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Protecting and Strengthening Social Security Options for the Administration of Personal Accounts

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Mr. Chairman and members of the Subcommittee, thank you for this opportunity to testify before you today. The National Academy of Social Insurance is a non-profit, non-partisan organization of the nation's leading experts on Social Security, Medicare, and related programs. Our mission is to promote sound policymaking on social insurance through research, education and the open exchange of ideas.

I will present findings of our new study panel report, *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy.* This is the work of twenty-seven top experts over the course of two and one half years. It was led by bi-partisan chairs, Mike Graetz of Yale law school and a top Treasury official in the George H. W. Bush Administration, and Kenneth Apfel of the LBJ School at the University of Texas and Commissioner of Social Security in the Clinton administration. The report is solely about how money would be paid out of individual accounts. Why are payouts important? Our co-chairs Mike Graetz and Ken Apfel said it best:

"Payouts are important because the central goal of Social Security is to assure some level of adequate income." "To date, payouts have been largely neglected. Yet it is crucial that policymakers resolve issues in this report if they decide to add universally available individual accounts to our current system of providing retirement income."

Our expert panel did not seek to agree on whether individual accounts in Social Security are a good idea. Nor did they agree on a blueprint for how to design payouts. Rather, they did agree that issues in this report are the right ones and how the questions get answered is critically important. The ten chapters cover such questions as: (a) How would retirees get the money? (b) If annuities are required, who would provide them, and how? (c) Could workers get the money before they retire? (d) What rights would spouses have? (e) How would accounts affect disability benefits? (f) How would children be affected? (g) How might "offsets" affect payouts? (h) How would payouts be taxed? I will focus on retirement payouts. First, I summarize what we called "financial demographics" that set the stage for considering accounts.

Financial Demographics

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

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

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

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

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

Financial Risks for Retirees

Retirees face four kinds of risks to their financial security. They don't know how long they will live, how long their spouses will live, how their investments will perform, or how much prices will rise in the future. Social Security covers these risks by paying benefits for life, with automatic cost of living increases, and automatic survivor benefits. Individual accounts, in and of themselves, do not cover these risks. But retirees can buy life annuities that turn their savings into guaranteed income for life. That is why life annuities are important.

The Life Annuity Trade-Off

From the retirees' perspective, the good news in buying a life annuity is that your income will last as long as you live. The bad news is that you pay the full purchase price up front, and the purchase is irrevocable. All the money used to buy the annuity is no longer available to leave to heirs. For example, if you use $40,000 to buy a life annuity and die a few months later, that $40,000 is gone. The insurer uses the money from people who die early to cover the costs of paying annuities to those who live a long time. In brief, annuities allow workers to trade ownership for retirement income security.

More Income Security Costs More

If a retiree wants his annuity to keep up with the cost of living, it will start lower. If he wants it to continue to pay his widow after he dies, his payment will start out lower. For example, in one set of assumptions, a 65-year-old retiree with $10,000 could buy a simple annuity of $80 a month. If it is to keep up with the cost of living (at say 3 percent a year), it would start out lower, $62 a month. If it would continue to pay as long either the retiree or his wife lived, it would start out at $50 a month. (These prices assume everyone would be required to buy annuities. If annuities were optional, they would pay less than shown here because of what is known in the insurance world as *adverse selection*.)

Guarantees Might Provide for Heirs

Some annuities guarantee payments to a death beneficiary if the retiree dies shortly after buying an annuity. A 10-year certain annuity assures payment for 10 years if the annuitant dies in less than 10 years. This feature will lower the initial monthly payment to the retiree (from $62 to $58, in the above example, if the annuity is inflation-indexed).

Changes in Marital Status

In general, life annuities cannot be rewritten to shift from a single-life to a joint-life annuity if one marries after retirement. Nor can one "undo" the purchase of a joint-life annuity and shift to a single life annuity if a marriage ends shortly after buying an annuity. This could affect married couples' decisions about whether and when to buy annuities. It could also produce very different incomes for widows depending on whether they were widowed before or just after buying annuities. For example, if John dies before buying an annuity, Mary could inherit his account, combine it with her own, and buy a single life annuity with the total amount. Consider this the base case. If instead, John and Mary both bought joint-life annuities, each would start out with a monthly payment that is about 81 percent of what a single-life annuity would provide. When one died, the survivor would receive 81 percent as much as the base case. The key point is that the timing of annuity purchase interacts with the timing of widowhood to produce very different results for retirees who are otherwise in similar circumstances.

Who Would Provide Inflation-Indexed Annuities?

Inflation-indexed annuities are very rare in the private insurance market. Our panel concluded that some help from the federal government would be needed to develop such a market. If the federal government increased the supply of long-duration (say 30-year) Treasury Inflation-Protected Securities (TIPS), insurers could use them to hedge inflation risk. Alternatively, the government could sell inflation-indexed annuities directly to retirees.

In either case, the government could be receiving a large amount of funds (from TIPS buyers or from retirees' annuity premiums) that would represent contractual obligations to make long-term inflation-indexed payments. For example, in a universal system, funds backing annuities funded with 2 percent of workers earnings could amount to about 15 percent of GDP when the system is fully mature. A key question for policymakers is, “how would the government manage (or spend or invest) the large volume of funds it received from TIPS buyers or annuity purchasers?”

Would Government Insure the Insurers?

Currently, state governments have sole responsibility for regulating insurance companies and guaranteeing their solvency. If federal law requires or encourages retirees to buy annuities, it might also be expected to guarantee the solvency of the insurance companies that have made long-term commitments to retirees. How that solvency guarantee would be organized is an important question. Would it resemble the Pension Benefit Guaranty Corporation, or the Federal Deposit Insurance Corporation, or other federal models?

Recap of Annuity Choices

The design of retirement payout rules will confront inevitable tension between offering choice and providing security. Hard and fast rules might ensure some level of security, but will also create pressure for exceptions. As accountholders approach retirement, they will face choices such as:

(a) Whether to buy a life annuity at all;

(b) How much of one’s account to spend on a life annuity;

(c) Whether the annuity would be indexed for inflation;

(d) When to buy a life annuity;

(e) Whether to buy a guarantee feature and, if so, what kind;

(g) If joint-life annuities are optional for unmarried retirees, whether to buy one and with whom; and

(h) If joint-life annuities are offered or required for married retirees, which type to buy and what level of benefit to provide the secondary annuitant.

Decisions on these questions will have lifelong consequences. To the extent that retirees have choices, it will be important that they receive advice and assistance to understand the consequences of different courses of action for themselves and for the well being of their spouses, dependents, and potential heirs. Organizing and paying for trustworthy advice could become an important issue in a new system that envisions many choices in the purchase of life annuities.

In the realm of consumer education, there is a risk of confusion about what we mean by "annuity." Two different products are called "annuities" and they are very different. *Deferred annuities* are investment products, not insurance. Only *life annuities* guarantee payments for life. Deferred annuities are far more common and more actively marketed by financial advisors, brokers or agents. In recent weeks, a few news reports have pointed to problems in the marketing of deferred annuities to seniors, who end up losing part of their life savings because they bought products that were not appropriate to their circumstances. (Moregenson 2005, Kirchheimer 2005).

The *Uncharted Waters* Study Panel of the National Academy of Social Insurance learned that payouts from individual accounts raise first order questions that need to be addressed. I am pleased that the Subcommittee is exploring these issues. I will be happy to answer any questions.

Sources:

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