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POLICY BRIEF

PAYOUTS IN INDIVIDUAL ACCOUNTS POSE NEW QUESTIONS

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EXECUTIVE SUMMARY

Key design issues must be addressed if individual accounts are added to Social Security or are created outside of Social Security. Many of the issues in payout policies also have implications for private retirement plans which increasingly are in the form of personal accounts.

Should Retirees Be Required to Buy Life Annuities? The answer will depend on the purpose of the accounts, the size of Social Security benefits that go with the accounts, and whether workers are required to put money in the accounts. If the accounts are meant to provide basic security and other Social Security benefits are not adequate, then policymakers might want to require retirees to buy products that resemble features of Social Security, with payments for life, that are indexed for inflation, and that automatically pay annuities to widowed spouses.

Will Joint Life Annuities Be Required? With individual accounts, the cost of paying spousal benefits means that payments to a spouse will reduce funds for the accountholder. To require joint life annuities could impose new reporting requirements and dispute resolution procedures beyond those required for Social Security benefits, where providing spousal benefits does not reduce a retiree's benefit.

Should pre-retirement access to accounts be restricted? The pros and cons of allowing early access to individual accounts will depend, in large part, on the intended use of the accounts, whether people have any choice about whether to participate, and whether the accounts are viewed as personal property. If the accounts are supposed to provide baseline economic security in old age, the case for banning early access is strong. Yet, if the purpose of the system is to expand opportunities for voluntary retirement saving, then early access might encourage people to save more than they otherwise would.

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INTRODUCTION

Amid calls for Congress to create individual accounts as part of Social Security, the National Academy of Social Insurance (NASI) in January 2005 issued a new report by a non-partisan expert panel that urges lawmakers to pay careful attention to how and when money from such accounts would be paid out to retirees, their spouses, and survivors. The report, *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy*, addresses key design issues that must be addressed if individual accounts are added to Social Security or are created outside of Social Security. Bi-partisan co-chairs of the panel were Kenneth S. Apfel, Commissioner of Social Security in the Clinton administration and now a professor at the LBJ School of Public Affairs at the University of Texas in Austin, and Michael J. Graetz, a top Treasury official in the George H.W. Bush administration and now a professor at Yale Law School.

The co-chairs saw the importance of the topic when they signed on to lead the study in May 2002. While various studies have examined how money would build up in new individual accounts, this project focused on the largely neglected questions about how the money would be paid out. The expert panel was not asked to agree on the desirability of creating individual accounts in Social Security, and it did not. Panel members hold sharply divergent views on that question. Nor was the Panel expected to provide a blueprint for how to design payouts. Panel members hold different views on many of those questions as well. Rather, the purpose of the study was to identify key questions that must be addressed in designing payouts and to begin to assess the implications and tradeoffs of various policy choices. Their breadth of expertise covers Social Security, pensions, private savings, wealth-building for low-income families, private insurance, social insurance, disability policy, spousal rights, family law, tax policy, financial markets, and federal and state regulation of financial institutions.

If accounts are to be part of Social Security, payouts are particularly important because a central goal of Social Security policy is to assure some level of adequate income. Many of the issues in payout policies also have implications for private retirement plans which increasingly are in the form of personal accounts. This article reviews financial demographics that are the backdrop for debates about individual accounts and then highlights tradeoffs in three areas of payout policies – retirement withdrawals, spousal rights, and early withdrawals.

FINANCIAL DEMOGRAPHICS

Social Security is the bedrock of income security for millions of Americans. The 47 million beneficiaries account for about one in six Americans living in one in four U.S. households. About two in three beneficiaries age 65 and older rely on Social Security for half or more of their total income. Women without husbands are the most reliant on Social Security; three in four such women over age 65 get half or more of their income from Social Security. For 44 percent of these women, Social Security is nearly all they have, making up 90 percent or more of their income.

Despite beneficiaries' reliance on Social Security, the benefits alone do not provide a comfortable level of living. The average benefit for a retired worker was about $955 a month, or $11,500 annually, in January 2005. Average benefits are somewhat lower for disabled workers ($894) and elderly widows ($920). Benefits for future retirees will grow somewhat more slowly than earnings, which will cause replacement rates to decline over the next 20 years as the "full benefit age" for retirement benefits rises from 65 to 67. Benefits for 65-year-old retirees will replace a smaller share of prior earnings than is the case today or at any time in the last 30 years. Because Social Security is not in long-run financial balance, other changes might be enacted that will further lower benefits or raise revenue.

Employer-sponsored pension plans have covered about half of private-sector workers over the past 25 years. These plans are shifting away from the defined benefits that dominated the 1970s and 1980s to defined-contribution or 401(k)-type plans. The newer plans give workers more choices about whether to participate and how much to contribute; workers can take the accounts with them when they change jobs; and they have choices about when and how to withdraw the money. At the same time, workers finance more of the plans themselves and bear the investment risk that employers take on in defined-benefit plans.

In 2001, about half of all U.S. families owned a tax-favored retirement account. The median balance of those accounts was $29,000. Older households had somewhat larger tax-favored savings, with a median value of $55,000 for the 59 percent of families age 55-64 who had such accounts. Tax-favored savings are concentrated among high-income households; families in the top 20 percent of the income distribution held two-thirds of all tax-favored retirement savings.

The heavy reliance on Social Security among retirees up through the middle of the income distribution, the shift away from defined-benefit pensions, and increased use of 401(k) plans amplifies the importance of payout options that convert savings into guaranteed incomes during retirement.

RETIREMENT PAYOUTS

Retirees face at least four kinds of uncertainty as they try to spread retirement savings over the rest of their lives. They do not know how long they will live (longevity risk), nor how long their spouses might live (spousal survivorship risk), nor how prices might rise in the future (inflation risk), nor what returns they will earn on their savings (investment risk). A life annuity is a financial product that allows a retiree to shift longevity risk and investment risk to an insurance company. The retiree pays a lump sum and in return the insurer has a contractual obligation to pay the annuitant a guaranteed income for life. Because insurers pool mortality risk among a large group of annuitants, the extra funds from annuitants who die early are used to cover the annuity costs of individuals who live a long time. From the retiree's perspective, the downside of buying a life annuity is that one pays the full price up front and the purchase is irrevocable. Other strategies to spread money over one's remaining life – such as taking phased withdrawals – do not guarantee the money will last for life. But the retiree still owns the unspent money and can use it for other purposes or leave it to heirs.

Should Retirees Be Required to Buy Life Annuities?

The answer will depend on the purpose of the accounts, the size of Social Security benefits that go with the accounts, and whether workers are required to put money in the accounts. If the accounts are meant to provide basic security and other Social Security benefits are not adequate, then policymakers might want to require retirees to buy products that resemble features of Social Security, with payments for life, that are indexed for inflation, and that automatically pay annuities to widowed spouses. Many Social Security individual account proposals require these features. On the other hand, if the accounts are discretionary savings on top of traditional Social Security benefits that are thought to meet basic adequacy goals, then policymaker might offer more payout choices as a way to encourage more workers to save.

Adding inflation-indexing and survivor benefits to a life annuity lowers the monthly payment one can buy with a given account balance. With $10,000, a 65 year-old retiree could buy a fixed life annuity of about $80 a month. If the annuity was indexed to keep pace with inflation at 3 percent a year, it would start out at about $62 a month. If it would continue to pay as long as either the annuitant or a 65-year-old spouse lived, the annuity would start out lower still, about $50 a month. These prices are based on the assumption that everyone would be required to buy life annuities.[1]

There are stark pros and cons to making the purchase of annuities mandatory. Compulsory annuities assure that people cannot outlive their money, but leave retirees no choice. Compulsory annuities cost less, on average. Optional annuities cost more (or pay less for any given premium) because people with short life expectancies tend not to buy them. Compulsory annuities pay more, on average, precisely because short-lived people are required to buy a product that is not a good deal for them.

Will Guarantees Cover Interests of Heirs?

Some life annuities guarantee a payment to a named death beneficiary if the annuitant dies shortly after buying an annuity. A *ten-year-certain* annuity guarantees payments for ten years even if the annuitant dies in less than ten years. A *refund-of-premium* annuity guarantees that the annuity will pay out at least the nominal purchase price. For example, if the retiree paid $10,000 for a life annuity and died after receiving only $1,000, then $9,000 would go to the death beneficiary.

Guarantees lower the monthly annuity that a given premium will buy. For $10,000, one could buy a single-life, inflation-indexed annuity of $62 a month. Adding a 10-year certain feature would lower the monthly amount to about $58, while a refund of premium annuity would lower the amount to about $55 a month. Many experts believe guarantee features are not a wise purchase on purely economic grounds. Yet annuitants often choose guarantees, perhaps as a way to avoid the serious regret their heirs might feel if the annuitant died shortly after paying a large amount for a life annuity that left nothing to heirs.

Who Will Provide Inflation-Indexed Annuities?

Many proposals for individual accounts as part of Social Security would require (or assume) that retirees buy inflation-indexed annuities. Creating a market for such products is likely to involve the federal government in some way. The government might issue a large volume of long-dated Treasury Inflation Protected Securities (TIPS) to help insurance companies hedge inflation risk or it might issue inflation-indexed annuities directly to retirees.

When TIPS were introduced in 1997, some observers thought that a thriving market in inflation-indexed annuities would evolve. Several conditions might explain why it did not. First, retirees might not recognize the value of inflation-indexed annuities. Second, TIPS may not exist in sufficient volume, duration, and predictability to encourage insurers to offer a large volume of inflation-indexed life annuities to retirees. The Treasury Department stopped issuing all 30-year bonds (including TIPS) in 2001, yet 30 years might be needed to cover the life spans of new retirees. Finally, insurers and their regulators might be concerned that inflation indexing would increase insurers' exposure to mortality risk. If insurers underestimated longevity, they would be exposed to far greater losses with inflation-indexed annuities than with fixed annuities that decline in value over time.

The volume of reserves required to back widespread inflation-indexed annuities could be substantial. In a universal system, reserves backing annuities funded with 2 percent of workers' earnings could amount to about 15 percent of GDP when the system is fully mature.[2] Those annuity reserves would be equivalent to roughly 7 percent to 8 percent of the value of total U.S. financial assets.[3]

The government might issue inflation-indexed annuities directly to retirees or it might issue a large volume of long-dated TIPS to back private inflation-indexed annuities. In either case, the government could be holding very large amounts of assets backing the annuities. A key question for policymakers to address is who would manage and invest the large volume of assets. New arrangements might be needed to segregate the funds from other taxing, spending, and debt management functions of the federal government, and new institutions might be needed to provide for prudent and diversified investment of the funds.

If insurance companies were to provide inflation-indexed annuities on a widespread basis, then policymakers might want the federal government to be involved in insuring the solvency of those companies. Proposals for the federal government to charter, regulate, and insure the solvency of life insurance companies might gain new interest in this case.

SPOUSAL RIGHTS

About 14.0 million people – 30 percent of all Social Security beneficiaries – receive benefits based at least in part on a spouse's work record. These beneficiaries are overwhelmingly women.[4] About 6.0 million women are entitled to Social Security as workers and to higher benefits as a widow, wife, or divorced wife. Another 7.8 million women receive Social Security solely as widows, wives, or divorced wives.

Will Joint Life Annuities Be Required?

The cost of paying spousal benefits is spread among all participants in Social Security; the benefit for a widow or wife does not lower the payment to the husband. In contrast, individual accounts represent a finite pool of assets, such that payments to a spouse will reduce funds for the accountholder. For example, if a 65-year-old retiree with a 65-year-old wife bought a symmetric[5] joint and two-thirds life annuity, his initial payment would be about 93 percent as much as a single-life annuity would pay. When he died, his widow would receive two-thirds of that amount, or about 62 percent as much as a single life annuity. Similarly, if his wife died first, his payment would drop to the 62 percent amount.

To require joint life annuities could impose new reporting requirements and dispute resolution procedures beyond those required for Social Security benefits, where providing spousal benefits does not reduce a retiree's benefit.

What Other Models for Rights of Widowed Spouses Might Apply?

If accounts are viewed as supplements on top of Social Security benefits that are considered adequate, then a spouse's rights to survivor benefits might follow other private sector models. These differ from plan to plan. Private defined-benefit plans assure the spouse a survivor benefit equal to 50 percent of the participant's payment, unless the spouse has signed away this right. The 50 percent survivor payment is also available if the participant dies before retirement. A 401(k) plan balance automatically goes to a widowed spouse when a participant dies, unless the spouse has consented in writing to an alternate beneficiary. Individual retirement accounts have no automatic spousal survivor rights. The balance in an IRA goes to the designated beneficiary, whoever it may be. When a 401(k) plan is rolled over to an IRA, the IRA rules apply; the widowed spouse no longer has an automatic right to a deceased partner's account balance.

Will Federal Rules Pre-Empt State Family Property Laws?

As a national program, Social Security has uniform rules throughout the country. State law has historically determined spousal rights to property, and states have distinctly different approaches. Common law states consider the title-holder to be the owner of property, although all such states call for an equitable division of property at divorce. The nine community property states, in which 29 percent of the population resides,[6] view property acquired during marriage as community property that belongs equally to husbands and wives. Holdings acquired before marriage and bequests received during marriage are considered personal property and outside marital property.

If Congress wants uniform rules about spousal rights, it will need to define the rules clearly in federal law. Alternatively, policymakers could explicitly provide that state law will determine spousal rights. This approach would be more flexible and it would produce different results from state to state. It might increase administrative costs and the need for account holders to have legal representation.

How Would Accounts Be Allocated at Divorce?

Federal rules could specify how accounts are allocated at divorce, or the decisions could be left up to states. Questions for policymakers include: whether federal law would require equal division of accounts, or make equal division a default rule, and if so, whether the property division would apply only to new contributions and investment earnings during the marriage or to entire account balances. In addition, if accounts involve worker-specific offsets, how offsets are handled at divorce becomes a key question. Whatever federal mandates or default rules apply, a final issue is whether state courts would retain authority to allocate (or reallocate) funds as part of an overall divorce settlement.

PRE-RETIREMENT ACCESS TO ACCOUNTS

The pros and cons of allowing early access to individual accounts will depend, in large part, on the intended use of the accounts, whether people have any choice about whether to participate, and whether the accounts are viewed as personal property. If the accounts are supposed to provide baseline economic security in old age, the case for banning early access is strong. Yet, if the purpose of the system is to expand opportunities for voluntary retirement saving, then early access might encourage people to save more than they otherwise would.

What U.S. Precedents Exist for Early Access to Retirement Funds?

Individual retirement accounts (IRAs) allow unlimited access as long as account holders pay taxes and, in certain cases, a 10 percent tax penalty on amounts withdrawn. Employer-sponsored 401(k) plans permit somewhat more limited access, but employees can usually get the money if they need it—through a loan or hardship withdrawal, or by leaving the job and cashing out the account. Most U.S. proposals that envision individual accounts as a partial replacement for Social Security retirement benefits would totally ban early access to the money.

If Early Access Is Restricted, Who Would Be the Gatekeeper?

If access is restricted, a gatekeeper will need to determine when a particular withdrawal is allowed. And individuals who are denied access to their funds would probably want and expect an opportunity to appeal the denial. Employers who sponsor 401(k) plans are responsible for deciding whether employees' withdrawals or loans comply with rules of the plan and with the Internal Revenue Code. The employer bears the risk of losing tax-favored status for the entire plan in case of wrongful determination, although the Internal Revenue Service can levy lesser penalties. A new system of individual accounts that are not sponsored by employers will pose such new questions as: What entity would be the gatekeeper? What incentives would encourage the gatekeeper to prevent wrongful withdrawals? What (if any) penalty would be imposed for non-compliance?

Will Others Have a Claim on Accounts?

Early access to retirement accounts can be a two-edged sword. Account holders' access to their own retirement funds may mean that third parties can also make a claim on the funds in cases of bankruptcy, divorce, or unpaid federal taxes. Further, some means-tested benefit programs treat accessible retirement funds as countable assets for the purposes of determining benefit eligibility. In such cases, if the account holder has access to the money, he or she must spend it to qualify for assistance.

No U.S. precedent yet exists for a total ban on access to individually owned retirement savings accounts. If policymakers create such a ban, history suggests that they will face pressure to ease the restrictions. Sustaining limits on access to retirement funds that are required for income security, but that account holders view as their own money, is an important issue and likely to be an ongoing challenge.

CONCLUSION

Payout issues about retirement withdrawals, spousal rights, inflation-protection, bequests, and early access are relevant to the broader retirement policy arena. As lump sums become the typical payout in employer-sponsored plans, the challenge of turning the money into a predictable and secure income for life becomes increasingly important.

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ENDNOTES

[1] Assumptions underlying the annuity estimates are consistent with assumptions used in the 2003 report of the Social Security Trustees. It is assumed that the purchase of annuities is mandatory, the federal government would provide the annuities, inflation is assumed to be 3.0 percent per year, and the real interest rate is 3.0 percent per year, such that the nominal interest rate is 6.1 percent.

[2] Assumptions underlying this estimate are: participation in the accounts and purchase of annuities would be mandatory; during the accumulation phase, accounts would earn a net real return of 4.6 percent; annuity reserves would earn a 3.0 percent net annual return.

[3] Today, total financial asset values are roughly twice the size of GDP, according to estimates of the Office of the Chief Actuary of the Social Security Administration. Assuming that relationship remained unchanged, annuity reserves would be about 7-8 percent of total financial asset values.

[4] Spousal benefits are paid to husbands and widowers on the same terms as to wives and widows. Such benefits are paid only to the extent they exceed the recipient's own benefit as a retired worker. Because wives generally earn less than husbands, recipients of spousal benefits are overwhelmingly women.

[5] Symmetric joint life annuities pay a specified reduced amount to whichever spouse is widowed. Contingent joint life annuities pay a reduced amount if the secondary annuitant is widowed, but continue the original amount if the primary annuitant is widowed.

[6] The nine community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin; population percentage calculated from data from the U.S. Census Bureau, *Statistical Abstract of the United States 2003*, Table 20.

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Virginia Reno, a fellow of the TIAA-CREF Institute, is Vice President for Income Security of the National Academy of Social Insurance (NASI). NASI is a non-profit, non-partisan organization made up of the nation's leading experts on social insurance. Its mission is to promote public understanding and informed policymaking on social insurance through research, training and the open exchange of ideas.

ADDITIONAL INFORMATION

NASI received financial report for the study from the TIAA-CREF Institute, the Ford Foundation, the Actuarial Foundation and the Foundation for Child Development. Copies of the full report can be purchased from the Brookings Institution's website at http://bookstore.brookings.edu. The ten-chapter report can be downloaded from NASI's website at www.nasi.org.