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Do Bailouts Encourage Ponzi Schemes?

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Say I convince my friend Elvis to invest $100 with me, promising to double his money in a month. Next I convince my friends Simon and Garfunkel. They each give me $100, and I use the $200 to pay off Elvis. Elvis is impressed and tells all his friends. I take $100 each from four of them — John, Paul, George and Ringo — and use the $400 to give back $200 each to Simon and Garfunkel. Suddenly everyone wants to invest with me. I take money from eight of them, then 16, then 32, and so on. When a lot of people are involved, I disappear with the money that I raised in the last round.

The scheme that I have just illustrated is called a Ponzi scheme. It is named after Charles Ponzi, who raked in $15 million in nine months in 1919 and 1920. At the height of his success, Mr. Ponzi was hailed by those he was cheating as the greatest Italian who ever lived. "You're wrong," he said modestly, "there's Columbus, who discovered America, and Marconi, who discovered radio." "But, Charlie, you discovered money," they told him.

What is being called the biggest Ponzi scheme of all time was uncovered just a few days ago. The Wall Street legend Bernard Madoff is reported to have told influential investors that he could guarantee them a 1 percent monthly return. That promise probably sounded too good to be true — and it was.

Ponzi schemes — to the extent that people realize, even subconsciously, that something is not right — should work only if investors are irrational. Investors in the last round know that they will lose their money when the organizer disappears with their funds. No one wants to play the last round, making the second-to-last round actually the last. Those people will refuse to take part as well. Using this logic again and again, no one should take part.

But sometimes our greed or our naivete trumps our rationality. Almost a century after Charles Ponzi, people continue to fall victim to Ponzi schemes like the one attributed to Mr. Madoff. A recent Google search revealed more than 100 such schemes being investigated all over the world.

Not all Ponzi-like economic activity is bad or illegal.

Social Security, which involves the younger generation paying some of the retirement benefits of the older generation, is a perfectly legal Ponzi scheme.

Asset pricing bubbles, where the intermediary takes in a cut every round, is a Ponzi scheme grafted to a bubble, and they are legal. For example, when people take out mortgages they can't afford, based on the expectation that their homes will continue to increase in value, they are engaging in legal Ponzi and bubble activity.

But what happens when the music stops and people find themselves playing the last round of the Ponzi game?

The federal government may chose to spend billions to bail out the last-round players to protect overall financial stability. The Ponzi participants will get a piece of the bailout but will still have a net loss. The problem is that taxpayers have to foot the bailout bill, and they may have even greater net losses than the people who initially signed up for the Ponzi game.

If taxpayers stand to lose more money than Ponzi players, it is suddenly rational to play the game. That's because only by getting a piece of the bailout will Ponzi participants protect themselves from the larger losses faced by taxpayers. This is what happened in the early 1990s in nearly all the countries transitioning from communism: promises of state bailouts encouraged gigantic Ponzi schemes. In Albania, it even led to a civil war.

Therefore, while some Ponzi-like behavior is legal and even beneficial for our economy, bailouts only serve to reinforce behavior that can lead to even riskier Ponzi schemes. So, though many of us recognize deals that are too good to be true, bailouts will encourage us to take part in such deals. The $700 billion federal bailout may eventually lead to Ponzi schemes large enough to make Mr. Madoff's reported $50 billion swindle pale in comparison.

Moral of the story: If you want to design such a scheme and get away with it, make it legal — like investments in subprime mortgages, or investments in energy from water. Then involve as many people as possible, so that it becomes "too big to fail." Some of the $700 billion bailout money may actually be used to rescue some of your investors.

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