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Social Security Ponzi Scheme? Perhaps, but That's Not the Problem

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Presidential candidate Governor Rick Perry's claim that Social Security is a "Ponzi scheme" -- that is, the program not very different from the operation run by Bernard Madoff -- sparked a firestorm, but the comparison is not wholly inappropriate. Even so, that is wrong issue to focus on. We've inherited a Social Security system which has survived court challenges, along with its unfunded liabilities -- regardless of the fact that Social Security's primary transactions resemble that of a Ponzi scheme.

The question is what are we going to do about it in our time -- sustain it or get rid of it? And, in both cases, how?

Many economists, including some Nobel laureates, have alluded to Social Security as a Ponzi scheme -- one that takes money from new investors to directly pay to older investors as a return. As long as the population of investors keeps growing, the money coming in is sufficient to provide a positive rate of return to earlier investors. Eventually, however, the population of new investors must stop growing-at which point, investors cannot be repaid and the entire scheme collapses.

Using the "Ponzi scheme" label to describe such ventures in the private sector is legitimate. But what about when such ventures are operated by the government -- such as Social Security? Full disclosure: In 1996, I co-wrote an Economic Commentary for the Cleveland Federal Reserve, essentially comparing Social Security to a Ponzi scheme. I still agree with much of what it says although, in hindsight, I would express some of its ideas differently today.

A key test of whether Social Security is exactly like a Ponzi scheme -- ignoring for the moment that it's operated by a sovereign -- is whether it produces anything of value. It's supposed to produce value by providing "social insurance." What is that, exactly?

Advocates of sustaining Social Security's current structure (as opposed to its objectives of providing economic security to retirees and associated individuals) claim that it more efficiently provides support for those who suffer economic misfortunes during their lifetimes. Another description is that Social Security enables the pooling of economic risks across generations through its benefit formula that averages across high and low productivity experiences of different worker generations.

These advocates are wrong. In the last chapter of my book, I examine whether Social Security reduces the variability of lifetime incomes across people from what it would be without it. I find a very small negative effect of the program on cohort-specific variance of lifetime income, most of it arising from payroll taxes and very little from the benefit side of Social Security. That suggests that the program's various redistributive features do little to alter the distribution of economic well being. Other studies also refute the idea that Social Security is successful in providing social insurance through its redistributive provisions. In yet another study, I show how Social Security's current rules can prevent people from becoming richer over generations. Social Security's rules induce low income households to save very little through retirement, thereby preventing them bequeathing wealth to their children -- unlike children of rich families.

Advocates of Social Security also point to its original intent of providing "old age insurance." But Social Security does a very poor job today of fulfilling this function. Living beyond Social Security's "full retirement age" of 66 is a relatively sure bet for 20-year-olds today compared to the 1930s when the program's full retirement age was set. Today, Social Security acts more as a "retirement saving" program than an "old-age insurance" program and its merits as a "productive business" -- as opposed to a forced saving mechanism that doesn't actually result in higher national saving -- should be seriously questioned. To restore its old age insurance function to earlier levels, its retirement, survivor, and other benefit eligibility ages would have to be increased by significantly more than the scheduled increases enacted by Congress in 1983, which are currently underway.

Even with the results from the studies cited, actuaries' and economists' knowledge about how Social Security operates, how it affects the economy, and how it will evolve in the future is still quite limited, in view of the myriad factors influencing its finances. The public debate on Social Security is mired in inaccuracies, untrue factoids, unsupportable claims, and diversions into immaterial discussions, partly, but not exclusively, due to this imperfect information. That's unlikely change anytime soon. The program will continue to bumble along until -- like a Ponzi scheme -- it doesn't.