IDEAS ON LIBERTY
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Uncle Sam's Retirement Scam

The legendary third rail of American politics, Social Security, is lighting up. The administration has proposed to move, ever so gently, toward a private system, while a bipartisan congressional coalition is determined to keep Americans locked into an inferior retirement system.

Social Security was long viewed as America's most successful social program. But it worked only because of demographics: when first created, dozens of workers supported each worker. Taxes were low, benefits secure.

But Ponzi schemes succeed for only a limited time. When Franklin Roosevelt was posing as the savior of the elderly, almost half the people died before collecting their first check. No longer, however. Most people receive not just the first check, but many more. By 2050 Americans will be living 12 to 14 years longer, on average, than they were in 1940.

As people live longer and parents have fewer children, the population itself is aging. Thus as the Baby Boom bulge hits retirement in the coming years, every retiree will become dependent on just two workers, down from three today. That will destroy the system.

Indeed, in just 15 years Social Security will be paying out more than it takes in. The program's defenders argue that $5.4 billion will be stockpiled in the Social Security "trust fund," but the money has been spent. All that sits in Social Security's vault are government IOUs to itself, which will require the government to hike taxes, borrow money, or cut other spending.

Even Senate Democratic leader Tom Daschle admitted in 1996 that "there is no such fund." If the system's special-issue bonds, which are not marketable to outsiders, disappeared tomorrow, nothing would be different. To pay promised benefits the government would have to hike taxes, borrow money, or cut other spending.

Perhaps the oddest argument comes from economist Paul Krugman, who contends that the trust fund is "a real asset" because "every dollar that the Social Security system puts in government bonds—as opposed to investing in other assets, such as corporate bonds—is a dollar that the federal government doesn't have to borrow from other sources." How can someone so smart make such a silly argument?

The dollars collected by the Social Security (FICA) tax were originally real assets. But the government has spent them. All that remains are some paper IOUs sitting in a government file cabinet.

The deficits will grow as the baby-boom retiree bulge grows. Deficits will go from tens to hundreds of billions a year.

Here Krugman is a bit more honest than his political allies. Don't worry about the meaningless trust fund, he writes. Just use general tax revenues to pay the bill.

At least that would destroy the illusion, long fostered by the Social Security system itself, that it is an actuarially balanced annu-

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ity program. Everyone would see it for a tax-funded welfare scheme, like any other.

But the taxes won't be cheap. The annual deficit will rise from $93 billion in 2020 to $271 billion in 2030 to $318 billion in 2035, in today's dollars.

Krugman, like most other welfare-state enthusiasts, suggests repealing the Bush tax cut. However, Social Security actuaries warn that doing nothing now will require doubling the system's "cost rate," essentially, the tax rate, by 2031, when the last of the boomers reach the usual retirement age.

Such a hike might not bother a well-compensated academic like Krugman. It would understandably anger most other Americans.

He could argue that higher taxes wouldn't be so bad if the return were good. But today the average return is less than 2 percent.

Many younger workers will actually lose money—a higher-income 38-year-old will have to live to 92, nine years past his life expectancy, just to break even. Minorities, who have shorter life spans, and women, who are disproportionately dependent on Social Security, do even worse.

In contrast, the average annual rate of return on private investment over the last 75 years, through the Great Depression, is almost 8 percent. Safe investments such as Treasury bonds pay about 3.4 percent.

It has taken only two decades for Social Security to go from Sure Thing to Rip-Off. In 1980 an average worker got back his and his "employer's" taxes, plus interest, in just 2.8 years. It will take 16.8 years in 2001. In 2030, assuming no tax hikes or benefits cuts, it will take 23.5 years.

But, of course, those, along with borrowing, are the only alternatives to "save" the system. Using the intermediate projections of the Social Security Trustees, Congress would have to hike taxes by 37 percent or cut benefits by 26 percent to fulfill its promises in 2040.

Or it could engage in an orgy of borrowing—about $7 trillion by 2040 and $47 trillion by 2075, in current dollars. This would be a larger share of GDP than at the end of World War II.

Thus the only way to look at Social Security is that it is in crisis. People are getting ever less for more. The trend will only accelerate as the baby boomers retire.

The answer is obvious. Allow people to invest their money in private, actuarially sound investments, rather than have it tossed into Social Security's black hole.

This is no radical concept. Nearly half of American families now invest in the stock market. Moreover, countries ranging from Chile to Britain to Sweden to Australia have moved or begun to move to fully funded private pension programs in place of government Ponzi schemes like Social Security.

Indeed, even President Bill Clinton was prepared to push for private accounts before the Monica Lewinsky scandal struck, forcing him to rely on left-wing allies to survive. And House Minority Leader Richard Gephardt, notable for the demagogic abuse he recently poured on the President's National Commission on Social Security Reform, suggested in 1998 that private accounts "can be part of the answer."

The alternative is what Democratic Commission member Robert Pozen calls the "do-nothing plan." Sit around while the system crumbles, then enact draconian tax hikes while cutting benefits. Such a strategy won't bother the wealthy, who will have ample private investments to fall back on. It will wreck the retirement of the poor and disadvantaged, who foolishly relied on the government for security. □

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Reducing Class Sizes: Other Things Are Not Always Equal

by E. Frank Stephenson

"The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups."

—HENRY HAZLITT

One frequently hears economists use the phrase "other things equal." For instance, other things equal, an increase in the price of gas will reduce the quantity of gas demanded. While this approach is often a useful framework for analyzing the effects of economic events, sometimes one cannot reasonably claim that other things are equal.

Consider the calls for reducing class sizes in government schools. Proposals at both the state and federal levels have called for class-size reductions in an effort to boost student performance. Typically, such proposals have implicitly assumed that teacher quality will remain constant when hundreds or thousands of additional teachers are hired to lead the smaller classes. This assumption is mistaken.

Assume a school district currently has 1,000 students in 40 classes of 25 students each. Suppose the school district reduces the classes to 20 students each by hiring ten additional teachers. Proponents of smaller classes rarely specify exactly how the reduction is supposed to improve student performance, but common sense suggests the benefit would come from the teachers' devoting more time to students individually, or perhaps from the teachers' ability to better control smaller-sized classes. But how much the 20 students benefit is unclear; if one assumes that a teacher spends half of each six-hour school day giving individual instruction, the amount of one-on-one time for each student rises from 7.2 to 9 minutes per day. While the extra attention should help students, the benefit of an extra two minutes per day is not likely to be large.

Lest we forget, there were initially five other students in each class. What happens to them? They get placed in classes with 15 other students and should also be able to receive more personal attention from their teachers. Therefore, at first glance, one would expect these students to benefit as well, though, as discussed, how much is unclear. Note, however, that these students will be taught by the teachers who were hired to reduce the student-teacher ratio. Why should this matter? Because, for reasons I discuss below, the ten newly hired teachers

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