

Social Security, Ponzi Schemes, and the Need for Reform

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Recently there has been much debate over whether Social Security is or is not a Ponzi scheme.

Clearly Social Security has many structural characteristics that resemble those of the classic Ponzi or pyramid scheme. For example, like a Ponzi scheme, Social Security does not actually save or invest any of a participant's payments. When a worker pays taxes into the system, that money is used to pay current beneficiaries. Therefore, participants receive payments, not from returns on their own investments, but directly from inflows from subsequent participants.

As a result, Social Security was able to pay early participants a windfall return on their money. But as demographic changes result in fewer workers paying into the program and more recipients taking benefits out, the return to subsequent generations grows steadily worse. Today's young workers will receive a rate of return far lower than what they could receive from private markets.

However, there is one crucial distinction between Social Security and a Ponzi scheme. Once Ponzi was unable to talk enough people into investing with him, his scheme collapsed. People participate in Social Security because the government makes them. And if the Social Security system begins to run short of people paying into the system, as it is now, it can always force those people to pay more.

Yet, Congress's ability to preserve Social Security through higher taxes and lower benefits should not distract from the more fundamental problem that the program's Ponzi-like structure makes it unable to pay currently promised levels of benefits with current levels of taxation. In short, the program is facing insolvency without fundamental reform.

Instead of just making a bad deal worse, that reform should fundamentally restructure Social Security. It should remove the Ponzi-like aspects of the program and allow younger workers to save a portion of their payroll taxes through privately invested personal accounts.