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 Less attention has been paid to how and under what circumstances funds could be withdrawn from these accounts.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 created 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,[1] 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.[2] 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 contribute 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.[3]

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)[4] 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 pensions, 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.[5]

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 accountholder 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.[6] 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.[7] 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.[8] 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.[9] Those annuity reserves would be equivalent to roughly 7 percent to 8 percent of the value of total U.S. financial assets.[10]

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 programs treat accessible retirement funds as countable assets for the purposes of determining benefit eligibility. In such cases, if the account holder has access to the money, he or she must spend it to qualify for assistance.

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

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,[11] 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 accountholders 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.[12] 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 dependents 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.[13] 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 question. 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 original 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.