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RISK ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM

EDITED BY

JOHN Y. CAMPBELL &
MARTIN FELDSTEIN

Risk Aspects of Investment-Based Social Security Reform

**A National Bureau
of Economic Research
Conference Report**

Risk Aspects of Investment-Based Social Security Reform

Edited by **John Y. Campbell and Martin Feldstein**

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Since this volume is a record of conference proceedings, it has been exempted from the rules governing critical review of manuscripts by the Board of Directors of the National Bureau (resolution adopted 8 June 1948, as revised 21 November 1949 and 20 April 1968).

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Preface

The design of social insurance programs involves a balancing of protection and distortion. Social security pension programs protect individuals against inadequate income during retirement but also distort national saving and labor markets. Saving is distorted because traditional pay-as-you-go social security programs substitute for personal saving without a corresponding increase in public saving. Labor market behavior is distorted because the low implicit rate of return that individuals receive on their "contributions" implies that those contributions are a tax that significantly reduces compensation. Pension rules often induce early retirement because the reward for continued work is very low.

Although these issues have concerned economists for many years, it is the financing problems caused by the aging of the population that has put social security reform on the political agenda in the United States and other major industrial countries. A key idea in many of the reform proposals is to use a system of investment-based personal retirement accounts to supplement the benefits that can be financed with the existing pay-as-you-go tax rate.

The National Bureau of Economic Research has been engaged for several years in a basic study of the feasibility and potential consequences of such a reform. The first project in this study was an examination of the issues that arise in the transition from a pure pay-as-you-go system to one that involves investment-based accounts: that was Martin Feldstein's *Privatizing Social Security,* published by the University of Chicago Press in 1998. The research in that project examined the experiences of several countries that have introduced investment-based systems and studied some of the likely costs and benefits of such a transition in the United States. Although the countries that have adopted investment-based systems differed substantially in their approaches to the transition, it is clear from their experiences that investment-based systems are viable in countries with far less developed capital markets than that of the United States and with populations that are much less familiar with investing than the American public.

The social security actuaries calculate that future demographic and economic trends imply that financing the benefits projected under current law, that is, a continuation of the existing replacement rates at each point in the earnings distribution, would require raising the existing 12.4 percent tax rate (for the benefits paid to retirees, their dependents, and their surviving spouses, as well as the disabled) to more than 19 percent. NBER simulations based on the same demographic and economic projections show that combining the existing 12.4 percent pay-as-you-go payroll tax with personal retirement account deposits of no more than 2.5 percent of payroll would avoid the 19 percent payroll tax and maintain the benefits projected in current law if the accounts earn a 5.5 percent real rate of return, a figure significantly less than the actual return on a portfolio of stocks and bonds over the past fifty years.

The projections presented in the first study of this project all assumed that the rate of return is known with certainty. In contrast, the papers in this volume recognize that the future rate of return is uncertain and focus on the question: How much risk is imposed on future retirees by shifting from a pure pay-as-you-go system to a system in which a portion of benefits is investment based with funds accumulated in individual accounts that are invested in a mix of stock and bond mutual funds? As a background to this question, the volume also looks at the risk in a pay-as-you-go system caused by the uncertain future political support for benefits as the implicit rate of return declines. The introductory chapter provides a general discussion of the risk aspects of investment-based reform and summarizes the individual studies in the volume.

Three more volumes of studies will be part of this NBER project: *Administrative Aspects of Investment-Based Social Security Reform* (edited by John B. Shoven), *Distributional Aspects of Investment-Based Social Security Reform* (edited by Martin Feldstein and Jeffrey Liebman), and *Social Security Pension Reform in Europe* (edited by Martin Feldstein and Horst Siebert).

The project has benefited from the interaction of a large number of NBER and other researchers who have prepared the individual studies and participated in the five conferences at which this work was presented. The research was also helped by the extensive discussions at the NBER Summer Institute and at the meetings of the NBER Public Economics Program and the NBER Program on Aging.

The papers in this volume were presented at a conference in January

1999. Dr. Pascal Maenhout prepared the summary of the conference discussion that is included in this volume.

We are grateful to the Ford Foundation and the Starr Foundation for the financial support that has made this project possible. We also thank the individual members of the NBER staff for their help with the many aspects of the planning and execution of the research, the conference, and the volume. In addition to the researchers and research assistants who are named in the individual papers, we thank Kirsten Foss Davis, Helena Fitz-Patrick, Norma MacKenzie, and Brett Maranjian for logistic support of the meetings and assistance in the preparation of this volume.