

# Uncharted Waters:

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## Paying Benefits From Individual Accounts in Federal Retirement Policy

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*Study Panel Final Report*

Co-Chairs

Kenneth S. Apfel

Michael J. Graetz

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This report presents new analyses and does not make recommendations. It was prepared by and for the Uncharted Waters Study Panel. In accordance with procedures of the Academy, the report has been reviewed by a committee of the Academy's Board of Directors for completeness, accuracy, clarity and objectivity.

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# Preface

That people are living longer and generally enjoying better health while doing so is unquestionably a good thing. But as the elderly become a larger portion of our population, new challenges arise for making sure that retirees have enough income to live on. In an effort to strengthen personal savings for retirement, President Bush and both Democratic and Republican members of Congress have advanced proposals for establishing some form of universally available individual savings accounts. However, the question whether these individual accounts should be apart from and in addition to Social Security, or instead integrated with Social Security and a part of any restructuring of Social Security, has sharply divided politicians and policy analysts alike.

Implementing any system of universally available individual accounts requires answers to three broad questions: How will money get into these accounts? How will the funds in these accounts be invested and managed? How will individuals or their families obtain payments from these accounts? Much analysis has been produced attempting to answer these questions in recent years, but most of the analyses have

focused on the “accumulation” phase — how individuals, in concert with their employers, a government institution or regulated private financial institutions, would get the money into the accounts, then invest and manage the accounts’ assets during the person’s working years. In contrast, questions surrounding the “payout” phase — how individuals would receive their funds after retirement or upon death or disability—have frequently been neglected. This report examines these largely unexplored issues in depth.

Why is it important to examine these “payout” issues? Since a central goal of retirement security policy is to assure some level of adequate income, it is essential that any debate about creating individual accounts include a complete understanding of how the benefits will be received. How would the assets accumulated in individual accounts be paid out during retirement? Will individuals have funds available to them before retirement? Do these answers change if an individual becomes disabled or dies before retirement? What rights does a spouse or former spouse have to these accounts? Can creditors reach the accounts? What institutions—

government or private—will be responsible for making payments from the accounts? If private institutions are responsible, will the federal or state governments regulate their conduct? If these new accounts are part of Social Security or integrated with Social Security reforms, what will happen to payouts of Social Security benefits? These are the kinds of questions this report addresses in detail.

It is crucial that these payout questions be clearly understood by policymakers. They must resolve each of the issues discussed in this report if they are going to add universally available individual accounts to our current system for providing retirement income. In addressing the issues here, this report has not concentrated on any one plan for revamping our existing system. Rather, it has considered a wide range of proposals that have been advanced across the political spectrum. Since it is important to understand how any new individual account program would fit with traditional Social Security, employer-based pensions and other tax-advantaged individual retirement savings vehicles to answer these questions, our decision to consider a variety of individual account proposals has substantially complicated our task. Moreover, rather than insisting on one “best” answer to the questions we examine here, this panel offers a range of potential answers. We hope that this complexity does not deter our readers from coming to their own conclusions about answers to these questions.

We want to emphasize that it never was the intention of this panel to come to agreement on the desirability of creating individual savings accounts as a part of Social Security. Indeed, panel members hold sharply divergent views on this issue. Nor was it our intention to present a “blueprint” for how to design payouts from individual accounts. Panel members hold quite different views on these issues as well. We did, however, all agree about what are the key issues that must be addressed in considering payouts from individual accounts. And our panel members also found common ground on the poten-

tial implications and trade-offs of various policy choices.

Pulling together more than two dozen knowledgeable, strong-minded, energetic and politically divergent experts to tackle these issues might have been a recipe for disaster. But through numerous meetings, untold conference calls and literally thousands of e-mails extending over a period of more than two years, this remarkable group of people generously gave their time, knowledge, and judgment to bring this report to fruition. Draft after draft has been subject to detailed debate. Controversies have arisen and been resolved over a panoply of issues large and small. The commitment of these panel members cannot be overstated.

Our panel was greatly assisted by the efforts of the Social Security Administration and its office of the Chief Actuary. We are also grateful for the financial support provided by the Ford Foundation, the Actuarial Foundation, the TIAA-CREF Institute and the Foundation for Child Development. That said, the substance of the report is that of the members of the panel and not of any of the organizations mentioned here.

Finally, this report would never have been completed without the sustained effort and expertise of the staff at the National Academy of Social Insurance. Particular thanks are due to Virginia Reno, who directed the NASI staff, and to Joni Lavery, who, along with Virginia, finalized this report. We also benefited from the expertise and work of Catherine Hill, who served as a staff member for this report in its early stages. Nelly Ganesan and Anita Cardwell also provided critical logistical support.

It has been an honor to serve as co-chairs of this exceptional panel.

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# Uncharted Waters:

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# Chapter 1

## Introduction and Summary

Calls for new individual savings accounts as part of federal retirement policy have come from various quarters, either as part of some Social Security reform proposals or as saving vehicles for individuals who do not have access to employer-sponsored pensions. Individual development accounts and other initiatives to help low-income people save also demonstrate growing public interest in the issue.

Much of the work on individual accounts as part of Social Security proposals has focused on how individuals would save and manage the assets in the accounts during their working lives. Less attention has been paid to how and under what circumstances funds could be withdrawn from these accounts. For example, what conditions, if any, would permit individuals to withdraw funds before retirement? Would individuals be required to convert account balances into lifetime annuities at retirement, or would they be allowed to access funds at whatever time and for whatever amount they wished? Payout schedules and pre-retirement withdrawals affect other family members, an issue that raises the question of what kinds of spousal rights would be recognized, and how these

rights would be applied in the event of divorce, retirement, or death. This study identifies payout issues raised by individual accounts in a public retirement system and analyzes the potential implications of different policy choices.

The Panel did not attempt to reach consensus on the desirability or feasibility of individual accounts in federal retirement policy. Panel members continue to hold sharply divergent points of view about personal accounts, particularly with regard to replacing any part of Social Security with individual accounts. Members do agree that the choices described in this report constitute essential issues on payouts from such accounts.

This report summarizes work conducted between October 2002 and November 2004 by a non-partisan panel of nationally recognized experts led by co-chairs Kenneth S. Apfel, of the LBJ School of Public Affairs at the University of Texas, and Michael J. Graetz, of Yale Law School. The Panel created a framework for analyzing how benefits might be paid in a national system of new individual retirement accounts. The Panel considered individual accounts creat-

ed within Social Security as well as proposals for accounts separate from and supplemental to Social Security.

This introductory chapter explores key features of social insurance and private property, two important components of retirement security in the United States. The chapter presents a framework for analyzing payout issues and offers a classification of individual account plans based on some of these attributes. A brief summary of Social Security finances and solvency projections presents a backdrop for the Panel's deliberations. Distinctions are drawn between reductions in scheduled benefits in response to solvency issues and reductions to accommodate the creation of individual accounts. The chapter concludes with highlights of report findings that cover financial demographics of American families, payout issues at retirement, institutional arrangements for selling annuities to retirees, issues about access to accounts before retirement, spousal rights, implications of account

payouts for disabled workers and their families and young survivor families, issues in the design of worker-specific offsets, and potential tax treatment of accounts.

## *Social Insurance and Property*

Some Social Security proposals call for creating a system of individual accounts as part of the Social Security retirement program. Individual accounts are typically considered to be personal property, while the traditional Social Security program is social insurance. Both personally owned property and social insurance are important components of retirement security; each has particular strengths, but they differ in important respects.

### **Property**

Owning and controlling property is the mainstay of a capitalist economy. Individuals are encouraged to own property – land, buildings, financial resources, or other types of assets – not

### **Purpose of the Uncharted Waters Study Panel Dispassionate Analysis, Diverse Views, and Varied Expertise**

The Uncharted Waters Study Panel was convened by the National Academy of Social Insurance to promote dialogue and analysis by scholars who bring highly diverse expertise, knowledge, and philosophical perspectives to a relatively unexplored set of questions about payout issues in individual accounts. The Panel includes experts in Social Security, pensions, private retirement savings, wealth building for low-income workers, private insurance, social insurance, disability income policy, family benefit policy, tax policy, financial markets, and federal and state regulation of financial intermediaries.

Panel members have very different personal views about the appropriate role of individual savings accounts in Social Security. Some panelists believe strongly that such accounts in some form are a very good idea. Other panelists believe strongly that any such accounts are a very bad idea. The Panel was not asked to resolve these differences, and it did not.

Rather, the purpose of the Panel is to bring its talent and knowledge to analyze in an even-handed way various issues that arise in designing the payout side of any new individual account system. The goals are to help policymakers identify and begin to resolve a range of policy questions. The scope of the inquiry includes accounts that aim to replace part of Social Security and other new savings vehicles – such as individual development accounts or new retirement savings vehicles – that are outside the Social Security system altogether. The Panel succeeded in finding common ground to identify and analyze payout issues in a clear, informative, and dispassionate way.

only to stimulate economic well being but also to help raise one's standard of living. Property ownership can enhance self-reliance and personal wealth can help secure one's own future and the future of one's heirs.

Property ownership is essentially a bundle of rights created by law. Individual ownership generally implies control of the owned asset (and to exclude others' rights to that asset), and ownership grants the holder wide discretion in asset consumption. However, these rights may be limited by the nature of the property right,<sup>1</sup> by regulations, spousal rights, creditors' claims, or when owner rights would reduce or infringe on the rights and security of others.

Property ownership carries with it a certain amount of risk. The assumption of risk is a key component of a capitalist ownership system, with greater rewards generally related to greater risk. Property owners can buy private insurance for some types of property risks, such as fires or theft, but some economic security risks, such as becoming disabled or living to very old age, are less commonly insured in the private market.

## Social Insurance

Like property ownership, social insurance seeks to preserve individual dignity and self-reliance, although methods differ for accomplishing these goals. Social insurance emerges, in part, as a response to market failure in private insurance (Graetz and Mashaw, 1999). Other rationales for social insurance build on the notion that a competitive economy sometimes fails to provide for all individuals, exposing them to risks outside their control and not commonly insured by the private market. Some workers earn low wages over their entire work careers and cannot save adequately for retirement, while others face circumstances that significantly derail their ability to save. A prolonged period of involuntary unemployment, sickness, or incapacity can deplete whatever savings have been set aside for the future. Social insurance, through universal participation, pools risks broadly to provide a basic level of economic security to all.

Social insurance has played an important role in many nations by protecting individuals from risks inherent in competitive economies. In the United States, social insurance programs compensate workers who are laid-off from their jobs or are injured on the job. Social Security, the nation's largest social insurance program, provides workers and families with benefits in retirement as well as protections against economic insecurity due to prolonged disability or the death of a family worker. Social Security benefits are closely tied to work and past wages from which contributions were paid.

## Comparing Features

The Panel recognizes that there are important differences between the social insurance features of Social Security and the ownership features of retirement savings accounts. A brief comparison of Social Security with voluntary employer-sponsored 401(k)-type savings plans highlights some of the differences between social insurance and private property.

### *Key Function or Purpose*

A 401(k)-type savings plan gives individuals and families an opportunity to save for retirement on a tax-favored basis. Social Security provides basic wage-replacement income in retirement for almost all American workers and their spouses and widowed spouses. Social Security also provides basic insurance protection when families lose wage income due to the disability or the death of a worker.

### *Relationship between Contributions and Payouts*

Owners of 401(k)-type accounts get out what they and their employers put in, plus investment returns, minus administrative costs. Investment risk is borne by account holders whose retirement payments depend on investment performance. Some individuals may contribute more than others, by choice or plan design. Further, choices made on fund investments and market swings may produce substantial variations in returns and payouts for individuals with similar contributions.

Returns from Social Security may also vary over time as legislation adjusts tax rates and benefits to adapt, for example, to numbers of workers versus numbers of beneficiaries. Social Security benefits are based on a formula, with payouts varying depending on earnings level, years of covered work, and family situation. Social Security pays relatively more for a given level of earnings and contributions to: (a) low earners, whose monthly benefits replace a larger share of past earnings; (b) some widowed and divorced spouses, who receive benefits without paying additional contributions; (c) disabled workers and young families of deceased workers, who have disability and survivor protection against these risks; (d) larger families, because additional benefits are paid for children without requiring additional contributions; and (e) people who live a long time into advanced old age, who benefit from the guarantee of inflation-indexed benefits that last for life. By the same token, groups who receive less relative to past wages and contributions have the opposite characteristics; they are higher earners, dual-earner couples, single workers, childless workers, and workers who die early without family members eligible for survivor benefits.

### *Terms for Contributing Funds*

Individuals have a choice whether to contribute to employer-sponsored 401(k)-type savings accounts largely because these accounts are in addition to the basic retirement income provided by Social Security. While matching funds may encourage workers to contribute, workers retain free choice about whether to put money into the accounts. Workers may also choose how much to contribute, subject to caps in plan rules and federal tax rules.

In contrast, Social Security contributions (or taxes) are mandatory. Workers do not have a choice to opt out.<sup>2</sup> Employers are required to withhold Social Security contributions from workers' wages and to pay matching amounts. The law sets the level of contributions for all workers in relation to their wages or self-employment income. Making everyone con-

tribute protects individuals from their own shortsightedness or bad luck and is consistent with a system that pools and redistributes funds. If contributions were voluntary, higher-income persons who believe they have a less than average likelihood of benefiting from the system might opt out, leaving lower earners to pay a larger share of the cost (Diamond, 2004; Langbein, 2004).

### *Terms for Withdrawing Funds*

In 401(k)-type retirement savings plans, account holders have wide latitude in choosing when and how to withdraw their funds. Participants can withdraw money at almost any time, as long as they pay required taxes and, in some cases of withdrawals before a particular age, a 10 percent tax penalty. The penalty is designed to discourage pre-retirement withdrawals, but participants can usually access their funds – either by taking out loans from the accounts or when leaving their jobs. At retirement, participants have many choices about the form of payouts, including leaving the money in the account until age 70½, taking it out in phased withdrawals, buying a life annuity, or withdrawing it in a lump sum.

In contrast, the choices for payouts in Social Security are very limited, are set in law, and promote ease of administration. Participants' only choices are whether to accept the benefits they are entitled to and when to begin retirement benefits between ages 62 and 70. No option exists to take the retirement money out early, to borrow against it, or to get it in any form other than monthly benefits. The lack of choice could be seen as a shortcoming, or as a way to protect individuals against unforeseeable risks.

### *Tradeoffs in Blending Concepts*

Policy proposals that blend concepts of social insurance and private property face tradeoffs in deciding which model to follow in particular situations or how to fit the two models together. In the chapters that follow, a recurring theme in considering payout rules for individual accounts that replace part of traditional Social Security

benefits is how to blend concepts of social insurance with concepts of personal ownership. Different perspectives emerge in considering issues on bequests, longevity insurance through the purchase of life annuities, tradeoffs between free choice and mandates in the timing and form of payouts before retirement, spousal rights, and how to preserve desired disability and life insurance for young families if part of Social Security is being shifted from social insurance to private property.

## **Framework for Analyzing Payout Rules**

The Panel believes that policymakers' decisions about payout rules for any new system of individual accounts will differ depending on: the intended use of the accounts; the level of traditional Social Security benefits that accompany the accounts; the source of funds for the accounts; and whether participation in the accounts is mandatory or voluntary.

### **The Intended Use of Individual Accounts**

If the main purpose of individual accounts—when combined with traditional Social Security—is to provide basic financial security during retirement to individuals and their family members, then individual account payouts might aim to resemble features of traditional Social Security, with an emphasis on payments for life, family protection, and inflation protection. Yet, if the main purpose of the accounts is to help build financial wealth, then payout rules might resemble rules that apply to other discretionary savings, such as individual retirement accounts (IRAs) or 401(k) plans. And, if the main purpose is to build funds to invest in human capital or business enterprise before retirement, then payouts should be designed to target these purposes.

### **The Level of Remaining Traditional Social Security Benefits**

Payout rules for individual accounts intended for retirement might differ depending on the

level of traditional Social Security benefits that accompany the accounts. If Social Security defined benefits are thought to meet basic adequacy goals, more discretion in payouts from individual accounts might be called for. Yet, if the account proceeds are viewed as an integral part of basic Social Security retirement income protection, more restrictions on payouts might be called for.

### **The Source of Funding for the Accounts**

Whether Social Security retirement benefits are adequate, too meager, or too generous is not a topic of this report. However, if a portion of the current scheduled Social Security contributions are used for individual accounts, there might be a stronger case for designing payouts to provide some of the protections found in traditional Social Security benefits. Yet, if accounts are funded with new contributions from workers, more discretion in payouts might be in order. Also, the source of contributions to the accounts and the tax treatment of those contributions are likely to affect views about tax treatment of payouts from the accounts.

### **Voluntary or Mandatory Participation**

The case for flexible payout rules is strengthened if policymakers want to encourage contributions. Voluntary participation may not be consistent with restrictive rules designed to achieve basic security. Highly restrictive payout rules could discourage individuals from participating at all or cause them to contribute less than they would if they had more choices about payouts.

The following section describes a typology of plans based on some of these attributes.

## **Examples of Individual Account Plans**

A host of different kinds of individual accounts have been proposed for different purposes and they could be grouped by any number of criteria depending on the scope of the discussion. For some of its deliberations, the Panel found it useful to classify proposals along two dimensions:

whether contributions to accounts would be mandatory or voluntary; and whether the accounts would be funded with new earmarked contributions from workers, or by using currently scheduled Social Security taxes, or by some other means, such as general revenues, as illustrated in Figure 1-1.<sup>3</sup>

The Panel also agreed that when discussing payouts from individual accounts, a key issue is whether proceeds from the accounts are meant to replace part of traditional Social Security retirement benefits or are intended to provide new retirement resources. This distinction also emerges in the typology in Figure 1-1.

In Figure 1-1, the first category (1) includes plans that create individual accounts with mandatory new contributions. Examples of Social Security proposals with these attributes generally view the proceeds from the accounts as part of Social Security retirement benefits. One such plan, the Individual Account plan, was recommended by Chairman Edward Gramlich of the 1996 Advisory Council on Social Security. That plan would scale back traditional benefits to a level that could be financed with currently scheduled Social Security taxes of 12.4 percent of wages. The plan would then require workers to pay an additional 1.6 percent of their wages to individual accounts. Proceeds from those accounts were envisioned as part of Social Security benefits (ACSS, 1996; NASI, 1996). Business leaders associated with the Committee for Economic Development also proposed a Social Security solvency plan along these lines in

their 1997 report, *Fixing Social Security* (CED, 1997). Their plan calls for further reductions in scheduled Social Security benefits, and requires both workers and employers to pay an additional 1.5 percent of workers' wages (for a total of 3.0 percent of wages) to fund individual accounts. Again, account proceeds were envisioned as part of Social Security retirement benefits.

The second category (2) of Figure 1-1 includes plans that call for mandatory participation using part of existing Social Security taxes to finance individual accounts. Proceeds from these accounts are also generally viewed as part of Social Security retirement income. A subset of the 1996 Advisory Council on Social Security, led by Sylvester Schieber and Carolyn Weaver, proposed one such plan, the Personal Security Account Plan. This plan would shift 5.0 percentage points of employees' share of Social Security taxes to individual accounts and scale back traditional Social Security to a flat benefit. The National Commission on Retirement Policy, in its 1999 report *The 21st Century Retirement Security Plan* (NCRP, 1999), also recommended a plan in this category. Co-chairs of the Commission were Senator Judd Gregg, Senator John Breaux, Representative Jim Kolbe, and Representative Charles Stenholm. The plan would scale back traditional Social Security benefits so that they could be financed with a Social Security tax of 10.4 percent of wages. The remaining 2.0 percent of current Social Security taxes were allocated to individual accounts on a mandatory basis. Subsequent legislation co-

**Figure 1-1.** *Categories of Individual Account Plans by Source of Funds and Nature of Participation*

Nature of Participation	New Earmarked Contributions for the Accounts	Currently Scheduled Social Security Taxes for Accounts	Unspecified General Revenues for Accounts
Mandatory Participation	(1)	(2)	(5)
Voluntary Participation	(3)	(4)	

sponsored by Representatives Kolbe and Stenholm in the 108th Congress (HR 3821) built on the Commission's recommendations.

The bottom sections of Figure 1-1 include plans with voluntary participation. Category (3) includes proposals that involve voluntary new contributions from workers and may include matching funds from other sources. All of these proposals envision the proceeds of the accounts as being separate from Social Security and its financing. In this respect, President Clinton's Retirement Savings Accounts of 2000 called for new contributions from households and federal matching funds for low-income households. The plan did not address Social Security finances. The *Social Security Plus* plan, offered by former Social Security Commissioner Robert M. Ball in 2003, would set up administrative mechanisms for workers to voluntarily save on top of a solvent Social Security system. Ball's solvency plan for Social Security did not depend on money in the accounts. Finally, a new and expanded system of individual development accounts (IDAs)<sup>4</sup> would also involve voluntary new contributions from individuals, perhaps with matching funds, and would create accounts independent of Social Security. The main purpose of IDAs has been to expand opportunities for asset accumulation for education, buying a home, or setting up a business, but IDAs could include saving for retirement.

Category (4) of Figure 1-1 includes plans that permit workers to shift part of their Social Security taxes into individual accounts. These plans generally consider the proceeds from the accounts to be part of Social Security. At retirement, individuals who had chosen to shift taxes to personal accounts would incur an offset (a reduction in scheduled Social Security defined benefits) based on an amount linked to the contributions to their accounts. Examples of plans that fit in this category include recommendations from President Bush's 2001 Commission to Strengthen Social Security. Other plans in this category include Representative Nick Smith's Retirement Security Act, introduced in 2002

(H.R. 5734, 107th Congress), then-Representative Jim DeMint's Social Security Savings Act of 2003 (H.R. 3177, 108th Congress) and Senator Lindsey Graham's Social Security Solvency and Modernization Act of 2003 (S. 1878, 108th Congress).

The last column of Figure 1-1, category (5), includes proposals for individual accounts funded by general revenues or other non-earmarked funds. Representative Clay Shaw's Social Security Guarantee Plus Act of 2003 (H.R. 75, 108th Congress) would allow workers to be credited with annual contributions from the general fund of the Treasury for personal accounts. While participation in this plan would be voluntary, it is assumed that participation would be universal. Another plan, Representative Paul Ryan's Social Security Personal Savings Guarantee and Prosperity Act of 2004 (H.R. 4851, 108th Congress), guarantees that the combination of Social Security benefits and payments from individual accounts would be at least equal to currently scheduled Social Security benefits through transfers from the general fund of the U.S. Treasury. Some plans in Category four (4) also require unspecified general revenues to pay scheduled Social Security benefits.

Panel members hold very different views about how to analyze plans that rely on unspecified general revenue transfers. The disagreement centers largely on whether the need for large general revenue transfers would result in pressure to further reduce traditional Social Security benefits, or whether the funding for such transfers could be accommodated from other sources, such as income taxes, reduced spending on other programs, or from an increase in public debt.

## *Social Security Finances and Solvency Projections*

While the Panel did not evaluate Social Security solvency, Panel members agreed that the long-range shortfall in Social Security finances was an important backdrop for our deliberations. Social Security retired-worker, disability, and survivor

benefits are financed mainly by earmarked Social Security taxes. Workers and employers each pay 6.2 percent of workers' earnings up to \$90,000 in 2005, for a total of 12.4 percent. The earnings cap subject to Social Security taxes rises each year to keep pace with economy-wide wages. The tax rate is scheduled to remain unchanged in the future. Currently the Social Security trust funds take in more in revenues than are paid in benefits, and consequently are building reserves. The reserves were \$1.5 trillion at the end of 2003, according to the 2004 report of the Social Security Trustees.

The Trustees project that tax revenue flowing into the trust funds will exceed outgo until 2018, under their intermediate, or best estimate, assumptions. After that, Social Security tax revenues plus interest earned on the Treasury bonds in the funds will exceed all benefit payments until 2028. Through the redemption of Treasury bonds plus Social Security tax revenue and interest income, scheduled Social Security benefits can be paid in full until 2042, at which time the trust funds are projected to be depleted. If no changes are made to the program, taxes coming into Social Security are expected to cover about 73 percent of the scheduled benefits. By 2078, the end of the 75-year projection period used by the Social Security Trustees, revenues are projected to cover about 68 percent of scheduled benefits.

Social Security solvency proposals address this long-term funding shortfall in various ways, generally by reducing scheduled benefits (such as by modifying the benefit formula, raising the full benefit age, or altering automatic cost-of-living adjustments in benefits) or by increasing revenues (such as by raising the Social Security tax rate, lifting the cap on wages subject to Social Security taxes, or earmarking other revenues for Social Security), or by using a combination of such measures.

This Panel's charge was not to recommend ways to achieve balance in Social Security. Rather, our purpose was to help policymakers think through

payout issues that arise in various types of proposals that would introduce individual accounts as part of Social Security. We also consider payout issues that might arise if a new system of individual accounts were set up separate from Social Security.

## *Benefit Changes for Solvency and Benefit Offsets*

Given this Panel's focus on payout issues, as opposed to the restoration of solvency to Social Security, we distinguish between reductions in scheduled defined benefits designed solely to help achieve solvency, and other reductions in traditional defined benefits that flow from decisions to shift part of currently scheduled Social Security taxes to personal accounts. These latter reductions are called "offsets."

### *Reductions in Scheduled Benefits to Achieve Solvency*

Many of the plans in categories (1), (2), (4) and (5) of Figure 1-1 call for reductions in scheduled benefits for the purpose of putting Social Security in long-run financial balance. These benefit reductions take many forms and the reductions could apply to all beneficiaries (for example, by reducing scheduled benefits across the board) or they could target particular subsets of beneficiaries, such as early retirees, high earners, dependent spouses, children, and so forth.

### *Benefit Offsets*

Plans that shift scheduled Social Security taxes to individual accounts, as illustrated in categories (2) and (4) of Figure 1-1, call for further changes in scheduled benefits to accommodate, or "offset," the partial shift of scheduled Social Security taxes to personal accounts. These offsets may take different forms depending on whether the shift of taxes is mandatory and universal – as is the case with proposals in category (2) of Figure 1-1 – or whether it is voluntary – as is the case in proposals in category (4) of Figure 1-1.

### *Across-the-Board Offsets*

If accounts funded with scheduled Social Security taxes are mandatory and universal, the offset in defined benefits to accommodate that tax shift could also be mandatory and universal. Proposals in category (2) of Figure 1-1 fit this category. That is, all Social Security contributors would automatically have part of their Social Security taxes put into individual accounts and all workers would be affected by across-the-board changes in defined benefits necessary to balance the remaining defined benefit system with a smaller amount of Social Security tax revenues. The across-the-board changes could take many forms.

### *Worker-Specific Offsets*

If workers have a choice whether to shift part of their Social Security taxes to personal accounts, then some mechanism is needed to personalize the reduction in scheduled benefits. A worker-specific offset would ensure that only individuals who chose to shift their Social Security taxes to individual accounts would have their traditional Social Security benefits reduced for this reason. These worker-specific offsets can be designed in a wide variety of ways and become a key aspect of payout issues. Proposals in category (4) of Figure 1-1 fit this category and involve worker-specific offsets. These offsets are discussed in Chapter Nine.

The Panel believes that the analyses in the chapters that follow make important headway in exploring the relatively uncharted waters governing payouts if a new system emerges that blends property concepts with social insurance. The chapters also provide insights for designing payouts in property-based systems that are separate from social insurance.

## *Financial Demographics*

As a backdrop for considering payouts from a new system of individual accounts, Chapter Two examines the role of Social Security in the incomes of retirees, recent developments in pen-

sions, and lessons from experiments to help low-income workers save.

### *Role of Social Security*

Social Security is the major source of income for most retired Americans. About 90 percent of people aged 65 and older receive benefits. For two in three of those beneficiaries, Social Security is half or more of their total income. Women without husbands are the most reliant on Social Security benefits. For three in four elderly unmarried women receiving Social Security, the benefits are more than half their income. For nearly three in ten of such women, Social Security is their only source of income.

Social Security benefits alone do not provide a comfortable level of living. The average benefit for a retired worker was about \$922 a month, or \$11,060 a year in 2004. Under current Social Security law, benefits for future retirees are scheduled to rise in real terms. Benefits will grow somewhat more slowly than earnings, however, because the 1983 law raised the “full benefit age” from 65 to 67. That law phases in over the next 20 years. Although the real level of benefits will be higher, 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 would either raise revenue or lower benefits.

### *Pension Trends*

Employer-sponsored pensions are an important supplement to Social Security for the half of married couples and one third of unmarried men and women age 65 and older who receive pensions. At any time over the past 25 years, about half of private-sector workers have been covered by pension plans. The form of these plans has shifted dramatically from the 1970s and 1980s when defined-benefit plans were dominant. Today, defined-contribution plans, such as 401(k) plans, are more common. In defined-contribution plans, workers have more choices about whether to participate and how much to

contribute; they can take the accounts with them when they change jobs; and they have more choices about when and how to withdraw the money. At the same time, workers take on more responsibility for financing the plans and bearing the investment risk that employers bear in defined-benefit plans. Today, about half of all U.S. families own a tax-favored retirement account. The median value of the accumulated balances in those accounts was \$29,000 in 2001. For the 59 percent of families headed by someone aged 55 to 64 who have such accounts, the median value was about \$55,000.

### Experience with Individual Development Accounts

Many Americans lack experience with financial institutions. This lack of financial experience merits attention in the design of a new individual account system. The size of the “unbanked” population – those who do not have a checking or savings account with a bank or credit union – is estimated to be between 10 and 20 percent of all U.S. families. Low-income and minority families are most likely to be without a connection to a financial institution.

Individual development account experiments have offered financial education and matched savings to low-income workers. The savings are earmarked for specific purposes, such as higher education, purchase of a first home, or starting a business. Conditions that appear to foster successful saving include: (a) access to a savings plan, (b) incentives through matching funds, (c) financial education, (d) ease of saving through direct deposit and default participation, (e) clear saving targets and expectations, and (f) restrictions on withdrawals.

### Payments at Retirement

Chapter Three examines financial risks retirees face and how life annuities can insure against those risks. It offers four illustrative options for payout rules at retirement and examines the impact of various annuity features on costs to

retirees, the interests of heirs, and implications for consumer education.

### Life Annuities Insure Against Financial Risks

Retirees face at least four sources of financial uncertainty. They do not know how long they will live (longevity risk), how long their spouse might live (spousal survivorship risk), how prices might rise in the future (inflation risk), nor what returns they will earn on their savings (investment risk). To illustrate longevity risk, while the average 65-year-old woman can expect to live 20 years, she has a 7 percent chance of dying within five years and a 14 percent chance of living for 30 years to her 95th birthday. To illustrate inflation risk, even modest price increases of just 3 percent per year will make \$100 today worth only about \$74 in ten years; after 25 years, the value would drop by more than half, to \$45. High and unexpected inflation could rapidly erode buying power of any given amount of money.

A life annuity is a financial product offered by an insurance company that promises payments for as long as the annuitant lives. When an individual buys a life annuity, the insurance company has a contractual obligation to pay the annuitant a guaranteed income for life. The annuity purchase shifts the individual’s longevity risk and investment risk to the insurance company. 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 annuitant’s perspective, the downside of buying a life annuity is that the full price is paid 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 account holder retains ownership of the money.

### Policy Options

Should retirees be encouraged or required to buy life annuities with their individual accounts?

Chapter Three presents four illustrative options. The first gives retirees *Unconstrained Access* to their account funds. It offers many choices and is based on the federal employees' Thrift Savings Plan. The second option, *Compulsory Annuities with Special Protections*, falls at the other end of the spectrum. It would require the purchase of life annuities that are indexed for inflation and that automatically provide survivor benefits for widowed spouses. A third option, *Default Annuities with Special Protections*, makes the annuities of option two a default, but would allow other payouts. Finally, option four, *Compulsory Minimum Annuities*, would require the annuities of option two, but only up to a given level.

Policy choices along this spectrum are likely to be influenced by the purpose of the accounts, the level of Social Security defined benefits that accompany the accounts, and whether participation in the accounts is mandatory or voluntary. If the purpose of the accounts is to provide basic security, then policymakers might want payouts to resemble the mandatory protections of the second option. Many proposals for accounts that aim to replace part of traditional Social Security call for mandatory inflation-indexed annuities with spousal protections. Yet, if the accounts are discretionary savings on top of traditional Social Security benefits, then payouts might resemble the broader choices of option one.

### Additional Protection Costs More

Each layer of protection for inflation-indexing and survivor benefits lowers the size of the annuity 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 were indexed to keep pace with inflation at 3 percent a year, it would start out lower, at about \$62 a month. If it would continue to pay for 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.<sup>5</sup>

Whether the purchase of life annuities should be compulsory is a key policy issue. Compulsory annuities assure that people cannot outlive their money, but allow 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 make higher payouts, on average, precisely because short-lived people are required to buy a product that is not a good deal for them.

### Joint-Life Annuities

Providing joint-life annuities that protect widowed spouses will reduce the size of the annuity that a given premium will buy. Many choices are possible, such as between *symmetric* and *contingent* joint-life annuities. For example, if John buys a contingent joint and two-thirds annuity, the payment for his widow will fall to two-thirds of the original amount if he dies, but the payment will remain the full original amount if he is widowed. In contrast, if he buys a symmetric joint and two-thirds annuity, the payment will always drop to two-thirds of the original amount when one partner became widowed. Each annuity type has different pros and cons that policymakers might want to address.

### Guarantees and Interests of Heirs

Some annuity contracts guarantee a payment to a named death beneficiary if the annuitant dies shortly after buying an annuity. A *ten-year-certain* annuity, for example, 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 annuitant paid \$10,000 for a life annuity and died after receiving only \$1,000, then \$9,000 would be paid 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 annuity buyers often choose guarantees, perhaps because the guarantees help their heirs avoid disappointment and serious regret if the annuitant paid a large amount for a life annuity and died soon after.

### Timing of Annuity Purchase and Heirs

The interests of heirs could influence the question of whether and when to buy an annuity. From a strictly selfish perspective, named beneficiaries might prefer that the account holder delay buying an annuity so that the account would remain inheritable. For example, an unmarried account holder might name an adult child, friend or other relative as a death beneficiary. If the account holder dies before buying an annuity, the entire balance would go to the heir. If the account is used to buy an annuity, the bequest is gone.

The timing tradeoff affects married retirees, too. If one spouse is expected to die relatively soon, the couple might be wise to delay or avoid buying joint-life annuities. The survivor's income in the form of a single-life annuity based on the balance in both accounts would be considerably higher than the survivor payment from joint-life annuities from both accounts.<sup>6</sup> So, both single and married retirees might want flexibility in the timing of annuity purchase.

### Recap of Choices

Retirement payout policies present tensions between offering choices and guaranteeing income for life. Possible questions to be determined by mandates or participant choices include the following: whether to buy an annuity at all; how much of the account to spend on an annuity; whether the annuity will be indexed for inflation; when to buy an annuity; whether to buy a guarantee feature and, if so, what type; whether to buy a joint life annuity and, if so, whether to choose a contingent or symmetric product and what size survivor benefit to buy.

### Informed Choice

If retirees have choices about buying annuities, a key policy issue becomes who will advise them and answer their questions. To what extent would the educators or advisors be responsible for the consequences if the advice produced disappointing results? As retirees have more choices about retirement payouts, these questions gain added importance.

The Social Security Administration has very little experience helping retirees make informed choices about payouts, because Social Security offers almost no choices. The only choices are whether and when to take benefits once one becomes eligible.

The federal government, in its role as employer, informs participants in the Thrift Savings Plan about payout options. Personnel offices provide seminars and explanations to employees who are planning to retire. While some large private employers might be equipped to help employees understand annuity choices in individual accounts, many small employers would not have the resources to do so.

### Institutional Arrangements for Providing Life Annuities

The existing market for life annuities in the United States is relatively small. Life annuities are offered by insurance companies, which are regulated by states.

### Life Annuity Market

Many financial products are called annuities, but are not life annuities. Life annuities are contractual obligations to pay the annuitant for the rest of his or her life.<sup>7</sup> Deferred annuities are tax-favored investment products that do not guarantee payment for life. More common than life annuities, deferred annuities are used mainly to defer taxes on fund accumulations.

Life annuities represent about 15 percent of annual new product sales of insurance companies. Some experts believe that life annuities are

a growth area as pension plans shift to lump-sum payouts. But such growth has not yet occurred, perhaps because of limited interest from both customers and financial advisors. Two drawbacks from advisors' perspectives are that life annuities generally pay smaller commissions than deferred annuities and life annuities end the opportunity to do further business with the funds because the money is turned over to an insurance company.

Whether insurers would be allowed to charge different prices to women and men is a key policy issue. In the individual life annuity market, insurers charge women more because women live longer than men, on average. Yet, in the group annuity market, federal policy bans differential pricing in annuities tied to employee benefits.

### Adverse Selection, Uniform Pricing and Selective Marketing

In a voluntary annuity market, if a company prices its annuities based on average risks, people with longer life expectancy would be more likely to buy the annuities while people with short life expectancies would not. This adverse selection would drive up the cost to the insurer and lead the company to raise its prices. The higher prices would further discourage short-lived people from buying annuities. If policymakers wanted uniform pricing of annuities for everyone of the same age (regardless of sex, health status, or other risk factors), the simplest way to avoid adverse selection would be to remove participant choice and require everyone to buy annuities. Uniform pricing in the presence of differential risks can lead to selective marketing, whereby annuity sellers target their sales efforts on population groups with shorter life expectancy. It is difficult for regulators to stop selective marketing without direct governmental oversight of marketing activities.

### Insurance Company Regulation

Insurance regulation in the United States has been the purview of the states since enactment of the McCarran-Ferguson Act in 1945. While

the federal government regulates the banking, securities, and defined-benefit pension industries, states regulate insurance companies. Such regulations cover the pricing of annuities, financial backing of annuities, provisions for guaranteeing payments in the case of insurance company failure, and other issues.

Unlike federal insurance programs, such as the Federal Deposit Insurance Corporation for banks, state guaranty funds for insurance companies are not pre-funded. Instead, states assess (that is, tax) other insurance companies doing business in the state to cover the cost of an insurance company failure after it occurs.<sup>8</sup> The largest such failure involved Executive Life Insurance Company in the early 1990s. State guaranty associations have paid about \$2.5 billion for that insolvency as of 2004.

Existing arrangements for guaranteeing life annuities might suffice for a new system of individual accounts if the accounts are viewed as supplemental savings and retirees are given wide discretion on how they take the funds at retirement. But new institutional arrangements are likely to be needed if policymakers want to strongly encourage retirees to buy life annuities indexed for inflation and that automatically provide protection for widowed spouses.

### Inflation-Indexed Annuities

A large market for inflation-indexed annuities does not yet exist in the United States and creating one 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, it might reinsure private insurers or guarantee their solvency, or it might issue inflation-indexed annuities directly to retirees.

Some experts thought that a substantial market in inflation-indexed annuities would evolve when TIPS were introduced in 1997. Three conditions might explain why that has not happened. First, consumers may not see the value of

inflation-indexed annuities. Retirees simply may not understand longevity risk and inflation risk. Second, TIPS may not exist in sufficient volume, duration, and predictability to encourage insurers to offer inflation-indexed annuities. The Treasury Department stopped issuing all 30-year bonds, including TIPS, in 2001. Insurers might believe that only 30-year TIPS are sufficient to cover the life spans of new retirees. Thirty-year TIPS are about \$40 billion (or roughly one percent) of the total Treasury securities market of \$3.3 trillion, which is about one third of the nation's economic output, or gross domestic product (GDP). Finally, insurers and their regulators might be concerned that inflation indexing would increase insurers' exposure to mortality risk. Even if inflation risk is hedged by Treasury securities, insurers who underestimate their annuitants' life spans will be exposed to much greater losses if the promised annuities keep pace with the cost of living.

The volume of reserves required to back widespread inflation-indexed annuities would be substantial. Reserves backing annuities funded with 2 percent of workers' earnings could amount to about 15 percent of GDP when the system is fully mature.<sup>9</sup> Those annuity reserves would be equivalent to roughly 7 percent to 8 percent of the value of total U.S. financial assets.<sup>10</sup>

### Options for Widespread Indexed Annuities

If insurance companies were to provide 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 and regulate life insurance companies might gain broader interest in this case.

The government could issue TIPS in sufficient volume and duration to back privately issued annuities or it could provide inflation-indexed annuities directly to retirees. In the latter case, the government would take on the longevity risk and the inflation risk. Whether the government provides annuities directly, or provides TIPS to

back privately issued annuities, 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 and spending functions of the federal government and new institutions might be needed to provide for prudent and diversified investment of the funds.

### Pre-Retirement Access to Individual 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.

### Precedents for Early Access

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.

### Tradeoffs Among Goals

Early access rules create tensions among three competing goals: ease of access, retirement security, and administrative efficiency. Participants will want easy access to their money when they need it. But the goal of retirement security calls

for minimizing leakage from the accounts by banning early access. Yet, if access is allowed, the retirement security goal argues for restricting access to only loans and only for hardship. The competing goal of administrative efficiency also argues for a total ban on access. As a second choice, administrative efficiency points to the opposite policy of allowing unrestricted withdrawals. More administrative resources are needed to process loans, which involve repayments, and to restrict reasons for withdrawals, which requires documentation, decisions, and perhaps a right to review when access is denied.

### Gatekeeping

If access to individual accounts is allowed but restricted in some way, a gatekeeper will be needed to determine whether a particular withdrawal is allowed. When access is denied, procedures will be needed to give participants an opportunity to have a denial appealed and reconsidered. 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 national system of individual accounts will pose new questions about: what entity would play the gatekeeper role; what incentives would prompt the gatekeeper to prevent wrongful withdrawals; what penalty would be imposed for non-compliance; and on whom the penalties should fall. If the overall purpose of the accounts is retirement income security, a penalty on the accountholder for a wrongful withdrawal might undermine the ultimate goal.

### Third Parties and Means Tests

Finally, early access to the 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 pro-

grams 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.

### Spousal Rights

About 14.0 million individuals – 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. 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.

The cost of paying traditional spousal benefits is spread among all participants in Social Security; the benefits for a widow or wife do not lower payments to the husband. As personal property, individual accounts represent a finite pool of assets, so that payments to a spouse would reduce funds for the accountholder and vice-versa.

Policy decisions about spousal rights to individual accounts will be influenced by the purpose of the accounts, the level of traditional Social Security benefits that accompany the accounts, and whether participation is mandatory or voluntary. If participation is voluntary, spousal rights rules will need to take into account the possibility that only one member of a couple may elect to participate.

## Federal or State Jurisdiction

A key question is whether spousal rights to individual accounts will be decided in federal law or left to the states. As a national social insurance program, Social Security has uniform benefit entitlement 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,<sup>11</sup> view property acquired during marriage as community marital 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 spousal rights in an individual account system are to be uniform, Congress will need to define the rules clearly in federal law. Alternatively, policymakers could explicitly provide that state law will determine spousal rights. While this approach would increase flexibility, it also would produce different results across states, and would likely increase administrative costs and the need for account holders to have legal representation.

## Spousal Rights during Marriage

During marriage, one option would be to divide account contributions equally between husbands and wives, building community property principles into the account system. Another approach would be to credit each spouse with his or her own personal contributions. A related issue is whether a married account holder would need spousal consent to take money out of the account or borrow it, if such access were allowed at all. If a spouse has a future claim on the account funds at widowhood or divorce, then spousal consent to use the funds for other purposes might be warranted. If a spouse had no such claim, the case for spousal consent would be reduced.

## Spousal Rights at Divorce

Approaches for allocating spousal rights at divorce could be based on federal mandates or default rules. In addition, there could be a role for state courts to allocate, or reallocate, funds as part of an overall divorce settlement. 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 the 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.

## Rights at Widowhood before Retirement

Another key set of policy issues is whether widows and widowers will automatically inherit their deceased spouse's account, or whether account holders will be free to bequeath their accounts to whomever they choose. Some Social Security proposals require that the accounts always go to the widowed spouse and be held for her or his retirement. These rules aim to protect widowed spouses in ways that resemble Social Security survivor benefits, but could pose new issues in the case of subsequent marriages. For example, if a widowed spouse remarried and subsequently died, the property interests of children from a first marriage and rights of the subsequent spouse might be in conflict. While family law deals with such issues, blending social insurance survivor protections with community property inheritance rights would pose new issues.

## Retirement Payouts for Married Account Holders

Many individual account proposals require married account holders to buy joint-life annuities in order to protect widowed spouses. When a retiree has a much younger (or older) spouse, the age disparity will affect the size of joint-life

annuities that a given premium will buy, because joint-life annuities are affected by the age of both the annuity partner and the annuity buyer.

Changes in marital status after one buys an annuity could pose new issues in allocating retirement income. In general, life annuities cannot be rewritten after purchase. So, if an individual marries after buying a single-life annuity, there is no easy way to change the contract to cover a spouse.

### Implementation Issues

Administering spousal rights in a new system of individual accounts could impose new reporting, verification, and dispute resolution procedures beyond those used to determine Social Security benefit entitlement. Social Security spousal benefits are determined when benefits are claimed – when a worker retires, dies, or becomes disabled. Implementing property rights for individual accounts could require new systems to link husbands’ and wives’ account records throughout the work life. A spouse’s right to individual account funds will likely incur more dispute-resolution procedures than occurs with traditional Social Security payments.

## *Disabled Workers and their Families*

Social Security pays disability as well as retirement benefits, and the risk of disability is significant. Payout policies at disability onset will depend on the purpose of the individual accounts. Six options are explored in Chapter Seven. General rules about payouts from individual accounts may take on new dimensions when accountholders are disabled-worker beneficiaries.

### Role of Social Security for Disabled-Worker Beneficiaries

About six million individuals aged 18-64 received disabled-worker benefits from Social Security at the beginning of 2004. Those benefits account for more than half of total family income for about one in two disabled-worker

beneficiaries. When compared to other people of the same age, disabled-worker beneficiaries are more likely to be black or Hispanic, unmarried, without a high school diploma, live alone, and to be poor or near poor.

### The Risk of Disability

The risk of becoming so disabled that one receives Social Security disabled-worker benefits is significant. About three in ten men, and one in four women, will become disability beneficiaries before they reach retirement age. Disability is not the last risk to income security that they will face. The death of disabled workers before retirement may leave family members who relied on their support, while those who live into retirement will need to consider the resources they will have in old age. In designing an individual account proposal, it is important to think through how the accounts, along with any accompanying changes in traditional Social Security benefits, will affect disabled workers and their families throughout the rest of their lives.

### Policy Options for Disability Beneficiaries and Purpose

Policy issues with regard to payouts from individual accounts for disabled-worker beneficiaries will vary depending on the purpose of the accounts. If the accounts are intended to be discretionary savings on top of Social Security, then payout rules might resemble IRAs and 401(k)s, which make the money available without penalty at the onset of disability.

Yet, if individual accounts become an integral part of Social Security, and scheduled retirement benefits are reduced in return for the new personal accounts, new issues arise about whether and how those offsets will apply to the traditional benefits of workers who become disabled. Because disability benefits are based on the same formula used for retirement benefits, across-the-board changes in the retirement benefit formula would automatically affect disabled workers unless policymakers specifically address these issues.<sup>12</sup> Other policy questions relate to when

and how funds in the accounts would become available to disabled workers. Various policy options are explained in Chapter Seven.

### Adapting General Rules to the Situation of Disability Beneficiaries

Many of the issues covered in prior chapters take on new dimensions when the general rules apply to people who have experienced career-ending disabilities. Sustaining a ban on access to account funds before retirement age – as discussed in Chapter Five – may pose new challenges when disability beneficiaries have a pressing need for the money, particularly if they have life-threatening conditions and have no family members with a survivorship interest in the accounts. If retirees are required to buy annuities at normal retirement age, will disabled-worker beneficiaries be required to buy them on the same terms as other retirees? Or might a market in “impaired life” annuities emerge, as has occurred in the United Kingdom? These products allow individuals who have shorter life expectancy to buy annuities on a more favorable basis. Mandating joint-life annuities for married retirees could present new issues if one or both members of the couple entered retirement as disabled-worker beneficiaries.

### Children, Life Insurance, and Bequests

Social Security proposals that call for individual accounts to replace part of traditional retirement benefits also involve questions about how the plan will affect young survivor families and other beneficiary families with young children. Because assets in individual accounts are not expected to spread risk the way insurance does, it is important to examine how new accounts might interact with Social Security benefits for children.

#### *Children on Social Security*

About three million children under the age of 18 receive Social Security as survivors and depend-

ents of deceased, disabled, and retired workers. These children account for about 7 percent of all Social Security beneficiaries and about 4 percent of all children in the United States. About half of the eligible children are survivors of deceased workers, while the others have a parent who is disabled or retired.

### Disabled Adult Children

Adults who became disabled before age 22 are eligible for benefits on the same terms as children under 18. About 750,000 persons age 18 and older with childhood onset disabilities receive Social Security, as children of deceased, disabled or retired parents. Mental retardation is the main diagnosis for most of these beneficiaries, while conditions of the nervous system or sensory organs are the next most prevalent. These beneficiaries range in age from young adults to senior citizens. About six in ten disabled adult child beneficiaries are poor or near poor and about four out of five receive Social Security through a representative payee because they are not able to manage their own funds.

### Policy Options for Defined Benefits

Many plans for mandatory individual accounts in Social Security call for across-the-board reductions (or offsets) in scheduled Social Security retirement benefits that will phase in as the accounts build up.<sup>13</sup> If these changes were made in the basic benefit formula for retirees, they would affect young survivor families as well. But young survivor families may not benefit from individual accounts in the same way that retirees do. Chapter Eight considers four possible approaches for adapting changes in retirement benefits to the particular situations of young survivor families. It also considers how policymakers might approach benefit changes for minor children and disabled adult children when the working parent is a disabled-worker beneficiary or a retiree.

### Children’s Rights to Parents’ Accounts

Whether a minor child or a disabled adult child would have any special rights to an account when a parent dies is also an important ques-

tion. Wives and husbands typically have certain inheritance rights under state law. Would policymakers want to specify any inheritance rights for minor children or disabled adult children? Or, should federal policy leave these decisions about bequests to working parents and to state laws that apply when one dies without a will?

### Bequests to Heirs other than Spouses and Children

Individual account proposals generally allow the account holder to bequeath funds if the worker dies before retirement. At the same time, many such proposals limit bequests by requiring account holders to buy annuities or by automatically transferring accounts to widowed spouses. These limits on bequests are generally motivated by a desire to preserve types of benefits that Social Security now provides, such as payments for life and spousal protections. New bequests are more likely to occur for unmarried account holders (widowed, divorced, or single) who die before buying annuities. In the eyes of many, these bequests are desirable and consistent with property ownership. Yet, from a social insurance perspective, such bequests could be viewed as “leakage” that is beyond the purpose of the social insurance system. To the extent that Social Security funds go to heirs who would not otherwise be eligible for benefits (such as able-bodied adult children, siblings, relatives, friends or institutions), either more money would be needed to pay other eligible beneficiaries, or their benefits would be lowered in some way. In designing payouts, policymakers have the opportunity to weigh tradeoffs between property rights and social insurance goals.

### Worker-Specific Offsets

When workers can choose whether to shift part of their Social Security taxes into a personal account, some mechanism is needed to personalize the offset of scheduled benefits to equitably distinguish between those who do and those who do not shift Social Security taxes to personal accounts. These worker-specific offsets can be designed in a variety of ways, becoming a key

aspect of payout issues. Possibilities for designing offsets are almost limitless and this chapter outlines some of the choices and questions.

### Basic Design Issues

In terms of basic design, should the offset reduce the account holder’s scheduled Social Security benefits, or should it reduce the size of his or her individual account? Offsets that reduce scheduled defined benefits require policymakers to decide which types of benefits would be affected (retirement or disability) and whether benefits of family members (spouses, widowed spouses, and children) would be reduced.

At retirement, what event should trigger the calculation and application of a worker-specific offset? Applying the offset when Social Security benefits are first claimed would ensure that no retirement benefits avoid the offset, but raises the question of whether contributions to the accounts should end and instead go to the Social Security trust funds when individuals keep working after claiming retirement benefits.

### Retired Couples

When couples retire, a number of questions also arise about how the offset would apply in the case of family benefits. A different sequence of calculating offsets and annuities could result in different outcomes. Rules for couples would also need to take account of the possibility that one spouse chose to shift taxes to a personal account while the other did not. Ideally, offset rules would be equitable to couples in which neither, both, or only one partner shifted taxes to a personal account.

### Offsets and Divorce

At divorce, if the proposal mandates (or permits) a division of accounts between husbands and wives, some conforming rules might be needed for worker-specific offsets. For example, if the personal account is viewed as an “asset” in divorce proceedings, should the accompanying offset be viewed as a “debt?” Would the debt transfer with the asset, or remain with the origi-

nal account holder? A case might be made for either approach.

### Offsets for Disabled-Worker and Young Survivor Benefits

Worker-specific offsets could be designed to exempt disabled-worker beneficiaries from the offset until they reach retirement age. Similarly, when a worker dies leaving minor children (or disabled adult children), policymakers could decide to exempt from the offset the benefits payable to his or her children. A key question is whether a worker's decision to shift Social Security taxes to a personal account should affect family life insurance protection otherwise provided by the worker's earnings and contribution history.

The application of worker-specific offsets could produce countless outcomes. This chapter is a step toward exploring details of the still largely uncharted waters of worker-specific offsets and their consequences for beneficiaries, taxpayers, and Social Security finances.

### Individual Account Taxation

Finally, how might individual accounts be taxed? The tax model selected can have a dramatic impact on the costs, participation levels, forms of payout, and benefits and burdens associated with creating individual accounts.

In general, one cannot understand how to tax payments from individual accounts without understanding how contributions to them are taxed. "Tax equivalences" summarize the distinctions among different tax regimes.

#### Tax Equivalences

In brief, the government can tax (T) or exempt (E) income at three points in the saving process: it can tax (1) deposits, (2) investment earnings, and/or (3) withdrawals. An income tax generally taxes deposits and investment earnings, but not withdrawals (summarized TTE). A consumption tax can operate in one of two ways: It may tax deposits and exempt investment earnings and

withdrawals (summarized TEE), or it may exempt deposits and investment earnings, but tax withdrawals (summarized EET). Under certain assumptions, these two tax regimes are economically equivalent. Finally, it is possible to exempt deposits, investment earnings, and withdrawals from a savings vehicle (summarized EEE), but doing so subsidizes savings in the vehicle and can actually allow taxpayers to extract the subsidy without increasing their net savings at all.

#### Models for Taxing Individual Accounts

Based on this general situation, four models for taxing individual accounts under current law could be used. The "*normal*" model for taxing savings mirrors the income tax regime (TTE). Money that is saved is taxed when initially earned, and the income generated by the savings is then taxed when it is realized. The *traditional* model for taxing retirement savings mirrors the consumption tax regimes. Income earned on qualified retirement savings is exempt from tax so that only the contributions made by workers and their employers are subject to tax. This is accomplished either by way of an upfront tax deduction for contributions (EET) or a tax exemption for withdrawals (TEE). Certain other forms of retirement savings are taxed under a third model of *deferral*, which taxes both contributions and income earned on contributions, but taxes contributions immediately while taxing income earned on contributions only upon withdrawal. Finally, *Social Security* contributions and benefits are taxed under a fourth, entirely different regime. The employee's half of contributions are taxed, and anywhere from zero to 85 percent of benefits paid are taxed, depending on the beneficiary's income level.

Each of these models can be, and in some cases is, combined with tax credits, preferential rates, and tax penalties, all of which can further affect tax burdens, subsidies, and incentives.

## Considerations in Determining the Tax Treatment of Accounts

Policymakers will need to take a variety of factors into account when deciding which of these models to apply to individual accounts, including the accounts' purposes and structure, and certain implementation issues. In particular, the tax treatment of individual accounts is likely to have important consequences for participation rates, complexity from a participant and governmental perspective, the form of payout, and distributional issues. The challenge for policymakers in determining the tax treatment of the accounts will be how to navigate between these frequently conflicting concerns.

An important question for policymakers is whether distributional concerns should be addressed through the tax treatment of the accounts, through the method for allocating funds to the accounts, or by adjusting traditional Social Security benefits. How the tax treatment of the accounts affects savings in other tax-preferred vehicles also merits attention.

With respect to complexity, the traditional model for retirement savings and, in some cases, the Social Security model, are likely the most simple. Unlike the other models, they do not require workers or the government to track the amount of each worker's contributions and the portion of investment earnings on which he or she has paid tax.

If the accounts are voluntary, policymakers may also wish to consider how the tax treatment of the accounts affects participation rates. In general, if the account system involves offsets, decisions about participation are likely to be

influenced by the after-tax value of funds shifted to the account relative to the after-tax value of the traditional Social Security benefits foregone. If the accounts are independent from the Social Security system, participation decisions are likely to be influenced by the tax treatment of the accounts relative to other savings vehicles.

How would the tax treatment of individual accounts affect the taxation of traditional Social Security benefits? If an individual account plan is funded out of existing Social Security taxes but is not funded equally from the employers' and employees' shares, the creation of individual accounts may raise the question whether adjustments are appropriate to the taxation of traditional Social Security benefits.

Finally, tax incentives and penalties could be used to discourage withdrawals before retirement, or to encourage phased withdrawals or annuitization of the accounts.

## Concluding Remarks

The Panel believes that the more detailed analyses in the following chapters make important headway in identifying issues in the design of a new system of individual accounts that blend property concepts with social insurance. Our purpose has been to provide dispassionate analysis that will aid policymakers in this important aspect of public policy. Although panel members disagree about a policy of replacing part of Social Security with individual accounts, all agree that the work presented in the chapters that follow is an important contribution to informed public policy.

## Chapter One Endnotes

- 1 For instance, ownership of land might not include mineral rights, and a vested right to a pension might not include the right to receive funds prior to retirement age.
- 2 Some state and local employees are exempt from Social Security coverage. Under historical arrangements, states and localities could choose whether to provide Social Security coverage to employees who are covered under state or local pension plans.
- 3 The choice to distinguish individual account plans by funding source was a difficult one for the Panel, given the potential fungibility of different types of government revenue. Given the focus on payouts from individual accounts, however, the Panel as a whole agreed that this distinction proved helpful.
- 4 Individual development accounts are matched savings accounts targeted to low-income workers and typically restricted to first-home purchase, small-business start-up, and post-secondary education and training.
- 5 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.
- 6 This occurs because single life annuities pay higher monthly amounts than a joint-life annuity that covers two lives. If the widowed partner would inherit the deceased partner's account, a single life annuity from the combined accounts of the deceased and the widowed spouse would be much higher than the survivor payments from joint-life annuities that both bought before the death occurred.
- 7 The account holder usually has the option to later use the funds in the deferred annuity to buy a life annuity, but relatively few people do so.
- 8 In general, the guaranty funds provide insurance coverage for annuities up to a net present value of \$100,000. To the extent that annuitants have policies above the limit, the uninsured portion would represent a claim on the failed insurance company and in all likelihood would not be paid in full.
- 9 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.
- 10 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.
- 11 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.
- 12 Chapter Nine examines worker-specific offsets in plans that permit workers to shift part of their Social Security taxes to individual accounts.
- 13 Chapter Nine examines worker-specific offsets in plans that permit workers to shift part of their Social Security taxes to individual accounts. Chapter Eight considers payment options when offsets are mandatory and apply to all retirees.

# Chapter 2

## Financial Demographics

Understanding how Americans save—or do not save—is critical groundwork for any new initiative on workers’ retirement income. Millions of people (most of them low-income and/or minority) have no relationship with a mainstream financial institution. Many more, including middle-income families, have saved little for retirement and can be expected to depend almost entirely on Social Security for retirement income.

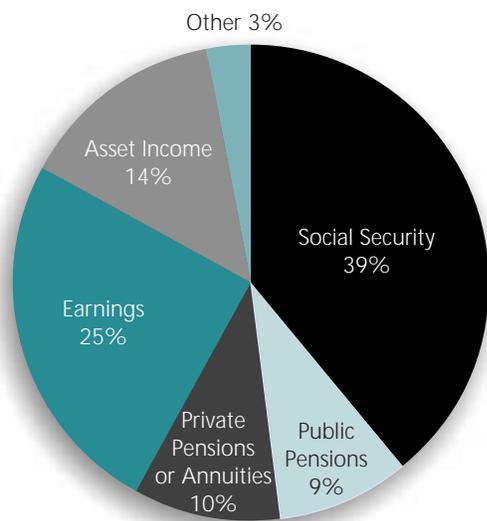
This chapter examines the components of income for Americans age 65 and older—including Social Security, employer-sponsored pensions, individual savings, and earnings from work—and the relative role these sources of income play for individuals at different income levels. Several indicators of economic well being, including homeownership and other assets not earmarked for retirement, offer further insight into how Americans save, as do measures of financial stress such as poverty, household debt, and personal bankruptcies. The potential size of individual accounts is also explored, based on given assumptions about the amount and duration of contributions to the accounts and investment earnings.

### *Components of Retirement Income*

Retirement income in the United States is often characterized as a “three-legged stool” made up of Social Security, employer-sponsored pensions, and individual savings. But some Americans age 65 or older who are still working, or who have a working spouse, receive employment income as well. Means-tested payments from Supplemental Security Income (SSI) can help individuals age 65 and older who have very limited assets and income.

In 2002, Social Security provided nearly 40 percent of the income of Americans age 65 and older (Figure 2-1), more than from any other single source. The next largest source of income, earnings from work, accounted for one-quarter of aggregate income, followed by employer-provided pensions (about evenly divided between private and public pensions) at 20 percent, and income from individually owned assets at 14 percent. Occupying a smaller portion of the aggregate were SSI, unemployment insurance, workers’ compensation, veteran’s benefits, cash

**Figure 2-1.** *Shares of Income from Specified Sources, 2002*  
*Married Couples and Unmarried Persons Age 65 and Older*



Source: U.S. Social Security Administration, Forthcoming. *Income of the Population 55 or Older, 2002*

assistance from state or local programs, and alimony and other contributions from individuals outside the household, which together comprised 3 percent of aggregate income for older Americans.

Almost all older Americans receive Social Security—about nine in ten Americans age 65 and older collect benefits (Figure 2-2). Pensions can provide an important supplement to Social Security, but about half of married couples and two-thirds of unmarried men and women lack pension income. More people have some asset income, but most of the elderly receive only small amounts. Indeed, just under half of couples and about one in three unmarried older Americans get as much as \$1,000 per year in asset income. Fewer than one in four elderly receive earnings from work, although some individuals earn substantial amounts.

Social Security is a major income source for retired workers through the middle of the income distribution. Low-income Americans are most reliant on Social Security because they are less likely to have other sources of support. Figure 2-3 illustrates what funds older Americans relied on in 2002, by income quintiles.

Those in the bottom two-fifths of the income distribution drew more than 80 percent of their total income from Social Security in 2002—four times Social Security’s share for the top income group. Those in the middle fifth of the distribution, with incomes between about \$15,000 and \$24,000, counted on Social Security for 64 per-

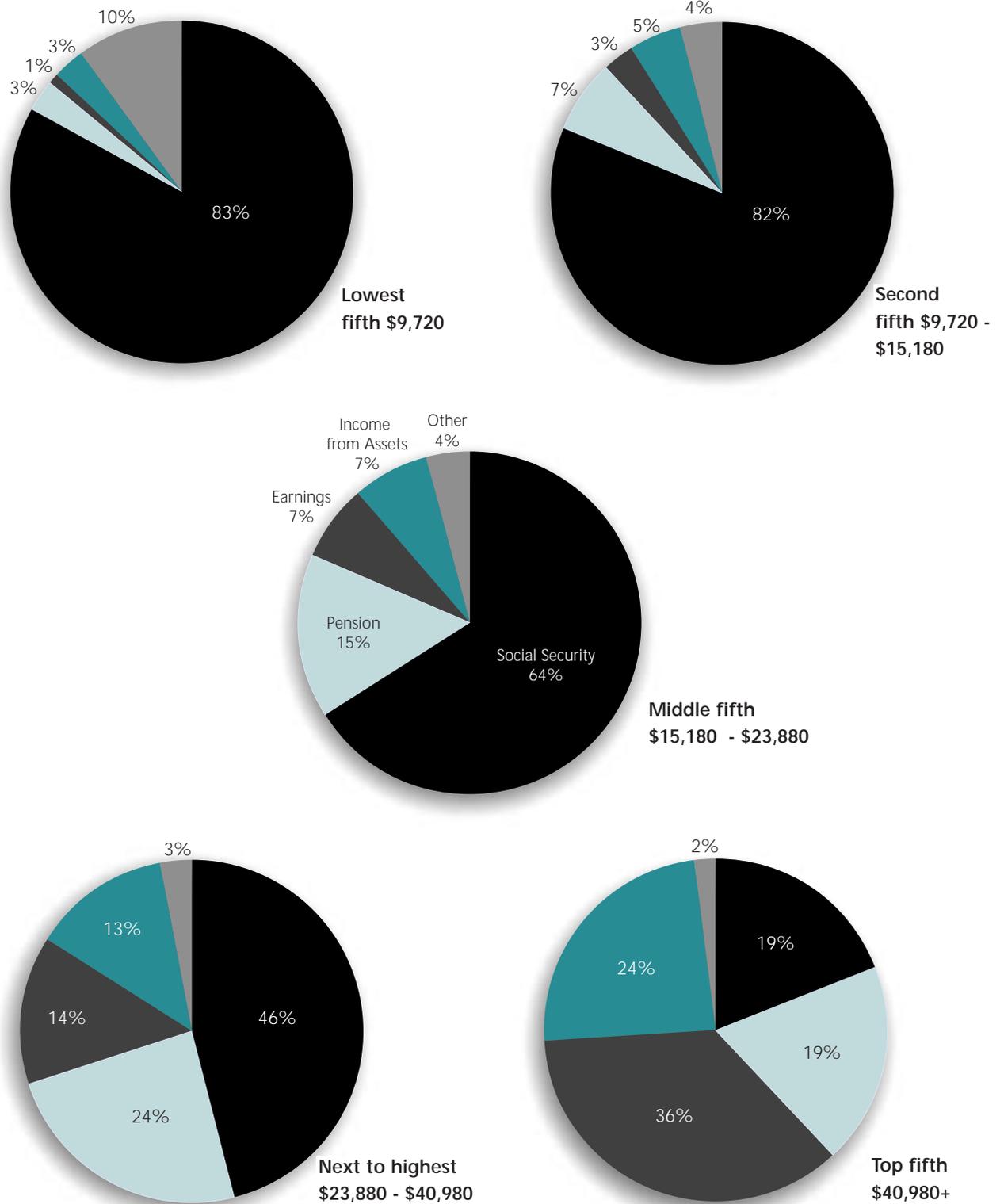
**Figure 2-2.** *Percent Receiving Specified Sources of Income, 2002*  
*Married Couples and Unmarried Persons Age 65 and Older*

Type of Income	Total	Married Couples	Unmarried Men	Unmarried Women
<b>Percent receiving</b>				
Social Security	90	91	87	89
Pensions – total	41	51	39	32
Public employee pensions*	15	19	13	13
Private pensions	29	37	28	21
Income from assets	55	67	47	48
More than \$1,000 a year	36	45	30	29
Earnings from work	22	36	18	12
Supplemental Security Income	4	2	5	6

\*Includes government employee pensions – federal military and civilian and state and local.

Source: U.S. Social Security Administration, Forthcoming. *Income of the Population 55 or Older, 2002*

**Figure 2-3.** Shares of Income from Specified Sources by Income Level, 2002  
 Married Couples and Unmarried Persons Age 65 and Older



Source: U.S. Social Security Administration, Forthcoming. *Income of the Population 55 or Older, 2002*

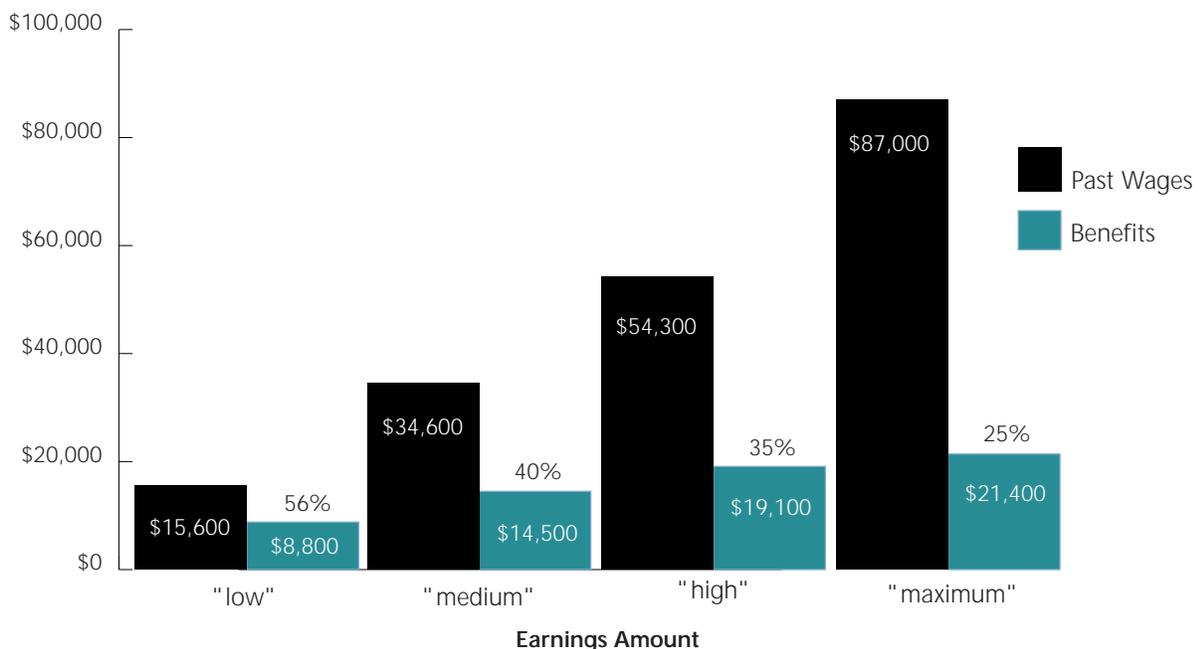
cent of total income, with pensions contributing the second-largest share (15 percent). Those in the “next to highest” income quintile had incomes between \$22,000 and \$41,000, of which Social Security comprised nearly half (46 percent) and pensions about one quarter. Finally, the top income group consisted of many beneficiaries not yet retired or with a working spouse. Earnings were the largest single income source for these individuals, at 36 percent of the total, followed by asset income, at 24 percent, and Social Security, at about 19 percent.

Social Security benefits replace part of the income needed to maintain the worker’s standard of living when he or she retires. But the program’s progressive benefit formula, as seen in Figure 2-4, replaces a larger monthly share of past earnings for low-wage workers. Although higher earners receive larger benefit checks, those checks represent a smaller fraction of previous earnings. For example, a 65-year-old who retired in 2004 with a lifetime of “medium” earnings (\$34,600 in 2003) would receive \$14,500 a year, a 40 percent replacement rate. But someone with a lifetime of low earnings

(\$15,600 in 2003) would receive 56 percent of prior earnings from Social Security. A retiree who always earned the maximum amount that is taxed and counted toward Social Security (\$87,000 in 2003) will see about a quarter of those past earnings in a benefit check. These comparisons are for single individuals who survive to retirement. When evaluated on a lifetime, family basis, the extent of redistribution through retirement benefits is diminished due to differences in life expectancy, spousal benefits, and other differences between high and low earners (U.S. GAO, 2004).

Figure 2-4 applies only to workers who claim Social Security at age 65. Although this has long been called the *normal retirement age*, the majority of Americans claim benefits before they turn 65. Workers who opt to start receiving Social Security at 62 (the earliest eligibility age) trigger a permanent benefit reduction of about 20 percent. Thus, most Americans receive less than the full benefits shown in Figure 2-4, but can receive these benefits for more years.

**Figure 2-4.** Social Security Benefits Compared to Past Earnings by Earnings Level, 2004  
Retired Workers Age 65



Source: Board of Trustees, 2004. *Annual Report of the Board of Trustees*

In January 2004, the average Social Security benefit for a retired worker was \$922 a month, or about \$11,060 a year. For a retired couple, the average combined benefit was about \$1,520 a month, or \$18,300 a year. Nearly two in three elderly beneficiaries (64 percent) rely on these benefits for more than half of their total income. One in five beneficiaries have no other source of funds.

## Role of Social Security—Past and Future

The role of Social Security in retirees' total incomes has been fairly stable for the past 25 years. Changes already enacted will cause future benefits to grow somewhat slower than wages. It remains to be seen what other policy changes in benefit levels or revenues will be made to bring the system into long-range balance.

### The Past 25 Years

For more than 25 years, Social Security has been the main source of income for older Americans. In 1976, as in 2002, about two-thirds of benefi-

ciaries drew more than half of their total income from Social Security—and about half of those people relied on the program almost exclusively (Figure 2-5). Unmarried women are the most reliant on Social Security, with three in four of these beneficiaries drawing at least half their income from Social Security. About one in three older unmarried women on Social Security have no other source of income. Today, more older beneficiaries rely on Social Security as their sole source of income than was the case in the 1970s.

### The Next 25 Years

The prognosis is mixed for upcoming generations of retirees. Future workers are projected to enjoy earnings that grow somewhat more than the cost of living. Because Social Security benefits for new retirees are indexed to earnings growth, future retirement benefits will reflect these real earnings gains.

At the same time, legislation enacted in 1983 called for gradually raising the age at which full retirement benefits would be paid from age 65

**Figure 2-5.** *Role of Social Security in Total Income, 1976 and 2002  
Married Couples and Unmarried Beneficiaries Age 65 and Older*

Year	Percent for whom Social Security is:		
	50 percent or more of total income	90 percent or more of total income	100 percent of income <sup>a</sup>
	<b>Total Married Couples and Unmarried Beneficiaries</b>		
2002	66	34	22
1976	66	28	16
	<b>Married Couples</b>		
2002	54	21	12
1976	56	18	8
	<b>Unmarried Men</b>		
2002	65	35	25
1976	70	28	21
	<b>Unmarried Women</b>		
2002	77	44	29
1976	74	36	21

a The earlier data are for 1978, the earliest year available.

**Sources:** U.S. Social Security Administration, Forthcoming. *Income of the Population 55 or Older, 2002*; U.S. Social Security Administration, 1979. *Income of the Population 55 or Older, 1976*

to 67. These changes are phasing in over the next two decades.<sup>1</sup> While early benefits will still be payable at age 62, recipients face a larger reduction for early retirement. When the full benefit age reaches 67, benefits claimed at age 62 will be reduced by 30 percent and benefits claimed at age 65 will be reduced by 13.3 percent. Benefits for future age-65 retirees will replace a smaller portion of their past earnings than has been the case for retirees in the past.

This change is illustrated in Figure 2-6. A medium earner who retired at age 65 in 2004 saw a monthly benefit of \$1,184, which replaces about 42 percent of his or her prior earnings. By 2030, a similar medium earner who retired at 65 (when the full benefit age is 67) would reap a benefit that replaced just 36 percent of his or her prior earnings. Because of real earnings growth, the dollar benefit would be higher, about \$1,385 in 2004 dollars. One who worked longer and delayed claiming benefits until 67 in 2030 would have a higher dollar benefit of nearly \$1,600 and a replacement rate similar to that of an age-65 retiree today, about 41 percent of prior earnings.

Other changes also will modulate future Social Security benefits. First, rising premiums for Part B of Medicare, which are deducted from most retirees' Social Security checks, will take a bigger bite because those premiums are projected to rise faster than benefits. Second, because the income threshold for taxing Social Security benefits is not indexed to rise as income rises, more

future beneficiaries will have part of their Social Security benefits subject to federal income taxes. Using projections of the Social Security and Medicare Trustees, Figure 2-7 illustrates how these developments together with the increase in the full benefit age will affect the level at which benefits replace earnings for a medium earner retiring at age 65. By 2030, benefits after Medicare premiums and new income taxes would represent about 30 percent of prior earnings, compared with about 39 percent today.

Social Security faces a long-run imbalance between revenue coming in and payments going out. This imbalance could be remedied by lowering benefits, which would further reduce the replacement rate (i.e. the ratio of benefits to former earnings), raising revenues, or a combination of both. At this point, the Social Security system is on track to produce benefits that are higher in real terms, but that replace a smaller share of workers' prior earnings, than has been the case for retirees today or at any time during the past three decades.

## Tax Favored Retirement Savings

Tax incentives are the federal government's principal policy tool for encouraging both workers and employers to set aside funds for retirement. Contributions to pension plans are a tax-deductible business expense for employers; employees, for their part, do not have to pay

**Figure 2-6.** Social Security Benefit and Replacement Rate, 2004 and 2030  
Scaled Medium Earner at Age 65 and at Normal Retirement Age

Year Attains Age 65	Retire at Age 65		Retire at Normal Retirement Age		
	Monthly Benefit*	Replacement rate (percent)	Normal Retirement Age	Monthly Benefit*	Replacement rate (percent)
2004	\$1,184	41.9	65:4	\$1,209	42.5
2030	\$1,385	36.3	67	\$1,599	41.1

\*Constant 2004 dollars

Source: Board of Trustees, 2004. *Annual Report of the Board of Trustees*

**Figure 2-7.** *Social Security Net Replacement Rate, 2003 and 2030  
Medium Earner Age 65*

Year and Reason for Change	Replacement Rate (benefit as a percent of prior earnings)
Age 65 retiree in 2000	41.2
Net, after deducting Medicare Part B premium	38.7
Age 65 retiree in 2030:	
After raising normal retirement age	36.5
Net, after deducting Medicare Part B premium	33.2
Net, after new personal income tax	30.5
Percentage change in net replacement rate	(-21)

**Source:** Munnell, 2003. "The Declining Role of Social Security"

taxes on pension accruals until they actually receive pension income. These policies are expensive: lost federal income tax revenue associated with pension and 401(k) plans are estimated to reach \$123 billion in fiscal year 2004. Incentives for retirement savings are one of the most significant losses in tax revenue for the federal government, rivaling tax expenditures for health care insurance and home ownership (U.S. Office of Management and Budget, 2004).<sup>2</sup>

Yet, tax breaks for retirement savings are not significant for large segments of the population, and most of these tax benefits accrue to high-income tax filers.<sup>3</sup> Only about half of the working population is covered by a retirement plan at any given time. College-educated, higher-income workers are more likely to have an employer-sponsored retirement plan than those with less education and lower earnings. As nearly all pension plans tie contributions (and benefits) to earnings level, lower-wage workers who do have a pension participate on a smaller scale than their higher earning counterparts.

### Pension Coverage Is Stable; The Form is Changing

Rates of pension coverage have changed little since the mid-1970s, at just under half of private-sector employees and a little over half of all workers (Munnell et al., 2003; Copeland, 2001). The kind of pensions that Americans hold, however, has undergone a major transformation.

Defined-benefit plans were the most common type in the 1970s and 1980s; today, defined-contribution plans dominate.

This shift has implications for the payout rules for new individual account proposals. In a defined-benefit plan, participants are promised a specified benefit level at retirement. Defined benefits have historically been paid as monthly amounts and last for the life of the retiree—and usually for the life of a widowed spouse. In recent years, however, defined-benefit plans have been adopting lump-sum cash out features for workers who leave their jobs before retirement.

The defined-benefit amount is usually calculated based on the worker's length of service and covered wages. For example, a plan might pay 1.5 percent of the employee's final salary for each year of participation in the plan, giving an employee who retired after 20 years a pension equal to 30 percent of his or her final pay. The employer is responsible for ensuring that its contributions into the plan, plus investment earnings, will suffice to pay promised benefits. Participation in a defined-benefit pension is usually automatic and does not depend on employees' out-of-pocket contributions. Employees have few (if any) choices to make before retirement.

With defined-contribution plans, however, retirement benefits vary with annual contributions

made to each participant's account, plus investment returns. In most cases, employees can decide each year whether and how much they will contribute. Many defined-contribution plans give employees primary responsibility for choosing how their accounts will be invested. Employees generally bear the risk that these pensions may fall short of producing an adequate supplement to Social Security and any other retirement income. Defined-contribution plans sometimes offer payments as monthly incomes (annuities); more commonly, they pay lump sums when employees leave the plan. Workers who take lump sums before retirement can roll over the funds into another tax-deferred retirement plan to avoid paying taxes on the money until retirement. Spousal rights are more limited in individual retirement accounts than in defined-benefit plans (see Chapter Six).

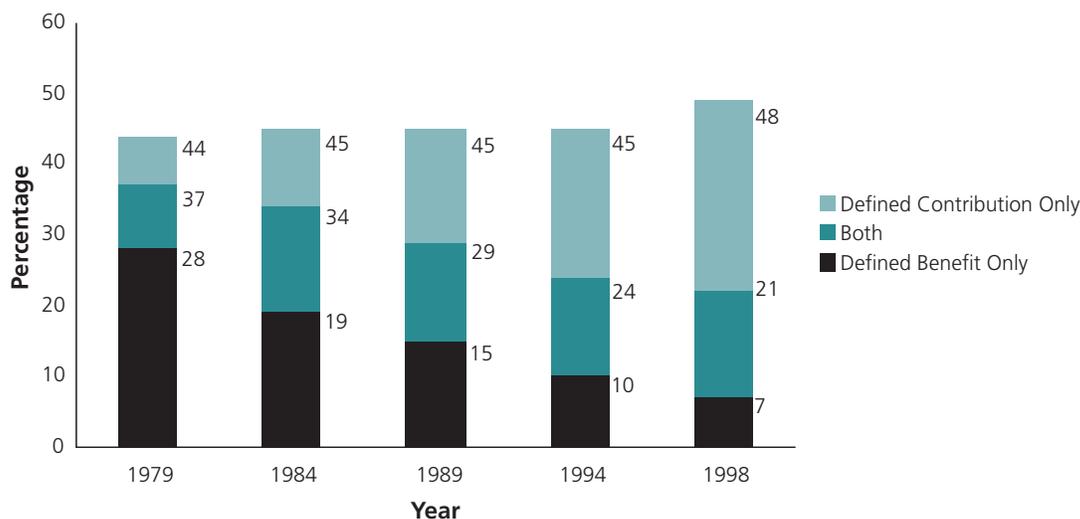
The most popular type of defined-contribution plan today is a 401(k) plan. This plan gives employees the opportunity to contribute part of their salary to the plan on a tax-deferred basis. Employers often match the contributions their employees make to the plan, up to a set percent. Participation in a 401(k) plan usually requires a

conscious decision by the worker to enroll and make contributions, although automatic enrollment is becoming more widespread. Lump sums are the typical form of payout. Workers usually have a role in determining investment choices.

These 401(k) plans have both advantages and disadvantages relative to traditional defined-benefit pension plans. They shift more of the responsibility and financial market risk to workers. But, 401(k)s give workers more choice in how their portfolio is allocated and more ways to access funds; plus, 401(k) balances are fully portable between jobs.

Between 1979 and 1998, the percentage of private sector workers participating in defined-benefit plans fell from 37 to 21 percent, whereas workers with only a defined-contribution plan grew from 7 percent to 27 percent (Figure 2-8). Providing workers with a supplemental defined-contribution plan (usually a 401(k) plan in addition to a defined-benefit plan) also became more common: the share of private sector employees with this option grew from 9 percent to 15 percent.

**Figure 2-8.** Pension Coverage Trends, 1979-1998  
Private Wage and Salary Workers



Source: U.S. Department of Labor, Pension and Welfare Benefits Administration, 2001-2002. *Abstract of 1998 Form 5550 Annual Reports*

## Occupation and Pension Coverage

A gap in pension coverage between white-collar and blue-collar workers grows with this trend toward defined-contribution plans. While 65 percent of white collar, professional, and technical employees participate in some sort of retirement plan, only 39 percent of blue collar and service employees do. In past decades, defined-benefit plans were associated with large, unionized companies where blue-collar jobs predominate – such as in automobile manufacturing, steel production and mining industries. U.S. employment in these sectors is a declining share of the workforce. Blue-collar jobs today infrequently offer pension plan coverage and white-collar workers are more likely than blue-collar workers to have defined-benefit pensions. About 26 percent of white-collar workers participate in traditional defined-benefit plans, compared with 17 percent of blue-collar workers.

Figure 2-9 shows that both white-collar and blue-collar workers are now more likely to have defined-contribution pension plans than traditional defined-benefit plans. Indeed, while nearly half (48 percent) of private employees had some type of retirement plan in 2000, fewer than one

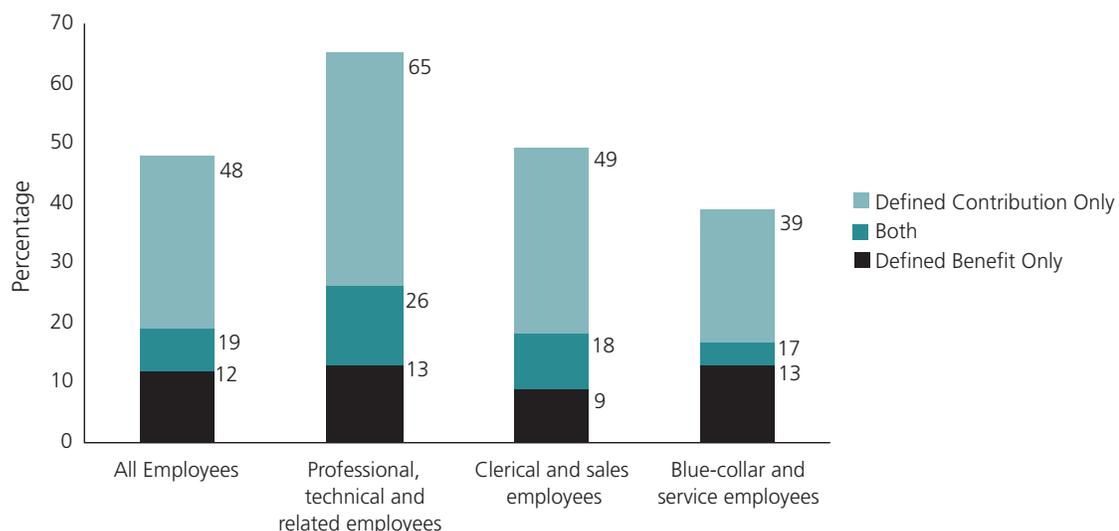
in five (19 percent) participated in a traditional defined-benefit pension plan.

## Tax-Favored Retirement Savings Accounts

Today, about half of American families have some sort of tax-favored retirement savings plan or account other than a defined-benefit pension plan (Figure 2-10). These plans include 401(k)s, other defined-contribution plans sponsored by their employers, and individual retirement accounts (IRAs). Ownership of IRAs increased during the 1990s, as job-switching workers opened these retirement savings accounts to rollover 401(k)s and other pension funds. Between 1992 and 2001, families with an IRA increased from one in four to nearly one in three (Copeland, 2003a).

Figure 2-10 divides American families into five income groups to illustrate the relationship between income and the median value of tax-favored retirement savings. The median value amounted to less than one year's income for those families, at all income levels, with savings. The median balance was about \$29,000 in 2001. Families in the lowest two-fifths of the

**Figure 2-9.** Pension Coverage by Occupation, 2000  
Private Employees



**Source:** U.S. Department of Labor, Bureau of Labor Statistics (BLS), 2003. *National Compensation Survey: Employee Benefits in Private Industry in the United States, 2000*

income distribution were much less likely to have such savings, and their balances were smaller. Indeed, the median value of retirement savings in these two income brackets was zero, because most of these households did not have a tax-favored retirement account. Among households in the middle quintile, by contrast, about half (53 percent) had savings with a median value of \$13,500. But when households without accounts are included, the median value falls to \$800.

Age differences also matter. Younger workers have more of their working lives ahead of them and can be expected to save additional funds before retirement, while older families have most of their retirement savings years behind them. Although younger families are about as likely as older ones to have retirement savings, the median value of the accounts rises with age. About 6 in 10 families headed by someone aged 55-64 owned tax-favored retirement accounts; the median value of those accounts was \$55,000 (Figure 2-11). By contrast, median account values totaled only \$28,000 for families aged 35-44.

Gaps among racial groups exist as well. African American and Hispanic American families are less likely than white families to have some type of tax-favored, retirement savings and their accounts tend to be smaller. The median account

value in 2001 was \$8,800 for the 39 percent of African American families that held accounts, and \$8,700 among the 31 percent of Hispanic families holding accounts. By contrast, 57 percent of white families had tax-favored retirement savings, with a median value of \$35,000.

While about half (52 percent) of all American families have some form of individual retirement savings, others have defined-benefit pension rights from their current or former employment. Taking all these resources together, 59 percent of families have either defined-benefit pensions or some type of retirement savings, or both, for at least one member of the family.

### Implications for the Design of Individual Account Payouts

Workers today have more responsibility for contributing to and managing their accounts, preserving funds until retirement, and deciding how and when to convert their accounts into retirement income. The shift from defined-benefit pensions to defined-contribution plans has made employees more responsible for generating their own retirement income. This shift has implications for the design of payout rules for individual accounts. Workers' experience with defined-contribution plans, such as 401(k) plans, may shape their expectations about any new savings program. Yet, the replacement of pensions that

**Figure 2-10.** *Ownership of Tax-Favored Retirement Accounts by Family Income, 2001*

Accounts include 401(k) plans, other defined-contribution plans, IRAs and Keogh plans

Income Group	Number of families (millions)	Median income	Percent owning accounts	Median account value in 2001 dollars		Percent of total account assets
				All families	Account holders	
Total	106.5	\$39,900	52	\$600	\$29,000	100
Lowest Fifth	21.3	\$10,300	13	\$0	\$4,500	1
Second fifth	21.3	\$24,400	33	\$0	\$8,000	4
Middle fifth	21.3	\$39,900	53	\$800	\$13,500	9
Next to highest fifth	21.3	\$64,800	74	\$16,000	\$31,000	19
Next to highest tenth	10.6	\$98,700	85	\$36,000	\$52,000	17
Top ten percent	10.7	\$169,600	88	\$102,000	\$130,000	50

Source: Orszag, 2003. Tabulations using the 2001 Survey of Consumer Finances

**Figure 2-11. Ownership of Tax-Favored Retirement Accounts, by Age, Race and Ethnicity, 2001**

Accounts include 401(k) plans, other defined-contribution plans, IRAs, Keogh plans

Family Characteristics	Number of families (in millions)	Percent owning accounts	Median account value (for owners) 2001 dollars
<b>All families</b>	<b>106.5</b>	<b>52</b>	<b>\$29,000</b>
<b>Age of Family Head</b>			
Less than 35	24.2	45	9,300
35-44	23.8	61	28,200
45-54	22.0	64	48,000
55-64	14.1	59	55,000
65-74	11.4	44	60,000
75 and older	11.0	26	46,000
<b>Race and Ethnicity</b>			
White, non-Hispanic	81.2	57	35,000
Black	13.9	39	8,800
Hispanic	8.5	31	8,700
Other	3.0	48	27,000

Source: Copeland, 2003b. Tabulations using the 2001 Survey of Consumer Finances

**Figure 2-12. Asset Ownership by Age, Race and Ethnicity, 2001**

Family Characteristics	Automobile	Health Insurance	Life Insurance <sup>a</sup>	Personal Retirement Accounts <sup>b</sup>	Mutual Funds, Stocks, Bonds	Businesses
<b>All Families</b>	84	77	69	52	41	12
<b>White Non-Hispanic Families</b>						
All ages	89	81	73	57	47	14
Under 35	85	81	64	52	40	9
35-64	93	85	77	52	51	18
65 or older	81	73	69	66	43	8
<b>Non-White and Hispanic Families<sup>c</sup></b>						
All ages	71	64	58	37	21	5
Under 35	64	58	46	31	17	2
35-64	78	70	62	47	24	7
65 and older	52	47	70	10	15	4

a Life insurance includes both whole life and term life insurance.

b Personal retirement accounts include 401(k) plans and other employment-based defined-contribution plans, IRAs and Keogh plans. Defined-benefit pension plans are not included.

c Non-white and Hispanic families are combined because the survey does not provide statistically reliable estimates for each group separately by age.

Source: Copeland, 2003b. Tabulations using the 2001 Survey of Consumer Finances

offer defined benefits for the life of a retired worker with plans that shift more responsibility and risk to workers may increase the importance of providing financial-risk protection in any new savings program (see Chapter Three).

## *Other Measures of Financial Security and Stress*

While the focus of this report is federal retirement policy, economic security in old age reflects financial circumstances and choices made throughout the working years. This section briefly reviews elements of financial well being, including homeownership and financial assets, and indicators of financial stress such as poverty, personal debt, and bankruptcy filings.

### *Assets of a Typical American*

A typical American family owns a car, their home, health and life insurance, and some kind of retirement savings account (Figure 2-12). About 84 percent of families own a car, and 68 percent own, or are buying, their homes. Health and life insurance are widespread, although by no means universal; about 77 percent of families have some type of health insurance and 69 percent have some kind of life insurance. Cash value life insurance policies are also used as savings vehicles. About half of all families have some kind of personal retirement account and about 41 percent own mutual funds, stocks, or bonds outside of a retirement account.

Significant differences in asset ownership among races and ethnicities exist today. Families where the head of the household described him or herself as Hispanic, African American, or a member of another minority racial group, are much less likely to have health insurance or life insurance other than Social Security, or to own other key assets. In fact, more than one-third of minority families are without any kind of health insurance, and three in ten such families do not own a car. While Hispanic and African American families tend to be somewhat younger than other families, and their relative youth may

account for smaller asset accumulations, racial and ethnic disparities persist within age groups.

### *Homeownership*

A home is often the largest single asset American families own. Individuals who approach retirement in homes they own, with mortgages nearly paid off, have an important source of financial security that their counterparts in rental housing lack. About two in three families own, or are buying, their primary residence. But homeownership is less common among non-white families and younger families (Figure 2-13). Moreover, non-whites who do own homes typically have less equity in their properties, and their homes have a lower value. To illustrate, about 74 percent of non-Hispanic white families owned their homes in 2001; their median home equity was \$76,000. But only 42 percent of Hispanic and non-white families were homeowners in 2001; their median home equity was \$42,000.

Older families are more likely to own or be buying their homes and, because they have had more time to pay off mortgages, they have built up more home equity. Within each age group, minority families are less likely to own their homes and, when they do, they have less home equity.

### *Economic Insecurity*

Economic insecurity is a fact of life for many American households. The poverty line serves as the basic measure of economic hardship.<sup>4</sup> By this measure, nearly one in five African Americans and Hispanic American families are poor (19 percent), compared with about 7 percent of white families in 2000 (U.S. Census Bureau, 2002).

Debt is another indicator of financial insecurity, and Americans owe more today, relative to their incomes, than at any time since World War II (Mishel et al., 2003). Between 1979 and 2001, aggregate household debt, as a percentage of disposable income, grew from 73 percent to 109 percent. Mortgage debt accounted for much of

**Figure 2-13.** Homeownership, Market Value and Home Equity by Age, Race and Ethnicity, 2001

Family attributes	Percent Owning or Buying Home	Median Amount	
		Market Value	Home Equity
<b>All Families</b>	68	\$121,000	\$70,000
<b>White Non-Hispanic</b>			
All white non-Hispanic	74	\$129,000	\$76,000
Under 35	45	\$95,000	\$26,000
35-64	81	\$135,000	\$75,000
65 or older	83	\$125,000	\$113,000
<b>Non-white and Hispanic<sup>a</sup></b>			
All non-white and Hispanic	47	\$90,000	\$42,000
Under 35	29	\$87,000	\$22,000
35-64	54	\$93,000	\$44,000
65 and older	59	\$92,000	\$59,000

a Non-white and Hispanic families are placed in a single category because the survey does not permit statistically reliable information for the groups separately by age.

Source: Copeland, 2003b. Tabulations using the 2001 Survey of Consumer Finances

this increase, growing from 46 percent to 62 percent of income over the period. The introduction of home equity loans in the late 1980s also contributed; these loans rose to 10 percent of disposable income by 2001. Consumer credit, as a share of disposable income, rose from 20 percent to 23 percent of income between 1979 and 2001. Debt as a share of assets grew more slowly over this period, from 14 percent in 1979 to 17 percent in 2001. Mortgages as a share of real estate assets were fairly stable during the 1980s but, between 1989 and 2001, the ratio of mort-

gages to real estate assets rose from 31 percent to 41 percent.

Not all debt is created equal. Credit card debt can be particularly problematic because it typically costs more than other kinds of loans. Three-quarters (76 percent) of American families have a credit card (Figure 2-14). Despite high interest rates and large penalty fees for late payments, just over four in ten families carry a credit card debt balance from month to month. Of families with incomes between \$10,000 and

**Figure 2-14.** Credit Card Debt by Family Income, 2001

Family income	Percent of all families with at least one credit card	Percent of card holders carrying a balance	Percent of all families carrying a balance	Average credit card debt
All families	76	55	42	\$4,126
under \$10,000	35	67	23	1,837
\$10,000-24,999	59	59	35	2,245
\$25,000-\$49,999	80	62	50	3,565
\$50,000-\$99,999	90	56	50	5,031
\$100,000 or more	98	37	36	7,136

Source: Draut and Silva, 2003. Calculations based on the 2001 Survey of Consumer Finances.

\$25,000, about one in three carries credit card debt from month to month, as do about half of families with incomes between \$25,000 and \$100,000. The average credit card debt was just over \$4,100 in 2001, according to tabulations of the Survey of Consumer Finances. These survey data may reflect considerable under-reporting. Economists at the Federal Reserve estimate the average credit card debt per household at about \$12,000 in 2001 (Draut and Silva, 2003).

An individual's level of indebtedness may well affect his or her willingness to participate in a federal savings program. For example, if an individual account program were voluntary, workers with high mortgage payments, credit card debt, or home equity loans might choose not to participate. Indeed, paying off high-interest debt rather than saving for retirement may be the right choice. Debtors may also want to gain access to account balances before retirement, particularly if the accounts offer 401(k)-type savings, against which account holders can take out personal loans. About a fifth of 401(k) holders have taken out loans against their savings. Indebtedness is a central factor in the financial demographics of Americans.

### Asset Poverty

Another measure of economic vulnerability is the capacity of families to withstand setbacks such as joblessness or prolonged illness. Haveman and Wolff (2001) define households as being *asset poor* if their access to wealth-type resources is insufficient to meet their basic needs for some limited period of time. They use a measure of poverty to define basic needs<sup>5</sup> and consider the amount of assets that would be needed to meet those basic needs if they had no income for three months. If total net worth is considered available to meet basic needs (including home equity and the value of fungible retirement assets as well as liquid financial assets), then about one in four families is asset poor. If only liquid assets are considered (not counting home equity and retirement assets), then four in ten families is asset poor (Haveman and Wolff, 2001).

### Personal Bankruptcies

Personal bankruptcies increased substantially in the 1990s. In 2001, 7 out of every 1,000 adults declared personal bankruptcy—three times the rate in 1980. If such a high rate were sustained for seven years, about 5 percent of the adult population would have declared bankruptcy during that period.<sup>6</sup> Changes in bankruptcy law, access to credit, and economic behavior over time mean that it is not possible to accurately estimate the proportion of the population who have ever filed for bankruptcy. It is also important to note that many individuals do not pay debts without formally declaring bankruptcy. One study based on data from a large credit card issuer reported that over 60 percent of its bad debt was “charged off” for reasons other than bankruptcy (Dawsey and Ausubel, 2002). In other words, more people simply didn't pay their credit card bill than filed for formal bankruptcy.

Illness, divorce, and job loss are common reasons for bankruptcy. One study found that nearly half of the one million Americans who filed for bankruptcy protection in 1999 did so, at least in part, because they could not cope with medical bills or the income loss associated with an illness or injury. The fact that nearly one in four American families in 2001 did not have health insurance (Figure 2-12) suggests that many families continue to be at risk of financial distress if serious illness strikes. Lack of medical insurance was a key factor in only a minority of bankruptcy filings. More typically, the problem was due to “underinsurance” (i.e., insurance that does not cover a significant amount of health care costs), lack of income to replace lost wages, or both (Jocoby et al., 2000). About three in ten private-sector workers lack any type of paid sick leave or short-term disability benefits that would continue their income during temporary periods of illness or recuperation of injuries (Williams et al., 2003).

Generally, creditors do not have access to a debtor's retirement savings. To the extent that the demarcation between retirement savings and

other forms of savings blurs, however, the argument for creditors' rights to accounts becomes more credible.

## How Big Might Individual Accounts Be?

If contributions to individual accounts are pegged to Social Security taxable earnings, then many accounts would be small. The data included in Figure 2-15 cover all wage and salary workers, including those who work part time or only part of the year (excluding self-employed workers). Workers' median earnings – where half of the workers earn more and half earn less – are \$21,600. Average earnings are considerably higher, at just under \$32,000. The average is higher than the median because the relatively small group of top earners brings up the average. In 2001, 55 percent of men and 73 percent of women earned less than \$30,000. At the high end, about 11 percent of workers earned \$60,000 or more, including 6 percent who earned the maximum amount that was taxed and counted toward Social Security benefits (\$80,400) in 2001.

**Figure 2-15.** Annual Earnings in Social Security Covered Employment, 2001: Wage and Salary Workers

Total number of workers (thousands)	144,803
Total percent	100
Less than \$5,000	18
\$5,000 - \$9,999	11
\$10,000 - \$19,999 (\$14,800 = "low")	19
\$20,000 - \$29,999	16
\$30,000 - \$39,999 (\$32,900 = "medium")	12
\$40,000 - \$59,999 (\$52,700 = "high")	13
\$60,000 - \$80,399 (maximum taxable)	5
\$80,400 or more	6
Median	\$21,516
Average	\$32,062
Percent earning less than the average	68

Source: U.S. Social Security Administration, 2004a. *Annual Statistical Supplement to the Social Security Bulletin, 2003*

To illustrate the potential size of individual accounts, the Office of the Chief Actuary of the Social Security Administration depicts earnings patterns for workers at four different lifetime earnings levels: a "scaled medium-earner" making a career-average wage of about \$34,700 (in 2003 dollars); a "scaled low-earner" making a career-average of about \$15,600; a "scaled high-earner" making a career-average of about \$55,500; and a "steady maximum-earner" who, each year, makes at least the maximum amount that is taxed and counted for Social Security benefits, or \$87,000 in 2003. The illustrative workers are shown in Figure 2-16, along with how much of their average career earnings would be replaced by current law Social Security retirement benefits.

Balances expected to accumulate in these illustrative workers' individual accounts are estimated by taking into account various assumptions about: (a) the portion of wages put into the accounts each year; (b) the number of years the worker contributes before reaching age 65; and (c) the investment returns on the account funds. Figure 2-17 shows results for new individual account systems with contributions of 2 percent, 4 percent, or 6 percent of earnings for a person reaching age 65 after 10, 20, 30, or 40 years of contributing to the new individual account system. The figure also shows the annuity income the account would produce if the 65-year-old bought a single-life annuity indexed for inflation. Investment returns on the accounts are assumed to be 4.7 percent.<sup>7</sup>

As would be the case with any new savings program based on career earnings, younger workers would have more working years to contribute to the program and be better able to take advantage of higher compounding over their careers than older workers. The years of contributions in Figure 2-17 are not intended to represent workers with only 10 or 20 years of work in their entire careers, but rather to represent possible account accumulations and potential annuities during the phase-in of an individual account plan.

**Figure 2-16.** *Wage Levels and Age-65 Replacement Rates, 2003 and 2030*  
*Scaled Illustrative Earners*

Illustrative earner	Career-Average Earnings, 2003	Social Security benefit at age 65 as a percent of career-average earnings	
		2003	2030
" Low"	\$15,600	55.6	48.9
" Medium"	\$34,700	41.3	36.2
" High"	\$55,500	34.8	30.0
" Maximum"	\$87,000	29.6	24.0

Career-average medium earnings are equal to the average wage of covered workers; low earnings are 45 percent of that amount, while higher earnings are 160 percent of the average wage. For scaled illustrative earners, wages vary by age to resemble typical lifetime wage patterns.

**Source:** Board of Trustees, 2003. *Annual Report of the Board of Trustees*

In a system where workers shifted 2 percent of their earnings into individual accounts, a scaled medium-earner who contributed to his or her individual account for 20 years would have an account balance equal to about 60 percent of his or her career-average annual earnings, assuming the investment returns and administrative cost indicated in Figure 2-17. If the worker contributed to an individual account for 40 years, the account balance would equal about 171 percent of career-average earnings. The younger worker's account balance would benefit from more years of contributions plus more years of compounded investment earnings. As the percent of Social Security taxable earnings contributed to individual accounts increases, the balance in the accounts and the replacement rates of the resultant annuities increase as well.

The worker who contributed 2 percent to an individual account for 20 years would realize a single-life annuity that would replace about 4.2 percent of his or her annual average earnings level, each year, assuming the investment return, administrative costs, and inflation rates assumed in Figure 2-17. The worker's individual account based on 40 years of contributions would produce a single-life annuity that would replace about 11.6 percent of his or her annual average earnings. These relationships can illustrate the potential size of accounts for scaled workers at

different earnings levels.<sup>8</sup> Expressed in terms of 2003 wage levels:

A scaled medium-earner, averaging about \$34,700 over his or her lifetime and retiring at 65 after 20 years in the 2 percent account system, would have a balance of about \$21,000 and single-life annuity income at age 65 of about \$1,500 a year, or about \$125 a month. A scaled medium-earner who participated in the account system for 40 years would accumulate approximately \$59,300, yielding a single-life annuity of about \$4,000 a year, or \$333 a month.

A scaled low-earner, making about \$15,600 per year, would have a balance of about \$9,400 at age 65 after 20 years. At age 65, the account would produce a single-life annuity of about \$660 a year, or \$55 a month. A scaled low-earner who contributed to the account program for 40 years would accumulate approximately \$26,700, yielding a single-life annuity of about \$1,800 per year, or \$150 per month.

A scaled high-earner, making about \$55,500 per year (career average), would have a balance of about \$33,300 after 20 years. His or her individual account would produce a single-life annuity at age 65 of about \$2,330

**Figure 2-17.** *Size of Account Balance and of Life Annuity at Age 65 as a Percent of Annual Earnings by Contribution Rate and Duration of Contributions: Scaled Medium Earner*

Year age 65 (duration of contributions)	Total account balance as a percent of career-average annual earnings by contribution rate			Single-life annuity as a percent of career-average annual earnings by contribution rate		
	2%	4%	6%	2%	4%	6%
2044 (40)	171	342	513	11.6	23.2	34.8
2034 (30)	119	224	336	7.8	15.6	23.4
2024 (20)	60	117	176	4.2	8.4	12.6
2014 (10)	22	44	65	1.6	3.2	4.8

Assumptions: Illustrative workers with investment returns during accumulation of 4.7 percent in excess of inflation. Inflation is assumed to be 3 percent per year. Single life annuity is indexed for inflation and based on investment return of 3 percent in excess of inflation.

Source: U.S. Social Security Administration, 2003a. Unpublished calculations from the Office of the Chief Actuary

a year, or \$195 a month. A scaled high-earner who contributed to the account program for 40 years would have an individual account worth approximately \$94,900, producing a single-life annuity worth \$6,440 per year, or \$536 per month.

Balances and accounts would grow larger the longer that workers were covered and contributing into the system. After 30 years of participation in a 2 percent account, workers are estimated to have a balance that is larger than their career-average annual earnings. When annuitized over their remaining lives after age 65, the payments would be between 7 percent and 8 percent of their annual earnings. Accounts would grow even more after 40 years of participation, and the life annuities would be commensurately higher.

### **Are Americans Linked to Potential Administrators of Accounts?**

Entities that might administer individual accounts or facilitate the exchange of information between account holders and account administrators include banks or other financial institutions, the Internal Revenue Service, the

Social Security Administration, and employers who have experience administering retirement savings plans for their employees and who report workers' wages to the Social Security Administration. This section considers the extent to which American adults do or do not have a connection with these institutions. How many Americans do not have a relationship with a financial institution or with the Internal Revenue Service? How many Americans are self-employed and could face new administrative burdens?

#### **“Unbanked” Americans**

The number of people who do not have a checking or savings account with a bank or credit union is an important indicator of the population's financial literacy. Individuals who do not have accounts will be less familiar with procedures for transactions and they will be more difficult to reach if banks are used as intermediaries.

Studies based on the Survey of Consumer Finance find that between 9 percent and 10 percent of Americans families do not have a bank account of any kind (Barr, 2004; Stegman, 2003). Studies based on data from the Survey of Income and Program Participation find that

about one-fifth of all households do not have a bank account (U.S. GAO, 2002; Carney and Gale, 1999). Further research is needed to determine why these data sets yield such different estimates. For the purposes of this report, it suffices to say that at least 9-10 percent of families do not have bank account of any kind. Groups most likely to have neither a checking or savings account with a bank or credit union are Hispanic Americans and African Americans, those under age 35 or over age 65, and families with incomes below \$20,000 (Figure 2-18).

There are many reasons why individuals do not have bank accounts. Many people cannot or do not want to pay the cost of owning an account. In addition to monthly fees for accounts with small balances, overdraft fees for bounced checks are often cited as a reason to avoid banks (Dunham and Bates, 2003; Caskey, 2001). It is also possible that banks do not advertise low cost accounts aggressively because they believe that other accounts are more profitable (U.S. GAO, 2002). Finally, individuals without bank accounts may simply find check-cashing outlets more convenient.

Unbanked families could be difficult to accommodate in the design of individual retirement savings accounts. A recent government effort to reach out to this population tells a cautionary tale. In 1996, Congress passed legislation requiring that all federal payments (other than tax refunds) would be paid electronically. The law also required that individuals receiving federal payments have access to a financial institution account “at a reasonable cost.” The Treasury Department created the federal alternative account program—Electronic Transfer Accounts—to fulfill this mandate. The program has had only modest success. Since 1999, 36,000 Electronic Transfer Accounts have been opened, representing less than 1 percent of “unbanked” beneficiaries (U.S. GAO, 2002). This experience illustrates the challenge of using the existing financial infrastructure for managing and making distributions from private accounts. Yet, an individual account system

**Figure 2-18.** *Percent of Families without a Checking or Savings Account by Race and Ethnicity, Age, and Income, 2001*

Family Characteristics	Percent
All families	9
<b>Race and Ethnicity</b>	
White, non-Hispanic	5
Black	19
Hispanic	30
<b>Age of Family Head</b>	
Under 25	22
25-34	12
35-44	9
45-54	8
55-64	7
65 and over	15
<b>Family Income</b>	
Less than \$10,000	40
\$10,000-\$19,999	29
\$20,000-\$29,999	10
\$30,000-4,999	5
\$50,000 or more	1

**Source:** Copeland, 2003b. Tabulations using the 2001 Survey of Consumer Finances; analysis of data by Leslie Parrish, New America Foundation

might encourage low-wage workers to open bank accounts, if that is one of the goals of the policymakers.

### Participation in the Income Tax System

The administration of an individual account system would need some way to receive information about workers, their contributions, and investment choices, and perhaps their marital and family status. Policymakers might seek to build on the wage-reporting system sent to the Social Security Administration. Alternatively, or in addition, policymakers might want to rely on reports directly from households to the Internal Revenue Service for tax-filing purposes.

Using regular filings with the IRS as a means of collecting and updating account-holder informa-

tion has some limitations. First, not everyone regularly files tax returns. Indeed, an estimated 18 million households (tax units), or about 12 percent of all American tax units, do not file an annual tax return (Figure 2-19). Most of these individuals are not evading the tax collector; rather, they do not owe taxes and they may not be eligible for any tax credits. For example, 97 percent of non-filers have incomes below \$10,000 a year, and the remaining 3 percent of non-filers have incomes below \$20,000 a year. Fully 90 percent have no dependent children, so they would not be eligible for the earned income tax credit available to low-income working families with children. Most are single and about half are age 65 and older.

If the IRS tax filing system is used to convey account holder information to the administrator of an individual account system, how can communication occur between account administrators and households that do not file taxes? This question might arise if account holders need to change ownership of an account, for example, following a marriage or divorce. Elderly or disabled individuals who may be withdrawing money from their accounts would also need a means of correspondence.

Another issue with the use of the IRS as a way to communicate with account holders is the negative perception that many people have of tax collectors. Encouraging voluntary participation

**Figure 2-19.** *All Tax Units and Non-Filers of Personal Income Tax, by Income, Family Status, and Age, 2002*

Income, family status and age	Percent distribution		Non-filers as percent of all
	All tax units	Non-filers	
Total number (in thousands)	151,256	18,131	12
Total percent	100	100	12
<b>Adjusted Gross Income (2002 dollars)</b>			
Negative	1	0	0
\$0 - \$9,999	29	97	40
\$10,000 - \$19,999	16	3	2
\$20,000 or more	54	0	0
<b>Number of Dependent Children</b>			
None	69	90	16
One	14	5	4
Two	12	4	4
Three or more	5	1	3
<b>Family Status</b>			
Single filers			
With dependents	14	9	7
No dependents	47	63	16
Married filers			
With dependents	18	3	2
No dependents	21	26	15
<b>Elderly Status</b>			
Non-elderly	92	49	7
Age 65 and older	8	51	36

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1)

in a savings program administered by the IRS could be challenging.

### Employers as Intermediaries

Employers play a central role in administering Social Security and pensions. In 1999, 14.6 million Americans, comprising between 9 percent and 10 percent of all earners covered by Social Security, were self-employed and responsible for administering their own tax payments (U.S. SSA, 2002a; Table 4.B3). Any administrative tasks delegated to employers should take into account the large number of individuals who are their own employers. In 2001, over 6 million small businesses employed 20 or fewer employees (U.S. Census Bureau, 2003; Table 744); these small employers may object to any additional administrative burden.

### Individual Development Accounts

Recent scholarship and experimentation have begun to address how to increase financial access and savings by low-income persons. Experts acknowledge that the problem extends beyond simply individual behavior, preferences, and information gaps. Solutions would require new financial products and public policies that can change the mix of financial instruments and opportunities available to Americans (Dunham and Bates, 2003). In this vein, experiments such as Individual Development Account (IDA) programs, and linked Earned Income Tax Credit programs (which encourage people to open accounts to receive federal benefits), may provide useful models.

Recent experimental research on IDAs – which are matched savings accounts targeted to low-income workers and typically restricted to first-home purchase, small-business start-up, and post-secondary education and training – have shown that low-income and disadvantaged persons can save and build assets. Michael Sherraden and other researchers believe that we must also consider a novel “institutional” view of savings to fully explain savings patterns not just by the poor, but also by persons at all levels of income (Sherraden and Barr, 2004).

According to Sherraden, institutional determinants of savings include: (1) *access* (is a 401(k) or IDA program available?); (2) *information* (do employees or residents know about it?); (3) *incentives* (is there a meaningful tax deduction or matching deposit available to encourage saving?); (4) *facilitation* (is there an automatic payroll deduction to make saving easy?); plus other mechanisms that, when present in policy and program design, will foster savings.

This research and experience could inform efforts to expand individual savings accounts. That is, to help ensure maximum participation in and better utilization of individual accounts, policymakers should consider the role that institutional mechanisms play in determining who does and does not save.

Finally, designing retirement savings instruments for low- and moderate-income households is particularly difficult because many face financial hardships during their working lives, and do not currently participate in pension plans or own retirement savings accounts. These households’ financial vulnerability and lack of alternative sources of funds will likely lead them to seek greater pre-retirement access to individual account funds than would wealthier workers who now have pensions and/or retirement savings.

### Summary

Retirement income in the United States is often characterized as a “three-legged stool” made up of Social Security, employer-sponsored pensions, and individual savings. But many Americans do not have employer-sponsored pensions and many have saved very little for retirement. For this reason, Social Security has been the main source of income for older Americans for several decades. The next 25 years will see the Social Security benefits for 65-year-old retirees grow more slowly than wages, though still faster than inflation, meaning that Social Security will replace a smaller portion of their previous earnings. Because the system is not in long-range

balance, changes in benefits, revenues, or both are being contemplated. The future level of the defined-benefit part of Social Security will be an important consideration in the design of payout rules for individual accounts.

About half of private-sector workers are not covered by a pension plan at any given time. Increasingly, employers are changing defined-benefit pension plans to defined-contribution plans, where employees assume more risk and responsibility, and have more choices concerning their retirement savings.

About half of American families do not have retirement savings accounts such as 401(k)s or other defined-contribution pensions, individual retirement accounts (IRA), or Keogh plans. Many workers, including some from middle-income households, are not building up tax-favored savings to supplement Social Security in retirement.

Other assets and liabilities also affect retirement security. Home equity is the largest asset for most American families, yet more than half of black and Hispanic families (as well as one in four other families) lack this important resource. “Asset poverty” – that is, assets insufficient to sustain a family through three months without income – is a risk for many middle-income Americans.

About one in ten families does not have a bank account and a similar number do not file taxes with the IRS. Special considerations might be required to help these families both save and participate in the financial mainstream.

Between 9 and 10 percent of workers covered by Social Security are self-employed. Presumably, these individuals would be responsible for managing any administrative tasks delegated to employers in a new individual account system.

## Chapter Two Endnotes

- 1 The full benefit age will gradually rise from 65 to 66 for those born between 1938 and 1943 and will later rise from age 66 to 67 for those born between 1955 and 1960.
- 2 The size of tax expenditures associated with health care insurance, home ownership and retirement plans can be calculated differently depending on the definition of these categories. For example, there are separate estimates for the exclusion of employer contributions for medical insurance premiums and medical care, for self-employed medical insurance premiums, for medical savings accounts, for workers' compensation and other health related categories. Likewise, there are separate estimates of the tax loss associated with employer plans, 401(k) plans, individual retirement accounts, Keogh plans, and other retirement related deductions. It should be noted that tax expenditures do not necessarily equal the increase in federal revenue that would result from the repeal of provisions because tax expenditures are interactive and because economic behavior could change.
- 3 About 70 percent of tax benefits from new contributions to defined-contribution plans accrue to the highest income level (20 percent of tax filing units in 2004); almost 60 percent of IRA tax benefits accrue to the top 20 percent of households (Burman et al., 2004).
- 4 In 2003, the federal poverty line for an individual was \$8,980 for a year and for a family of four it was \$18,400 a year. The poverty line has been widely criticized for not ensuring even a minimum standard of living and for not including all income sources available to families. Nevertheless, it remains the common standard for measuring poverty and economic hardship.
- 5 The measure of basic needs is based on work by Citro and Michael (1995), which examined alternative measures of poverty for families with children. That threshold for a family of four (two adults and two children) in 1997 was just under \$16,000 a year.
- 6 Individuals who have declared bankruptcy may not file again for seven years.
- 7 It is assumed that the funds are invested half in stocks, with an average real return of 6.5 percent, and half in corporate bonds, with an average real return of 3.5 percent. The portfolio's average real return of 5.0 percent becomes 4.7 percent after deducting administrative costs of 0.3 percent.
- 8 The relationship of balances and annuities to wages will be similar across wage levels as long as wage patterns over the lifetime are the same across wage levels and assumptions about investment returns are the same. The assumptions are described in Figure 2-17.

# Chapter 3

## Payments at Retirement

Retirement creates a new set of financial risks for any individual. Policymakers designing an individual account system must decide how, and to what extent, to protect retirees against vulnerabilities. Some protections might require constraining individual choice through rules that limit or regulate a retiree's access to account funds. In this regard, when and how payments would be made to account holders during retirement are key policy questions in individual account design.

This chapter describes the financial risks that retirees face. In light of these risks, the chapter sets out a framework policymakers might use in analyzing individual account proposals. A short primer on annuities offers clarity to the many proposals that include some form of life annuity.

Four broad options are presented for retirement payouts. The first option provides for *Unconstrained Access*. It is based on privately managed individual retirement accounts (IRAs) and, to some extent, the federal employees' Thrift Savings Plan (TSP), which is often suggested as a precedent for individual accounts. The second option, *Compulsory Annuities with*

*Special Protections*, falls at the other end of the spectrum in terms of protection and individual choice. This option includes some of the protections currently provided by Social Security, and it gives retirees minimal discretion over access to their account funds. The third option, *Default Annuities with Special Protections*, transforms compulsory annuities into a default choice while offering several other options that retirees could take instead. The last option, *Compulsory Minimum Annuities*, calls for annuities similar to those in the second option, but requires them only up to a given level.

Many questions arise about the design and implementation of retirement payouts. This chapter examines how mandatory joint-and-survivor annuities affect couples under different circumstances, for instance one-earner couples compared to dual-earner couples, what happens when spouses are different ages or when only one spouse participates in an individual account plan, and how widowhood could affect the timing of an annuity purchase. Whether or not the interest of heirs should be considered when designing annuity rules is examined, as is how to provide individual account holders with accu-

rate and complete information concerning retirement payout choices.

## Financial Risks in Retirement

No matter how diligently an individual has saved and planned over the years, a new set of financial risks loom once the working life ends. Social Security is public recognition that retirees should be protected from particular financial vulnerabilities. Although the risks of retirement may be inevitable, retirement income can make a substantial difference in a retiree’s economic well being.

Retirees face potential income insecurity in four key areas: uncertainty about how long they will live (*longevity risk*), loss of purchasing power over time (*inflation risk*), unpredictable investment returns (*investment risk*), and uncertainty about the longevity of one’s spouse (*spousal survivorship risk*). In addition, retirees face the possibility of unpredictable changes in their financial needs due to prolonged illness, long-term care, family expenses, and a host of other reasons.

### Longevity Risk

No one knows how long he or she will live. The average American woman at her 65th birthday has a life expectancy of about 20 years; her male

counterpart has about 17 years (Figure 3-1). No one knows if he or she will be “average.” The varied life spans in Figure 3-1 show the difficulty of trying to estimate one’s remaining years from an average. For example, about 11 percent of men and 7 percent of women reaching age 65 will die before they reach age 70. Yet, about 6 percent of men and 14 percent of women will live more than 30 years, to beyond their 95th birthdays.

This uncertainty makes it difficult to allocate money wisely throughout retirement. If retirees live longer than they planned for, they risk running out of funds. If they try to avoid that problem by spending conservatively, they may have a lower standard of living than they could otherwise afford.

### Inflation Risk

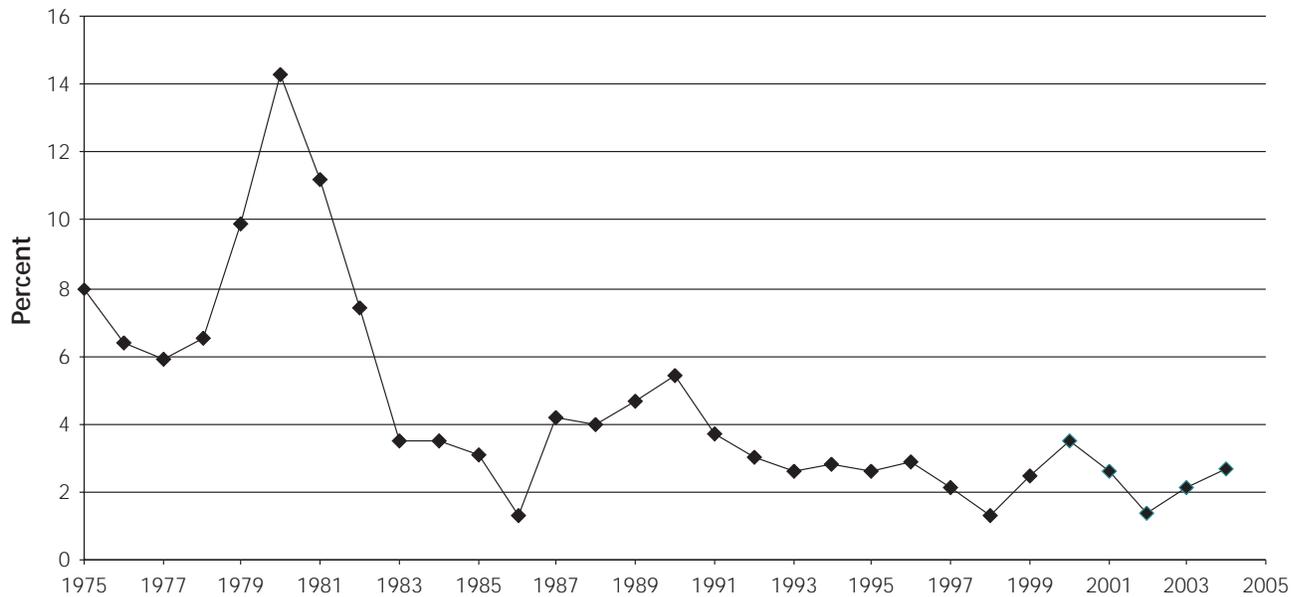
Even a modest rate of inflation can significantly erode the long-term purchasing power of a fixed income. Annual inflation of just 3 percent—well within the range experienced in the United States in recent years—will make \$100 today worth only about \$74 in 10 years. After 25 years, the value would drop by more than half, to about \$45. With Americans living longer than ever before, inflation protection is becoming even more urgent. As shown in Figure 3-1, near-

Figure 3-1. Cohort Life Expectancy of Americans Age 65 in 2005

	Total	Men	Women
Average life expectancy at age 65	18.3	16.8	19.8
<b>Percent who will be alive at age</b>			
70	90.7	88.8	92.6
75	78.9	74.9	82.6
80	63.9	58.0	69.4
85	45.6	38.4	52.3
90	25.7	19.0	31.8
95	10.2	6.3	13.7
100	2.6	1.3	3.7

Source: U.S. Social Security Administration, 2003a. Unpublished calculations from the Office of the Chief Actuary; Board of Trustees, 2003. *Annual Report of the Board of Trustees*

Figure 3.2. Cost-of-Living Adjustments in Social Security Benefits, 1975-2004<sup>1</sup>



Source: U.S. Social Security Administration, 2004c. *Automatic Increases, Cost-of-Living-Adjustments*

ly one woman in three and one man in five at age 65 is projected to live at least 25 more years.

The volatility of inflation over long time periods is a large part of inflation risk. In the three decades since Social Security implemented cost-of-living adjustments, the annual adjustment in Social Security benefits has ranged from a low of 1.3 percent to a high of 14.3 percent (Figure 3-2). Over a single five-year period (1977-1982), benefits rose by 60 percent just to preserve their purchasing power. Although inflation has hovered between 2 percent and 4 percent since the early 1990s, these examples from the not-so-distant past warn against assuming that recent trends will hold.

### Investment Risk

Some retirees invest in financial markets to protect themselves against loss of purchasing power. But such investments yield uncertain gains or losses, producing both year-to-year income volatility and an unknown income stream over the entire retirement period. In general, the higher-risk investments—such as corporate stocks—offer a higher expected return, but they also pose greater risk of financial loss.

### Spousal Survivorship Risk

Married retirees could also suddenly have to fend for themselves if they divorce or are widowed. Concerns about surviving alone are particularly acute for women, who have longer life expectancy and tend to be younger than their husbands. Also, retired widows are more likely than men to remain unmarried, in part because unmarried women outnumber unmarried men after age 65 by about three to one.

To maintain a comparable standard of living after widowhood, the newly single spouse needs about two-thirds to three-quarters of the couple's prior income. The official poverty threshold pegs the needs of a single elderly person at about 79 percent of the needs of a couple.<sup>2</sup>

### Uncertain Spending Needs

Retirees also face uncertainty about how much it will cost to meet their needs in old age. High out-of-pocket medical expenses or the costs of long-term care could wreck even the best-laid plans. Retirees face limited options for adjusting to financial setbacks. During the work life, individuals can adapt by working more, delaying

retirement, or spending less. In advanced old age, spending less might be the only option.

## **Framework for Analyzing Retirement Payout Options**

Policymakers might consider a range of factors in designing individual account payout rules, with one crucial factor being the system's relationship to Social Security.

### **Intended Use of Account Funds**

If the main purpose of the accounts is to provide basic income security, then retirement payout rules might aim to resemble features of Social Security. If the main purpose of the accounts is to expand ways to save in addition to Social Security, then payout rules might resemble those of 401(k) plans, the federal employees' Thrift Savings Plan, or individual retirement accounts (IRAs). If the purpose of the accounts is to expand wealth creation during the work life – through earmarked savings for homeownership, higher education, or a business enterprise, for example – then the accounts would normally have been used long before retirement and retirement payout rules would not be a major issue. This chapter focuses on accounts that are for retirement.

### **Level of Social Security Benefits**

The lower the level of remaining Social Security benefits, the stronger the case would be for requiring that individual account payouts provide the kinds of protections found in Social Security, such as inflation indexing, lifetime payments, and spousal protections. On the other hand, if Social Security is thought to provide an adequate baseline of retirement income, more flexible payment options might be favored.

### **Voluntary or Mandatory Participation**

If workers have a choice whether or not to participate in the individual accounts, unpopular payout rules could deter workers from participating. Workers might choose other forms of

retirement savings or decide to save less to avoid the rules.

If participation were required, then unpopular payout rules would not reduce participation. Highly unpopular payout rules could, however, weaken public support for the system altogether, or the rules could be overturned through the legislative process.

### **Tax Treatment of Account Funds**

Subsidies or favorable tax treatment create a case, at least arguably, for structuring payout rules to ensure qualifying for the tax preference. Minimum distribution rules in tax-favored retirement plans, for example, require that at least part of tax favored retirement savings are used and taxed in retirement rather than used solely for bequests.

### **Private or Public Management of Payouts**

Finally, the payout rules might vary depending on whether account payouts are provided by the government or by private companies—and in the case of annuities, whether the government serves as annuity provider or as annuity regulator.

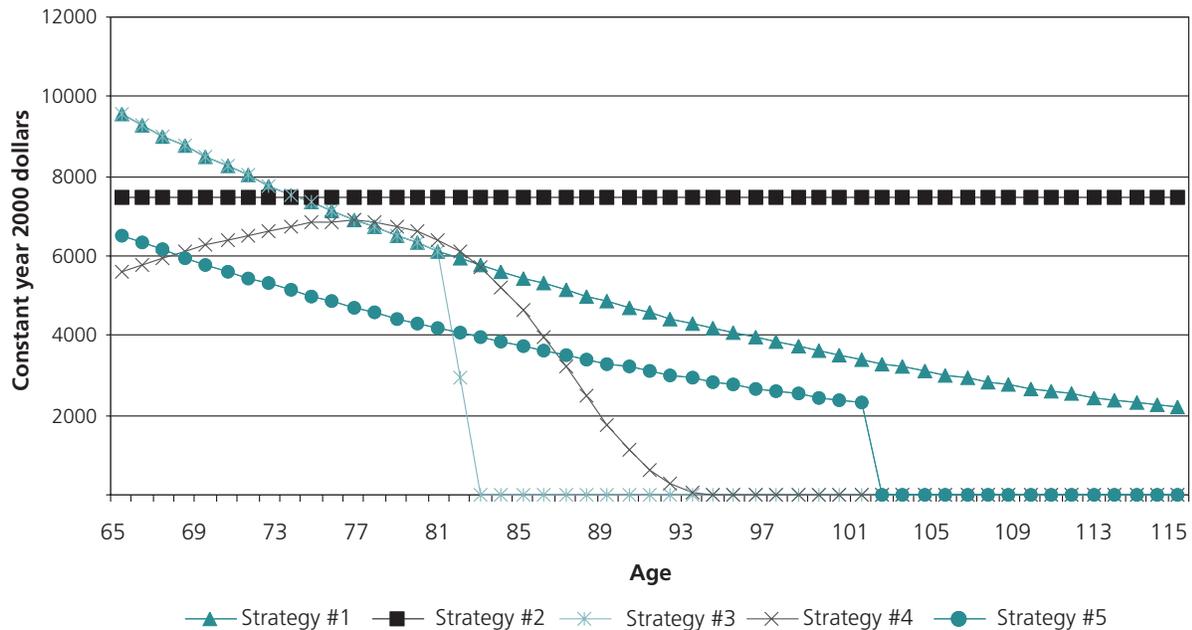
The interplay of these factors can be seen in the existing proposals for individual accounts, which vary greatly in their aims and, consequently, in their retirement payouts rules (Figure 3-3). Plans that envision individual accounts as a partial replacement for Social Security often call for compulsory inflation-indexed annuities—as in the plan offered by the chair of the 1994-1996 Advisory Council on Social Security and in various Social Security proposals since then. Other plans would require annuities only up to a specified monthly income, including proposals by Kolbe-Stenholm, DeMint-Armev, Gramm-Hagel, and the 2001 President's Commission to Strengthen Social Security. Finally, proposals that envision the retirement accounts as separate from Social Security do not require annuities, as in the Social Security Plus plan proposed by Robert M. Ball, former Commissioner of Social

**Figure 3-3. Retirement Payout Rules in Selected Individual Account Proposals**

Proposal	Retirement Payout Provisions
<b>Mandatory Accounts Funded with New Contributions</b>	
ACSS (Gramlich): Individual Account Plan, 1996	<ul style="list-style-type: none"> <li>• Automatic CPI-indexed annuitization of full account balance at retirement, with a 1-year certain annuity guarantee.</li> <li>• Default joint-and-survivor annuity for married retiree, unless spouse declines.</li> </ul>
Committee on Economic Development, 1997	<ul style="list-style-type: none"> <li>• Committee “ favors ensuring that funds are withdrawn gradually over the life of the participant, (as would occur if account were annuitized at retirement).”</li> </ul>
<b>Mandatory Accounts Funded with Scheduled Social Security Taxes</b>	
Reps. Kolbe-Stenholm: Bipartisan Retirement Security Act of 2004 (H.R. 3821 in 108th Congress)	<ul style="list-style-type: none"> <li>• No withdrawal until retirement or until account balance is sufficient to purchase annuity (or phased withdrawal) equal to at least 185% of poverty level. Solvency estimates assume CPI-indexed annuities.</li> <li>• Requires annuitization of the account balance such that when the account annuity is combined with the Social Security benefit, it guarantees a payment equal to 185% of the poverty level. Any remaining account balance may be taken as a lump sum.</li> </ul>
<b>Voluntary Accounts Funded with New Contributions from Workers</b>	
Clinton Retirement Savings Accounts, 2000	<ul style="list-style-type: none"> <li>• No annuitization requirement.</li> </ul>
Social Security Plus (proposed by R.M. Ball, 11/2003)	<ul style="list-style-type: none"> <li>• No annuitization requirement. Payouts would follow IRA rules.</li> </ul>
<b>Voluntary Accounts Funded with Scheduled Social Security Taxes</b>	
President’s Commission (PCSSS) Models 1,2, 3 (2001)	<ul style="list-style-type: none"> <li>• Joint-and-survivor annuity required for married retirees.</li> <li>• Annuity or gradual withdrawal required for all others.</li> <li>• Can take as a lump sum the portion of the balance that exceeds the amount needed to provide a monthly payment (Social Security + the annuity) above the poverty line. Solvency estimates assume CPI-indexed annuities or variable annuities.</li> </ul>
Reps. DeMint-Army: Social Security Ownership and Guarantee Act of 2001 (H.R. 3535 in 107th Congress)	<ul style="list-style-type: none"> <li>• Compulsory CPI-indexed annuitization of a minimum of 40% of the account balance with additional amounts annuitized as needed to guarantee a combined Social Security benefit (reduced by an offset) plus annuity equal to 100% of the poverty level.</li> <li>• Any remaining funds could be withdrawn as a lump sum.</li> </ul>
<b>Unspecified General Revenues for Accounts</b>	
Rep. Shaw: Social Security Guarantee Plus Act of 2003 (H.R. 75 in 108th Congress)	<ul style="list-style-type: none"> <li>• Compulsory scheduled withdrawals would be transferred to Social Security Trust Funds to pay defined benefits.</li> <li>• At retirement or disability, 5 percent of account balance paid as lump sum.</li> </ul>

**Sources:** U.S. Social Security Administration, 2004b, Selected solvency memoranda; National Academy of Social Insurance, December 1996, *Social Insurance Update*; Robert M. Ball, 2003, *Social Security Plus*, and November 2002 communication; Committee on Economic Development, 1997, *Fixing Social Security*

**Figure 3-4.** Five Strategies to Make Income Last a Lifetime  
Purchasing Power of Income Stream from Age 65 to 115



**Strategy #1.** If a 65-year-old bought a *fixed life* annuity with \$100,000, it would pay about \$9,700 a year, assuming unisex pricing. Given annual inflation of 3 percent, after 25 years the annuity would be worth just over \$4,630. If the annuitant lives to 110, the purchasing power would fall to about \$2,565.

**Strategy #2.** If the same person bought an *inflation-indexed (real) life annuity*, the payments would start out lower, at about \$7,450 a year, but they would rise with inflation. The annuity would maintain its purchasing power for as long as the annuitant lived.

**Strategy #3.** If the annuitant followed a *fixed withdrawal strategy*, each year he or she would simply withdraw about \$9,700 from the account—the amount available from a fixed annuity. This person saves the upfront purchase price of an annuity, but would not be able to provide \$9,700 annually for life, since this approach lacks the annuity provider’s risk pooling advantage. If this individual continued to withdraw \$9,700 a year, the money would run out after about 16 years and the individual would have nothing left.

**Strategy #4.** A *one-over-life-expectancy* approach might make the money last longer. Each year the individual would divide the total account balance by remaining life expectancy and withdraw the resulting amount. For example, if at 65 the individual expected to live 18.3 more years, he would withdraw  $(1/18.3 \times \$100,000)$  from his savings and leave the rest to earn investment returns. The next year, he would divide his remaining resources by 17.3, and withdraw accordingly. While this strategy would make his money last longer than Strategy #3, withdrawals would decline to negligible amounts if this person lives much beyond age 90.

**Strategy #5.** Finally, this individual could *amortize-to-age-100* and try to make the money last until he or she reaches 100 years of age. One would choose an investment with a secure return and then determine how much he could withdraw each year to make his money last until his 100th birthday. If he lived beyond that age, he would have no income.

**Source:** Brown, 2003. “Redistribution and Insurance: Mandatory Annuitization with Mortality Heterogeneity”

Security, and President Clinton's Retirement Savings Accounts.

## A Primer on Life Annuities

A life annuity is a financial product that can guarantee money will last for the rest of a retiree's life.<sup>3</sup> When an individual buys a fixed life annuity from an insurance company, the insurer assumes a contractual obligation to pay the annuitant a guaranteed income for life, in effect, transferring the mortality risk and investment risk to the insurance company. The insurer pools the mortality risk among a large group of annuitants, with the extra funds from those who die early used to cover the annuity costs of those who live a long time.

### Comparing Annuities to other Strategies

Economic analyses indicate that a life annuity would be a rational choice for a person who wanted to ensure income for life (Davidoff et al., 2003; Diamond, 2004). Consider a healthy 65-year-old who has a savings account of \$100,000 and who wants to produce income for life. Figure 3-4 compares two annuity options and three "do-it-yourself" strategies that this individual could employ. As the figure indicates, an annuity would be an advantageous choice.

The lesson from Figure 3-4 is that only the two annuity options provide the certainty of income for life and, of the two annuities, the inflation-indexed payments start out somewhat lower but soon surpass the purchasing power of the fixed annuity.

But guaranteed lifelong income comes with tradeoffs. An annuity requires the buyer to pay the full price up front (in this example, \$100,000), and the purchase is irrevocable. Strategies 3, 4, and 5, by contrast, allow the retiree to keep the money not consumed. The unused money remains available for emergencies or other unforeseen spending, it can be invested, and it can be set aside for bequest.

## Annuity Features

A basic life annuity covers the risk of outliving one's income, but additional annuity features can help mitigate other retirement risks such as loss of purchasing power and the loss of a spouse's income. Below, we focus on three annuity features that insure against inflation, widowhood, and loss of bequests if the annuitant dies early.

### Fixed, Rising, Inflation-Indexed, or Variable Life Annuities

*Fixed annuities* pay a flat dollar amount for the life of the annuitant; as such, they lose purchasing power over time, as illustrated in Figure 3-4. Some insurance companies offer *rising or graded annuities* with payments that increase at a specified rate, such as 3 percent a year. These relatively easy-to-design annuities provide partial protection against the erosion of purchasing power. Neither of these two options guarantees against purchasing power loss due to unexpected inflation.

*Inflation-indexed annuities*, by contrast, are adjusted each year by the recent rate of inflation, much as Social Security benefits are now adjusted. Currently, the U.S. market for inflation-indexed annuities is almost non-existent; few insurers offer them and few consumers, if any, actually buy them. Inflation-indexed annuities are somewhat more common in the United Kingdom, but still comprise only about 10 percent of the life annuity market (Finkelstein and Poterba, 2000).

Finally, a *variable life annuity* is tied to the performance of a particular investment portfolio, such as corporate stocks or bonds. Depending on the portfolio chosen, variable annuities have the potential to pay higher average returns (particularly over longer time periods), but payments could decline if the underlying assets lose value. While other types of life annuities shift investment risk to the insurance company, individual annuitants bear the investment risks and returns with variable life annuities.

### Single-Life or Joint-Life Annuities

A *single-life annuity* pays monthly income for the life of one person. A *joint-and-survivor annuity* pays a guaranteed stream of income for two lives: the primary annuitant (the individual buying the annuity) and an annuity partner or secondary annuitant (usually a spouse). Joint-life annuities can take several forms, including the following typical examples:

**Full Benefit to Survivor.** The death of either the primary annuitant or the partner produces no benefit reduction to the survivor. Whoever lives the longest will continue to receive the full annuity.

**Two-thirds Benefit to Survivor.** The death of either the primary annuitant or annuity partner reduces the income of the survivor to two-thirds of the original amount. Under this option, the primary annuitant foregoes the guarantee of full benefits for life in exchange for spousal protection.

**Half Benefit to Annuity Partner.** If the annuity partner is widowed, the payment is reduced by half. If the primary annuitant is widowed, the original annuity amount continues. Here, unlike in the cases above, the annuity partner is treated less generously than the primary annuitant when widowed. This option is the default spousal pro-

tection in private pension plans under the Employee Retirement Income Security Act (ERISA).

### Guarantee Payments when Annuitants Die Early

Some annuity contracts guarantee a payment to the annuitant's named beneficiary if the annuitant dies within a prescribed period after the purchase. For example, under a *10-year certain annuity*, the annuitant's death within 10 years after the initial purchase triggers payments for the remaining period to the annuitant's named beneficiary. Alternatively, a *refund of premium annuity* guarantees that the annuity will pay out at least the nominal purchase price. If the annuitant dies before the total nominal payments received total the initial purchase price, the named beneficiary receives a lump sum equal to the difference.

### Price Comparisons

Each additional layer of inflation or survivor protection lowers the initial monthly annuity payment a given premium will purchase relative to a fixed, single-life annuity. A 65-year-old with an account worth \$10,000 could buy a flat, single-life, monthly annuity of about \$80, as shown in Figure 3-5. If he wanted inflation protection, an annuity set to rise 3 percent each year would start out lower, at about \$62 a month, but

**Figure 3-5.** Effect of Inflation Indexing and Survivor Protection on Initial Monthly Annuity for \$10,000 Premium: 65-Year-Old with 65-Year-Old Spouse

Type of Annuity	Initial Monthly Payment
Single-life, flat monthly payment	\$80.46
Single-life, inflation indexed	\$61.78
<b>Joint-Life, Inflation-Indexed Annuities</b>	
100 percent survivor benefit	\$50.18
Two-thirds survivor benefit	\$57.39
Payment to survivor	\$38.28

Annuity estimates are based on assumption that: purchase of annuities is mandatory (reflecting total population life tables for individuals age 65 in 2005); annuities are priced the same for men and women; the annual inflation rate is 3.0 percent; and the real annual interest rate is 3.0 percent. Joint-life annuities are symmetric, in that they pay the same amount to whichever spouse lives longer.

**Source:** U.S. Social Security Administration, 2003a. Unpublished calculations from the Office of the Chief Actuary

**Figure 3-6.** *Effect of Inflation Indexing and Guarantee Features on Initial Monthly Annuity for \$10,000 Premium: 65-Year-Old*

Type of Annuity	Initial Monthly Payment
Fixed, single life, flat monthly payment	\$80.46
Indexed 3 percent – no guarantee	\$61.84
Indexed 3 percent – 10-year certain	\$58.43
Indexed 3 percent – refund of premium	\$54.78

Annuity estimates are based on assumptions that: purchase of annuities is mandatory (reflecting total population life tables for individuals age 65 in 2005); annuities are priced the same for men and women; the annual inflation rate is 3.0 percent; and the real annual interest rate is 3.0 percent.

**Source:** U.S. Social Security Administration, 2003a. Unpublished calculations from the Office of the Chief Actuary

would maintain purchasing power over time. If that indexed annuity were to cover both the annuitant and his 65-year-old wife at full value, the monthly payment would start out lower still, about \$50 a month. Reducing survivor benefits to two-thirds would raise the initial payment to about \$57 a month, but would lower the widowed partner's benefit to about \$38 a month. Assumptions underlying these estimates are described in Box 3-1.

Guarantees also lower the monthly annuity that would otherwise be paid. A 10-year certain feature would lower the indexed, single-life annuity for this 65-year-old from about \$62 to \$58, or 6 percent; a refund of premium feature would be more expensive, reducing the payment by about 11 percent, from \$62 to about \$55 (Figure 3-6). Many economists believe guarantees are a relatively expensive way of providing protection for one's heirs in the case of an early death, as discussed in more detail below.

### Box 3-1. Annuity Estimates and Assumptions

To price an annuity, the provider must make assumptions about: (a) the interest rate it will receive on the invested annuity premiums; (b) expenses for administration and profit; and (c) the pattern of remaining life expectancy of the pool of annuitants. Inflation-indexed annuities also require making separate assumptions about the inflation rate and the real (net of inflation) interest rate.

The Office of the Chief Actuary of the Social Security Administration provided the annuity examples used in this chapter unless otherwise noted. The estimates are consistent with long-range intermediate, or "best estimate" assumptions in the 2003 report of the Social Security Trustees. The annual inflation rate is assumed to be 3.0 percent. The interest rate on special issue Treasury securities (in which Social Security trust funds are invested) is assumed to be 3.0 percent in excess of inflation, or 6.1 percent total ( $1.03 \times 1.03 = 1.0609$  or 6.1 percent, rounded). This 6.1 percent interest rate is used for most of the annuity examples in this report.

These estimates assume that the purchase of annuities is mandatory by normal retirement age and that annuities are priced the same for men and women. The calculations are theoretical in that they reflect no explicit expense for administrative fees, risk, or profit. Other issues affecting the pricing of annuities in the private market are discussed in Chapter Four – Institutional Arrangements.

## Few People Buy Annuities

Although annuities help people offset some of the financial risks of retirement, relatively few people actually buy them. As said in Chapter Two, the U.S. private retirement system is moving away from pension plans that pay set monthly benefits (defined-benefit plans).

While Social Security and some defined-benefit pensions continue to pay benefits only in the form of monthly benefits, other retirement plans are shifting to lump-sum distributions. When given a choice between taking a lump sum or buying an annuity, people usually take the lump sum. These trends are evident in private pensions and 401(k) plans, in the Thrift Savings Plan for federal employees, and in TIAA-CREF.

A growing number of defined-benefit pensions are offering the choice of taking a lump sum instead of monthly benefits for life. A study of over 1,500 participants in defined-benefit plans that offered lump sums as well as immediate or deferred annuities found that 88 percent of workers who left the plans took lump sums (Watson Wyatt, 1998). Participants might have rolled the money over into other tax-favored retirement savings plans, or used it for other purposes.

Private 401(k) plans rarely pay annuities. A recent survey of several hundred 401(k) plan sponsors found that all offered lump-sum distributions while a declining number offered annuities. Between 1999 and 2003, plans with an annuity option declined from 31 percent to 17 percent and only 2 percent of participants chose annuities (Hewitt Associates, 2003). Some individuals retiring with 401(k) accounts use their accounts as supplements to both defined-benefit pensions and Social Security. Thus, these individuals might feel they have enough wealth in the form of monthly income and prefer, instead, to hold the 401(k) funds in a form that can be bequeathed to heirs.

The Thrift Savings Plan for federal employees offers annuities as one of several forms of pay-

out, but even its favorable annuity rates attract few takers. In 2002, about 54,000 civilian employees retired on immediate pensions from federal jobs, but only 870 used their TSP funds to buy annuities (FRTIB, 2002).<sup>4</sup>

Finally, the Teachers' Insurance Annuity Association and College Retirement Equity Funds (TIAA-CREF) is the largest private provider of defined-contribution retirement plans in the United States. As its name implies, life annuities have been a key feature since the system began in 1918. In fact, until 1989, life annuities were the only form of retirement payments the plan offered. Since then, however, participants have been allowed to choose among non-annuity payouts, including an "interest only" benefit, a minimum distribution option, or systematic withdrawals. In all of these cases the individual retains ownership of the funds not yet withdrawn. After these non-annuity payments became available, the portion of retirees choosing annuities declined from 94 percent in 1990 to 43 percent in 2003 (Ameriks, 2002). These findings refer only to the participant's first decision about the form of distribution – some retirees may later decide to buy an annuity.

Many explanations have been offered for why people do not choose annuities (Brown and Warshawsky, 2001; Mackenzie, 2002). First, many retirees with funds available to annuitize may already have sufficient monthly income. In fact, TSP participants receive monthly incomes from both Social Security and defined-benefit pensions in addition to their TSP accounts. As indicated in Chapter Two, many private employees with 401(k) plans have both Social Security and defined-benefit pensions. For a retiree who can count on receiving two monthly checks for life, the risk of outliving one's assets might seem distant—and the marginal value of further annuitization small.

In addition, when facing the tradeoff between the upfront loss of the purchase price in return for a fixed future income, many people may prefer to retain ownership of their money and

invest it themselves. Retirees might want savings in case of uninsured health expenses or long-term care, or they might want to bequeath the money to an heir. An unwillingness to bind one's income in an annuity may explain the popularity of TIAA-CREF's recently introduced non-annuity options; a retiree could always decide to buy an annuity later, but that road can only be crossed once.

Related to this desire to keep one's options open is the concept of wealth illusion. People tend to put a much higher value on a pot of money in hand than on a stream of future income of equal value (Kahneman, 1999). Studies also indicate that people tend to be shortsighted and are particularly myopic when choosing between immediate gratification and long-term gains (Fetherstonhaugh and Ross, 1999). In principle, people want their lives to improve and be secure over time; in practice, they are often driven by short-term temptations or concerns. Further, people are more distressed by prospective losses than they are pleased by the prospect of equal or even larger gains. When buying an annuity, the sacrifice is immediate and tangible while the gains are uncertain and distant (Loewenstein, 1999).

Finally, on the supply side, insurers do not actively market life annuities. Insurance companies largely emphasize life insurance and variable deferred annuity products over life annuities. Most variable annuities sold in the United States today are used solely as investment products and are rarely converted into life annuities.

### Tradeoffs between Optional and Compulsory Annuities

The designers of retirement payouts from individual accounts face basic tradeoffs in the pros and cons of compulsory or optional annuities. The tradeoffs include adverse selection, which affects annuity costs, the treatment of people with different life expectancies, the risk of outliving one's money, and how individual accounts interact with means-tested programs.

### *Compulsory Annuities Assure that People Will Not Outlive Their Money*

Compulsory life annuities would eliminate the risk that people would outlive the money in their accounts. Making annuities optional would remove that guarantee from people who choose not to purchase annuities.

### *Optional Annuities Cost More*

Optional annuities generally pay less for any given premium because of what insurers call "adverse selection." People with short life expectancies tend to not buy annuities, while people who expect to live a long time are more likely to annuitize. It is estimated that the size of private individual annuity payments in the United States is reduced by 6 to 12 percent because of adverse selection (Mitchell et al., 1999; Brown et al., 2000; Liebman, 2002). If annuities were compulsory, payouts for any given premium would be somewhat higher, although the extent of such an improvement is not clear.

### *Optional Annuities Are More Acceptable to the Sick and Short-Lived*

Higher payouts from compulsory annuities occur precisely because people who are sick, dying, or who otherwise have short life expectancies are forced to pay full premium, despite the likelihood of fewer payments. Optional annuities break up the collective risk pool by allowing those who are ill, dying, or short-lived to opt out of the purchase. This feature of annuities may be of particular concern for certain subgroups, as life expectancy differs among socioeconomic groups (Brown, 2003).

### *Compulsory Annuities May Reduce Reliance on Means-Tested Benefits*

Some policymakers want to avoid creating opportunities or incentives for individuals to qualify for means-tested programs, such as Supplemental Security Income (SSI) or Medicaid. This concern could interact with annuity policy. If retirees' entire monthly incomes (including their potential annuities) would be about equal to the SSI threshold, they could improve their

quality of life by spending the funds and then relying on SSI for monthly income. Optional annuities would permit this; compulsory annuities would not.<sup>5</sup> Low-income individuals would be required to use their accounts to buy annuities so as to reduce their reliance on SSI.

## Retirement Payout Options

This section describes four options for retirement payouts. *Option One: Unconstrained Access* offers broad account holder discretion about the form and timing of payouts. *Option Two: Compulsory Annuities with Special Protections* goes to the other end of the spectrum: it is designed to resemble aspects of Social Security, including mandatory, inflation-adjusted life annuities and spousal protections. These protections also appear in *Option Three: Default Annuities with Special Protections*, but as a default rather than a mandate. Similar annuities are again compulsory in *Option Four: Compulsory Minimum Annuities*, but only up to a specified threshold. Many variations on these broad options are possible.

### Option One: Unconstrained Access

This option would give retirees a great deal of discretion about the form and timing of retirement withdrawals. It is based on privately managed individual retirement accounts (IRAs) and, in some respects, the Thrift Savings Plan (TSP) for federal workers.

The TSP is designed to resemble a 401(k) plan for federal employees, with optional participation and government (employer) matching contributions. The TSP provides a third tier of retirement income in addition to each federal employee's defined-benefit pension and Social Security. (For married participants, the TSP constrains access in some important ways; for more on spousal rights, see Chapter Six.)

Four payout choices would be made available to retirees under this option: leaving the money in the account; withdrawing the entire amount as a

lump sum; buying an annuity; or taking phased withdrawals.

### Leaving Money in the Account

Payout rules might impose certain limits on retirees' choice to leave small amounts of money in their accounts indefinitely. First, the TSP's minimum balance rule provides that any TSP account containing less than \$200 will be automatically cashed out to the employee when he or she leaves federal employment. This minimum balance rule is designed to eliminate administrative costs for very small accounts.

Second, in return for granting tax-favored status to retirement accounts such as the TSP or IRAs, the Internal Revenue Code (IRC) requires that retirees take minimum distributions after a certain age. The purpose of this rule is to ensure that at least part of the funds set aside for retirement are, in fact, used and taxed in retirement, instead of being bequeathed to heirs. So minimum distribution rules could apply to any individual account system with favorable tax treatment.

Under the IRC, minimum distribution rules apply the year after a retiree reaches age 70<sup>1/2</sup>. If a person over the statutory age fails to take the minimum amount and count it as taxable income, he or she would owe a tax penalty equal to half the mandated distribution. The TSP helps its retirees avoid tax penalties by calculating and disbursing the account in accordance with minimum distribution rules. Presumably, individual account administrators could perform this same function.

### Taking a Lump Sum

Unmarried TSP retirees can withdraw their account funds or transfer the funds to other tax-favored retirement plans.<sup>6</sup> The withdrawn funds are subject to income tax, and an additional 10 percent penalty if the TSP retiree is not at least age 55. Individual retirement account (IRA) withdrawals are also taxable and subject to a 10 percent penalty if the withdrawal is taken before

### Box 3-2. TSP Annuity Choices

**Single life** with *level payments* or *increasing payments*. The latter rises with the cost of living, but not more than 3 percent per year.

**Joint-and-Survivor** with a spouse with *level payments* or *increasing payments*. The annuitant can choose either a 100 percent survivor annuity or a 50 percent survivor annuity.

**Joint-and-Survivor with someone other than a spouse** with *level payments* only. The same two survivor options are available as for joint annuities with a spouse. In addition, an annuitant can choose the following features to provide guaranteed payments if the annuitant dies early:

**Cash refund.** This option ensures that the total annuity amount paid is at least equal to the purchase price of the annuity. If the annuitant dies before total payments equal the purchase price, the difference will be paid to a named death beneficiary or to the annuitant's estate.

**Ten-year certain.** Payments will continue for ten years even if the annuitant dies before that time. If the annuitant dies after eight years, for example, the named death beneficiary would receive payments for two more years. This option is not available under a joint-life annuity.

age 59<sup>1/2</sup>. Similar rules could apply to individual accounts.

#### Buying Annuities

TSP participants with at least \$3,500 in their accounts can buy annuities. Through competitive bidding, the TSP Board selects an insurance company that provides annuities to participants under terms set by the TSP, with a variety of annuity choices offered (Box 3-2). The current provider is Metropolitan Life Insurance Company (MetLife). The TSP helps participants buy annuities but then drops out of the process. Once the annuity is purchased, the annuitant is no longer in the TSP and he or she deals directly with MetLife on all further arrangements with the annuity.

#### Phased Withdrawals

Finally, instead of buying an annuity, an unmarried retiree (and a married retiree who obtains spousal consent, if applicable) can leave his or her money in the TSP and choose one of the following options for receiving substantially equal monthly payments:

- (a) *Monthly payments computed by the TSP based on IRS life expectancy tables.* The payment is calculated according to the person's age and account balance and is updated annually. (This method is similar to Strategy #4 illustrated in Figure 3-4.)
- (b) *Specified dollar payments.* The retiree can choose a monthly payment of at least \$25. The TSP will pay the specified amount until the balance is gone.

This *Unconstrained Access* option offers retirees a great deal of flexibility, possibly subject to certain spousal rights. (For further discussion of spousal rights, see Chapter Six.) It reflects the purpose of the TSP as a system for optional, tax-favored saving on top of Social Security and defined-benefit pensions. The unconstrained access approach would have drawbacks if the purpose of individual accounts were to produce basic security for retirees and their families who might otherwise lack adequate defined-benefit income.

### Box 3-3. Social Security for Married Retirees

Social Security benefits are paid only as monthly amounts that continue for life and that keep pace with inflation.

A spouse and dependent children are eligible for benefits in addition to the retiree's benefit. The spouse benefit is equal to 50 percent of the retiree's full benefit and is paid only to the extent that it exceeds the spouse's benefit from his or her own work record. A 50-percent benefit is also paid to dependent children (if unmarried and under age 18, or under age 19 and still in high school, or any age and disabled since childhood). A maximum amount caps the total amount payable to the family when two or more dependents are eligible.

Social Security also pays a widowed spouse after the retiree dies. A widow can receive up to 100 percent of the deceased worker's benefit, but only to the extent that it exceeds the widow's own benefit as a retired worker. If the husband and wife had been receiving 100 percent and 50 percent of the husband's benefit, respectively, the surviving spouse's 100 percent benefit would be a one-third reduction from the prior 150 percent benefit previously received by the couple.

Benefits are available on the same terms to wives and husbands and to widows and widowers. Because most husbands earn more than their wives, relatively few men receive benefits as spouses or surviving spouses based on their wives' work records.

### Option Two: Compulsory Annuities with Special Protections

Option Two resembles, by design, aspects of Social Security for both retirees and their widowed spouses. Current spousal benefits are briefly described in Box 3-3.

This option has three key features: (1) retirees would be required to buy annuities with their account funds; (2) the annuities would have to be indexed for inflation; and (3) married retirees would be required to purchase joint-life annuities with their spouses. The goal is to produce a stream of income that resembles three aspects of Social Security: monthly payments that last for life, that maintain their purchasing power, and that provide continuing income to widowed spouses.

Social Security provides supplemental benefits to spouses, minor children, and/or adult children disabled since childhood. These benefits are financed by Social Security taxes on workers'

earnings. Consequently, the system shifts resources from households without eligible family members to those with eligible family members. Such explicit transfers are less likely to be feasible in individual accounts, as they would probably be viewed more as a property-rights based system with benefits based on account contributions. Individual accounts might be conceptualized as personal assets rather than government entitlements derived from tax revenue. Individual account issues relating to children, including disabled adult children, are discussed in Chapter Eight, while spousal rights under individual accounts are discussed in more detail in Chapter Six.

#### *Compulsory Annuities*

As noted earlier in this chapter, the pros and cons of compulsory annuitization depend on the individual account system's overall goals and structure. Compulsory annuities prevent retirees from either outliving their money or spending down their accounts and turning to SSI for

means-tested benefits. Also, by eliminating adverse selection, compulsory annuities provide higher monthly payouts to the average retiree. Yet, the higher payouts are achieved by requiring the sick, dying, and other short-lived workers to pay more than the product is worth to them. Indeed, annuities, by their very nature, shift resources from short-lived to long-lived workers and making them compulsory would maximize this transfer.

Predictably, some individuals—the terminally ill, for example—would want an exemption from the annuity requirement. Should exceptions be granted? A strong case could be made for exempting the dying because forcing them to buy annuities might be viewed as harsh and unfair. Yet, to exempt the ill or dying raises new administrative and equity problems (Mackenzie, 2002). In terms of equity, the terminally ill are not the only group who could make a case for exiting the annuity pool. Anyone facing large unexpected expenditures—such as high medical bills, or a sick family member—could argue for exemption. Even defining what constitutes a terminal illness could be a matter of dispute. From the viewpoint of account administration, granting exceptions on a case-by-case basis would require new rules and adjudicative processes (including appeal rights), which could significantly raise administrative costs. It could even be argued that to allow any exceptions would ultimately unravel the mandate and forsake any advantage of universal annuities. Chapter Seven further discusses possible exceptions for workers who become disabled.

### *Compulsory Inflation Protection*

Inflation poses a significant risk to retirees' economic well-being. Yet, when given the option, few people who annuitize actually choose inflation protection—both in the United States and abroad (Liebman, 2002). Possible widespread misunderstandings about inflation risk support the argument for compulsory inflation indexing. Institutional arrangements for providing inflation-indexed annuities are discussed in Chapter Four.

### *Compulsory Joint-Life Annuities for Married Retirees*

An individual account system modeled on Social Security would require all married retirees to buy spousal protection in the form of joint-and-survivor life annuities. If a married account holder died before annuitizing, the account would go to the widowed spouse to be used for the spouse's annuity. Key design questions about joint-life annuities involve the size of the survivor benefit and whether spousal protection would be symmetric.

**Symmetric Treatment of Husbands and Wives.** Symmetric joint-life annuities provide identical protection for the primary annuitant (the husband, for example) and the annuity partner (the wife, for example). That is, a two-thirds survivor annuity would pay two-thirds of the husband's original amount to the wife if she became widowed and would also reduce the husband's annuity to two-thirds of the original amount if he became widowed.

“Contingent” joint-life annuities are not symmetric as they pay a reduced amount only if the annuity partner (the wife, for example) is widowed. If the primary annuitant is widowed, the original amount continues. The ERISA minimum requirement for spousal protection is contingent. It requires that a widowed spouse receive at least 50 percent of the retiree's payment, but it does not require that the retiree's payment be reduced if he is widowed. While contingent joint-life annuities are the default in ERISA pension policy, most joint-life annuities in the private individual annuity market provide symmetric treatment (Sondergeld, 1998).

We examine three levels of symmetric survivor annuities: a full (100 percent) survivor payment; a two-thirds payment, and a three-fourths payment.

**Full Survivor Payment.** These annuities continue the original annuity amount when a spouse dies. A full survivor payment is one of three joint-life options offered to TIAA-CREF participants and

it is the most popular by far. About three-fourths of male annuitants chose joint-life annuities in 1994. Of those, nearly three in four of them (73 percent) took full survivor payments, 6 percent chose the ERISA default (half payment to the annuity partner), and 21 percent took a two-thirds survivor payment (King, 1996). The popularity of the full benefit to survivors suggests that male annuitants wanted to avoid any reduction in monthly income when either they or their wives became widowed.

**Two-thirds Survivor Payment.** Many individual account plans that aim to resemble Social Security survivor protection call for symmetric joint-life annuities that pay two-thirds of the original amount to the widowed spouse. For a one-earner couple, the current Social Security benefit for a widowed retiree or spouse is two-thirds of the prior benefit received by the couple. The two-thirds survivor annuity aims to replicate this feature.

**Three-fourths Survivor Payment.** Some proposals would change Social Security's defined benefits so that a widowed spouse would receive 75 percent of the prior benefit received by the couple. The goal is to reduce poverty among elderly widows (Liebman, 2002).<sup>7</sup> Annuities could also be designed to pay a 75 percent survivor benefit.

### Option Three: Default Annuities with Special Protections

Option Three would turn the compulsory annuity of Option Two into a default option: the account would be automatically annuitized upon retirement, unless the account holder (and, in the case of a married account holder, the spouse) chose differently. The default life annuity would be inflation indexed and, in the case of married retirees, would provide a two-thirds symmetric survivor benefit.

The other payout options that retirees could choose under this system might include those elaborated in Option One. That is, the retiree could take a lump sum, receive phased withdrawals, or leave money in the account subject

to minimum balance and minimum distribution rules.

Although spousal protection would not be mandatory, the system could require spousal consent for the account holder to take any payment that provides less than the default two-thirds survivor benefit to the widowed spouse. ERISA imposes a spousal consent requirement. The couple could also choose greater spousal protection through full survivor payments or 75 percent survivor benefits.

Many studies show that default options have a significant impact on behavior. When decisions are difficult or confusing, consumers might avoid them by procrastinating or by accepting the default (Loewenstein, 1999). A natural experiment illustrated this point. Buyers of auto insurance in New Jersey and Pennsylvania were given a choice to pay lower insurance rates in return for a reduced right to sue for pain and suffering. In Pennsylvania, the default was the full right to sue, with a rebate for accepting reduced rights. In New Jersey, the default was a limited right to sue with a surcharge to get the full rights. In both states, about 75-80 percent of drivers took the default option (Johnson et al., 1993; Loewenstein, 1999).

Kahneman (1999) further observes the appeal of defaults, noting that:

“Staying with the default option is undemanding; it is what we do when we are not thinking very hard.... The default is also favored by a desire to conform and to do what most other people do. Finally, in the context of choices that are offered by a benevolent agency, the default is likely to be perceived as an implicit recommendation about what is best for most people.”

Defaults also influence behavior in retirement plans. For example, when enrollment in a 401(k) plan is the default, more employees participate (Choi et al., 2002; Madrian and Shea, 2001). Making spousal survivor benefits the default in private pension plans under ERISA

increased the number of wives who obtained that protection from their husband's pension (Holden and Zick, 1998). Defaults also influence how workers invest retirement funds. When Sweden introduced its new, supplemental, defined-contribution pension plan in 2000, one-third of Swedish workers did not make an investment decision, ending up in the default fund (Cronqvist and Thaler, 2004). Since then, 92 percent of new enrollees did not make a choice and were added to the default fund (Krueger, 2004). The Swedish experience highlights the importance of well-designed defaults as many people end up in them (Sundén, 2004).

#### Option Four: Compulsory Annuities Up to a Specified Level

This option would require the annuities proposed in Option Two only up to a certain threshold. It poses a series of new issues about setting and implementing the desired threshold for compulsory annuities.

Policymakers could look to compulsory partial annuitization to serve several objectives. The limited mandate could aim to produce an adequate baseline of retirement income. But what level of income is deemed “adequate?” The official poverty threshold is one common measure; another is the replacement of a stated fraction of prior earnings. A related approach might set the annuity threshold to approximate currently payable or currently scheduled Social Security benefit levels. Finally, those concerned about increased dependence on means-tested benefits might set an annuity threshold at a level high enough to preclude eligibility for SSI.

#### Poverty Line Thresholds

Using the poverty threshold to set the level for compulsory annuitization raises several issues. First, would the threshold take into account the retiree's family living situation? Official poverty measures count the incomes of all family members who live together, with a higher poverty threshold for larger families. Using family income to set a compulsory annuitization threshold for an individual could be compli-

cated because living arrangements and family members' incomes can change significantly from month to month. A simpler approach could set the annuity requirement at the poverty threshold for a one-person household, regardless of the retiree's living situation.

How would the retiree's other sources of income be counted toward meeting the mandated annuity threshold? Presumably, Social Security defined benefits would be considered. For example, if the poverty threshold were \$800 a month and the retiree had \$750 in Social Security, he or she would be required to annuitize only that portion of the account needed to produce an inflation-indexed annuity of \$50. Would other sources of monthly income – such as pensions, interest on savings accounts, or earnings from work – also count toward the annuity requirement? Presumably, only inflation-indexed and highly predictable income sources would be good candidates to count toward the mandated annuity level, although counting only these would likely raise administrative costs. Otherwise, the once-in-a-lifetime compulsory annuity purchase could be affected by temporary changes in one's income.

#### Replacement Rate Thresholds

A second approach to basic retirement income adequacy would set the compulsory annuity threshold to achieve a target rate of earnings replacement. This threshold is more similar to the existing Social Security system, where the benefit formula is structured to produce particular replacement rates. If individual account annuities were structured similarly, the replacement rate requirements would be lower at higher levels of pre-retirement earnings. The annuity requirement could be set with the aim of equaling present-law *payable* or *scheduled* benefits when combined with remaining Social Security defined benefits. Payable benefits are lower than scheduled benefits, starting in about 2042 when the trust funds are projected to be exhausted.

### Means-Tested Program Thresholds

A minimum annuity mandate could reduce eligibility for means-tested programs by requiring retirees to annuitize as much of their account as necessary to produce monthly income that, together with Social Security, reaches the limit for means-tested programs such as Supplemental Security Income (SSI). The SSI limit of countable retirement income for an elderly person living alone in 2004 is \$564 a month.

Some may find this partial annuitization option appealing as a compromise between the competing goals of income security and individual choice. Some see an advantage in that high earners would not be required to use their entire account balances to buy annuities. This would reduce the amount of annuitization by high earners and would permit lower annuity prices. It would reduce transfers from low earners (who on average have lower life expectancy) to high earners (with higher life expectancy) that a universal full annuity pool would entail.

Yet, the annuity threshold requirement would force low-income account holders to buy annuities with their entire account balances, while higher earners would be allowed more choices.

This could create what might seem like a regulatory class system. To the extent that compulsory annuities might not be popular, this potential disadvantage for low-income individuals and their families could enhance the perceived unfairness.

### Design and Implementation Issues

Regardless of payout option, policymakers designing the payout rules will face major issues about the institutional arrangements for providing annuities and the role of government or private insurers in bearing the inflation, mortality, and investment risk inherent in annuities. These issues are discussed in Chapter Four. Other issues include the implications of joint-life annuities for couples in different circumstances; the timing of annuity purchase; rules about guarantees; and, how to ensure that retirees with decisions to make have enough information to make informed choices.

#### Joint-Life Annuities for Couples in Different Circumstances

Plans that require joint-life annuities for married individuals are generally designed to resemble

**Figure 3-7.** *Joint-Life Annuity\* and Traditional Social Security for One-Earner Couple Age 65: Payments as a Percent of Amount for a Single Worker*

Marital status and situation	Benefit as percent of amount for a single worker	
	Traditional Social Security	Joint-Life Annuity*
Single retiree – Bob	100	100
Married retire – John	100	93
John's non-working wife spouse – Mary	50	0
Total for John and Mary	150	93
When John or Mary is widowed	100	62

\* Symmetric life annuity that pays two-thirds of the original amount to whichever spouse lives longer. Annuity estimates are based on assumptions that: purchase of annuities is mandatory (reflecting total population life tables for individuals age 65 in 2005); annuities are priced the same for men and women; the annual inflation rate is 3.0 percent; and the real annual interest rate is 3.0 percent.

**Source:** Author's calculations based on present law and annuity examples provided by the U.S. Social Security Administration's Office of the Chief Actuary, 2003

features of Social Security. How such plans actually compare with traditional Social Security would be different for one-earner couples than for two-earner couples. Results may also differ depending on the ages of the spouses, the choices they make (when they have choices), the timing of widowhood, and treatment of marriage after retirement. Further issues about spousal rights are discussed in Chapter Six.

### *One-Earner Couples*

In traditional Social Security, a one-earner couple receives 150 percent of the benefit of a single retiree (the spouse receives a separate check equal to 50 percent of the worker's benefit). The widowed spouse receives two-thirds of that amount, or 100 percent of the single retiree's benefits (Figure 3-7). The cost of spousal benefits is borne by all workers paying into the Social Security system.

With annuities, in contrast, the retiree takes a cut in his or her monthly annuity to provide survivor benefits for a spouse. The size of the cut would depend on the respective ages of the husband and wife. If John and Mary were both age 65, a two-thirds survivor annuity would lower John's initial benefit to about 93 percent of what a single annuitant would receive. No supplemental annuity is available for John's wife. When one of them dies, the survivor receives two-thirds of the "93-percent annuity," or about 62 percent as much as a single retiree would have from an account like John's.

In brief, a symmetric joint and two-thirds survivor annuity would ensure that a widowed spouse receives two-thirds of the amount paid before widowhood. But a one-earner couple's income from such an annuity is smaller than the income a single person would receive from the same size account for two reasons. First, joint-life annuities start out lower than single-life annuities because of the added cost of covering two lives without subsidy. Second, only two-thirds of the reduced amount is paid to the survivor after a spouse dies.

### *Dual-Earner Couples*

In dual-earner couples, the husband and wife would each have their own annuities. With compulsory survivor protection, each would be required to buy joint-life annuities. When one spouse died, the survivor would receive both survivor annuities. This is somewhat different from traditional Social Security.<sup>8</sup>

Survivor annuities for dual-earner couples would generally be added together. As illustrated in Figure 3-8, if both John and Mary purchased joint-life annuities with their accounts of \$20,000 and \$5,000, respectively, their combined monthly annuities would be about \$144 while both are alive; John would receive \$115 and Mary would receive \$29. When one of them died, the widowed person would shift to receiving two-thirds of each annuity, for a total of \$96.

If members of dual-earner couples compare their annuities to those of single persons with similar earnings, they sometimes have more and sometimes have less. For example, in the dual-earner couple with unequal earnings, John's annuity of \$115 is less than the \$124 annuity that his single counterpart, Jack, receives. If John became widowed, his annuity would drop to \$96, falling further behind his counterpart Jack. But Mary, the low-earner in the couple, has survivor protection not available to her single counterpart. Mary's survivor annuity of \$96 is more than she would have if single.

In the dual-earner couple with equal earnings, both Bob and Sue take a modest cut in their annuities to provide survivor protection. If widowed, either one would have higher combined annuities (\$96) than if they were single like Diane, who has a single-life annuity of \$77, but a smaller combined annuity than Richard, who—with the same earnings as the couple—has a single-life annuity of \$155.

In brief, a great deal of variation exists in how annuities might compare to traditional benefits for dual-earner couples if symmetric joint and

**Figure 3-8.** *Joint-Life\*, Inflation-Indexed Annuities: Dual-Earner Couples Both Age 65*

Individual	Account balance	Monthly payment	Payment to survivor*	
<b>Dual-Earner Couple – Unequal Earnings</b>				
John	\$20,000	\$115	(67%)	\$77
Mary	\$5,000	\$29	(67%)	\$19
Total		\$144	(67%)	\$96
<b>Dual-Earner Couple – Equal Earnings</b>				
Bob	\$12,500	\$72	(67%)	\$48
Sue	\$12,500	\$72	(67%)	\$48
Total		\$144	(67%)	\$96
<b>Single Individuals</b>				
Jack	\$20,000	\$124		\$0
Martha	\$5,000	\$31		\$0
Richard	\$25,000	\$155		\$0
Diane	\$12,500	\$77		\$0

\* Symmetric life annuity that pays two-thirds of the original amount to whichever spouse lives the longer. Annuity estimates are based on assumptions that: purchase of annuities is mandatory (reflecting total population life tables for individuals age 65 in 2005); annuities are priced the same for men and women; the annual inflation rate is 3.0 percent; and the real annual interest rate is 3.0 percent.

**Source:** U.S. Social Security Administration, 2003a. Unpublished calculations from the Office of the Chief Actuary

two-thirds survivor annuities were required. The higher earner in the couple would often have a smaller annuity than his single counterpart. This does not occur with traditional Social Security because survivor protection is subsidized. Yet, couples with nearly equal earnings could have higher annuities as widowed spouses than they would have had if single, because they can combine the survivor payments from their own accounts and their deceased spouses' accounts.

If an individual account plan is a part of Social Security, the ultimate impact on combined income from the annuity and traditional benefits will depend on the size of traditional benefits and the accounts, and how, if at all, they are coordinated or offset against each other.

### *When Spouses Are Different Ages*

How would compulsory survivor protection work when one spouse is considerably older than the other? For example, if the husband was age 65 and his wife age 53, he would buy a

joint-life annuity. Twelve years later, when the wife reached age 65 and the husband age 77, she would buy a joint-life annuity. Then, whoever lived the longest would receive two-thirds of both annuities.

Using examples for 65-year-olds, Figure 3-9 shows that an individual with \$10,000 could buy a single-life annuity, indexed to rise by 3 percent per year, of \$62 a month. If he had a 53-year-old wife, buying a joint and two-thirds survivor annuity would reduce the initial payment to about \$48 a month, a drop of 22 percent. When the wife later reached age 65 and used her \$10,000 to buy a joint and two-thirds annuity with her 77-year-old husband, her immediate annuity would be about 10 percent higher than the single-life annuity she could buy.<sup>9</sup>

The key point is that a young spouse reduces a married retiree's own annuity as well as the survivor protection, while a much older spouse will increase one's own joint-life annuity. In brief,

**Figure 3-9.** *Effect of Spouse's Age on Initial Joint-Life, Inflation-Indexed Annuity for \$10,000 Premium: Retiree with Spouse Age 53 or Age 77*

Attribute	Initial Monthly Annuity
<b>Retiree only, age 65</b>	
Single life annuity	\$61.84
<b>Retiree age 65 with spouse age 53</b>	
Joint and two-thirds survivor annuity	\$48.54
Size of survivor benefit	32.36
Joint and 100% survivor annuity	42.79
Size of survivor benefit	42.79
<b>Retiree age 65 with spouse age 77</b>	
Joint and two-thirds survivor annuity	\$69.12
Size of survivor benefit	46.08
Joint and 100% survivor annuity	58.23
Size of survivor benefit	58.23

\* Symmetric joint-life annuities that pay the same amount to whichever spouse lives the longer. Annuity estimates are based on assumptions that: purchase of annuities is mandatory (reflecting total population life tables for individuals age 65 in 2005); annuities are priced the same for men and women of the same age; the annual inflation rate is 3.0 percent; and the real annual interest rate is 3.0 percent.

**Source:** U.S. Social Security Administration, 2003a. Unpublished calculations from the Office of the Chief Actuary

while joint and survivor annuities can be designed to resemble some features of Social Security, annuities for couples of different ages, or in different circumstances, produce monthly incomes quite different from what Social Security provides in defined benefits. While Social Security benefits are adjusted for the age of the retiree when benefits are claimed, the age of the retiree's spouse does not affect the retiree's benefit amount.

### *When Spouses Make Different Choices to Participate*

In a voluntary account system, a husband and wife could make different choices about participation. These different choices might undermine the goals of symmetric treatment and adequate spousal protection if joint-and-survivor annuities were compulsory for married couples. For example, if the wife—but not the husband—decided to join the individual account plan, she presumably would be required to buy a joint-and-survivor annuity that provided for him. He, however, would not have an individual account

or an annuity to provide survivor protection for her. Should policymakers require that husbands and wives make similar choices about participation in the accounts, or at least require that the higher earner participate to provide protection for a more dependent spouse?

In theory, rules could require that husbands and wives make the same choice and, if they cannot agree, provide a default rule to determine their status. But new marriages and remarriages would create mismatches between spousal participation. In the end, it appears that the intended outcomes of compulsory joint-life annuities for married retirees would be achieved only if participation in the accounts was also mandatory.

### *Timing of Annuity Purchase and Widowhood*

Whether a married person died before or right after buying a joint-life annuity would impact the widowed spouse's financial security. For example, consider John and Mary who have accounts of \$20,000 and \$5,000, respectively, as

*Timing of Annuity Purchase and Widowhood:  
Joint-Life Annuities or Delaying Annuity Purchase Beyond Widowhood*

	John	Mary	Total
<b>John and Mary each buy joint and two-thirds, inflation-indexed life annuities</b>			
Account balance	\$20,000	\$5,000	\$25,000
Joint and two-thirds life annuity	\$115	29	\$144
Two-thirds payment to survivor	\$77	\$19	\$96
<b>John and Mary delay annuity purchase until after one is widowed</b>			
Account balance	\$20,000	\$5,000	\$25,000
Single-life, inflation-indexed annuity			\$155

Symmetric joint-life annuities that pay two-thirds of the original amount to whichever spouse lives longer. Annuity estimates are based on assumptions that: purchase of annuities is mandatory (reflecting total population life tables for individuals age 65 in 2005); annuities are priced the same for men and women of the same age; the annual inflation rate is 3.0 percent; and the real annual interest rate is 3.0 percent.

**Source:** U.S. Social Security Administration, 2003a. Unpublished calculations from the Office of the Chief Actuary

shown in Figure 3-10. If they both purchased joint and two-thirds survivor annuities, their combined income while both are alive would be \$144. If either John or Mary died shortly thereafter, the survivor's monthly income would drop to two-thirds of the original amount, or \$96.

Yet, if one died before they bought annuities, the widowed person would have much higher income. This would occur because the widowed spouse, for example Mary, would inherit John's account which, when combined with her own account, would purchase a single life annuity of \$155 a month. The same would be true if John were widowed before they annuitized. He, too, would have a life annuity of \$155. If they had delayed buying annuities, the income for the widow or widower would be more than 60 percent higher than the joint and two-thirds survivor annuities from their two accounts. This disparity in survivor protection appears to be unavoidable. A single life annuity purchased by a widow or widower with the proceeds of two accounts will always be larger than the sum of the survivor benefits from two joint-life annuities purchased with the same premium.

This discontinuity in survivor benefits does not occur in traditional Social Security because survivor benefits are not affected by whether one is widowed just before or just after taking retirement benefits.

### **Annuities, Guarantees, and the Interests of Heirs**

Annuitization uses funds that would have been inheritable and the purchase is irrevocable, so heirs have some interest in the account holder's decision to buy an annuity. The prospect that the annuitant will die shortly after buying an annuity prompts an interest in guarantee features.

#### *Would Guarantees Be Offered or Allowed?*

Guarantees provide that a life annuity will pay a certain amount even if the annuitant dies within a specified period after the purchase, but guarantees come at a price: they lower the monthly annuity that a given premium will buy. For a 65-year-old individual, adding a 10-year certain feature would lower the annuity by about 6 percent, while a refund of premium would lower the monthly amount by about 11 percent.<sup>10</sup> Nonetheless, guarantee features are popular. Of TIAA-CREF participants who bought single-life

annuities in 1994, two out of three chose annuities with guarantee periods of 10, 15, or 20 years (King, 1996).

Some of the appeal of guarantees is psychological and emotional. Annuitants might want to avoid the serious disappointment for their heirs and survivors if they paid a large amount for an annuity and died shortly thereafter. The large outlay with nothing to show for it might feel like a big mistake and a very bad deal.

Many experts believe guarantees are not a wise purchase. If the annuitant wishes to leave a bequest to heirs, these experts suggest other less expensive and more predictable ways to do so. One could buy a smaller annuity and keep the rest of the funds as liquid assets to spend or bequeath. This strategy would produce a predictable bequest instead of a random amount that would depend on when the annuitant died (Diamond, 2004). For example, instead of buying a refund of premium annuity (which would lower the annuity by 11 percent), a 65-year-old could keep 11 percent of the premium to spend or bequeath and buy the same size annuity with 89 percent of the original premium.

Given these mixed verdicts on annuity guarantees, would guarantees be allowed in an individual account system with compulsory annuities? Aside from the expert criticisms mentioned above, the main drawback of guarantees for compulsory annuities is that they reintroduce some of the longevity risk and adverse selection that universal, required annuitization is supposed to eliminate. Yet, policymakers might find it difficult to ban guarantees because they ease the serious regret and financial losses for people who end up on the short end of the annuity wager.

Some have suggested that it might be possible to ban guarantees if retirees were required to annuitize only a portion of their accounts (as in some versions of Option Four). A partial mandate might reduce the desire for guarantees if liquidity in case of early death is their main attraction.

But this policy would not address the psychology of the annuity tradeoff. Buyers might still want a guarantee against the risk of losing the entire purchase if they die soon after annuitizing only part of their accounts.

### *Would Guarantees or Bequests Pay a Lump Sum or Periodic Payments?*

If guarantees are offered, the pros and cons of different forms of guarantee payments merit some attention. At the election of the annuitant, guarantees can be designed to either pay a lump sum or to make periodic payments to a named beneficiary. The periodic payments can be in the form of life annuities for the death beneficiaries or installment payouts. Standard life insurance settlements offer policyholders a choice of these options. If the policyholder did not specify, the beneficiary can choose the payment form or choose to leave the funds as an interest-bearing deposit with the insurance company. These choices for the form of guarantee payments or bequests could be built into an individual account program, or the plan could limit the choices to only a few. A lump sum payment would pose a lesser administrative burden on the annuity provider.

### *How Might Guarantees Ease the Tension Between Annuities and Heirs' Interests?*

There is an inevitable tension between buying a life annuity and the interests of heirs who would get the money if it had not been spent on an annuity. Guarantee features or partial annuitization could ease some of this tension.

Figure 3-11 illustrates how partial annuitization or guarantees could affect outcomes for a single, 65-year-old retiree with a \$20,000 account who has named her nephew as her death beneficiary. If she dies before buying an annuity, the entire \$20,000 account goes to her nephew but, if she buys a single-life annuity with the entire account, she is guaranteed \$124 a month for life while her nephew will inherit nothing. To avoid completely wiping out his inheritance, she could buy a \$15,000 annuity and reserve \$5,000 for a potential bequest. Her monthly annuity is now

**Figure 3-11. Full and Partial Annuities, Bequests, and Guarantees: Single Individual**

Single Individual Aged 65 with a \$20,000 Individual Account In all cases, annuity purchased is single-life, 3% inflation indexed		Monthly Annuity	Payment to Beneficiary
#1	Dies before buying an annuity	0	\$20,000
#2	Buys \$20,000 annuity with no guarantee feature	\$124	0
#3	Buys \$15,000 annuity with no guarantee feature, holds \$5,000 as bequest		
	(a) Dies 3 months later	\$93	\$5,000
	(b) Lives 20 more years and still holds \$5,000 bequest	\$93	\$5,000
#4	Buys \$20,000 annuity with a refund of premium guarantee.		
	(a) Dies 3 months later	\$110	\$19,670
	(b) Lives at least 16 more years	\$110	0

Annuity estimates are based on assumptions that: purchase of annuities is mandatory (reflecting total population life tables for individuals age 65 in 2005); annuities are priced the same for men and women; the annual inflation rate is 3.0 percent; and the real annual interest rate is 3.0 percent.

**Source:** U.S. Social Security Administration, 2003a. Unpublished calculations from the Office of the Chief Actuary

reduced to \$93, but her nephew stands to inherit \$5,000 (plus any interest earned if she invests the money).

If the system allowed guarantees, the retiring aunt could buy a refund of premium annuity, which would reduce her monthly income by about 11 percent, to \$110 a month. Upon her death, her nephew would receive the difference between the full \$20,000 premium and the sum of benefits she received. If she lived only three months, for example, her \$20,000 premium would have paid her \$330, so her nephew would inherit \$19,670. Yet, if she were still alive after 16 years there would be nothing left for her nephew.

In brief, the purchase of an annuity is a permanent loss to heirs. A retiree who wishes to bequeath part of an account would have to purchase a smaller annuity. If she decides to leave a portion of her account for a beneficiary, she is accepting lower income for herself. The tradeoff of partial annuitization may be appealing to her: it leaves funds available for her own unexpected spending needs or as a bequest if she does not need the balance.

By contrast, the retiree could choose to provide for her nephew by purchasing a guarantee feature. In this case, her nephew's inheritance is expressly contingent upon how long she lives. The only thing certain about her "guarantee" is that she will receive a lower income than she could otherwise have afforded. In return for this sacrifice, her nephew could end up with a large bequest, a small bequest, or nothing at all.

The question about whether to buy guarantees or partial annuities could also arise for married or widowed retirees who wish to leave a bequest to their adult children.

### Timing of Annuity Purchase

Concerns about the interests of heirs can add complexity to the timing of the annuity purchase. From a strictly selfish perspective, named beneficiaries might prefer that their benefactors would never buy an annuity so as to keep the account in a form that can be inherited. If asked for advice, an heir's self interest might encourage delay. Retirees, too, might want to delay; they might simply be hoping for a more favorable interest rate. More importantly, delay might reveal new insights about the wisdom of buying an annuity at all. As noted earlier, a life annuity would not be the preferred choice for one who

has a life-threatening illness, nor would joint-life annuities be the best choice for a couple in which one partner is expected to die soon. The timing of annuitization is tied to market risk, longevity risk, and the interests of widowed spouses and other heirs.

### *How Would Delaying Annuity Purchase Affect Potential Income?*

All other things being equal, delaying the purchase of an annuity results in a smaller future income stream (Ameriks, 1999). Future changes in one’s own status (such as becoming widowed, divorced, or married) or changes in annuity terms (such as a rise or fall in interest rates) would also alter the income stream that could be purchased with a given sum of money.

As shown in Figure 3-12, a retiree hesitant about buying an annuity could take systematic withdrawals for several years. This arrangement seems attractive on its face: the retiree would have “annuity-like” monthly income, would retain the liquidity of the remaining account balance, and would retain the option to buy an annuity down the road.

The delay comes with a price, however. The steadily depleting account balance will buy an increasingly smaller annuity as time goes by. If the 65-year-old retiree shown in Figure 3-12 took systematic withdrawals for ten years and then purchased a standard annuity, her annuity

income would be 15 percent lower than what she could have received if she had made the purchase at age 65. If she waited 20 years to buy an annuity at age 85, it would be only 13 percent the size of what was originally available to her.

### *Would Timing of Purchase Affect the Annuity Amount?*

The timing of annuity purchase is also important because the annuitant faces two financial risks that could change the annuity terms over time. Fluctuations in asset value or interest rates can alter both the account balance available for annuitization and the income stream that can be bought with a given sum of money.

All account holders would face *investment risk*, or the possibility of short-term changes in the value of assets in the account. An account could be invested in equities, for example, and the stock market could decline just before the account holder is due to buy an annuity. In this case, the unfortunate timing of the market slump could significantly reduce the account holder’s retirement income for life. This investment risk is always present, but it could be reduced if people were required to invest their accounts in bonds, money market funds, or other relatively safe products as they approach retirement. After annuitization, the risk is transferred to the annuity provider (except under a variable annuity, which shifts the risk to the

**Figure 3-12.** *Relative Size of Fixed, Single-Life Annuity by Age Purchased*

Age Annuity is Purchased	Monthly Income from Annuity
Age 65	\$100
Age 70	\$95
Age 75	\$85
Age 80	\$62
Age 85	\$13

Assumptions: Account accumulation ends at age 65. If annuity purchase is delayed, the withdrawal each year is the size a fixed annuity would be if purchased at age 65. Annuity is single-life standard annuity based on 6.5 percent interest rate and mortality based on Annuity 2000 merged unisex tables with ages set back two years.

**Source:** Ameriks, 1999. “The Retirement Patterns and Annuity Decisions of a Cohort of TIAA-CREF Participants”

annuitant or spreads the investment risk between the insurer and the annuitant).

Fluctuations in *interest rates* will also affect the size of the annuity purchased with any given lump sum. For a given price, a lower interest rate will produce a smaller annuity. Gradual annuity purchases could reduce the interest rate risk. For example, a retiree could be given the option of buying annuities gradually over a 10-year period between the ages of 62 and 71. During that time, the retiree would receive income from a small but growing annuity as well as investment returns on the balance not yet annuitized. In the first year, for example, the retiree would have an annuity based on 10 percent of the account balance and would receive investment returns on the other 90 percent.

Gradual annuitization provides only limited protection against interest rate fluctuations. Gradual purchase may lessen the impact on retirement income from year-to-year interest rate changes, because it spreads the annuitant's interest rate risk over a longer period. Still, one who gradually bought annuities over a decade when interest rates averaged 3 percent would get far smaller income than one who bought annuities over a decade of 8 percent average rates.

Gradual annuitization also has its downsides. Retirees would not know how much income their accounts would provide until almost all the annuities had been purchased. In addition, administrative costs would be higher.

### *Would Purchase of Annuities Coincide with Claiming Social Security?*

If the accounts are considered an integral part of Social Security, there may be a case for requiring that retirees buy annuities when they claim Social Security benefits. Yet, there may be reasons why it is not in a retiree's best interest to buy an annuity then. For example, if joint-life annuities were required of married retirees, a couple with a terminally ill spouse would be better off to delay annuitizing even though they are ready to claim Social Security. As noted earlier, a

single-life annuity purchased by a widow or widower with the proceeds of two accounts will always be larger than the sum of the survivor benefits from two joint-life annuities from the same accounts. Likewise, a single retiree with short life expectancy may prefer to delay buying an annuity even though he or she is ready to claim Social Security benefits. If annuities were mandatory, or joint-life annuities were required for married retirees, some flexibility in timing might reduce the extent to which such policies are perceived as unfair because they require retirees to buy an undesirable product.

### **Providing for Informed Choice**

If retirees in an individual account system are to have any choice about whether, when, or how to annuitize, who will advise them and answer their questions? And to what degree would the educator or adviser be held responsible for the consequences if the advice turns out badly? As background for answering these questions, it is useful to consider how the federal employees' Thrift Savings Plan and Social Security provide for informed choice among participants.

#### *Informed Choice in the Thrift Savings Plan: Employer Assistance*

Retirees in the TSP face a broad range of choices about the form and timing of payouts. Responsibility for ensuring that retirees understand their choices rests largely with their employers. Federal agencies' personnel offices provide retirement planning seminars to help employees understand their retirement benefits, including health coverage, life insurance, defined-benefit pensions, and payout options under the TSP. Participants can also use the TSP website, which provides information and annuity calculators to help retirees choose payout options.

In the private sector, many large employers also provide help with retirement planning, along with information about retiree health, pension, and life insurance benefits. Some employers also provide information about Social Security benefits to their retirees, but they have been reluctant

to provide retirement investment advice for fear of fiduciary liability under ERISA.

An individual account system could not rely solely on employers to educate retirees. Further, a universal individual account system would include more low-income workers who may be less educated. Such workers might need more extensive help understanding individual account plans than those workers with employer-sponsored pension plans. An individual account system would also include more part-time or contingent workers and casual laborers who might not have a regular employer to help them with their retirement choices. Not all employers could provide the necessary services; small companies, or companies with high employee turnover, lack capacity to provide employee benefits and do not offer retirement advice.

If federal policy introduced individual accounts on a universal or widespread basis, some large employers might add information about payout options to their retirement planning seminars. But it is not reasonable to expect that smaller employers would be equipped to educate and advise employees about a new system of federally sponsored accounts.

### *Limited Choice in Social Security*

Social Security's answer to the problem of informed choice is to give retirees almost no choice. All beneficiaries receive monthly inflation-indexed benefits that last for life. Retirees can choose only *whether* to take their entitled benefits and *when* to take them.

The first decision—whether or not to take Social Security benefits—is straightforward. No exchange is required to get benefits or to provide family protection. With no downside to accepting, very few people actually decline benefits.<sup>11</sup>

The second decision—when to take benefits—involves some financial tradeoffs, but Social Security policies on retirement age, benefit eligi-

bility, and returning to work after retirement avoid sharp cliffs in a retiree's income.

Under current policy, a retiree can take benefits any time from age 62 onward. Benefits are reduced for each month they are received before the statutory full-benefit age, which is set to rise from 65 to 67 over the next two decades. Monthly benefits are increased for each month they are not received between that age and age 70. After age 70, there is no financial advantage to delaying the benefit claim.

Early retirees who decide to go back to work can stop receiving reduced benefits. When they reclaim their retirement benefits, the benefits will be adjusted to reflect an early retirement reduction only for the months that early benefits were actually received. (An early retiree can even undo any early retirement reduction by paying back the early benefits received.)

The Social Security Administration (SSA) keeps its administrative costs low (less than 1 percent of benefit outlays), in part because the law offers almost no benefit choices to retirees. If the SSA were called upon to administer an individual account program, any rules that offered more choice would increase administrative burdens and costs.

### *Recap of Choices*

Policymakers designing individual account payout rules will confront an inevitable tension between offering choice and guaranteeing adequate retirement income for life. Hard-and-fast rules, mandates, or defaults might ensure that the system meets certain high-priority goals, but they might also create pressure for exceptions. The following list summarizes the issues that arise as individuals approach retirement. How many of these issues would actually be left up to the retiree's choice, and the kind of options that would be available, would depend upon the ultimate design of the payout rules:

- (a) Whether to buy an annuity at all;

- (b) How much of one's account to spend on an annuity;
- (c) Whether the annuity would be indexed for inflation;
- (d) When to buy an annuity;
- (d) Whether to buy a guarantee feature;
- (e) If a guarantee is desired, whether it is period-certain (and for how long) or a refund of premium, and whether it would go to a named beneficiary or to the estate;
- (f) If joint-life annuities were optional for unmarried individuals, whether to buy one and with whom;
- (g) If joint-life annuities were offered or required for married individuals, whether to buy symmetric or contingent products;
- (h) If joint-life annuities were offered or required, what size survivor protection to provide;
- (i) Whether to buy a guarantee in addition to a joint-life annuity;
- (j) Whether to coordinate claiming Social Security with the purchase of an annuity.

## Summary

Life annuities are financial products that can help solve the problem of making a sum of money last for the rest of one's life. Yet, few people choose to buy life annuities and insurers do not seem to actively market life annuities. Investment and tax-deferral products that are called annuities are more actively marketed, but do not have the positive features of life annuities. Genuine life annuities provide varying degrees of protection for annuitants and their families and each of the various features involve some tradeoffs. Policymakers might want to decide what baseline protections would be required depending on the goal of the individual

account system and its relationship to Social Security.

If provision of guaranteed lifelong income were the goal of annuitization, then an inflation-indexed annuity would be important to ensure that the income would maintain its purchasing power even at advanced age. If annuities are not inflation-indexed, retirees could face substantial loss of purchasing power, even over relatively short time periods. Institutional arrangements for providing inflation-indexed annuities are discussed in Chapter Four.

Individual account annuities could be compulsory, partially compulsory, or optional with a wide range of features. In designing the annuitization rules, policymakers will face tradeoffs.

Compulsory annuities would result in higher average payouts for any given premium but the higher payouts would be achieved by requiring the sick, dying, or other short-lived workers to buy a product that might be disadvantageous.

While life annuities can make lump sum retirement savings resemble defined benefits, life annuities and defined benefits are distinctly different. A defined-benefit plan computes a retiree's benefit based on his or her past work record, age, family status, and a variety of other factors. When the retiree qualifies, the specified payments are automatic; there is no purchase. In contrast, an annuity arises from a financial transaction between a seller and a buyer, with the buyer making an immediate sacrifice in exchange for the life annuity contract. Mandating life annuities means requiring people to buy a product they may not want.

Symmetric joint and two-thirds survivor annuities would ensure that widowed spouses receive two-thirds of the amount paid before widowhood. A one-earner couple's monthly income from such an annuity is smaller than the income a single person would receive from the same size account for two reasons. First, joint-life annuities start out lower than single-life annuities because of the added cost of covering two lives

without subsidy. Second, only two-thirds of the reduced amount is paid to the survivor after the spouse dies.

A great deal of variation remains in how annuities might compare to traditional benefits for dual-earner couples if symmetric joint and two-thirds survivor annuities were required. The higher earner in the couple would often have a smaller annuity than his single counterpart. This does not occur with traditional Social Security because survivor protection is subsidized. Yet, couples with more nearly equal earnings could have higher annuities as widowed spouses than they would have had if they were single because they can combine the survivor payments from their own accounts and their deceased spouses' accounts. If an individual account plan is a part of Social Security, the ultimate impact on combined income from the annuity and traditional benefits will depend on the size of traditional benefits, the accounts, and how, if at all, they are coordinated or offset against each other.

Annuitization also involves tradeoffs between the interests of retirees and the interests of their heirs. An annuity purchase marks the end of an heir's possibility of inheriting the funds. Guarantee features could provide the possibility that heirs would receive some portion of the price paid if the annuitant dies early, but the guarantee lowers the annuitant's lifetime income. Partial annuitization—setting aside part of one's account for bequest purposes—could also help accommodate the interests of heirs.

Again, however, this accommodation comes in exchange for a smaller monthly payment for the retiree.

The timing of annuity purchase can make an important difference in the protection it provides. For example, whether a married person dies right before buying a joint-life annuity, or just after buying such an annuity, would make a significant difference in the widowed spouse's survivor benefit. This disparity occurs because the sum of the survivor benefits from both spouses' joint-life annuities will always be less than the single-life annuity the widow could buy with the combined balances from both accounts. These features could affect policies about the timing of mandated annuitization.

In general, delaying the purchase of an annuity allows time to gather more information to aid the annuity decision. Changes in marital status, life expectancy, or annuity terms (such as interest rates) will alter the payout for a given premium. However, taking phased withdrawals or any other consumption of funds during the delay period will generally reduce the size of the annuity one could buy later.

The following chapters provide more detail on the many individual issues that are relevant to the decisions about payout rules. As this chapter has made clear, the goal of providing retirement income security requires acknowledging the interests of individuals beyond the particular retiree.

## Chapter Three Endnotes

- 1 Cost-of-living adjustments to Social Security benefits are based on the increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W), referred to here simply as inflation.
- 2 Estimates of equivalence scales in the economics literature vary. See Citro and Michael (1995), pp. 166-182.
- 3 This chapter focuses on life annuities – that is, products that guarantee payments for the life of the annuitant. Other financial products are called “annuities,” but are not life annuities. These products are also discussed in Chapter Four. “Deferred” annuities, sometimes called “variable” annuities, are tax-favored investment products that do not guarantee payments for life, although they can be converted to life annuities. These products are essentially mutual funds wrapped in a life insurance contract. While these deferred annuity products offer participants an option to convert the balance into a life annuity at retirement, there is no requirement that they be converted and only a small fraction of contracts are converted in this way.
- 4 Civilian pensions are paid from the Federal Employees’ Retirement System (FERS), which began in 1986, and the older Civil Service Retirement System (CSRS). Employees in FERS are covered by Social Security and a supplemental pension and the TSP. CSRS employees are not covered by Social Security, but have a pension that is designed to fill the role of both Social Security and a supplemental pension.
- 5 This discussion assumes that the individual account would be a countable asset and annuity income would be countable income for purposes of the SSI and Medicaid means tests. Whether the accounts are or should be are important policy questions that are discussed in Chapter Five.
- 6 Married TSP retirees in the Federal Employees Retirement System can withdraw or transfer their account funds only if the spouse consents; married Civil Service Retirement System participants may withdraw funds after notice has been given to the spouse.
- 7 Many such proposals would cap the 75 percent survivor benefit for dual-earner couples so as to target the benefit increases only to low- and moderate-income couples. Some versions of this proposal would also lower the spouse benefit from 50 to 33 percent of the retiree’s benefit. This achieves a 75 percent relationship between the retiree or widow’s benefit and the couple’s benefit (100/133), by lowering the couple’s benefit rather than by increasing survivor protection for those couples.
- 8 Under the Social Security dual-entitlement rules, a widowed spouse receives an amount equal to the larger of his or her own benefit or up to 100 percent of the deceased partner’s benefit. The survivor does not receive both benefits in full.
- 9 The joint-life annuity, in this case, is larger than the single life annuity because the joint-life annuity pays less when the primary annuitant is widowed, which is highly probable when the spouse is 12 years older. Illustrative annuity amounts are for those purchased in 2005. Annuities purchased in future years are likely to show similar relationships among age groups, but will be different dollar amounts.
- 10 As previously noted, a 10-year certain annuity guarantees that the regular payments will continue for at least 10 years; a refund of premium annuity pays a lump sum equal to the amount by which total payments fall short of the initial premium.
- 11 A rarely used provision of the Social Security Act, section 201(i), authorizes the Social Security trust funds to accept gifts and bequests. Individuals can decline benefits and designate them as unconditional gifts to the trust funds, if they wish. In 1980, 59 gifts were received. Most were less than \$100, while one was over \$10,000 (U.S. SSA, 1982).

# Chapter 4

## Institutional Arrangements for Providing Annuities

A life annuity is an insurance product that promises payments for as long as the annuitant lives. Chapter Three explored how policymakers might set rules for workers to withdraw funds from their individual account at retirement. One policy option would grant retirees broad latitude to withdraw funds as they wish, as is common in voluntary, supplemental retirement savings plans in the United States. To date, when retirees are given these choices, few buy life annuities. Other policy options would place much more emphasis on the purchase of life annuities at retirement. Proposals that view the proceeds from the accounts as an integral part of Social Security often require, or strongly encourage, the purchase of a life annuity that is indexed for inflation and that automatically provides income for a spouse widowed after retirement.

This chapter considers the institutional arrangements for providing life annuities. It begins with background on the U.S. annuity market and how it is regulated by the states. Both the existing private market (model 1) and a modified private market that reflects the role of the federal

government in designing annuity options for retirees in the federal employees' Thrift Savings Plan (model 2) are described. Either of these existing models might be compatible with a system of voluntary retirement accounts on top of Social Security that offers retirees wide choice about payouts, but neither is likely to be appropriate for individual accounts that aim to replace part of Social Security retirement benefits.

This chapter also examines new arrangements for providing inflation-indexed life annuities – products that are rarely found in the U.S. market today—and describes hybrid models for providing inflation-indexed annuities on a broad scale, assuming that such annuities are mandated or strongly encouraged in a new system. Model 3 emphasizes a private sector role, with the federal government helping insurers to hedge inflation risk. In model 4, the federal government or a quasi-governmental administrative authority takes on administrative tasks, but leaves the management of mortality and investment risk with the private sector. In model 5, the

federal government serves as the annuity provider and contracts out investment management activities to the private sector.

## U.S. Market in Life Annuities

Life annuities are insurance products that respond to two contrasting features of human mortality—while the length of life of any individual is quite uncertain, the distribution of life spans of a large group of persons can be predicted with a much higher degree of accuracy. From an insurer’s perspective, life annuity contracts complement life insurance policies. Both products insure the uncertain duration of individual lives, but in opposite directions. Life insurance protects the insured against the financial consequences of dying early (that is, dying before the insured’s financial goals for his or her survivors have been met), while a life annuity protects against living long (that is, against the risk of outliving one’s savings).

In the United States, life annuities are provided by life insurance companies and are regulated by the states. Key aspects of the life annuity market involve the assumption of mortality risk and investment risk, the design of annuity products, and issues in pricing and marketing annuities. As regulators, the states are responsible for monitoring the financial soundness of annuity providers and for providing a degree of protection to customers in the event of insurance company failure.

### Mortality and Investment Risk

Operating a life annuity pool in the current U.S. market poses at least two kinds of risks to the annuity provider – mortality risk and investment risk.<sup>1</sup> *Mortality risk* refers to the danger to the insurer that the life spans of persons in the annuity pool will exceed the mortality assumptions on which the annuity contracts were priced. In this case, the insurer will have to make payments longer than anticipated, which will erode company profits or cause outright losses. Insurers price their life annuity products based on the expected mortality for the insured

group, projected investment returns, plus a margin for administrative costs, marketing costs, and profit.

*Investment risk* inheres in the process of investing the assets needed to support the promised annuity payments. In the case of a life annuity, the insurer usually takes in a large sum of money up front, which it will invest to earn returns until the annuity obligation has been fully paid. Because life insurers invest largely in corporate bonds and other fixed-income securities, interest rates have an important effect on annuity pricing. Higher interest rates lead to more investment income, which allows the insurer to charge less for a given level of annuity payment.

### Annuity Products

Many products are called “annuities” but are not life annuities. It is important to distinguish life annuities from deferred annuities and term annuities (see Box 4-1).

Only life insurance companies provide *life annuities*, which are contractual obligations requiring the insurer to make payments to the annuitant for the rest of the annuitant’s life. The insurer assumes both mortality and investment risk.

*Deferred annuities* are tax-favored investment products that do not guarantee payments for the life of the annuitant. The account holder has the option to use the funds in a deferred annuity account to buy a life annuity, but relatively few people do so. The product is used mainly as a mechanism for deferring taxes on fund accumulations. *Fixed term annuities* are also different from life annuities. A term annuity is a contract to pay the annuitant a specified amount of money for a specified period of time – such as five or ten years. The provider of a term annuity bears investment risk, but does not take on mortality risk.

Life annuities can be designed and priced to provide a fixed nominal payment over time, to grow by a specified percentage each year, or to

## Box 4-1. Types of Annuities

### Different Products

*Life annuities* are issued by insurance companies and are a contractual obligation to make payments for the life of the annuitant. Typically, one buys a life annuity by paying a lump sum or “single premium” to the insurance company.

*Deferred annuities* are tax-favored investment products that do not provide payments for life, but they can be converted to life annuities. The account holder has the option to use the proceeds to buy a life annuity, but relatively few do. The product is used mainly as a mechanism for tax deferral during fund accumulations.

*Fixed term annuities* are contracts that promise specified payments for a given term, say five or ten years. The annuity provider bears no mortality risk.

### How Do Life Annuity Payments Change Over Time?

A *fixed life annuity* pays a flat dollar amount, usually monthly, for the life of the annuitant.

*Rising life annuities* pay amounts that rise at a prescribed rate, say 3 percent per year, for the life of the annuitant.

*Inflation-indexed life annuities* pay monthly amounts that are adjusted each year to keep pace with the consumer price index.

*Variable life annuities* pay benefits that vary from year to year depending on investment returns. Payments can go down as well as up. The annuitant bears all or part of the investment risk.

*Participating variable life annuities* are variable life annuities in which the risk of changes in life expectancy is shared between annuitants and the annuity provider. TIAA-CREF provides participating variable life annuities.

### How Many Lives Are Covered? What Does the Survivor Get?

*Single life annuities* make payments only for the life of the individual annuitant.

*Joint-life annuities* make payments for the life of the primary annuitant and a secondary annuitant (typically the primary annuitant's spouse).

*Symmetric joint-life annuities* pay the same amount to a widowed primary annuitant as would be paid to a widowed secondary annuitant. The payment to the longer-lived person could be 100 percent, 75 percent, 67 percent, or any other fraction of the amount paid while both were alive.

*Contingent joint-life annuities* pay a lower amount to a widowed secondary annuitant than to a widowed primary annuitant. The primary annuitant's payment is not reduced if he or she is widowed. If the secondary annuitant is widowed, the payment could be 75 percent, 67 percent, 50 percent or any other fraction of the amount previously paid to the primary annuitant.

### Guarantee Features

A *ten-year certain annuity* will make payments for ten years, even if the annuitant dies within ten years. Period-certain annuities can guarantee five, ten, twenty, or other durations of payments.

A *refund of premium annuity* guarantees to pay until the sum of payments equals the nominal purchase price of the annuity.

be inflation-indexed. Life annuities can also be designed to shift part of the investment risk and returns or the mortality risk to the annuitants. For example, variable life annuities guarantee payments for life, but have the annuitant share in all or part of the investment risk.

Participating variable life annuities also guarantee payments for life, but have annuitants share in both investment risk and changes in life expectancy that occur after the annuity is purchased.

### Size of the Life Annuity Market

Life annuities are a relatively small share of the total business of life insurance companies. Of life insurance companies' \$300 billion in new product sales annually, life annuities represent about 5 percent, or \$15 billion, of which \$5 billion is annual direct sales of life annuities and about \$10 billion represents the conversion of deferred annuities to life annuities (LIMRA International, 2004). Other products, including life insurance and deferred annuities, constitute 95 percent of the volume of insurance company business.

Some experts in the insurance industry see life annuities as an area for growth, particularly as private pensions and retirement plans shift from monthly payments to lump-sum payouts. Obstacles to growth in this market appear to be consumers' weak demand for life annuities, as discussed in Chapter Three, and financial advisors' limited interest in marketing them. From the advisor's perspective, life annuities have two drawbacks compared to deferred annuities: life annuities generally pay smaller commissions (typically 4 percent) than do deferred annuities (typically 6 percent). Perhaps more important, deferred annuities hold the prospect for future transactions and commissions, while the purchase of a life annuity ends the advisor's opportunity to generate future business from the funds because the money is turned over to an insurance company in exchange for the annuity contract. It remains an open question whether and how consumer demand for, and the marketing of, life annuities will change as future retirees

receive less of their retirement resources in the form of monthly income. New individual accounts that required, or strongly encouraged, the purchase of annuities would change the existing market.

### Pricing and Marketing Annuities

Insurance companies have considerable latitude in the design of life annuities, as suggested by the many features described in Box 4-1. Joint-life annuities, which will pay for the life of the primary annuitant and a secondary annuitant (typically a spouse), offer various choices about how much will be paid to the longer-lived annuitant. Guarantee features ensure continued payments to the annuitant's heirs if the annuitant dies shortly after buying an annuity. As discussed in Chapter Three, while these guarantee features lower the size of the monthly annuity, they appear to be quite popular among annuity buyers.

In pricing life annuities, insurance companies seek characteristics that are good predictors of their customers' future life spans. Insurers put together groups of purchasers with similar mortality risks to estimate the necessary price. The most obvious characteristics are age, health status, and sex. While differentiation by age has not been controversial, policy views differ with regard to differentiation by sex or health status.

#### *Price Differences between Men and Women*

A key policy issue with regard to individual account annuities is the extent to which annuity providers will be allowed to differentiate prices between men and women. In the individual annuity market, insurers charge different prices because women live longer than men, on average. For example, a 65-year-old who wishes to buy an annuity with \$10,000 is offered \$65 a month, if male, or \$62 a month, if female ([www.annuityshopper.com](http://www.annuityshopper.com)). While this differentiation is common in the individual annuity market, federal policy bans sex discrimination in group annuities or pensions that are provided as part of an employment relationship. The U.S. Supreme Court ruled in 1978 that Title VII of

the Civil Rights Act of 1964, as amended, forbids this differentiation in employee benefits, even if it is justified on actuarial grounds (City of Los Angeles Department of Water and Power v. Manhart, 1978).

If individual accounts require unisex pricing, men might be discouraged from buying annuities. From an insurer's perspective, men would be more profitable customers, on average. Yet, to the extent that individual accounts require or encourage the purchase of joint-life annuities for married individuals, the sex differences diminish because mortality assumptions for husbands and wives are averaged in pricing joint-life annuities (Brown, 2002). Still, a requirement for unisex pricing would lead insurers in the single-life annuity market to favor men over women, unless other mechanisms were in place to avoid market segmentation (Box 4-2).

#### *Price Differences between Healthy and Unhealthy People*

In the U.S. annuity market, price distinctions between healthy and unhealthy annuity buyers have not yet developed. Relatively few people buy life annuities and those who do buy them tend to have above average life expectancy. But if the purchase of annuities were to become much more widespread, or even mandatory, the question of explicit price distinctions between sick and healthy buyers is likely to become important. In the United Kingdom, where purchase of annuities is required by age 75, a market for "impaired life" annuities has emerged. In 2002, the impaired life market accounted for 9 percent of total individual annuity premiums in the UK. This was roughly a 50 percent increase in volume of impaired life annuity premiums over the prior year. Industry experts in the UK estimate that the payout rate on these annuities is about 5 percent to 20 percent higher than ordinary annuities (Watson Wyatt, 2003).

If a U.S. system of individual accounts called for mandatory annuities, access to impaired life annuities is likely to become important to individuals with short life expectancies. Impaired life

annuities are discussed briefly in Chapter Seven with regard to payouts for disabled-worker beneficiaries when they reach retirement age. A drawback of impaired life annuities is that they increase the cost of annuities for healthy retirees.

#### *Other Factors Affecting Annuity Pricing*

Annuities purchased from different vendors may be priced differently because insurers may have different cost structures and profit margins. One study found a difference of about 20 percent in the annuity payouts between the ten highest and ten lowest payout companies in the United States in 1995 (Mitchell et al., 1999). Estimates of overhead charges associated with annuities require a number of assumptions and are difficult to calculate. A study of the U.S. markets in the late 1990s estimated average overhead charges to be in the range of 5 percent to 15 percent of costs for annuity purchasers and found roughly comparable overhead charges in studies of foreign annuity markets (Brown et al., 2002).

In addition to differences in administrative costs, annuity providers may have other reasons to offer different prices to different customers. For example, companies may be willing to offer a better deal on annuity prices to customers with whom they have (or hope to have) business involving other financial products and services. Wealthy account holders would be attractive annuity customers on this score.

Companies may also price life annuities differently because they have different views of future mortality rates or because they follow different strategies about how aggressively they pursue new business.

#### *State Regulation of Life Insurers*

The life insurance and annuity business has long been a sphere of intense governmental regulation. A striking feature of insurance regulation in the United States is that Congress ceded this regulatory authority to the states under terms of the McCarran-Ferguson Act of 1945. While there is a strong component of federal regulation

### Box 4-2. Adverse Selection, Uniform Pricing, and Selective Marketing

The cost of providing insurance varies based on the risk characteristics of the persons being insured. Because it is cheaper to provide life annuities to people with short life expectancy, insurance companies will tend to charge them less than they charge individuals with longer life expectancy. In a voluntary annuity market, if a company priced its annuities based on average risks and charged everyone the same price, people with longer life expectancy would be more likely to buy the annuities, while people with short life expectancy would not. This *adverse selection* would drive up the cost to the insurer and lead the company to raise its prices. The higher prices would further discourage short-lived people from buying annuities.

Adverse selection occurs when the purchase of insurance is voluntary and sellers do not charge different prices for buyers who pose different risks. If policymakers wanted *uniform pricing* of annuities for people of the same age (regardless of sex, health status, or other risk factors), then the simplest way to avoid adverse selection would be to remove participant choice. Proposals that mandate the purchase of life annuities minimize adverse selection, as long as all sellers use uniform pricing. If a dual market were to exist (i.e., where buyers can choose between government-provided annuities with uniform pricing or privately provided annuities differentially priced based on risk), then adverse selection would again occur.

Even when annuity purchase is required and all annuities use uniform pricing, adverse selection could occur if buyers have a choice among types of annuity products. For example, if annuities were mandatory, but retirees could choose whether or not to buy a guaranty that the full purchase price would be paid back to the annuitant's heirs in the event of an early death, then retirees with short life expectancies would prefer this feature. This adverse selection in favor of guaranty features among short-lived annuitants would introduce some increase in the average price of annuities for everyone.

Uniform pricing in the presence of differential risk can lead to *selective marketing*. If multiple annuity sellers are competing for the same pool of buyers, sellers will have an incentive to seek out participants with shorter life expectancies. For example, if policymakers required uniform prices for men and women, then insurers would prefer to sell annuities to men because they have shorter life expectancy. Regulations could be put in place to discourage explicit targeting, but sellers might still find indirect ways to attract male customers, such as by advertising in men's magazines, male-oriented television sports programs, or commercials geared to appeal to men. It is difficult for regulators to stop selective marketing without direct government oversight of marketing activities.

of the banking, securities, and defined-benefit pension industries in the United States, regulation of the insurance industry remains under the jurisdiction of the 50 states. Important areas for regulation include the design and pricing of annuities, standards for determining insurers' financial backing for annuities, and provisions

for guaranteeing payments in case of insurance company failure.

#### *Licensing, Approval of Products, and Pricing*

States have licensing rules for insurance companies and agents that do business within their borders. States typically also require companies to submit new products for approval. In the

individual life annuity market, insurance companies are generally permitted to set prices based on their own underwriting criteria.

### *Financial Backing for Annuities*

Regulations on the financial backing of annuities include: (a) limitations on investment in risky assets, such as common stocks, (b) reserve requirements, and (c) minimum capital standards. Some states limit the extent of insurance companies' investment in stocks explicitly, while others do so by requiring additional assets (or capital requirements) when funds are invested in stocks, effectively limiting stock investment.

For every life insurance or annuity contract on its books, a life insurance company must hold assets backing their reserves. Required reserves for life annuities are the insurer's legal liabilities, which are calculated according to formulas set by states using specified mortality tables and interest rates. Each state's laws and regulations specify the minimum amount of reserves for various products. Most state laws closely follow the "standard valuation law" developed by the National Association of Insurance Commissioners, the national organization of state insurance regulators.

Capital requirements come in two forms. First, an insurance company must have a certain minimum level of capital to be licensed in a given state, and this requirement varies from state to state. Second, additional capital requirements depend on each company's investments and other risks. If a company invests in Treasury bonds, it does not need to hold additional capital to guard against default risk (or most other risks), but it pays a price in terms of lower returns. If a company chooses to invest in stocks, then state regulators require that additional capital be held as a form of insurance against the various risks associated with investing in stocks. These capital requirements are not "reserves" in that they are not directly related to specific contractual obligations.

### *State Guaranty Funds*

The 50 states and the District of Columbia have set up guaranty funds to ensure payment of annuities and other life insurance products in the event of an insurance company failure.

Unlike federal insurance programs – such as the Federal Deposit Insurance Corporation, which insures bank deposits, or the Pension Benefit Guaranty Corporation, which insures defined-benefit pensions – state guaranty funds are not pre-funded. Instead, funds must be found to cover the cost of an insurance company failure after it occurs, by making assessments on (that is, taxing) other companies doing business in the state. In general, these guaranty funds provide insurance coverage for annuities up to a net present value of \$100,000.<sup>2</sup> To the extent that an annuitant has a policy or policies above the coverage limit, the uninsured portion would represent a claim on the receivership of the failed insurance company and, in all likelihood, would not be paid in full. State laws limit the amount of insurance company assessments that can be made per year, based on total premium volume. This capacity might be inadequate to meet potential losses if several large insurers fail.

The National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) was set up about two decades ago to help states deal with insurance company insolvencies that involve three or more states. About 150 such insolvencies involving multi-state insurers have occurred since NOLHGA began in 1983; most were small insurers. Total state guaranty association assessments since 1988 add up to about \$5.8 billion. The largest insolvency involved Executive Life Insurance Company of California and its subsidiary, Executive Life of New York. So far, state guaranty associations have paid about \$2.5 billion across the country for the Executive Life insolvency ([www.NOLHGA.org](http://www.NOLHGA.org)). Ultimate losses to policyholders remain in dispute (Box 4-3).

In general, when an insurer licensed to write insurance in a particular state becomes insolvent, that state's guaranty association (made up

### Box 4-3. Executive Life Insurance Company

In 1991, the failure of a large insurer active in the pension annuity markets, Executive Life Insurance Company (ELIC) of California, resulted in defaults that imposed losses on pension plan participants. In the 1980s, Executive Life had been particularly aggressive in soliciting annuity business from terminating defined-benefit pension plans. It attracted this business by underpricing its competitors. Executive Life obtained its price advantage by pursuing a higher-risk investment policy, investing heavily in so-called junk bonds. When the junk bond market declined, Executive Life became insolvent. In receivership, Executive Life was able to pay its pension annuitants about 70 cents on their promised dollars (Langbein and Wolk, 2000; U.S. GAO, 1992). State solvency funds covered policyholder losses up to state guaranty limits.

As part of a comprehensive rehabilitation plan adopted in September 1993, policyholders were given a choice to “opt-out” and accept new coverage from another company (Aurora Life Assurance Company) or “opt-in” and surrender their policies for cash. Over the years, as ELIC assets were liquidated, proceeds were distributed to Aurora toward the policies of those who “opted-in” and to individual ELIC policyholders who “opted-out.”

In 1999, the Insurance Commissioner of California sued the entities that bought junk bonds from ELIC during the rehabilitation and the owners of Aurora Life Insurance Company. The suit alleges that they intentionally deceived the Commissioner in order to gain control of ELIC’s junk bonds and insurance policies. The suit seeks return of all profits gained by the defendants, or alternatively, all damages caused by their deceit. Any recoveries from the lawsuit would go to the policyholders (Conservation and Liquidation Office, 2002). The ultimate size of losses experienced by ELIC policyholders who were not fully covered by state guaranty funds remains in dispute (Executive Life Action Network, 2004).

of all insurers who are licensed in the state) is responsible for providing protection to all resident policyholders or annuitants of the insolvent insurer. Annuitants in states where the insolvent insurer is not licensed are covered, in most cases, by the guaranty association in the state where the insolvent insurer is located ([www.NOLHGA.org](http://www.NOLHGA.org)). Because each state writes its own rules about guaranty rules, jurisdictional disputes could arise if other large annuity providers were to fail, although NOLHGA attempts to minimize these disputes.

Jurisdictional boundaries are important because life annuities are long-term contracts and an annuitant sometimes moves away from the state of purchase. Depending on the state law, the guarantee might not cover out-of-state residents. To consider an example, suppose that John bought a life annuity from XYZ Insurance Company in Michigan and later moved to

Florida. Then XYZ Insurance Company failed. Would other insurance companies in Michigan be obligated to make good on XYZ’s broken promise to John in Florida? If the failed XYZ Insurance Company was also licensed in Florida, would the Florida guaranty fund (funded by Florida insurers) be required to make good on the promise to John? State rules may differ about exactly which annuitants are protected, what amounts are covered, which insurers’ obligations are covered, and which other insurers will be taxed to meet those obligations. So, considerable complexity could ensue if one or more large annuity providers were to fail.

### *A Framework and Existing Annuity Arrangements*

The various functions involved in providing annuities can be grouped into three broad

categories – risk bearing, management and administration, and regulation. At least three potential entities could perform those functions – private insurers, state governments, and the federal government. A three-by-three framework can show the various combinations of ways to carry out these functions. Before considering new institutional arrangements, this section uses such a framework to describe two models that currently exist: (1) the individual annuity market; and (2) arrangements for offering annuities to federal employees through the Thrift Savings Plan. Either of these approaches might be acceptable for a system of voluntary supplemental savings that offers wide choices about retirement payouts. Neither approach is suggested as a way to provide payouts from accounts that aim to replace, in part, for Social Security retirement benefits. Neither of these models provides inflation-indexed annuities; neither has other federal protections that retirees might expect if the federal government were to require or strongly encourage the purchase of private annuities.

### Model 1: The Current Private Annuity Market

The current market for individual life annuities is quite small. The key players are individuals who wish to buy longevity insurance, insurance companies who provide it, and states who regulate, as shown in Figure 4-1.

Private insurers bear mortality risk and investment risk in offering life annuities. Individual annuitants bear the risk of inflation in that inflation-adjusted annuities are generally not available.<sup>3</sup> Insurers also design, price, and market life annuities, manage their invested assets, and administer payments. All regulatory oversight and solvency guarantees rest with state governments.

Existing institutional arrangements for annuities offered by insurance companies under the supervision of state regulators might be acceptable to policymakers if the individual accounts were voluntary supplemental savings plans in which retirees had broad choices about the form and timing of withdrawals. But current arrangements present many drawbacks for providing wide-

**Figure 4-1.** *Current Private Annuity Market and State Regulation*  
*Actual Division of Responsibilities*

	Federal Government	State Government	Private Life Insurers
<b>Risk Bearing</b>			
Mortality risk			X
Investment risk			X
Inflation risk	n.a.	n.a.	n.a.
<b>Management</b>			
Annuity design			X
Pricing			X
Consumer education & marketing			X
Administration			X
Investment management			X
<b>Regulatory Oversight</b>			
Annuity design		X	
Consumer education & marketing		X	
Solvency regulation		X	
Solvency guaranty		X	

spread annuities to replace part of Social Security. Among the potential drawbacks are: the absence of inflation-indexed annuities in the current market; different prices for men and women, and other market segmentation that might be viewed as problematic; possible shortcomings of the state guaranty system if insurance companies should fail; and potentially inadequate consumer education.

### Model 2: Annuity Arrangements in the Thrift Savings Plan

The Thrift Savings Plan (TSP) for federal employees is another existing model for offering life annuities to retirees. It allows retirees broad choices in form and timing of payouts. It also introduces a federal role in simplifying annuity choices and in consumer education. In its role as plan sponsor, the federal government selects a range of annuity products to make available to its retirees and, through competitive bidding, the government contracts with one or more insurance companies to offer those annuities to retirees.

Under this approach, the federal government acts to simplify the potentially vast array of

annuity choices, negotiates favorable prices, and informs retirees about annuity choices and other payout options. As discussed in Chapter Three (Box 3-2), annuities available in the Thrift Savings Plan include: (a) monthly payments that are fixed or will rise by 3 percent per year; (b) annuities with unisex pricing; and (c) joint-life annuities that are symmetric (such that the payment to the longer-lived annuitant will be the same whether he or she is the primary or the secondary annuitant).

In the Thrift Savings Plan, the retiree is under no obligation to accept any of the annuity choices. He or she can take a lump-sum distribution and shop for an annuity in the individual market. As illustrated in Figure 4-2, private insurers bear mortality and investment risk. The insurer prices the annuity and is responsible for selling and administering it for the TSP participant who buys it. Once retirees buy annuities, they deal with insurance companies on all future transactions. The insurer is responsible for investing the annuity premiums. Regulatory oversight and solvency guarantees remain with the states.

**Figure 4-2.** *Annuity Arrangements in the Thrift Savings Plan*  
*Actual Division of Responsibilities*

	Federal Government	State Government	Private Life Insurers
<b>Risk Bearing</b>			
Mortality risk			X
Investment risk			X
Inflation risk	n.a.	n.a.	n.a.
<b>Management</b>			
Annuity design	X		
Pricing			X
Consumer education & marketing	X		
Administration			X
Investment management			X
<b>Regulatory Oversight</b>			
Annuity design	X		
Consumer education & marketing	n.a.	n.a.	
Solvency regulation		X	
Solvency guaranty		X	

Like the current annuity market model, the TSP approach might suffice for a new system of individual accounts if the funds were envisioned as discretionary supplemental savings and retirees had wide discretion in payouts. TSP goes beyond the purely private market model in that the government ensures that participants have a specified number of annuity choices and requires unisex pricing.<sup>4</sup> Nonetheless, the TSP approach has shortcomings if payouts are considered to be an integral part of Social Security because the TSP does not provide inflation-indexed annuities. Further, reliance on state guaranty funds could be problematic if the federal government were to require, or strongly encourage, retirees to buy life annuities with their accounts.

## Providing Inflation-Indexed Annuities

Life annuities that are automatically adjusted for inflation would expose the insurer to inflation risk in addition to mortality and investment risk. Private insurers in the United States rarely offer such products, yet many proposals for individual accounts call for inflation-indexed annuities.

In theory, there are at least three ways to try to have annuities keep pace with inflation, but only one provides full inflation protection. The first method would be to purchase a variable annuity invested in a portfolio that might keep pace with inflation. Recent research suggests that variable annuities invested in stocks do not ensure inflation protection; in fact, over short time horizons, stock returns and the rate of inflation tend to move in opposite directions (Brown et al., 2001).

Another way to seek inflation protection with existing products would be to buy an annuity that rises at a pre-determined rate, which might match the inflation rate. This strategy would not, of course, protect against unexpected surges of inflation. For example, a 3 percent pre-determined increase in annuity payments would fall short of full protection if the cost of living rose by 10 percent, or if double-digit inflation were

to persist for several years in a row, as occurred in the late 1970s and early 1980s (Figure 3-2).

The third, and only, way to ensure full protection against inflation is to have an annuity be automatically adjusted each year by the actual change in the consumer price index experienced in the recent past. Such products do not yet exist in any significant numbers in the private annuity market in the United States.

Developing a market for such inflation-indexed annuities would probably involve the federal government in some way. The government could issue a large volume of inflation-indexed securities, which private annuity providers could use to hedge inflation risk; the government could reinsure private insurance companies for the inflation risk; or, the government could issue inflation-indexed annuities directly to retirees. Absent any of these developments, inflation-indexed annuities are not likely to evolve (Box 4-4).

## United States Treasury Inflation-Protected Securities

Private insurers might sell inflation-indexed annuities if they could back them with securities guaranteed to keep pace with inflation. U. S. Treasury Inflation-Protected Securities (TIPS) are such a product. The Treasury Department adjusts the principal value of TIPS daily, based on a rolling average of the consumer price index in the recent past. The fixed rate of interest on the security is applied to the adjusted principal and is paid every six months. At maturity, Treasury redeems the security at its inflation-adjusted principal amount (Box 4-5).

Some experts expected that the government's introduction of TIPS in 1997 would launch a market in private inflation-indexed annuities. Several explanations have been offered on why the market has not evolved. Weak consumer demand is one possible reason. Just as there seems to be weak demand for life annuities in general, there seems to be even weaker demand for life annuities that keep pace with the cost of

#### Box 4-4. Private Insurers and Inflation Protection

In theory, private insurers could take on inflation risk if they could charge a sufficiently high premium to cover the risk. A key question is what regulators would require as reserves for such a product. To date, the National Association of Insurance Commissioners has not developed detailed rules for how to compute reserves on true inflation-indexed annuities (as distinct from annuities that rise by a pre-determined percentage each year). Experts in the insurance industry believe, however, that because of states' emphasis on solvency considerations, the required reserves for inflation-indexed annuities would be so large as to make the product essentially impossible to sell. That is, the required capital could be so great as to make inflation-indexed annuities cost more than customers would be willing to pay for the product.

Source: Correspondence, Bruce Schobel, New York Life Insurance Company, 2004

living. If consumers do not understand the risk of inflation, they might prefer a higher initial payment without inflation protection instead of a smaller initial payment that keeps pace with the cost of living.

A second possible explanation is that the supply of TIPS is not yet of sufficient size, duration, and predictability to support a market in inflation-indexed annuities. When TIPS were first introduced in 1997, the Treasury Department issued both 30-year and 10-year TIPS. But in October 2001 Treasury stopped issuing all 30-year securities. Only 10-year TIPS were issued in the next two years. Some new five-year and 20-year TIPS were added in 2004 (Bitsberger, 2004). Today, TIPS remain a relatively small share of the total Treasury securities market; in June 2004 they totaled about \$200 billion, or about 6 percent of the total Treasury securities market of about \$3.3 trillion. Only about \$40 billion in TIPS are of 30 years' duration, a period that insurers might consider necessary to cover life spans of new retirees.

A third possible reason why a market in inflation-indexed annuities has not developed is that insurance companies and their regulators have not yet worked out how inflation risk might interact with the other risks that insurers bear. Even if inflation risk is fully backed by the government through TIPS, inflation-indexed annuity payments would increase insurers' exposure to

mortality risk. That is, with fixed annuities, insurers lose money if they underestimate their annuitants' life spans, but the losses would be mitigated by the fact that unanticipated payments in the distant years would have declined in value due to inflation. If annuity payments in the out years kept pace with inflation, then losses to the insurer due to unanticipated increases in longevity would be much greater.

#### Federal Reinsurance of Private Annuities

Instead of expanding its supply of Treasury Inflation Protected Securities, the government could try to encourage a private market in inflation-indexed annuities by serving as reinsurer for private-sector annuity providers. Reinsurance means that all or part of the original insurer's risk is assumed by another entity in return for part of the premium paid by the insured. The federal reinsurance could be limited to the insurer's risk of inflation in excess of some predicted level, or the government could reinsure the full set of provider risks—that is, mortality and investment risk, as well as inflation.

#### Federal Government as Annuity Provider

The third possible role for the federal government in promoting inflation-indexed annuities would be to provide annuities directly to retirees. The federal government already has experience paying Social Security benefits and

#### Box 4-5. U.S. Treasury Inflation-Protected Securities (TIPS)

TIPS are a special class of Treasury securities. Like other securities, TIPS make interest payments every six months to holders and pay back the principal when the security matures. TIPS are unique, however, in that the interest and redemption payments are tied to inflation.

The Treasury Department adjusts the principal value of TIPS daily, based on the consumer price index (CPI). The fixed rate of interest is then applied to the inflation-adjusted principal. Each interest payment will be larger than the previous one if inflation occurs throughout the life of the security. At maturity, Treasury redeems the security at its inflation-adjusted principal amount (or, in the rare event of sustained deflation, at the higher par value).

TIPS are generally exempt from state and local income taxes but are subject to federal income tax. When the principal grows, the gain is reported as income for the year, even though the inflation-adjusted principal is not actually paid until the security matures.

**Source:** U.S. Department of the Treasury, 2003. Bureau of the Public Debt, Treasury Inflation-Indexed Securities (TIPS)

civilian and military employee pensions indexed for inflation. New issues that arise with the government as an annuity provider are discussed later in this chapter.

Before examining particular arrangements for providing inflation-indexed annuities, we examine three cross-cutting questions. First, how big would the inflation-adjusted annuity market be? Second, what role might capital markets play in providing inflation-indexed annuities (Box 4-6)? And third, how binding is the obligation to pay automatic inflation adjustments, whatever the inflation rate may be?

#### How Big Would the Annuity Reserves Be?

If an individual account system required or encouraged retirees to buy inflation-indexed annuities, how big would the annuity reserves be? The answer would depend on the size of the contributions to the accounts, the investment returns, and the degree to which funds were annuitized. We use three possible benchmarks to illustrate the potential size of annuity reserves in a mature system. The first benchmark is gross domestic product (GDP), which is the value of all goods and services produced by the U.S.

economy in a year. A second benchmark is the aggregate of all publicly held government securities (the federal debt held by the public). Yet a third benchmark is the value of all financial assets in the United States.

As an illustrative plan, we assume that all workers contribute 2 percent of their Social Security taxable earnings to individual accounts, hold the funds until retirement, and then buy inflation-indexed annuities. In this illustrative scenario, the reserves backing the annuities would equal about 15 percent of GDP when the system was fully mature, according to estimates by the Office of the Chief Actuary of the Social Security Administration.<sup>6</sup> This suggests that if the annuities were provided by insurance companies and fully hedged by inflation-adjusted securities issued by the federal government, those securities would amount to about 15 percent of GDP. Similarly, if the government provided inflation-indexed annuities directly to retirees, then reserves held by the government to back the annuities might equal about 15 percent of GDP.<sup>7</sup>

Today, the aggregate of all government securities held by the public (the publicly-held federal

debt) is about one-third of GDP. So, in this scenario, inflation-indexed government securities that would back private annuities might be equivalent to about half of today's federal debt. Or, if government were the annuity provider, its annuity reserves in the illustrative individual account system would be equivalent to about half the publicly held federal debt today.

Finally, we can compare the estimated size of annuity reserves to the value of financial assets in the United States. Today, total financial asset values are roughly twice the size of GDP.<sup>8</sup> This suggests that reserves backing annuities in the fully mature individual account system outlined here might amount to about 7 percent to 8 percent of national financial assets.

#### Box 4-6. A Potential Role for Capital Markets

For the most part, this chapter proceeds as if the risks associated with underwriting inflation-indexed annuities must be borne by private insurance companies and/or the federal government. It is possible, however, that private capital markets might also play a role in assuming some of the risks of underwriting inflation-indexed annuities. Theoretically, the package of risks embedded in an inflation-indexed life annuity could be split into pieces, and capital-market investors could be paid for bearing some portion of these risks. The capital markets now share the risks of underwriting mortgage loans, which financial intermediaries once bore exclusively. By gaining access to new sources of capital in this way, the size of the market for inflation-indexed annuities could grow and the pricing for consumers could improve.

Inflation-indexed annuities carry three main risks that could be broken out: mortality, inflation, and investment performance. Capital markets routinely take on investment risk. But some investors might find mortality risk attractive because it is virtually uncorrelated with other financial investments, increasing the degree of diversification in their portfolios. The property and casualty insurance industry has already discovered that some investors are willing to take on the risk of hurricanes or earthquakes, risks traditionally borne exclusively by insurance companies. Blake and Burrows (2001) have proposed that governments issue "survivor bonds" that would pay out solely on the basis of future mortality rates for the population as a whole. Dowd (2003) has suggested that private markets could equally well meet this need.

There is also room for the capital markets to complement the government's role in taking inflation risk off the backs of the insurers. First, the United Kingdom, which has issued inflation-indexed government bonds for some years, has developed a modest market of privately issued inflation-indexed bonds, such as from utilities. A complementary market could develop in the United States as well. Second, investment banks are capable of creating "synthetic" inflation-indexed corporate bonds by combining Treasury inflation-protected securities with existing corporate bonds. Availability of inflation-indexed corporate bonds might allow insurers to provide better annuity pricing by increasing the rate of return on the investments they use to match future inflation.

The degree to which capital market innovations might facilitate the underwriting of inflation-indexed annuities is a matter of speculation. Experiences over the past few decades suggest that such innovation is at least a possibility. If these market innovations occur, it will be important that regulatory oversight keeps pace in order to handle the greater complexity that can arise when complex instruments, such as mortality bonds or inflation-indexed corporate bonds, are developed to take advantage of the flexibility of the capital markets.

A larger or smaller individual account program would, of course, result in larger or smaller aggregate annuity reserves. For example, if all workers contributed 4 percent of wages instead of 2 percent of wages, the reserves would be twice as big in a fully mature system. These estimates reflect a fully mature system after almost all retirees would be receiving annuities based on lifelong accumulations. The annuity reserves would accumulate gradually as early cohorts of retirees would have been in the individual account system only part of their lives.

### How Binding Would the Government's Inflation-Indexing Obligations Be?

The nature of the government's promise to provide inflation-indexed payments in the future could be somewhat different depending on how the inflation protection is provided. Would the government be: (a) promising future cost-of-living increases to Social Security beneficiaries; (b) issuing large quantities of long-duration, inflation indexed Treasury securities to investors; or (c) entering into inflation-indexed annuity contracts with individual retirees? In considering ways to provide inflation protection to retirees, policymakers may want to also consider the implications of modifying the automatic inflation adjustment if future circumstances should warrant such action.

#### *Social Security as a Statutory Entitlement*

Social Security benefits are a statutory entitlement, which Congress can change by amending the Social Security Act. The benefits are not a contractual obligation of the federal government, as the Supreme Court decided in 1960.<sup>9</sup> While Congress has generally approached changes in future Social Security benefits with care, it has renegotiated the social insurance compact a few times in the past. In fact, some have argued that the very nature of a pay-as-you-go defined-benefit social insurance system will require adjustments in benefits or revenues from time to time to keep it in balance (Diamond, 2004). Changes in automatic cost-of-living increases were part of the benefit adjustments in 1983. In the late 1970s and early

1980s, inflation (on which benefits are based) rose much faster than wages (on which revenues are based). This brought a serious near term shortfall in Social Security finances. The solvency legislation enacted in 1983 included a provision to delay all future cost-of-living adjustments by six months as part of a package of revenue and benefit changes. That provision accounted for 24 percent of the solution to the near-term financial shortfall and about 15 percent of the solution to the long-run imbalance (Svahn and Ross, 1983).

#### *Treasury Securities as Contractual Obligations*

In contrast with Social Security benefits, Treasury Inflation-Protected Securities are contractual obligations that are backed by “the full faith and credit of the United States’ government.” From the federal government’s perspective, issuing long-duration, inflation-indexed securities would represent a more binding commitment to make inflation-indexed outlays in the future than is represented by the promise of inflation-indexed Social Security benefits. It would be a major departure from precedent – with significant implications for domestic and international financial markets – if the government tried to modify the terms of its outstanding debt. Inflation has been modest since Treasury introduced inflation-indexed securities in 1997, so it does not yet have experience with these products during periods of unexpectedly high or erratic inflation.

#### *Inflation-Indexed Annuities as Contract or Promises*

Inflation-adjusted annuities issued by the federal government could, in theory, be designed to have the same legal status as Social Security benefits – that is, a statutory expectation that could be changed through the legislative process. Another option is that they could be designed as contractual obligations backed by the “full faith and credit of the United States’ government,” akin to government bonds. If individuals buy the annuities by relinquishing funds from their personally owned accounts, then the case for treat-

ing the annuities as binding contracts would be stronger. Policymakers may want to address the legal status of the annuity contract and automatic inflation protection in thinking through the design of retirement payouts in a new individual account system.

The next section of this chapter examines hybrid approaches to institutional arrangements for providing life annuities indexed to keep pace with the cost of living.

## *Hybrid Models to Provide Inflation-Indexed Annuities*

If the goal of an individual account plan is to offer widespread life annuities at retirement that are indexed for inflation, then what would be the respective roles of insurers, state governments, and the federal government? This section explores several hybrid arrangements. Model 3 relies on private insurers, but involves the federal government to help insurers bear inflation risk. Model 4 sets up a central administrative authority for administrative activities, but continues to rely on the private sector to insure mortality risk. Finally, model 5 envisions the government as annuity provider, but with investment management functions contracted out to the private sector.

### **Model 3: Private Annuities Backed by TIPS**

Under this approach, the federal government would issue TIPS in sufficient volume and duration to back privately insured, inflation-indexed life annuities. Private insurers would bear mortality risk and investment risk, as illustrated in Figure 4-3. The government might play a role in annuity design, for example, by stipulating unisex pricing and setting minimum standards for joint-life annuities. Nonetheless, retirees might still have a broad range of choices about guarantee features, the timing of annuities, level of survivor protection, and whether to buy annuities at all. The government might also take some role in consumer education. Consumer education responsibilities could be substantial if

retirees have many choices, as discussed in Chapter Three.

In this model, private insurance companies would administer the annuity payments. The insurers would be responsible for making timely payments, adjusting annuities for the cost-of-living each year, keeping track of annuitants' change of address or change of direct deposit institutions, reporting annuity income to the Internal Revenue Service (and withholding income taxes as appropriate), documenting annuitant deaths, and making the transition to survivor payments in joint-life annuity cases.

At least three important policy issues remain in this model with regard to: whether and how to deal with adverse selection and selective marketing in the private annuity market; how the federal government would use and manage the funds it receives when it issues a large volume of TIPS; and whether the federal government would have a role in regulating and ultimately guaranteeing the solvency of private annuity providers or leave it with the states.

### *Adverse Selection and Selective Marketing*

The more choices retirees have about whether to buy annuities, when to buy them, and what type to buy, the greater the likelihood that adverse selection and selective marketing will occur, as discussed in Box 4-2. For example, if federal policy required unisex pricing of life annuities, then men might delay or avoid buying them. At the same time, insurers would want to selectively market life annuities to men, because men would be more profitable customers on average. More generally, if retirees have a choice whether and when to buy annuities, those who are in poor health or believe they have a short life expectancy will avoid or delay buying annuities, which will drive up the average price of annuities for those who do buy them.

### *Government Use of Funds from Sale of TIPS*

If the government issues a large volume of TIPS that insurers would use to back inflation-indexed annuities, how would the government

**Figure 4-3.** *Private, Inflation-Indexed Annuities, Backed by TIPS*  
*Hypothetical Division of Responsibilities*

	Federal Government	State Government	Private Life Insurers
<b>Risk Bearing</b>			
Mortality risk			X
Investment risk			X
Inflation risk	X		
<b>Management</b>			
Annuity design	X		
Pricing		X	
Consumer education & marketing	X		X
Administration			X
Investment management			X
<b>Regulatory Oversight</b>			
Annuity design	X		
Consumer education & marketing	X		
Solvency regulation	??		??
Solvency guaranty	??		??

account for and manage the money it receives from issuing TIPS? Would the long-duration TIPS gradually substitute for existing shorter duration, non-indexed debt instruments as they matured? Or would the long-duration TIPS add to the federal debt? It is possible to envision several ways in which the government might use the new funds. In theory, it might spend the money for current budget obligations, or invest it in public infrastructure (which might resemble spending). Alternatively, it might set up institutional arrangements to invest the funds in private financial markets. These new institutions might seek to wall off investment decisions from other federal priorities.

### *Solvency Regulation and Guarantees*

If the federal government required or strongly encouraged people to buy life annuities, should it guarantee those annuities? According to Mackenzie, (2002), a moral hazard issue could arise if the government guaranteed privately provided annuities. Government guarantees could “create an incentive for the provider to offer excessively generous terms (i.e., relatively

low premiums) to attract customers since customers will suffer no loss even if the company’s investment experience is unfavorable.”

Nonetheless, if the government required or strongly encouraged the purchase of private inflation-indexed annuities, buyers might expect the government to guarantee those annuities in case of insurance company failure. If the federal government were to be the solvency guarantor, then policymakers might want the federal government to have a role in solvency regulation as well – that is, in setting reserve requirements, investment restrictions, and capital requirements. If the government were involved in setting these standards, jurisdictional issues would arise regarding the interaction between federal rules, which (at a minimum) would apply to federally specified life annuities, and state rules, which might still apply to other business of the life insurance companies. The layering of federal and state regulation could introduce new complexities for both insurance companies and consumers.

The life insurance industry is currently developing a proposal to give insurance companies who do business in more than one state the option of operating under federal, rather than state, regulations (Insure.com, 2004). A proposal put forth by the American Council of Life Insurers would create an Office of National Insurers within the U.S. Treasury Department. The Office might resemble the Office of the Comptroller of the Currency for banks, or the Office of Thrift Supervision for savings institutions. A presidential appointee would head the Office, which would be funded by assessments on insurance companies. The new federal Office would oversee consumer protection, marketplace practices, and the regulation of sales and premiums rates. Insurance companies could choose whether to operate under state or federal regulation. Federally regulated insurers would be required to join the guaranty association of each state in which they do business. The proposal would also set up a national guaranty association of insurers operating in states where the guaranty fund does not meet federal standards. To date, the proposal is generally opposed by the National Association of Insurance Commissioners and the National Conference of State Legislatures and has not been acted upon by Congress (Insure.com, 2004).

#### **Model 4: Federal Administration: Private Risk Bearing and Fund Management**

This approach might set up a new central administrative authority – either as part of the government or a new semi-private entity to administer interactions with account holders and annuitants. As in the prior model, the government would issue TIPS in sufficient volume and duration to back the insurers' inflation risk. Private insurance companies would underwrite the annuities and bear the mortality and investment risk as bulk annuity providers described below (Figure 4-4).

The design of annuities would be specified in federal law or regulations. The government would be responsible for consumer education and would sell annuities to individual retirees

and collect their premiums. The government would then package large pools of annuities and contract with private insurers who, in return for receiving bulk premiums, would make future bulk annuity payments back to the government each month to cover promised payments to annuitants. The government would construct pools of annuitants with demographic characteristics that represent the entire population of annuitants. This pooling could avoid the risk of selective marketing by insurers and give the government the capacity to manage adverse selection issues.

For the insurance companies who serve as contractors, the government could set contractual requirements for creditworthiness, servicing capability, or other relevant factors. Insurers who met these requirements would be allowed into a panel where they would be able to bid on the pooled annuities.

The federal government would make the actual payments to annuitants, possibly by adding the annuities to Social Security benefits. The government would be the recordkeeper and would inform each insurance company of the aggregate monthly annuities payable to annuitants in that company's pool each month.

In this model, insurance companies would set prices based on pools set up by the federal government. As with Model 3, two questions remain. First, would the existing system of state solvency regulations and solvency guaranties be sufficient if such annuities were mandatory or strongly encouraged by the federal government? Second, how would the government account for and manage the money it received from the sale of a large volume of long-duration TIPS?

#### **Model 5: Federal Annuity Provider: Private Investment Management**

If the goal of an individual account plan were to produce widespread life annuities at retirement that resemble aspects of Social Security, then the federal government might decide to provide those annuities directly. The federal government

**Figure 4-4.** *Private Risk Bearing and Federal Administration Hypothetical Division of Responsibilities*

	Federal Government	State Government	Private Life Insurers
<b>Risk Bearing</b>			
Mortality risk			X
Investment risk			X
Inflation risk	X -- TIPS		
<b>Management</b>			
Annuity design	X		
Pricing			X
Consumer education & marketing	X		
Administration	X		
Investment management			X
<b>Regulatory Oversight</b>			
Annuity design	X		
Consumer education & marketing	X		
Solvency regulation	??	??	
Solvency guaranty	??	??	

already has experience paying Social Security benefits. As discussed in Model 3, if the federal government were to be the guarantor of individual account annuities, then it might be simpler to have the government bear the risks, rather than have it involved in regulating and ultimately guaranteeing the solvency of private insurers. Figure 4-5 illustrates a framework for arrangements in which the federal government is the provider of inflation-indexed annuities.

As is the case with Social Security benefits, the federal government would bear mortality risk and inflation risk. The government would also design annuities as called for in the individual account law, inform account holders about the new system, educate consumers, and carry out all administrative tasks in dealing directly with annuitants.

If the government were the annuity provider, important issues remain with regard to the investment management function. In contrast to Social Security, genuine life annuities would be wholly prefunded, placing both investment risk and investment management responsibilities on the federal government. The reserves backing

universal annuities that are funded with 2 percent of workers' earnings could amount to 15 percent of GDP when the system is fully mature. This large volume of funds poses a number of new questions. What investment policy would apply to the funds and who would be responsible for the investments? How would the funds be viewed in terms of the unified federal budget?

#### *How Would Annuity Reserves Be Invested?*

Should the investment of annuity reserves follow the rules for the Social Security trust funds, which are invested solely in special-issue Treasury securities? Or should annuity premiums be invested in a more diversified portfolio? Diversification into corporate bonds and stocks would produce higher expected returns over the long run, but doing so would create major concerns in the business community about federal involvement in corporate decisions.

One approach might follow the Thrift Savings Plan precedent, which invests in private indexed funds through one or more private fund managers selected through a competitive bidding process.

**Figure 4-5.** *Federal Annuity Provider and Private Investment Management Hypothetical Division of Responsibilities*

	Federal Government	State Government	Private Fund Managers
<b>Risk Bearing</b>			
Mortality risk	X		
Investment risk	X		
Inflation risk	X		
<b>Management</b>			
Annuity design	X		
Pricing	X		
Consumer education & marketing	X		
Administration	X		
Investment management			X
<b>Regulatory Oversight</b>			
Annuity design	X		
Consumer education & marketing	X		
Solvency regulation	n.a.		
Solvency guaranty	X		

The fund managers’ sole responsibility is to earn returns that match the performance of the index funds. Fund managers do not invest in any particular company’s stocks or bonds. With the TSP, the allocation of funds across the index funds is determined by the aggregate choices of plan participants. If policymakers followed this strategy for investing annuity reserves, some investment board or other entity would need to select the portfolio allocation across various index funds and government securities (Box 4-7).

*How Would Annuity Assets Be Counted in the Unified Budget?*

Budget scoring rules can affect how policymakers think about various types of federal funds when they make taxing and spending decisions. A large volume of annuity reserves – if viewed as government receipts when premiums are received – could distort the federal government’s taxing and spending decisions. So, mechanisms might be needed to segregate annuity reserves from other federal funds. Such arrangements would be a top priority if the federal government were to become an annuity provider. Box

4-8 describes some of the current conventions and issues in budget treatment of various kinds of federal transactions.

**Summary**

Existing institutional arrangements for making annuities available to retirees might suffice for a new system of individual accounts if those accounts were voluntary, supplemental savings, and retirees had wide discretion about fund withdrawals at retirement. But if policymakers wanted to require, or strongly encourage, retirees to take payments in the form of life annuities that resemble Social Security, then new institutional arrangements would be needed. Developing a market for inflation-indexed annuities would involve the federal government in some way. The government might issue a large volume of Treasury Inflation-Protected Securities to help private insurers hedge inflation risk; it might reinsure private insurers; or it might issue inflation-indexed annuities directly to retirees.

The volume of reserves required to back widespread inflation-indexed annuities would be

#### Box 4-7. Examples of Thrift Savings Plan Index Funds

TSP participants have several investment options. The C Fund aims to match the performance of the S&P 500 index; the S Fund aims to track the performance of the Wilshire 4500 index, a broad market index made up of stocks of U.S. companies not included in the S&P 500; and the I Fund aims to match the performance of the Morgan Stanley Capital International EAFE (Europe, Australasia, Far East) index, a market index made up of stocks of companies in 21 developed countries.

#### Box 4-8. Budget Scoring Conventions

**Treasury securities.** When Treasury issues securities, no budget transaction occurs. It is simply an exchange of assets. The government receives cash and issues securities of equal value. There is no budget outlay and no receipt.

**Federal loan programs.** Under the Credit Reform Act of 1990, federal loan programs are scored in a way similar to Treasury securities. Loans are an exchange of assets, but the assets are not of equal value if the loan program subsidizes certain groups. Only the present value of the subsidy is counted as a budget outlay in the year the loan is approved.

**Entitlements programs.** Under the unified budget, Social Security revenues are counted as receipts and benefit payments are counted as outlays. Reserves held by the trust funds are viewed as government money.

**Contributions to the Thrift Savings Plan (TSP).** When federal agencies put money in the TSP accounts of their employees, the money is counted as a federal outlay when it is contributed. The money in TSP accounts is outside the federal government and owned by account holders.

**Federal insurance programs.** Federal insurance activities are generally scored on a cash basis. For example, Pension Benefit Guaranty Corporation premiums are counted as receipts and pension payments are counted as outlays. Experts have recommended that concepts reflected in the Federal Credit Reform Act of 1990 would provide better accounting of federal insurance.

**Federal investment in corporate bonds or stocks.** There are conflicting views about how the federal government's purchase of corporate stocks and bonds should be scored. Office of Management and Budget Circular A-11, a basic document on budget rules, says that such a purchase is a government outlay, while the sale of such assets is a government receipt. Many budget experts believe this rule is wrong. They argue that it would be more consistent to treat the transaction as an exchange of assets. When the assets are of equal value, there is no budget transaction. Consistent with this view, Congress in 2002 allowed the Railroad Retirement Board to invest its assets in stocks and corporate bonds and both the Congressional Budget Office and the Office of Management and Budget scored the transactions as an exchange of assets.

**Sources:** Douglas Elliott, Center on Federal Financial Institutions, and Richard Kogan, Center on Budget and Policy Priorities, personal communication, 2003

substantial. Reserves backing universal annuities funded with 2 percent of workers' earnings could amount to 15 percent of GDP when the system is fully mature. Whether the government provides annuities directly to retirees or provides TIPS to back privately issued annuities, the government could be holding very large amounts of assets backing the annuities. A key question for policymakers to address would be who would manage and invest the large volume of assets. New arrangements might be needed to segregate the funds from other taxing and spending functions of the federal government and new institutions might be needed to provide for prudent and diversified investment of the funds.

If inflation-indexed life annuities were provided on a widespread or universal basis by private insurance companies with backing from TIPS, policymakers might want the federal government to be involved in guaranteeing the solvency of the insurance companies. Unlike federal insurance funds – such as the Federal Deposit Insurance Corporation, which insures bank deposits – solvency of private insurance companies is left to the 50 states. Proposals for the federal government to charter life insurance companies might gain broader interest if life annuities were to be encouraged or required by federal policy.

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## Chapter Four Endnotes

- 1 Annuities that are automatically adjusted for inflation would also expose the insurer to inflation risk. Such products are rarely available in the U.S. annuity market. Issues and options for providing inflation-indexed annuities are discussed later in this chapter.
- 2 The \$100,000 cap in some cases applies to the sum of all life insurance and annuity products a customer has with the company. In some jurisdictions the cap, or combined cap is higher, say \$300,000.
- 3 With rising life annuities, as described in Box 4-1, annuitant would have inflation protection as long as inflation did not rise faster than the annual adjustment in annuity payments.
- 4 Some consumers might find it advantageous to buy annuities in the private market if they have short life expectancies that permit more favorable pricing. This adverse selection could cause price differentials to reemerge to some degree, notwithstanding uniform pricing for federally negotiated options. See Box 4-2, Adverse Selection, Uniform Pricing and Selective Marketing.
- 5 Cost-of-living adjustments to Social Security benefits are based on the increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W), referred to here simply as inflation.
- 6 The estimate assumes that individual account funds earn a net real return of 4.6 percent per year and that annuity reserves earn a net real return of 3.0 percent per year. When the system is fully mature, total assets in accounts plus annuity reserves would be about 45 percent of GDP. Annuity reserves would be about 15 percent of GDP, while accounts not yet annuitized would be about 30 percent of GDP. For comparison, TIAA-CREF, the largest defined-contribution retirement system in the United States, has combined assets in retirement accounts and annuity reserves of about 3 percent of GDP today.
- 7 The entire portfolio of annuity reserves might not be invested in inflation-indexed securities. The point of this estimate is to suggest the size of the assets backing the inflation-indexed annuities.
- 8 The market valuation of domestic based equities is roughly equal to GDP. Adding all government and corporate bonds brings the total to roughly two times the size of GDP.
- 9 The Supreme Court found that “To engraft upon the Social Security system a concept of 'accrued property rights' would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands.” — *Fleming v. Nestor*, 363 U.S. 603 (1960).

# Chapter 5

## Pre-Retirement Access to Individual Accounts

Individual savings accounts for retirement pose an essential question: would workers have access to the money in the accounts *before* retirement? If so, what limitations would there be on pre-retirement access to the funds? This chapter reviews issues that might influence the rules for early access to the funds, including the various precedents and options for access rules.

Four options are presented for access rules before retirement. *Option One: Broad Early Access* allows unconstrained access to the funds and is based on the precedent of Individual Retirement Accounts (IRAs). *Option Two: No Early Access* is at the other end of the spectrum. Through banning access to the retirement funds, Option Two aims to resemble features of Social Security. *Option Three: Limited Early Access* aims to discourage, but not wholly ban, pre-retirement access to the funds. Finally, *Option Four: Access Only Above a Threshold* bans early access in the same way as Option Two, but the ban is lifted on account accumulations that exceed some threshold thought to produce an adequate level of retirement income.

Specific policy and implementation issues are raised by the various options. For instance, allowing early access raises policy questions about the type and form of access—whether loans or withdrawals, and for what purposes—and the types of restrictions, if any. Any restrictions, as well as an outright ban on early access, would require enforcement mechanisms and oversight.

No matter which rules are chosen, questions will arise about how early access rules would affect creditor claims and the account holder's eligibility for means-tested assistance.

### *Framework for Analyzing Access Rules*

Would workers be allowed to withdraw funds from their accounts before retirement? If so, would there be any limits on the amount or form of the withdrawals? The answers to these questions will depend, in part, on at least four factors: the intended purpose of the account funds; the nature of the property rights associat-

### Box 5-1. Lessons from Individual Development Accounts

Individual development accounts (IDAs) are subsidized savings accounts earmarked for low- and moderate-income individuals' wealth building. Savings are subsidized for individuals through matching funds, not tax breaks. Participants earn matching funds for specified uses, usually the purchase of a home, post-secondary education, or to start a business; sometimes automobile purchases and retirement are permitted uses. IDAs have been tested in demonstrations funded by public and private sources starting in the late 1990s, but have not yet been established on a permanent, national basis. At least 20,000 Americans are saving in IDAs.

The American Dream Demonstration, funded by a consortium of private foundations,<sup>1</sup> enrolled about 2,400 participants in 13 sites around the country, and another 840 in one experimental site. The demonstration ran from 1997-2003 (Schreiner et al., 2002).

Separately, the 1998 Assets for Independence Act authorized federal funds for IDA demonstrations run by the Office of Community Services in the U.S. Department of Health and Human Services. Community-based, nonprofit organizations (project grantees) received federal funds to sponsor IDA programs for low-income workers. The workers enter into a savings plan agreement that sets goals and schedules. Savings used for approved purposes are matched (which under federal rules could range from \$1 for \$1 to as much as \$8 for each \$1 saved, although the typical match rate was \$2 for every \$1 saved). The matched savings can be used only for: (1) the purchase of a first home; (2) to start a business; or (3) post-secondary education. Participants must attend financial education classes. Withdrawal of subsidized savings requires the written approval of both the low-income saver and a project grantee official. Withdrawals of the saver's own money for other purposes are discouraged and result in a loss of matching funds. Certain statutorily defined emergency withdrawals are permitted, but matching funds are forfeited if withdrawn funds are not replaced within 12 months (Office of Community Services, 2001).

No formal evaluations are yet available from the Assets for Independence demonstration; however, Abt Associates and others have evaluated the privately funded American Dream Demonstration, yielding some useful findings. Most important, Abt reported "the findings from this evaluation provide important new evidence that an IDA program can have significant favorable impacts on asset-building among low-income persons" (Mills, et al., 2004).

The key lessons from IDAs are that low-income people can and do save, and that low-income people have multiple savings needs, not just long-term asset accumulation. As expected, the amounts are modest. The researchers found that saving was not strongly related to income, welfare receipt, or most other individual characteristics. Accordingly, institutional factors appear to shape savings success. Those factors include: (a) access to a savings plan; (b) incentives in the form of matching funds; (c) financial education; (d) making savings easy through direct deposit and default participation; (e) setting targets and creating social expectations; and (f) restrictions on access (Sherraden and Barr, 2004).

This "hands on" approach is costly relative to the net savings achieved (and higher than pure savings products such as 401(k)s, but costs are comparable to other intensive interventions, such as Head Start.

ed with the accounts; whether participation is voluntary or mandatory; and the funding source for the accounts.

### Purpose of Account Funds

If the accounts are principally designed to provide baseline economic security in old age (similar to that now provided by Social Security), then there is a case for limiting access to account funds before retirement except, perhaps, if the account holder dies or becomes disabled.

But if the main purpose of the accounts were to provide additional avenues for the accumulation of retirement wealth, then a ban on early access would be less important. Allowing some limited access to the funds might be more appropriate.

A third type of individual account system might aim to encourage fund usage before retirement. Such accounts could promote investment in human capital or wealth building—for example, to buy a home, pay tuition, or start a business—along the lines of individual development accounts. In this case, the relevant questions concern whether and how to ensure that the funds are used only for these earmarked expenditures (Box 5-1).

### Property Rights to the Accounts

The intended use of the accounts also depends on the extent to which the funds are viewed as personal property of the account holder. If the accounts are viewed less as personal property and more as social insurance, then it might be consistent to limit early access to the funds. If the accounts were personal property—either in a legal sense or in the popular view of account holders—then it would be consistent to allow ready access to the accounts.

### Voluntary or Mandatory Participation

A voluntary individual account system might be able to boost participation by allowing early access to the retirement savings. If contributions to the system were voluntary, a ban on early access could discourage workers from participating or lead them to contribute less. If workers

were required to participate and contribute specified amounts, incentives to boost participation would not be relevant.

### Source of Account Funds

The government could make direct contributions or extend tax credits to help workers build up account funds. If so, the case for banning early access might seem particularly strong, at least with respect to the portion of the funds not contributed by workers. Such government contributions would likely not be viewed as an account holder's property in the same way as his or her own contributions, so more restrictions might be appropriate. Applying different rules to different components of the account balance, however, would make the overall system more complex.

## *Precedents for Access to Retirement Funds*

U.S. retirement plans offer varied rules about early access to set-aside funds. When participation is voluntary and funds are viewed as personal property, an account holder generally has ready access to the money, although taxes or penalties may be levied on early withdrawals. Yet, social insurance systems are not personal property and do not allow access to the money except as prescribed benefits. Details about rules for early access to these plans are in Appendix Figure 5-A and are summarized briefly below.

### Individual Retirement Accounts

Americans have unlimited access to funds they set aside in tax-favored IRAs, although withdrawals are subject to federal income taxes if the funds were tax-deferred when contributed. Withdrawals before age 59½ are also subject to a 10 percent tax penalty unless certain conditions are met.

### 401(k) Plans

Employees' access to tax-favored retirement funds in 401(k) plans is more limited than with IRAs. But employees can usually get access to the funds, either through loans (if employers

offer this feature), by taking hardship withdrawals, or by cashing out of the plan when they leave their jobs. Early withdrawals, including hardship withdrawals, are subject to income taxes and generally to an additional 10 percent tax penalty.

### Thrift Savings Plan

The Thrift Savings Plan (TSP), enacted in 1984 for federal employees, is analogous to a private 401(k) plan. The TSP allows employees to take loans for any reason (with special terms for mortgage loans) and allows withdrawals if employees can prove financial hardship, subject to spousal consent or notice.<sup>2</sup>

### Defined-Benefit Pension Plans

In a traditional defined-benefit pension plan, workers earn vested rights to future benefit payments rather than to the plan's assets. A defined-benefit plan may not pay benefits to workers before they leave employment or reach the plan's normal retirement age. Many plans do not pay benefits to terminated employees until they have reached a defined retirement age, but it is becoming more common for plans to allow workers to choose a lump-sum payment of their vested benefits.

### Social Security Benefits

The Social Security program does not allow access to retirement benefits before retirement. The program pays benefits only as specified by law. Risks are shared broadly and benefits are not the personal property of the recipient until he or she establishes entitlement to the benefits and receives monthly checks. Benefits are paid only when a worker dies, becomes disabled, or reaches retirement age.

### Approaches in Individual Account Proposals

Most proposals for individual accounts designed to replace part of Social Security would not allow access to the money before retirement; only if the worker dies would the money be released from the account to go to his or her heirs. The President's Commission to Strengthen

Social Security examined this issue at length and concluded in its 2001 report that early access should not be allowed. Given the prominence of the Commission and the relevance of its conclusions in this area, we quote its rationale in full:

While prohibiting pre-retirement access might seem very restrictive at first glance, it is important to recognize that even among people facing difficult circumstances during pre-retirement years, most are still expected to spend some years in retirement. Difficulties in pre-retirement years do not justify facing even greater difficulties during retirement due to a lack of resources. While some people might suggest that accounts should be accessible in some "hard cases" (e.g., disability) we believe that those needs are best handled with other government policy, and not with funds set aside for retirement. Furthermore, allowing for pre-retirement access in the "hard cases" potentially opens Pandora's Box for less discriminating account access in the future. In the same way that Social Security benefits cannot be accessed before retirement or used as collateral for a loan, neither should assets held in personal accounts be available for other purposes. However, unlike Social Security, assets held in personal retirement accounts can be bequeathed to heirs if the account owner dies before retirement. In this way, wealth accumulation in the family need not be cut short with the death of the primary earner (PCSSS, 2001).

In general, other proposals for individual accounts designed to partially replace Social Security benefits also prohibit pre-retirement access to the funds, as shown in Figure 5-1. One exception is the *Bipartisan Retirement Security Act of 2004* proposed by Representatives Jim Kolbe (R-AZ) and Charles Stenholm (D-TX) (HR 3821, 108th Congress). This plan would allow early access only to the account funds that exceed the amount needed, when combined with any traditional benefits, to provide monthly income equal to 185 percent of the poverty line.

**Figure 5-1.** *Pre-Retirement Withdrawal Rules in Selected Individual Account Proposals*

Proposal	Pre-Retirement Withdrawal Provisions
<b>Mandatory Accounts Funded with New Contributions</b>	
ACSS (Gramlich): Individual Account Plan, 1996	• No withdrawals before age 62
Committee on Economic Development, 1997	• No pre-retirement withdrawals
<b>Mandatory Accounts Funded with Scheduled Social Security Taxes</b>	
ACSS (Schieber & Weaver): Personal Security Accounts, 1996	• No pre-retirement withdrawals
Reps. Kolbe-Stenholm: Bipartisan Retirement Security Act of 2004 (H.R. 3821 in 108th Congress)	• Early withdrawals allowed only for funds in excess of those needed to produce income of 185 percent of the poverty line (annuity combined with Social Security) taken as a lump sum
National Commission on Retirement Policy, 1999	• No withdrawals prior to retirement, disability, or death
<b>Voluntary Accounts Funded with New Contributions from Workers</b>	
President Clinton's Retirement Savings Accounts, 2000	• Withdrawals only for purchase of a first home, medical emergencies, or paying for a college education; withdrawals allowed only after five years
Social Security Plus (proposed by R.M. Ball, 11/2003)	• Withdrawals and tax treatment would follow IRA rules
<b>Voluntary Accounts Funded with Scheduled Social Security Taxes</b>	
President's Commission (PCSSS) Models 1,2, 3 (2001)	• No withdrawals prior to retirement or death
Reps. DeMint-Army: Social Security Ownership and Guarantee Act of 2001 (H.R. 3535 in 107th Congress)	• No withdrawals prior to retirement or death
Rep. Smith: Social Security Solvency Act of 2003 (H.R. 3055, 108th Congress)	• No withdrawals prior to reaching age 59½
<b>Unspecified General Revenues for Accounts</b>	
Rep. Shaw: Social Security Guarantee Plus Act of 2003 (H.R. 75 in 108th Congress)	• No withdrawals prior to retirement, death, or disability

**Sources:** U.S. Social Security Administration, 2004b, Selected solvency memoranda; National Academy of Social Insurance, December 1996, *Social Insurance Update*; Robert M. Ball, 2003, *Social Security Plus*, and November 2002 communication; Committee on Economic Development, 1997, *Fixing Social Security*

In sharp contrast with plans that ban or restrict early access, the *Social Security Plus* plan, proposed by former Commissioner of Social Security, Robert M. Ball, in January 2003, would follow IRA rules with regard to early access. In this proposal, the accounts are a voluntary supplement to Social Security and would be subject to the same tax treatment and withdrawal rules that apply to IRAs. Other proposals for voluntary savings (including subsidized

savings) might also follow existing early access rules for IRAs or 401(k) plans.

### *Options for Early Access*

This section explores four options that put varying restrictions on access to funds in individual accounts before retirement.

## Option One: Retirement Accounts with Broad Early Access

Option One allows the broadest access to account funds and builds on experience with IRAs. It is consistent with retirement payouts Option One in Chapter Three, which would allow unconstrained access to funds at retirement as well. Following the IRA model, contributions to the accounts could be voluntary, tax deductible, and supplemental to both Social Security and any employer-sponsored pensions the participant might have. If treated like traditional IRAs, withdrawals would be subject to income taxes and, if taken before age 59<sup>1/2</sup>, would also be subject to a 10 percent tax penalty (unless certain other conditions are met, as explained in Appendix Figure 5-A). A broad early access policy might increase workers' willingness to participate in voluntary accounts and to contribute more than they would in a less accessible system.

## Option Two: No Pre-Retirement Access

Option Two would ban access to retirement funds before retirement except, perhaps, in the case of the account holder's death or disability.

(See Chapter Seven for a discussion on issues concerning access at disability.) The ban is designed to resemble features of Social Security, which ensures benefit payments at certain events – retirement, death or disability – but there is no accumulated wealth for participants to withdraw or borrow against before benefits become payable.

Prohibiting pre-retirement withdrawals is consistent with a retirement payout requirement that the account be used to buy life annuities. In fact, a mandate to purchase life annuities at retirement could be rendered meaningless by a policy that permitted individuals to withdraw and spend the money before retirement. Similarly, a requirement for spousal protections in the form of joint-life annuities could be seriously eroded if workers could use the money for other purposes before reaching the mandatory annuitization age.

## Option Three: Limited Early Access

Option Three is designed to discourage, but not ban, early access to retirement savings. It is consistent with a goal of encouraging voluntary par-

### Box 5-2. Permitting Loans and Banning Withdrawals

Both the federal employees Thrift Savings Plan (TSP) and 401(k) plans permit tax-free loans and hardship withdrawals subject to taxes and penalties. When a participant does not (or cannot) repay a loan, the unpaid balance is converted to a taxable withdrawal. In effect, the withdrawal is an escape valve to resolve unpaid loans.

If a system permitted loans and banned withdrawals, how would it deal with delinquent loans? The TSP had such a policy before 1997; loans were permitted, but no in-service withdrawals were allowed. The program avoided delinquent loans by requiring loan repayments through payroll deductions. Employees could renegotiate loan repayments with their payroll office, but they could not default on their loan payments as long as they remained on the federal payroll. If the employee left the government, any unpaid loan balance would become a termination withdrawal subject to taxes and penalties. Separation of service served as the ultimate safety valve to convert a loan to a withdrawal.

A national system of individual accounts would not be linked to a specific employer. Consequently, there would be no "separation of service" safety valve to convert a delinquent loan to a withdrawal. Without that safety valve, it might not be feasible to permit loans and ban withdrawals.

participation in a new retirement savings account system, while minimizing leakage from it. Participants could be granted access to their accounts in cases of genuine need, but with fairly strict limits. For example, access could be permitted only as a last resort in financial hardship cases. This option might offer only loans rather than outright withdrawals, although there are practical considerations about how such a policy would work. As a practical matter, if loans are permitted, it might be necessary to also allow withdrawals, if for no other reason than to reach closure on unpaid loans. The Thrift Savings Plan originally permitted only loans, but that policy was changed in 1997 (Box 5-2). A policy of allowing loans and discouraging withdrawals would need a way to close out unpaid loans.

#### Option Four: Ban Access Up to a Threshold

Option Four would ban early access to account funds, as called for in Option Two, but only up to a certain threshold. It is consistent with a retirement payout option that would mandate annuities up to a threshold. Chapter Three discusses various approaches to setting a threshold for mandatory annuitization. Possible thresholds would include the poverty line, wage replacement goals, or means-tested program thresholds. Similar approaches could apply to a threshold above which workers could withdraw or borrow funds before retirement.

All of these options would ban access to account funds for those most likely to need the access – that is, low-income individuals who have few other sources of ready cash. At the same time, these approaches would expand choices for upper-income individuals who already have other fungible assets; the accounts would add to their repertoire of assets potentially available for borrowing or spending during their work lives.

If the mandatory annuitization threshold also served as a threshold for pre-retirement withdrawals, new issues would arise about how to translate a retirement-adequacy threshold to a

lump-sum threshold mid-way during the work life – when it would not yet be known what the worker's ultimate Social Security benefit or ultimate account balance would be by retirement age.

## Design and Implementation Issues

Any choice of pre-retirement access rules would lead to a number of key design and implementation decisions. Allowing early access raises policy questions about the type and form of access—whether loans or withdrawals, and for what purposes—and the type of restrictions, if any. Significant restrictions, as well as an outright ban on early access, would require enforcement mechanisms and oversight. Questions arise about how early access rules would affect creditor claims and the account holder's eligibility for means-tested assistance, and finally, decisions would be needed about how best to administer early access rules.

### Type and Terms of Early Access

Decisions about the type and terms of early access reveal competing goals. Participants might want, or even demand, access to the money when they need it, particularly if they view their accounts as personal property. But if the accounts were to serve as a basic source of retirement security, minimizing leakage from the accounts would be an important goal. So, if access were to be allowed, this goal would suggest offering only loans and only for hardship. Finally, minimizing administrative burdens and costs becomes another important objective. Administrative simplicity would argue for no early access. If that policy failed, the second choice for administrative simplicity would allow outright withdrawals for any reason – a policy that would maximize leakage.

### Loans or Outright Withdrawals

As an early-access feature, loans could reduce permanent losses from the accounts, especially if they are paid back with interest. In 401(k)

plans, repaid loans are not subject to penalties or taxes, which makes 401(k)s appealing to participants.

The availability of loans does seem to increase participation in 401(k) plans, although not as much as when the employer makes matching contributions to the plan. Loans appear to increase the participation rate from about 54 percent to 60 percent among workers whose employers did not provide matching funds, and from about 78 percent to 84 percent among workers whose employers did provide matching funds (U.S. GAO, 1997). Other studies suggest similar results (Hungerford, 1999; Fidelity Investments, 1999). The availability of loans also appears to increase the amount that workers contribute; in one study, the ability to borrow 401(k) funds increased workers' contribution rate by about 1 percentage point (Munnell et al., 2001).

Loans from 401(k) plans are fairly common—about 17 percent of eligible 401(k) participants had outstanding loans in 2002. Loan balances, on average, amounted to about 16 percent of the remaining account balance (Holden and VanDerhei, 2003). Those who borrow from 401(k) plans tend to be participants who have few other financial options; borrowers tend to have lower family income, lower net worth, and more non-housing debt, on average, than do non-borrowers (U.S. GAO, 1997). African American and Hispanic participants are almost twice as likely as white participants to borrow against their 401(k) accounts (U.S. GAO, 1997). Few defaults are recorded on 401(k) plan loans, but outstanding loan balances converted to withdrawals when employees change jobs do not count as defaults.

The primary drawback of permitting loans (compared with outright withdrawals) is greater administrative burden. Outright withdrawals are one-time transactions in that plans can issue funds to participants, withhold any required taxes or penalties and, if required, report transactions to the Internal Revenue Service. Loans,

in contrast, create a series of ongoing administrative tasks extending over an indefinite time period. The administering entity must arrange a repayment schedule, monitor compliance over months or years, deal with late payments or defaults, and ultimately determine whether failure to repay a loan constitutes a withdrawal, which must be reported to the Internal Revenue Service to assess taxes and penalties. Indeed, experts advise private employers to weigh administrative burden before adding loans to their 401(k) plans, as shown by the questions in Box 5-3.

#### *Reasons for Access: Hardship, Investment, or Any Reason*

If either loans or withdrawals were allowed, access could be restricted to only certain purposes, such as buying a home or investing in higher education, or access could be allowed only for documented emergencies or hardship. At the other extreme, early access could be allowed for any purpose.

**Hardship.** Private 401(k) plans allow access to account funds for financial hardship. Employers, as plan sponsors, serve as gatekeepers to determine that hardship actually exists, typically following the “safe harbor” guidelines established by the Internal Revenue Service. Those guidelines stipulate that the account holder must establish that the withdrawal is essential to meet an immediate and heavy financial need. Safe harbor hardship withdrawals include: (a) Certain medical expenses for the account holder, the account holder's spouse or dependents; (b) Purchase of a primary residence (excluding mortgage payment); (c) Payments of certain post-secondary education expenses over the next year for the account holder, the account holder's spouse, or dependents; or (d) To prevent eviction from or foreclosure on a primary home.

**Human Capital Investments.** Individual accounts could also permit the use of funds for various income-generating or asset-building purposes. Individual development accounts, for example, permit participants to access subsidized matched

### Box 5-3. Check List for Plan Sponsors before Offering Loans from 401(k) Plans

1. How will the loan provision be communicated to plan participants?
2. How will your plan handle the Department of Treasury requirement that participants must borrow the maximum amount from their 401(k) plans before hardship withdrawals are permitted?
3. Will loans be permitted for any reason, or for only specified purposes such as buying a home? Who will decide whether the loan has been requested for a valid purpose?
4. For loans that are used to buy a home, will the maximum loan term be limited to five years?
5. Will more than one loan be permitted per participant? If so, how many?
6. What participant collateral will secure loans?
7. Who will be responsible for the loan modeling? Who will prepare the amortization schedule?
8. Who will prepare the promissory note and other loan documents?
9. Will loans be repaid only through payroll deductions?
10. How is the loan payment schedule affected if the participant is temporarily laid off or on an unpaid leave of absence?
11. What happens when participants who have outstanding loan balances leave the company? If these participants leave their 401(k) account balances in your plan, will they be kept on a monthly loan payment schedule or will there be automatic acceleration? Will these participants be permitted to take out new loans?
12. How will the interest rate be established and will it be fixed or variable?
13. How often will the interest rate for new loans be adjusted?
14. Will each loan be considered an asset assigned to the participant's account, or will loans be combined into a general loan fund?
15. Will loans be initiated through manual paperwork, or after participants call a voice response unit?
16. How will loan payments be invested in the plan?
17. Will participants be able to select the investment fund(s) from which the loan withdrawal will be made, or will plan provisions dictate a withdrawal priority order?
18. From which contribution sources, such as employee pre-tax and employer matching funds, and in what order, will the borrowed money be taken?
19. Will participants be charged a fee for setting up the loan in addition to the annual administrative fee?

**Source:** Benna, 1997. *Helping Employees Achieve Retirement Security: Features Answers to the Most Often Asked 401(k) Questions*

savings only for higher education expenses, first-time homebuyer costs, and business capitalization or expansion costs. Likewise, IRAs allow

penalty-free withdrawals for the purchase of a first home, as well as for higher education and medical expenses.

**Unrestricted Access.** From the perspective of both participants and account administrators, permitting access for any reason is much easier to administer because it does not require evidence or determination that the situation matches the criteria. The access rules governing IRAs could provide one model for a regime of unrestricted pre-retirement access to individual accounts.

### *Segmented Account Funds from Different Sources*

Early access rules could also differ depending on whether the participant, employer, or government generated the funds. For example, 401(k) plan rules differ between the employee's own contributions and the employer's matching contributions. Similarly, individual development accounts have different access rules for the saver's own contributions and for the matching funds. If individual accounts contain funds from different sources, it may be necessary to spell out separate access rules for each source of funds.

### *Other Limits on Loans or Withdrawals*

Policymakers would have other means for limiting (or expanding) early access through the rules of the account system. Spousal consent or notice might be required (see Chapter Six). Technical decisions about the terms and amounts of loans and withdrawals could also be used to help meet any intended balance between access and fund preservation.

If withdrawals were permitted, policymakers would have to decide how much could be withdrawn. Withdrawals could be restricted to a certain percentage of the account balance or permitted only once the balance had reached a set threshold dollar level. For example, some proposals permit withdrawals only when the account is sufficient to produce a life annuity above the poverty threshold. (See Chapter Three for further discussion of the poverty threshold in the context of retirement income.)

If loans were allowed, a more complex set of decisions about the loan terms and conditions would have to be made, such as:

**Loan ceilings.** The system could fix a standard limit—for example, no more than the lesser of 50 percent of the account balance or \$50,000—on the amount of total outstanding loans allowed to any participant. Alternatively, the percentage and dollar caps could vary with the size or age of the account.

**Interest rate policy.** The interest rate on individual account loans could be designed to encourage, or discourage, borrowing from individual accounts as opposed to credit cards, bank loans, or home equity loans. A low interest rate would make the loan more affordable and would encourage borrowing from the account rather than from other commercial lenders. A low interest rate would also result in lower interest payments back to the individual's account.

**Limit on duration of loan.** The repayment period could be limited, following the example of TSP loans (must be repaid in four years) and 401(k) loans (repayment in five years).

**Limit on number of loans.** The system could limit the number of outstanding loans or the number of new loans allowed per participant each year.

**Death or disability.** Forgiveness or special treatment of an outstanding loan could be considered in the event of death or disability.

Finally, loan policies would need to specify the conditions under which failure to repay a loan would constitute a withdrawal. In an individual account system modeled after the current TSP or a 401(k) plan, the consequences of converting a loan into a withdrawal would be taxes and penalties on the unpaid balance.

## Enforcing and Sustaining Restrictions

Once decisions were made concerning pre-retirement access to individual account funds, it would be necessary to determine what entity would be responsible for enforcing the system's regulations.

### *Finding a Gatekeeper: Who Bears the Risk of Decision-Making, and With What Consequences?*

If account holders could access their funds only under certain conditions, a gatekeeper would be needed to determine whether a particular withdrawal meets the requirements. If the gatekeeper were expected to deny some requests (for example, in cases of failure to demonstrate hardship), procedures would likely be needed for review and appeal of the gatekeeper's decision.

What incentive could (or should) be used to motivate the gatekeeper to make accurate decisions? In particular, what incentives might be needed to discourage wrongful withdrawals? What would be the penalty, and on whom would it fall? Existing savings vehicles offer some precedents.

**Individual Retirement Accounts.** IRAs set no restrictions on withdrawals, but some are subject to penalty taxes. For example, the account holder must pay a 10 percent surtax on withdrawals before age 59½ and a 50 percent surtax on insufficient withdrawals after age 70½. The financial institution is responsible for informing the IRS of the withdrawal, but the penalty falls on the account holder.

**401(k) Plans.** The fiduciary in charge of the 401(k) plan, usually the plan sponsor (employer), is responsible for deciding whether employees' withdrawals or loans meet IRS and plan rules and, if so, for notifying IRS of any withdrawals taken. In theory, the government has a blunt means of punishing and deterring wrongful determinations: the loss of tax-favored status for the entire retirement plan. But the employer can avoid that fate by reporting the violation to the IRS and paying a (usually small) penalty.

**IDA Experience.** Community-based organizations that receive federal or foundation grants are responsible for approving a particular use of IDA matching funds. Only after the purchase is approved are the funds released. If a participant withdraws funds for an unapproved purpose, he or she forfeits the matching funds. During recent efforts to authorize a federal tax credit to financial institutions that administer and match IDAs, questions of accountability and legal liability became paramount. Specifically, should the financial institution, its contractual partners (typically nonprofit organizations) who help administer the program, or the IDA account holders bear the ultimate legal responsibility for using the IDAs in accordance with the law? This question was thoroughly discussed by policymakers, financial institutions, and others but was not resolved. This suggests that similar issues may arise in efforts to find an appropriate "gatekeeper" for restricting withdrawals from a new individual account system.

None of these three precedents appear to be promising models for enforcing restricted access to a national individual account system. The IRA model allows unlimited access, as long as the account holder pays a 10 percent penalty. The 401(k) model relies on employers for enforcement, but it is not clear that employers would be willing or able to serve as gatekeepers for a mandatory, universal system. While employers who already have 401(k) plans might be able to serve this function, many others lack the capacity to manage 401(k) plans. Still others have highly mobile and transitory work forces that would make gatekeeping far more difficult than it would be for a large employer with a stable work force. The IDA model that relies on community-based organizations as gatekeepers is not a cost effective model for a national program, and IDA proposals to place financial institutions in a gatekeeper role were met with some resistance.

In brief, the question of who would serve as gatekeeper and what would motivate the gatekeeper to do its job well is complex. If the over-

all purpose of the accounts is retirement income security, then punitive treatment of the account holder for wrongful withdrawal seems contrary to the purpose of the overall scheme. If the accounts were held in private financial institutions, could those institutions be made gatekeepers? What incentives – carrots or sticks – would make financial institutions diligent enforcers of withdrawal restrictions? If the government were the gatekeeper, would this arrangement require that the government also be the holder of the accounts? Such questions merit further attention if restrictions on access to retirement funds are contemplated.

### *Sustaining Restrictions on Access*

As a matter of political reality, a ban or significant restrictions on pre-retirement access to account funds might not be popular. The United States has no precedent for a total ban on access to individually-owned retirement savings. If policymakers do decide to put such limits in place, significant pressures could be placed on Congress to ease access to retirement funds when deserving and sympathetic claims are made, such as preventing eviction or paying for medical emergencies. As discussed further in Chapter Seven, this is a central issue in designing the appropriate policy when account holders become sufficiently disabled that they qualify for Social Security disability benefits.

The federal laws governing IRAs and the federal employees' TSP have, in recent years, expanded early access to account funds. When IRAs were created in 1974, participants faced a 10 percent penalty tax on withdrawals before age 59½. The Health Insurance Portability and Accountability Act of 1996 waived that penalty for withdrawals used to pay for medical care and, a year later, the Taxpayer Relief Act of 1997 waived the penalty on withdrawals to pay for higher education and a first home. Similarly, when the TSP was first enacted in 1984, it allowed only loans and only for specified purposes; amendments in 1996 expanded access to loans for any purpose and permitted withdrawals for hardship.

This history has led the Joint Committee on Taxation (1999) to emphasize, in describing possible systems of individual accounts, that no matter what rules policymakers originally decide, political pressures will build for pre-retirement access:

As a practical matter, it may be difficult to restrict access to private accounts. Pressures under present law have resulted in numerous exceptions to the 10-percent early withdrawal tax for IRAs and, in some cases, qualified plan distributions. For example, the 10-percent early withdrawal tax does not apply to IRA withdrawals for education, medical, and first-time homebuyer expenses. In addition, many employer-sponsored retirement plans permit individuals to borrow from their retirement accounts. The ability to maintain withdrawal restrictions may depend in part on how individuals view the private accounts. If they are viewed as part of Social Security or as a pension benefit, then they may be more willing to not have access to funds prior to retirement, as that is consistent with the way in which Social Security works today (as well as private defined-benefit pension plans). On the other hand, if individuals view private accounts more as personal savings, or as supplements to other retirement income, they may be more opposed to restrictions on pre-retirement access to funds.

Given the novel legal and political questions raised by a national individual account system, and the history of the federal TSP and IRAs, restricting access to funds that account holders consider their own money is likely to be a difficult challenge.

### **Impact of Access Rules on Third Party Claims and Means-Tested Benefits**

Access can be a two-edged sword. Under existing law, the extent to which individuals can reach into their retirement accounts sometimes affects whether others can make a claim on the funds as well. Account holders' access can also

influence how the asset is treated in means-tested programs.

### *Claims of Third Parties*

The more the account holder has access to the account, the more likely it is that creditors, such as the IRS for overdue taxes or creditors in bankruptcy filings, can make a claim on the account as well. Ex-spouses or parents owed child or spousal support, or entitled to a share of marital property, may make claims against retirement plans, but procedures are simpler for accounts to which account holders have easier access. If policymakers wish to protect accounts from creditors, specific provisions could be put into law.

**Bankruptcy.** Under federal law, assets held in most retirement plans are usually not subject to the claims of creditors, garnishment, or assessments and are not included in bankruptcy proceedings. Some courts have ruled that federal bankruptcy protections are not applicable to IRAs because liberal access rules make them more like a savings account than a traditional pension plan; other courts have disagreed. The U.S. Supreme Court heard arguments on this issue in the case, *Rousey v. Jacoway*, 03-1407, in November and a ruling is expected by July 2005 (Yen, 2004). Assets in IRAs may receive protection under state bankruptcy laws.

**Child and Spousal Claims.** A Qualified Domestic Relations Order (QDRO) is required to obtain child or spousal support, or a share of marital property, from defined-benefit and 401(k)-type plans, but is not required to obtain a share of an IRA.

**Overdue Federal Taxes.** The IRS may place a levy against most retirement plans and IRAs for unpaid taxes.

### *Access and Means-Tested Benefits*

To qualify for means-tested public benefits such as food stamps or Medicaid, applicants generally must demonstrate limited financial assets and income. These asset tests exclude some

resources, such as defined-benefit pensions, but often count assets in defined-contribution plans and IRAs toward allowable limits. So, low-income workers often must draw down, or spend, most or all of the balance in their defined-contribution accounts or IRAs (regardless of early withdrawal penalties or other tax consequences) before they can qualify for means-tested programs. The rules for the major federal benefit programs are discussed below.

**Medicaid.** The Medicaid asset test was a federal standard tied to the former Aid to Families with Dependent Children (AFDC) program test.<sup>3</sup> Today, eligibility determinations for Medicaid have been devolved to the states. Some 22 states have eliminated asset tests for low-income families with children, and all but a few states have eliminated asset tests for children. Most, but not all, states that do have asset tests for families count funds in defined-contribution plans and IRAs against the asset limits. In addition, most states apply asset tests in determining eligibility for Medicaid for individuals age 65 and older and those receiving disability benefits. For these individuals, Medicaid asset tests are often linked to the asset test used in the federal Supplemental Security Income program; the SSI asset test requires that defined-contribution accounts and IRAs be counted. States can make alterations, however, and some states use different Medicaid asset tests for different categories of elderly persons and people with disabilities.

**Food Stamps.** The food stamp rules generally require accessible assets to count toward the program's asset test. That standard is commonly understood to mean that defined-contribution plans and IRAs—which are generally accessible prior to retirement, albeit at the cost of a significant tax penalty—are counted. There is an exception for assets held in 401(k) and 403(b) accounts; they are *not* counted. (IRAs and Keogh accounts *are* counted.) A provision in the Farm Security and Rural Investment Act of 2002 (Section 4107 of P.L. 107-171) allows states to conform the definition of assets used in the Food Stamp Program to the definition in TANF-

funded cash assistance or the Medicaid family category. Until final regulations are issued, it is unclear whether this provision will allow a state to exclude IRAs from the food stamp asset test if the state excludes IRAs from counting as assets under TANF or Medicaid.

**Supplemental Security Income.** The federal government sets the SSI asset test in which defined-benefit pension plans do not count against the program's asset limit, but assets in defined-contribution plans do. The general principle is that if the funds are accessible, they are countable assets.

**Tuition Assistance.** The rules governing access to student loan programs and Pell Grants exclude balances in 401(k) plans and IRAs from countable assets.

Given the complexity of asset tests, it is possible that individual account balances could be countable assets that would make a family ineligible for some means-tested programs, particularly if the account holder has access to the funds. A blanket exemption already excludes funds in individual development accounts from asset limits used in any means-tested programs. Policymakers might want to consider an analogous blanket exemption for any new national system of individual accounts so account holders would not need to spend down their account assets to qualify for Medicaid, food stamps, SSI, TANF, or tuition assistance programs.

### Administrative Issues

This chapter is based on the assumption that any individual account proposal would designate a central administrative entity to track contributions, balances, and withdrawals. In the absence of such a centralized entity, pre-retirement withdrawals (along with rest of the individual account system) could prove difficult to monitor.

Administrative issues pose a particular challenge with regard to loans, as discussed earlier. The impact of loans on account balances will depend

on the method of repayment. Loans from 401(k) plans have a very low default rate when repayment is made through payroll deductions, but loans generate considerable leakage from the system when borrowers leave their jobs. Typically, the outstanding loan is offset against the account balance and never restored to the account.

One approach to repayment of loans would require individual account participants to repay via automatic payroll deductions and direct deposits from their current employers to the account system administrator (or its designee). Many employers already have direct deposit arrangements that use a portion of an employee's paycheck to make mortgage or auto loan payments. If individual account borrowers left their employers, repayment could be made by automatic debit from an account in a bank or other financial institution unless and until a new employer assumed the tasks. Participants who are unemployed or who are unable or unwilling to make such an arrangement with their employers would be required to post collateral for any loans. Requiring employers to offer this type of loan repayment could place a significant burden on the nation's many small employers who might not have automated payroll systems.

The feasibility of a large-scale, employment-based payroll deduction direct deposit system for repayment of individual account loans otherwise unrelated to employment has not been tested. Payroll deduction repayment in these circumstances might not work as effectively as when the employer sponsors the plan. So, the administrative savings involved in employer administration of loans are uncertain in the context of individual accounts. Repayment mechanisms that do not rely on the borrower's employment status would have certain administrative advantages, in that termination of employment would not trigger an account distribution, nor would it interrupt repayment of a loan.

## Summary

The pros and cons of allowing early access to individual accounts would depend, in large part, on the intended use of the accounts, whether individuals have any choice about participation, and the extent to which participants view accounts as personal property. If the accounts are supposed to provide baseline economic security in old age (similar to that now provided by Social Security), there is a case for banning access to the funds before retirement. But in a voluntary system, allowing access to funds might encourage more people to participate and to save.

Precedents for early access rules for retirement accounts include IRAs, 401(k)s, and the federal TSP. 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)s permit more limited access than IRAs, but employees can often get their money if they need it—through a loan or hardship withdrawal, if offered by the employer, or by leaving the job and cashing out the account; such withdrawals are taxable and usually subject to a 10 percent tax penalty. Most U.S. proposals that envision individual accounts as a partial replacement for Social Security retirement benefits would ban early access to the money. Proposals that view the accounts as separate from Social Security would allow more liberal access.

Rules addressing the form and purpose of early access to retirement accounts would create tensions among three competing goals. Participants would want access to their money when they need it, but the policy goal of providing basic economic security in retirement calls for minimizing leakage from the accounts. The goal of retirement security argues for a total ban on early access but, if access were allowed at all, concerns about retirement security would argue for allowing only loans and only for hardship. The competing goal of administrative efficiency argues for a total ban on access. As a second

choice, administrative efficiency points to minimal regulation—withdrawals for any reason—because loans (which involve repayments) and restrictions on reasons for access (which require documentation and determinations) require more administrative resources.

If access to individual accounts were allowed with some restrictions, a gatekeeper would be needed to determine whether a particular withdrawal meets the criteria—and procedures would be needed to give participants an opportunity to have a denial reconsidered. In 401(k) plans, the fiduciary in charge of the plan, usually the plan sponsor (employer), is responsible for deciding whether employees' withdrawals or loans meet IRS and plan rules. The employer bears the risk of losing tax-favored status for the entire retirement plan in cases of wrongful determination, although the IRS has procedures for levying lesser penalties.

In a national system of individual accounts, what entity could play an analogous gatekeeper role? What incentives would prompt the gatekeeper to prevent wrongful withdrawals? What might the penalty be for noncompliance, and on whom would it fall? If the overall purpose of the accounts is retirement income security, a penalty on the account holder for a wrongful withdrawal may undermine the ultimate goal.

Early access to retirement funds can be a two-edged sword. Under existing laws, account holders' access to their own retirement funds sometimes also permits creditors to make a claim on the funds in cases of bankruptcy or unpaid federal taxes. Moreover, some means-tested government benefit programs treat accessible retirement funds as assets for the purposes of determining benefit eligibility; in such cases, if the account holder has access to the funds, he or she must spend down the account balance in order to qualify for means-tested assistance.

Despite these potential drawbacks to pre-retirement individual account access, the political reality remains that there might be significant

pressure to allow individuals to withdraw their funds before retirement. No U.S. precedent exists for a total ban on access to individually-owned retirement savings and even if policy-makers create such a ban, the history of IRAs and the federal TSP shows that Congress might

experience significant pressure to ease legislative restrictions on access to retirement savings. So, no matter what the policy chosen at the outset, sustaining restrictions on access to retirement funds that account holders view as their own money is likely to be an ongoing challenge.

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## Chapter Five Endnotes

1 Funders of the American Dream Demonstration include the Ford Foundation, the Charles Stewart Mott Foundation, the Joyce Foundation, the F.B. Heron Foundation, the John D. and Catherine T. MacArthur Foundation, Citigroup Foundation, Fannie Mae Foundation, Levi Strauss Foundation, Ewing Marion Kauffman Foundation, the Rockefeller Foundation, and the Moriah Fund.

- 2 The TSP for participants in the Federal Employees Retirement System requires spousal consent for loans and withdrawals. The TSP for participants in the Civil Service Retirement System requires spousal notice.
- 3 AFDC was replaced by the Temporary Assistance to Needy Families (TANF) program under legislation enacted in 1996.

## Appendix: Precedents for Early Access

Retirement savings plans have different early access rules. Table 5-A provides further detail on the rules for early access to funds in Individual Retirement Accounts, 401(k) plans, and the Thrift Savings Plan for federal employees.

**Figure 5-A.** *Federal Rules and Tax Treatment of Withdrawals and Loans from IRAs, 401(k)s, and the Thrift Savings Plan*

Type of plan	Withdrawals before Retirement	Loans
<p><b>Individual Retirement Accounts</b> (regular) Contributions are tax deductible</p>	<p><b>Rules:</b> Withdrawals are permitted at any age. <b>Taxation:</b> All withdrawals are subject to federal income tax. Those taken before age 59½ are subject to an additional 10 percent penalty, unless:</p> <ul style="list-style-type: none"> <li>(a) The owner has died and the account passes to a beneficiary;</li> <li>(b) The owner has become disabled;</li> <li>(c) The funds are used to pay non-reimbursed medical expenses that exceed 7.5 percent of adjusted gross income;</li> <li>(d) The funds are used to pay a federal tax liability;</li> <li>(e) The withdrawals are part of a series of “substantially equal periodic payments” made over the lifetime or life expectancy of the account holder (or the holder and designated beneficiary);</li> <li>(f) The funds, up to \$10,000, are used for purchasing a first home; or</li> <li>(g) The funds are used to pay health insurance premiums while unemployed for at least 12 weeks.</li> </ul>	No loans allowed
<p><b>Roth IRAs</b> Contributions from after-tax income</p>	<p><b>Rules:</b> Withdrawals are permitted at any age. <b>Taxation:</b> Contributions withdrawn are not taxable. Earnings held in a Roth IRA for at least five years are not taxable if taken after age 59½, death, disability, or for purchase of first home. Earnings taken for other purposes, or those held less than five years, are subject to federal income tax and a 10 percent penalty on the same terms as for traditional IRAs.</p>	No loans allowed
<p><b>401(k) plans</b> Employee contributions not taxable</p>	<p><b>Rules:</b> Employers who sponsor 401(k) plans generally cannot allow employees to withdraw their own contributions until the employee: (a) reaches age 59½; (b) terminates employment; (c) dies, (d) becomes disabled, or (e) experiences financial hardship.<sup>i</sup> Departing workers can: (a) leave the funds in the plan<sup>ii</sup> (if less than \$5,000, the sponsor can roll it over or cash it out); or (b) take a distribution. <b>Taxation:</b> Funds withdrawn by departing workers that are not rolled over into another tax-deferred retirement plan are subject to federal income taxes on the distribution, including 20 percent income tax withholding. An additional 10 percent penalty</p>	<p>Plans may offer loans under certain conditions, but are not required to do so.</p> <p>Federal rules permit loans up to the lesser of \$50,000 or half of the employee’s vested 401(k) account. The loan must be repaid in five years, unless it is</p>

**Figure 5-A.** *Federal Rules and Tax Treatment of Withdrawals and Loans from IRAs, 401(k)s, and the Thrift Savings Plan (continued)*

Type of plan	Withdrawals before Retirement	Loans
<p><b>401(k) plans</b> continued</p>	<p>applies unless:</p> <ul style="list-style-type: none"> <li>(a) The worker is age 59<sup>1/2</sup>;</li> <li>(b) The worker has terminated employment with the plan's sponsor after reaching age 55;</li> <li>(c) The worker has died and the account passes to a beneficiary;</li> <li>(d) The worker has become disabled;</li> <li>(e) The distribution is made to a former spouse or child under a Qualified Domestic Relations Order incident to a divorce;</li> <li>(f) The funds are used to pay non-reimbursed medical expenses that exceed 7.5 percent of adjusted gross income;</li> <li>(g) The funds are used to pay a federal tax liability; or</li> <li>(h) The withdrawals are part of a series of "substantially equal periodic payments" made over the lifetime or life expectancy of the account owner (or the owner and designated beneficiary).</li> </ul>	<p>used to buy a home. Amortization must be level over the term of the loan, and payments must be made at least quarterly. Interest is payable at commercial rates set by the plan.</p> <p>Non-repaid loans become withdrawals and are subject to income taxes and a 10 percent tax penalty unless one of the penalty exceptions on departing worker withdrawals applies.</p> <p>Otherwise, the 10 percent tax penalty and the 20 percent income tax withholding do not apply to loans.</p>
<p><b>401(k) plans</b> Employer matching contributions</p>	<p><b>Rules:</b> 401(k) plans generally are permitted to allow employees to withdraw most types of employer contributions during employment, if the employee has at least five years of participation in the plan or if the contribution has been in the plan for at least two years.</p> <p>Plans can impose more stringent withdrawal restrictions, and certain types of employer contributions must be subject to restrictions similar to those applicable to employee pre-tax contributions.</p>	<p>Same loan provisions as for employee contributions.</p>

**Figure 5-A.** *Federal Rules and Tax Treatment of Withdrawals and Loans from IRAs, 401(k)s, and the Thrift Savings Plan (continued)*

Type of plan	Withdrawals before Retirement	Loans
<p><b>Thrift Savings Plan</b> Federal worker, non-taxed contributions</p>	<p>Until 1997, in-service withdrawals were not permitted for any reason.</p> <p><b>Rules:</b> Since 1997, in-service withdrawals are permitted in two cases: (a) employees who can prove “financial hardship,” and (b) an employee age 59½ or older can take a one-time withdrawal for any reason. Spousal consent required for FERS TSP participants; spousal notice for CSRS TSP.</p> <p><b>Taxation:</b> Either type of withdrawal is subject to federal income taxes (and 20 percent withholding). Financial hardship withdrawals are also subject to a 10 percent tax penalty. (The availability of general purpose loans eased the demand for early withdrawals.)</p>	<p>Until 1997, loans were permitted only for specified reasons, including financial hardship.</p> <p>Since 1997, two types of loans are offered. General purpose loans between \$1,000 and \$50,000 (but limited to the account balance) must be repaid in 4 years. Residential loans must be repaid within 15 years. The interest rate is that paid on the G-fund, a fund of treasury securities offered by the TSP. Loans are repaid through payroll deductions. Spousal consent required for FERS TSP participants; spousal notice for CSRS TSP.</p>

i 401(k) plans can permit employees to take “hardship” withdrawals of their own contributions. The worker must show an “immediate and heavy financial need” such as medical costs, the purchase of a principal residence, college tuition, and expenditures to avoid eviction from a principal residence. Participants must also have exhausted all other withdrawal options and non-taxable loans, and they must suspend all new contributions to retirement plans for at least six months. The hardship withdrawal may not be rolled over into another employer plan or IRA.

ii Unless a departing worker asks for a cash withdrawal or directs the plan to roll over the funds to a specified IRA, pension rules require that companies roll over accounts of between \$1,000 and \$5,000 to an IRA established by the company for the worker. These requirements will not become effective until the Department of Labor issues regulations interpreting them.



# Chapter

# 6

## Spousal Rights

Amid all the work on creating individual Social Security accounts for retirees, policymakers have paid less attention to individuals whose eligibility for Social Security benefits is based on family relationship or disability. This is an important oversight, as about half of all beneficiaries have their eligibility based on family status or disability. This chapter focuses on the rights of spouses. The next two chapters focus on disabled workers and children, respectively.

This chapter reviews spousal rights precedents found in Social Security, in state family law, and in federal rules that apply to retirement plans other than Social Security. It also explains a key decision policymakers must make on individual accounts—whether to establish uniform federal policies concerning spousal rights or leave those policies to be resolved by state law. Spousal rights are considered in the context of other individual account features, such as whether participation is voluntary or mandatory and the goals and purposes of the plan. It explores tensions and tradeoffs in blending the spousal protections in Social Security with the property concepts inherent in individual accounts. The chapter also examines new information and pro-

cedures that might be required to implement spousal rights.

### *Precedents for Spousal Rights*

Rules that define spousal protections in individual accounts could be based on precedents in Social Security law, in state family law, or in the retirement plans that currently supplement Social Security. New concepts have been put forth in proposals for individual accounts as part of Social Security reform.

### **Social Security Benefits for Spouses**

Social Security benefits are designed to provide baseline income security for a spouse when a worker's earnings end due to retirement, disability, or death. The wife or husband of a retired or disabled worker is eligible to receive an amount equal to 50 percent of the worker's benefit; an elderly widow or widower, an amount up to 100 percent of the worker's benefit (providing no early retirement reductions apply). Disabled widowed spouses may claim benefits equal to 71.5 percent of the deceased worker's benefit starting at age 50 (non-disabled widowed spouses

es may claim benefits starting at age 60). Spouses' benefits continue to be paid for life and are annually indexed for inflation. A spousal benefit is paid only to the extent that it exceeds the benefit that would be paid to the spouse based on his or her own work record. For example, if Jane's own benefit as a retired worker is \$700 and her benefit as a widow is \$850, she would receive her \$700 benefit plus \$150 as a widow for a total of \$850. Benefits are paid to husbands and widowers on the same terms as benefits paid to wives and widows, but because men rarely earn less than their wives over their lifetimes, few men receive benefits as husbands or widowers.<sup>1</sup> While this chapter speaks of "wife" or "widow" benefits, the same benefits are payable to and the same issues arise with

respect to benefits payable to husbands and widowers.

Of the nearly 46 million individuals receiving Social Security benefits, only about half receive benefits solely as retired workers, while the other half receive benefits based on disability or on family relationships to a worker (Figure 6-1). About 12 percent of Social Security recipients are disabled-worker beneficiaries and 8 percent receive benefits as children of workers.

In all, about 14 million individuals – 30 percent of all beneficiaries – receive Social Security benefits based at least in part on a spouse's work record. These beneficiaries are overwhelmingly women. About 6.0 million women are entitled to Social Security as workers and to higher ben-

**Figure 6-1.** *Number of Beneficiaries by Basis for Entitlement, December 2001*

Type of Benefit	Number (thousands)	Percent of Total
Total	45,874	100.0
Entitled based on own work record only	28,031	61.1
Retired worker only	22,766	49.6
Disabled worker	5,265	11.5
Dually entitled to a higher benefit as a family member	6,076	13.2
Dually entitled retired worker and spouse of deceased worker	3,467	7.5
Dually entitled retired worker and spouse of retired or disabled worker	2,609	5.7
Entitled only as a family member	11,767	25.7
(i.) Of deceased worker	6,915	15.0
Non-disabled widow(er)s	4,625	10.1
Children	1,890	4.1
Widowed mothers and fathers	195	0.4
Disabled widow(er)s	202	0.4
Parents	3	0.0
(ii.) Of retired worker	3,205	7.0
Spouses, age 62 or older	2,738	6.0
Children	467	1.0
(iii.) Of disabled worker	1,647	3.5
Spouses	157	0.3
Children	1,490	3.2

Note: Children include children under age 18, students under age 19 and adults disabled since childhood (before age 22) who receive benefits on the account of a deceased, disabled or retired parent.

Source: U.S. Social Security Administration, 2002a. *Annual Statistical Supplement to the Social Security Bulletin, 2002*

efits as a widow, wife, or divorced wife. Another 7.8 million women receive Social Security solely as widows, wives or divorced wives.

Benefits for divorced wives are calculated the same way as benefits for wives and widows.<sup>2</sup> To be eligible for Social Security benefits as a divorced wife or widow, the marriage must have lasted at least 10 years and the individual must be unmarried when applying for benefits. As of December 2001, about 475,000 individuals received benefits solely as divorced spouses or surviving divorced spouses and an additional 490,000 women were dually entitled to retirement benefits from their own earnings as well as a secondary benefit as divorced wives or widows (U.S. SSA, 2003b). Taken together, almost one million women age 62 or older receive Social Security benefits based in full or in part on the work record of an ex-spouse. They account for just less than 5 percent of the 21.4 million women age 62 and older who receive Social Security benefits.

As more women work in paid employment, more women will be eligible for benefits based on their own covered work records and fewer will receive benefits solely as wives or widows. At the same time, more women will be dually entitled. That is, they will be eligible both for a retired-worker benefit based on their own covered earnings and for a higher benefit as a wife

or widow. By 2040, the proportion of women who will qualify for benefits only as wives or widows is projected to decline from 34 percent to 7 percent, while those who receive benefits solely as retired workers will increase from 38 percent to 55 percent (Figure 6-2). The share of women dually entitled as workers and widows is estimated to rise from 16 percent to 28 percent (Favreault and Sammartino, 2002). The share of women dually entitled as wives will decline as more women's own work records provide a benefit equal to at least half of their husband's benefit; the percentage of dually entitled widows will increase because the benefit on their work record will still be lower than their husbands. For most dually entitled widows, the top-up from the secondary benefit will be significant: 20 percent to 69 percent of their total benefit, or \$300 to \$1,000 per month in 1998 dollars.

Because the dual entitlement rule limits payment of spousal benefits in two-earner couples, existing spousal protections pay more relative to past earnings and contributions to one-earner couples than to two-earner couples with the same combined earnings. In addition, because spousal benefits are based on the retired-worker benefits of the primary beneficiary, the higher replacement of lower average earnings than of higher average earnings is duplicated in spousal benefits. This redistribution occurs in the Social

**Figure 6-2.** *Type of Social Security Benefits Received, 2000 and 2040  
Women Age 62 and Older (Percent distribution)*

Type of Benefit	2000	2040
Total – All Benefit Types	100	100
<b>Insured on own record as retired worker</b>	<b>66</b>	<b>93</b>
Entitled as worker only	38	55
Dually entitled	28	38
Wife	12	10
Widow	16	28
<b>Entitled only as spouse</b>	<b>34</b>	<b>7</b>
Wife	13	3
Widow	22	4

Source: Favreault and Sammartino, 2002. "The Impact of Social Security Reform on Low-Income and Older Women"

Security system because benefits are based on a formula that varies with average covered earnings. It would be more difficult in an individual account system, where funds reside in personal accounts rather than a pool of federal tax revenue.

## Family Law Precedents for Spousal Rights

If individual accounts were considered property, then state laws on spousal property rights might determine account disposition during marriage, at divorce, and/or when the account holder dies.

All but nine states follow English common law principles. The other nine states follow community property rules derived largely from Spanish civil law, in which wives and husbands have a half interest in all property accumulated during marriage.

Over time, common law states began to incorporate community property principles by enacting laws that called for equitable distribution of property at divorce. Before these laws were passed, wives were entitled only to the property to which they held title. Today, all common law states have adopted equitable principles for division of property at divorce.

States still vary significantly in how they treat married couples. As family structures have grown more complex (children from multiple marriages, for instance), states have adopted varying solutions to resolve issues presented by contemporary family life. Most states—both common law and community property—allow state rules on property rights to be overridden by a contract that is mutually and fairly agreed to by the husband and wife before or during a marriage or at divorce.

### *Community Property States*

About 29 percent of all Americans live in the nine community property states—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. In these states, all property acquired during a marriage is held jointly by the spouses, regardless of

whose name is on the deed or title. Property acquired before the marriage and inheritances during the marriage are considered separate property, although the increase in the value of this property during marriage may be considered marital property (unless the asset is clearly declared and separately held as individual property). The value of property, including retirement accounts, acquired prior to residence in a community property state (what is sometimes labeled the “determination date”) may be considered individual property, but subsequent contributions and increases in value to those accounts will be marital property. So, moves by married couples between community property and common law states will result in mixed property that is only partially community property.

**Control of community property during marriage.** Most community property states allow either the husband or the wife to singly manage the community property. If title is in the name of only one spouse, for example, only that spouse may be able to manage the property. If a spouse is operating a business that is community property, exclusive control of the business may be given to that spouse. However, a spouse who manages community property generally has a fiduciary responsibility to protect the interests of the other spouse. Most community property states require that both spouses agree to transfers or mortgages of community real property (Dukeminier and Krier, 2002). As a practical matter, enforcement of state laws on management or control of community property generally becomes an issue only in cases of marital dispute.

**Community property at divorce.** In general, at divorce each spouse is entitled to half of the marital or community assets, and each spouse retains his or her separate property that is outside the community assets.

**Community property at death.** When a spouse dies in a community property state, the widow or widower automatically retains his or her sep-

arate personal property and his or her half of the marital community property. At issue is whether the widowed spouse has a claim to the decedent's half of the marital property or the decedent's separate property. This disposition is determined by the decedent's will. In the past, in the absence of a will, a widowed spouse would typically get only his or her half of the community property and the children would get the decedent's half; most states now give the widowed spouse all of the marital property if the partner dies intestate, although children of the deceased from a former marriage may also have an automatic claim to a share of the marital property. Divorce and remarriage increase the probability that marital property will be divided between a current widowed spouse and children from a former marriage.

### *Common Law States*

In common law states, property belongs exclusively to the spouse who holds title. Spouses may, of course, hold joint title, and such an arrangement is particularly important in these states because courts may look at the title when distributing assets at divorce.

**Common law property at divorce.** Traditionally, marital property remained the property of the spouse holding the title at divorce. A wife was entitled to alimony as long as she was not at fault for the divorce. Today, common law divorces look more and more like those in community property states. All common law states enacted equitable distribution of property laws, with these laws calling for allocation of marital assets according to equitable principles. These principles vary considerably from state to state and some states require a determination of fault to help guide the equitable division concept.

**Common law property at widowhood.** Widows were not, historically, entitled to property, only to upkeep. Today, if a spouse dies without a will, common law states generally stipulate that a share of the decedent's property goes to the widowed spouse. Even if there is a will, the decedent cannot unilaterally disinherit a spouse.

Most common law states stipulate a minimum share for the widowed spouse. If the will provides less than this share, the widowed spouse can sue in state court to obtain that allotment.

### **Spousal Rights in Pensions and Retirement Savings Accounts**

Social Security and state family law are not the only precedents for spousal rights. Tax-favored retirement plans established under federal law also offer a model for an individual account system. The appendix to this chapter summarizes spousal rights in these plans. Pensions and retirement savings programs include defined-benefit pensions, defined-contribution pensions, such as 401(k) plans and 403(b) plans, and individual retirement accounts (IRAs). Each defines the rights of account holders and spouses differently.

#### *Pension Plans*

Defined-benefit pension plans and money purchase defined-contribution plans provide broad spousal rights that extend beyond the worker's death and, in some cases, beyond divorce. The default pension paid to a married worker by a private, employer-provided pension must be a joint and (at least) 50 percent survivor annuity. A married participant who seeks to receive pension benefits with a less generous or no payment to the survivor must obtain the spouse's notarized consent. The spouse must also consent to any loan that would use the benefit as collateral. A widowed spouse has a waivable entitlement to at least 50 percent of the annuity that would have been paid to the deceased worker, whether the death occurs before or after retirement. Divorced spouses, by contrast, do not have any automatic rights, though at divorce they may seek rights to a share of the account or benefit. This settlement must be expressed in a Qualified Domestic Relations Order (QDRO). The extent of the divorced spouse's rights varies from state to state, depending upon whether a state uses common law or community property rules.<sup>3</sup>

### 401(k) Plans

Defined-contribution plans such as a 401(k) provide fewer rights for spouses. At retirement, no spousal consent is needed if funds are taken as a lump sum (the typical payout) or in periodic payments. Only if the plan offers annuities and the worker chooses one is spousal consent required for a payment other than a joint-and-survivor annuity. Account holders can take loans or withdrawals against their accounts without spousal consent. A divorced spouse may obtain some portion of the account in a divorce proceeding through a QDRO but he or she does not automatically receive a share. A widowed spouse does, however, have significant inheritance rights to account assets held in the plan. Unless the spouse had previously consented to the participant naming another beneficiary, he or she will automatically receive the entire account balance as a death benefit.

### Thrift Savings Plan

The Thrift Savings Plan (TSP), a 401(k)-type plan for federal employees, has different rules for spousal protection.<sup>4</sup> In general, spousal consent is needed before a worker can withdraw or borrow against the TSP account before retirement. As with 401(k) plans, a divorced spouse may seek some portion of the account in a divorce settlement, but he or she has no automatic share. Unlike 401(k) plans, the worker can name anyone as a death beneficiary; if no beneficiary is named, the spouse is the default beneficiary in the TSP line of succession. Like defined-benefit pension and money purchase defined-contribution plans—and unlike 401(k)s—the TSP requires notarized spousal consent before a worker can take a post-employment withdrawal from the account other than in the form of a joint-life annuity with a 50 percent survivor benefit.<sup>5</sup>

### Individual Retirement Accounts

IRAs give the least protection to spouses and the most freedom to account holders. No spousal consent is needed for pre-retirement withdrawals. In the event of divorce, spouses may seek IRA funds as part of the settlement under

state law, but awards are not automatic. The account holder can choose anyone as the death beneficiary.

### Summary

The spousal benefit provisions in other pension and retirement savings plans provide useful comparisons for the discussion of spousal rights in individual accounts. It is important to note, however, that these employer-based pensions and retirement savings account systems were created assuming the existing Social Security system. These benefits were intended to build on the Social Security base—not to replace Social Security in whole or in part. Should Congress develop individual accounts that would replace some share of retired-worker or disability benefits, and alter the spousal safety net that Social Security now provides, the rules regulating such accounts would acquire much greater significance.

### Federal or State Jurisdiction

State laws already address spousal rights, but states define these rights in a variety of ways. If Congress establishes a system of individual accounts, a key question is whether to have uniform federal policies on spousal rights or leave those policies to state jurisdiction.

### Federal Legislation Can Trump or Defer to State Law

The Social Security program provides uniform benefit rights throughout the country for spouses, widowed spouses, and ex-spouses. At the same time, the federal program relies on state law to determine whether a claimant is married, widowed, or divorced, with one exception—the Defense of Marriage Act of 1996 prohibits paying spousal benefits from Social Security or veterans' benefits to same sex couples, even if they are married under state law.

Under the federal system of government, laws that govern property rights during marriage, at divorce, and at the death of a spouse have traditionally been the province of state courts and legislatures. This historical delegation has pro-

duced marked differences in law and policy among states. If policymakers wish to implement uniform spousal rights under an individual account system, they will need to define the rules explicitly in federal legislation. Absent a federal pronouncement, state courts and legislatures will make determinations about spousal protection, the treatment of accounts at divorce, and account inheritance.

It is well established that when Congress creates a federal benefit program, it has the power to legislate on matters that would otherwise fall within the province of the states. Despite the general deference accorded to state jurisdiction in the area of family law, the Supreme Court has held that federal legislation preempts state law wherever state jurisdiction would do “‘major damage’ to ‘clear and substantial’ federal interests.” For example, in *Hisquierdo v. Hisquierdo*, 439 U.S. 572 (1979), the Supreme Court decided that a California decision to award the wife an interest in the husband’s expected benefits under the Railroad Retirement Act of 1974 was an impermissible conflict with the federal act, which provides benefits similar to those under the Social Security Act. Similarly, in *McCarty v. McCarty*, 453 U.S. 210 (1981), the Supreme Court decided that federal law precluded the state court of California from dividing military pensions upon divorce. In the following year, Congress enacted the Uniformed Services Former Spouses’ Protection Act, Title 10 U.S.C. sec. 1408, which permits state courts to treat military retired pay as property and divide it upon divorce.

The courts are likely to allow the federal government substantial leeway in structuring spousal rights for individual accounts. However, these precedents suggest that no spousal protections would be guaranteed unless specified in federal legislation on individual accounts.

Congress may decide to define spousal rights as a matter of federal law, or to defer to state law, or to do some of both.<sup>6</sup> If Congress does not deal with these issues, uncertainty about

whether these powers remain with the state or were implicitly preempted by federal law would generate considerable litigation and inconsistent results.

### *Pros and Cons of Federal Treatment of Spousal Rights*

The advantage of having national rules is clear: they ensure uniform treatment for all account holders, no matter where they work or reside. Moreover, uniform rules can reduce costs by reducing the need for lawyers to represent the rights of account holders and spouses and by simplifying plan administration. But creating federal policy on spousal rights in an individual account system would require making difficult choices because individual accounts represent a finite pool of assets—when one person receives a share, another person loses. In contrast, spousal benefit awards under Social Security do not reduce the worker’s benefit, as the cost of providing family benefits is spread among all Social Security participants.

State determination of spousal rights in individual cases would not provide the uniformity or administrative simplicity of federal rules. But state jurisdiction, arguably, might ensure more equitable treatment for individuals. State courts, for example, routinely decide how to divide the marital property of divorcing spouses who have been unable to reach settlement. Other retirement accounts (such as IRAs and 401(k)s), are already subject to division by state courts at divorce. The advantage of this approach lies in its flexibility: one divorcing spouse might want to exchange his or her right to a retirement account for the family home, while another divorcing spouse who expects to live a long life might prefer the interest in a retirement account. State courts might arbitrate these disputes and supervise settlements that better address the marital breakup circumstances.

At the same time, relying on state courts to determine spousal rights presents a number of challenges, particularly in the context of an individual account plan designed to reach low- and

moderate-income people who may be unable to afford lawyers. It is common for people to get divorced without the benefit of an attorney. Studies in individual states consistently find that in most family law cases, one or both parties is unrepresented. In California, for example, two-thirds of petitioners in family law cases did not have attorneys; by the time a divorce was granted, 80 percent were unrepresented (Judicial Council of California, 2004). Likewise, a Florida study found that about two-thirds of domestic relations cases began with at least one party unrepresented and the share of unrepresented parties grew by the time the cases ended (Greacen, 2002a). Of litigants filing for marital dissolution in the state of Washington, 62 percent of those without children and 47 percent of those with children were unrepresented (Greacen, Administrative Office of the Courts, 2002b). So, in determining the rules and procedures for dividing assets in an individual account at the time of divorce, it is important to recognize that at least one party often does not have a lawyer. The unrepresented spouse could be in a very precarious position.

## Framework for Analyzing Spousal Rights

Rules for delineating spousal rights or spousal protections for individual accounts would be influenced by the overall purpose of the accounts, the level of Social Security benefits that accompany the accounts, and whether participation is mandatory or voluntary.

### Purpose of Accounts

The suitability of spousal rights rules would depend on what role individual accounts are intended to play in relation to the Social Security system. More extensive federal spousal rights would be called for if individual accounts were designed to replace, in whole or in part, traditional federal Social Security benefits—which include spousal benefits. To the extent that individual accounts would supplement Social Security, more flexibility could be considered for account holders and/or for the role of state law.

## Level of Social Security Benefits

Similarly, the level of traditional Social Security benefits that accompany an individual account system could influence policymakers' views about spousal rights. The lower the level of remaining Social Security benefits, the stronger the case would be for requiring that accounts provide some mandatory protections found in Social Security. If traditional Social Security benefits are thought to provide an adequate baseline of retirement income, then more flexibility could be considered.

## Voluntary or Mandatory Participation in Accounts

If participation in an individual account system were voluntary, restrictive policies could deter participants. Individuals might be less interested in participating if contributions must be shared with the spouse, if accounts are automatically divided at divorce, if bequests cannot be made to beneficiaries other than the spouse, or if joint-and-survivor annuities must be purchased.

A voluntary individual account system also raises some specific challenges to designing and implementing spousal rights policies. If participation were voluntary, there would be no guarantee that spouses would make the same decision to participate. Indeed, many individuals enter the labor force and start contributing to Social Security before they marry. Consequently, spouses might have made different decisions about participation. Even if the plan allowed individuals to change their initial election about participation when they marry, efforts to require spouses to make the same choice would face the problem of multiple marriages. So, decisions would have to be made about how spousal rights rules would apply if only one spouse elects to participate. Mandatory spousal rights are not likely to achieve their intended purpose in a voluntary participation system.

## Worker-Specific Offsets and Spousal Rights

A new set of spousal rights issues arise in proposals that would allow workers voluntarily to

shift part of the scheduled Social Security taxes to personal accounts. These proposals call for worker-specific offsets against the worker's future benefits or account proceeds to compensate the Social Security Trust Fund, so as not to further jeopardize system solvency and to treat participants and non-participants in accounts equitably. How these offsets would interact with future benefit rights of the worker's spouse, ex-spouse, or widowed spouse raise complex questions, which are discussed in Chapter Nine.

## *Policy Choices for Spousal Rights*

Policymakers will need to decide how spousal rights would be addressed at different possible distribution points: during marriage, at divorce, at death, or at retirement. Many different answers are suggested by various Social Security proposals that call for individual accounts (Figure 6-3). We consider each life event in turn.

### *Spousal Rights during Marriage*

Federal policymakers would need to consider what spousal rights to recognize during marriage. For example, whether contributions to accounts would be split equally between husbands and wives and whether spousal consent would be required for pre-retirement loans or withdrawals, if such options exist.

#### *Contribution Splitting or Not*

A contribution splitting approach would divide account deposits equally between the husband and wife. Only contributions made during marriage would be divided in such a way—each spouse would retain any contributions and investment earnings accumulated while single or from previous marriages. A contribution-splitting approach would build community property principles into an individual account system.<sup>7</sup>

Contribution splitting is consistent with the partnership view of marriage and it gives each spouse a share of property to manage independently. Such a partnership view has gained national currency as women and men enter the

workforce in more nearly equal numbers. Unlike traditional Social Security, contribution splitting would provide portable spousal rights for women who divorce after fewer than 10 years of marriage.

If contributions were divided between spouses, policymakers could give each spouse the ability to singly control their own account. Policymakers could decide that accounts would not be subject to division at divorce (since each spouse had already received and invested their share of the marital earnings); spousal consent would not be required for pre-retirement withdrawals, and each spouse could decide what to do with his or her own account at retirement. Another option is that policymakers could establish some additional spousal rights, such as the right to inherit the spouse's account at widowhood.

A key issue with contribution splitting would be how to get accurate and on-going marital status reports so that contributions could be credited to each account in a timely and accurate manner. If contribution splitting were mandatory, this would be particularly important in cases of workers not wanting to report their marital status. Administrative issues are discussed later in this chapter.

#### *Spousal Consent for Loans or Withdrawals*

Contribution splitting would make each spouse's decisions about loans or withdrawals independent. If contributions were not split, decisions would have to be made about spousal-consent rules for account holders to withdraw or borrow against funds in their own individual accounts. The requirement of spousal consent would logically depend on whether a spouse had a claim on the partner's account at retirement, divorce, or widowhood. If the plan provided for dividing accounts at divorce or for spousal survivorship rights, then spouses would have a clear interest in preserving their partners' accounts. If the spouse had no such claims, the case for spousal consent would be reduced.

**Figure 6-3. Spousal Protection Rules in Selected Individual Account Proposals**

Proposal	Treatment of Individual Account at Certain Events				
	During marriage	At divorce	At death of worker	At retirement	Use after divorce or widowhood
<b>Mandatory Accounts Funded with New Contributions</b>					
ACSS (Gramlich): Individual Account Plan, 1996	No split; no access before age 62	Not specified	Widowed spouse must inherit. Unmarried worker names any heir.	Married buy joint-life inflation-indexed annuity unless spouse declines it.	Surviving spouse must keep acquired funds for own retirement. Other heirs spend it.
<b>Mandatory Accounts Funded with Scheduled Social Security Taxes</b>					
Reps. Kolbe-Stenholm: Bipartisan Retirement Security Act of 2004	Not specified	Not specified	Account holder names any heir	Not specified	Not specified
<b>Voluntary Accounts Funded with New Contributions from Workers</b>					
Ball, Social Security Plus, 2003	No split; IRA rules for access	Court can include in settlement like IRA	Worker can name any death beneficiary	Open access at retirement.	Former spouse can use acquired funds.
<b>Voluntary Accounts Funded with Scheduled Social Security Taxes</b>					
President's Commission (PCSSS) Models 1, 2, and 3 (2001)	No split; no early access	50-50 split of contributions made during marriage	Widow(er) must inherit. Unmarried worker names any heir.	Solvency estimates assumed married must buy joint and 2/3-survivor annuity (either CPI-indexed or variable)	Former spouse & surviving spouse must keep IA for own retirement. Other heirs can spend it.
Rep. Smith, Social Security Solvency Act of 2003 (H.R. 3055, 108th Congress)	50-50 split; no early access	Divorce terminates 50/50 sharing	Funds go to worker's estate	Purchase of CPI-indexed life annuity such that Social Security plus the annuity meets poverty line	No provisions
Pozen, 2002	No split; no early access	Not specified	Funds go to widowed spouse or estate	Default joint and 2/3 survivor annuity (solvency estimates assumed CPI-indexed)	Surviving spouse must keep for own retirement

**Sources:** U.S. Social Security Administration, 2004b, Selected solvency memoranda; National Academy of Social Insurance, December 1996, *Social Insurance Update*; Robert M. Ball, 2003, *Social Security Plus*, and November 2002 communication; Committee on Economic Development, 1997, *Fixing Social Security*

Even if federal law did not require spousal consent for all pre-retirement withdrawals or loans, it could require account administrators to comply with a preliminary order in a divorce case constraining account holders from depleting their accounts, and require spousal notice to promote consultation about a decision with potentially long-term financial consequences for the couple's retirement income.

## Spousal Rights at Divorce before Retirement

Any individual accounts proposal must also address what happens at divorce. If contribution splitting does not occur during marriage, then divorce might trigger a division of accounts between husbands and wives. The following six approaches show various ways to combine federal mandates for contribution-splitting during marriage, dividing accounts at divorce, and various roles for state courts. It will be important for policymakers to provide explicit guidance on two issues; whether or not accounts would be automatically divided at divorce and whether or not state courts would have authority to reallocate the funds as part of an overall divorce settlement.

**(1) Contribution splitting only.** If policymakers adopted contribution splitting during marriage, then at divorce each spouse could retain his or her own account—nothing more and nothing less. This approach might be the simplest to administer at the time of divorce if contribution splitting had already created two separate accounts. This policy would also represent a congressional decision to shield accounts from state divorce proceedings.

**(2) Contribution splitting and allow divorce reallocation.** This approach would establish contribution splitting with no further division at divorce as the default, but would allow a state court to reallocate accounts at divorce if necessary to avoid an inequitable result. This would be analogous to the approach taken by some states on the reallocation of separate property

during a divorce, which can be done in special circumstances.

If contribution splitting had not already occurred during marriage, then possible rules at divorce might be:

**(3) Mandate a 50/50 split** of account contributions and accumulations during marriage and permit no exceptions;

**(4) Set the default as a 50/50 split** of account contributions and accumulations during marriage, but permit other allocations if agreed by both parties or ordered in a divorce settlement;

**(5) Defer to state divorce proceedings explicitly.** Federal law would permit reallocation of accounts if negotiated or ordered as part of the divorce settlement, as with 401(k)s or IRAs;

**(6) Shield the accounts from state divorce proceedings altogether.** Federal law could explicitly preempt state family laws that otherwise would give spouses a claim to a share of the other spouse's account at the time of divorce.

### *Would Funds Acquired at Divorce be Accessible?*

If individual accounts were transferred between spouses at divorce, what restrictions, if any, would limit the recipient's use of the funds? When IRAs or 401(k) funds are transferred at divorce, the recipient can freely use the funds as long as taxes and tax penalties are paid on the withdrawals. Federal laws also permit the tax-favored account to be rolled over into another qualified tax-favored account for the ex-spouse without paying taxes or penalties.

As indicated in Chapter Five, most proposals for individual accounts as part of Social Security call for banning any access to individual account funds before retirement. Would that ban also apply to funds acquired at divorce? Whether or not funds acquired at divorce are accessible could influence property settlement negotiations. For example, a party in need of immediate cash

might trade off inaccessible retirement funds to get more liquid assets for immediate needs.

### When A Spouse Dies before Retirement

If a married worker dies, important questions are raised about the nature of the widowed spouse's rights to the deceased worker's account. State laws on widow's or widower's rights differ depending on whether states follow community property rules or common law rules and, in many cases, on whether children from the current marriage or a former marriage also survive the worker (Shammas, et al., 1987).

Pension and retirement savings plans offer a variety of precedents that preempt state property and family laws. Many individual account proposals that are part of Social Security reform include rules designed to protect widowed spouses. Possible options include:

**(1) Mandatory spousal inheritance.** This option would require that the deceased worker's account go to the widowed spouse without exception. If the account holder was unmarried, the account could go to a named beneficiary.

**(2) Spousal inheritance, unless the spouse consents otherwise.** The default in this option would transfer the account to the widowed spouse. If the spouse had waived the inheritance right in writing, the account could go to another named beneficiary. Federal rules call for this policy in most defined-contribution plans. In defined-benefit plans, however, widowed spouses are entitled to a survivor annuity of at least 50 percent, unless the spouse has waived this right.

**(3) Free choice for account holder with default to a federal order of precedence.** In this option, the account holder could name anyone he or she chose as death beneficiary without spousal consent. If, however, no death beneficiary were named, an order of precedence established by federal law would apply and the spouse would be first in line. The TSP follows this option.

**(4) Free choice for account holder with default to the estate and state law distribution.** This option would let the account holder name anyone he or she chose as death beneficiary without spousal consent. If, however, no death beneficiary were named, the proceeds would be part of the decedent's estate, unless the account rules specified an order of precedence for inheritance. Without such rules, the account would be distributed according to the terms of the decedent's will or, if there were no will, through state intestacy laws. This is the approach used with IRAs.

### Would Inherited Funds Be Accessible?

A key question is whether widowed spouses or other heirs would be restricted in what they could do with funds inherited from individual accounts. In IRAs, the TSP, and retirement plans, the heir is free to use the funds in any way he or she chooses. Many proposals that aim to replace part of traditional Social Security benefits with individual accounts are more restrictive with regard to widowed spouses; these proposals require that the widow(er) always be the death beneficiary and, in addition, that the funds be preserved for retirement. If there is no widowed spouse, the death benefit can go to any other named beneficiary and no restrictions are placed on use of the funds (Figure 6-3). In brief, these plans treat the widow's (or widower's) inheritance as a transfer that remains subject to the restrictive rules of the retirement system, while inheritance by others is an unrestricted bequest outside the retirement system.

While restricting a widow's use of funds might be motivated by a desire to protect the widow's retirement security, the policy could be viewed as unfairly restrictive. At a spouse's death, a widowed spouse might have a number of immediate and pressing financial needs, such as funeral expenses. Restricting use of death benefits only for widowed spouses and not for other beneficiaries could encourage account holders to name someone else as a death beneficiary – such as a child or trusted relative – to provide the surviving family with immediate access to the money.

Social Security currently pays benefits to two groups of non-elderly widows: widows with children under age 16 and disabled widows age 50 and older. Even if the rules for individual accounts generally restrict widows' pre-retirement access to the funds, the rules might allow access for these widows. However, allowing for early payment would reduce the future retirement benefits that could be paid from individual accounts. (See Chapter Eight for a discussion of payment options for young survivor families, which could include benefits for widows caring for minor children as well as children's benefits.)

Requiring the widow to preserve inherited funds for retirement might also be important if a plan utilizes worker-specific offsets as part of its design and financing (see Chapter Nine). If only bequests to a spouse were subject to an offset, this could also provide an incentive to name another death beneficiary, if permitted by the plan.

### *Spousal Inheritance and Second Marriages*

A number of Social Security reform plans would require that accounts always go to the widowed spouse and that the inherited account must be preserved for the widowed spouse's retirement. This policy could generate unintended results in the event of second marriages. For example, Mary inherits John's retirement account at his death and later marries Peter. If Mary dies before retirement, this policy would mean that Peter would get all of Mary and John's accumulated accounts. From a property perspective, other potential heirs of John and Mary – such as their children – might believe they have a more legitimate claim to their deceased parents' accounts than does their mother's second husband.

If individual account policy followed community property concepts, then inherited accounts preserved for retirement would not be co-mingled with marital property in a subsequent marriage. Separate accounting could facilitate separate treatment of inherited accounts in future distributions. It also could raise new administrative

hurdles in situations where individuals hold multiple accounts from different sources.

### *Implementation Issues in Free Choice of Death Beneficiaries*

The IRA and TSP models allow free choice of death beneficiary. In a large national system, administrative complexities will arise if a death beneficiary has not been named, cannot be found, or has predeceased the account holder. The TSP retirement plan and IRA systems use somewhat different procedures to determine inheritance rights in cases of ambiguity. The TSP has a federal statutory standard of inheritance rights in cases where the distribution at death is unclear. In contrast, retirement plans and IRAs often include rules for determining beneficiaries where none has been named. Otherwise, the assets become part of the participant's estate or, if there is no will, the question of inheritance is settled by state law.

The TSP model provides federal statutory standards to guide inheritance where there is no surviving designated beneficiary; it turns to state law only after pursuing an order of precedence that is consistent throughout the country. The federal default procedures follow an order of precedence similar to that found in many state intestacy laws, with the widowed spouse first in line, followed by the decedent's children. Box 6-1 summarizes the TSP order of precedence.

By comparison, if a plan participant or an IRA holder fails to name a death beneficiary, the account becomes part of the decedent's estate like other property left behind. The funds are then distributed according to the account holder's will (subject to any claims the widowed spouse might have against the will) or, in the absence of a will, according to state intestacy law. If the beneficiary predeceases the IRA participant, the beneficiary's heirs lose any claim to the account and the account is divided among other named beneficiaries. If no beneficiaries survive, the balance goes to the account holder's estate. IRA beneficiary designations also provide for cases in which the named beneficiary cannot

### Box 6-1. Thrift Savings Plan Default Order of Precedence When No Named Death Beneficiary Exists

If no death beneficiary has been named (or no named beneficiary outlives the account holder), the account is distributed according to the following order of precedence:

- (1) To the widowed spouse;
- (2) If none, to the account holder's child or children\* equally, and descendants of children by representation;\*\*
- (3) If none, to the account holder's parents equally or to the surviving parent;\*\*\*
- (4) If none, to the appointed executor or administrator of the estate;
- (5) If none, to the next of kin who is entitled to the estate under the laws of the state in which the account holder resided at the time of death.

\*Children include biological and adopted children, but not stepchildren who have not been adopted.

\*\*"By representation" means that if a child of the account holder had died, the deceased child's share will be divided equally among his or her children.

\*\*\*A parent does not include a stepparent, unless the stepparent had adopted the account holder.

**Source:** Federal Retirement Thrift Investment Board, 2001. *Summary of the Thrift Savings Plan for Federal Employees*

be found (the account goes to the estate), or when ambiguities or conflicts arise (the custodian can consult counsel and institute legal proceedings to be paid for with account funds). Language from a sample IRA beneficiary designation form is shown in Box 6-2.

### Retirement Payouts for Married Account Holders

Retirees face questions about how to ensure that their savings will last the rest of their lives (see Chapter Three for a detailed treatment of this issue). Outside of any retirement account system, individuals could purchase private annuities, withdraw from their retirement accounts at a fixed rate, or just spend the money as they like. For its part, Social Security offers no choice about the form of payments in old age, consistent with its goal of ensuring a basic retirement benefit throughout the lifespan. When qualified retirees or spouses or survivors apply, benefits are automatically paid in regular monthly

amounts. Payments last for life and are adjusted each year to keep pace with inflation. Benefits for wives, widows and children are supplemental; they do not reduce the worker's benefit.

Spousal rights in individual accounts present different policy issues because any money designated for a spouse would reduce the money available to the worker. In contrast to Social Security, where contributions are pooled and family benefits are funded from Social Security tax revenue, couples with individual accounts could pull only from their own account funds. Policymakers, then, would have to balance the interests of workers with the interests of spouses, and design rules that best coincide with program goals. More flexible structures might help lure participants if individual account participation is voluntary, but greater flexibility might not offer spousal protections that policymakers regard as adequate, especially if individual

### Box 6-2. Sample Death Beneficiary Designation for an IRA

I elect that when I die, my interest in my IRA will become the property of:

- The primary beneficiary, if he or she survives;
- Or if no primary beneficiary survives, the contingent beneficiary.

If no designated beneficiary survives, or if the custodian cannot locate the beneficiary, then the custodian will distribute the benefits to my estate.

I understand that if I fail to indicate percentage of benefits, the plan administrator will divide benefits equally among the beneficiaries I designate.

If a primary beneficiary dies after my date of death, but before receiving his or her percentage share of the IRA, his/her share should be transferred/distributed to his/her estate.

I understand that if any primary or contingent beneficiary dies and I wish to name a new beneficiary, or modify existing beneficiary information, I must complete a new IRA beneficiary form.

I reserve the right to revoke or change this beneficiary designation. I understand that any change or revocation will not be effective until it is given in writing to the plan administrator. This designation revokes all prior designations (if any) of primary or contingent beneficiaries.

I understand that if the plan administrator determines that my beneficiary designation is not clear with respect to the amount of the distribution, the date on which the distribution shall be made, or the identity of the party or parties who will receive the distribution, the plan administrator will have the right, in its sole discretion, to consult counsel and to institute legal proceedings to determine the proper distribution of the account, all at the expense of the account, before distributing or transferring the account.

**Source:** Charles Schwab & Co., 2004. *Retirement Accounts for Individuals*

accounts are intended to replace traditional Social Security benefits.

#### *Would Payouts Be Structured Like Social Security?*

Some individual account proposals aim to provide benefits somewhat analogous to Social Security's current protections for spouses widowed after retirement by requiring married retirees to buy inflation-indexed monthly annuities with joint and two-thirds survivor benefits.<sup>8</sup> Inflation indexing is particularly important to individuals expected to live for many years after retirement because purchasing power can be sig-

nificantly eroded by even modest rates of inflation over long periods of time.

Policymakers could make the purchase of joint-and-survivor annuities mandatory, or establish that option as the default, allowing a spouse to waive the right to receive an annuity, as is the case with defined-benefit pensions. If both the husband and wife purchased joint and two-thirds life annuities, when either one died the widowed spouse would begin receiving two-thirds of his or her own annuity and two-thirds of the deceased partner's annuity.

Policymakers could provide more spousal protection by requiring (or permitting) retirees to buy a joint and 100 percent survivor annuity. In this case, the widowed spouse would suffer no loss in income.

### *Impact of Survivor and Inflation Protection on Annuity Amounts*

The extensive protections of joint-and-survivor annuities are not costless. Each increment of extra insurance—inflation indexing, two-thirds joint-and-survivor benefits, 100 percent survivor benefits—will be reflected in lower monthly payments granted to annuitants; as the protections mount, monthly payments decrease. For example, a 65-year-old with a slightly younger spouse with an account of \$10,000 could buy a simple annuity with no inflation or survivor protection that would pay about \$80 a month (Figure 3-5 in Chapter Three). Inflation protection (assuming 3 percent inflation) would lower the individual annuity to about \$62 a month. Adding two-thirds survivor protection for a spouse aged 62 would lower the initial annuity to about \$55 a month for the account holder, with the survivor benefit starting at about \$37 a month. Requiring 100 percent survivor annuities would produce an even smaller annuity while both were alive—\$48 a month in this example—but the payment would continue undiminished to the widowed spouse.

### *Disparities in Age*

Joint-life annuities will vary depending on the ages of both the husband and wife. If a retiree had a much younger wife, the annuity would be smaller. For example, if a 65-year-old retiree had a 53-year-old wife, he would take a bigger cut in his annuity to provide survivor protection for his wife. If he had \$10,000 to spend, giving his wife a two-thirds survivorship interest in the annuity would reduce his immediate payment from \$62 (under a single-life annuity) to about \$48—a drop of about 22 percent—well below the approximately \$55 payment if his wife were 62 (Figure 3-9 in Chapter Three). Twelve years later, when the wife reached age 65 and her husband was 77, she would buy a joint and two-

thirds survivor annuity but, in her case, the immediate annuity payment would be about 10 percent higher than the single-life annuity she could buy at that age.<sup>9</sup>

### *Change in Marital Status After Annuitization*

In general, life annuities cannot be rewritten after they are purchased to, for example, change from a single-life annuity to a joint-and-survivor annuity, or vice versa, or to name a different beneficiary for the survivor annuity. So, if an individual marries after annuitization, it could be difficult for the new couple to ensure survivor protection in widowhood. Joint-and-survivor annuities help people who are married at the time they annuitize, but someone who was single, divorced, or widowed at retirement would have purchased a single-life annuity. If this retiree then got married, he or she would be unable to convert the single-life annuity into one that protected his or her new spouse as well.<sup>10</sup> But if the spouse were younger, she or he would be required, under a pure annuity mandate for all married retirees, to buy a joint-and-survivor annuity when she or he annuitized at retirement age. The result would be an asymmetry of benefits between the two spouses.

The treatment of individuals who divorce after at least one has purchased an annuity poses other issues. If both spouses had purchased joint and two-thirds survivor annuities, then each might keep his or her own annuity and the survivorship interest in the other's account even after a divorce. But if either remarried there would be no survivor annuity to leave to a new spouse.

If only one spouse had annuitized before divorce, a variety of approaches are possible. One option would divide the un-annuitized account according to the plan's usual rules for division at divorce. This would leave one spouse with the right to receive a survivor benefit from the spouse who had annuitized, and the spouse who had annuitized with a share of the other spouse's account. (The plan would also have to decide what options are available to someone

who receives account proceeds through division at divorce or by inheritance after annuitization.) Another approach would allow state courts to decide how to address the issues, for example, by dividing the account in an equitable way, ordering the spouse who had not yet annuitized to name the former spouse as the beneficiary of a joint-and-survivor annuity at the time of annuitization (which would eliminate any survivor benefits for a subsequent spouse), or awarding other property or income to achieve an equitable result.

In summary, a system providing maximal spousal rights would mandate contribution splitting during marriage or automatic division of accounts at divorce, spousal inheritance of an account if death occurs before retirement, and purchase of joint-and-survivor annuities by all married individuals at retirement. At the other end of the spectrum, a regime with no spousal rights would have federal law preempt state law and create no federal spousal rights. As such, spouses would lose any state law claims to contributions to an account made by the other spouse during marriage, shield individual accounts from divorce settlements, allow the account holder to name anyone he or she wanted as a death beneficiary, and give the account holder unfettered discretion over the use of funds at retirement. Policies for spousal benefit rules could fall anywhere between these two extremes.

## Implementation Issues

Administering spousal rights in an individual account system could impose new reporting and verification requirements, beyond those faced by the Social Security system. For its part, Social Security simplifies administration of family benefits in a number of ways.

### Determining Family Status at Benefit Entitlement or Over the Lifetime

Social Security benefit entitlement is generally based on the family relationships in existence when individuals establish entitlement to bene-

fits—when workers retire, die, or become disabled. The system does not need to track marriage and divorce over the working life. If individual accounts required ongoing updates on the account holder’s family status before becoming entitled to benefits, Congress would need to authorize new administrative arrangements for reporting and resolving disputes or discrepancies in marital status. Additionally, the ongoing updates would need to account for less formal family relationships such as common law marriage (recognized by some states, but not by all), informal separation or abandonment, or parent-child relationships. These less formal family relationships are more time-consuming to document because they are based on evidence of living arrangements and financial support rather than on official records of marriage, divorce, birth, or adoption. Documenting these changes only at the time of benefit entitlement requires fewer resources than year-by-year reporting and verification.

Evidence of divorce and marriage duration is required only infrequently to determine eligibility for Social Security benefits. About 1 million of the 46 million Social Security beneficiaries in 2001 received benefits based wholly or in part on an ex-spouse’s work record. Of the 4.2 million people newly awarded Social Security benefits in 2001, roughly 100,000 of the cases involved evidence of divorce—a scant one-tenth of the approximately one million divorces that occur every year in the United States (U.S. Census Bureau, 2001). As these numbers indicate, an individual account system requiring the division of accounts at divorce would likely require far more frequent and extensive collection of evidence of marriage, spousal identity and contributions, duration of marriage, and divorce. This collection would, in turn, mean a major step-up in administrative capacities and costs over the current system.

### Incentives to Report and Document Family Status

The current Social Security benefit structure provides a strong incentive for individuals to report

and document family relationships. Spouses and divorced spouses receive benefits in addition to those paid to workers, with no consequent reduction in workers' own benefits. When a worker divorces and remarries, for example, both the divorced spouse and the subsequent spouse could receive benefits with no change in the worker's own benefit income. In other words, it is a win-win proposition to report and document marital and family information accurately: the worker suffers no loss, and it is to the advantage of the spouse. These rules help ensure the necessary flow of information from claimants to the Social Security Administration.

By contrast, if individual accounts were divided between husbands and wives, either by contribution splitting year-by-year or by dividing accounts at divorce, account holders might fail to report a marriage because they do not want a spouse to receive funds at their own expense. As a result, administering an automatic division of accounts at divorce—a rule that on its face has the appeal of simplicity and administrative ease—could entail new reporting and verification. If the rule for division at divorce were limited to just the contributions and earnings accumulated during marriage, then historical records of year-by-year individual contributions and investment earnings would be needed along with evidence and dates of marriage and divorce.

### Mechanisms for Reporting Family Status

Employers, the federal income tax system, state marriage and divorce records, and individuals themselves are four possible sources of information about marital status and spousal identities.

Employers' W-2 and W-3 reports are the main source of information that the Social Security Administration relies on to correctly credit each worker's annual earnings to his or her Social Security record. This system works remarkably well, but it is not foolproof. Wages that cannot be matched to a Social Security number are placed in a suspense file. This suspense file currently holds 236 million wage items totaling

about \$375 billion, \$49 billion of which was added in tax year 2000 (U.S. SSA, 2003c).

When a wage report does not match identifying information in its records, the Social Security Administration uses a series of automated routines to check for common mismatches – variations in the spelling of common names or nicknames, or transposed digits in the Social Security number. When these routines do not yield a match, the Social Security Administration contacts the employer to help resolve the discrepancy. In sectors that experience high labor turnover – such as agriculture, food service, and construction – employers are often unable to help resolve discrepancies because the employee has moved on and the employer has no further information.

While employers might be willing to pass on marital status information that their employees voluntarily report, it is doubtful that employers would want to be responsible for ensuring the accuracy of spousal information sufficient for an individual account system administrator to match records. Nor would employers likely want to become intermediaries for resolving discrepancies between the Social Security Administration's records and the spousal identifying information supplied by a current or former employee. A system beyond employer reports would be needed to document and verify spousal identities.

Federal income tax returns might be used to link information about husbands and wives, at least in cases in which couples chose to file joint tax returns. Using income-tax reporting as a basis for enforcing the division of individual accounts between husbands and wives could influence whether or not taxpayers file joint returns.

Because marriage is a state-defined legal status that imposes responsibilities on spouses for children and sharing of property and expenses, states maintain marriage records in order to document a legal status that cannot be duplicated and that can only be terminated through a legal procedure. Because an individual might

marry in one state and divorce or become widowed in another state, validation from several states might be needed to document a marital history. One approach to obtaining marriage and divorce data is to establish a national reporting system, perhaps through the National Center for Health Statistics (NCHS), the federal agency that now collects data on deaths from state and county records. Use of a standard reporting form and paying states for the death data has led to fuller state compliance and uniformity. The National Death Index maintains a national record on each death from computer files submitted by state vital statistics offices. This file is currently used by the Social Security Administration to validate deaths. States maintain marriage and divorce records and some states, such as Massachusetts, have historical records that are publicly available. Other states offer the ability to request marriage and divorce certificates online.

The NCHS once tried to construct a national system of state marriage and divorce records, but abandoned this effort in 1995, due to budgetary pressures and concerns about the quality and completeness of the divorce data. In theory, the agency could renew effort to collect marriage and divorce data for administering individual accounts. Responsibility for creating such a system could also be assigned to another federal agency. For example, the Federal Case Registry is a national record system maintained by the federal Office of Child Support Enforcement. The Registry is designed to include information about all child support cases handled by state child support agencies and all support orders established or modified after October 1, 1998, even if they are not being enforced by state agencies.

A central depository of state marriage and divorce records would reduce problems of incomplete reporting associated with a voluntary reporting system or with an income-tax based system that does not require everyone to file. It would require uniform reporting across states and may raise confidentiality issues that now

vary across the states. While a national index of marriage and divorce records would document marital histories, it would not resolve changes in property rights that might occur as individuals move from state to state.

New resources would be needed to set up a national marriage and divorce record system and ensure that states collect the information in a uniform, complete and timely way. Decisions would be needed about how much of the information is publicly accessible and how to protect the privacy and security of non-public information.

Finally, individuals could be asked to provide correct and current information about their marital status through the Social Security statement that is currently mailed every two years to workers age 25 and older.

Depending on how accounts were managed, information about marital status might need to be transmitted from the government to a private entity managing the account. Policymakers would need to determine how to assign responsibility for verifying the information.

### *Resolving Disputes*

The division of an individual account would produce winners and losers. Since money, once paid out of an account, would be difficult to recover, disputes about family status are more likely to arise with an individual account plan than with Social Security. Policymakers would need to develop procedures for hearing and resolving disputes.

## *Summary*

Social Security currently provides spousal benefits to wives, widows, husbands, widowers, as well as ex-wives and ex-husbands, protecting them against the income consequences of a worker's death, retirement, or disability. These benefits are provided without reduction in the benefit paid to the worker. Spousal benefits are paid only to the extent that the benefit exceeds

what the spouse would receive based on his or her own work record; benefits paid for life and are annually indexed for inflation. The introduction of individual accounts would require resolution of what rights for spouses and survivors would be required in those accounts, with that resolution being more important if the accounts were designed to replace a part of Social Security benefits.

If Congress establishes a system of individual accounts, a key question is whether to have uniform federal rules concerning spousal rights or leave the issues to state jurisdiction. Rules that define spousal rights and protections in individual accounts could be based on federal law precedents in Social Security, federal provisions in current pension and retirement plans, or could be delegated to state family law.

The federal Employee Retirement Income Security Act and the Internal Revenue Code determine spousal rights in private pensions and retirement savings. These spousal rights vary widely across types of retirement accounts, but generally protect only current spouses. Private employer-provided defined-benefit plans require that a spouse receive at least a 50 percent survivor pension from the plan, unless the spouse has waived that right. Providing the survivor pension lowers the pension amount for the retiree. Tax-deferred individual retirement accounts provide no special rights to spouses, although the accounts can be divided at divorce under state family law.

In the United States, the historical delegation to states of jurisdiction over family property rights has produced marked differences in law and policy among states. Common law states consider the title-holder to be the owner of the property, although all common law states now call for equitable distribution of property at divorce or death. Community property states view property acquired during the marriage as belonging equally to husbands and wives.

If policymakers wish to implement uniform spousal rights under an individual account system, they will need to define the rules explicitly in federal legislation. Absent a federal pronouncement, state courts and legislatures will make determinations about spousal protection, the treatment of accounts at divorce, and account inheritance. These determinations will lead to differences in the way accounts are treated for account holders residing in different states. State rules may also lead to changes in the property treatment of accounts as account holders move between common law and community property states.

If policymakers wish to have uniform federal rules, important tradeoffs remain in choosing between spousal protections that resemble features of traditional Social Security and spousal rights that relate to property concepts with regard to inheritance rights and equitable divisions of marital property at divorce.

A voluntary individual account system also raises some specific challenges to designing and implementing spousal rights. If participation were voluntary, there would be no guarantee that both spouses would make the same decision to participate. Rules that seem equitable when both parties are participants could have unintended outcomes if only one party participates in the plan. Proposals for voluntary accounts also often call for worker-specific offsets against future Social Security benefits or account proceeds; how these offsets would interact with spousal payments from traditional Social Security or the individual account raise complex questions that are discussed in Chapter Nine.

Administering spousal rights in an individual account system could impose new reporting and verification requirements and dispute-resolution procedures beyond those needed to implement Social Security. Social Security family benefits are generally based on family relationships in effect when people claim benefits – when a worker retires, dies or becomes disabled. Divorced spouses claims are also determined at

that time. In contrast, updated marital status data would be needed if marital property concepts were used to allocate spousal rights during marriage. While a national marriage and divorce registry would accomplish this, such a system does not now exist. Without such a system, some administrative mechanisms would be needed to resolve factual disputes about marital status, timing, and duration between parties who stand to gain or lose by the allocation of spousal rights. Such disputes are minimized in traditional Social Security because benefits for a worker

and current spouse are not affected by the benefit claims of an ex-spouse.

As the foregoing discussion illustrates, any individual account proposal must look beyond the individual account holder and address the issues of spousal rights to the account during marriage, at divorce, at retirement, and at death. A clear articulation of congressional intent as to the rights of current and ex-spouses would be necessary to clarify the process of payouts from individual accounts.

## Chapter Six Endnotes

- 1 In this chapter “spousal benefit” describes benefits based on a former or current marriage to a primary beneficiary. The term includes benefits to wives, husbands, widows, and widowers. “Wife” benefits refer to the benefits paid to women and men married to a retired or disabled worker. “Widow” benefits refer to benefits paid to widows and widowers of deceased workers.
- 2 Divorced spouses are included as spouses or widowed spouses in Figure 6-1 but are not identified separately.
- 3 In community property states an employer-provided defined-benefit pension plan may be considered community property while both husband and wife are alive, but the interest of the secondary spouse may terminate upon that spouse’s death. That is, the non-pensioner may not have a right to bequeath a share of the other spouse’s defined-benefit pension.
- 4 There are two versions of the TSP. For employees covered under Social Security and the newer Federal Employees’ Retirement System (FERS) that began in 1986, the TSP involves employer-matching contributions and has somewhat stricter rules for spousal consent and protections. Employees who remain in the old Civil Service Retirement System (who are not covered by Social Security) can contribute to the TSP but have no employer matching funds and their TSP accounts have somewhat weaker spousal protections, in that the rules call for spousal notice, but not spousal consent.
- 5 The FERS TSP requires spousal consent as described; the CSRS TSP requires spousal notice.
- 6 For example, under federal law, a widowed spouse has a right to a 50 percent survivor’s annuity in a defined benefit plan regardless of state inheritance laws, but the division of benefits at the time of divorce is explicitly left to state courts.
- 7 Contribution splitting has some similarity to proposals for earnings sharing. Earnings sharing proposals would divide Social Security wage credits on which Social Security defined benefits are based. See, Technical Committee on Earnings Sharing, Center for Women’s Policy Studies, *Earnings Sharing in Social Security: A Model for Reform* (Edith Fierst and Nancy Duff Campbell, eds., 1988). Contribution-splitting as discussed here would divide contributions to individual accounts each year as contributions are made.
- 8 As discussed in Chapter Three, joint-life annuities produce somewhat different results than Social Security benefits for both one-earner couples and two-earner couples in retirement.
- 9 The joint-life annuity is larger than the single life annuity because the joint-life annuity pays less when the primary annuitant is widowed, which is highly probable when the spouse is 12 years older.
- 10 The current Social Security system does provide this benefit, protecting the new spouse against loss in income upon the death of the remarried covered worker.

## Appendix: Precedents for Spousal Rights

Figure 6-A. Spousal Rights and Benefits in Various Retirement Savings and Pension Plans

	Pre-Retirement Distribution	Distribution at Retirement	Divorce	Pre-Retirement Death	Post-Retirement Death
<b>IRA<sup>1</sup></b>	None. The account holder may spend IRA funds without spousal consent (although tax penalties apply for withdrawals before age 59½).	None. The account holder may spend any or all IRA funds without spousal consent.	IRA funds generally are subject to division at divorce. The spouse can seek some portion of IRA funds in divorce proceedings, but does not automatically receive a share. Any annuity award reduces the funds that the account holder will receive.	IRA funds will be distributed to the designated beneficiary. The account holder may designate anyone he or she chooses as a beneficiary.	None. If IRA funds remain, they will be distributed to the designated beneficiary.
<b>401(k)</b>	None. The participant may take loans <sup>2</sup> or hardship withdrawals from his or her account while employed by the plan sponsor without spousal consent.  If the participant leaves the sponsoring employer, he or she may spend 401(k) funds (although tax penalties apply) or roll the funds into an IRA without spousal consent.	None if account funds are distributed as a lump sum or in periodic payments (the most common and often the only options). The participant may spend any or all thereby distributed 401(k) funds without spousal consent. If annuities are an option, spousal consent is required for any annuity purchase other than a joint-and-survivor.	401(k) funds are subject to division at divorce. A participant's spouse can seek some portion of 401(k) funds in divorce proceedings, but does not automatically receive a share. Any award will reduce the funds that the participant will receive.	If a participant dies before retirement, his or her spouse will receive the 401(k) account balance, unless the spouse has previously consented in writing to the designation of an alternate beneficiary.	None, to the extent the balance was already distributed before or at retirement. If any funds remain in a participant's 401(k) account, the spouse will receive the account balance unless the spouse has previously consented in writing to the designation of an alternate beneficiary.

1 Generally, state law governs IRAs. Spousal rights vary both between common law and community property states, and among states in each category.

2 401(k) plans typically allow participants to borrow 50 percent of their account balances, up to \$50,000.

**Figure 6-A. Spousal Rights and Benefits in Various Retirement Savings and Pension Plans (continued)**

	Pre-Retirement Distribution	Distribution at Retirement	Divorce	Pre-Retirement Death	Post-Retirement Death
<b>Defined-Benefit/ Money Purchase Pension Plan</b>	A participant's spouse must consent if the participant seeks to use the accrued benefit as collateral for a loan. Other than for loans, which very few plans allow, participants are generally unable to access their accrued benefit prior to retirement.	A participant's spouse must consent if the participant seeks to receive pension benefits other than a joint and at least 50 percent survivor annuity. A survivorship interest for the spouse will reduce the participant's annuity.	Pension benefits are subject to division at divorce through a properly executed QDRO. <sup>3</sup> A spouse can seek a portion of the participant's annuity and/or a survivor annuity, but does not automatically receive these benefits. Any annuity award reduces the benefits that the participant will receive. <sup>4</sup>	A participant's spouse will receive a survivor annuity equal to not less than 50 percent of the annuity that would have been paid to the participant, unless the spouse has previously waived this right in writing. <sup>5</sup>	A participant's spouse will receive a survivor annuity equal to not less than 50 percent of the annuity that was paid to the participant while the participant was alive, unless the spouse has previously waived this right in writing. <sup>6</sup>
<b>CSRS and FERS<sup>7</sup></b>	Under FERS, a participant's spouse must consent to in-service loans and withdrawals.  Under CSRS, a participant may make voluntary contributions to fund a higher annuity. The participant can withdraw these funds at any time, without spousal consent. <sup>8</sup>	A participant's spouse must consent if the participant seeks to receive pension benefits other than a joint and no more than 55 percent survivor annuity. A joint-and-survivor annuity will reduce the annuity payments that the participant will receive.	Pension benefits are subject to division at divorce. A participant's spouse can seek some portion of the participant's annuity and/or a survivor annuity in divorce proceedings, but does not automatically receive these benefits. Any annuity award reduces the benefits that the participant will receive.	A participant's spouse will receive a survivor annuity. <sup>9</sup> Each child of a participant will receive a survivor annuity, if the child is dependent; unmarried; and either (1) under 18, (2) incapable of self-support because of a disability, or (3) between the ages of 18 and 22 and a full-time student. The amount of the annuity depends on whether the child's other parent is still living. <sup>10</sup>	A participant's spouse will receive a survivor annuity equal to no more than 55 percent of the annuity that was paid to the participant while the participant was alive, unless the spouse has previously waived this right. <sup>10</sup>

3 Private pension plans are not required to recognize orders that do not satisfy the requirements for Qualified Domestic Relations Orders set forth in ERISA. Even if a divorced spouse is able to obtain a revised order in state court, plans sometimes refuse to recognize revised QDROs or ODROs issued after a divorce is final.

4 Under federal law, a participant's former spouse is eligible to receive a survivor annuity if he or she had been married to the participant for at least one year.

5 A plan may specify that benefits will not be payable to a participant's surviving spouse unless the participant and spouse have been married for one year preceding the death of the participant.

6 A plan may specify that benefits will not be payable to a participant's surviving spouse unless the participant and spouse have been married for one year preceding the commencement of annuity payments or the death of the participant.

7 In 1987, federal employees were given the option to elect coverage under either the Federal Employees' Retirement Service (FERS) or the Civil Service Retirement System (CSRS). Unless otherwise indicated, the elements of the CSRS and FERS pension plans set forth in this section of the chart are identical.

8 There is no consent requirement for the form of payment of an annuity funded by voluntary contributions; a participant may, but need not, reduce his or her higher annuity in order to provide a survivor annuity for his or her spouse.

9 Under CSRS, the widow or widower's survivor annuity will be equal to 55 percent of the annuity that the participant would have received. Under FERS, the survivor annuity will be equal to either 50 percent of the participant's annual rate of pay plus \$15,000 or 50 percent of the annuity that would have been paid to the participant, depending how long the participant worked for the federal government.

10 In addition, at the time of retirement, a participant may elect to reduce his or her annuity in order to provide a survivor annuity for a beneficiary with an insurable interest in the participant's income. Spousal consent is not required, unless the participant seeks to provide a survivor annuity for his or her spouse under the insurable interest annuity provisions. Current spouses, blood or adopted relatives closer than first cousins, former spouses, someone to whom the participant is engaged, and common law spouses are presumed to have an insurable interest; for all others, the participant must submit evidence showing the extent to which the beneficiary is dependent on the participant and "the reasons why the named beneficiary might reasonably expect to derive financial benefit from the continued life of the employee or member." The exact amount of the insurable interest annuity is not set forth by statute, but the participant's annuity may not be reduced by more than 40 percent to pay for such an annuity.

**Figure 6-A. Spousal Rights and Benefits in Various Retirement Savings and Pension Plans (continued)**

	Pre-Retirement Distribution	Distribution at Retirement	Divorce	Pre-Retirement Death	Post-Retirement Death
<b>CSRS Thrift Savings Plan</b> <sup>11</sup>	When a participant applies for in-service loans or withdrawals, the participant's spouse must be notified. Once a participant has left the civil service, he or she may withdraw funds from the TSP account in a single or monthly payment, or as an annuity. <sup>12</sup> If a participant who has left civil service applies for a withdrawal and his or her TSP account balance is more than \$3,500, the participant's spouse must be notified within a year of the application. If the TSP balance is less than \$3,500, a participant who has left civil service may apply for a withdrawal without notifying his or her spouse.	If a participant who has left civil service applies for a withdrawal and his or her TSP account balance is more than \$3,500, the participant's spouse must be notified. A participant who has left civil service may withdraw TSP funds without notifying his or her spouse.	TSP funds are subject to division at divorce. Consequently, a participant's spouse can seek some portion of TSP funds in divorce proceedings, but does not automatically receive a share. Any award reduces the funds that the participant will receive.	If a participant dies before electing a payout, the funds will be distributed to the designated beneficiary. The participant may designate anyone he or she chooses as the beneficiary. Thus, a participant's spouse will receive TSP funds at the participant's death only if designated as the beneficiary. <sup>13</sup> If a participant dies after electing to receive his or her TSP account balance as a joint-and-survivor annuity for the participant and his or her spouse, the spouse will receive the TSP funds. <sup>14</sup> If a participant dies after electing to receive his or her TSP account balance as a single or monthly payment, a single-life annuity, or a joint-and-survivor annuity for the participant and a beneficiary with an insurable interest, none. <sup>15</sup>	If a participant elected a joint-and-survivor annuity, the spouse will receive a survivor annuity equal to 50 percent of the annuity that was paid to the participant while the participant was alive. If a participant elected to receive his or her TSP account balance as a single or monthly payment, a single-life annuity, or a joint-and-survivor annuity for the participant and a beneficiary with an insurable interest, none. <sup>16</sup>

<sup>11</sup> The Thrift Savings Plan (TSP) for federal employees is similar to a 401(k) plan for private employees. FERS, but not CSRS, TSP participants receive automatic agency contributions to their TSP accounts as well as agency matching funds.

<sup>12</sup> The participant may elect a single-life annuity, a joint-and-survivor annuity for the participant and his or her spouse, or a joint-and-survivor annuity for the participant and a former spouse or other individual with an insurable interest in the participant's income. The participant may also elect for the payment or payments to occur at a future date. The participant may change or cancel a withdrawal election before the withdrawal is disbursed, but a CSRS participant's spouse must be notified.

<sup>13</sup> Alternatively, if there is no designated beneficiary, his or her spouse will receive the funds; if there is no spouse, the participant's child or children (or descendants of deceased children) will receive the funds.

<sup>14</sup> The spouse will receive the TSP funds as either an annuity or a lump sum, depending on whether an annuity had been purchased at the time of death.

<sup>15</sup> If the participant elected to receive a single or monthly payment, the spouse or other family member will receive the TSP account balance if designated as the beneficiary by the participant—or, if there is no beneficiary, according to the statutory order of precedence. If the participant elected but had not purchased a single-life annuity, then the spouse or other family member will receive the TSP account balance if designated as the beneficiary by the participant—or, if there is no beneficiary, according to the statutory order of precedence. If the participant selected a joint-and-survivor annuity with a beneficiary with an insurable interest, the spouse or other family member will receive the TSP account balance if designated as the beneficiary by the participant.

<sup>16</sup> If the participant elected to receive a single or monthly payment and TSP funds remain, the spouse or other family member will receive the TSP account balance if designated as the beneficiary by the participant—or, if there is no beneficiary, according to the statutory order of precedence. If the participant elected a single-life annuity, benefit payments will be made accordingly. If the participant selected a joint-and-survivor annuity with a beneficiary with an insurable interest, the spouse or other family member will receive the TSP account balance if designated as that beneficiary by the participant.

**Figure 6-A. Spousal Rights and Benefits in Various Retirement Savings and Pension Plans (continued)**

	Pre-Retirement Distribution	Distribution at Retirement	Divorce	Pre-Retirement Death	Post-Retirement Death
<b>FERS Thrift Savings Plan</b>	<p>Spouse must consent before participant receives an in-service distribution or loan.</p> <p>Once a participant has left civil service, he or she may withdraw funds from the TSP account in a single payment, in monthly payments, or as an annuity.<sup>17</sup></p> <p>If the TSP balance exceeds \$3,500 and a participant wishes to withdraw TSP funds after leaving civil service, the spouse must consent. Otherwise, the TSP funds will be distributed in the form of a joint and 50 percent survivor annuity, unless the spouse waives this right.</p> <p>If the TSP balance is less than \$3,500, no consent is required.</p>	<p>If the TSP account balance exceeds \$3,500, a participant's spouse must consent if the participant seeks to receive TSP account funds in any form other than a joint and 50 percent survivor annuity.</p> <p>If the TSP balance is less than \$3,500, none. A retired participant may withdraw TSP funds without spousal consent.</p>	<p>TSP funds are subject to division at divorce. A participant's spouse can seek some portion of TSP funds in divorce proceedings, but does not automatically receive a share. Any award reduces the funds that the participant will receive.</p>	<p>If a participant dies before electing a payout of his or her TSP funds, none. The funds will be distributed to the designated beneficiary. A participant may designate anyone he or she chooses as the beneficiary. Thus, a participant's spouse will receive TSP funds at the participant's death only if designated as the beneficiary.<sup>18</sup></p> <p>If a participant has elected a joint-and-survivor annuity, the spouse will receive the TSP funds.<sup>19</sup></p> <p>If a participant's spouse waived the right to receive a joint-and-survivor annuity, none.<sup>20</sup></p>	<p>If the TSP account balance exceeds \$3,500, a participant's spouse will receive a survivor annuity equal to 50 percent of the annuity that was paid to the participant while the participant was alive, unless the spouse has previously waived this right.</p> <p>If a participant's spouse waived the right to receive a joint-and-survivor annuity, none.<sup>21</sup></p>

17 The participant may elect a single-life annuity, a joint-and-survivor annuity for the participant and his or her spouse, or a joint-and-survivor annuity for the participant and a former spouse or other individual with an insurable interest in the participant's income. The participant may also elect for the payment or payments to occur at a future date. The participant may change or cancel a withdrawal election before the withdrawal is disbursed, but a FERS participant's spouse must consent (unless the spouse previously waived the joint-and-survivor annuity option).

18 Alternatively, if there is no designated beneficiary, his or her spouse will receive the funds; if there is no spouse, the participant's child or children (or descendants of deceased children) will receive the funds.

19 The spouse will receive the TSP funds either in the form of an annuity or as a lump sum, depending on whether the annuity had been purchased at the time of death.

20 If the participant elected to receive a single or monthly payment, the spouse or other family member will receive the TSP account balance if designated as the beneficiary by the participant—or if there is no beneficiary, according to the statutory order of precedence. If the participant elected a single life annuity but an annuity has not been purchased, then the spouse or other family member will receive the TSP account balance if designated as the beneficiary by the participant—or if there is no beneficiary, according to the statutory order of precedence. If the participant selected a joint-and-survivor annuity with a beneficiary with an insurable interest, the spouse or other family member will receive the TSP account balance if designated as that beneficiary by the participant.

21 If the participant elected to receive a single or monthly payment and TSP funds remain, the spouse or other family member will receive the TSP account balance if designated as the beneficiary by the participant—or if there is no beneficiary, according to the statutory order of precedence. If the participant elected a single-life annuity, benefit payments will be made accordingly. If the participant selected a joint-and survivor-annuity with a beneficiary with an insurable interest, the spouse or other family member will receive the TSP account balance if designated as that beneficiary by the participant.

Prepared by the National Women's Law Center, October 2002. The Center appreciates the comments of Pamela Perun.

# Chapter 7

## Disabled Workers and their Families

### *Introduction*

When considering individual accounts as part of Social Security, it is important to take account of disabled-worker beneficiaries<sup>1</sup> and their families. In 2003, about 16 percent of all Social Security beneficiaries were disabled-worker beneficiaries and their dependent children or spouses.

Changes in basic disabled-worker benefits would affect other beneficiaries, including former disabled workers who are reclassified as retirees when they reach normal retirement age, children and widowed spouses of deceased disabled workers, widows in old age who receive benefits based on the work record of a spouse disabled before he died, and disabled adult children who receive benefits based on the work record of a parent who is deceased, disabled or retired. More information about disabled adult child beneficiaries is in Chapter Eight.

Any changes in Social Security defined benefits that would affect disabled-worker beneficiaries and their families throughout the rest of their lives should be thought through carefully. It is

important to distinguish between two reasons why Social Security benefits might be reduced. First, because Social Security is not in long-term financial balance, various proposals call for reducing traditional defined benefits as part of a solvency proposal. These benefit reductions for solvency are not the topic of this report. We are not assessing ways to bring Social Security into balance, nor are we weighing tradeoffs between benefit reductions and revenue increases to restore solvency. Rather, our purpose is to help policymakers think through payout issues that arise in various types of proposals that create individual accounts as part of Social Security.

Second, plans that shift Social Security taxes to individual accounts generally call for additional reductions in scheduled retirement benefits to phase in as the accounts build up. These so-called “benefit offsets” are typically designed with retirement benefits in mind, and, depending on how they are designed, could have unintended effects on the benefits of disabled workers or other beneficiaries who may not share in the proceeds of the individual account. These bene-

fit offsets usually differ depending on whether participation in the accounts is mandatory or voluntary.

Consider a case in which account participation is mandatory (that is, all Social Security contributors would automatically have part of their Social Security taxes put into individual accounts). Of the many ways of adjusting the defined benefit formula to accommodate this change, one simple approach would be to gradually phase in reductions in the primary insurance amount (PIA) formula. This type of change could have unintended outcomes for beneficiaries who might not benefit from creation of the individual account, such as young disabled workers or young survivor beneficiaries. These issues are discussed in this chapter.

A different set of issues arise when Social Security contributors can choose whether or not to shift part of their Social Security taxes to personal accounts. In this case, worker-specific offsets would be designed to apply only to those who shift Social Security taxes to personal accounts. These worker-specific offsets are discussed in Chapter Nine.

### Disability Issues Depend on the Purpose of Individual Accounts

Payout policies for disabled workers and their families vary greatly depending on the purpose of the individual accounts. If the purpose is to supplement Social Security defined benefits, then treatment of accounts at the onset of disability could be based on existing rules for supplemental retirement savings plans – such as tax-favored individual retirement accounts (IRAs), employer-sponsored 401(k) plans, or the Thrift Savings Plan (TSP) for federal employees.

If the accounts' purpose is to fill part of the role that Social Security has traditionally filled for retirees, then treatment of the account at disability onset might be more complex. A reduction in the PIA formula as a way to accommodate mandatory creation of individual accounts with Social Security taxes would automatically reduce

scheduled benefits for disabled workers and their families, unless special rules prevented those reductions.

If special rules exempt disabled workers from benefit cuts for retirees, then the discontinuity between retirement and disability benefits would raise new issues. When and how disabled workers would have access to their individual account funds are also key questions. Would disabled workers have access at disability or would they be required to preserve the accounts for retirement? Would disabled workers be required to buy annuities under the same terms that apply to healthy workers? Would joint-life annuities be required of disabled workers and their spouses on the same terms that apply to other married individuals? This chapter examines these issues.

### Many Disabled Workers Are Financially Vulnerable

About 5.9 million individuals aged 18-64 received Social Security disabled-worker benefits in January 2004; their average benefit was \$862 a month, or about \$10,000 a year. In addition, 1.6 million children of disabled workers received benefits, averaging \$254 a month.

The test of disability in the Social Security program is strict – the worker must be unable to work because of a medically determinable physical or mental impairment expected to last for at least one year or to result in death within a year. The person must also have recent work in employment covered by Social Security. For those who qualify, Social Security disability benefits begin five full months after the onset of the disabling condition. In this chapter, we assume that any individual account proposal would continue this disability definition for Social Security benefits.

Social Security retirement benefits are normally based on a worker's highest 35 years of earnings over his or her lifetime. In the case of disability, benefits are based on the period of potential work years before the disability occurred. The

disabled worker's PIA is the same as that of a retiree at normal retirement age with the same average earnings.

When a disabled worker reaches the full benefit retirement age, his or her benefits remain the same but are classified as retirement benefits. Benefits for qualifying family members of the disabled worker are subject to a family maximum cap that is lower than the maximum that applies in retirement and survivor cases.

When compared to other people aged 18 through 64, disabled-worker beneficiaries are disproportionately male, due in part to men being more likely than women to have the recent work needed to be eligible for benefits. About 60 percent of disabled workers are men, as are about 49 percent of other people aged 18-64. As women are working more continuously than in the past, more women will be insured for disability in the future. On other measures, disabled-worker beneficiaries are a relatively disadvantaged group (U.S. SSA, 2001a). When compared to other working aged adults, disabled-worker beneficiaries are more likely to be:

- Black or Hispanic (17 percent compared to 10 percent);
- 50 years of age or older (60 percent compared to 21 percent);
- Unmarried (51 percent compared to 42 percent);
- Divorced (24 percent compared to 12 percent);
- Without a high school diploma (37 percent compared to 13 percent);
- Without education beyond high school (75 percent compared to 48 percent);
- Living alone (23 percent compared to 11 percent).

The median adjusted family income of disabled-worker beneficiaries is about half that of other people aged 18-64. Disabled workers are at high risk of being poor or near poor, with family incomes below 125 percent of the poverty threshold. About 34 percent of disabled workers are poor or near poor, compared to 13 percent of others aged 18-64.<sup>2</sup>

Social Security is half or more of total family income for about one in two (48 percent) disabled-worker beneficiaries. For nearly one in five (18 percent), Social Security is 90 percent or more of their income (Figure 7-1).

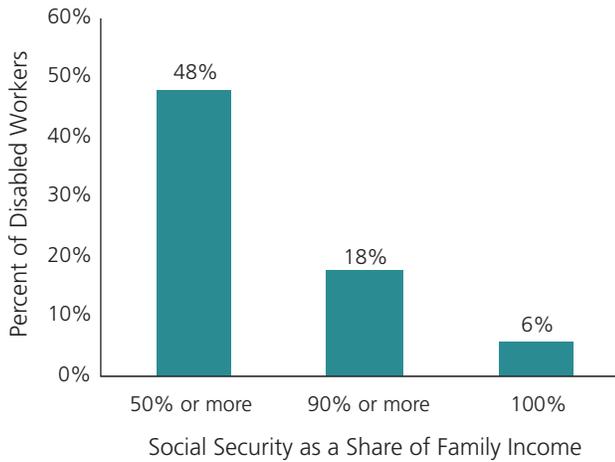
Married disabled workers often rely, in part, on continued income from a working spouse, while those who are unmarried typically have little income other than Social Security. Of married disabled workers, about one in three relies on Social Security for half or more of total income. Of those who live alone, nearly four out of five (78 percent) rely on Social Security for half or more of their total income and one in three (33 percent) relies on Social Security for 90 percent or more of total income (Figure 7-2).

### The Risk of Becoming Disabled Is Significant

The risk of becoming so disabled that one qualifies for disability benefits is greater than many people think. About three in ten men and one in four women will become disabled before reaching normal retirement age, according to projections by the Office of the Chief Actuary of the Social Security Administration (Figure 7-3).

Further, disability is not the last risk to income security that workers and their families might face. Some workers will die after starting to receive Social Security disability benefits, leaving children, including disabled adult children, who will rely on survivor benefits from Social Security. And, a widowed spouse might later turn to survivor benefits in old age based on the disabled-worker beneficiary's record. Over a lifetime, about 8 percent of men and 5 percent of women in an age cohort will receive disabled-

**Figure 7-1.** *Disabled Workers' Reliance on Social Security as a Share of Family Income*



**Source:** U.S. Social Security Administration, 2001a. *Income of Disabled-Worker Beneficiaries*

worker benefits and then die before reaching retirement age. Others – about 20 percent of men and 18 percent of women in an age cohort – will receive disability benefits and then shift to retirement benefits at the normal retirement age. These workers' Social Security income will need

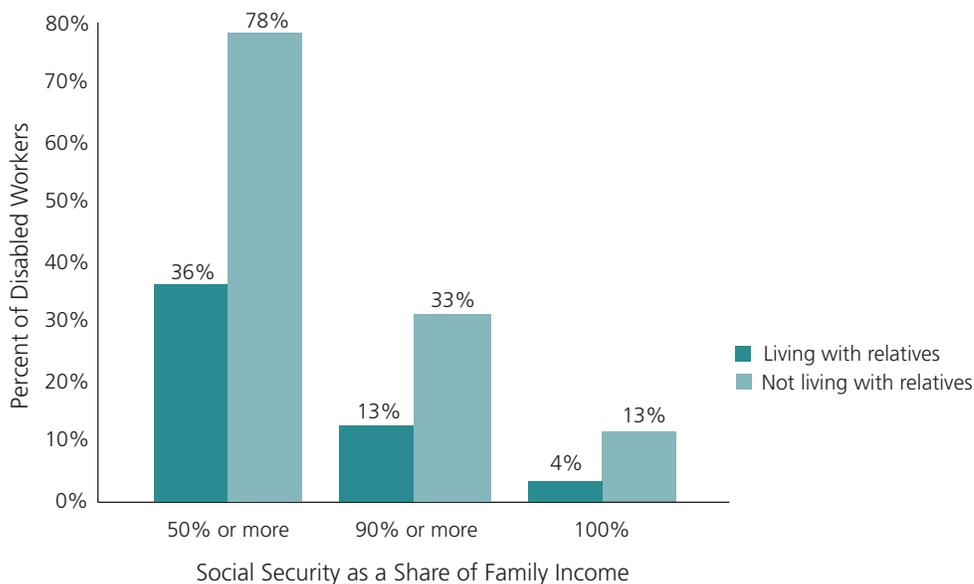
to span disability as well as retirement years and, perhaps, the remaining life of a spouse widowed in old age or a disabled adult child. Finally, a smaller number of individuals – about 1 or 2 percent of an age cohort – will receive disability benefits, then stop receiving benefits because they recover or return to work, and later come back to claim Social Security as retirees.<sup>3</sup>

### **Payment Options for Disabled Workers**

Individual account proposals treat disabled-worker beneficiaries in a variety of ways. Figure 7-4 illustrates some of the ways disability benefits are addressed in selected Social Security reform proposals.

The design of payout rules for disabled workers will depend on the nature and purpose of the individual account proposal. *Option One – Access at Disability Onset: The IRA Approach* is based on the precedent of individual retirement accounts (IRAs) and other savings that supplement Social Security.

**Figure 7-2.** *Disabled Workers' Reliance on Social Security by Living Arrangements*



**Source:** U.S. Social Security Administration, 2001a. *Income of Disabled-Worker Beneficiaries*

**Figure 7-3.** *Probability of Becoming Disabled or Dying Before Age 67  
Persons Age 20 in 2004*

Probability of:	Men	Women
Living not disabled until age 67	61	69
Dying before 67, no disability	9	6
Becoming disabled before age 67 — Total	30	25
Then dying before 67	8	5
Remaining disabled until 67	20	18
Stop receiving benefits and living to 67	2	2

Source: U.S. Social Security Administration, Office of the Chief Actuary, 2004d. Personal correspondence

Five other options described here explore disability payout rules in plans where accounts are meant to partially fill the role of Social Security defined benefits at retirement. For this discussion, we assume a generic Social Security individual account plan with three basic features: (a) accounts would generally be preserved for retirement; (b) annuities would be the expected payout from the accounts at retirement; and (c) income from the accounts would replace part of existing Social Security retirement benefits.

If participation in the accounts were mandatory, then the conforming changes in retirement benefits might be accomplished by scaling back PIAs across the board. These types of proposals are discussed in Options Two through Six. If participation were voluntary, then worker-specific offsets might be designed in a number of ways, as discussed in Chapter Nine.

*Option Two – Treat Disability Like Retirement*, would simply apply the retirement rules of the generic plan to the case of disability. The lower retirement PIA would be paid at disability onset.

*Option Three – Mandate Private Disability Insurance* explores the notion of adding mandatory private disability insurance to Option Two, and preserving the account for retirement.

*Option Four – Pay a Higher Disability PIA and Take Back the Account* explores introducing a higher defined benefit for disability than for retirement. In return, the disabled worker’s individual account would be turned over to the dis-

ability insurance trust fund. *Option Five – Pay a Higher Disability PIA and Preserve the Account for Retirement* seeks to avoid the potentially unpopular feature of taking back the individual account at disability. Finally, *Option Six – Pay a Higher Disability PIA that Shifts to a Blended PIA and Annuity at Retirement* would, like Options Four and Five, pay a higher PIA for disability than for retirement. At retirement, the disabled worker would shift to a somewhat lower PIA and start receiving an annuity from the account. Each option is described more fully below.

### Option One – Access at Disability Onset: The IRA Approach

This option for disability payouts is based on the precedent of tax-favored retirement savings plans – such as IRAs, 401(k) plans, and the Thrift Savings Plan for federal employees. In all of these systems, contributions to the accounts are new funds unrelated to Social Security. These accounts serve as a second or third tier of retirement income and make the money available, without penalty, to account holders who suffer severe long-term disabilities. Receipt of Social Security disability insurance benefits would be evidence of such a disability.

The accounts in this option would supplement Social Security and give the account holder broad discretion about whether and how to use the money. The worker could withdraw the money in a lump sum, or continue to preserve it

**Figure 7-4. Disability Benefit Rules in Selected Individual Account Proposals**

Proposal	Provisions Affecting Disabled-Worker Beneficiaries
<b>Mandatory Accounts Funded with New Contributions</b>	
ACSS (Gramlich): Individual Account Plan, 1996	<ul style="list-style-type: none"> <li>• Reductions in the primary insurance amount (PIA) for retirees apply to disabled worker benefits as well.</li> <li>• Individual accounts must be preserved for retirement.</li> </ul>
Committee on Economic Development, 1997	<ul style="list-style-type: none"> <li>• Disability benefits not specifically addressed</li> </ul>
<b>Mandatory Accounts Funded with Scheduled Social Security Taxes</b>	
Reps. Kolbe-Stenholm: Bipartisan Retirement Security Act of 2004 (H.R. 3821 in 108th Congress)	<ul style="list-style-type: none"> <li>• PIA reductions due to creation of individual accounts do not apply at disability.</li> <li>• Accounts must be preserved for retirement.</li> <li>• At retirement, disabled individual's benefit is a blend of disability PIA and retirement PIA, and individual account annuity.</li> <li>• Requires annuitization, such that the annuity plus the Social Security benefit will pay at least 185 percent of the poverty line.</li> </ul>
National Commission on Retirement Policy, 1999	<ul style="list-style-type: none"> <li>• PIA reductions due to creating the accounts apply to disability benefits.</li> <li>• Accounts must be preserved for retirement.</li> </ul>
<b>Voluntary Accounts Funded with New Contributions from Workers</b>	
Clinton Retirement Savings Accounts, 2000	<ul style="list-style-type: none"> <li>• No special provision.</li> </ul>
Social Security Plus (proposed by R.M. Ball, 11/2003)	<ul style="list-style-type: none"> <li>• Account holder could use funds, penalty free at disability.</li> </ul>
<b>Voluntary Accounts Funded with Scheduled Social Security Taxes</b>	
President's Commission (PCSSS) Models 1,2, 3 (2001)	<ul style="list-style-type: none"> <li>• Disability benefits would be subject to offset based on the annuity value of the account.</li> <li>• No early access to account funds at disability onset.</li> </ul>
Reps. DeMint-Army: Social Security Ownership and Guarantee Act of 2001 (H.R. 3535 in 107th Congress)	<ul style="list-style-type: none"> <li>• Benefit payable to disabled workers and their dependents and survivors under age 60 are not subject to an offset based on the annuity value of the account.</li> </ul>
<b>Unspecified General Revenues for Accounts</b>	
Rep. Shaw: Social Security Guarantee Plus Act of 2003 (H.R. 75 in 108th Congress)	<ul style="list-style-type: none"> <li>• Individuals would receive a distribution of 5 percent of their account as a lump-sum distribution upon entitlement to disability benefits.</li> </ul>

**Sources:** U.S. Social Security Administration, 2004b, Selected solvency memoranda; National Academy of Social Insurance, December 1996, *Social Insurance Update*; Robert M. Ball, 2003, *Social Security Plus*, and November 2002 communication; Committee on Economic Development, 1997, *Fixing Social Security*

for other emergencies later. Since unexpected expenses often accompany the onset of disability, the funds in the individual account could help meet everyday living expenses during the five-month wait for disability benefits, or be used to help cover health insurance continuation premiums for the additional 24-month wait before Medicare begins,<sup>4</sup> or be used for other purposes.

In the following options, the individual account is a mandatory and integral part of a Social Security reform plan. As is common in many proposals that call for individual accounts in Social Security, we assume that the basic features of the Social Security plan for retirement would include: (a) generally preserving the individual accounts for retirement; (b) annuities would be the expected payout at retirement; and (c) income from the account would be expected to replace part of existing Social Security retirement benefits. Each proposal raises new issues about adequacy, complexity, and incentives; the final option seeks to balance all three.

### Option Two – Treat Disability Like Retirement

Under this approach, a disabled worker would have access to the individual account at disability onset and would receive the reduced retirement PIA for life. The symmetry of treating disability like retirement is simple and appealing on the surface, but this approach might be problematic if the overall goal of the reformed Social Security system is to achieve basic income adequacy. The disabled worker's individual account balance would likely be smaller than that of a similar earner who worked until retirement age. Workers who become disabled in their 30s, 40s, or even 50s might not have enough in their accounts to produce the intended level of income in retirement, much less for years of disability prior to retirement.

The form of payment from the account would pose new questions. Permitting a *lump sum* payment would leave the disabled individual only the reduced Social Security benefit as a source of

monthly income. *Phased withdrawals* are another option, but because the length of the worker's remaining lifetime is particularly uncertain, it would be difficult to allocate the withdrawals prudently. The purchase of *life annuities* at disability onset would also pose many issues. With the great variability in life expectancy for disabled individuals, pricing annuities might be problematic. Death rates in the early years after disability onset are very high, with about one in four disabled workers dying within five years of first receiving disability benefits (Mashaw and Reno, 1996b). Other disabled workers live a long time into retirement.

### Option Three – Mandate Private Disability Insurance

This option would require that the individual account be preserved for retirement and would pay the reduced Social Security retirement PIA at disability. Here, a portion of all workers' individual account contributions must be used to purchase long-term disability insurance (LTDI). In theory, the supplemental disability insurance would take effect when a worker was found eligible for Social Security disability benefits.

Private group long-term disability insurance is provided by some employers either through self-insuring the benefits or by purchasing coverage from an insurance company. In 2003, about 28 percent of private sector workers had such coverage that was financed, at least in part, by their employers (U.S. Department of Labor, BLS, 2004). Some employment-based LTDI plans are financed solely by employees so that benefits, when paid, are tax-free. The typical private policy calls for replacing roughly 60 percent of a worker's prior earnings and the payments are usually reduced dollar for dollar by Social Security disability benefits. If Social Security disability benefits were lowered, private employers or the insurers that provided LTDI would pick up more of the cost unless they modified their plans to adapt to Social Security benefit changes.

White-collar employees are more likely than service or blue-collar workers to have private

disability coverage. Forty percent of professional and technical workers had long-term disability coverage in 2003, but only about 20 percent of blue-collar and 10 percent of service workers were covered (U.S. Department of Labor, BLS, 2004). As Social Security's weighted benefit formula pays lower levels of wage replacement to higher earners, supplementary private LTDI benefits become a larger share of total benefits for higher earners. Private insurers use their own definitions of disability to determine eligibility for LTDI benefits. In some cases, the test is less strict than the Social Security definition.

In brief, existing private LTDI differs from Social Security disability benefits in many respects. Private insurance does not use a weighted benefit formula and generally does not pay additional benefits for dependent children of disabled workers. Pricing of private disability insurance does not reflect a broad risk pool that includes everyone, and private group disability insurers have little or no experience insuring the roughly three-quarters of private sector workers whose employers do not offer this coverage. In addition, many people with disabilities who work would be uninsurable under private disability plans. If the goal of the Social Security individual account plan were to mitigate or avoid benefit offsets for disabled workers and their families, then it might be simpler to do so through adjustments in the plan directly.

#### **Option Four – Pay a Higher Disability PIA and Take Back the Account**

At disability onset, this option would avoid any across-the-board reduction or offset in the PIA that would normally apply at retirement due to the creation of the individual account. In return, the individual account balance would be turned over to the DI trust fund to help finance the unreduced PIA. All future Social Security benefits for the disabled worker and his or her family members or survivors would be based on the unreduced “disability” PIA. The individual account would be gone.

Policymakers would need to decide what to do in the case of a disabled worker who stops receiving disability benefits because of recovery or return to work. When a disabled individual goes back to work, would he or she begin contributing to a new individual account? Would the higher disability PIA still prevail when he or she later retires? Or would the trust fund give back the account with interest when the individual returns to work, or at retirement? About 1 or 2 percent of individuals in an age cohort stopped receiving disability benefits because they no longer meet the medical criteria for disability or because they recovered and/or returned to work and later claimed retirement benefits (Figure 7-3).

This option conflicts with the notion of individual accounts as personal property and might not be popular among people who place great value on owning the account. The more the account is viewed as personal property, the more difficult it might be to require that it be turned over to the trust funds at the onset of disability.

#### **Option Five – Pay a Higher Disability PIA and Preserve the Account for Retirement**

This option aims to avoid the potentially unpopular feature of taking back the account; it would pay an unreduced disability PIA for life, and it would require that the individual account be preserved until normal retirement age, when the account would be annuitized.

For workers who become disabled in their 50s or early 60s, this option would produce considerably higher old-age benefits than if they had not received disability benefits because: (a) the benefit would be the higher disability PIA that, in this option, is payable for life; and (b) for those disabled late in their careers, the annuities based on their individual accounts would be almost as large as that for a comparable retiree. There is some concern that this option could raise new incentives to claim disability benefits instead of early retirement benefits, which are reduced under current law (Larin and Greenstein, 1998).

Early Social Security retirement benefits claimed between age 62 and the normal retirement age are actuarially reduced. The reduction at age 62 has historically been 20 percent but is scheduled to increase to 30 percent when the normal retirement age rises to age 67 for people born in 1960 and later. The availability of unreduced disability benefits at age 62 and older could be an incentive to claim disability benefits instead of early retirement benefits.<sup>5</sup> This option would further widen the disparity between disability and early retirement benefits beyond what is already forecast for the future.

### Option Six – Pay a Higher Disability PIA and Shift to a Blended PIA Plus an Annuity at Retirement

This option, like Options Four and Five, would base benefits for the disabled worker and his or her family on a disability PIA that is not reduced because of the creation of the individual account. And, the individual account would not be available until the disabled worker reaches normal retirement age, at which time it would be annuitized under the rules that apply to other retirees. If the disabled worker dies before normal retirement age, the account would go to his or her heirs according to the rules that apply to non-disabled workers. Additionally, defined ben-

efits for surviving children would be based on the higher disability PIA.

A unique feature of this plan is the treatment of the PIA at retirement. When the disabled worker reaches normal retirement age, he or she would shift to a blended PIA that would be a weighted average of the lower retirement PIA (after an offset due to the individual account) and the higher disability PIA. The relative share of each would depend on the portion of the work life that the individual was disabled. For example, if John had been disabled one-fourth of his potential working-age years, his blended PIA at normal retirement age would be 25 percent of his unreduced disability PIA, plus 75 percent of his reduced retirement PIA, as illustrated in Figure 7-5. In addition, he would receive an annuity from the individual account. Presumably, the blended PIA at normal retirement age would become the basis for any family member's benefits payable after that time. This type of feature is included in the Bipartisan Retirement Security Act (HR 3821, 108th Congress) introduced by Representatives Kolbe and Stenholm (Figure 7-4).

Figure 7-6 illustrates the blended PIA approach if John were able to work only one-quarter of his potential working life before becoming disabled.

**Figure 7-5.** *Blended PIA for Worker Disabled One-Quarter of Working Life*

	Disability PIA	Retirement PIA	Blended PIA	IA Annuity
At time of retirement	\$900	\$700		\$400
Adjustment—disability 1/4 of potential working life:				
25% of disability PIA	\$225			
75% of reduced retirement PIA		\$525		
Total blended PIA*			\$750	
Full IA annuity				\$400
Total Retirement Income**				\$1,150

\*Disability PIA and reduced retirement PIA

\*\*Blended PIA and full IA annuity

**Figure 7-6.** *Blended PIA for Worker Disabled Three-Quarters of Working Life*

	Disability PIA	Retirement PIA	Blended PIA	IA Annuity
At time of retirement	\$450	\$350		\$200
Adjustment—disability 3/4 of potential working life:				
75% of disability PIA	\$338			
25% of reduced retirement PIA		\$88		
Total blended PIA*			\$425	
Full IA annuity				\$200
Total Retirement Income**				\$625

\*Disability PIA and reduced retirement PIA

\*\*Blended PIA and full IA annuity

Under this option, the disabled worker’s income would change when he or she reaches normal retirement age; it could go up or down, depending on the difference between the disability PIA and the blended PIA, and the size of the annuity from the individual account.

Option Six could have major implications for family members. The option of using a blended PIA might prove beneficial for survivors and other family members. In both of the above examples, survivor benefits based on the blended PIA would be higher than benefits based on the reduced retirement PIA. Since children must be under age 18 or 19 to qualify for benefits on a disabled worker’s record, it is likely that most children’s benefits would be based on the unreduced disability PIA (the blended PIA is not applicable until the worker reaches full retirement age). Yet, people who receive benefits as disabled adult children based on their parents’ work histories would have their benefits based on the reduced blended PIA once the parent retired. See Chapter Eight for more information about disabled adult child beneficiaries.

## *Design and Implementation Issues*

Issues discussed in other chapters are pertinent when considering disabled workers. For example, sustaining a ban on early access to the money (as discussed in Chapter Five) might be reconsidered if the account holder is disabled. Similarly, mandating joint-life annuities for married individuals (as discussed in Chapter Three) might take on a different cast if one (or both) of the spouses is converting from disability to retirement benefits at normal retirement age.

### **Sustaining a Ban on Disabled Account Holders’ Access to the Funds**

Chapter Five points out the difficulty of sustaining a ban on account holders’ access to the money when they need it. The case for allowing access might become more compelling if the worker were disabled. As noted earlier, disabled workers are financially vulnerable and must wait at least five months after they were no longer able to work to receive benefits that replace a fraction of their prior earnings. Also, disabled workers must wait another two years before they gain Medicare coverage. A hardship case for access to the individual account might

be compelling, particularly if these workers expect to die before retirement.

### *Exceptions for the Terminally Ill*

One rationale for banning early access to the funds is that workers will need the money for retirement. But if an account holder is terminally ill, this rationale would not be convincing. Should policymakers allow an exception to the ban on access if an account holder is terminally ill?

There have been proposals to modify the traditional Social Security disability program for terminally ill applicants – for example, by shortening or eliminating the waiting period for cash benefits or Medicare. While the Social Security Administration has expedited claims procedures for terminally ill claimants, no new or different benefits are accorded to designated individuals. Recurring questions on offering new or different benefits include: Who would designate terminal illness and how? What is the recourse or outcome when the individual does not die as expected?

### *Exceptions for Unmarried Individuals*

Another rationale for banning access to the account is that the money would be needed to provide some protection for an account holder's spouse. Again, this rationale is not compelling for account holders who are single and terminally ill. Should policymakers consider early withdrawals when account holders are terminally ill and have no spouse or dependents?

### *Would Loans or Viaticals Be Allowed?*

Presumably, if disabled workers were not allowed to withdraw funds, loans would be disallowed as well. Otherwise, a loan could easily turn into a withdrawal, simply by failure to repay the loan.

Account holders might instead turn to viatical settlements as a way to access the funds. Some state insurance rules allow viatical settlements, which help policyholders access funds available only following their deaths. Under a viatical set-

tlement, the owner of a life insurance policy (viator) sells the policy for a percentage of the death benefit. The buyer of the policy, or viatical provider, becomes the new owner and death beneficiary. The entity that represents the seller, the viatical broker, can shop for viatical offers and is paid a commission by the viatical provider (Iowa Insurance Division, 2004). There have been cases in which individuals with life-threatening illnesses have sold their insurance policies in return for immediate cash. A healthy person might also sell a life insurance policy to get cash. In brief, if policymakers intend to ban access to individual accounts, they might also consider rules about new financial products that could evolve to circumvent the ban on access.

## **Disability and Mandatory Joint-Life Retirement Annuities**

Chapter Three discussed at some length issues about requiring that accounts be used to buy retirement annuities and requiring that married retirees buy joint-life annuities. Some of those issues take on new dimensions with regard to individuals who enter retirement as disabled workers or spouses of disabled workers.

### *Would Disabled Workers Be in the Annuity Pricing Pool?*

In 2002, 11 percent of the individuals claiming Social Security retirement benefits did so after receiving disability benefits prior to retirement (U.S. SSA, 2004a). Would these retirees be in the annuity pricing pool on the same terms as other retirees? Ideally, the appeal to consumers of risk pooling in annuities means that everyone in the pool has an equal chance of at least being average, and a chance of at most living longer than the next person. For disabled retirees, the odds might work against them. If all account holders were required to purchase annuities at retirement, and if disabled retirees were included in a universal pool of annuitants, the terms of the annuity purchase might be unfavorable for disabled retirees. An individual account plan might, however, create a special disabled retirees annuity pool that provides more favorable pricing for this group.

Figure 7-7. Annual Income From \$55,000 UK Lifestyle Annuity Purchase

Age at Purchase	Male		Female	
	Smoker	Non-Smoker	Smoker	Non-Smoker
60	\$3,733	\$3,418	\$3,476	\$3,395
65	\$4,383	\$3,768	\$3,954	\$3,746
70	\$5,281	\$4,250	\$4,589	\$3,987

Annuity products are available in the United Kingdom (UK) that take into consideration individual medical and lifestyle situations. For instance, standard annuities are priced without regard to medical or lifestyle information, while “smoker annuities” are based purely upon smoking history and “enhanced annuities” are underwritten on medical and lifestyle information. Figure 7-7 illustrates the annual income generated from approximately \$55,000 for both a male and female smoker and non-smoker.<sup>6</sup>

Most annuity providers in the UK offer only standard annuities, but the move toward greater pricing refinement allows those with lower life expectancy to access improved annuity rates. It is possible, however, that provision of lifestyle annuities might lead to higher-cost standard annuities for those without evidence of substantial life expectancy.

#### *Compulsory Joint-Life Annuities When One Spouse Is Disabled*

Compulsory joint-life annuitization of individual account balances might prove disadvantageous to disabled workers and their spouses compared to non-disabled workers. Aside from concerns about pricing unfairness discussed earlier, two additional outcomes need to be considered that apply specifically to disabled workers and their spouses. First, a disabled worker’s individual account might be significantly smaller than it would have been at normal retirement age, producing a much smaller annuity, which would be reduced even further due to a joint-survivor mandate. And second, if the disabled worker dies earlier than most non-disabled workers (as is sometimes the case), the disabled worker’s

spouse would need to live on a survivor annuity for more years than would a non-disabled worker’s spouse.

#### *More Choices In The Case of Disability*

If disabled beneficiaries were allowed to opt in or out of retirement annuity requirements, or if they were provided with more types of guarantees or more types of joint-life annuities, it would be important that participants understand their choices and how the different options would affect their long-term financial security. Additionally, if one group of account holders, such as disabled workers, receives special options not afforded all account holders, lawmakers might be pressured to expand the special options to the entire universe of individual account holders. Further, any special options designed specifically to enhance the economic security of disabled workers might inadvertently encourage more workers to file for disability benefits.

### *Summary*

At the beginning of 2004, almost 6 million individuals aged 18-64 received disabled-worker benefits from Social Security. Social Security accounts for half or more of total family income for about one in two (48 percent) disabled-worker beneficiaries. In designing a Social Security plan that involves individual accounts, it is important to think through how the accounts, with any accompanying changes in Social Security defined benefits, would affect disabled workers and their families.

Policy issues on payouts for disabled-worker beneficiaries will vary depending on the purpose of the individual accounts. If the accounts are intended to be discretionary supplemental savings on top of Social Security, then payout rules could be based on existing supplemental savings plans. All such existing plans make the money in the account available, without penalty, at disability onset.

Yet, if individual accounts are intended to replace part of Social Security, and retirement benefits are offset on a mandatory basis to accommodate the accounts, then new issues arise about whether and how the retirement offsets apply to disability benefits and how and when the account funds become available.

Many of the issues discussed in earlier chapters take on new dimensions if beneficiaries have experienced career-ending disabilities. The challenge of sustaining a ban on access to the funds before retirement age might be revisited when a disabled individual has a pressing need for the money – particularly if there is no spouse or there are no children. Mandating joint-life annuities for married retirees could present new issues if one or both members of the couple were disabled workers. Many key questions arise for integrating individual accounts with provisions for disabled workers and their families.

## Chapter Seven Endnotes

- 1 Although it is preferable to refer to people with disabilities rather than disabled people, the term “disabled-worker” is a term of art in the Social Security system. It refers to workers who are insured for disability benefits who became entitled to benefits when they were found to be unable to work for at least a year due to the onset of a disabling physical or mental condition.
- 2 Family income is adjusted for family size and composition using the equivalence scale built into the official poverty index, which takes into account economies of scale and different needs of children and adults. Family income is divided by the ratio of the family’s poverty threshold to the one-person poverty threshold.
- 3 The return-to-work rate over five to six years following receipt of disability benefits is higher for younger disabled workers; of those who began receiving disability benefits in their 30s, nine percent recovered or returned to work within six years. Testimony of Virginia Reno before the Social Security Advisory Board’s Discussion Forum on the Definition of Disability, April 14, 2004; based on data provided by the Social Security Administration in the mid-1990s in Mashaw and Reno, (1996a).
- 4 Federal law requires employers with 20 or more employees who provide health insurance to offer continuation coverage during the Medicare waiting period to former employees who become disabled. The employer can charge 150 percent of the full group premium. In 1999, the average premium for individual insurance coverage was estimated to be roughly 40 percent of the average disabled-worker benefit. The family coverage premium was roughly equal to the average disability benefit (Fronstin and Reno, 2001).
- 5 The availability of disability benefits at early retirement ages under current law does not appear to entice many older workers to claim disability benefits in lieu of reduced early retirement benefits. The number of people who are newly awarded disability benefits declines at age 62, and continues to decline at ages 63 and 64 (U.S. SSA, 2002a). Even though early retirement benefits are reduced, they might be more attractive than disability benefits for the following reasons: (a) no medical evidence or exams are required; (b) there is no five-month waiting period after earnings have stopped; (c) partial retirement is possible under the retirement earnings test, while earnings above a low threshold cause disability benefits to end; (d) the benefit for families of three or more is higher for retirees than for disabled workers; and (e) disability benefits are offset for workers’ compensation, while retirement benefits are not (Mashaw and Reno, 1996b).
- 6 The annuities in this table for non-smokers are based on rates from Norwich Union, and the annuities for smokers are from Britannic Retirement Solutions, both as of September 2003. Information provided by Alec Findlater, 2003.

# Chapter 8

## Children, Life Insurance, and Bequests

### *Introduction*

Individual accounts as part of Social Security reform are generally designed with retired workers in mind. Less attention has been paid to beneficiaries whose eligibility is based on a family relationship or disability. The previous two chapters focused on rights of spouses and on benefits for disabled workers within an individual account system. This chapter focuses on children, both minor children and those disabled adult children who receive benefits on the basis of their parents' work history.<sup>1</sup>

Social Security is most commonly known for paying retirement benefits to workers who have contributed to the system throughout their working careers. But Social Security also provides life and disability insurance in that it pays benefits to children under the age of 18 (19 if the child is still in school) and to disabled adult children when a parent dies, becomes disabled, or retires. It is important to examine if, and how, new accounts might interact with Social Security benefits for children since assets in indi-

vidual accounts are not expected to spread risk the way insurance does.

This chapter examines current Social Security benefits for children and how those benefits might change with the creation of an individual account system. It also considers four possible payment options for children in young survivor families, what rules might apply to defined benefits for children of disabled and retired workers, what, if any, rights minor or disabled adult children would have to their parents' individual accounts, and issues about bequests other than to spouses and children. The chapter presents a profile of disabled adult children with the aim of aiding policymakers in deciding what rules should apply to this group.

### *Current Social Security Benefits for Children*

About three million children under age 18 received Social Security in December 2002 (U.S. SSA, 2004a). These child beneficiaries represent about 7 percent of all Social Security beneficiar-

ies and 4 percent of all children in the United States (U.S. SSA, 2002a). About half (49 percent) of child beneficiaries are survivors of deceased workers, 38 percent are dependents of disabled workers, and about 12 percent are children of retired workers (U.S. SSA, 2002a). Another 2 million children live in families in which another member receives benefits from Social Security, for a total of 5 million children who receive part of their family income from Social Security (Hill and Reno, 2003).

Adults who have been severely disabled since childhood (before age 22) are eligible for benefits on the same terms as minor children. They become eligible for benefits when a parent dies, becomes disabled, or retires. About 749,000 disabled adults received these benefits in December 2002. Like minor children, disabled adult child beneficiaries could be considered for special protections in the design of an individual account plan that is part of Social Security.

### Current Benefits for Young Survivor Families

Social Security is the main source of life insurance for most families with children. Almost all U.S. jobs (96 percent) are covered by Social Security (U.S. SSA, 2002a). According to actuaries at the Social Security Administration, Social Security protection had a net present value equivalent to a life insurance policy with a face value of \$403,000, and a disability policy with a present value of about \$353,000 for a young average earner with a spouse and two young children in 2001 (U.S. SSA, 2001b).<sup>2</sup>

Workers qualify for Social Security life insurance fairly quickly.<sup>3</sup> About 98 percent of American children would receive Social Security benefits if a working parent died.

The average monthly Social Security benefit for a widowed mother with two or more children was \$1,909, or about \$22,900 a year, in January 2004 (U.S. SSA, 2004a). The benefits keep pace with inflation and continue until the child reaches age 18, or 19 if he or she is still in high

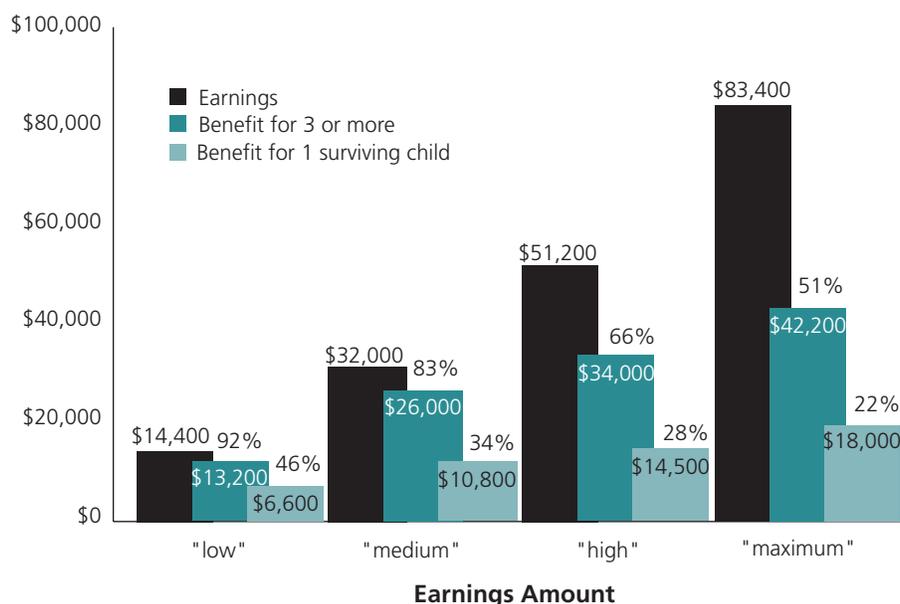
school. Benefits for young survivor families are based on the same primary insurance amount (PIA) formula used for retirement benefits. Surviving children are eligible for a benefit equal to 75 percent of the deceased workers' PIA. A widowed spouse caring for an eligible child is also eligible for 75 percent of the PIA unless he or she has remarried.<sup>4</sup> A family maximum limits the total monthly benefits payable to a family of three or more.

Social Security benefits are based on a progressive formula that replaces a higher proportion of the earnings of a lower earner than a higher earner, as discussed in Chapter Two. Consequently, the system pays higher benefits to families of high earners but benefits replace a greater share of the income lost by families of low earners (Figure 8-1).

For example, a low-earner's child would have a benefit that replaced about 46 percent of lost earnings, while a worker who had always earned the maximum amount taxed and counted for Social Security benefits would produce a child survivor benefit that replaced about 22 percent of lost earnings. If three or more children (or two children and a widowed spouse) were eligible for benefits, the replacement rates would range from 92 percent of lost earnings for a low-earning worker to 51 percent of lost earnings for a worker who had earned the maximum amount.

The Social Security Act defines the parent-child relationship broadly. All biological and adopted children, as well as stepchildren in many cases, are eligible for Social Security in the event of a parent's death. Children of unmarried parents are also eligible; if paternity is disputed, Social Security follows state law. If a child's parents are deceased or disabled, a child can receive benefits based on the work record of a custodial grandparent. Grandchildren who are adopted by their grandparents can receive benefits based on a grandparent's work record as long as a parent is not living in the same household as the grandparent and adopted grandchild.

**Figure 8-1.** Social Security Benefits for Children of Deceased Workers Compared to Past Earnings, 2004\*



\*For family of deceased worker age 40 in 2004.<sup>5</sup>

Source: U.S. Social Security Administration, Office of the Chief Actuary, 2004d. Personal correspondence

### Possible Changes in Children's Defined Benefits with Individual Accounts

In considering the impact on Social Security benefits paid to children, it is important to distinguish between two reasons why scheduled Social Security benefits might be reduced. First, because Social Security is not in long-term financial balance, various proposals call for reducing traditional defined benefits as part of a solvency proposal. These benefit reductions for solvency are not the topic of this report. Second, plans that shift Social Security taxes to individual accounts generally call for offsets in scheduled Social Security retirement benefits that would phase in as the accounts build up. These benefit offsets differ in design depending on whether account participation is mandatory or voluntary.

When participation is mandatory, some plans phase in a reduction, or offset, in the primary insurance amount (PIA) formula as the accounts build up. This type of change could have unintended results for beneficiaries who might not receive payments from the individual account, such as children. This chapter considers how

proposals for mandatory accounts financed with Social Security taxes might be modified if policymakers wanted to avoid applying offsets to benefits of surviving children and disabled adult children.

A different set of issues would arise when participation in the accounts is voluntary. In this case, worker-specific offsets are designed to apply only to workers who chose to shift their Social Security taxes to personal accounts. These worker-specific offsets are discussed in Chapter Nine.

### Defined-Benefit Payment Options for Young Survivor Families

The design of payment rules for young survivor families in individual account proposals will depend on the nature and purpose of the accounts. The first option is based on an individual retirement account (IRA) model that is supplemental to Social Security. The other options explore potential outcomes for chil-

dren's benefits in plans that shift Social Security taxes to individual accounts on a mandatory basis and phase in lower defined benefits for retirees. These approaches would also apply to survivors who are disabled adult children.

### Option One – The IRA Approach

Option One – The IRA Approach – is based on the precedent of tax-favored retirement savings that supplement Social Security, such as IRAs, 401(k) plans, and the Thrift Savings Plan for federal employees. All these systems have voluntary contributions that represent new funds unrelated in any way to Social Security. The accounts are on top of Social Security and often on top of supplemental pensions. Money in these accounts becomes available to a designated beneficiary when a worker dies before retirement, a treatment that could apply to individual accounts that follow an IRA model wholly independent of Social Security.

The remaining three options assume mandatory accounts are financed with Social Security taxes and scheduled Social Security retirement benefits are scaled back as the accounts phase in.

### Option Two – Shield Young Survivor Families from PIA Reductions

Option Two would shield children of deceased workers from any PIA reductions due to the creation of individual accounts. This would mean having a PIA calculation for benefits paid to young survivor families that differs from the one used for retirees. Similar approaches were discussed in Chapter Seven with regard to disabled-worker beneficiaries. The purpose of this option would be to avoid benefit reductions for young families due to creation of the accounts because the families would not be expected to receive life insurance protection from the accounts.

### Option Three – Mandate Purchase of Private Life Insurance

This option would use a scaled-back PIA to pay young survivor families and require that a portion of each worker's individual account contri-

butions be earmarked to buy life insurance for his or her family.

About 69 percent of families have some kind of life insurance (Figure 8-2). About half of all families have term life insurance, which provides coverage for a specified period, such as one year. When the term ends, coverage ends unless the policy is renewed. Whole life policies are less common. About 28 percent of families own whole life insurance. Whole life insurance often includes a cash value component that policyholders can borrow against. The typical value of these accounts is modest. In 2001, the median cash value of whole life insurance was \$10,000 (Copeland, 2003a).

In some cases, workers receive life insurance as part of their benefit package on the job. About half (54 percent) of private-sector employees had life insurance through their employers in 2000 (U.S. Department of Labor, BLS, 2003). These policies typically pay a lump sum at death, either a pre-determined flat amount or a payment based on a multiple of the deceased worker's annual salary. About 2 percent of private-sector workers had life insurance coverage that would pay on-going monthly benefits.

Social Security and private life insurance differ in important ways. Social Security pays monthly benefits to each child, resulting in higher benefits to larger families up to the family maximum. Social Security also replaces a higher proportion of income for low earners, as shown in Figure 8-1. Private life insurance pays a lump sum directly related to the premium. Private life insurance pools mortality risk among policyholders, but does not pay extra benefits for larger families, nor is it designed to pay more relative to contributions for lower earners. In a voluntary private life insurance market, insurers typically group individuals with similar risks and charge higher rates to those with greater risk. Social Security pools children's risk of having a working parent die among all contributors, including those with young children, the childless, and those whose children have grown. The social insurance sys-

**Figure 8-2.** *Percent of Families with Life Insurance, 2001*

	Number (in thousands)	Percent Owning		
		Any Life Insurance*	Term Life Insurance	Whole Life Insurance
<b>All Families</b>	<b>106,496</b>	<b>69</b>	<b>52</b>	<b>28</b>
<i>Family Income</i>				
Less than \$19,999	25,321	41	29	15
\$20,000-\$49,000	37,380	68	51	26
\$50,000-\$99,999	28,327	85	67	35
\$100,000 or more	15,466	88	71	42

\*Includes families with both types of life insurance.

**Source:** Copeland, 2003b. Tabulations using the 2001 Survey of Consumer Finances

tem reflects a view that basic income security for children when a working parent dies is a shared responsibility for society.

To require purchase of private life insurance as a replacement for part of Social Security survivor benefits brings into clearer relief the distinctions between social insurance concepts and private insurance principles. For this option, a key question for policymakers is which set of principles would or should prevail if individual accounts were to be part of Social Security.

#### **Option Four – Mandatory Accounts with No Special Provisions for Young Survivors**

Option Four –Mandatory Accounts with No Special Provisions for Young Survivors – would apply a plan’s general rules for retirement payouts to young survivor families. The scaled-back retirement PIA would be used to calculate benefits for children in young survivor families. Unlike retirees, these children would not have account annuities to supplement the scaled-back monthly benefits. Instead, they would experience the full change in monthly income reflected in the PIA adjustment. Many individual account proposals stipulate that the account could be bequeathed to a widowed spouse to be preserved for her or his retirement. Even if the account were immediately available to the young family, assets in the account would gener-

ally not substitute for Social Security life insurance protection for the children. Further, in some cases the eligible surviving children live in separate households with different custodial parents. In this case, the assets in the account might not be distributed to families in the same way that Social Security benefits to children would be allocated.

#### ***Payment Options for Children of Retired and Disabled Workers***

Minor children and disabled adult children of retired and disabled workers also receive Social Security. Like benefits for child survivors, their benefits are based on the working parents’ primary insurance amount. The benefit amount for children of retired or disabled workers is 50 percent of the parent’s PIA. A key issue is whether policymakers wish to apply any offset in the parent’s PIA (due to creation of the individual account) to the children’s benefits.

Chapter Seven discussed various ways that disabled workers could be exempted from benefit cuts due to the creation of individual accounts. If the disabled worker were exempt from the PIA cuts, then presumably his or her eligible children would also be exempt.

When retirees have their defined benefits offset because part of their Social Security taxes were shifted to individual accounts, policymakers could make a separate decision about whether the changes in those retirees' benefits should apply to the benefits of his or her children. The retiree would have had a full work life to accumulate assets in the account and would presumably have an annuity from the account, but the children might not share in that annuity.

## *Children's Rights to their Parents' Individual Accounts*

Another set of questions with regard to children and proposals for retirees' individual accounts is whether, and to what extent, children would have any special rights to, or claims on, their parents' accumulated individual accounts.

As discussed in Chapter Six on Spousal Rights, wives and husbands often have certain minimum inheritance rights under state law. Further, the Employee Retirement Income Security Act of 1974 (ERISA), as amended, spells out additional rights of spouses to pensions accumulated under tax-favored employer-sponsored retirement schemes. Would, or should, children, including disabled adult children, have any special rights to individual accounts in the event that a parent died before retirement?

*Would minor children or disabled adult children have any special rights to inheritance of individual account balances?*

Most individual account plans specify inheritance rights only for widowed spouses and only for a current spouse. If there were no spouse, most plans would let the account holder pick anyone he or she chose as the death beneficiary (or beneficiaries). In this case, the account holder could name someone other than dependent children, or name only some children and leave out others. State laws have varied rules with regard to children's rights, generally defining the rights of children if a parent dies intestate. If a deceased individual leaves his or her estate entirely to a spouse, children do not have clear

rights to that estate. If Congress establishes a system of individual accounts, a key question is whether to have uniform federal policies concerning children's rights or to leave the issues to state jurisdiction.

Would policymakers want the individual account plans to specify any special inheritance rights for minor children or disabled adult children? If accounts were considered part of Social Security life insurance protection, then a case would exist for trying to direct the account to dependent children, and this would require federal law. Yet, if the accounts are not considered part of Social Security life insurance, then shielding children from reductions in Social Security benefits due to the accounts' creation becomes more important. Here, the children's inheritance rights outside of Social Security might be left to state law as they are today.

*Would a widowed spouse with children have the option to use inherited funds for immediate needs?*

Many plans stipulate that accounts be bequeathed to a widowed spouse and, further, the widowed spouse must preserve the individual account for her or his retirement. The funds would not be available to help with immediate spending needs following the death of the worker or to care for children. In these plans, if the account went to anyone other than a widowed spouse, the heir could use the funds as he or she wished. The greater choices available to other heirs could lead to pressure to ease the restrictions on use of inherited funds by widowed spouses. These issues are discussed further in Chapter Six.

*If children and a widowed spouse live in separate households, how would interests of each be accommodated?*

Balancing the rights of children and widowed spouses could be an issue, as many children do not live in the same household as a surviving spouse. A study by the National Center for Education Statistics found that in 1996 only 57 percent of students in grades 1 through 12 lived

with two biological parents, while the others lived in some other family arrangement (Nord and West, 2001). If a non-custodial parent had remarried and then died, presumably the new spouse would inherit the deceased worker's account. The children in another household might not share in the inheritance, unless special rules were written to apply to such cases.

### *How would child support requirements affect distribution of accounts at a parent's death?*

If a worker who was subject to court-ordered child support died, would the custodial parent or child have any claim on the account of the deceased? Under existing precedents, the custodial parent would have a claim against the entire estate for any past due child support at the time of death. Settling this and other debts of the estate would occur before bequests could be made. In most states, death ends a non-custodial parent's future child support obligation, yet Social Security benefits are intended to cover future costs. If the account is mandatory and replaces Social Security benefits, policymakers may wish to make arrangements to protect the children. For that reason, divorce decrees might order the non-custodial parent to take out a life insurance policy for the benefit of the child.

### *Bequests to Heirs other than Spouses and Dependent Children*

Almost all individual account proposals allow account holders to bequeath their funds to heirs if death occurs before retirement. At the same time, proposals financed with Social Security taxes usually limit or foreclose bequests by such features as mandatory annuitization, or mandatory transfer of the account to a widowed spouse or, as suggested in the prior section, special inheritance rules for minor children. These constraints on bequests are generally motivated by a desire to preserve benefits that Social Security now provides. An annuity mandate, for example, ensures that retirees cannot outlive

their incomes. Mandates for joint-life annuities and for spousal inheritance of accounts generally seek to preserve Social Security protections for widows, whether they are widowed after retirement or before.

Given these constraints, bequests from accounts financed with Social Security taxes would result in new payouts in various cases where benefits are not paid under current Social Security rules. In particular, when unmarried persons (whether single, divorced or widowed) die before buying an annuity, their accounts would go to their named beneficiaries. Such bequests are consistent with a personal ownership view of the accounts. From a strictly social insurance perspective, however, bequests could be viewed as "leakage" that is outside the purpose of the system. To the extent that funds from Social Security taxes are paid to heirs who would not otherwise be eligible for Social Security (such as non-disabled adult children, siblings, other relatives, friends, or institutions), either more money would be needed to pay eligible beneficiaries or their benefits would be reduced in some way.

If policymakers wanted to protect children by mandating their inclusion as eligible beneficiaries, rules would need to be established that define that eligibility. For instance, would there be an age limit for eligible children? Would required bequests and required insurance purchases be prorated by age? If so, how would the rule be enforced if someone died leaving children of significantly different ages? Social Security currently pays benefits to non-disabled children under age 18 (or age 19 if still in school).

In brief, there is a basic tradeoff between the ownership model that calls for bequests, and the social insurance model that targets payments only to eligible beneficiaries. While bequests are consistent with a personal property view of individual accounts, they impose some new costs on a social insurance system.

## Disabled Adult Children – A Profile

If proposals for financing individual accounts from Social Security taxes call for reducing defined benefits on workers' accounts, policy-makers would need to make explicit decisions about whether those changes in defined benefits should apply to disabled adult child beneficiaries. Methods to avoid reductions described earlier in this chapter could be applied to these beneficiaries. This section offers a brief description of the disabled adults who receive Social Security benefits as the child of a worker who has died, retired, or become disabled.

About 749,000<sup>6</sup> adults who have been disabled since childhood receive benefits based on their parents' PIAs; they receive the same types of benefits payable to minor children. About two-thirds of these beneficiaries (nearly 500,000) are children of a deceased working parent. Their average benefit was \$609 a month, in December 2002, based on 75 percent of the deceased parent's primary insurance amount (Figure 8-3).

The other third are children of retired or disabled parents who are entitled to 50 percent of their parents' PIA. The average benefit for disabled adult children of retired workers was \$465, while the average benefit for children of a disabled worker was \$349 in December 2002 (U.S. SSA, 2004a).

Disability standards for disabled adult child beneficiaries are the same as those for disabled workers; that is, the individual is unable to work (to engage in substantial gainful activity). Mental retardation is the primary diagnosis for the majority of individuals who receive Social Security as disabled adult children; 60 percent are diagnosed with mental retardation, and 17 percent have other mental disorders as a primary diagnosis. Conditions affecting the nervous system or sensory organs are the next most prevalent diagnosis, accounting for 12 percent of disabled adult child beneficiaries.

Individuals receiving benefits as disabled adult children range in age from young adults to senior citizens. About 4 in 10 are under 40 years of age, while another four in 10 are between 40 and 54, and about 2 in 10 are age 55 or older. In nearly all cases, these individuals continue to receive Social Security for the rest of their lives.

In some cases, disabled adults receive means-tested Supplemental Security Income (SSI) before they become entitled to Social Security when a parent retires, dies, or becomes disabled. If the Social Security benefit is what causes them to lose SSI eligibility, they might lose automatic eligibility for Medicaid depending on where they live.<sup>7</sup> The disabled adult child will be eligible for Medicare after a 24-month waiting period. The benefit package in Medicare notably lacks long-term care coverage and the more complete prescription drug coverage that many state Medicaid programs provide.

**Figure 8-3.** *Disabled Adult Child Beneficiaries, December 2002*

	Distribution	Average monthly benefit
Total number (in thousands)	749	\$551
Total percent	100	
Working parent deceased	66	\$609
Working parent retired	26	\$465
Working parent disabled	8	\$349

**Source:** U.S. Social Security Administration, 2004a. *Annual Statistical Supplement to the Social Security Bulletin, 2003*

Most disabled adult child beneficiaries live with relatives and many are poor or near poor. About one in four (23 percent) had family incomes below the poverty threshold and fully six in ten (60 percent) had family incomes below twice the poverty threshold in 1999 (U.S. SSA, 2002b).

About four in five disabled adult child beneficiaries receive benefits through a representative payee. The Social Security Administration assigns a payee when it determines that the recipient is unable to manage his or her own funds. The payee can be a relative of the beneficiary or a social service agency that is responsible for helping the individual manage his or her affairs. In brief, individuals who receive disabled adult child benefits from Social Security are some of America's most vulnerable citizens.

## Summary

This chapter has explored various approaches to exempt young survivor families, children of disabled or retired workers, and adult beneficiaries disabled since childhood, from reductions in scheduled defined benefits or PIAs that might otherwise apply to retirees in mandatory individual account plans that are financed with currently scheduled Social Security taxes. Without special attention to these categories of beneficiaries, proposals could inadvertently reduce some income security protections for some of

America's most vulnerable adults and millions of minor children. Preserving defined benefit protections for these groups would add to the cost of individual account proposals that do not have these protections.

The chapter also examines questions about whether and to what extent young children or disabled adult children would have any special rights or claims on the individual accounts their parents accumulate. If so, the question would be whether these rights would be left to determinations of state inheritance laws, or specified in federal legislation creating the accounts.

Finally, individual account proposals might present the opportunity for some account holders to make bequests to recipients other than spouses or children. In the eyes of many, these bequests are desirable and consistent with property ownership. Yet, from a social insurance perspective, such bequests could be viewed as leakage that is beyond the purpose of the system. To the extent that Social Security funds go to heirs who would not otherwise be eligible for benefits (such as able-bodied children, relatives, or institutions) either more money would be needed to pay eligible beneficiaries or their benefits would be lowered in some way. In designing payouts, policymakers have the opportunity to weigh trade-offs between property rights and social insurance goals.

## Chapter Eight Endnotes

- 1 Here “child” refers to the relationship, not to age. It is the nature of the parent/child relationship that places discussion of disabled adult children in this chapter.
- 2 This example is for a male worker with average earnings at age 27 (with a wife also age 27 and children aged 0 and 2) who dies or becomes disabled in 2001. The value of the disability benefits includes benefits after normal retirement age and survivor benefits.
- 3 To be permanently insured for survivor protection, workers need ten years of covered earnings. Younger workers have this family survivor protection if they have worked at least one-fourth of the time since they were age 21. Workers who do not meet these tests would still have life insurance protection for their families if they worked in covered employment for at least six calendar quarters in the last 13 quarters (including the quarter in which they died). About 97 percent of covered workers ages 20-49 had earned survivor protection for their children (U.S. SSA, 2003d).
- 4 Survivor benefits are subject to a retirement earnings test applicable to beneficiaries below normal retirement age. Thus, a widowed mother or father who is working might have his or her benefits fully withheld under this earnings test. The widowed parent’s earnings do not affect the children’s eligibility for benefits. Each child’s own earnings would cause his or her benefit to be withheld.
- 5 The earnings level for the maximum worker does not equal the tax maximum in the year prior to entitlement due to the historical ad hoc increases of the tax maximum.
- 6 The Social Security Administration has found that some individuals who receive Supplemental Security Income (SSI) disability benefits might be eligible for Social Security disability benefits. It has a work in progress (known as the special disability workload), which, over the next few years, might identify more people who are eligible for Social Security benefits as disabled adult children.
- 7 States known as 209(b) states are allowed to use stricter eligibility criteria for Medicaid. Statutory protections to ensure continued Medicaid eligibility for people receiving disabled adult children benefits are not applicable in 209(b) states.

## Appendix: Profile of Disabled Adult Children

**Figure 8-A1.** Age of Disabled Adult Child Beneficiaries, 2001

	Number	Percent
All Disabled Adult Children	736,553	100
Under 25	68,191	9
25-29	62,650	9
30-34	75,849	10
35-39	100,785	14
40-44	110,263	15
45-49	93,495	13
50-54	71,871	10
55-59	52,710	7
60 and older	100,739	14

Source: U.S. Social Security Administration, 2002b. *Annual Statistical Report on the Social Security Disability Insurance Program, 2001*

**Figure 8-A2.** Age of Disabled Adult Child Beneficiaries Awarded Benefits, 2001

	Number	Percent
All Newly Awarded Disabled Adult Children	37,700	100
Under 20	3,100	8
20-24	9,300	25
25-29	4,500	12
30-34	5,600	15
35-39	7,300	19
40 or older	7,900	21

Source: U.S. Social Security Administration, 2002a. *Annual Statistical Supplement to the Social Security Bulletin, 2002*

**Figure 8-A3.** Disabled Adult Child Beneficiaries by Diagnostic Group and Representative Payee Status, December 2001

	Number	Percent Distribution	Percentage with a Representative Payee
All disabled adult children	736,553	---	79
With diagnosis available	518,767	100	76
Mental retardation	312,260	60	89
Other mental disorders	89,858	17	64
Diseases of the nervous system and sensory organs	60,578	12	51
Congenital anomalies	6,395	1	66
Injuries	8,599	2	38
Other conditions	41,077	8	78

Source: U.S. Social Security Administration, 2002b. *Annual Statistical Report on the Social Security Disability Insurance Program, 2001*

**Figure 8-A4.** Poverty Status of Disabled Adult Child Beneficiaries, December 1999

	Total	Under 100 percent of poverty	100-199 percent of poverty	200-299 percent of poverty	300 percent or more
Number	625,172	144,711	228,184	151,389	100,982
Percent	100%	23%	36%	24%	16%

Source: U.S. Social Security Administration, 2002b. *Annual Statistical Report on the Social Security Disability Insurance Program, 2001*



# Chapter 9

## Worker-Specific Offsets

Certain proposals for Social Security individual accounts would allow workers to shift part of currently scheduled Social Security taxes to these accounts. These proposals generally provide measures to compensate the Social Security trust funds for the loss of this revenue, which is necessary to pay current benefits. This compensation could take the form of additional revenue (such as transfers from general revenues, increased taxes, or dedicating specific tax revenue to Social Security) or reduced future benefits, or some of both. Proposals with mandatory account participation could provide this compensation in a number of ways, including across-the-board benefit reductions that are not worker-specific (reductions that are not linked to workers' specific account contributions). Accounts with voluntary participation involve worker-specific offsets to treat participants and non-participants equitably. This chapter examines issues related to worker-specific offsets.

This chapter provides background about what offsets are intended to accomplish and examines generic issues in how offsets might be designed. Also examined are issues in applying worker-specific offsets at retirement (including how the

offsets might apply to husbands and wives at retirement) and issues in applying worker-specific offsets at other life events, such as divorce, disability, or death before retirement. Some administrative and legal issues to be considered when designing worker-specific offsets are explored.

### *Intention Behind Offsetting Benefits*

Benefit offsets arise in proposals that shift scheduled Social Security taxes to individual accounts. A simple example illustrates this idea. Suppose that one dollar was shifted from John's Social Security taxes and deposited into his personal account. If there were no adjustment to John's traditional Social Security benefit, then John would be made better off by one dollar. John would still have the same benefit from Social Security as he had before; in addition, he would have one dollar in his individual account. As a result of transferring this dollar to John's account, the Social Security trust fund balance would be reduced by one dollar. (In the absence of other changes, this would increase the unified

### Box 9-1. Accounts, Investment Returns, and Offsets

If John's account were invested in a manner similar to the investments of the Social Security trust funds (in long-term Treasury bonds), then John's expected total future retirement income would be unchanged. Of course, whether or not John's realized total retirement income would be higher or lower than what he would have had without participating in the account depends on how he invested the dollar, how financial markets performed prior to his retirement, and the design of the offset.<sup>1</sup> If his account investments generated a higher rate of return, then account participation would increase his total retirement income; if his investments generated a lower rate of return, then account participation would decrease his total retirement income. Thus, the combination of the offset rule and John's portfolio choice would, together, determine the expected level and the riskiness of John's total retirement income.

Thus far, this example assumes that the offset is designed so that it precisely compensates Social Security's trust funds in future years for the one-dollar account contribution. However, there is an important variation of this simple example to consider. Policymakers could design the benefit offset to be either higher or lower than the level that would just compensate Social Security's trust funds in present value. If the benefit offset were less than one dollar, it is more likely that John would end up with higher total benefits by participating in the account. At the same time, the smaller benefit offset would also lead to a decline in Social Security's finances – implying that some worker or beneficiary or other taxpayer would ultimately have to make up the difference. Conversely, if the benefit offset were more than one dollar, then it is more likely that John would end up with lower total benefits by participating in the account. This case would bring a net improvement in Social Security's finances – freeing up resources that would provide gains to some worker or beneficiary.

budget deficit by one dollar.) The deterioration of Social Security's long-run finances means that this one-dollar gain to John must eventually result in a one-dollar cost to John or to other taxpayers or beneficiaries, because traditional benefits will continue to be paid from the trust funds.

Instead of having other taxpayers or beneficiaries pay for John's one-dollar gain, policymakers might reduce John's future claim to traditional Social Security benefits by one dollar. In return for shifting one dollar of his Social Security taxes into his account, John could be required to compensate the Social Security trust funds by giving up the future benefits that this dollar would have financed had it stayed in the traditional system. This forgone future benefit is the "benefit offset" associated with the individual account. Box 9-1 describes further the relation-

ship between the account, investment returns, and offsets.

Compensation of the Social Security trust fund could also be accomplished by shifting funds out of John's individual account back into the trust funds. Either offset method—reducing the individual account or reducing the future claim on traditional Social Security benefits—could have the same overall effect on John's retirement income and on the trust funds.

If the present value of the benefit offset (taking into account interest over time) were equal to the present value of the account contribution, then Social Security's trust funds would be fully compensated in future years. The *timing* of Social Security's cash flows would still be affected, however. In general, taking money out of the system in the near term would increase the system's revenue needs in the near term, while

reducing benefits in the future would reduce the system's revenue needs at a later date.

Interactions between account contributions and the level of traditional benefits arise explicitly (but not exclusively) in plans that use scheduled Social Security taxes to finance the accounts.<sup>2</sup> The important policy questions about the design of benefit offsets arise most clearly when account contributions are voluntary, as in proposals that would fit in quadrant four of Figure 9-1.

An important distinction must be made between benefit reductions that arise due to the need to put Social Security into long-range fiscal balance and reductions in traditional Social Security benefits that arise because individual accounts are replacing traditional benefits. Many individual account proposals include both types of benefit reductions, but the term *offset* refers only to reductions due to the creation of individual accounts. If a plan calls for mandatory individual accounts, the offset could be accomplished through a general benefit reduction applied to all workers. In this case, distinguishing between the two types of benefit reductions becomes more difficult, and perhaps less important, than in a voluntary account system because the reduction for the purpose of offsetting the accounts applies to everyone and need not be coordinated with contributions to the account at an individual level. If policymakers want to mitigate benefit reductions for some categories of beneficiaries (for example, those who would not receive payouts from the accounts), they could adopt exceptions to any general benefit reductions, as discussed in Chapter Seven, regarding disabled workers, and in Chapter Eight, regarding children.

Offsets in a voluntary system would also need to be carefully designed to achieve policymakers' particular goals. If the goals were to reduce benefits only for persons who participate in the individual accounts, and ultimately to compensate the trust funds fully for lost revenue, then designers would seek to avoid two types of unintended results: one would be to avoid reducing benefits of people who do not receive payouts from the individual accounts; another would be to ensure that the trust funds recoup enough to compensate for Social Security taxes that were shifted out of the trust funds into individual accounts.

When traditional Social Security benefits are offset due to the creation of individual accounts using Social Security taxes, policymakers would face many of the same issues regarding whether and how to apply reductions in traditional benefits to workers and their families, regardless of whether participation in the accounts were mandatory or voluntary. However, worker-specific offsets would present more complex choices. The remainder of this chapter focuses only on voluntary plans with worker-specific offsets.

### *Design of Worker-Specific Offsets*

Individual account proposals that permit workers to shift Social Security taxes to personal accounts vary widely in the way worker-specific benefit offsets are designed. This section examines two questions for policymakers. First, would the benefit offset be based on the actual individual account balance, or would it be based on a hypothetical balance calculated from contributions plus some predetermined interest rate? Second, would the offset reduce traditional

**Figure 9-1.** *Categories of Individual Account Plans by Source of Funds and Nature of Participation*

Nature of Participation	Other Funds for Accounts	Current Social Security Taxes Used for Accounts
Mandatory	(1)	(2)
Voluntary	(3)	(4)

Figure 9-2. *Examples of Worker-Specific Offset Designs*<sup>3</sup>

	Offset Reduces Individual Account	Offset Reduces Social Security Benefits
Offset Based on Actual Individual Account Balance (contributions plus actual account earnings)	(1) Rep. Shaw; HR 75	(2) Rep. DeMint; HR 3177
Offset Based on Hypothetical Individual Account Balance (contributions plus predetermined interest rate)	(3)	(4) PCSSS Models 1, 2, & 3 Sen. Graham; S 1878 Rep. Smith; HR 3055 Robert Pozen

Social Security benefits, or would it reduce the individual account? To begin this discussion, Figure 9-2 illustrates some possible offset designs.

### Offsets Based on Actual Individual Account Balances

If an offset were based on an actual individual account balance, an annuity could be calculated from that balance at retirement (whether or not the worker actually purchased an annuity), and the worker’s Social Security retirement benefit could be reduced by this monthly annuity amount.<sup>4</sup> For example, Bill’s individual account balance of \$20,000 would produce a single-life, inflation-indexed annuity for a 65-year old of about \$124 per month. The retiree’s traditional Social Security benefit could be reduced, or offset, by this amount for life. In this case, Bill’s retirement benefit of \$900 (for example) would be reduced to \$776 a month because Bill had shifted Social Security taxes to a personal account. He would also have the \$20,000 account, which he might use to buy the life annuity of \$124. The distinguishing feature of this offset design is that the offset would be based on the individual worker’s accumulated Social Security tax contributions and actual investment experience from his individual account.

An offset based on an actual account balance would be consistent with a plan that does not allow individual account withdrawals prior to retirement. Two problems would arise if early withdrawals were allowed and the offset is based on only the actual account balance that remained at retirement. First, workers would have an incentive to withdraw their funds before retirement to avoid the benefit offset. Second, the offset would not achieve its intended purpose – that is, to compensate the trust funds for taxes shifted in the past from the trust funds into workers’ accounts.

To avoid these adverse effects, the calculation could be modified to require that the offset be based on what the actual account would have been worth if no withdrawals had been taken (even if withdrawals were taken). A mechanism might be developed to track what the account would have been worth (and make assumptions about how it would have been invested) as if no money had been withdrawn.

### Offsets Based on Hypothetical Individual Account Balances

A number of proposals that would permit workers to shift Social Security taxes to personal accounts would base an offset on a hypothetical account – that is, the offset would be based on the value of Social Security taxes put into the

actual account plus some predetermined interest rate. For example, the plans proposed by the President’s Commission to Strengthen Social Security include a benefit offset based on the actual value of Social Security taxes put into a worker’s account, plus interest accumulated over a worker’s career at 3.5 percent, 2 percent, and 2.5 percent over price inflation (for the Commission’s Models 1, 2, and 3, respectively). In these proposals, contributions and accumulated interest are tracked in *hypothetical* or *shadow* accounts.

At retirement, the offset could be determined in one of two ways. In the first, a worker’s hypothetical account might be “annuitized,” with the monthly annuity amount deducted from the worker’s traditional Social Security benefit. In the second, the value of the shadow account would be divided by the present value of all expected Social Security benefits payable based on the worker’s earnings, and this *offset rate* would be applied so as to reduce all benefits paid from the worker’s earnings record.

The distinguishing feature of offsets of this type is that they would not depend on the size of the actual individual account. A worker taking withdrawals from her individual account would not affect this type of offset, nor would the off-

set be affected by actual market returns earned by the account.

Figure 9-3 illustrates what could happen to Joan’s total retirement income if her offset were calculated from a hypothetical individual account using interest rates that are (1) higher than her actual account investment earnings; (2) the same as her individual account investment earnings; and (3) lower than her actual individual account earnings.

In the example, Joan’s traditional Social Security benefit is \$1,200 and the annuity value of her actual individual account is \$300 per month. If the returns on the hypothetical account exactly matched the returns on her actual individual account, her offset would reduce her traditional benefit by \$300 and her combined retirement income would be increased by her \$300 individual account annuity, resulting in no change in net retirement income (scenario 2). Yet, if the hypothetical account is larger than Joan’s actual account (scenario 1), her offset will be larger than the annuity value of her account and she will end up with lower net income from traditional Social Security benefits plus her individual account annuity. Scenario 3 shows the opposite result; Joan’s hypothetical account produces an offset that is smaller than the annuity value of

**Figure 9-3.** *Examples of Offsets by Size of Hypothetical Account Relative to Actual Individual Account Annuity*

	Annuity value of hypothetical account relative to actual individual account annuity		
	(1) Hypothetical Account Offset Larger Than Actual Account Annuity	(2) Hypothetical Account Offset the Same as Actual Account Annuity	(3) Hypothetical Account Offset Smaller Than Actual Account Annuity
Traditional Social Security retirement benefit	\$1,200	\$1,200	\$1,200
Hypothetical annuity value reduces Social Security benefit	-450	-300	-150
Net traditional Social Security benefit	\$750	\$900	\$1,050
Plus actual individual account annuity	+300	+300	+300
Total retirement income	\$1,050	\$1,200	\$1,350

her actual account, and she ends up with higher net retirement income.

The specified offset rate used to calculate the value of the hypothetical account, which differs depending on the proposal design, is generally set so that plan participants would have a chance of achieving a better realized yield on their actual account investments (but that still fully compensates the Social Security trust funds). How an account actually performs, of course, depends on a participant's investment choices and on market performance.

### Offsets That Reduce Traditional Social Security Benefits

As shown in Figure 9-2, proposals that permit workers to shift Social Security taxes to individual accounts generally apply offsets against traditional Social Security benefits. Proposals may also include an offset provision when accounts are financed from other sources, such as from unspecified general revenue as in the case of the Shaw proposal. These offsets could be based on the actual individual account balance – as in quadrant (2) – or on a hypothetical account balance using the total value of the contributions to the account plus a predetermined interest rate – as in quadrant (4).

Offsetting traditional Social Security benefits has advantages and disadvantages. If the intention of the offset is to compensate the trust funds, in full or in part, for Social Security taxes shifted to individual accounts, it may seem logical to reduce individual account holders' future Social Security benefits in exchange for their reduced participation in traditional Social Security. This offset application creates a direct link between Social Security taxes, traditional benefits, and individual accounts. However, because Social Security also provides life insurance (to surviving spouses and children of deceased workers) and disability insurance, reducing an account holder's traditional Social Security benefits could mean that these non-retiree benefits are also reduced. If the offset were designed to reduce traditional Social Security benefits, policymakers

would need to decide if all the benefits payable from a given worker's record should be reduced or only some of the benefits.

### *Offset Applied Only to the Account Holder's Benefit*

One approach would apply the offset only to the benefits of the worker who shifted Social Security taxes into a personal account and leave unaffected the benefits of that worker's family members. This result could be achieved by reducing just the account holder's monthly benefit, while the spouse (or widowed spouse) and children of that worker (including disabled adult children) would have their Social Security benefits calculated from the worker's unreduced primary insurance amount (PIA).<sup>5</sup> This approach would require a larger monthly offset against the account holder's retirement benefit (to recoup the value of Social Security taxes plus interest) than if the offset applied to all benefits paid from the worker's earnings record, though the *overall* offset obligation would be the same. There are no examples of current individual accounts proposals utilizing this approach.

The primary drawback of this approach occurs when married workers are required to purchase joint and two-thirds survivor annuities from their individual accounts at retirement. If the survivor's annuity is less than the survivor's offset, the surviving spouse's retirement income will be lower than when both individuals were alive.

### *Offsets Applied to the Primary Insurance Amount*

If offsets were applied to the PIA, traditional benefits for the account holder and for all family members would be reduced. A proposal by Rep. Kasich (HR 5659, 106th Congress), for example, would apply an offset to the PIA, by reducing traditional Social Security benefits one-third of 1 percent for every year of *potential* contributions to the individual account. In this case, all workers with the same years of potential contributions to the accounts would have the same percentage reduction in their traditional Social Security benefits. And, all qualifying family

members of such workers would have the same percentage reduction in their benefits because family benefits are based on the worker's PIA. This means that any traditional Social Security benefits paid to spouses, ex-spouses, surviving spouses, and qualifying children (including disabled adult children) would be reduced whether or not the beneficiary received a payout from the individual account.

If an offset were applied to the PIA, two workers with equal earnings and contributions to their individual accounts might have very different expected total *amounts* of offset against traditional benefits. For example, a worker with a spouse and children who all receive Social Security benefits would expect to have a much greater total dollar offset than a single worker (because all family benefits would be offset), even though the accumulation in their individual accounts would be the same.

Applying an offset to an account holder's PIA would also result in a lower-earning spouse absorbing two offsets. For instance, if Joan qualified for Social Security retirement benefits based on her own work history, and for a supplemental benefit based on her husband's work record, her own retirement benefit would be reduced by her own account and her spousal benefit would be reduced based on her husband's reduced PIA.

Rules could be adopted that exempt certain beneficiaries from the offset, as in Rep. DeMint's *Social Security Savings Act of 2003* (HR 3177), which stipulates that retired worker and aged survivor benefits would be offset, but Social Security benefits paid to survivors (other than surviving spouses age 60 or older) would not be subject to an offset.

### *Offsets Applied to Expected Total Traditional Benefits*

A third approach would apply the offset not to the PIA or to just the account holder's monthly benefit, but would calculate the offset on the total *expected* future benefits payable from the worker's earnings record, including benefits to

qualifying spouses and children, and apply the offset to all benefits paid. Models 2 and 3 of the President's Commission to Strengthen Social Security follow this approach. Steps in calculating this type of offset include: (a) computing the value of the participating worker's offset at retirement (based either on the hypothetical account balance or the actual account balance); (b) calculating the present value of all future traditional Social Security benefits expected to be paid from the worker's earnings record, including benefits for a spouse, widowed spouse, and children; and (c) dividing (a) by (b) to determine the offset rate to be applied to all Social Security benefits paid from the account holder's earnings record. This approach results in a smaller *percentage* reduction when family members are eligible for traditional Social Security benefits, because it is intended to produce the same expected total dollar amount of offset as for a single worker. This concept is illustrated in the following examples for Bachelor Bob and Husband Harold, who otherwise have similar histories of earnings and account participation.

Bachelor Bob has a hypothetical individual account of \$30,000. His monthly Social Security benefit of \$900 (at age 65) is equivalent to a lump sum of about \$145,000. His Social Security benefit would be reduced by 20.7 percent ( $\$30,000/\$145,000$ ), so he would receive 79.3 percent of his traditional Social Security benefit for the rest of his life. He would also have his actual account balance, which could be more or less than \$30,000, depending on his investment returns.

Husband Harold's hypothetical individual account is also \$30,000. The present value of traditional benefits on Harold's earnings record would include benefits payable to him (roughly \$145,000 like Bachelor Bob) plus the expected value of benefits payable to Wanda, age 59, as a wife and potential widow. Wanda's expected benefits would depend on her work record as well as her age. Assuming her benefits on his work record have an expected value of \$55,000, total benefits payable on Harold's earnings

record would be \$200,000. The reduction applied to all traditional Social Security benefits paid to Harold and to Wanda from Harold's work record would be 15 percent ( $\$30,000/\$200,000$ ). Like Bachelor Bob, Husband Harold would also have his actual individual account balance, which could be more or less than \$30,000, depending on his investment returns.

Bachelor Bob's traditional Social Security benefits would be subject to a greater percentage reduction than Husband Harold's. However, if Bachelor Bob purchased a single-life annuity with a \$30,000 account at the same time as Husband Harold purchased—with the same size account—a joint-and two-thirds survivor annuity for himself and his younger wife, Bachelor Bob would receive higher monthly annuity payments (see Chapter Three).

An offset also would be calculated for Wanda that would be applied to her own worker benefits. Wanda's hypothetical individual account balance is \$10,000. The present value of expected traditional benefits on her work record is \$100,000. Wanda's traditional Social Security benefits on her own work record would be reduced by 10 percent ( $\$10,000/\$100,000$ ).

Using an offset rate approach to reduce Social Security benefits for individual account participants has advantages and disadvantages. The primary advantage of this approach is that it attempts to equalize the total offset amount for single workers and married couples. Since married couples potentially receive more benefits from Social Security than single workers, their offset percentage (or rate) is smaller because it is applied to all benefits payable on a given work record.

Any offset mechanism based on marital status at the time of calculation would need to be flexible enough to address the issue of divorce and possibly remarriage (or multiple divorces and marriages). For example, if Bachelor Bob married after starting to receive Social Security benefits,

his new wife would be eligible to receive traditional spouse and surviving spouse benefits on Bob's work record. Would those benefits be calculated based on Bob's original higher offset rate, or would the offset rate be recalculated? Different answers to this question might produce very different results for Bob and his new wife and for the trust funds. If Harold had been married for more than ten years prior to his marriage to Wanda, policymakers would need to decide whether to include the potential Social Security benefits payable to his ex-wife when calculating his offset rate. If those benefits were included, it would mean that any benefits paid to Harold's ex-wife would be reduced by Harold's offset rate. A further discussion of the complexities in the case of divorce continues in the next section.

Designers of an offset rate mechanism would also need to consider the case in which the lower-earning spouse was younger than the higher-earning spouse. For instance, if Wanda was in her 50s when Harold retired, it would be difficult to determine how much of a dual entitlement (if any) she would be eligible for based on Harold's earnings record because her own Social Security benefit is based on her earnings up to her own retirement. It could be the case that when Wanda finally retires she has earned enough during her career that she would not qualify for a spouse benefit paid from Harold's earning record. Since Harold's offset rate was calculated *as if* Wanda would receive a dual entitlement benefit, Harold's lower offset rate would represent a windfall for Harold (and a corresponding shortfall to the trust funds) if his offset rate were not recalculated.

And, finally, an offset based on family situation at the time of retirement would reduce the predictability of one's retirement income from traditional Social Security benefits, making retirement planning more uncertain.

As a general rule, if an offset were applied to traditional Social Security monthly benefits, then

it would be consistent to calculate it as either an offset rate or as a monthly amount.

It is important to note that even if an individual account program were mandatory, the interactions between offsetting Social Security benefits across-the-board and paying family benefits results in some of the same types of outcomes as illustrated above. In other words, an across-the-board offset applied to all workers' Social Security benefits would still raise the possibility of all non-retiree benefits being reduced, unless rules prohibited this. The key to the offset puzzle lies in determining the extent to which family benefits should be affected if an offset were applied to traditional Social Security benefits.

An offset could be applied to the individual account, avoiding the complications that arise when family benefits are paid from any given worker's Social Security earnings record (but possibly raising other complications).

### Offsets That Reduce Individual Accounts

An offset could be designed to reduce a worker's individual account instead of his or her traditional Social Security benefit. This type of offset, commonly referred to as a *clawback*, would shift at least part of a worker's individual account into the Social Security trust funds. The offset could be designed to reduce the individual account in one of two ways: the account could be reduced by the entire offset obligation, in a lump sum, or both the offset obligation and at least part of the individual account could be converted to "annuities" with the reduction taken on a month-to-month basis. The offset funds from the individual account would be shifted to the Social Security trust funds.

While this offset design is less common in recent individual account proposals, applying an offset to the individual account has a few simplifying features. Offsetting the individual account would avoid reducing family Social Security benefits paid from individual account holders' earnings records. This offset method would also avoid the need to convert the retiree's potential

stream of future social insurance benefits into a dollar amount to calculate an offset rate, or to convert the individual account balance into a future benefit stream that resembles traditional Social Security benefits to calculate an offset dollar amount. While such calculations could be made, they introduce some level of complexity and uncertainty.

If a worker-specific offset were applied to the value of the individual account itself, it would be consistent for policymakers to make the form of the offset match the form of the payout from the account. For example, if a retiree could take his individual account balance as a lump sum at retirement, then it would be consistent to calculate and apply the offset to the personal account as a lump sum. If the retiree were allowed to take phased withdrawals, it would nevertheless be straightforward and consistent to apply the offset as a lump sum before estimating the phased withdrawals. Finally, if annuities were the required payout from an individual account program, an offset could be applied either as a lump sum, before the annuity is calculated, or as a monthly offset to the annuity amount based on the total offset obligation.

### Applying Offsets at other Life Events

Policymakers would also need to explore whether, and how, offsets would apply in situations other than retirement. What issues might arise, for example, if early withdrawals are, or are not, allowed? How would offsets apply at various life events? For example, how might offsets work in plans that permit or require account assets to be divided between husbands and wives at divorce? What rules apply when workers die before retirement? How would offsets apply to disabled workers?

### Offsets and Early Access to Accounts

Some individual account proposals allow early withdrawals if account balances are of sufficient size to keep workers above the poverty level in retirement. Some proposals might also allow

access to the accounts only for certain purposes—for health emergencies, home purchase, higher education, starting a business, or other reasons—as is the case with 401(k)s and the TSP (see Chapter Five for a complete discussion).

If early withdrawals were allowed and the offset were based on the actual individual account balance at benefit entitlement, the offset would need to be designed to keep track of the final account balance plus any withdrawals (including any subsequent potential earnings), to determine the full offset value. Without this tracking mechanism, a worker could avoid the offset by reducing his or her individual account to zero before retirement.

An offset based on hypothetical individual accounts avoids this adverse incentive problem. Since hypothetical account offsets would track the value of Social Security taxes shifted to the accounts plus a predetermined interest rate, these types of offsets would not depend upon the actual individual account balance in any way, and the offset calculation would be unaffected by any activity in an actual individual account. However, policymakers would have to decide how to deal with situations in which the remaining individual account balance or the traditional benefit, depending on how the offset is applied, is insufficient to absorb the offset.

### Offsets If Accounts Are Split at Divorce

Some individual account proposals would permit courts to divide account accumulations between divorcing parties; other plans mandate such a division. This raises policy questions about how the transferred account funds would be counted for offset purposes. The general notion described above – that workers should not be allowed to deplete their accounts to minimize their offsets – might become less clear-cut if workers were required to transfer part of their accounts to ex-spouses.

If we think of the personal account as an “asset,” then we might consider the offset based on that account as a “debt.” If part of the asset

transfers at divorce, should part of the debt transfer as well? If so, to what benefit would the debt (or offset) apply? Would the offset apply to the recipient spouse’s own retirement benefit, or only to benefits based on the account of the donor spouse? Should the full “debt” remain with the person who shifted Social Security taxes into the personal account?

If an offset (debt) were based on a hypothetical account balance, while the asset transfer is based on the actual account balance, then the hypothetical account balance would presumably reflect the transfer of contributions implied by the actual account balance transfer at divorce. In each case, policymakers should consider and clarify the intended results for divorcing couples.

To illustrate, assume that Harold and Wanda are divorcing before retirement. Both Harold and Wanda had individual accounts and their offsets were based on the value of Social Security taxes shifted to their accounts plus a predetermined interest rate.<sup>6</sup> The system administrator tracked the shifted Social Security taxes and interest in hypothetical individual accounts. At divorce, their actual individual accounts were split 50-50, but the hypothetical accounts were not (Figure 9-4).

If the intent of policymakers is to recoup the value of the Social Security taxes (plus interest) from each worker individually, it would not be necessary to adjust their hypothetical accounts to reflect the division at divorce; Harold would have an offset calculated on his hypothetical individual account balance of \$2,900 (while his *actual* individual account would be worth only \$2,200 following the divorce), and Wanda’s offset would be calculated on her hypothetical balance of \$900 (while her *actual* individual account would be worth \$2,200 following the divorce).

Yet, if the intent of policymakers is to consider the value of the actual individual account as part of total retirement income when calculating an offset (as in the offset rate design described

**Figure 9-4.** *Individual Account Splitting at Divorce*

	Harold	Wanda
Balance in individual accounts up to time of divorce (Social Security taxes plus actual earnings on investments)	\$3,200	\$1,200
At divorce, accounts split 50-50	-1000	1,000
Balance in individual accounts after divorce	\$2,200	\$2,200
Balance in hypothetical individual accounts up to time of divorce (Social Security taxes plus predetermined interest rate)	\$2,900	\$900

above), the individual account administrator would need to be informed of the change in the accounts due to divorce.

A situation could arise where an offset would be larger than the benefit payable. In the above example, for instance, if Wanda's offset were calculated on the actual individual account balance following divorce, and the offset were to be applied to her traditional Social Security retirement benefit, her benefit might not be large enough to absorb the complete offset. Yet, if Harold's offset were based on a hypothetical individual account, and the offset applied to what was left in his actual individual account, the actual account might not be large enough to absorb the offset.

Offset policies with regard to transferring accounts at divorce would also need to take into account the possibility that spouses may have made different decisions on participation. Because worker-specific offsets are necessary only in proposals in which participation is voluntary, it would be quite possible for one spouse to have shifted Social Security taxes into a personal account while the other spouse did not. If Wanda had not participated in the individual account plan, but she received half of Harold's account at divorce, would her benefits be reduced due to the presence of the individual account in spite of the fact that she did not (personally) shift any Social Security taxes out of the trust funds?

Any offset design would also need to stipulate what would happen in the case of an ex-spouse qualifying for benefits on an individual account holder's Social Security earnings record. For example, suppose Harold was married to June for 12 years prior to his marriage to Wanda, and prior to the start of an individual account program.<sup>7</sup> Under current Social Security law, June is entitled to the same survivor benefit as Wanda (based on Harold's work record) provided she has not remarried. If an offset were applied to Harold's Social Security benefit such that any survivor benefits were reduced, June's survivor benefit would be reduced due to Harold's individual account. June would probably not receive anything from Harold's individual account because June is not a qualified survivor under current joint-and-survivor annuity rules. The private annuities market offers many options beyond basic joint-and-survivor provisions, as examined in Chapters Three and Four, and provisions for surviving divorced spouses could be added in the future. However, purchasing an annuity that provides benefits on three lives (Harold's, June's, and Wanda's) is likely to provide lower benefits to each than an annuity payable to one annuitant and survivor. Just as policymakers would have to consider how accounts are divided in the case of divorce and possibly remarriage, the issue of how any offsets would be divided is also important.

## Offsets and Disability Benefits

It is important to consider how an individual account plan, and any accompanying offsets, would affect disabled workers and their families throughout the rest of their lives. Chapter Seven outlines six options, including five ways to provide for disabled workers and their families in proposals for mandatory accounts financed with Social Security taxes. The last of these options seems to raise the fewest new challenges and might be a model for worker-specific offsets in a voluntary plan when personal accounts are financed with Social Security taxes.

This option has the following features: (a) disabled workers and their families would receive traditional disability benefits that were not offset because of the creation of the individual account; (b) the individual account would not be available until the disabled worker reached normal retirement age, at which time it would be annuitized under the rules that apply to other retirees; and (c) when the disabled worker reached normal retirement age, he or she would shift to a *blended* traditional benefit that would be a weighted average of the lower retirement benefit (after applying an offset due to the individual account) and the higher “unoffset” disability benefit. The relative share of each benefit

would depend on the portion of the work life that the individual was disabled. For example, if John had been disabled one-fourth of his potential working-age years, his blended traditional benefit at normal retirement age would be 25 percent of his “unoffset” disability benefit, plus 75 percent of his offset retirement benefit, as illustrated in Figure 9-5. In addition, at retirement he would have his individual account or an annuity from it.

If the individual account were annuitized at retirement, and if the annuity and the offset were based on similar calculations, the disabled worker would experience little change in monthly income when he or she shifted from disability benefits to offset retirement benefits plus a life annuity.

In this policy scenario (delaying application of a disabled worker’s offset until he retired), other questions arise if he should die before retirement. Would his account then go to his heirs or estate? If so, he and his estate would have borne no offset for having shifted Social Security taxes to the personal account; the trust funds would absorb a net loss, and the estate would experience a net gain. This issue raises the broader question of death before retirement discussed below.

**Figure 9-5.** *Blended PIA for Worker Disabled One-Quarter of Working Life*

	Disability PIA	Retirement PIA	Blended PIA	IA Annuity
At time of retirement	\$900	\$700		\$400
Adjustment—disability 1/4 of potential working life:				
25% of disability PIA	\$225			
75% of reduced retirement PIA		\$525		
Total blended PIA*			\$750	
Full IA annuity				\$400
Total Retirement Income**				\$1,150

\*Disability PIA and reduced retirement PIA

\*\*Blended PIA and full IA annuity

## Worker-Specific Offsets and Benefits for Children of Deceased Workers

As discussed in Chapter Eight, Social Security also pays survivor benefits to children if the children are unmarried, and under age 18 (or up to age 19 if still attending elementary or secondary school full time). Adults disabled since childhood are also eligible for benefits when a parent dies. Qualifying children can receive up to 75 percent of the deceased worker's basic Social Security benefit. Would these benefits for children be subject to offset? Would the answer be different if the children did, or did not, inherit the account?

### *Offset traditional benefits for young survivors*

One option would be to offset the deceased parent's basic benefit (PIA) that is used to calculate benefits to children. In this case, the benefits for surviving children would be lower if their deceased parent had chosen to set aside Social Security taxes in a personal account. Under this option, if the parent had chosen not to shift taxes to a personal account, then life insurance protection for his or her children would remain intact.

### *Shield young survivor families from benefit offsets*

An offset could be designed so that young survivors' benefits would not be subject to any offset, and some individual account proposals have adopted this rule. Under this approach, surviving children would not have their benefits subject to an offset. All surviving children would be treated the same, whether or not the parent had chosen to shift Social Security taxes to an individual account.

## Other Situations of Death before Retirement

Additional questions arise about how to equitably apply worker-specific offsets when workers die before any offset has been applied to their retirement benefits. As noted above, this could occur if a worker died after becoming disabled,

or died leaving minor children. In this and other scenarios involving death of the worker before retirement, policymakers would have a number of policy choices to make.

- (a) First, what would happen to the individual account? Who would get it? Would the inheritance be offset by any amount?
- (b) Second, who (if anyone) would receive lower traditional benefits because Social Security taxes had been shifted from the trust funds to the individual account? Would benefits be reduced for heirs who received the account? Would benefits be offset only if traditional benefits were payable from the deceased worker's earnings record? Would the offset and inheritance be independent?
- (c) To which benefits would an offset apply? For example, if a widow inherited an account, would her own benefit as a retiree be offset? Would any offset apply only to benefits payable to survivors from the deceased worker's earnings record? If an able-bodied adult child or sibling (who would not qualify for Social Security benefits from the deceased worker's earnings record) inherited the account, would an offset apply to the heir's own retirement benefit?
- (d) Under what circumstances would the trust funds recoup any of the revenue from workers who chose to put Social Security taxes into individual accounts and who then died before retirement?

Policymakers might have different rules depending on the different circumstances under which workers die and whether the deceased left dependents who had relied on the deceased workers' income. Possible scenarios include:

1. Worker dies before retirement, leaving no eligible spouse or children.
2. Worker dies leaving dependent children, either minor children or one or more dis-

abled adult children, as discussed in the prior section.

3. A worker dies leaving a widowed spouse, who inherits the account.
4. A worker dies leaving a widowed spouse, who does not inherit the account (plan allows for designation of another beneficiary with or without spousal consent).

Each of these scenarios could include cases in which the worker (and family, if any) had been receiving disability benefits before death. The scenarios could also include cases in which no Social Security benefits had yet been paid, but survivor benefits would be immediately available to the children and widowed spouse. The circumstance could be that no immediate benefits are payable, but the widowed spouse might, in the future, become eligible for benefits as a retiree on her or his own work record, or as a widowed spouse with traditional benefits based on the work record of the deceased. In another case, if no child or widowed spouse survived the worker, the account might be willed to other relatives who would have no traditional Social Security benefit rights on the deceased worker's earnings record, in which case no revenue would be recouped for the Social Security trust funds.

Some proposals that include worker-specific offsets would offset survivor benefits only for benefits payable to aged widowed spouses. Many current proposals exempt surviving children's benefits from any offset, and some proposals exempt children and/or young widowed spouses from any offset. Many proposals would allow bequests to individuals not eligible for traditional Social Security survivor benefits. Typically such proposals have no explicit provision for the trust funds to recoup the funds bequeathed to heirs when workers die before retirement.

## *Offset Administrative and Legal Issues*

Regardless of design, offsets raise administrative and legal issues to be considered when integrating offset provisions with other payout features of a proposal. This section will examine some of the issues triggered by benefit offsets.

### *When to Calculate and Apply the Offset*

An offset proposal would need to specify what event would trigger the calculation and application of a worker-specific offset. Two potential triggers for calculating and applying the offset are: (a) when retirees claim Social Security benefits; or (b) when retirees first take withdrawals from their individual accounts.

### *Claiming Social Security Benefits*

Workers can claim Social Security benefits at any age after 62 and there is no advantage to waiting beyond age 70 to claim benefits. If an offset were to reduce traditional Social Security benefits, it would make sense to calculate the offset no earlier than when benefits were initially claimed. This policy would avoid the possibility that the value of the calculated offset would be out of sync with the value of Social Security taxes shifted to the individual account. For example, if John's offset were calculated at age 62, and he continued to shift Social Security taxes into an individual account until age 68 when he actually claimed traditional benefits, the offset would fail to reflect five years of Social Security taxes shifted to his account.

Similarly, if the offset were applied to traditional Social Security benefits, then it would need to be calculated and applied no later than when benefits were first claimed. This policy would avoid the possibility that retirement benefits could be received without offset.

Calculating and applying an offset when traditional retirement benefits were initially claimed would ensure that individual account participants would not receive any benefits from Social Security without incurring the offset, and that

the offset would reflect all contributions to individual accounts before benefit receipt.

### *Initial Withdrawal from Individual Account*

If the offset were taken as a lump sum from the individual account (instead of a monthly reduction in Social Security benefits), then some mechanism would be needed to ensure that accounts are not depleted before an offset were applied. It might still be necessary to apply the offset when the worker claims Social Security, ruling out the possibility that a worker could receive (non-offset) Social Security benefits, while delaying indefinitely using the money in the individual account (and incurring an offset from it).

Ultimately, the fewest issues seem to arise if an offset were calculated and applied at the time a worker filed for Social Security benefits (and not later than when funds were first taken from the account). While workers could avoid an offset by not filing for Social Security benefits, the value of their traditional benefits would stay in the trust funds and be available to pay other workers' benefits.

Once an offset is calculated and applied, two approaches are possible for any subsequent earnings. First, policymakers could simply end the worker's voluntary contributions to the personal account and direct all of his future Social Security taxes, if any, to the trust funds. Second, in the case of an offset rate, the rate could be recomputed each year by adding any additional account contributions to the original calculation.

### **Offsets and Mandatory Annuity Thresholds**

Some proposals require that retirees annuitize their account balances only to the point where, when combined with traditional Social Security benefits, the account holder would receive monthly payments that would keep him or her above some specified income level (see Chapter Three). This intent would need to be coordinated with the application of a worker-specific offset. For example, if an offset would reduce

John's traditional benefits by \$300 a month, then John's level of mandatory annuitization from his personal account would be \$300 a month higher after applying the offset.

### **Coordinating an Offset Calculation and Annuity Purchase**

Policymakers might want to consider whether to encourage (or require) that the calculation of an offset and the purchase of an individual account annuity are coordinated in time. As discussed in Chapter Three, the timing of annuity purchase – with regard to interest rates and market performance – could have an impact on the monthly annuity income an individual account would produce. If an offset were based on the actual individual account, then significant variations could occur based on timing. Workers would all want to purchase annuities when the market and interest rates are high (to produce higher annuities) and they would like to have offsets calculated when the market and interest rates are low (to produce smaller offsets).

### **Offset Accountability**

When designing an offset mechanism, the decision must be made whether each individual account holder would be legally responsible for his or her entire offset, or if it would be assumed that any overall target offset amount would be met across the entire individual account population. If the intention behind benefit offsets is to recover Social Security taxes shifted to individual accounts (without affecting those who did not participate in the accounts), the offset design needs to address what would happen if a worker dies before his or her entire offset amount were recovered. For instance, if John's offset were based on a hypothetical annuity calculated from the total amount of Social Security taxes contributed to his individual account, plus interest, the total amount of taxes and interest would be the offset amount due from John. If John dies before that entire offset is recovered, other workers—including those who did not participate in individual accounts—might be called on to make up the difference.

If a pooled approach to total offset recovery were taken, the trust funds would get back less of an offset from workers who die early and more of an offset from workers who live longer. A longer-lived worker would receive more in Social Security benefits, and more from his or her individual account annuity (if annuities were required), and absorb more of an offset, than a shorter-lived worker.

If each individual account holder is personally responsible for his or her entire offset amount, provisions would be needed to recover any remaining offset from a worker's estate if he or she dies before the offset is completely recovered. Conversely, if a worker lives long enough that his or her entire offset is recovered, provisions would be needed to restore the worker's benefit to the original amount.

### Minimum Benefit Guarantee

Some individual account plans, such as Rep. DeMint's "Social Security Savings Act of 2003," guarantee that the total monthly payments available from the combination of the individual account and traditional Social Security benefits would not be less than some specified level, such as the scheduled traditional benefit level in current law. If a guarantee of this type were included in the proposal, the offset mechanism would be expected to apply first, with a subsequent determination on a case-by-case basis of whether additional payments were needed to meet the guarantee.

### Spousal Rights Upon Divorce or Death

If federal law determines all issues of spousal rights in individual accounts, federal law would determine the allocation of offsets. But, if the plan allows some spousal rights issues to be determined by state law, a separate decision would be needed as to whether state or federal law would determine the division of offsets.

In a divorce, state courts divide responsibility for a couple's debts as well as the couple's assets. Would state courts have jurisdiction over a couple's individual account balances as well as their

offsets? If so, it could be possible for the court to split the balance in an account 50-50, but decide that no offset would accompany the transfer to the lower-earning spouse. Conversely, the state court could decide how the account balances would be divided, while federal law would determine the division of the offsets (as federal law determines the federal tax consequences of assets divided in divorces).

Allowing states to make decisions about the division of offsets as well as balances would encourage state decision-makers to consider the net value of a share of an individual account when one is divided. However, leaving decisions about offset allocation to state judges, lawyers, and parties—in the many cases in which parties lack legal representation—poses a risk that a decree could fail to address the offset issue or do so incorrectly. Even if rules about the allocation of offsets are set by federal law, if they are based on decisions made at the state level about the division of balances, it will be necessary for federal rules to anticipate a range of possible orders (such as orders reserving part of an IA for the benefit of children) or place some constraints on the nature of the orders. Allowing states to make these decisions would also require a timely and accurate reporting system to inform the individual account system administrator of the decision. Accurate and timely reporting could be particularly crucial if the offset design is calculated using a hypothetical individual account.

Individuals, couples, lawyers, and courts would need full information about how offsets affect spousal rights in order to make informed decisions about whether to seek a share of an individual account during a divorce, and whether to waive the right to inherit an individual account. Depending on the offset design, assessing the impact of an offset on the value of an account might require putting together information held by account administrators and the Social Security Administration. An individual account plan should ensure access to the necessary information.

## Summary

Proposals that would allow workers to choose whether or not to shift Social Security taxes to individual accounts typically include worker-specific offsets. The reasons for such offsets are to compensate the Social Security trust funds for the lost revenue and to distinguish equitably between workers who do and who do not shift Social Security taxes to personal accounts. This chapter has explored some of the wide-ranging issues for policymakers to consider when designing worker-specific offsets if individual accounts became part of federal retirement policy. We recap some of the key questions here.

In terms of basic design, should the offset reduce Social Security benefits, or should it reduce the size of the worker's individual account? Offsets that reduce the individual account would not impinge upon family benefits paid by Social Security. Offsets that reduce Social Security benefits would require policymakers to decide which types of benefits would be reduced (retirement or disability) and what family benefits (spouses, widowed spouses, disabled widowed spouses, young surviving spouses and children) would be reduced due to the worker's participation in the individual accounts.

Should the offset be based on the size of the actual individual account balance, or should it be based on a hypothetical account balance that is based on contributions plus some predetermined interest rate? Offsets based on the actual individual account balance would be influenced by market returns. Such offsets could also be affected by pre-retirement withdrawals or loans from the account, unless special rules mandated that such activity would not affect the offsets. Offsets based on hypothetical account balances would be affected only by the amount of contributions to the account and the assumed (or hypothetical) return on those contributions. Offsets based on hypothetical accounts might provide a clearer relationship between the offset and the taxes shifted to individual accounts, but the offset could exceed the actual account bal-

ance or traditional benefit to which it is to be applied. In addition, accurate and timely reporting of life events would be necessary so that hypothetical and actual individual accounts reflect comparable balances when the offset is calculated.

If an offset applies to future traditional benefits, whose benefits should be offset? Should the offset apply only to individual workers' future benefits, or should it reduce family benefits payable on the account holder's earnings record as well?

At retirement, what event would trigger the calculation and application of a worker-specific offset? Would the trigger be when the individual first claims Social Security benefits, or when he or she first takes funds from the individual account? Applying the offset when Social Security benefits are first claimed would ensure that no retirement benefits avoid an offset. If retirees keep working after claiming benefits, would contributions to the account end and instead go to the Social Security trust funds? How might this rule affect incentives with regard to timing of benefit claims?

At retirement, if an offset applies to the actual individual account, would the offset be taken as a lump sum or as a monthly amount? It would be consistent to match the form of the offset to the form of the individual account payout. When the account is annuitized, would policy require that the same assumptions be used to calculate the annuity as were used to calculate the offset against the annuity?

If the offset were applied to traditional Social Security retirement benefits, a number of approaches are possible. First, an offset could be applied only to the account holder's benefit, leaving traditional spousal benefits unaffected. Second, an offset could be applied to the worker's primary insurance amount, reducing both worker and spousal benefits. Third, an offset could be applied to total expected retirement benefits. Each approach would produce a differ-

ent pattern of benefits for the couple and the surviving spouse.

The third approach—applying the offset to total expected retirement benefits— attempts to equalize the total offset amount for a single worker and a married couple, while spreading the offset between both members of the couple, rather than applying it just to the account holder’s benefit as the first approach would do. However, calculating the expected benefits payable on a work record is complicated by the possibility of divorce and remarriage and uncertainty about the future earnings of a spouse who has not yet reached retirement age. Therefore, an offset based on expected family benefits at the time one member of the couple retires would reduce the predictability of traditional Social Security benefits. Rules for couples would also need to take account of the possibility that one spouse had chosen to shift Social Security taxes to an individual account, while the other did not.

At divorce, if the overall proposal permits courts to divide accounts between husbands and wives, or if it mandates such a division, some conforming rules might be needed for worker-specific offsets. For example, if the personal account is viewed as an “asset” in divorce proceedings, should the offset associated with that account be viewed as a “debt?” Would part of the “debt” transfer when the account is divided? Should the offset obligation remain with the original account holder? The rules would need to cover cases in which both parties were account holders, as well as cases in which only one chose to have an account. Questions of federal versus state jurisdiction also arise in determining how much discretion courts would have to divide accounts and the offset obligations that accompany them. Individuals, couples, lawyers, and courts would need full information about how offsets affect spousal rights in order to make informed decisions about whether to seek a share of an account during marriage and whether to waive the right to inherit an account, if such options were part of the individual account proposal.

At the onset of disability, worker-specific offset policies could be designed to exempt disabled workers from a worker-specific offset and to apply the offset later when the disabled worker reaches retirement age. Similarly, when a worker dies leaving minor children (or disabled adult children), benefits for children could be exempted from application of a worker-specific offset. Policymakers will need to decide whether a worker’s decision to shift Social Security taxes to a personal account should or should not affect family life insurance protection otherwise provided by that worker’s earnings and contribution history.

When workers die before any offset applies, policymakers have a range of choices: What should happen to the individual account? Who would receive it? Who, if anyone, would get lower traditional benefits because Social Security taxes were shifted to the account? Would traditional benefits for an aged widow be reduced even if the widow did not inherit the account? If the person who inherits the account is not eligible for benefits on the deceased worker’s record, does that heir experience any sort of offset? Under what circumstances would the trust funds recoup revenues that had been shifted to personal accounts in cases where account holders die before any offsets have been applied?

In conjunction with offsets, policymakers would also need to decide if each individual account holder would be personally responsible for his or her entire offset amount and, if the plan included a minimum benefit guarantee, how the offset would be applied to insure the minimum.

The application of worker-specific offsets could result in many different outcomes. The purpose of this chapter has been to provide a broad overview of the kinds of questions policymakers would need to address in designing these offsets in a system that allows workers to shift Social Security taxes to personal accounts.

## Chapter Nine Endnotes

- 1 The expected, or average, return on stocks is higher than the expected, or average, return on bonds. This average higher return is the market's way of compensating investors for the fact that, due to stock's higher volatility, investing in stocks entails more risk. Actual rates of return can be higher or lower than the expected return.
- 2 Generally, individual account proposals that use new funds, either by increasing Social Security taxes or by using transfers from general revenue, do not include offsets because Social Security's trust funds are unaffected. Representative Shaw's *Social Security Guarantee Plus Act of 2003* (H.R. 75, 108th Congress) presents an important variation in which accounts financed with unspecified general revenue are used to finance benefit payments scheduled from Social Security rather than to provide a basis for offsets against these benefits.
- 3 This taxonomy does not include all possible offset designs. For instance, former U.S. Congressman John Kasich proposed offsetting traditional Social Security benefits by 1/3 of a percentage point for each potential year of participation in individual accounts (H.R. 5659, 106th Congress). The offset designs listed in Figure 9-2 are some common examples.
- 4 Alternatively, an offset could be calculated as a percent of the actual individual account balance. Another possible offset of this type, like Rep. Shaw's, would shift into the Social Security trust funds a calculated amount from a worker's individual account. Representative Shaw has not referred to this feature of HR 75 as an offset; his plan is mentioned here for illustrative purposes only.
- 5 The primary insurance amount is the basic calculation that determines the level of traditional Social Security benefits paid to a worker and to all eligible family members.
- 6 In this example, the interest rate used for the hypothetical account (upon which the offset is based) is lower than what the couple earned in their actual individual accounts.
- 7 To qualify for Social Security divorced surviving spouse benefits, the marriage must have lasted at least ten years.



# Chapter 10

## Individual Account Taxation

The tax treatment of individual accounts can have a dramatic impact on the costs, participation levels, forms of payout, and benefits and burdens associated with them. Tax issues are further complicated because one cannot understand how to tax payouts from individual accounts without understanding how contributions to the accounts are taxed. This is true because of “tax equivalences.”

In brief, policymakers can tax or exempt income at three different points in the saving process: they can tax deposits, investment earnings, and/or withdrawals. An income tax generally taxes savings deposits and investment earnings but not withdrawals. A consumption tax, however, can operate in one of two ways that, under certain circumstances, are economically equivalent. A consumption tax may tax deposits and exempt investment earnings and withdrawals, or it may exempt deposits and investment earnings but tax withdrawals. Finally, it is theoretically possible to exempt deposits, investment earnings, and withdrawals but doing so can produce a negative tax rate without increasing savings at all.

Based on this general situation, four current-law models for taxing individual accounts are examined, along with ways in which they could be modified.<sup>1</sup> The “*normal*” model for taxing savings mirrors the income tax regime where money that is saved is taxed when initially earned, and the income generated by the savings is then taxed when it is “realized.” The *traditional retirement savings model* mirrors the consumption tax regimes where income earned on qualified retirement savings is exempt from tax so that only the contributions made by workers and their employers are subject to tax. This is accomplished either by an upfront tax deduction for contributions or a tax exemption for withdrawals. Certain other forms of retirement savings are taxed under a third model—*deferral*—which taxes contributions immediately and taxes income earned on contributions upon withdrawal. *Social Security* contributions and benefits are taxed under a fourth model where the employee’s half of contributions are taxed, and between zero and 85 percent of benefits paid are taxed, depending on the beneficiary’s income level.

Each of these models can be, and in some cases is, combined with tax credits, preferential rates,

and/or tax penalties, all of which can have a substantial effect on tax burdens. As a result, these four models by no means comprise a complete list of options. Other models could easily be developed depending on policymakers' objectives.

Tax equivalences and the options for taxing individual accounts are explored, as are considerations policymakers might bear in mind when deciding which model or models to apply in light of an individual account plan's purposes and design.

## Tax Equivalences

Tax issues are unique because one cannot understand how to tax payouts from individual accounts without understanding how contributions to the accounts are taxed. This consideration of the contribution phase is necessary because of "tax equivalences," which summarize the relationship between regimes that tax income at different points in time. The government can tax (T) or exempt (E) income at three points in the saving process: It can tax (1) deposits, (2) investment earnings, and (3) withdrawals, in that order. An income tax generally taxes deposits and investment earnings but not withdrawals (summarized TTE). By contrast, a consumption tax may operate at the individual level in two ways. A consumption tax may, as with Roth individual retirement accounts (IRAs), tax deposits and exempt investment

earnings and withdrawals (summarized TEE), or it may, as with deductible IRAs, exempt deposits and investment earnings but tax withdrawals (summarized EET). Finally, it is possible to exempt deposits, investment earnings and withdrawals (summarized EEE), but this method is rarely pursued for reasons described below.

Figures 10-1 through 10-3 illustrate three important insights of "tax equivalences." First, as shown in Figure 10-1, the two consumption tax regimes (TEE and EET) are generally economically equivalent if tax rates applicable at the time of deposit, during the accumulation period, and at withdrawal are the same and unchanging.<sup>2</sup> Essentially, the taxpayer has to pay tax either when money is deposited or when it is withdrawn from the account, but not on both occasions. If tax is paid earlier, when funds are deposited, it is generally equal in present value terms to the tax that otherwise would have been paid upon withdrawal. This holds true only if the taxpayer makes the same pre-tax contribution and the rate of return that the taxpayer can earn is identical under each scenario.

A second insight of tax equivalences is that applying the income tax regime (TTE) imposes higher taxes on people who defer consumption by saving than it imposes on people who receive the same income and consume immediately. Applying the consumption tax regimes (TEE and EET) is neutral regarding the timing of con-

**Figure 10-1.** *Equivalence of Roth IRA and Deductible IRA Models*

	TEE (Roth IRA)	EET (Deductible IRA)
Contribution Limit	300	400
Pre-Tax Contribution	400	400
Tax on Contribution	100	0
After-Tax Contribution	300	400
Investment Earnings	478	637
Tax on Investment Earnings	0	0
Pre-Tax Balance at Withdrawal	778	1037
Tax on Withdrawal	0	259
<i>After-Tax Withdrawal</i>	778	778

*Assumes that tax rate is 25 percent; interest rate is 10 percent; inflation is zero; and deposits are invested for 10 years.*

**Figure 10-2.** Value of Consumption for Immediate Consumption Versus Saving

	TTE, TEE & EET Consume	TTE Save	TEE Save	EET Save	EEE Save
Pre-Tax Funds Available	400	400	400	400	400
Tax on Consumption / Deposits	100	100	100	0	0
Tax on Investment Earnings		106	0	0	0
After-Tax Investment Earnings		318	478	637	637
Tax on Withdrawals		0	0	259	0
Net Consumption	300	618	778	778	1037
Value of Consumption in Year 10	778	618	778	778	1037

Assumes that tax rate is 25 percent; interest rate for borrowing and investing is 10 percent; inflation is zero; taxpayer consumes immediately or invests funds for 10 years. Consumption is shown at time of withdrawal.

sumption.<sup>3</sup> This occurs because the income tax regime taxes earnings accumulated on savings, but the other regimes do not. Figure 10-2 illustrates how the present value of consumption is identical under the consumption tax regimes, regardless of whether a taxpayer chooses to consume funds immediately or save them, but that this is not true of the income tax and total exemption regimes. These results crucially assume, however, that interest payments are not deductible and that taxpayers do not finance saving through deductible borrowing.

If savings are in fact financed through deductible borrowing,<sup>4</sup> the results are quite different. Figure 10-3 demonstrates that in such circumstances applying the consumption tax regimes

(TEE and EET) to a savings vehicle can effectively result in negative tax rates, and applying the total exemption regime (EEE) produces even greater subsidies without necessarily increasing savings at all. Taxpayers who borrow to participate in a savings vehicle can use interest deductions and the tax benefits associated with the savings vehicle to reduce taxes they otherwise would have paid on other income. As a result, they can extract a subsidy from the government without increasing their net savings overall. Denying any deduction for interest on borrowed funds, including home mortgage loans, can prevent this opportunity for taxpayers to “game” the system. The income tax regime also prevents this tax arbitrage. But, under the total exemption regime, taxpayers can, though borrowing,

**Figure 10-3.** Negative Rates of Tax when Saving Financed Through Borrowing

	All Models Consume	TTE Save	TEE Save	EET Save	EEE Save
Amount Borrowed	400	400	400	400	400
After-Tax Amount Saved <sup>6</sup>	0	400	400	533	533
After-Tax Investment Earnings <sup>7</sup>		637	899	1198	1198
Tax on Withdrawal		0	0	433	0
After-Tax Account Balance		1037	1299	1299	1731
Principal & Interest Owed	1037	1037	1037	1037	1037
Value of Subsidy in Year 10	0	0	262	262	694

Assumes that tax rate is 25 percent; interest rate for borrowing and investing is 10 percent; inflation is zero; taxpayer consumes immediately or invests funds for 10 years.

extract a subsidy without saving even if interest is not deductible.<sup>5</sup>

## Models for the Tax Treatment of Individual Accounts

Based on this analysis, the tax code's four current models for taxing savings can be more clearly understood. Some models mirror the general tax regimes described above, while others make important modifications.

### Traditional Retirement Savings Model

The traditional retirement savings model mirrors the consumption tax regimes by exempting income generated by savings through one of two mechanisms. In Roth IRAs (equivalent to TEE), taxpayers make contributions from their after-tax earnings or savings, but accumulated income and withdrawals are tax-exempt. Alternatively, traditional IRAs and employer-based retirement plans (equivalent to EET) allow taxpayers to deduct contributions or exclude them from income, and to defer tax on all income earned on the accounts until the funds are withdrawn. The full amount of the withdrawal is taxed as ordinary income without regard to the character of the earnings. Under certain conditions, these two mechanisms for exempting income earned on retirement savings are economically equivalent.

### Deferral Model

A second current-law model for taxing individual savings accounts, which applies to a smaller number of retirement savings vehicles, taxes both contributions and account earnings but does not tax account earnings until withdrawal. The model applies to annuities and to savings in excess of the contribution limits in certain employer-sponsored retirement plans.<sup>8</sup> Effectively, tax on the earnings accumulated on after-tax contributions is deferred under this model, but not eliminated as under the traditional retirement savings model. The value of this deferral can be substantial.

### “Normal” Tax Treatment of Savings

The third option for taxing individual accounts is to follow the “normal” model for taxing savings under current law, which mirrors the income tax regime (TTE). Generally, both contributions to non-retirement savings accounts and income earned on such contributions are subject to tax. Taxpayers take no deduction for income saved for an unspecified purpose, and must report any income generated by such savings to the Internal Revenue Service (IRS). For example, if an individual invests in a corporate bond, tax must be paid at ordinary rates on interest as it accrues. In contrast, if the individual invests in stock, tax must be paid at lower rates on dividends received and on capital gains when the stock is sold.

This model differs from the traditional retirement savings and deferral approaches because income generated by savings is taxed. In some cases, it is taxed only when it is realized.

### Social Security

The Social Security system presents a fourth option for taxing individual accounts. Social Security contributions and benefits are taxed at both higher and lower rates relative to the models described above, depending on the beneficiary's income level.

Social Security is funded half with after-tax dollars (the Social Security taxes paid by workers, which they cannot deduct or exclude from their income) and half by pre-tax dollars (the Social Security taxes paid by employers, which are deducted by employers but are not included in workers' taxable income). The portion of distributions that must be included in income rises with income: low-income beneficiaries need not include any Social Security benefits in their taxable income, while higher-income beneficiaries must include 50 to 85 percent of benefits. The effective income tax rate on both the employee's share of Social Security taxes and the portion of benefits that the employee must include in income depends on the taxpayer's income tax

rate, which will vary from person to person and in some cases will be zero.

The Social Security model stands in contrast to the other three models described above because the percentage of account earnings included in income varies by income level at the time of withdrawal. Assuming constant tax rates over time, the Social Security model is more advantageous than the traditional retirement models for lower-income taxpayers and is generally less advantageous than the traditional retirement savings models (and in some cases, the deferral model) for higher-income taxpayers. Some analysts view the 85 percent method as approximating the deferral method, with a general assumption that contributions are equal to 15 percent of benefits under the Social Security benefit formula.<sup>9</sup> However, the 85 percent method may understate contributions for more recent, higher-income retirees and, even if not, it is disadvantageous for higher-income taxpayers relative to the traditional methods of taxing retirement income. It may also in some cases be less advantageous than the “normal” model for taxing savings for higher-income taxpayers.

### Tax Credits

Beyond these four general models, it is possible to alter the tax treatment of individual accounts by funding them in whole or in part with tax credits. Under current law, the only tax credit available for retirement savings matches low-income taxpayers’ contributions to accounts following the traditional retirement savings model. However, each of the models could be combined with tax credits to lower effective tax rates on savings, augment contributions for some or all account holders, or to provide incentives or disincentives for certain types of withdrawals.

Tax credits provide a way to offer tax incentives or subsidies for savings in individual accounts that do not necessarily rise with income because the value of a tax credit need not depend on the taxpayer’s tax rate. By contrast, the deferral, Social Security, and traditional retirement savings models all use deductions and exclusions as

incentives and subsidies, and these are inherently worth less to lower-income taxpayers who are subject to lower tax rates or, in many cases under current law, are not required to pay income tax at all.<sup>10</sup>

In addition, tax credits can vary along different eligibility criteria, such as income, family structure, and contribution size. Tax credits may also be “refundable,” meaning that taxpayers who owe no federal income taxes still receive the full amount from the government. Refundable tax credits are a way to provide universal tax incentives to save in individual accounts, and are perhaps the best incentive for workers in the bottom half of the income distribution who currently do not often participate in traditional tax-preferred retirement savings vehicles.<sup>11</sup>

## Summary of Tax Policy Choices

Ultimately, the tax policy decisions that must be made when developing any model for the taxation of an individual account system turn on eight major factors.<sup>12</sup> Each of the models described above represent one set of choices along these dimensions but, as illustrated by Appendix B, which summarizes the tax treatment rules of selected individual account proposals, different decisions would generate still more models. Eight factors that would influence the design of any tax model for the accounts follow.

### Funding Source

Individual accounts may be funded from a variety of sources, including the existing or an expanded Social Security tax, general tax revenues, voluntary or mandatory individual contributions, employer contributions, or some other dedicated revenue stream.

### Tax Treatment of Contributions

Contributions may be made on a pre-tax basis, in which the account holder typically receives a deduction or is allowed to exclude contributions made on his behalf, or contributions may instead come from after-tax income. As illustrat-

ed by the tax equivalence discussion, policymakers also have the option to tax contributions when account funds are withdrawn.

### Tax Treatment of Account Earnings

Income tax on the earnings from individual account contributions may be imposed at different times and at different rates. In particular, income generated by individual accounts, such as interest, dividends, and capital gains, may be tax exempt or taxed at different stages: as accrued, when realized, when withdrawn, or at some other time. Preferential rates may apply to all account earnings or certain types of earnings. If earnings are taxed when withdrawn or distributed, different methods may be used to determine what portion of each withdrawal is attributable to contributions as opposed to account earnings.

### Eligibility Requirements

Eligibility to participate in any individual account program, or to receive certain tax benefits associated with the program, may be restricted through various means. For example, policymakers might establish contribution caps or participation might be restricted to workers with income below a certain threshold.

### Tax Credits

Tax credits may be used to match contributions or earnings on account balances, to persuade employers to contribute to accounts, or to encourage financial institutions to market and administer the accounts.

### Differential Tax Treatment of Withdrawals

Account holders may be subject to penalties or incentives for certain withdrawals. For example, some current retirement savings vehicles penalize withdrawals prior to age 59½ unless withdrawals are for approved purposes, such as education or a first-time home purchase. Penalties may also be imposed if accounts are not annuitized or if a portion of the account is not withdrawn each year during retirement (to prevent taxpayers from using individual accounts as

estate planning devices). Sufficiently high penalties may function as a disincentive for certain uses of individual accounts that policymakers deem undesirable. Conversely, tax deductions, exclusions, credits, and preferential tax rates may be used to create incentives for certain withdrawals.

### Transfer Tax Treatment

Estate and gift taxes might also be used to further tax policy goals with respect to individual accounts. Workers may have to pay gift tax, for example, if they transfer their rights to an account. If withdrawals are taxed, a bequest or gift could also trigger recognition of income as if account assets were withdrawn.

### Implicit Taxes

Finally, implicit taxes may be levied by public and private sector means-tested programs (for example, scholarship policies that consider personal accounts in setting scholarship awards), and by involuntary distributions resulting from, for example, third-party creditor claims.

## Potential Designs of Individual Accounts

Lawmakers will likely be influenced by the basic design of an individual account system when making decisions about tax policy. Of particular importance for tax purposes is how the accounts would be funded and what rules would govern withdrawals. There are generally five ways of funding individual accounts, depending on both the source of revenue and the rules of participation (Figure 10-4). *Currently scheduled Social Security taxes* might be used to fund either a *mandatory* account system, where some portion of each worker's current Social Security contributions would be shifted to an individual account, or a *voluntary* system where workers could choose to shift a portion of their current Social Security contributions to individual accounts.<sup>13</sup> Alternatively, policymakers might look to *new, earmarked* contribution sources from workers, their employers, and/or the feder-

al government (for example, through increased Social Security taxes or general revenue spending). Again, participation in and contributions to a program funded with new revenues could be *mandatory* or *voluntary*. Finally, policymakers might fund the accounts with unspecified general revenues.

In addition to the funding source, the design of an individual account system depends on whether and how account funds are withdrawn both before retirement (if permitted) and at retirement. Two general payout methods are the most relevant for tax purposes. An account holder (and potentially his or her spouse) might elect to receive one or more lump sums and might transfer undistributed amounts as a gift or bequest. *Life annuities*, in contrast, would guarantee annuitized payments for the remainder of the account holder's (and potentially a spouse's) life.<sup>14</sup>

These methods of funding and paying out funds from individual accounts are not mutually exclusive. For example, all workers might be required to annuitize base accounts funded through mandatory contributions but also have an option to supplement their accounts through voluntary contributions not subject to an annuitization requirement. This flexibility may be a virtue, but it may further complicate the question of how the accounts should be treated for tax purposes.

### Implications of the Design and Purpose of Individual Accounts

Having laid out the potential designs of an individual account system, this final section exam-

ines considerations policymakers may wish to take into account in deciding which tax treatment model to apply, and in understanding what each tax model practically entails. We examine each potential design separately,<sup>15</sup> but in many cases the considerations of earlier designs will be relevant to the designs examined subsequently.

### Mandatory Accounts Funded with Current Social Security Taxes

If a portion of all workers' current Social Security taxes were automatically shifted to individual accounts, some aspects of account taxation would be pre-determined: there would be no eligibility or contribution limits, and contributions would come from the Social Security tax. However, the broad questions of how to address any distributional concerns and whether to provide incentives or penalties for certain forms of withdrawals would remain.

In addition, the question would arise whether contributions were deemed to come from the employer or employee share of Social Security taxes. If contributions were split between the employer's share and the employees' share, half would be after-tax and half would be pre-tax. Alternatively, if all the contributions came solely from the worker's share of Social Security tax, the entire amount would be after-tax. But in this circumstance, it might be necessary to adjust the tax treatment of traditional Social Security benefits because the current tax treatment assumes that they are funded half with pre-tax and half with after-tax contributions. Accordingly, for simplicity, the following discussion generally assumes that individual accounts would be fund-

Figure 10-4. Categories of Individual Account Plans by Source of Funds and Nature of Participation

Nature of Participation	New Earmarked Contributions for the Accounts	Currently Scheduled Social Security Taxes for Accounts	Unspecified General Revenues for Accounts
Mandatory Participation	(1)	(2)	(5)
Voluntary Participation	(3)	(4)	

ed half with the employer share and half with the employee share of Social Security taxes.

### *Addressing Distributional Concerns through Account Taxation*

In general, the distribution of benefits among different demographic groups under a mandatory individual account program funded with current Social Security taxes may be affected in four ways: through the benefit formula governing the remaining defined-benefit portion of the Social Security system, through the method for allocating shifted Social Security taxes to individual accounts, through offsetting savings in other vehicles, or through the tax treatment of account earnings and distributions.<sup>16</sup>

Under any combination of these mechanisms, it is difficult or impossible to design individual accounts in such a way that, together with traditional Social Security benefits, they provide the same benefit coverage and exactly compensate the Social Security trust funds for lost revenues, even disregarding transition costs.<sup>17</sup> Nonetheless, these mechanisms might be used to approach (or modify) the distributional effects of the current Social Security system. This chapter, however, focuses on designing the accounts' tax treatment and what administrative and design issues each tax treatment model would raise. The actual choice of which tax treatment model to adopt will likely be driven not just by distributional objectives, but also by revenue costs and administrability concerns.<sup>18</sup>

### *Applying the Social Security Model*

If the purchase of life annuities were mandatory and the accounts followed the Social Security model in their tax treatment, the treatment would depend on whether the contributions came from employer or employee taxes. For example, if half of the contributions came from each, withdrawals should be taxed as if they were Social Security benefits, with zero percent to 85 percent of the withdrawal included in income, depending on the beneficiary's income level. In this case, the main differences between new individual accounts and Social Security

would be that individual accounts would likely have a different distributional effect than Social Security, retirement income would be pre-funded (to the extent of individual accounts), workers might have some degree of property rights to their accounts, and workers might have authority to determine how their accounts are invested. Workers would still likely have little or no control, however, over when and how they receive their account funds.

Assuming that half of contributions are from employers and half from employees, one potential advantage of following the Social Security model is simplicity for beneficiaries: because Social Security benefits are the only form of retirement income for roughly 20 percent of retirees, many people would need to understand only one taxing regime. However, if funding were not half from employers' and employees' shares of Social Security taxes or, as discussed below, if annuitization were elective, following the Social Security model would be far more complicated.

Another potential advantage of following the Social Security model is that it eliminates one source of distributional and revenue differences between individual accounts and Social Security benefits. Stated differently, if an individual account program seeks to fully compensate the Social Security trust fund for lost revenue and maintain the distributional profile of the Social Security system as a whole—and is somehow able to accomplish this result through offsets on a pre-tax basis—presumably policymakers would want to follow the Social Security model for taxing the accounts to maintain this result on a post-tax basis as well.<sup>19</sup> It will, however, be difficult, if not impossible, to create an individual account program that is distributionally neutral and revenue neutral given issues like variable investment returns, and the complex entitlements that the Social Security system creates for children, former spouses, surviving spouses, and disabled adults.

### *Applying the Traditional Retirement Savings Model*

If mandatory annuitized accounts instead aim to follow the traditional model for retirement savings, the treatment would also depend on whether the contributions came from employer or employee taxes. For example, if half of the contributions came from each, 50 percent of withdrawals should be taxed as ordinary income, reflecting the 50 percent of account contributions that would have come from the pre-tax dollars of employer Social Security taxes.<sup>20</sup> In effect, the income earned on the accounts would then be exempt from tax. One advantage of this model is that it is relatively simple and intuitive if people understand that half of their contributions were not taxed. It would, however, alter the distributional profile of the current Social Security system because the portion of distributions subject to tax would not vary by income, as is the case with Social Security benefits today.

### *Applying the “Normal” Model for Taxing Savings*

If the accounts were to follow the “normal” model for taxing savings, workers would be taxed currently on earnings from the accounts and, if the model were followed strictly and contributions were funded half from the employers’ share of Social Security taxes, workers would also have to include the employers’ share of their Social Security tax contributions to their individual accounts in taxable income. While such tax treatment might address distributional concerns, its distributional impact would depend on the percentage of income that different demographic groups contribute, and the levels of capital income tax rates applicable to different taxpayers relative to their ordinary income tax rates. This model would also be relatively complicated, especially for taxpayers who would not otherwise report capital income. Account holders would have to keep records of account earnings and annually report and pay taxes on such income at varying rates depending on both their level of income and the form of the investment income. A system would also have to be

put in place to apportion their after-tax contributions across annuity payments.

### *Applying the Deferral Model*

Alternatively, the accounts might follow the deferral model, which would tax all Social Security tax contributions to individual accounts currently, but would not tax account earnings until they are withdrawn. At that point, the entire amount of each annuity payment would be included in income to the extent that it exceeded the allocated share of Social Security tax contributions, which would have already been taxed. This option would avoid the need for annual reporting of account earnings under the “normal” model for taxing savings. However, this model could potentially be more administratively difficult and costly because taxpayers or account administrators would need to keep records of contributions accumulated over their entire careers, and possibly at multiple financial institutions. Like the “normal” model for taxing savings, if contributions were funded half from the employer’s share of Social Security taxes, workers would also have to include the employer share of their Social Security tax contributions to their individual accounts in taxable income.

### *Other Options*

Other simpler options that do not fit within any of the existing models are also possible. For example, workers might be required to include, or be permitted to exclude, 100 percent of account withdrawals from income.<sup>21</sup> Alternatively, all withdrawals could be taxed as Social Security benefits. These one-size-fits-all approaches would avoid both the liquidity problems of the “normal” model and the complexity of the deferral approach. These alternative approaches would, however, alter the distributional profile of Social Security. The first option could be criticized as involving double taxation if contributions came in part from the after-tax employee share of Social Security taxes. As discussed in the section on tax equivalences, the second and third options could be criticized as resulting in a subsidy without resulting in any

new saving if contributions came from the pre-tax employer share of Social Security taxes or if individuals financed their accounts through borrowing. Many tax experts believe that individual accounts should be taxed at least once (either by taxing contributions or withdrawals) except to the extent that the accounts are intended to be a mechanism for redistribution to low-income workers.

### Considerations If Accounts Are Not Annuitized

If workers are not required to annuitize their accounts, additional questions arise with respect to their tax treatment. Under elective annuitization, in contrast to Social Security, some proposals would permit workers to withdraw their funds before retirement, receive lump-sum distributions (or periodic withdrawals) at retirement, and/or transfer their assets to third parties. As a result, it would become necessary to determine how to treat transfers of the accounts to third parties for tax purposes and whether to apply minimum payout rules. Many of the current tax-favored retirement savings vehicles require that account holders withdraw (and include in income) a portion of their accounts each year after they reach a certain age or retire to ensure that the accounts are used for retirement income rather than estate planning purposes.

If annuities were elective, the tax system could also be used to create incentives to annuitize through tax deductions, exclusions, or credits, or through penalty taxes on non-annuitized withdrawals. Further, elective annuitization would also create design challenges in applying the Social Security, traditional retirement savings, or deferral taxation models because workers might be subject to high tax brackets and degrees of inclusion relative to their actual financial position. For example, if a worker received a large lump-sum withdrawal, the Social Security approach of requiring taxpayers to include benefit payments in taxable income based on their income level might result in a high proportion of the lump sum being subject to tax—and at a high rate—even though the

worker is generally low-income. To address these problems, it would be necessary to impute an annuity or provide for some other form of income averaging when determining the degree of income inclusion and tax rate. Either of these approaches would introduce further complexity.

Finally, if annuitization were elective, the question would arise whether to permit, and how to treat, withdrawals prior to retirement. This question is addressed generally in Chapter Five. As that chapter suggests, the answer depends on the goals of an individual account system and whether and how policymakers seek to affect behavior. For instance, if the accounts were funded from the same revenue stream as Social Security, workers might be prohibited from, or penalized<sup>22</sup> for, withdrawing funds prior to retirement, in order to promote retirement security. Alternatively, withdrawals might be restricted to uses deemed socially productive.

### Voluntary Accounts Funded with Current Social Security Taxes

Many of the implications for taxation described above would remain the same if accounts funded with current Social Security taxes were voluntary, rather than mandatory. The amount of contributions would likely be fixed or limited to a percentage of Social Security taxes. If annuitization were mandatory, the accounts could be taxed according to any of the four existing models, or the other models outlined above, with similar implications to those described above (for example, taxing 50 percent of withdrawals as ordinary income in the case of the traditional retirement savings model if 50 percent of the contributions were pre-tax). And, elective annuitization would raise the same questions about whether minimum distribution rules should apply, whether and how to provide tax incentives to annuitize, how to tax transfers and lump-sum withdrawals, and whether workers should be subject to penalties or prohibitions for certain pre-retirement withdrawals.

### *Addressing Distributional Concerns*

Two significant new taxation issues would arise if the accounts were voluntary. First, achieving any distributional objectives would become more complicated because it is likely that those who might benefit more from the individual account system than from the traditional Social Security system would disproportionately elect to participate. If participants were disproportionately higher-income, this would reduce Social Security tax revenues available to achieve any distributional objectives through the remaining Social Security system. One way that policymakers could try to avoid this distributional effect and revenue loss is by using offsets. If the objective is to render the individual account program distributionally and revenue neutral on a pre-tax basis (and this could somehow be accomplished through offsets), policymakers would probably want to apply the Social Security tax treatment model to individual accounts (including requiring contributions to be half pre-tax and half post-tax) in order to maintain this result on a post-tax basis. In addition, policymakers might adjust the distributional effects of individual accounts through mechanisms such as restricting eligibility for individual accounts, disproportionately allocating shifted Social Security taxes to the accounts of lower-income workers, providing more favorable tax rules for the withdrawals of lower-income workers, or applying offsets to the individual accounts that effectively return a portion of the individual accounts to the Social Security trust fund.

### *Effect on Participation Rates*

A second, related issue that arises with voluntary accounts is whether to use taxes to create incentives (or disincentives) to shift Social Security taxes into an individual account program, putting aside distributional objectives. Voluntary accounts necessarily introduce further complexity into the retirement savings system because workers must choose whether to participate by projecting which option is best for them in the future. Absent incentives or disincentives, it is unclear whether and to what extent workers

would elect to create individual accounts. For example, a risk-averse person might shy away from the accounts given their uncertain returns. By contrast, some workers might be attracted to individual accounts as a means of potentially shielding their future retirement income from political whims and budget constraints. Further, people with different priorities may disagree about whether workers should be encouraged or discouraged to create individual accounts in place of a portion of their Social Security benefits as a policy matter. The uncertain returns from the accounts may increase the number of retirees that the government must support during retirement; yet, the accounts might provide workers with more freedom and autonomy.

Depending on the actual and preferred level of participation in a voluntary individual account program, some additional tax incentives to create the accounts may be desirable. Taxation models that exclude a larger percentage of contributions or withdrawals from income would tend to offer participation incentives, while those that include a larger portion of contributions and withdrawals in income would tend to discourage participation. In addition, policymakers would need to pay particular attention to incentives or disincentives created by the interaction between the tax treatment of the accounts and any benefit offsets. For instance, if Social Security benefits were offset by the value of a hypothetical annuity purchased with the pre-tax account balance at retirement, and the accounts were taxed more favorably than Social Security benefits, this could create a participation incentive.

### **Mandatory Accounts Funded with New Revenues or Unspecified General Revenues**

If individual accounts were mandatory and funded with new revenues, many of the tax considerations would be similar to the two designs discussed above where contributions were made from Social Security taxes. The key difference would be that the tax treatment would no longer be constrained by the fact that funding

came from current Social Security taxes. As a result, policymakers might, for example, combine tax credits with any of the models to address distributional concerns.<sup>23</sup> When contributions come from a non-Social Security tax source, several new issues arise.<sup>24</sup>

### *Applying the Social Security Model*

First, applying the Social Security model to mandatory accounts funded from non-Social Security revenues would be relatively complicated. Perhaps 50 percent of contributions could be taxable<sup>25</sup> and withdrawals, if annuitized, could be included in income as if they were Social Security benefits. But, as described above, applying the Social Security model would be complicated if annuitization were not mandatory.

### *Applying the Traditional Retirement Savings Model: Roth IRAs v. Deductible IRAs*

Second, if taxation of the accounts aimed to follow the traditional retirement savings model, policymakers would need to decide whether to employ the deductible IRA or Roth IRA method. Under the deductible IRA method, the full value of accounts funded with pre-tax contributions would be taxed as ordinary income when withdrawn, while under the Roth IRA method accounts funded with after-tax contributions would be tax exempt when withdrawn. The Roth IRA method would have the benefit of providing a more certain stream of retirement income to workers because workers would not need to plan for possible changes in the tax rates that would otherwise apply to their retirement income. It is also generally more favorable to workers who are currently low- and middle-income and do not benefit from current deductions. Yet, by providing its tax benefits up front, the deductible IRA method might achieve higher levels of participation for a given cost if, as discussed below, the accounts were voluntary.

The political risk and revenue implications of the deductible IRA and Roth IRA methods differ. Under the deductible IRA method, there may be pressure not to tax withdrawals later on, resulting in a negative tax rate relative to an

income tax, while under the Roth IRA method there may be pressure to tax future distributions to upper-income taxpayers. At the same time, the impact on future government revenues from deductible and Roth IRAs depends on future tax rates. For example, the Roth IRA model might potentially exacerbate the long-term fiscal gap (relative to the deductible IRA model) because the present value of the associated revenue loss would be greater if tax rates are expected to rise over time, and because much of the associated revenue loss would be outside the five or ten-year budget window and is less likely to be taken into account by legislators.

### *Administrative and Complexity Concerns Raised by Other Models*

Finally, if the accounts were mandatory and funded with non-Social Security revenues, technical and administrative complications would arise if taxation of the accounts aimed to follow the deferral model or the “normal” model for taxing savings, as discussed above.

Contributions would have to be after-tax, taxpayers or account administrators would need to keep records of total contributions and account earnings, and a system would have to be developed for allocating basis (the portion of the account already taxed) over multiple withdrawals. In the case of the “normal” model for taxing savings, taxpayers or account administrators would also need to keep records of their basis in individual assets held in their accounts, and the tax treatment would vary depending on the type of assets in the accounts.

### *Voluntary Accounts Funded with New Revenues or Unspecified General Revenues*

The final individual account design—voluntary accounts funded with new revenues—raises many of the questions outlined above whose answers again depend on the accounts’ goals with regard to distributional results, simplicity, and revenue. This design also raises several new issues.

As a preliminary matter, the taxation options depend on the chosen contribution method. It is unlikely that new voluntary accounts would be funded through Social Security taxes if the accounts were not a part of the Social Security system because that arrangement would impose complicated withholding requirements on small businesses, requiring them to track whether each of their employees had elected to participate in the program, and if so, at what level. Also, even though voluntary accounts would not mandate universal participation, the system could only make individuals universally eligible to participate by separating contributions from the employment-based Social Security tax system. As a result, contributions would likely come directly from individuals or employers electing to participate in the program.

Once the method for contributions is determined, policymakers could choose among the existing taxation models or could create a different taxation system through exemptions and/or credits. As discussed above, the Social Security model would be difficult to apply if contributions were made outside the Social Security tax system. It would also make little sense to follow the “normal” model for taxing savings, standing alone, because taxpayers would then have no incentive to participate relative to other tax-preferred forms of retirement saving. The remaining options are (1) the traditional retirement savings model; (2) the deferral model; (3) exempting contributions and taxing withdrawals like Social Security benefits; or (4) supplementing one of these options, or the “normal” model, with tax credits.

### *Use of Tax Credits*

The extensive use of tax credits to stimulate participation might raise new concerns, especially about abuse. A voluntary individual account program funded with new revenues might rely more extensively on tax credits than other individual account designs, both because tax credits could be used to alter the distribution of tax benefits in a system funded with new revenues, and because refundable tax credits would be

necessary if universal tax incentives to participate were an important goal. If tax credits were used to match contributions, and there were no restrictions in pre-retirement withdrawals, taxpayers might make contributions and immediately withdraw them, in order to receive the tax credits. Even if penalties were imposed on pre-retirement withdrawals, this “churning” could be advantageous if the match rate were high enough relative to the penalties. Accordingly, to the extent that tax credits were a significant element of an individual account program that permitted pre-retirement withdrawals, anti-abuse rules would likely be necessary.

Ultimately, the decision about which of the models to apply would depend largely on the normative objectives of the individual account program. For instance, if the program sought to redistribute or to ensure a base level of retirement income or assets for all, refundable tax credits, and perhaps eligibility or contribution limits, would be needed. In contrast, if the program sought to eliminate disincentives for savings in the tax system, irrespective of the distribution of benefits, the traditional retirement savings model might be advisable. Finally, if the accounts aimed to increase national savings overall, there is a robust debate about whether incentives to save that are directed at the less affluent (for example, refundable tax credits) or the more affluent (such as, exempting income earned on the accounts from tax) would be more effective, and it would be important that the new savings not be funded by increased government borrowing.

## *Summary*

This chapter has explored various ways in which individual accounts could be treated for tax purposes. The tax treatment of individual accounts can have dramatic consequences for the cost of any individual account program, the distributional aspects of the system, and (if the accounts were voluntary) participation rates. Some of the key tax policy decisions policymakers will need

to make with respect to any individual accounts system follow.

How would the accounts be funded?

Possibilities include existing or expanded Social Security taxes, general tax revenues, individual contributions, employer contributions, or some other dedicated revenue stream. The accounts' revenue cost, distributional profile, and size will depend on their funding source and on whether the accounts are voluntary or mandatory.

Who would be eligible for any tax benefits associated with the accounts and at what contribution level? For example, tax benefits could be restricted to certain low- and moderate-income workers, or to contributions below a certain level. Both of these policies would affect the distributional impact of the accounts and reduce their cost.

Would tax credits be used to supplement the accounts of certain workers, or to create incentives to establish accounts, contribute to accounts, or to make certain types of withdrawals? For instance, tax credits might be used to match individual or employer contributions, persuade financial institutions to administer the accounts, or to encourage participants to annuitize account balances. If the individual account program were voluntary, refundable tax credits are one way to provide universal incentives to participate.

How would the tax treatment of individual accounts affect the taxation of traditional Social Security benefits? If an individual account plan is funded out of existing Social Security taxes but is not funded equally from the employers' and employees' shares, the creation of individual accounts may raise the question whether adjustments are appropriate to the taxation of traditional Social Security benefits.

How would account contributions, investment earnings, and withdrawals be taxed? In general, current law provides four models.

Under the “normal” model for taxing savings, contributions to savings vehicles are taxed and then income earned on such savings is taxed as soon as it is accrued or realized, often at different rates depending on the type of income. For example, interest income is taxed at ordinary rates, while dividends and capital gains are taxed at preferential rates. Withdrawals are not taxed except to the extent that they result in income earned on the savings being realized.

Under the traditional model for taxing retirement savings, either (1) contributions are taxed, but income earned on such savings and all withdrawals are tax exempt, or (2) contributions and income generated by the contributions are not taxed, but all withdrawals are taxed at ordinary rates. Penalty rates typically apply to pre-retirement withdrawals. Under certain conditions, these two methods are economically equivalent.

Under the Social Security model, 50 percent of contributions are subject to income taxation, and a portion of each withdrawal is included in taxable income, ranging from zero percent for low-income workers to 85 percent for higher-income workers.

Finally, under a deferral model, contributions are taxed and income generated by such savings is taxed, but such income (and only such income) is taxed when withdrawn.

Ultimately, the choice between these four models, and the answers to the other questions raised by this chapter, will depend on distributional objectives, revenue concerns, administrability considerations, and how policymakers would like to affect different individuals' incentives to participate.

## Appendix A: Current Rules for Taxing Savings

The current law on the taxation of savings is a monument to mind-numbing and ever-changing complexity, and a detailed description could consume volumes. What follows is a brief overview that illustrates the options that might be appropriate in the context of individual accounts.

### The Primary Alternatives Under Current Law

#### *The “Normal” Model for Taxing Savings: Saving with After-Tax Dollars and Current Taxation of Income*

Absent special provisions, a worker pays current income tax on earnings and has only after-tax dollars to put aside for savings. Interest on those savings (unless tax exempt) is taxed currently at ordinary rates, but dividends are taxed at preferential rates and, if the savings are invested in a capital asset, gain on that asset is also taxed at preferential rates only when that asset is sold. The “normal” model imposes no restrictions on withdrawals or distributions, and the owner of the assets has control over transfers of the assets to third parties.

#### *Social Security*

The tax treatment of savings in Social Security differs radically from the “normal” model for savings. Contributions are mandatory and made through the Social Security tax, half of which is paid by employers and half by employees. Employer contributions are excluded from the employee’s gross income, while the employee’s contributions are not. Accordingly, workers generally save through Social Security with half pre-tax and half post-tax dollars.

Workers may receive Social Security benefits only when certain events, such as retirement or disability, trigger eligibility. The progressive benefit formula gives lower-income beneficiaries higher replacement rates for their wages than those available to higher-income beneficiaries. A

portion of benefits received may also be taxed at ordinary rates, but the specific percentage subject to tax varies from zero percent for low-income beneficiaries to 85 percent for higher-income beneficiaries. This percentage bears no necessary relation to the earnings that would have accumulated on the worker’s contributions.

#### *The Traditional Retirement Savings Model I: Saving with Pre-Tax Dollars and Taxing Distributions*

As a partial supplement to Social Security, numerous provisions in the tax law allow taxpayers to save for retirement using pre-tax dollars. So, individuals may exclude such savings from their income (such as contributions to 401(k)s and other qualified plans) or deduct contributions to tax-preferred savings vehicles (for example, traditional IRAs, SEP, and SIMPLE IRAs). Income on these savings (such as interest and dividends), and any gain on the sale of assets held in these accounts, is not taxed. Rather, all withdrawals are taxed at ordinary rates as those withdrawals occur (including those representing capital gains and dividends that would otherwise be taxed at preferential rates). In effect, these provisions provide two tax benefits for retirement savings: they allow taxpayers to save with pre-tax dollars and to defer the taxation of income that might otherwise be taxed.

Eligibility and contribution limits for such tax-preferred savings generally follow two models: (1) employer-based programs (for example, 401(k)s, qualified plans) and (2) individual-based programs (such as traditional IRAs). The employer-based model seeks to achieve broad coverage of employees through nondiscrimination requirements. Employer-based programs also have relatively high caps on contribution amounts, and they permit a fair amount of flexibility in deciding whether to make contributions mandatory and in determining the relative percentages of contributions from employers and employees. Individual-based programs, in contrast, do not require employer sponsorship. These programs seek to alter the distribution of the tax benefits through eligibility restrictions

and contribution limits. Individuals voluntarily make contributions.

These programs usually prohibit withdrawals before retirement, as in defined-benefit plans, or restrict such withdrawals to certain uses such as first-time home buying, education, or pursuant to Qualified Domestic Relations Orders in cases of divorce. If pre-retirement withdrawals are prohibited, the plans often impose restrictions on transfers to third parties, such as through a joint-and-survivor annuity requirement. If pre-retirement withdrawals are not prohibited, non-qualified withdrawals generally are subject to a 10 percent tax penalty on top of the normally applicable tax rate. This penalty is intended both to recover the benefit of tax deferral that the account holder has received, and to deter non-qualified withdrawals.

#### *The Traditional Retirement Savings Model II: Saving with After-Tax Dollars and Exempting Distributions from Tax*

As an alternative to saving with pre-tax dollars, a number of provisions in the tax law follow the traditional model for taxing retirement savings by permitting taxpayers to fund tax-favored accounts with after-tax dollars, and exempting all income earned on the accounts and withdrawals from tax (for instance, Roth IRAs, Coverdell Education Savings Accounts, Section 529 Plans, and life insurance<sup>26</sup>). All else being equal, the tax implications are the same under this model as under the previous model where contributions were pre-tax.<sup>27</sup> Of course, all else is seldom equal because the worker is rarely taxed at the same rate when he withdraws funds as he was when he made the contributions. A worker currently taxed at low rates, who anticipates facing higher rates in retirement, would prefer to save with after-tax dollars and receive tax-free withdrawals, while a worker currently taxed at high rates, who anticipates being taxed at lower rates in retirement, would prefer to save with pre-tax dollars and pay tax on withdrawals. And, setting rates aside, workers may prefer the cash flow certainty that comes with non-taxed withdrawals under this model.

Like individual-based accounts funded with pre-tax contributions, some of these provisions (for example, Roth IRAs and Coverdell Education Savings Accounts) restrict eligibility and have contribution limits, presumably to reduce the cost and ensure that the tax benefits do not disproportionately flow to more affluent savers. However, Section 529 plans, which are regulated at the state-level, have relatively high contribution limits and are open to all.

Unlike some accounts funded with pre-tax contributions (such as defined-benefit pensions), plans that exempt account earnings typically impose no prohibitions on non-qualified withdrawals. And when non-qualified withdrawals are penalized, such withdrawals are taxed only to the extent that the account holder withdraws more funds from the account for a non-qualified use than were contributed, in part because contributions are made after taxes. In such cases, the excess generally is taxed as ordinary income plus a 10 percent penalty.

#### *The Deferral Model*

In addition to the traditional retirement savings options described above, a smaller number of vehicles tax both contributions and income earned on contributions, but in the latter case only when the income is withdrawn. This treatment applies, for example, to annuities and to savings that exceed the contribution threshold in 401(k) plans that elect to receive after-tax contributions, which generally are treated under the annuity rules if annuitized.

Under the annuity rules, if an annuity pays fixed sums for a period of years, basis (the worker's total after-tax contribution) is recovered pro rata. Stated differently, if the worker receives ten equal payments, upon each distribution he will pay tax on one-tenth of the amount by which the total payments due exceed his total contributions. If an annuity does not have a fixed duration (a life annuity), the annuitant can exclude from income a portion of each payment equal to the basis divided by the number of payments he is expected to receive based on mortality tables.

In effect, tax on both of these forms of annuities is deferred because the annuitant pays tax when income is received as an annuity rather than when it accrues or is realized.

Like traditional IRAs and 401(k)s, distributions from annuities and savings vehicles following the deferral model are taxed as ordinary income (including any portion that otherwise would be taxed at preferential rates) to the extent they exceed contributions. But, in contrast to traditional IRAs and 401(k)s, contributions to annuities and savings vehicles following the deferral model are not deductible or excludable from income. Indeed, annuity taxation may be less favorable than taxation under the “normal” model for taxing savings if the spread between the ordinary and capital gains rates is large enough and the annuity contributions accumulate income over relatively few years or if the income is mostly unrealized capital gains

While there are no contribution or eligibility limits on purchasing annuities, non-qualified withdrawals are subject to a 10 percent tax penalty and treated as income to the extent that the amount received exceeds basis. In addition, the definition of a qualified withdrawal is relatively limited, excluding, for example, education and first-time home buying expenses. The 10 percent tax penalty also applies to other savings vehicles following the deferral model, but these savings vehicles must be sponsored by an employer and impose fewer restrictions on withdrawals.

### *Credit-Based Saving Subsidies*

Finally, while far less common, several current and proposed measures provide saving incentives or subsidies in the form of tax credits,

which may be refundable and/or automatic.<sup>28</sup>

Examples of these measures include the Section 25B Saver’s Credit, Retirement Savings Accounts (RSAs), and Universal Savings Accounts (USAs). These arrangements may be viewed as enhanced versions of savings with pre-tax dollars, where the dollar value of the credit for low-income taxpayers is comparable to, or greater than, the value of a tax deduction for higher-income taxpayers (for example, traditional IRA holders eligible for the Saver’s Credit). Alternately, tax credits can have the potential effect of exempting from tax both earned income and income from capital (for example, Roth IRA holders eligible for the Saver’s Credit).

The Saver’s Credit piggybacks on existing savings vehicles that exempt from tax income earned on accounts. Low-income savers receive a non-refundable tax credit (funded from foregone general revenues) for up to 50 percent of their savings in these vehicles. The credit reduces a worker’s tax liability, and the worker has complete discretion over whether to spend the credit or contribute it to the savings vehicle. In contrast, some proposals that incorporate tax credits (such as USAs) would automatically deposit refundable tax credits into individual accounts for low-income workers regardless of whether they have saved, and/or automatically deposit tax credits in individual accounts that match all or a portion of workers’ voluntary contributions.

These credits might be thought of as grants, which may be taxable or nontaxable depending on the overall tax treatment desired.

## Appendix B: Tax Treatment in Account Proposals

Figure 10-B. Tax Treatment Rules in Selected Individual Account Proposals

Proposal	Tax Treatment Provisions
<b>Mandatory Accounts Funded with New Contributions</b>	
ACSS (Gramlich): Individual Account Plan, 1996	<ul style="list-style-type: none"> <li>• Accounts would be funded with new worker Social Security tax contributions; tax treatment is not specified.</li> <li>• Accounts would be annuitized but tax treatment of withdrawals is unclear.</li> </ul>
Committee on Economic Development, 1997	<ul style="list-style-type: none"> <li>• Accounts would be funded with increased Social Security tax contributions from both workers and employers. Both shares would be excluded from employee income.</li> <li>• Contribution limits for other tax-preferred savings vehicles would not be changed.</li> <li>• Withdrawals would be taxed as ordinary income.</li> <li>• Account balances would be included in a worker's estate if the individual died before retirement.</li> </ul>
<b>Mandatory Accounts Funded with Scheduled Social Security Taxes</b>	
ACSS (Schieber & Weaver): Personal Security Accounts, 1996	<ul style="list-style-type: none"> <li>• Accounts would be funded with current Social Security taxes.</li> <li>• Other details of tax treatment unclear.</li> </ul>
National Commission on Retirement Policy, 1999	<ul style="list-style-type: none"> <li>• Mandatory accounts would be funded with current Social Security taxes. Tax treatment is not specified.</li> <li>• Tax treatment of withdrawals unclear.</li> <li>• Additional voluntary contributions of up to \$2,000 (net of IRA contributions) could be made to accounts.</li> <li>• Voluntary contributions would be after-tax and earnings accumulated on voluntary contributions would be taxed when withdrawn.</li> </ul>
Reps. Kolbe & Stenholm's 21st Century Retirement Security Act (H.R. 2771, 107th Congress)	<ul style="list-style-type: none"> <li>• Mandatory accounts would be funded with current Social Security taxes. Tax treatment is not specified.</li> <li>• Additional after-tax voluntary contributions of up to \$5,000 could be made to accounts.</li> <li>• Refundable tax credit would match low-income workers' voluntary contributions (\$150 for the first dollar, and 50 percent thereafter up to a maximum match of \$600). An additional credit would match voluntary contributions from Earned Income Tax Credit refunds.</li> <li>• Withdrawals of mandatory contributions would be taxed like Social Security benefits. Withdrawals of voluntary contributions and matching tax credits (and earnings thereon) would be excluded from income.</li> </ul>
<b>Voluntary Accounts Funded with New Contributions from Workers</b>	
Clinton's Retirement Savings Accounts, 2000	<ul style="list-style-type: none"> <li>• Workers earning under \$80,000 could contribute up to \$2,000 to accounts on an after-tax basis.</li> <li>• Refundable tax credit would match 200 percent of the first \$200 that a low-income couple contributed, and 100 percent of the next \$1,800 in contributions. Match rate would phase out at higher incomes. Tax credit must be deposited to an account if not used to offset tax liability.</li> <li>• Account earnings would be taxed, but only upon distribution.</li> </ul>

**Figure 10-B. Tax Treatment Rules in Selected Individual Account Proposals (continued)**

Proposal	Tax Treatment Provisions
R.M. Ball, Social Security Plus, 2003	<ul style="list-style-type: none"> <li>• Workers could elect to have employer deduct 2 percent of wages (on top of current Social Security taxes) and pay into an account.</li> <li>• Workers could receive deduction for contributions.</li> <li>• Withdrawals included in ordinary income.</li> <li>• At death, account balance would be included in estate.</li> </ul>
Savings for Working Families Act of 2003 (S. 476, 108th Congress)	<ul style="list-style-type: none"> <li>• Up to \$1,500 per year could be deposited in IDAs offered by qualified financial institutions to low-income taxpayers.</li> <li>• Financial institutions would match up to \$500 of participant contributions annually on a one-to-one basis, and would receive a tax credit to offset such matches. Financial institutions would also receive an annual \$50 credit per account to maintain the account and provide financial education. The tax credits could be transferred.</li> <li>• Participant's contributions and account earnings on such contributions would be taxed.</li> <li>• Matching contributions and earnings on such contributions would not be taxed when deposited or, in the case of a qualified withdrawal, when withdrawn.</li> </ul>
<b>Voluntary Accounts Funded with Scheduled Social Security Taxes</b>	
PCSSS Model 2, 2001	<ul style="list-style-type: none"> <li>• Worker could elect to redirect 4 percent of wages (up to \$1,000) from Social Security taxes to an account. Tax treatment is not specified.</li> <li>• Tax treatment of withdrawals unclear.</li> </ul>
PCSSS Model 3, 2001	<ul style="list-style-type: none"> <li>• Worker could elect to redirect 2.5 percent of wages (up to \$1,000) from Social Security taxes to an account if they voluntarily contributed 1 percent of wages in an account. Tax treatment is not specified.</li> <li>• Low-income taxpayers could receive a refundable tax credit to offset a portion of voluntary contributions.</li> <li>• Tax treatment of withdrawals unclear.</li> </ul>
Sens. Moynihan & Kerrey's Social Security Solvency Act of 1999 (S. 21, 106th Congress)	<ul style="list-style-type: none"> <li>• Workers could elect to have employee payroll tax reduced by 1 percentage point, or to have 2 percent of wages (1 percent employee share, 1 percent employer share) deposited in an account. Tax treatment is not specified.</li> <li>• Tax treatment of withdrawals unclear.</li> </ul>
<b>Unspecified General Revenues for Accounts</b>	
Rep. Shaw's Social Security Guarantee Plus Act of 2003 (H.R. 75, 108th Congress)	<ul style="list-style-type: none"> <li>• Workers would receive a refundable tax credit of 4 percent of wages each year (up to \$1,000, indexed to average wages).</li> <li>• Account earnings would accumulate tax-free.</li> <li>• Distributions would be taxed to the same extent as the worker's Social Security benefits. If the worker died before benefit entitlement, account distributions would not be taxable as benefits and would not be subject to the estate tax.</li> </ul>

## Chapter Ten Endnotes

- 1 Details on these models and others can be found in Appendix A.
- 2 Because personal circumstances change, individuals change tax brackets throughout their lives, and future tax rates are unpredictable, this assumption is unlikely to hold true. The direction of the difference, however, is uncertain.
- 3 The total exemption regime is not applied to consumption in this analysis because if it were applied generally to both saving and consumption the government would raise no revenue.
- 4 A taxpayer could finance saving through deductible borrowing by, for example, taking out a home equity loan on the appreciated value of the house, deducting interest paid on the loan, and using the borrowed proceeds to invest in the savings vehicle.
- 5 If interest is not deductible, the after-tax account balance under the total exemption regime would be \$1,382 in Figure 10-3, and the present value of consumption would be \$345, also implying a negative tax rate. Under the consumption tax regimes, the after-tax account balance would be \$1,037 and the present value of consumption would be zero, implying zero taxes and zero subsidies.
- 6 These figures assume that the taxpayer increases contributions to compensate for the value of deductions and exclusions claimed. Stated differently, it assumes that the taxpayer's after-tax income available for consumption is unchanged relative to the taxpayer's position prior to investing in the savings vehicle.
- 7 These figures assume that taxpayers annually add to their accounts the value of interest deductions claimed on the borrowed funds.
- 8 Annuities and after-tax employer-sponsored retirement plans tax contributions at ordinary rates when deposited and earnings on contributions at ordinary rates when withdrawn. This means that when the income is mostly in the form of unrealized capital gains, the deferral method may be disadvantageous in comparison to the "normal" method of taxing income. Theoretically, it is possible to tax contributions at ordinary rates, but to tax earnings on contributions at ordinary or preferential rates depending on the character of the earnings.
- 9 See, for example, Yvonne Hinson & Daniel Murphy, "Is the 85-Percent Social Security Inclusion Ratio High Enough?" 59 *Tax Notes* 571 (Apr. 26, 1993).
- 10 Approximately 35 percent of all tax units in a given year are not required to pay federal income tax after expenses, exclusions, exemptions, deductions and credits. See Tax Policy Center, *Federal Tax Liability By AGI* (citing Joint Committee on Taxation 1999 data), available at <http://www.taxpolicycenter.org/TaxFacts/overview/liability.cfm>. Over time, however, far more tax units face a positive federal income tax liability.
- 11 Employer matches are economically similar to refundable credits but are far from universal.
- 12 While state tax considerations are certainly relevant to how individual accounts should be taxed, such issues are beyond the scope of this chapter. As a general matter, some states piggyback on federal rules, some do not have an income tax, and some vary from the federal regime in important respects.
- 13 As discussed in Chapter One, some individual account proposals fund the accounts with current Social Security taxes but use general revenues or other revenues to compensate the Social Security Trust Fund for the taxes that have been shifted.
- 14 As discussed in Chapter Three, annuities can provide payments in a variety of ways, for example for a set number of years or for life with a minimum total payment.
- 15 We do not address category 5 separately from categories 2 and 4.
- 16 As discussed in Chapters Six and Seven, the intra-family distributional concerns that currently inform Social Security might be addressed in individual accounts by requiring joint-and-survivor annuities, or splitting payroll contributions

into an account for each spouse if a worker files jointly.

- 17 Chapter Nine discusses some issues in achieving this goal in the context of offsets.
- 18 In this regard, it is worth noting that technically individual accounts would only be funded out of current Social Security taxes if their tax treatment followed the Social Security model because all of the other models involve more or less amounts of foregone revenue than the current Social Security system.
- 19 Theoretically, offsets could be calculated on a post-tax basis, however this approach would require detailed information about each beneficiary's specific tax circumstances.
- 20 Some individual account proposals have deemed contributions to come only from employee Social Security taxes. In this case, the traditional retirement savings model would imply excluding withdrawals from income. However, as discussed above, it might then be necessary to adjust the tax treatment of traditional Social Security benefits to reflect that as much as 100 percent of the contributions might be pre-tax. If policymakers also wanted to apply the traditional retirement savings model to traditional Social Security benefits and the portion of Social Security benefits shifted was large enough, this might entail including all traditional Social Security benefits in taxable income. In addition, the possibility of funding individual accounts solely with either employee or employer Social Security taxes raises other issues discussed in the section below entitled "*Applying the Traditional Retirement Savings Model: Roth IRAs v. Deductible IRAs.*"
- 21 A version of the 100 percent exclusion option is the tax treatment afforded to Health Savings Accounts ("HSAs"), a special provision initiated by Congress to respond to particular issues of cost control in the health care context. In certain circumstances, 100 percent of both contributions to, and withdrawals from, HSAs can be excluded from income. This would imply funding the accounts solely with employer Social Security taxes, which are pre-tax. We do not take the treatment afforded to HSAs as a precedent for retirement savings or income and, in this sense, it would be a new model.
- 22 The traditional retirement savings model imposes a 10 percent additional tax penalty on most early withdrawals.
- 23 The distributional impact of the accounts could also be adjusted by taxing different proportions of withdrawals depending on the taxpayer's income (similar to the Social Security model); funding the accounts through a revenue source with a different distributional burden; changing the formulas used to determine benefits or contributions; or altering savings in other vehicles. In particular, policymakers disagree about whether mandatory individual accounts funded with new revenues would result in reduced or increased savings (including, but not limited to, in employer-sponsored retirement plans) and, if so, among which workers.
- 24 Theoretically, if the accounts were universal, applying any of the tax treatment models that involve funding the accounts on a pre-tax basis might present liquidity problems. For example, if the government deposited a fixed annual amount in each person's account, an individual with no income in a given year might be subject to tax for contributions made on his or her behalf from general revenues. In practice, this is unlikely to be a problem given the standard deduction and personal and dependent exemptions.
- 25 It is debatable what "after-tax" means in the context of accounts funded with income tax revenues. Most likely all contributions would then be treated as after-tax.
- 26 Life insurance only follows this model if benefits are paid upon the death of the policyholder. If the policyholder instead cashes out the policy, he is taxed on his gain at that time, in line with the deferral model. It is important to bear in mind that the pure insurance element of life insurance contracts (the amount the policyholder would pay for pure term life insurance) is sometimes quite small.
- 27 To see how the two arrangements are equivalent, it is useful to put the calculation in algebraic terms. If  $T$  is the tax rate,  $D$  is the amount

deposited,  $i$  is the rate of return, and  $y$  is the years over which the deposit accumulates, the taxation of contributions but not of earnings on the account can be represented as  $(T \cdot D) \cdot (i)^y$ . The taxation of account earnings, but not of contributions, can be represented as  $T \cdot (D \cdot (i)^y)$ . And  $(T \cdot D) \cdot (i)^y = T \cdot (D \cdot (i)^y)$ . In general, each of

these arrangements can be viewed as exempting from tax the income from capital.

- 28 As noted above, this overview of the current options for taxing savings is by no means exhaustive. Many other types of savings receive other forms of favorable tax treatment (such as home ownership).

## Glossary

**Adverse selection:** A term used in the insurance field to describe the situation whereby those more likely to use or benefit from the insurance are more likely to purchase it. For example, adverse selection occurs when individuals with above average life expectancy are more likely to buy life annuities. The buyers' self-selection is adverse to the insurer.

### **Aid to Families with Dependent Children**

**(AFDC):** A state-based federal assistance program created as part of the Social Security Act of 1935 that provided cash assistance to families in need of monetary aid who met specific income requirements. The Temporary Assistance to Needy Families (TANF) program was enacted in 1996 to replace AFDC.

**Annuitization (life):** The process of converting funds in a person's retirement account into monthly (or other periodic) income that is paid for the rest of the person's life; the purchase of a life annuity.

**Annuity (life):** A guaranteed periodic (usually monthly) income that is paid for the life of the annuitant. Annuity contracts are sold by life insurance companies. The insurance company receives premiums, either in a lump sum or a series of payments, from an annuity buyer and, in return, has a contractual obligation to pay a guaranteed income to the annuitant for the rest of his or her life.

**Consumer Price Index (CPI):** An index formulated and published by the Bureau of Labor Statistics of the U.S. Department of Labor that measures average changes in the prices of goods and services.

**Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W):** An index calculated and published by the Bureau of Labor Statistics of the Department of Labor that is used to annually adjust Social Security benefits to keep pace with inflation.

**Contingent joint-life annuity:** An annuity that pays a lower amount to a widowed secondary annuitant than to a widowed primary annuitant. The primary annuitant's payment is not reduced if he or she is widowed. If the secondary annuitant is widowed, the payment could be 75 percent, 67 percent, 50 percent, or any other fraction of the amount previously paid to the primary annuitant.

**Contributions:** Payments into a retirement plan. Social Security taxes on wages are also sometimes called contributions.

**Corporate bond:** An IOU issued by a corporation. By selling the bond, the corporation borrows money from the investors who purchase the bonds. Corporate bonds are also referred to as corporate debt instruments. Most bonds pay interest at regular intervals until they mature, at which point investors get their principal back. Alternatively, some bonds are sold at a discount to their face value – for example, \$800 for a \$1,000 bond – and do not pay interest at regular intervals. In this case, the investor gets \$1,000 when the bond matures, receiving both the interest and principal repayment in a lump sum.

**Cost-of-living adjustment (COLA):** Periodic increases in Social Security benefits (in effect since 1975) to keep pace with inflation as measured by the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W).

### **Civil Service Retirement System (CSRS):**

Originated in 1920, the system provides retirement, disability and survivor benefits for civilian employees of the federal government. It is a defined-benefit retirement program funded by employee and government contributions. Employees covered under the CSRS are not covered by Social Security. The CSRS continues to cover federal employees who were hired before 1984 and did not elect to shift to the new Federal Employees Retirement System (FERS). CSRS-covered employees can make contributions to the Thrift Savings Plan, but they do not

receive matching contributions from the government.

**Disabled adult child benefits:** Social Security benefits paid to adults who have been disabled since childhood (before age 22) and are eligible as the children of insured workers who have died, retired, or become disabled.

**Deferred annuity:** A tax-favored investment product that, unlike a life annuity, does not guarantee payments for life. The account holder has the option to later use the proceeds to buy a life annuity. The product is used mainly as a mechanism for tax deferral during fund accumulation.

**Defined-benefit plan:** A retirement plan that promises to pay the participant a specific monthly benefit for life. The monthly benefits are often calculated through a formula that considers the participant's salary and work history. The plan sponsor is responsible for having sufficient funds to pay the promised benefits. The Social Security program is an example of a defined-benefit plan.

**Defined-contribution plan:** A retirement plan that provides an individual account to each participant. The funds available at retirement depend on contributions to the account, investment gains or losses, administrative expenses, and whether funds were withdrawn before retirement.

**Employee Retirement Income Security Act (ERISA):** Enacted in 1974, ERISA was designed to secure the benefits for participants in private pension plans by setting federal rules regarding participation, vesting, funding, reporting, and disclosure and establishing the Pension Benefit Guaranty Corporation.

**Electronic Transfer Accounts (ETA):** A low-cost account designed by the Treasury Department to ensure that individuals who are required to receive federal payments electronically have access to an account at a reasonable cost and with the same consumer protections available to

other account holders at the same financial institution.

**Equity:** An ownership share in a corporation, also called a stock.

**Federal Employees Retirement System (FERS):** The retirement system for federal employees who were hired after 1983 and are automatically covered by Social Security. FERS also covers employee hired before 1984 who elected to be covered by Social Security and FERS. FERS participants are eligible for defined benefits that supplement Social Security and receive government matching contributions to the Thrift Savings Plan.

**Fixed life annuity:** An annuity that pays a flat dollar amount (usually monthly) for the life of the annuitant.

**Fixed term annuity:** A contract that promises specified payments for a given term (for example, five or ten years). The annuity provider bears no mortality risk.

**Federal government debt:** The federal debt is the total of all the Treasury bonds, bills and notes representing obligations of the federal government to repay the holders of these instruments. These bonds, bills and notes are held by the public and by various federal trust funds, including the Social Security trust funds. The debt is the net accumulation of past annual federal budget deficits and surpluses.

**Federal Retirement Thrift Investment Board (FRTIB):** An independent government agency created by the Federal Employees' Retirement System Act of 1986 that oversees and administers the Thrift Savings Plan (TSP).

**Gross domestic product (GDP):** The total dollar value of all final goods and services produced in a year by labor and property located in the United States, regardless of who supplies the labor.

**Health Savings Account (HSA):** Accounts created by the Medicare Prescription Drug, Improvement and Modernization Act of 2003 that permit individuals to save on a tax-free basis for future qualified medical and retiree health expenses.

**Illustrative average (low, high, or maximum) earner:** See steady earner and scaled earner.

**Individual development account (IDA):** A type of savings account that is subsidized with matching funds for low- and moderate-income individuals. The funds can be used for specific asset- and wealth-building purposes, such as the purchase of a home, post-secondary education, or business start-up costs. The accounts are operated by community-based nonprofit organizations with funds from private foundations and federal funds under the 1998 Assets for Independence Act.

**Inflation-indexed life annuity:** A life annuity that is adjusted each year to keep pace with inflation as measured by the consumer price index.

**Internal Revenue Code (IRC):** Title 26 of the United States Code that contains the tax laws of the United States.

**Internal Revenue Service (IRS):** The agency of the U.S. Treasury Department that is responsible for implementing the tax rules of the United States.

**Joint-and-survivor or joint-life annuity:** An annuity that pays a regular monthly income for lives of two people: the primary annuitant and a secondary annuitant, or annuity partner (often the primary annuitant's spouse). A joint-life annuity pays until both annuitants have died.

**Long-term disability insurance (LTDI):** Insurance that provides a partial replacement of a worker's earnings that are lost due to a serious illness or injury that renders the worker unable to work. LTDI policies vary in the duration and amount of payout.

**Means test:** A feature of eligibility criteria for assistance programs. Assistance programs may stipulate that only individuals with income below certain thresholds (an income test) and assets below certain amounts (an asset test) are eligible for the assistance.

**National Organization of Life and Health Insurance Guarantee Associations (NOLHGA):** An organization created in 1983 to help states coordinate guaranty funds to cover insurance company insolvencies that involve three or more states.

**Offset:** A term of art as used in this report, an offset is a feature of proposals that shift scheduled Social Security taxes to personally held individual accounts. The offset is a reduction in the account holder's future Social Security benefit or individual account that is intended to compensate the Social Security trust funds in full or in part for the value of Social Security taxes shifted to individual accounts.

**Participating variable life annuity:** A variable life annuity in which the risk of changes in life expectancy is shared between annuitants and the annuity provider.

**Pension Benefit Guaranty Corporation (PBGC):** A federal corporation created by the Employee Retirement Income Security Act of 1974 to provide pension benefit insurance for participants in private defined-benefit pension plans. PBGC maintains separate insurance programs for single-employer defined-benefit pension plans and for multi-employer defined-benefit pension plans. Plan sponsors must pay premiums to PBGC based on the number of participants in the plan.

**Primary Insurance Amount (PIA):** The Social Security benefit an individual receives if he or she elects to begin receiving benefits at normal retirement age. The PIA is calculated by a formula in law that is based on the worker's average indexed monthly earnings in Social Security covered employment. All Social Security benefits

for family members are based on a worker's PIA.

**Qualified Domestic Relations Order (QDRO):**

A judgment, decree or order that establishes or acknowledges the existence of an alternate payee's right to receive, or assigns to an alternate payee the right to receive, all or a portion of the benefits payable with respect to a participant under an ERISA-qualified employee benefit plan.

**Real annuity, inflation-indexed life annuity:** A life annuity that is automatically adjusted to keep pace with inflation as measured by the consumer price index.

**Real wage growth:** Wage growth in excess of inflation.

**Refund of premium annuity:** An annuity that guarantees payments equal to the nominal purchase price of the annuity.

**Rising life annuity:** An annuity that pays amounts that increased at a prescribed rate (for example, 3 percent a year) for the life of the annuitant.

**Scaled earners:** Illustrative workers with lifetime earnings patterns that vary by age to reflect typical age-earnings profiles. Created by the Office of the Chief Actuary of the Social Security Administration, the scaled earners are illustrated at three earnings levels: (1) a scaled medium earner (whose career average indexed earnings are equal to the Social Security average wage index); (2) a scaled low earner (whose lifetime career average indexed earnings are equal to 45 percent of the Social Security average wage index); (3) a scaled high earner (whose career average indexed earnings are equal to 160 percent of the Social Security average wage index).

**Single-life annuity:** An annuity that pays regular monthly income for the life of one person.

**Steady earners:** Illustrative workers with lifetime earnings that are a constant fraction of the

average wage of all U.S. workers. Created by the Office of the Chief Actuary of the Social Security Administration, the steady earners are illustrated at four earnings levels: (1) a steady average earner (who always earned the average wage of all workers); (2) a steady low earner (who always earned 45 percent of the average wage); (3) a steady high earner (who always earned 160 percent of the average wage); and (4) a steady maximum earner (who always earned the maximum amount that is taxed and counted for Social Security purposes).

**Stock:** An ownership share in a corporation; also called an equity. Some stocks pay periodic dividends (a share of the company's profits) to their owners. A stock can be sold at a price higher or lower than was originally paid.

**Supplemental Security Income (SSI):** A federal assistance program administered by the Social Security Administration that pays monthly benefits to aged and disabled individuals who have low incomes and limited financial resources.

**Survey of Consumer Finances (SCF):** A survey of U.S. households conducted by the Federal Reserve Board every three years (since 1983) of the balance sheet, pension, income, and other demographic characteristics of U.S. families. The survey also gathers information on the use of financial institutions. The SCF oversamples higher income families.

**Survey of Income and Program Participation (SIPP):** A survey of U.S. households conducted by the U.S. Census Bureau of the demographic and economic characteristics of persons and families. It provides detailed information about sources and amounts of monthly income, taxes, assets, liabilities, and participation in government benefit programs. The SIPP oversamples lower income families.

**Symmetric joint-life annuity:** An annuity that pays the same amount to a widowed primary annuitant as would be paid to a widowed secondary annuitant. The payment to the longer-lived person could be 100 percent, 75 percent,

67 percent, or any other fraction of the amount paid while both were alive.

**Temporary Assistance to Needy Families**

**(TANF):** Created by the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, TANF replaced Aid to Families with Dependent Children (AFDC) and the Job Opportunities and Basic Skills Training (JOBS) programs. TANF provides assistance and work opportunities to low-income families by granting states federal funds and wide flexibility to develop and implement welfare programs.

**Ten-year certain life annuity:** A type of period-certain life annuity that provides payments for ten years, even if the annuitant dies within ten years. Period-certain life annuities guarantee payments for a specific amount of time even if the annuitant dies before the period has elapsed.

**Treasury Bond:** An IOU issued by the federal government; also called debt. By selling a bond, the federal government borrows money from the investor who purchases it and has a legal contract to pay it back with interest. Treasury also sells short-term debt, called notes and bills.

**Treasury Inflation-Indexed Securities (TIPS):** A special class of Treasury securities in which interest and redemption payments are tied to inflation. Like other Treasury securities, TIPS make interest payments every six months to holders and pay back the principal when the security matures. Unlike other securities, the Treasury Department adjusts the principal value of TIPS daily, based on the consumer price index.

**Thrift Savings Plan (TSP):** A retirement savings and investment plan for federal employees, established in 1986 as part of the Federal Employees' Retirement System Act and administered by the Federal Retirement Thrift Investment Board (FRTIB). The TSP is a tax-deferred defined-contribution plan similar to a private 401(k) plan.

**Variable life annuity:** An annuity that is tied to the performance of a particular investment portfolio, such as corporate stocks or bonds. Payments can go down as well as up. The annuitant bears all or part of the investment risk.



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