Retirement Income
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A response to last week's cover story

By David Babbel *Thu, Mar 12, 2020*

The author, an emeritus professor at Penn's Wharton School, doesn't fully agree with the thrust of last week's RIJ cover story, 'At These Rates, Why Bother to Save?'

Thank you for including a synopsis of the Shoven et al. study in *Retirement Income Journal*. In your summary comment on the Shoven **article**, you stated:

"The paper suggests that it doesn't make much sense for people in the bottom half of the income distribution to defer Social Security benefits until age 70 or to buy life annuities."

Much of what Shoven et al. observe is correct. But I don't agree that negative real interest rates necessarily imply that there's no reason to defer Social Security benefits until age 70 or to buy life annuities (particularly deferred life annuities).

Let me explain.

Under current practices, Social Security benefits beyond 62 years of age tend to increase by roughly 8% per year of delay up to age 70. This is due to the mortality assumptions and the assumed interest rate embedded in those increments. Because the 8% yearly increment (which remains inflation-adjusted throughout the remainder of life) is higher than can be justified on economic and actuarial grounds, it still may be a good choice to delay Social Security until later years, even 70.

In addition, the tontine nature of life annuities, and particularly deferred income annuities, means that their high "mortality credits" should continue to attract new buyers, despite very low or even negative embedded real rates of interest.

Arrow, Debreu and Hirshleifer provided the theoretical basis for that attraction in their Nobel Prize elaborations of "state-preference theory." They showed that the value that one places on money depends upon the state of nature, including the individual circumstances, under which money is received.

In such states, one may use negative discount rates to assess annuities' future value, thereby leading to potentially attractive returns. Thus, annuity payments that are "loaded up" with mortality credits can be particularly valuable, especially when someone can't work or is dependent on assistance from a possibly insolvent government.

Even if the government is able to honor its promises without debasing its currency, the mortality credits will create impressive returns for those who survive beyond the average lifetime.

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