Security Administration was so concerned about that issue that it warned its employees to “play down the use of terms such as insurance and not allow, in any official reports or publicity, the coupling of the tax titles with the two insurance titles lest the Court take judicial notice when considering the constitutionality of the Act.”⁷

On May 24, 1937, the Supreme Court sided with the federal government by upholding the constitutionality of the Social Security Act. In doing so, the Court essentially deferred to Congress on the question of which welfare schemes fall within the ambit of the Constitution’s General Welfare Clause. However, the Court also explicitly concluded that Social Security was not an insurance program. The Court noted, “The proceeds of both employee and employer taxes are to be paid into the treasury like any other internal revenue generally, and are not earmarked in any way.”⁸

The majority in *Helvering* did not provide a definitive answer about what legal relationship, if any, a worker has with the U.S. government with respect to his FICA payments. Social Security was not insurance. But what was it? Is the nexus between Social Security taxes and the welfare scheme so close that workers have constitutionally protected property rights in those payments? Something akin to an annuity purchased from a private insurance company? Or perhaps an individual retirement account?

That question would be decided in a second case, *Flemming v. Nestor*, which picked up where *Helvering* left off. Ephram Nestor was a one-time resident alien and, briefly, a member of the U.S. Communist Party. From December 1936 to January 1955, both Nestor and his employers had made FICA tax payments to the federal government. Classified as an undesirable alien because of his prior Communist Party affiliation, Nestor was deported to his native Bulgaria in July 1956.

In 1954, 15 years after Nestor had ceased being a communist and 18 years after he began paying his FICA taxes, Congress passed a law providing that any person who had been deported by reason of communist affiliation would have his Social Security benefits cut off. Accordingly, on his deportation, Nestor’s old-age benefits were cut off.

Nestor sued, arguing that because he had paid Social Security taxes he had a right to

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Social Security benefits. Among other things, Nestor argued that he had a “property right” in his Social Security benefits and that, by cutting off those benefits, the government had made an unlawful “taking” of his property under the Fifth Amendment.

However, the Court disagreed. Standing on the shoulders of *Helvering*, Justice Harlan wrote:

To engraft upon the Social Security system a concept of “accrued property rights” would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands.

The Court continued:

It was doubtless out of an awareness of the need for such flexibility that Congress included in the original Act, and has since retained, a clause expressly reserving to it “[t]he right to alter, amend, or repeal any provision” of the Act. S 1104, 49 Stat. 648, 42 U.S.C. s 1304, 42 U.S.C.A. s 1304. That provision makes express what is implicit in the institutional needs of the program. . . . We must conclude that a person covered by the Act has not such a right in benefit payments as would make every defeasance of “accrued” interests violative of the Due Process Clause of the Fifth Amendment.⁹

The Court also rejected any comparison of Social Security with insurance or an annuity:

It is apparent that the noncontractual interest of an employee covered by the Act cannot be soundly analogized to that of the holder of an annuity, whose right to benefits is bottomed on his contractual premium payments.¹⁰

In reaching those decisions, the Supreme Court was simply affirming the intent of Congress and the authors of Social Security, who, despite the rhetoric surrounding the program, always understood that workers would have no contractual rights to Social Security benefits.

In 1953, the House Committee on Ways and Means held hearings on that very issue. Among

the witnesses was Arthur J. Altmeyer, who, having just retired as commissioner of the Social Security Administration, had been associated with the program since its inception. Altmeyer was a reluctant witness who ultimately had to be subpoenaed to appear. However, under questioning by Rep. John Dingell Sr. (D-Mich.), he admitted, “There is no individual contract between the beneficiary and the Government.”¹¹

That led to the following exchange between Altmeyer and Rep. Lawrence Winn (R-Kans.):

Congressman Winn: Mr. Altmeyer, there being no contractual obligation between the Government and the worker, it follows, does it not, that the benefit payments under Title II of the Social Security Act are merely statutory benefits which Congress may withdraw or alter at any time?

Mr. Altmeyer: I have answered your question, sir. If you will refer to section 1101, you will find, as you read into the record, that there are no vested rights.

Congressman Winn: We have also established that there is no insurance contract between the Government and the worker within a covered wage whereby the rights and obligations of a party are set; that is correct, is it not?

Mr. Altmeyer: No. You did not establish that. That has been self-evident since the law was passed in 1935.¹²

Even the Social Security Administration’s official Web site notes that “entitlement to Social Security benefits is not [a] contractual right.”¹³ The SSA states, “There has been a temptation throughout the program’s history for some people to suppose that their FICA payroll taxes entitle them to a benefit in a legal, contractual sense.” However, SSA notes, “Congress clearly had no such limitation in mind when crafting the law.” The SSA goes on to state, “This is the issue finally settled by *Flemming v. Nestor*.” There is no right to Social Security benefits.

To reiterate, Social Security as it is currently structured is a welfare program.¹⁴ The government collects tax revenues through FICA and

commingles them with its general assets. Congress then authorizes benefit payments out of general assets to those people it deems eligible. The citizen has no “property” interest in the scheme. There is no segregated “account.” There is no “insurance contract.” There is no “trust.”

The bottom line is this: there is no legal nexus between what is taken in and what is disbursed. The government is free at any time to change the rules of the game or to close the game down altogether. When it comes to future Social Security payments, we are no more than supplicants.

Can We Trust the “Trust Fund”?

If individuals have no direct property right in Social Security, is there, perhaps, an indirect one through the Social Security Trust Fund? A “trust” is a fiduciary relationship with respect to “property.”¹⁵ The trustee takes title to the property for the benefit of the beneficiary. The trustee has a judicially enforceable duty of undivided loyalty—that is, a duty to act solely in the interest of the beneficiary. In other words, the trustee is accountable to the beneficiary. In another case, Justice Cardozo, writing for the majority, said:

A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions.¹⁶

Trust funds are segregated from the trustee’s own assets and thus are insulated from the claims of the trustee’s creditors and from diversion to purposes unrelated to the trust. The beneficiary’s interest under a “trust” is said to be an equitable, or beneficial, interest. That beneficial, or equitable, interest is itself “property.” A

simple example of such a “property” interest is a mutual fund share. The trustees of the mutual fund have the title to the underlying assets. The investors, however, have the equitable, or beneficial, interest. Although the trustees have the legal title, the actual economic interest is with the investors.

The Social Security Trust Fund involves no “trust,” as that term is commonly understood. The U.S. government is not a trustee of FICA receipts. The receipts are not segregated in the sense that they are legally insulated from diversion to governmental purposes that are unrelated to paying old-age, survivors’, or disability benefits. Social Security affords no equitable, or beneficial, property interest to anyone other than the federal government. In other words, under the current Social Security system, there is no judicially enforceable duty of undivided loyalty to workers and their families.¹⁷

Social Security, Property Rights, and Risk

The question of risk is extremely important to the debate over Social Security’s future, because much of the opposition to privatizing Social Security has been based on the faulty premise that the current Social Security system is less risky than private capital markets.

Of course, that argument overstates the risks of private markets. True, as Justice Putnam in the landmark trust case *Harvard College v. Amory* opined, “Do what you will, the capital is at hazard.”¹⁸ In other words, there is no investment that is risk free. However, over the long term, prudent, diversified private capital investments have proven remarkably safe and lucrative. That cannot be said for Social Security, which continues to place workers and their families at considerable economic risk. Why at risk? Because the scheme does not involve private property and the protections and the safeguards that go with it.

Social Security is facing a severe financial crisis. By 2014, the system will be running a deficit. Overall, Social Security is more than \$10.4 trillion in debt.¹⁹ One likely response to this shortfall will be a reduction in benefits.

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And, because workers have no property right to their benefits, Congress is free to cut them.

That would not be unprecedented. Social Security benefits have been cut in the past, both directly and indirectly. For example, the retirement age has been raised. Workers who entered the workforce in 1955 were told then that they would be able to retire at age 65 and receive full benefits. They paid taxes into the program under that expectation. However, in 1983, Congress changed the rules. Those workers must now work until age 65 years and two months to receive full benefits. For workers retiring in the future, the retirement age will continue to rise until it reaches age 67. Congress is already debating several future benefit cuts, including additional increases in the retirement age, reductions in the cost-of-living adjustment, and means testing. Indeed, if such cuts are to keep Social Security solvent, they will involve trillions of dollars in promised—but lost—benefits. That makes the current Social Security system very risky indeed.

However, the risks posed by not having a legal property right to Social Security benefits go well beyond the program's future financial problems. Some Americans have already had their Social Security benefits arbitrarily reduced as the result of political decisions. For example, in an effort to combat "double dipping," Congress cut the benefits of retired federal workers. Many federal workers retire after 20 years of service and become eligible for a government pension. Because they are still quite young, many go back to work in the private sector in jobs at which they pay Social Security taxes. However, they do not receive full Social Security benefits in exchange for those taxes. Instead, those benefits will be reduced by an amount equal to two-thirds of their federal pension. Similar reductions apply to survivors' and spousal benefits. In essence, a large portion of those federal workers' Social Security benefits has been confiscated.

The government also confiscates a portion of the benefits of individuals who work after the age of 65. The Social Security earnings test reduces Social Security benefits by one dollar for every three dollars earned above a certain threshold. Earnings tests also apply to survivors' and disability benefits.²⁰

Such unfairness is the inevitable result of a system in which benefits are determined solely

by political decisions and are unrelated to any sort of property right.

Finally, it is important to note that, because there is no property right in Social Security, benefits do not become part of an individual's estate on death but, instead, revert to the government. As a result, Social Security benefits are not inheritable. A worker might pay Social Security taxes during his entire working life, but, if that person dies young, without a spouse or children under age 18, none of his benefits may be passed on to his heirs.

In contrast, workers would have a true property right in individual accounts. Not only would such accounts earn much higher rates of return, and therefore greater retirement benefits, through private investment, but also those benefits would be the worker's property. Because a worker would *own* his retirement nest egg, the government, under the Fifth Amendment of the U.S. Constitution, could not chip away at it or take it away altogether. Government could not arbitrarily reduce benefits for some categories of workers or impose earnings tests. Funds in an individual account would be fully inheritable, like any other property in an individual's estate. For instance, if the worker purchased an annuity with the proceeds of his account, he could go to court to enforce his rights should the insurance company not comply with its agreement. The same could not be said for a worker's so-called interest in the Social Security system.

Conclusion

Despite the widespread belief that workers have a right to their Social Security benefits, it has been settled law that workers have no legal right to Social Security benefits. In *Helvering* and *Flemming*, the Supreme Court ruled that Social Security taxes are simply taxes and convey no property or contractual rights to Social Security benefits.

Thus, in the current system, a worker's retirement security is dependent entirely on political decisions made by the president and Congress. Benefits may be reduced or even eliminated at any time. Given the program's looming financial crisis, such benefit cutbacks are increasingly likely, which places workers' retirement security at considerable risk.

In contrast, a privatized Social Security system, based on individual accounts, would provide workers with true ownership of their retirement benefits and all the advantages—legal, economic, and otherwise—that go therewith.

Notes

1. *Flemming v. Nestor*, 363 U.S. 603 (1960).
2. *Helvering v. Davis*, 301 U.S. 619 (1937).
3. Tom Bethell, *The Noblest Triumph: Property and Prosperity through the Ages* (New York: St. Martin's, 1998), p. 19.
4. *Lynch v. Household Finance Corp.*, 405 U.S. 538, 552 (1972).
5. American revolutionary Arthur Lee, quoted in James W. Ely, *The Guardian of Every Other Right* (New York: Oxford University Press, 1992), p. 26. See also Bethell, p. 170.
6. Quoted in Carolyn Weaver, *The Crisis in Social Security: Economic and Political Origins* (Durham, N.C.: Duke University Press, 1982), p. 109.
7. Quoted in Charles McKinley and Robert Fraser, *Launching Social Security: 1935–1937* (Madison: University of Wisconsin Press, 1946), p. 453.
8. *Helvering* at 635.
9. *Flemming* at 610–11.
10. *Ibid.* at 610.
11. *Congressional Record* (83d Cong., 1st sess., November 27, 1953), p. 918.
12. *Ibid.*, pp. 920–21.
13. <http://www.ssa.gov/history/nestor.html>.
14. *Helvering* at 640–45.
15. Charles E. Rounds Jr., *Loring: A Trustee's Handbook* (Greenville, N.Y.: Panel, 2000), p. 1.
16. *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).
17. While not relevant to the issue of the Social Security Trust Fund, which does not constitute a true trust fund, the U.S. government, under some circumstances, may act as a common law trustee. That was suggested by the Supreme Court in the 1982 case of *United States v. Mitchell*, which involved an action against the United States for alleged mismanagement of timberlands on an Indian reservation. The Court held that “[a]ll of the necessary elements of a common-law trust are present: a trustee (the United States), a beneficiary (the Indian allottees), and a trust corpus (Indian timber, lands and funds).” None of those elements applies to the Social Security Trust Fund.
It is interesting, however, to at least consider whether the U.S. government can ever be a *suitable* trustee of any-

thing. Even its track record of looking after intangible personal property has been abysmal. Currently, there is a class action pending against the U.S. government for alleged mismanagement of funds to which it holds title as trustee for the benefit of individual Native Americans. On February 23, 1999, the *Wall Street Journal* editorialized that the dramatic events surrounding the litigation reveal a structural, even cultural, inability or unwillingness on the part of the government to act as a prudent common law trustee:

The contempt orders against Interior Secretary Bruce Babbitt and Treasury Secretary Robert Rubin grew out of a class-action law suit over the government's mishandling of 300,000 trust fund accounts totaling \$2.5 billion that it managed on behalf of American Indians. Last year, Senator John McCain said that if anyone in the private sector had operated the way the government had “they would be in jail today.” . . . Indeed, the bottom line of U.S. District Court Judge Royce Lamberth's ruling is that Washington isn't exempt from the standards it sets for private trustees . . . that the government has a fiduciary obligation to properly manage accounts it controls (Social Security trustees take note). He noted that the Bureau of Indian Affairs lacked records for \$2 billion of tribal account transactions over a 20-year period.

Why is the government chronically deficient in the stewardship department? I suggest that it is because there is no accountability. As a practical matter, the government is answerable to no one but itself. Accountability is the linchpin of the common law “trust.” It is what keeps a private trustee honest. The trustee of a private “trust” is accountable to the beneficiaries. The private trustee of a charitable trust is accountable to the state's attorney general. Accordingly, the beneficiary or the state's attorney general, as the case may be, has standing to bring the matter of a private trustee's stewardship before a court for adjudication. Litigation over the stewardships of private trustees goes on all the time in the state courts. For the private trustee, a judicial sanction of fine or removal is a credible threat. The same, however, cannot be said for the government when it purports to act as a trustee.

18. *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446, 461 (1830).

19. Dan Crippen, director, Congressional Budget Office, Testimony before the House Committee on Ways and Means, November 9, 1999, <http://waysandmeans.house.gov/fullcomm/106cong/11-9-99/11-9crip.htm>.

20. The House of Representatives has voted to repeal the earnings test for retirement, though not for disability, benefits. However, the principle still holds.