articles

Social Security: From Ponzi Scheme to Shell Game

A prejudiced primer on privatization.

By Michael Kinsley

Posted Saturday, Dec. 14, 1996, at 12:30 AM PT

Privatizing Social Security is a solution in search of a problem. Oh, the problem with Social Security is real enough. But "privatization"--the hot policy idea of the season--simply doesn't address the problem. It's as if you were crawling across the desert, desperately thirsty, and you meet a fellow who says, "What you need is some lemonade." You say water would suffice. He says, "Oh, but lemonade is much nicer. Here"--handing you a packet of lemonade powder--"just add water and stir."

In this week's report by a government commission on Social Security, a majority supported various forms of partial privatization. And lemonade (privatization) is an appealing drink in many ways. But it's a testament to the agenda-setting influence of conservatives these days that, on Social Security, we're debating the merits of lemonade, when the real issue is: *Where do you get the water?*

Social Security privatization was ably discussed several weeks ago in our "Committee of Correspondence." But in this case, at least, that discussion seems not to have provided the dialectical pathway toward ultimate and inevitable truth that we had hoped for. So, let us try again. And--ladies and gentlemen--I will now attempt to discuss Social Security with no numbers, no graphs, and not a single use of the word "actuarial."

According to polls, more members of Generation X believe in UFOs than do in Social Security. Of course, those who delight in this factoid never tell you how many Gen-Xers actually believe in UFOs--which might be the alarming bit. But, because it serves their particular generational self-pity, Gen-Xers seem more willing than older folks to grasp the essential truth about Social Security, which is that it is a Ponzi scheme. Payments from later customers finance payouts to earlier customers. The ratio of retirees taking money out to workers putting money in is rising, due to 1) people having fewer children, and 2) people living longer. This means the Ponzi scheme cannot go on. The famous Stein's Law--an inspiration of our own Herb Stein--holds, in brief, that what cannot go on, won't. The issue is how exactly this Ponzi scheme will stop going on.

Discussions of the Social Security "crisis" often confuse three different problems. First, with baby boomers in their peak earning years, Social Security currently brings in more revenue than it pays out in benefits. The surplus is invested in government bonds. These are special government bonds. Statistics about the federal deficit--and both parties' promises to balance the budget over the next few years--count the Social Security surplus as revenue, and don't count these bonds as debt. But within a couple of decades, the annual surplus will evaporate, and Social Security will have to start drawing on this nest egg. For the government to honor these bonds will require huge borrowing (essentially replacing these IOUs to itself with real IOUs to private individuals) or a huge tax increase.

The second problem is that even if the government honors these bonds in full--principal and interest--a point will be reached, well into the next century, when the Social Security "trust fund" is exhausted, and not enough money is coming in to pay the currently promised benefits.

The third problem is that even if today's benefit promises can somehow be kept, Social Security represents a much worse return on "investment" (taxes paid in) for future retirees than past and present retirees have enjoyed. This is partly because some minor benefit reductions are scheduled already (raising the retirement age slightly and gradually). It is mainly because younger people will have paid much higher Social Security taxes throughout their working lives. The average return on Gen-Xers' Social Security investments will

almost certainly be worse than they could have done by investing in the stock market.

Whether all this adds up to a crisis is a matter of rhetorical taste. The fact that boomers and Gen-Xers will get a worse deal from Social Security than their parents--mainly because part of the money they put into the system was, in effect, transferred to their parents--doesn't seem horribly tragic to me. Even after this transfer we will still, on average, be better off than our parents were. Where's the injustice? Problem 2, that Social Security will run dry many decades from now, depends on essentially impossible predictions about the distant future and, in any case, can be solved by very minor adjustments, if they're made pretty soon.

No. 1 is a real problem. It's hard to imagine the government actually reneging on its IOUs. But it's also hard to see an easy way of avoiding that.

For all three problems there are only three solutions: cut benefits, raise revenues, or borrow. Privatization is not a solution. Privatization means allowing individuals to invest for themselves all or part of what they and their employers put into Social Security. Whatever the merits of this idea--and there are some--it does not address the problem at hand. Social Security is a Ponzi scheme. Current payers-in are financing current payers-out, not their own retirements. Privatization assumes an end to the Ponzi scheme: Every generation saves for its own retirement. But you can't get there from here without someone paying twice--for the previous generation and the current one--or someone getting less (or someone--i.e., the government--borrowing a lot of money).

Privatization enthusiasts sometimes admit to this as a *transitional* problem. But it is not a transitional problem. It is the entire problem. As Brookings economist Henry Aaron pointed out in the "Committee" discussion, if you could pour in enough money to pay for the "transition" to privatization, the system would no longer be out of balance. The problem, or crisis, would be solved. Privatization would not be needed.

You have to watch closely as the privatizers describe their schemes. They play a shell game: Take this part of the Social Security tax and convert it into a mandatory savings contribution; take today's benefit and divide it into two parts; give everybody this new account and that minimum guarantee; take this shell and put it there and bring that shell over here, and--hey presto! But no matter how you divvy it up, the same money can't be used twice. That is the problem with Social Security now, and it is the problem with privatization. All you've said when you endorse privatization is that *if* there were water, it should be used to make lemonade. Not obviously wrong, but not terribly helpful.

Privatization is a shell game in a second way. It is supposed to bring more money into the system because returns on private securities are generally higher than returns on government bonds. Even members of the recent commission who oppose full privatization supported investing part of Social Security's accumulated surplus in the private marketplace. But (as Stein pointed out in the "Committee"), every dollar Social Security invests privately, instead of lending to the Treasury (as happens now), is an extra dollar the government must borrow from private capital markets to finance the national debt. The net effect on national savings, and therefore on overall economic growth, is zilch. Every dollar more for Social Security is a dollar less for someone else.

If Social Security manages to achieve a higher return, by investing some or all of its assets privately, the rest of the economy will achieve a lower return, by having more of its assets in government bonds. In essence, the gain to Social Security will be like a tax on private investors--an odd thing for conservative think tanks to be so enthusiastic about. Also, the arrival of this huge pot of money looking for a home will depress returns in the private economy, while the need to attract an equally huge pot of money into the Treasury to replace the lost revenue will increase the returns on government bonds. Result? The diversion

will be at least partly self-defeating.

The size and security of future retirement benefits ultimately depend on the country's general prosperity at that time in the future. Checks to be cashed in the year 2055 (whoops! there's a number) will be issued in 2055, whatever promises we make or don't make today. The most direct way for Social Security to affect future prosperity (as Aaron pointed out in the "Committee") is to increase national savings, of which the Social Security reserve is part, by trimming benefits and/or increasing revenues. Since we have to do that anyway--even as a prelude to privatization--why don't we do it first? Then we can argue about privatization at our leisure.

*Michael Kinsley is **Slate**'s founding editor.*

Article URL: http://slate.msn.com/id/2405/