

Reducing the Risk of Investment-Based Social Security Reform

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Policy Abstract

This paper presents a new market-based approach to reducing the risk of investment-based Social Security that could be tailored to individual risk preferences. With this new form of risk reduction, substituting an investment-based personal retirement account (PRA) for the traditional pure pay-as-you-go Social Security system could achieve both a significantly higher expected retirement income and a very high probability that the investment-based annuity would be at least as large as the pay-as-you-go benefit. A key feature of the approach developed here is a guarantee that the individual would not lose any of the real value of each year's PRA savings and might be guaranteed to earn at least some minimum real rate of return. In one example of such a plan, the current 12.4 percent pay-as-you-go tax is compared with a mixed plan that has a 6.2 percent pay-as-you-go tax and 6.2 percent annual PRA savings. This new mixed plan, when fully phased in, would have the following desirable characteristics: (1) The median value of the combined retirement income (i.e., the sum of the pay-as-you-go benefit and the PRA annuity) would be 147 percent of the traditional pay-as-you-go benefit. (2) There would be a 95 percent probability that the combined retirement income exceeds the traditional pay-as-you-go benefit. (3) There would be less than one chance in one hundred that the combined retirement income would be less than 96 percent of the traditional pay-as-you-go benefit. (4) Each year's PRA saving would be guaranteed to earn at least a one percent real rate of return between the time that it is saved and its value at age 66 (and generally substantially more). The paper considers a range of "No Lose" options with varying trade-offs between the guaranteed minimum return and the distribution of possible higher returns.