BARRON'S

One of the Costliest Ponzi Schemes Ever

By: Gene Epstein - February 23, 2013

Now is the time to grapple with deficit spending, before Uncle Sam must tell 80 million boomers to take a hike.

In a 1967 Newsweek column, the late Nobel laureate economist Paul Samuelson called Social Security "a Ponzi scheme that works." While Ponzi schemes in the private sector always go bust, the government's version worked, according to Samuelson, because it was financed by an ever-expanding tax base, which in turn was fueled by an ever-growing economy.

Samuelson's error has been effectively exposed by another Nobel Prize winner, economist James M. Buchanan, who died last month. According to Buchanan's public-choice theory, which he also called "politics without romance," politicians reap short-term gains from spending money that can be paid back long after they leave office. They therefore have a strong incentive to preach and practice continued fiscal irresponsibility, to the point that future tax bases become heavily mortgaged. The revenues that could be realized don't even come close to covering the sums that are being committed.

Buchanan didn't use the term Ponzi, as far as I know. But he warned prophetically that chronic deficits were becoming an institutionalized part of the way government operates. When Samuelson defended Social Security in 1967, other entitlement programs -- Medicaid and Medicare -- had been enacted just two years before. Tally in 2013 all entitlement programs mandated at the federal level, including the drug benefit signed into law by President George W. Bush and the new health-care legislation of President Obama, and we confront one of the costliest Ponzi schemes ever contrived, passing burdens that look increasingly unsustainable to future generations.

Then assume that all other federal spending grows at its normal historical pace, and add the daunting fact that all the baby boomers will be over 65 by 2029. Result: The burden of accumulated debt could eventually trigger a fiscal crisis not unlike what recently occurred in Greece, accompanied by the risk of a default on promises made to the elderly.

That was the thesis of my cover story in Barron's last week. It was gratifying that most of the many comments from readers were directed at the core points of the story. These readers seemed to understand that my arguments weren't motivated by the desire to single out President Obama as the only villain in the tragedy, any more than political-choice theorist James Buchanan would have done so. Obama happens to the key player at the moment, but only at the moment, and he's far from the only player.

The system itself is at fault. Obama's constituencies are also part of that system, not to mention those his bully-pulpit can persuade. The president's recent State of the Union address, in which we were assured that the debt problem is "more than halfway" solved, got three-quarters of respondents to a CNN poll to say they agreed or agreed strongly with what he had to say. Kind of scary, isn't it?

SPEAKING OF THE SYSTEM, deficit dove Paul Krugman was on to something when he recently observed that "George W. Bush squandered the Clinton surplus on tax cuts and war, and that window has closed." (His views on my cover story, and my response, are quite another matter.) Why the "window has closed" implies a defeatism that defies logic. Not even Buchanan thought change was impossible. Also, the "Clinton surplus" had a great deal to do with the defeat of "Hillarycare" and the influence of Newt Gingrich on the Clinton budget.

Krugman also might have added that, as mentioned, Bush created a new entitlement for the elderly. But the larger point is valid -- that by the late 1990s, Clinton at least talked the talk, as did vice-president and later presidential candidate Al Gore. Remember the "lock box," his short-hand expression for our need to accumulate surpluses in order to later pay for exploding entitlements?

Krugman's own views on the deficit seem to depend on which party is in power. As recently as Feb. 11, 2005, when the deficit was running at 2.6% of GDP, he declared in a New York Times column that "the deficit is indeed a major problem." In 2013, the deficit is expected to run at 5.3% of GDP, and according to Krugman, it's no longer much of a worry. A nonpartisan approach would recognize that Clinton and Gore were right in proposing to grapple with a problem that hasn't gone away.

That problem is fairly straightforward: the high-probability risk that the aging baby boomers will render the federal government unable to meet its promises to its creditors and to the elderly. Clinton might have been able to "end welfare as we know it" to people young enough to work, but you can't tell 80 million old people who were counting on your help that they must suddenly seek help elsewhere. That's why Clinton and Gore were right that we must take steps now. But nothing should be off the table.

In that regard, I recommend Cato Institute senior fellow Chris Edwards' Website, www.downsizinggovernment.org. It offers a treasure-trove of statistics and other information on the federal budget, including a department-by-department guide to cutting the fat.