Reforming Social Security with Progressive Personal Accounts

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Policy Abstract

Over the last year, the nation has been engaged in a heated debate about whether to replace part of the current, defined benefit Social Security system with a system of defined contribution personal accounts. Advocates for retaining the current system argue that (1) social security should redistribute wealth from those who have earned more over their whole working lives to those who have earned less, and (2) different generations should share in the risks and benefits of macroeconomic growth. Advocates for personal accounts, on the other hand, support (3) ownership by individuals of tangible assets that cannot be revoked by a future government and (4) market valuations of those assets as they are accrued so that rational planning for retirement can take place outside of Social Security. Our purpose in this study is to find a common ground between these two approaches which preserves the core goals of each. We show that in fact it is perfectly possible to convert social security into a system of personal accounts with irrevocable ownership of market priced assets, while at the same time redistributing benefits based on lifetime income and sharing risks across generations. Redistribution based on lifetime income is accomplished via a variable government match (or tax) on contributions. Risk sharing across generations is accomplished through the creation of a new kind of derivative security whose payoffs depend on the average earnings of those working at a specific point in time in the future. We call this security a Personal Annuitized Average Wage security, or PAAW. Additional benefits could be achieved through a public market for the PAAW security.