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Social Security, Ponzi Schemes, and the Need for Reform

by Michael Tanner

Executive Summary

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.

Michael Tanner is a senior fellow with the Cato Institute and director of the Cato Project on Social Security Choice, and editor of Social Security and Its Discontents: Perspectives on Choice *(Washington: Cato Institute, 2004).*

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Introduction

> Ponzi Scheme: a fraudulent investment plan in which the investments of later investors are used to pay earlier investors, giving the appearance that the investments of the initial participants dramatically increase in value in a short amount of time.
>
> —West's Encyclopedia of American Law

In his book, *Fed Up*, Texas governor Rick Perry claims that Social Security is "set up like an illegal Ponzi scheme."[1] He explicitly compares Social Security's financing to the type of illegal scheme "that sent Bernie Madoff to prison," explaining that, like a Ponzi scheme, "Deceptive accounting has hoodwinked the American people into thinking that Social Security is a retirement system and financially sound when clearly it is not."[2]

Perry's statement has been roundly denounced by other Republican candidates, especially former Massachusetts governor Mitt Romney, as well as many Social Security advocates and portions of the media.

It is not as though Perry was the first to observe that Social Security has many of the characteristics of a Ponzi scheme. For example, Milton Friedman called Social Security "the biggest Ponzi scheme on earth."[3] So did his fellow Nobel laureate Paul Samuelson, who famously referred to Social Security as "a Ponzi scheme that works."[4] Even some of the program's most ardent defenders have used the term. For example, Paul Krugman wrote of Social Security's "Ponzi game aspect, in which each generation takes more out than it put in."[5]

Others suggest that Social Security is at least Ponzi-like. *The Economist* says that "a better term for Social Security would be a pyramid scheme, which [Webster's] dictionary defines as 'a usually illegal operation in which participants pay to join and profit mainly from payments made by subsequent participants.'"[6] Boston University economist and former Clinton administration official Laurence Kotlikoff prefers to liken Social Security to a "chain letter."[7]

Whatever the terminology, these economists and commentators base their descriptions on the basic structure of Social Security, under which, as *The Economist* noted, "future workers do have to generate the tax revenues that pay the benefits of future pensioners, and that is a problem if one generation is smaller than the one before."[8]

So the question remains, is Social Security a Ponzi scheme?

The Original Ponzi Scheme

To answer that question, we must consider how a Ponzi scheme works. The operator of the Ponzi scheme recruits "investors," promising high returns on their investment or contribution. But the operator does not actually invest the money, and instead pockets it for himself. Because no investments are made, the scheme's operator can only pay returns in one of two ways: 1) return a portion of the investment as "interest" or "profit," while convincing the investor to keep his principle invested; and 2) recruiting new investors and using their money to pay the earlier ones. However, these new investors will now have to be paid, requiring the operator to recruit a third round of investors large enough to pay for both the initial and secondary investors. This continues until the operator is no longer able to recruit sufficient new investors and the system ultimately collapses.[9]

Ponzi's scheme was not the first such swindle, but it was the classic model that has come to define such plans, as well as their near identical cousins, pyramid schemes and chain letters.

In December 1919, Carlo "Charles" Ponzi approached a group of friends and acquaintances in Boston with a new investment opportunity.[10] Ponzi claimed that he had found a way to make money by exploiting postal rates between countries, using postage coupons that were then widely available for use in purchasing stamps. At the time, postal systems worldwide offered coupons that could be used to purchase stamps for replying to a letter, roughly the equivalent of a postage prepaid envelope. While the coupons were supposed to have a fixed value regardless of their country of origin, the post–World War I devaluation of many European currencies created an arbitrage opportunity. Ponzi proposed buying coupons on the cheap in countries such as Spain and then using them to purchase postage in countries like the United States, where they were worth more. It might be considered similar to playing international currency markets today.

In reality, however, while there was a logical argument to be made for Ponzi's proposal, he had already tried and failed to make money at such a scheme, defeated by the international postal system's bureaucracy and red tape. Administrative costs ate up any profits, while continual bureaucratic delays prevented him from moving money around fast enough to take advantage of fluctuations in coupon values.

But Ponzi did not reveal this failure to his potential new investors. Instead, he promised them that for every $100 they invested, he would guarantee—in writing—a return of $150 within 90 days. And he appeared to deliver. Not only did Ponzi's initial investors receive their 50 percent return, often well before the 90-day term, but he soon increased his guarantee to a 100 percent profit within 90 days. As word spread, the money poured in, more than $9 million in eight months.

Ponzi's secret was that he was not actually buying postal coupons with the money or making any other investments. Instead, he was simply using the investments of later investors to pay returns to his earliest investors. At the height of his plan's popularity, with thousands of potential investors lined up to give him money, this was relatively easy to do. Eventually more than 20,000 people invested with him, at one point contributing as much as $200,000 per day.

But by the summer of 1920, skeptical newspaper articles and a legislative investigation were making it more difficult for him to continue attracting enough new investors to maintain payouts to the growing number of investors that needed to be paid. In August, after a *Boston Globe* exposé revealed that Ponzi had previously been arrested for forgery in Canada and raised additional questions about his business model, there was a run on Ponzi's offices by investors demanding their money back. On August 9th, Ponzi admitted that he had no assets with which to pay them and filed for bankruptcy. Four days later he was arrested by federal agents. Ponzi was eventually convicted of fraud and served four years in federal prison.

Social Security as a Ponzi Scheme

Some defenders of the current system insist that Social Security cannot be a Ponzi scheme because, as *USA Today* editorialized, "Ponzi schemes are a criminal enterprise; Social Security is not."[11] But this is simply a tautology that says nothing about the program's structure.

Other defenders point out that Ponzi schemes are, by their very nature, fraudulent, making promises that the scheme's operator has no intention of keeping. Moreover, the operators lie about whether or not they are investing the participant's money. Social Security, on the other hand, they say, is transparent, honest about its structure, and honest about the benefits it will deliver. In one widely cited column, political blogger Jonathan Bernstein put it this way: "[S]aying that Social Security is a Ponzi scheme or is like a Ponzi scheme is basically a false accusation of fraud against the U.S. government and the politicians who have supported Social Security over the years."[12]

Here, the program's defenders are on even shakier ground. While the Social Security Administration's website and official publications are indeed straightforward about

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how the program operates, many Americans still mistakenly believe that their Social Security taxes are somehow saved for their retirement. One only has to listen to any Social Security debate where seniors assert that they are "getting back what they paid into the system" to realize that many recipients are not clear on the program's financing. Social Security's use of terminology, such as "Trust Fund," has perpetuated much of this misunderstanding. Again, witness how many Americans believe that Social Security is in trouble because the government has spent, borrowed, or "looted" the money that should be in the Trust Fund. According to a recent Rasmussen poll, just 10 percent of voters know that Social Security taxes are not reserved for Social Security payments.[13]

More significantly, in keeping with the earlier definition of a Ponzi scheme, Social Security *does* promise benefits that the government knows it cannot deliver. For example, if a worker uses the Social Security Administration's "Benefit Calculator," he or she will receive an estimate of his or her Social Security benefits under current law.[14] However, given current levels of financing, the Social Security system cannot pay those benefits in full after 2037. In fact, by law, benefits would have to be reduced by 24 percent after that date.[15]

From 1999 until March of 2011, this benefit estimate was mailed to workers annually. During the Bush administration, the Personal Benefits Statement (PEBS) contained a disclaimer that:

> Your estimated benefits are based on current law. Congress has made changes to the law in the past and can do so at any time. The law governing benefit amounts may change because, by 2037, the payroll taxes collected will be enough to pay only about 76 percent of scheduled benefits."[16]

This warning was discontinued when the Social Security Administration stopped mailing paper copies of the benefit statement, and it is not included in the online calculator. While the Social Security Administration website includes discussions of the program's financial problems elsewhere on the site, someone looking for what his or her benefits will be would not be told that Social Security cannot pay the listed benefit. And even during the Bush administration, the disclaimer was on a separate page of the PEBS from the listed benefit level, and buried within a lengthy text. Small print aside, the Social Security Administration is providing a misleading promise of benefits.

Social Security *does* promise benefits that the government knows it cannot deliver.

Defenders of Social Security also suggest that the investment structure of the program is irrelevant because Social Security resembles an "insurance" program more than it resembles an investment plan. As the *Los Angeles Times* puts it, "It's not a retirement savings program; it's an insurance plan designed to help the elderly, the disabled, and their families stay out of poverty."[17] But even if one accepts the definition of Social Security as insurance, that is a description of benefits and how they are determined, not of financing.

Indeed, insurance companies "are required to maintain reserves and capital and surplus at all times and in such forms so as to provide an adequate margin of safety."[18] All 50 states impose capital reserve requirements on insurers, guaranteeing their ability to pay claims. Typical is New York, which mandates, "Every insurer shall . . . maintain reserves in an amount estimated in the aggregate to provide for the payment of all losses or claims incurred."[19] No insurance company could legally plan to fund future claims out of future premiums. An insurance company that did so would resemble a Ponzi scheme. Yet, that is very close to how Social Security promises to pay future claims to its benefits.

Finally, some defenders of Social Security suggest that the program shouldn't be compared to a Ponzi scheme because, unlike a Ponzi scheme, Social Security's purposes are beneficent. As Perry's rival, former Massachusetts's governor Mitt Romney, says, the program is "a recognition that we want to

Table 1
A PAYGO Social Security System

	Period 1	Period 2	Period 3	Period 4
Generation 0	Retired **benefits**	Dead	Dead	Dead
Generation 1	↑ Working ↑ **contributions**	Retired **benefits**	Dead	Dead
Generation 2	Unborn	↑ Working ↑ **contributions**	Retired **benefits**	Dead
Generation 3	Unborn	Unborn	↑ Working ↑ **contributions**	Retired **benefits**
Generation 4	Unborn	Unborn	Unborn	↑ Working ↑ **contributions**

Source: Thomas Siems, "Reengineering Social Security for the New Economy," Cato Institute Social Security Paper no. 22, January 23, 2001.

care for those in need, and our seniors have the need of Social Security."[20] But the implication of this argument is that, if Charles Ponzi had given his proceeds to charity, or if he had really believed that he could pay profits to his investors, there would have been no problem with his scheme. Clearly, intent and outcome are two different things.

None of these arguments deal with the underlying question of Social Security's financial structure. Even if one concedes that Social Security is a legal, transparent, and beneficent insurance scheme, if it is set up structurally as a Ponzi scheme it will ultimately fail. And it is in this structure that, with one important distinction, Social Security does indeed resemble a Ponzi scheme.

Social Security is a *pay-as-you-go* (PAYGO) program, in which Social Security taxes are used to immediately pay benefits for current retirees. It is not a *funded* plan, where contributions are accumulated and invested in financial assets and liquidated and converted into a pension at retirement. Rather, it is a simple wealth transfer from current workers to current retirees.

Table 1 shows a basic model of overlapping generations, where people are born in every time period, live for two periods (the first as workers, the second as retirees), and finally die. As time passes, older generations are replaced by younger generations. The columns represent successive time periods, and the rows represent successive generations. Each generation is labeled by the period of its birth, so that Generation 1 is born in period 1, and so on. In each period, two generations overlap, with younger workers coexisting with older retirees.

In Table 1, a PAYGO pension system provides a start-up bonus to Generation 0 retirees by taking contributions from Generation 1 workers to pay out benefits to those already retired. The PAYGO program provides initial (Generation 0) retirees a windfall because they never paid taxes into the system. Subsequent generations both pay taxes and receive benefits. There is no direct relationship between taxes paid and benefits received.[21] As a result of this structure, Social Security resembles a classic Ponzi scheme in many aspects.

There is no investment. 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

Social Security resembles a classic Ponzi scheme in many aspects.

Trust Fund accumulations are spent like any other government revenue.

system, that money is used to pay current beneficiaries. Since Social Security began running a cash-flow deficit this year, paying out more in benefits than it takes in through taxes, every dollar collected in Social Security taxes (and more) is used to pay benefits.[22] There is no money left over to invest. And since Social Security is currently projected to never return to surplus, there will be no future investments.

However, what about the surplus Social Security taxes that accumulated in the Social Security Trust Fund from 1984 to 2010, a period when Social Security did collect slightly more in taxes than it paid in benefits? Could that have been considered as invested?

When Social Security was running a surplus, the excess revenues were used to purchase special-issue treasury bonds. When the bonds were purchased, the Social Security surplus became general revenue and was spent on the government's annual general operating expenses. What remained behind in the Trust Fund were the bonds, plus an interest payment attributed to the bonds (also paid in bonds, rather than cash). Currently the Trust Fund holds roughly $2.9 trillion in such bonds. Those bonds are, in essence, a form of IOU, a promise against future taxes. When the bonds become due, the government will have to repay them out of general revenue.

Since Trust Fund accumulations are spent like any other government revenue, the Social Security Trust Fund could be considered an investment to the degree that general government spending could be considered investment. But relatively little federal spending meets that definition, including infrastructure and some education spending. Most government spending is simply transfer payments or other forms of consumption. In fact, by the government's own estimates, only 15.7 percent of federal spending can be considered investments.[23] Since the maximum Social Security surplus represented just 15 percent of Social Security taxes, an investment rate of less than 16 percent of federal spending means that less than 2.5 percent of Social Security taxes were ever invested in anything.

Taking a slightly different tack, others, such as Center for American Progress blogger Matthew Yglesias, argue that all Social Security taxes should be considered to have been invested in the U.S. economy as a whole, since recipients are ultimately relying on the fruits of that economy to pay their benefits. He claims that Social Security is similar to private pensions or even 401(k) plans in this sense. With stocks or other private investments, he writes:

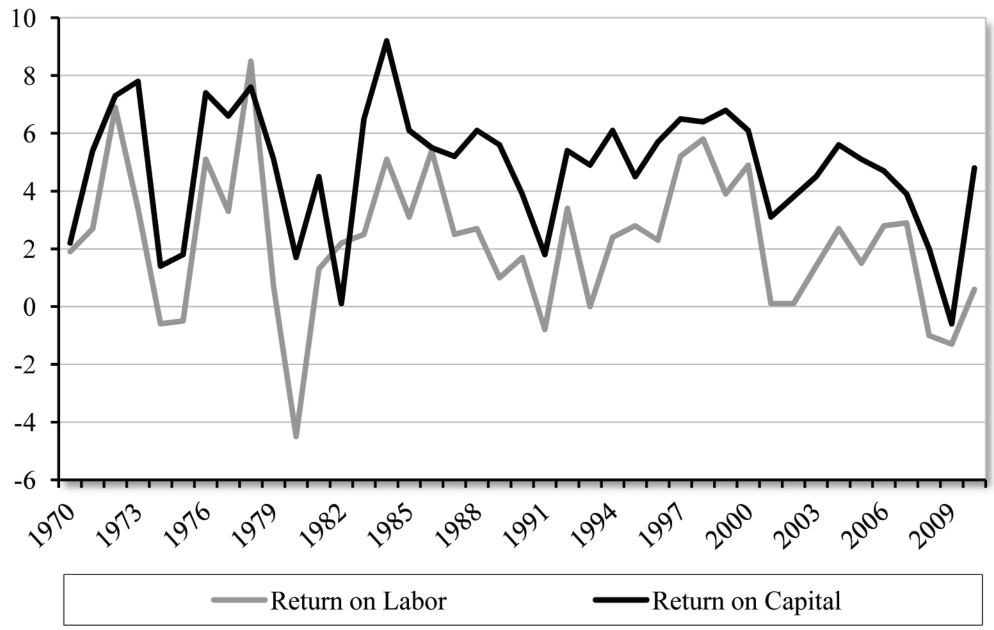
> Your expectation is that at a future date . . . you'll be able to exchange those shares for money. More money than you paid for them in the first place. Why would that work? Well, it could work because you were just stupendously lucky. But the reason we anticipate that it will work *systematically* is that we anticipate that there will be economic growth. In the future, people will in general have more money, so assets will be more valuable.[24]

Yglesias goes on to argue that the same can be said of Social Security:

> Its actuarial situation is just the same as a stock market investment in this regard. If future economic growth is lower than anticipated, it will be impossible to pay the anticipated level of benefits. On the other hand, if future economic growth is faster than anticipated, it would be possible to pay even more benefits than had been promised.[25]

It is true that, whether you are talking stocks or Social Security, returns are ultimately a claim on the wealth produced by future generations. The future value of stocks, bonds, property, and other investments is ultimately dependent on future cash flows

Figure 1
Return on Capital vs. Return on Labor 1970–2010



Source: Author's calculations using Social Security Adminstration data Table V.B2 and Table V.B1.

such as dividends, interest, and rents. They are, in turn, dependent on economic growth. If economic growth in the future is poor, the taxes available to pay Social Security will not be available, but asset values will likely also decline.

However, this analysis ignores the fact that in a dynamically efficient economy the rate of return on labor, the basis for the payroll taxes that will be used to pay future benefits, is lower than the rate of return on capital, the basis for investment returns. As Figure 1 illustrates, in the United States the return on capital has generally run about 2.5 percentage points higher than the return on labor.

Yglesias's analysis also ignores the impact that private investment has on economic growth. Whereas, as shown above, Social Security is simply a transfer program, feeding consumption rather than investment, private pension programs *do* invest their contributions, thereby boosting economic growth. In fact, Martin Feldstein and others have suggested that Social Security's impact may actually be worse than no investment. Because individuals substitute Social Security for private savings, the program actually displaces savings and investment that would otherwise occur. Feldstein, for example, suggests that if the amount currently paid in Social Security taxes were instead invested privately, it would "increase the economic well-being of future generations by an amount equal to 5 percent of GDP each year."[26]

Earlier investors win big. Like a Ponzi scheme, Social Security paid early participants a windfall return on their money. There are two reasons for this.

First, because individual Social Security taxes are not saved or invested for that individual's retirement, the Social Security benefits that the individual receives are not directly linked to the taxes paid. As the Supreme Court ruled in *Flemming v. Nestor* (1960), this means that people have no legal, contractual, or property right to benefits.[27] Congress can change, reduce, or take away those benefits at any time. However, it also

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means that Congress can set a minimum benefit level that is also unrelated to contributions.

That is what Congress did in the case of Social Security's earliest recipients. As Edward Witte, executive director of Franklin Roosevelt's Committee on Economic Security, told the House Ways and Means Committee in 1935, if benefits were proportional to contributions:

> The man at $40 [in wages per month] will get a pension of around 20 cents a month after 5 years of contributions, which is such a small amount that it would not be considered satisfactory. . . . Although the actuaries may compute that his contributions would buy a monthly annuity of only 20 cents, he is apt to think that he has earned a pension of $10 or $15 at least. It is that psychological factor that you have to take into account. A pension of such a small amount as people who are in the system only a short time can buy, will never be satisfactory to them. It will seem to them that they are being cheated.[28]

Congress therefore set an initial minimum monthly benefit of $10 for anyone who had paid into the system for at least five years. This meant that early beneficiaries received payments far in excess of any contributions. For example, the very first Social Security recipient, Ida Mae Fuller of Vermont, paid just $22.54 in Social Security taxes, but the long-lived Mrs. Fuller collected $22,888.92 in benefits.[29]

Second, because the early stages of a PAYGO Social Security system, like the early stages of a Ponzi scheme, are characterized by a high ratio of contributors to beneficiaries, taxes can initially be set at artificially low rates.

Current recipients depend on recruiting subsequent recipients who receive lower returns. Like a Ponzi scheme, Social Security participants receive payments, not from returns on their own investments, but directly from inflows from subsequent participants. That means that, as in a Ponzi scheme, the system can only continue to provide benefits as long as it is able to recruit additional people to pay into it.

Yet, the demographic changes described above mean that Social Security has not been able to maintain a sufficient number of taxpayers/contributors. Fewer contributors per beneficiary means that the initially low tax rates must rise faster than benefits (see below), resulting in lower rates of return for subsequent participants who must pay more in taxes per dollar in benefits than earlier participants. As a result, the overall internal rates of return have declined steadily.

In theory, each generation's rate of return should be equal to the rate of growth in the wage base covered by the system. The growth of the wage base, in turn, is based on the growth in the labor force plus the growth in real wages.[30] As long as the wage base continues to grow, Social Security can continue to yield a positive rate of return.

Calling Social Security "a Ponzi Scheme that works," Paul Samuelson summed up this point:

> The beauty of social insurance is that it is actuarially unsound. Everyone who reaches retirement age is given benefit privileges that far exceed anything he has paid in—exceed his payments by more than ten times (or five times counting employer payments)! How is it possible? It stems from the fact that the national product is growing at a compound interest rate and can be expected to do so for as far ahead as the eye cannot see. Always there are more youths than old folks in a growing population. More important, with real income going up at 3 percent per year, the taxable base on which benefits rest is always much greater than the taxes paid historically by the generation now retired. Social Security is squarely based on what has

Figure 2
Demographic Changes and Social Security

Source: William G. Shipman, "Retiring with Dignity: Social Security vs. Private Markets," Cato Institute Social Security Choice Paper no. 2, August 14, 1995, http://www.cato.org/pubs/ssps/ssp2.pdf.

> been called the eighth wonder of the world—compound interest. *A growing nation is the greatest Ponzi game ever contrived.* (Emphasis added).[31]

Samuelson would be correct if there were no demographic factors to consider. As long as the wage base supporting Social Security grows faster than the number of recipients, the program can continue to pay higher benefits to those recipients. But the growth in the labor force has slowed dramatically. In 1950, for example, there were 16 workers paying taxes into the system for every retiree receiving benefits from the program. However, Americans have been living longer and having fewer babies. As a result, there are now just 2.9 workers per beneficiary, and by 2020 there will be only two (see Figure 2)[32]. And real wage growth (especially in wages below the payroll tax cap) has not been nearly fast enough to offset this demographic shift.

Thus, as Michael Boskin of Stanford University explained, "While the percentage of transfers in benefits is largest for the first cohort of retirees (who receive virtually a complete windfall), the positive intergenerational transfers received by retirees . . . [eventually turns] negative for subsequent retirees."[33] A worker earning the median wage who retired in 1984 earned an approximate internal return of 4 percent on his or her taxes. In contrast, a similar worker retiring this year can expect a return of 2.2 percent. If that worker were age 30 this year and planning to retire in 2037, he or she would hope to earn a return of just 1.5 percent.

Thus, not only can current workers expect a far poorer rate of return than that experienced by earlier participants, but the return they receive is far lower than the return

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to private capital investment.

In all these aspects, therefore, Social Security clearly resembles a Ponzi scheme.

A Crucial Distinction

There is, however, one important difference between Social Security and Ponzi schemes. As the courts have pointed out in regard to Ponzi schemes:

> A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors.[34]

As Mitchell Zuckoff, the Boston University journalism professor who wrote the definitive biography of Charles Ponzi, explains, this is not the case with Social Security:

> A Ponzi scheme is unsustainable because the number of potential investors is eventually exhausted. That's when the last people to participate are out of luck; the music stops and there's nowhere to sit. It's true that Social Security faces a huge burden—and a significant, long-term financing problem—in light of retiring Baby Boomers. . . . But Social Security can be, and has been, tweaked and modified to reflect changes in the size of the taxpaying workforce and the number of beneficiaries. . . . [T]he government could change benefit formulas or take other steps, like increasing taxes, to keep the system from failing.[35]

Unlike the perpetrators of Ponzi schemes, the government can maximize the size of its investor pool by forcing people to participate. As an article in *Mother Jones* put it, crudely but accurately, the difference between Social Security and a Ponzi scheme is that Social Security "is run by the government, which can print money and tax people."[36]

And when shifting demographics limit the number of new participants available, it can increase the contribution from those who are available by raising taxes. The Social Security Administration itself makes the distinction this way:

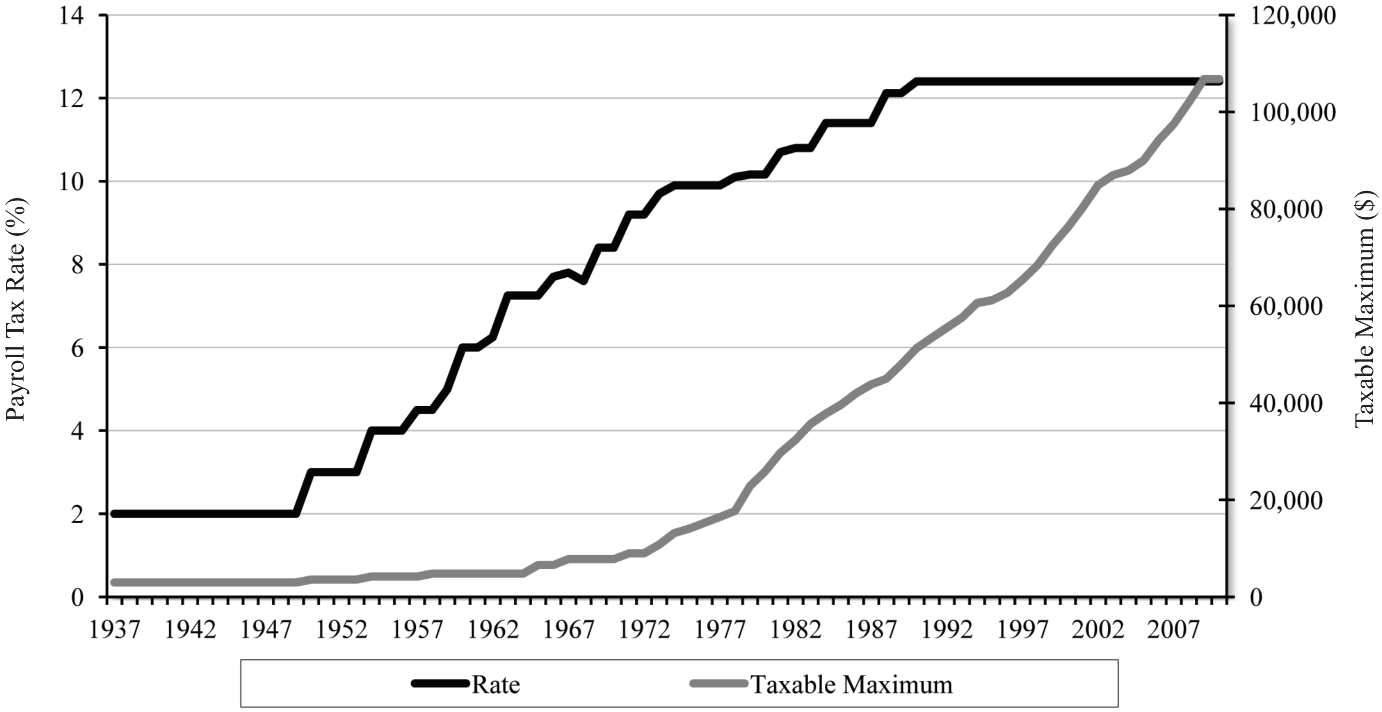
> As long as the amount of money coming in the front end of the pipe maintains a rough balance with the money paid out, the system can continue forever. There is no unsustainable progression driving the mechanism of a pay-as-you-go pension system and so it is not a pyramid or Ponzi scheme.[37]

Certainly, throughout its history, Social Security taxes have been raised frequently to keep the system financially viable. The initial Social Security tax was 2 percent (split between the employer and employee), capped at $3,000 of earnings. That made for a maximum tax of $60. Since then, as Figure 3 shows, the payroll tax rate and the ceiling at which wages are subject to the tax have been raised a combined total of 64 times. Today, the tax is 12.4 percent, capped at $106,800, for a maximum tax of $13,234. Even adjusting for inflation, that represents more than an 800 percent increase.

Alternately, to preserve the system, Congress can reduce Social Security benefits. For example, in 1993 the Social Security retirement age was increased for workers age 45 and younger at the time. Since the amount of payments a recipient will receive over a lifetime depends in part on how long they collect benefits, delaying the age at which they begin to receive those benefits effectively reduces the total amount of those benefits. Thus, while it is technically true that, as the Social Security Administration claims, "it has never missed a payment," it has paid less than originally promised.

Both tax hikes and benefit reductions reduce the return that workers can expect on

Figure 3
Payroll Tax Rate and Taxable Maximum Increases



Source: "Social Security and Medicare Tax Rates," Social Security Administration, http://www.ssa.gov/oact/progdata/tax, and "Contribution and Benefit Base," Social Security Administration, http://www.ssa.gov/oact/cola/cbb.html.

their contributions (taxes). As we saw above, the average 30-year-old will receive barely a third of the return that someone did who retired in 1985. Most workers will receive returns far below those provided by private investment. Some will actually receive less in benefits than they pay into the system, a negative return. Yet, no matter how bad a deal Social Security becomes, workers cannot refuse to participate.

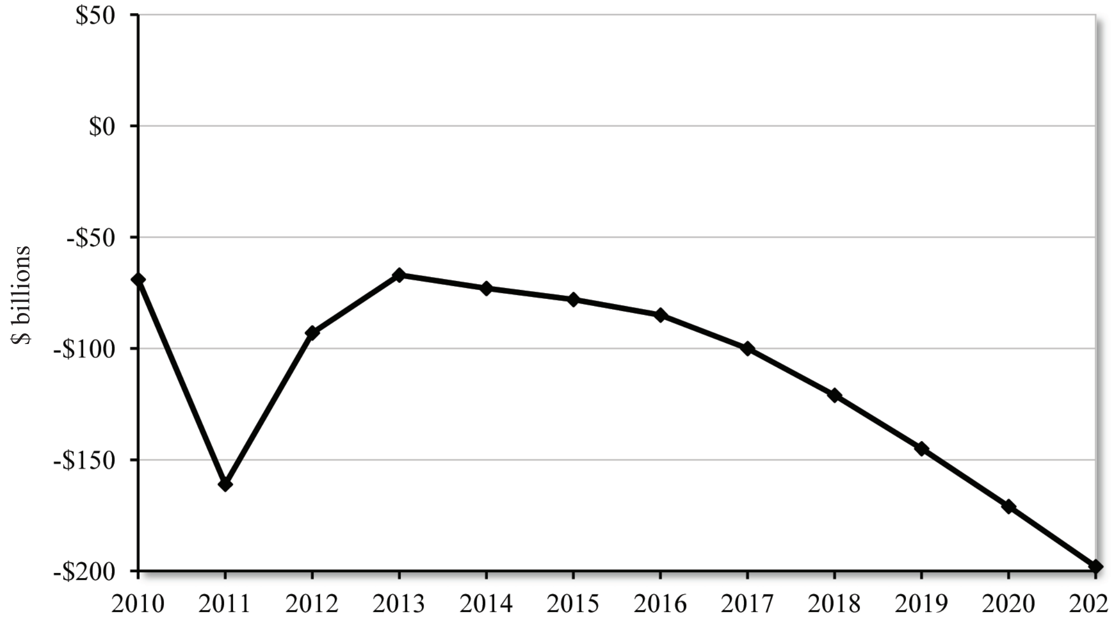
Social Security's defenders make much of the fact that, whereas most Ponzi schemes collapse within months or, at most, a few years, Social Security has survived for more than 75 years. As the Social Security Administration's website proudly notes, "The American Social Security system has been in continuous successful operation since 1935. Charles Ponzi's scheme lasted barely 200 days."[38] What goes unsaid, however, is that Social Security has only been able to continue its operation and make those payments by forcing workers to pay higher and higher taxes.

The Bigger Picture

The back and forth over how to describe Social Security has obscured a much more important fact: Social Security's finances continue to deteriorate. As noted above, Social Security began running a cash-flow deficit this year, paying out more in benefits than it takes in through taxes (Figure 4).[39]

In theory, of course, Social Security is supposed to continue paying benefits by drawing on the Social Security Trust Fund until 2036, after which it will be exhausted.[40] At that point, *by law*, Social Security benefits will have to be cut by approximately 24 percent.[41]

Figure 4
Social Security Cash-flow Deficit



Source: Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2011–2021," January 2011.

The Social Security Trust Fund is not an asset that can be used to pay benefits.

However, in reality, the Social Security Trust Fund is not an asset that can be used to pay benefits. As the Clinton administration's Fiscal Year 2000 Budget explained it:

> These [Trust Fund] balances are available to finance future benefit payments and other Trust Fund expenditures—but only in a bookkeeping sense. . . . They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large Trust Fund balances, therefore, does not, by itself, have any impact on the Government's ability to pay benefits.[42]

Even if Congress can find a way to redeem the bonds, the Trust Fund surplus will be completely exhausted by 2036.[43] At that point, Social Security will have to rely solely on revenue from the payroll tax—but that revenue will not be sufficient to pay all promised benefits. Overall, Social Security faces unfunded liabilities of nearly $18.9 trillion ($20.8 trillion if the cost of redeeming the Trust Fund is included).[44] Clearly, Social Security is not sustainable in its current form. That means that Congress will again be forced to resort to raising taxes and/or cutting benefits in order to enable the program to stumble along.

And either the tax increases or benefit reductions would need to be significant. For example, to restore Social Security to solvency would require raising the current 12.4 percent Social Security payroll tax to at least 17.6 percent, a 42 percent increase, or the equivalent amount of revenue from other taxes.[45] (Eliminating the cap on taxable income for the payroll taxes, one frequent suggestion, would actually do little for the program's long-term solvency.[46])

On the other side of the ledger, as pointed out above, restoring the program to solvency would require at least a 24 percent reduction in benefits. Suggested changes include further raising the retirement age, trimming cost-of-living adjustments, means-testing, or changing the wage-price indexing formula.

Obviously, there are better and worse ways to make these changes. But the larger point is that continued tax increases and benefit cuts will be necessary until the basic structure of Social Security is changed from the PAYGO model that so resembles a Ponzi scheme, to a system where at least some of an individual's Social Security taxes are saved for that person's retirement and invested in real assets.

Table 2 shows what that would mean. Unlike the current Social Security system, each working generation's contributions actually would be saved and would accumulate as time passes. This accumulation, including the returns earned through real investment, would then be used to pay that generation's benefits when they retire. Under a funded system, there would be no transfer from current workers to current retirees. Each generation pays for its own retirement.[47]

In this system, there is a direct link between contributions and benefits. Each generation receives benefits equal to their contribution plus the returns their investments earn. And because real investment takes place and the rate of return on capital investment can be expected to exceed the growth in wages, workers can expect to receive higher returns than under the current system.

Although from a strictly economic viewpoint it makes no difference whether investment under such a funded system is done by the government directly or through personal accounts, one need look no further than the Troubled Asset Relief Program or the auto industry bailout to see reasons to be concerned with government investment. If the goal is to move away from a Ponzi-style PAYGO system to a program based on savings and investment, a much better approach is to allow younger workers to save at least a portion of their payroll taxes through individual accounts.[48]

Social Security is not a Ponzi scheme, because Charles Ponzi didn't have a gun.

Table 2
A Funded Social Security System

	Period 1	**Period 2**	**Period 3**	**Period 4**
Generation 0	Retired	Dead	Dead	Dead
Generation 1	Working → **contributions**	Retired **benefits**	Dead	Dead
Generation 2	Unborn	Working → **contributions**	Retired **benefits**	Dead
Generation 3	Unborn	Unborn	Working → **contributions**	Retired **benefits**
Generation 4	Unborn	Unborn	Unborn	Working → **contributions**

Source: Thomas Siems, "Reengineering Social Security for the New Economy," Cato Institute Social Security Paper no. 22, January 23, 2001.

The Social Security program is facing insolvency unless it is fundamentally reformed.

The failure of President George W. Bush's bungled 2005 campaign for personal accounts is widely believed to have taken that idea off the table for the foreseeable future. None of the recent deficit commissions included personal accounts in their recommendations. However, several new representatives and senators elected in the 2010 mid-term elections appear sympathetic to personal accounts, meaning that a combination of benefit reductions and personal accounts remains not only the best policy option for Social Security reform, but also a viable political option.

Conclusion

So, is Social Security, as currently constituted, a Ponzi scheme? It certainly embodies many of the characteristics of one. It makes no investments. Instead, it relies on future contributors to pay current recipients, providing a windfall to the first participants, but declining returns to subsequent joiners. It is a system that worked well when demographics were favorable, but is facing insolvency as the ratio of recipients to contributors increases.

However, unlike Charles Ponzi's scheme, Social Security will never go broke as long as the government can force people to pay more taxes and accept fewer benefits. In the end, that is the crucial difference. Social Security is not a Ponzi scheme because Charles Ponzi didn't have a gun.

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. That reform should not just make young workers pay more and receive less. Rather, it should remove the Ponzi-like aspects of the program by allowing younger workers to save a portion of their payroll taxes through privately invested personal accounts.

A system of personal retirement accounts would be one that clearly is not a Ponzi scheme.

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