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At Least Ponzi Didn't Threaten Violence

by David G. Surdam

Suppose while perusing your annuity fund's quarterly statement you read: "By 2038, the funds will be exhausted and the contemporary contributions will be enough to pay only about 73 percent of benefits owed." Your emotions might run the gamut from outrage to fear.

In the wake of the Enron, WorldCom, and (insert the latest name) corporate scandals, legislators are decrying the lack of ethics in business and demanding more regulations.

Now consider Social Security. In the interest of accuracy, I quote the actual phrase from "Your Social Security Statement": "The excess funds are credited to Social Security's trust funds, which are expected to grow to over $4 trillion before we need to use them to pay benefits. In 2016, we'll begin paying more in benefits than we collect in taxes. By 2038, the trust funds will be exhausted and the payroll taxes collected will be enough to pay only about 73 percent of benefits owed." Let me faintly praise the Social Security Administration for at least calling your payments "taxes." For a long time, the officials preferred the term "contributions."

By concentrating their scrutiny on business ethics, the press and public are missing a bigger story. Indeed, some legislators are using the business scandals to promote Social Security and to bash privatization schemes. I find such efforts deeply ironic. Corporate scandals that upset the media and politicians usually involve allegedly using "anti-competitive" tactics; endangering the "public welfare"; employing accounting tricks to mislead citizens; using willfully obfuscating terminology; exploiting consumers' "greed" and fear; and flouting regulations. Yet Social Security displays many of the same outrageous practices.

From the first, Social Security was swathed in misleading statistics. In her 1982 book *The Crisis in Social Security,* economist Carolyn Weaver argues that advocates for social insurance relied on faulty data and erroneous interpretation of the financial status of older Americans during the 1920s. The advocates claimed that older Americans were at greater risk for being impoverished, although older Americans typically have had greater wealth than younger Americans. The pre-Depression era was no exception. If older Americans experience a diminution of their incomes, they may draw down their wealth. Before the Depression, private companies were developing an array of financial tools to help Americans save for old age, and Americans were taking advantage of them. Only the extreme depth and persistence of the Great Depression led enough Americans to embrace social insurance.

The champions of social insurance were not secure enough to let Social Security face real competition. Senator Bennett Champ

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Clark of Missouri offered an amendment to the legislation that would have allowed employers to opt out of the nascent program by offering comparable retirement plans. Clark argued that the private alternative would provide flexibility and freedom of choice (which some modern politicians favor only in the context of abortion rights). Social-insurance advocates rightly saw the amendment as a threat to the viability of a government-run retirement program, and they fought long and hard to preclude it.


Coutesy U.S. Congress

Sen. Bennett Clark of Missouri

Although President Franklin Roosevelt made some effort to put the Social Security program on an actuarially sound basis, the program quickly assumed a pay-as-you-go nature. Today the stakes involved in the combined business scandals pale before the stakes involved in Social Security. Instead of billions, Social Security involves trillions of dollars of unfunded liabilities.

The Social Security program has been dubbed a "Ponzi scheme," even by some of its defenders. The allegation is unfair to Mr. Ponzi. Charles Ponzi set up a pyramid scheme right after World War I, when he noticed an arbitrage opportunity with international postal-reply coupons. He promised investors $15 within three months for every $10 they put in. The initial investors did get the 50 percent return, but of course the pyramid grew exponentially and finally collapsed. Notice that, fraudulent as his scheme was, Ponzi had to persuade people to invest. The federal government doesn't use persuasion. As the commercial says, "It's the law."

Vice Is Virtue

Nobel Prize-winning economist Paul Samuelson recognized the pyramid aspect of the program. In his February 13, 1967, *Newsweek* column, he conceded that Social Security was actuarially unsound, but he lauded this as a virtue:

> The beauty of social insurance is that it is *actuarially* unsound. 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 and can be expected to do so for as far ahead as the eye cannot see. Always there are more youths than old folks in a growing population. More important, with real incomes growing at some 3 per cent per year, the taxable base upon which benefits rest in any period are much greater than the taxes paid historically by the generation now retired. . . . Social security is squarely based on what has been called the eighth wonder of the world—compound interest. A growing nation is the greatest Ponzi game ever contrived. And that is a fact, not a paradox.

Unfortunately for Samuelson's reputation as a prognosticator, the Baby-Boom generation opted for fewer children and productivity may have slowed down after 1973. The pyramid began to wobble badly. At least Samuelson was candid about the program's nature; many Social Security officials are either deluded, or they are less than forthright.

Although changing demographics account for some of Social Security's actuarial imbalance, much of the imbalance is due to overly generous benefits for some workers and expansion of coverage to people who did not pay into the program. Consumer advocates warn us about the "too good to be true" offers we all receive. Politicians all too often engage in similar shenanigans. Social Security proved an admirable vehicle for creating obvious winners while camouflaging the losers, a process that I believe to be the essence of politics.

A private insurance company that awarded benefits to uninsured parties or that maintained inadequately funded liabilities would violate many existing regulations, and the officers would be subject to civil and possibly criminal penalties. Not only is Social Security actuarially unsound, but the government places its own IOUs into a "trust

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fund." Readers may recall that one of the current business scandals involves corporate officers who "borrowed" from the company coffers. When Social Security runs a surplus, the rest of the government borrows from it, and the Treasury issues an interest-bearing instrument to the Social Security Administration. Eventually, Treasury will have to redeem its debt by running its own surplus, borrowing money from the public, or printing money, exactly the alternatives if there were no trust fund. As economist Martin Feldstein wrote in the *Wall Street Journal* (February 1, 1999): "Extending Social Security solvency to 2055 is based on a complex accounting sham so duplicitous that it is hard to believe." Why abuse the word "trust"? Why not call it an obfuscatory fund?

The government has powers beyond those of mortal men and corporations. Its ability to borrow (backed by its ability to coerce) far exceeds that of any corporation. Indeed, the government can run an inadequately funded retirement program for an extended time (if not into perpetuity), but why not be candid about the process? Why the counting and double-counting, the elaborate illusions? Why co-opt terminology from insurance: reserves and surpluses? F.A. Hayek suggested in *The Constitution of Liberty* that the use of insurance terminology was a "stroke of promotional genius" that allowed Social Security's sponsors to "capitalize on the goodwill of private insurance" and to gain public acceptance. It is interesting that the government envied the trust that private insurers had gained after years of probity and honesty.

Misleading Language

Roosevelt was shrewd enough to make sure that proponents of Social Security ran the program and controlled the flow of information. The misleading language and the unwillingness to identify the true nature of the program created confusion among the public. The cynicism of administrators was evident in one official's anonymous quote in the April 26, 1965, issue of *Barron's*: "The continued general support for the Social Security system hinges on continued public ignorance of how the system works. I believe that we have nothing to worry about because it is so enormously complex that nobody is going to figure it out."

Even Congress was concerned enough about the misconceptions that in the 1950s it held hearings. In some ways nothing has changed. For instance, many people are genuinely surprised to discover that there is no account holding their taxes (both employee and employer shares) and accumulated interest. Indeed, people assume that, similar to a 401(k) or other retirement fund, there is a contractual agreement between the U.S. government and its citizens. As reported in the December 7, 1964, *U.S. News & World Report*, then-Social Security commissioner Robert Ball admitted before Congress: "No, there is no such contract. This is one of the major distinctions between a private insurance arrangement and a government social insurance arrangement. But, under a government program, people have statutory rights."

Advocates argued that statutory rights

were sufficient because of the compulsory nature of the tax. Don't you feel much better with your statutory rights? Don't you wish that your 401(k) rested on statutory rights instead of contractual rights? In any case, the Baby Boomers and the subsequent generations will get Social Security payments at the sufferance of the government. Although I fully expect Social Security to be around for a long time, the uncertainty surrounding its future diminishes its value as a retirement tool. How much in benefits will you receive? How will such benefits be taxed in the future? Retirement planning just became much more uncertain.

"Employer contributions" are another misleading aspect of the program. The notion of employer contributions via the payroll tax is an egregious use of the term. Currently, workers pay 7.65 percent of their wages or salaries into Social Security and Medicare, although there is a cap on the amount going into the former. The employer pays another 7.65 percent of wages and salaries. Initially, you might think, as the politicians hope you will, "Great, my money is being doubled automatically." The system creates the illusion of employees getting something for nothing (this is similar to the Clintons' push for employers to "pay" health insurance premiums for their workers).

Of course, the real issue is whether the employer would have paid the workers the 7.65 percent in wages or whether the employer passed the extra cost on to consumers in higher prices. Many economists believe that the worker essentially pays the entire 15.3 percent. Therefore, designating "employee" and "employer" contributions is spurious. Anyway, as Carolyn Weaver showed, Franklin Roosevelt understood the chicanery involved in the financing of Social Security: "I guess you are right on the economics, but those [taxes] were never a problem of economics. They are political all the way through. . . . With those taxes there, no damn politician can ever scrap my social security program."

Of course, when your employer "matches" your retirement-plan contribution, the story is similar. The contribution is in lieu of higher cash wages. But both of you prefer the arrangement due to the favorable tax treatment, and, of course, the arrangement may have been negotiated between your employer and you. Coercion is no part of it.

The politicians who created and the bureaucrats who have administered Social Security have been less than candid about the nature of the program and its long-term viability. That we're coerced into participating makes it all the more offensive. □

> The official assumption is that there will always be more Peters to be robbed than there are Pauls presently to be paid. In fact, the susceptible Peters will be so numerous and will be robbed at such high rates of return that the Pauls can all be paid, with billions left over each year. . . .This is now the official theory of the same government that put Charles Ponzi in jail for fraud.
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> —Clarence Manion, "Ponzi Was a Piker"