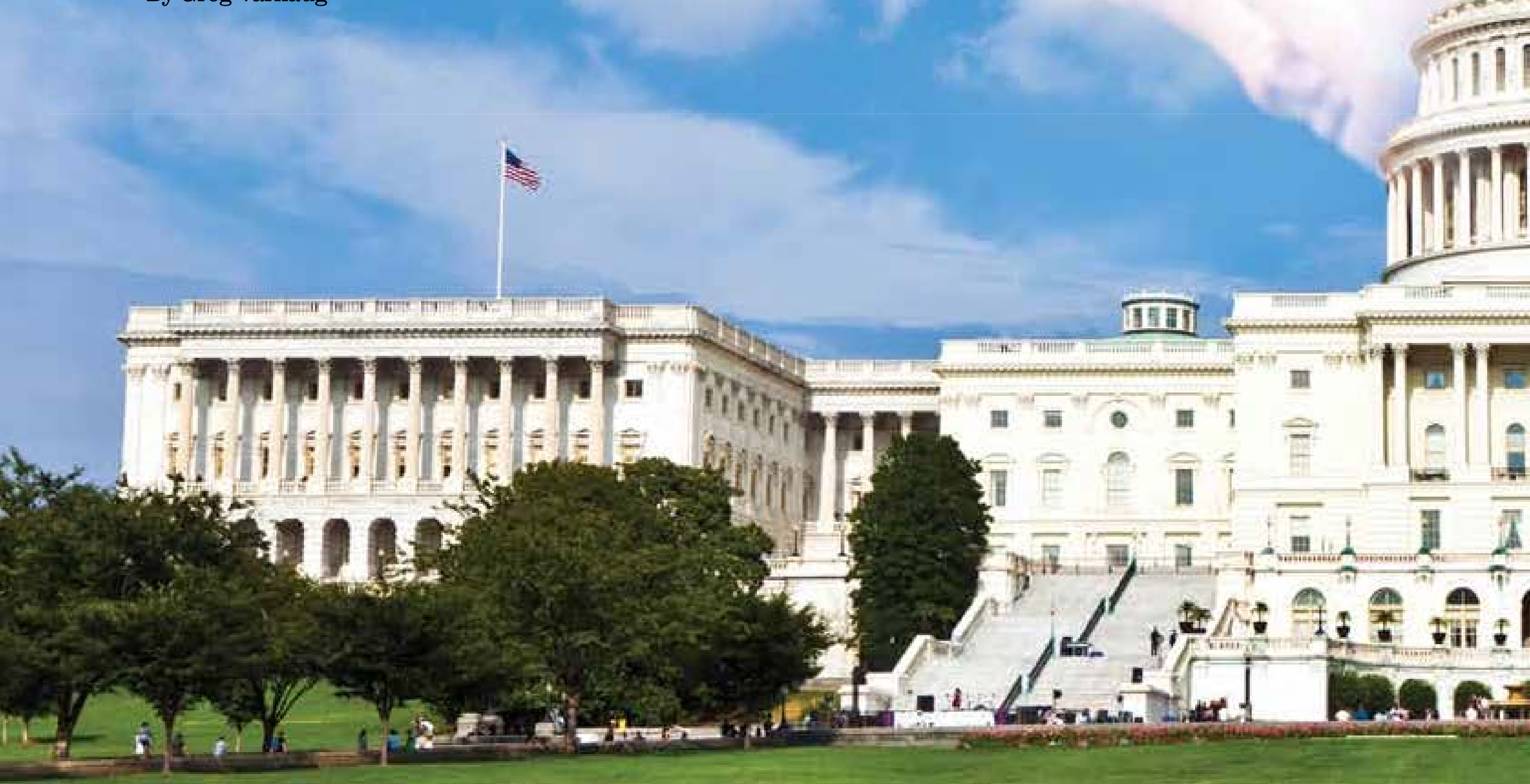
SOCIAL SECURITY

Smoke and Mirrors?

By Greg Varhaug



In his 2010 book *Fed Up*, Texas Governor Rick Perry famously called Social Security a "Ponzi scheme." He repeated a similar charge in a presidential debate last September 7th. He said that to maintain the "status quo" constituted a "monstrous lie to our kids," implying that the program isn't "going to be there."

And he's not alone in charging that Social Security is unsustainable. The catchphrase in the press, from a 2011 government report, is that the program is "not sustainable under currently scheduled financing." And what about the trillions of dollars that taxpayers are going to have to pony up in the coming decades to cover Social Security's Treasury bonds?

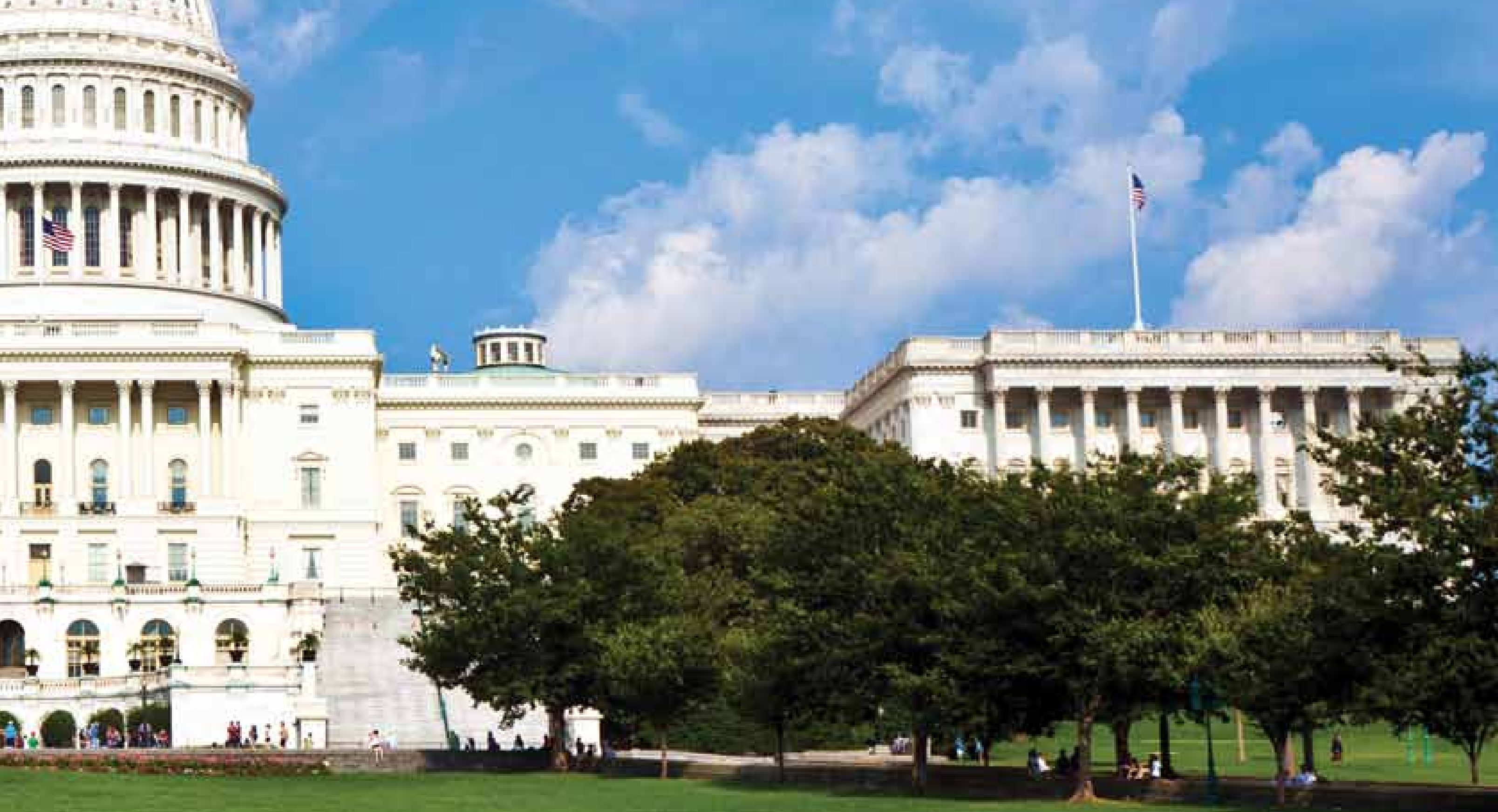
What Is a Ponzi Scheme?

A Ponzi organization pays investors either from money which they themselves have invested into the organization, or with money from other investors while claiming that payments are the result of profits earned by the organization. Deception and false claims are central to the definition of a Ponzi.

A detail in the story of Charles Ponzi you might miss is that he was trying to go "legit" when he started the Securities and Exchange Company in 1920. It would have been just another failed business if he hadn't employed all sorts of elaborate ruses to hide his losses.

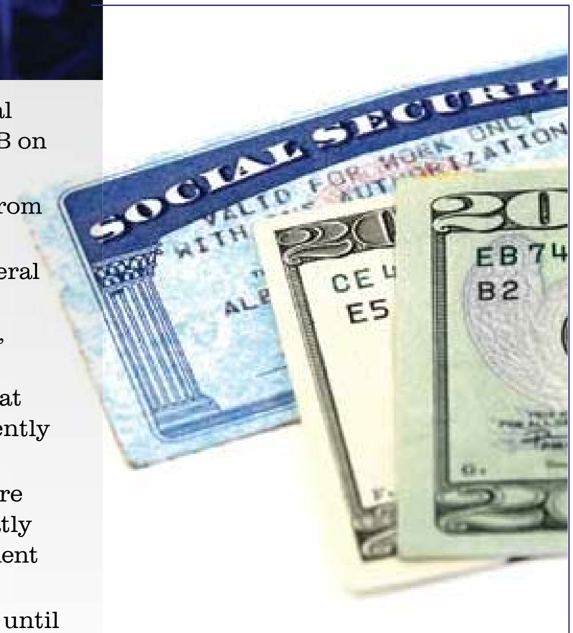
Our own Enron, maybe not technically a Ponzi, was a complicated case of an established, legitimate business that expanded into illegal enterprises. Enron's energy transportation services were the core of their legitimate operations. Later they branched into energy trading and broadband, where they were guilty of market manipulation and using off-balance-sheet partnerships to hide their losses. Enron shareholders lost an estimated $11 billion.

Another key ingredient to Ponzis is a suspiciously high and/or rapid return on investments. These are usually given with the hope of spurring more investments from victims. In the case of Enron, there were



SOCIAL SECURITY FACTS

- At present, Social Security accounts for around 20 percent of the annual federal budget. The federal government is expected to spend over $700B on Social Security in 2012.
- Payments to Social Security (through payroll taxes) are not separated from the rest of the federal government's general revenue.
- Social Security is funded through FICA taxes, and is paid out of the federal government's general revenue. Social Security is part of the Federal Mandatory Budget, along with Medicare, Medicaid, veterans programs, and the TARP.
- At present, there are more than three workers for each SS recipient. That ratio is set to decrease steadily in the coming years. People born as recently as 1946 are now eligible to draw Social Security benefits.
- Social Security holds trillions in United States Treasury bonds. These are physical, government-issued bonds that you can hold in your hand, neatly organized in three-ring binders and stored in a filing cabinet in a government office in Parkersburg, West Virginia.
- Payroll taxes will provide adequate funding for Social Security benefits until the year 2025. From 2025 to 2037, SS will draw on the government bonds. These projections assume steady wage increases over the coming years. ■



instances where key players invested in the company, and then received unrealistically large payouts a short time later.

Enron is also frequently held up as an example of a "pump-and-dump" stock scam. The idea is to "pump" up the price of a stock, usually with a series of false claims, then "dump" the stock before its inevitable drop. This technique has also been used by unscrupulous officers who borrow money from their company with the agreement to pay back a specified number of shares. The officer dumps his shares, and buys back cheaper shares after the price drops.

The incidence of Ponzis has skyrocketed since 2000. There have been at least nine Ponzis resulting in losses of over $1 billion since 1990. And Ponzis are only one category of white-collar crime. The Better Business Bureau says that Ponzis are "the biggest single fraud threat confronting American investors."

Tom Petters was convicted for wire and mail fraud, as well as money laundering, in an operation that lasted 13 years. His scam was based on securing huge loans for a phony business, resulting in losses of over $3 billion by 2008. Petters' firm owned Polaroid, Fingerhut, and an airline.

Petters was taken down when his company VP turned whistleblower, secretly taped conversations with Petters.

Texas native Allen Stanford, head of the Stanford International Bank, was charged with 21 counts in 2009, including fraud and money laundering, in an alleged Ponzi based on high-yield certificates of deposit. He's in jail awaiting trial, and being treated for a drug dependence. He's expected to stand trial in January.

Former NASDAQ Chairman Bernard Madoff currently holds the record for the most costly Ponzi scheme in history. Madoff himself claimed that there were $50 billion in losses, but early on, investigators doubted the amount was that much. *The Financial Times* recently put the amount at over $19 billion.

Harry Markopolos, an independent fraud investigator, tried for nine years to bring Madoff to the attention of the SEC. Regulators and the business press refused to act, or even to question Madoff's legitimacy. After Madoff was exposed, Markopolos blasted the SEC in testimony before a U.S. House committee.

Because Madoff pleaded guilty, there was no trial. A lot of questions will never be answered. There are attempts to track down and take back illegal profits that were distributed to legitimate investors into Madoff's operation.

In its 2010 Report to the Nations on Occupational Fraud and Abuse, The Association of Certified Fraud Managers reports that "organizations tend to over-rely on audits. External audits were the control mechanism most widely used by the victims in our survey, but they ranked comparatively poorly in both detecting fraud and limiting losses due to fraud." The report notes that surprise audits are rarely used by the organizations that the Association surveyed. They also point out that many frauds are discovered because of tips from informants. Such was the case for Enron, Petters, and Madoff.

Is Social Security a Ponzi Scheme?

The comparison of Social Security to a Ponzi is not new. Social Security does pay early investors with money from late investors, like a Ponzi scheme, but so do many public and private pension programs. This doesn't make them Ponzis.

Social Security was originally designed in 1935 as a national insurance program for survivors and the elderly. It acts in some ways like a defined-benefit pension plan, because it follows a formula. It also acts as a "spendthrift trust," preventing recipients from spending their money too quickly, and protecting their money from creditors and lawsuits. This aspect offends free-marketers and Randians.

Social Security is a pay-as-you-go system, a well-established pension model, used in numerous countries, where today's workers pay for yesterday's workers.

There are some initial costs for starting this kind of program. A few

> **“Then, as now, nobody gave a rap for ethics. The almighty dollar was the only goal. And its possession placed a person beyond criticism for any breach of ethics incidental to the acquisition of it.”**
>
> *– Charles Ponzi in 1937*

THE ORIGINAL PONZI

The Original Ponzi – Charles Ponzi (1882-1949) had an illustrious career as a thief and swindler. The scam he became famous for revolved around a company he created in February, 1920, The Securities and Exchange Company.

Ponzi’s original plan was a novel, admittedly unethical, but legal, arbitrage scheme. After the First World War, there were special international postal coupons used in the U.S. and many foreign countries. Ponzi’s original plan was to take advantage of the spread between the values of these coupons in different countries. The scheme looked good on paper. Everyone who heard the idea thought it was ingenious. Investors flocked to the scheme. But in the end, his idea proved unworkable.

Ponzi didn’t let on that he was having any difficulties with the scheme. There were a few close calls where the whole operation nearly fell apart, but public confidence in Ponzi remained high, and investments continued to pour in. By early summer of 1920, Ponzi had managed to gain a controlling interest in a large Boston bank.

Ponzi promised a 100 percent profit in 90 days. It’s questionable whether Ponzi himself ever really believed it would work. He sued a newspaper writer for libel when the writer dared to question the legitimacy of Ponzi’s operation. There were two separate panic runs by investors. He made huge payouts both times, and managed to stave off suspicions from his investors, and from bank regulators.

The whole venture lasted about 200 days. By mid-August 1920, it was all over. The state bank commissioner discovered many irregularities in the books, and took over the bank just in time to stop Ponzi from taking money from the vault to temporarily cover his losses. Thus the term “Ponzi” had entered the American lexicon for notorious scams, along with shell game and Three-card Monte.

During the storm of legal troubles that ensued after the collapse, Ponzi sued the state of Massachusetts in a case alleging double-jeopardy that went all the way to the U.S. Supreme Court. The court ruled that the state could file its own charges, even if Ponzi had been tried on federal charges surrounding the same criminal enterprise.

In his autobiography, Charles Ponzi claims throughout that he intended to make good on his debts. He claims he was trying to work other deals to cover his losses. That was his justification, although it appears he was positioning himself to just perpetuate the scam.

A few years after his release from prison, Ponzi was selling swampland in Florida to unsuspecting investors. After getting out of prison for that, he was deported to Italy, and eventually settled in Brazil. Ponzi died broke.

Kurt Vonnegut’s *Jailbird* offers an interesting look inside the mind of a serial swindler. The book’s protagonist, Walter F. Starbuck, is in jail for refusing to tell who hid a million dollars cash – President Nixon’s illegal campaign money – in his (Walter’s) office in the White House.

Walter is imprisoned with a Doctor di Sanza, who was twice convicted of running Ponzi schemes. The doctor brags that he’s been a millionaire twice, and will be again when he gets out of jail. Walter concludes that the Doctor is morally and intellectually incapable of grasping the problems with the kinds of enterprises he is in jail for. The Doctor reasons that, for a time at least, he made a lot of people happy.

How do otherwise intelligent people fall for get-rich-quick schemes? Why do so many fall for deals that are too good to be true? There is the human tendency to see what we want to see, and to cultivate blindness for that which we don’t. As William James said a century ago in *The Will To Believe*, “As a rule we disbelieve all the facts and theories for which we have no use.” ■

of the earliest participants usually receive more under the program than the majority who enter later. This is done as a kindness, because without some kind of allowance, early participants don't have time to accrue the same level of benefits as later participants.

Highly controversial at the time it was passed, the original Social Security Act excluded workers in many job categories, including agricultural and domestic workers. There were many challenges to its constitutionality, though none prevailed. The program is legal because it's an extension of the government's right to tax.

Over time, changes to the system have widened its coverage to include more and more people. The courts have played a major part in shaping the program over the years.

It has also been perhaps the most popular government program ever. In the 1960s, and until recently, Social Security was the "third rail of politics." Any politician who dared to touch it was guaranteed an immediate political death. For a half century, those who favored Social Security were the largest and most powerful constituency of single-issue voters in America.

In the 1980s, we were told that Social Security was on the verge of bankruptcy. The Commission, headed by Alan Greenspan, implemented changes in 1983 that would ensure Social Security's solvency 75 years into the future. This was confirmed in 2009, when the Board of Trustees reported large surpluses in revenue due to the '83 measures.

Social Security turned 75 last year. And we've known since at least the 1960s that there was going to be a strain on the system when large numbers of Baby Boomers retired around the turn of the century.

Social Security's Treasury Bonds

Social Security has consistently had revenues greater than its expenditures. These leftover revenues are invested in special U.S. Government Treasury bonds. These bonds comprise the Social Security Trust Fund. The amount collected by Social Security soon became so large that it didn't make sense to simply keep it in a savings account.

With the money from these bonds, the federal government funds public works projects – in this case, things like schools, bridges, parks, bailouts, and wars.

Social Security has been accruing these bonds for decades. The plan for some time has been for Social Security to begin drawing on those bonds in 2025, and to continue doing so until 2037, when the Trust Fund will be exhausted. After that, Social Security can continue to pay out at 75 percent of current benefit levels until 2084.

Possibility of Default

The Interim Report of The President's Commission to Strengthen Social Security from August 2001 points out a few disturbing facts. The report states that "Social Security will begin running annual cash deficits in 2016." With the Treasury bonds, it can continue to pay full benefits until 2038.

The report points out that payments on the bonds will have to come from the federal government's general revenue. Social Security's bonds "are a liability to the federal Treasury. Revenue must be raised from taxpayers to redeem these bonds."

The report goes on to explain, "This situation arose because past payroll taxes were not truly saved, but rather were used to finance other government spending. As a result, future repayment of Trust Fund bonds will not be any less difficult." Suggestions in the press that the government might or should default on the Social Security Treasury bonds began appearing shortly after that.

A Moody's managing director's warning in 2000 to a House Subcommittee on Social Security that they expect pension defaults in "almost every country" was widely reported, and

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held up as evidence that a default on Social Security's Treasury bonds was possible. Usually not mentioned, the Moody's official tempered his assessment with regard to the U.S.

This was followed by calls from pundits and think tanks for the government to default on the Social Security bonds. One argument goes that Social Security won't need the money from the bonds for several years to come. So defaulting on the bonds now would allow the government to pay off some of its costlier debts earlier, and save some money on interest. Presumably, the government could figure out how, or how much, it wants to fund Social Security later.

There's no legal provision for defaulting on Social Security's bonds. It's doubtful that such a default would be legal, or even constitutional. This question was raised during the debt ceiling debates last summer. There was open speculation over whether President Obama would be compelled to order a raise in the debt ceiling, whether it was constitutional to allow a default. All sides agree the American public doesn't want a default on Social Security.

It's often argued that Social Security was never designed to handle a population spike like we see with retiring Baby Boomers. The fact is, the designers of Social Security didn't envision a scenario where GDP would grow steadily, but where at the same time, the median wage would remain flat for three decades or more.

Means testing would be fair, but there isn't much savings to capture from high-income recipients. Adjustments to the payroll tax, including a raise in the payroll tax cap, would solve the problem. And it's a solution that most Americans, including many conservatives, will support today. **N**

Greg Varhaug has written software instruction manuals and procedural manuals for many Houston companies. He operates HoustonGuitar.com, a commercial music-instruction website.