

NATIONAL ACADEMY OF • SOCIAL INSURANCE

UNCHARTED WATERS: PAYING BENEFITS FROM INDIVIDUAL ACCOUNTS IN FEDERAL RETIREMENT POLICY

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Fact Sheet #5: Families and Annuities

Annuities offer a regular stream of income, a certainty, but they can be a tough sell for skeptical consumers. Research on economic behavior shows that most people tend to be shortsighted and are particularly myopic when choosing between immediate gratification and long-term gains. 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.

In dealing with personal accounts, compulsory life annuities would eliminate the risk that people would outlive the money in their accounts. Making annuities optional, on the other hand, would mean that people who choose not to purchase annuities would have no such guarantee.

Additional Protection Costs More: Even after a decision is made to annuitize, retirees still have many choices to make. Adding additional features to an annuity costs money and can reduce the payout to the annuity holder.

A 65-year-old with \$100,000 in a personal account can buy a fixed annuity that will yield about \$9,700 a year. This is called a fixed life annuity because there is no change in the annual payout over the purchaser's lifetime. If prices rise at the rate of 3 percent a year, after 25 years the annuity will be worth about \$4,630 a year; if the retiree lives to age 110, the buying power of the annuity would fall to \$2,565 a year.

To deal with the threat of rising prices to his standard of living, the retiree might buy an inflation-indexed annuity. Payments would start lower, at \$7,450 a year, but would rise to match the increase in prices, preserving his purchasing power.

Suppose this same person wanted to provide full income and inflation protection for his wife in the event of his death. He could purchase a 100 percent joint-life, inflation-indexed annuity. The annual benefit would be about \$6,000 a year and would keep pace

with inflation. After he died, his wife would continue to get the full, inflation-adjusted benefit.

Policymakers, even if they are satisfied that an individual worker could be protected by an annuity, would have to consider whether they want lifetime protection extended to the spouse too. If so, they would have to consider mandating that all married owners of personal accounts purchase an annuity that provides spousal protection. But this protection always lowers the retirees' primary benefit.

Also, the price of the annuity could vary if there were a big difference in age between the spouses. If one spouse has a much greater life expectancy, the joint-and-survivor annuity covering both of them would have a significantly smaller payout.

The Role of Inheritance: The interests of heirs could influence the question of whether and when to buy an annuity. From a strictly selfish perspective, beneficiaries of an account wouldn't want the retiree to buy an annuity. An unmarried account holder, for example, might name an adult child, friend, or other relative as a death beneficiary. If the account holder died before buying an annuity, the entire balance would go to the heir. If the account was used to buy an annuity, the bequest is gone.

Annuities and People with Disabilities: The value of annuities can pose special issues for disabled workers and their spouses. In 2002, 11 percent of the individuals claiming Social Security retirement benefits did so after receiving disability benefits prior to retirement. Would these disabled retirees be in the annuity pricing pool on the same terms as other retirees? The appeal to consumers of risk pooling 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.

Timing of Annuity Purchase: The timing of annuities can have profound impact on finances for a family or an individual. Suppose John and Joan have each worked for 35 years, and contributed to individual accounts. They have both retired, and they each buy a single-life annuity, which means they get the maximum payments, and the money from their own annuity stops when the annuity holder dies. John dies a week after they buy the annuities. His account balance has disappeared; Joan cannot inherit it because the money has gone into the annuity. Her income is limited to the payments from her own annuity.

Suppose they had delayed buying annuities for a month. John dies, and Joan inherits everything in his personal account. She has his money, plus all the funds in her own account. She can buy a single-life annuity with the two sources of funds. She will receive a monthly payment for life larger than it would have been if she and John had annuitized their money a month before.

Source: Reno, Virginia P., Michael J. Graetz, Kenneth S. Apfel, Joni Lavery, and Catherine Hill (eds.), (2005). *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy*, Study Panel Final Report, Washington, DC: National Academy of Social Insurance, January.

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