

# **Defined Contribution Accounts under Social Security: Their Implications for Distributions**

**Pamela Perun, Ph.D., J.D.**

## **Abstract**

**Using the private pension plan system as a model, this paper analyzes three recent proposals for Social Security reform from the perspective of distributions. It focuses in particular on two proposals which advocate adding a second tier of benefits through the introduction of individual defined contribution accounts. It discusses the role of individual choice, control and risk inherent in such accounts as well as their proposed structure for distributions. It finds that such accounts are theoretically simple concepts which often require complex systems of implementation and raises some questions regarding the appropriate structure for those accounts and the role to be played by the private sector.**

The author is an attorney in the Tax Department of Morgan, Lewis & Bockius, LLP, Washington, D.C. The opinions expressed in this paper are solely those of the author. This paper was prepared for the National Academy of Social Insurance, Washington, D.C.

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# Defined Contribution Accounts: Their Implications for Distributions

## Introduction

A pension plan, even a very large pension plan like Social Security, is a simple animal. It has three stages: contributions are made; contributions are invested; and benefits are paid. Three reform proposals have recently been made which might change all three stages of Social Security as we know it today.<sup>1</sup> This chapter focuses on the distribution stage. It uses the private pension system as a model and examines how benefits might be paid under these proposals.<sup>2</sup> This stage is an important but often overlooked determinant of retirement income and has a crucial impact on the financial security of individual retirees and their dependents.

The first reform proposal maintains Social Security benefits essentially intact. The second two proposals advocate adding a second tier of benefits through a defined contribution component. Through this second tier, the benefits individuals ultimately receive depend on the accumulation of contributions and investment earnings in their individual accounts. Because individuals own their accounts, it is natural to consider giving them greater control over them, including the form of the distribution, than is available today under Social Security.

Although the primary purpose of the reform proposals is to stabilize the long-term financing of the program, the changes contemplated raise fundamental philosophical questions and practical considerations. Should Social Security continue to be structured as a form of pooled social insurance? Should the program continue to be administered by the federal government exclusively or is there a role for the private sector? If so, where should the line be drawn between the federal

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<sup>1</sup>See *Report of the 1994-1996 Advisory Council on Social Security, Volume I: Findings and Recommendations* ("Volume I"), Washington, D.C.: GPO, 1997 and *Report of the 1994-1996 Advisory Council on Social Security, Volume II: Reports of the Technical Panel on Trends and Issues in Retirement Savings, Technical Panel on Assumptions and Methods, and Presentations to the Council* ("Volume II"), Washington, D.C.: GPO, 1997.

<sup>2</sup>This paper will rely heavily on concepts developed in the private pension system when examining how Social Security might be adapted to a more privatized format. The private pension system encompasses a large variety of plans: I.R.C. §401(a) tax-qualified plans sponsored by private employers, including plans permitting salary-reduction contributions by employees under I.R.C §401(k); I.R.C. §403(b) tax-sheltered annuities sponsored by certain tax-exempt organizations; I.R.C. §408 IRAs and employer plans built on the IRA model such as simplified employee pension plans; I.R.C. §409 employee stock option plans; I.R.C. §457 deferred compensation plans sponsored by state and local governments and tax-exempt organizations; and non-qualified (from a tax perspective) plans designed to compensate corporate executives. Many of these plans are also subject to the requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), including plans which provide participants with the right to direct the investment of their accounts ("404(c) plans"). For purposes of this paper, the model will generally be that of the private employer plan subject both to the provisions of the Tax Code under I.R.C. §401(a) *et. al.* and ERISA because they represent the legal state-of-the-art with respect to retirement benefits.

government and the private sector? If there is a role for the private sector, who will protect the interests of workers? Who decides when benefits will be paid? Who decides how benefits will be paid? All of these questions will play a role in shaping the distribution stage of Social Security in the future and underlie the discussion which follows.

The paper begins with a brief discussion of the importance of Social Security distributions for retirement income security today. It then describes two pension plan models and their application to Social Security today and the reform proposals. The following section presents a general discussion of distributions along with a more detailed examination of annuities as a form of distribution. The paper concludes with a consideration of certain implementation issues specific to two of the reform proposals.

## **I. The Current Importance of Social Security Distributions**

Before considering how Social Security might change in the future, it is useful to review how it is intended to work today and how well it satisfies its current mandate. Under its present format, Social Security distributions have two primary goals. They are intended to provide a stream of income beginning at retirement and continuing for life. They also intended to provide a floor retirement benefit for almost all Americans. All three reform proposals have considered these goals in detail. The life income provided by Social Security distributions plays a crucial role in the retirement income security of today's elderly. Social Security is designed to make sure that "the most impoverished of the elderly ... are brought up to a minimum standard of living."<sup>3</sup> Its current formula pays proportionately higher benefits to low-wage than high-wage workers because they are less likely to have other important sources of retirement income such as pensions or savings. Social Security does more, however, than just provide retirement income to workers. It also provides important benefits to their dependents and survivors.

Social Security in its present format does its job well. It is recognized that the economic status of the elderly as a group has improved dramatically in recent decades. Quinn and Smeeding report that "in 1991, the median before-tax income of households aged 65 and older was \$16,975 - a gain of more than 40 percent in purchasing power since 1971. Moreover, the 1991 median income was more than twice the level of the poverty threshold for an elderly couple (\$8,241)."<sup>4</sup> Since 1959, poverty rates among the elderly have fallen from 35 percent in 1959 to 13 percent in 1992. Increases

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<sup>3</sup>See Volume I, p. 15.

<sup>4</sup>Joseph F. Quinn and Timothy M. Smeeding, *The Present and Future Economic Well-Being of the Aged*, Chapter 1 in Richard Burkhauser and Dallas Salisbury (eds.), *Pensions in a Changing Economy*, Washington, DC: Employee Benefit Research Institute, 1993, pp. 5-18.

in both the coverage and size of benefits attributable to Social Security and other federal transfer programs beginning in the 1960s receive much of the credit for this improvement.<sup>5</sup>

It would be hard to overemphasize the importance of Social Security distributions as an income source for the elderly. In 1994, Social Security benefits were received by about 91% of all household units aged 65 or older. In contrast, about 67% received income from savings, just over 40% received income from pensions and only 21% had earned income.<sup>6</sup> Moreover, Social Security represented 42 percent of the total cash income of such households. In 1962, before the substantial increases in Social Security benefits during the late 1960s and early 1970s, the equivalent amount was only 31 percent.<sup>7</sup> In 1994, Social Security benefits were by far the largest income source as income from employer pensions accounted for only 19 percent, earnings for only 18 percent and asset income such as interest and dividends for only 18 percent.<sup>8</sup> In addition, as was intended by its design as a floor retirement income program, Social Security is the largest source of income for the elderly poor. Among the poorest 40% of Americans aged 65 and older, Social Security provided 81% of all cash income in 1994. The comparable figure for the most affluent 20% was only 23%.<sup>9</sup> Without Social Security benefits, about 54% of individuals aged 65 or older would have been below the poverty threshold in 1994.<sup>10</sup>

Among the elderly, “poverty status also varies significantly by gender and marital status. Single, widowed, or divorced women are much more likely to live in poverty than couples or unmarried men.”<sup>11</sup> Among the most vulnerable of the elderly poor are unmarried women. Recent testimony before Congress noted that

Elderly unmarried women are much more likely to be living below the poverty line. Twenty-two percent of unmarried elderly women have income below the poverty threshold,

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<sup>5</sup>See Volume II, pp. 48-49.

<sup>6</sup>See *Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform*, GAO/HEHS-97-81, Washington, D.C.: GAO, July 1997.

<sup>7</sup>Joseph Quinn, *Criteria for Social Security Reform*, Paper presented at the 1997 Pension Research Council Symposium, *Prospects for Social Security Reform*, The Wharton School of the University of Pennsylvania, May 12 and 13, 1997, pp. 3-4.

<sup>8</sup>*Ibid.*

<sup>9</sup>*Ibid.*

<sup>10</sup>See GAO study, footnote 6 above.

<sup>11</sup>*Ibid.*

compared with 15 percent of unmarried elderly men and only 5 percent of elderly married couples.<sup>12</sup>

Even though the economic status of the elderly has improved in general, elderly widows remain an especially vulnerable group.<sup>13</sup> Older women are nearly three times as likely as men to be widowed, and widowhood is a risk factor for income inadequacy.<sup>14</sup> Due to lower levels of labor force participation resulting in smaller individual Social Security benefits and lower pension benefits, the survivor benefits available under Social Security remain a critical source of income in retirement. For example, “women make up about 60 percent of the elderly population and less than half of the Social Security beneficiaries who are receiving retired worker benefits, but they account for 99 percent of those beneficiaries who receive spouse or survivor benefits.”<sup>15</sup> Even though differences between men and women in labor force participation, level of earnings, amount of Social Security benefits and pension coverage continue to narrow, they have not been completely eliminated. As a result, the survivor benefits provided by Social Security are likely to remain an important source of income for elderly women in the foreseeable future.

## **II. Distributions: Current and Proposed**

In early 1997, the 1994-1996 Advisory Council on Social Security presented its findings and recommendations regarding the future of the Social Security program in face of widespread concern over its long-term financing.<sup>16</sup> Included in its report were three models of how the Social Security program might be changed. The first, Option I (the “Maintain Benefits” or “MB” plan) proposes changes in the way that benefits are earned and contributions are invested but not in the current types of distributions. Option II (the “Individual Accounts” or “IA” plan) and Option III (the “Personal Security Accounts” or “PSA” plan) would also adjust the benefit formula. But, more importantly, both plans, while retaining the current distribution forms, would reduce them in size and importance to a basic floor benefit. Both the IA and the PSA plans would, for the first time, add a defined contribution component to Social Security. Under both plans, a second tier of benefits would be funded and distributed through an individual account established for each worker.

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<sup>12</sup>*Social Security Reform - Implications for the Financial Well-Being of Women*, Statement of Jane L. Ross, Director, Income Security Issues, Health, Education and Human Services Division, GAO, before the Subcommittee on Social Security, Committee on Ways and Means, House of Representatives, April 10, 1997.

<sup>13</sup> See Karen Holden, *Women as Widows under a Reformed Social Security System*, Paper presented at the 1997 Pension Research Council Symposium, *Prospects for Social Security Reform*, The Wharton School of the University of Pennsylvania, May 12 and 13, 1997.

<sup>14</sup>See Volume II, p. 96.

<sup>15</sup>Jane Ross, footnote 12 above.

<sup>16</sup>See Volume I.

In order to understand the implications of these changes, it is first necessary to understand the difference between a defined benefit and a defined contribution pension plan. Subsection A provides a brief overview of these two different types of pension plans. Subsections B, C and D then use this framework to explain the MB, IA and PSA proposals in more detail while Subsection E focuses on the topic of survivor benefits.

## **A. The Two Types of Pension Plans**

In the private pension system, there are two basic types of plans: defined benefit and defined contribution. The Tax Code provides incentives for employers to sponsor one or more of these plans. Normally, when an employer pays compensation to an employee, the employer receives a deduction for the amount paid and the employee is taxed on the amount received. But, if instead of paying the employee directly, the employer contributes compensation on behalf of the employee to a retirement plan, different tax rules apply. If the plan is properly designed and operated (i.e., “tax-qualified”), an employer who makes such contributions will continue to receive an immediate income tax deduction. But employees for whose benefit the plan holds such contributions will not be taxed until they actually receive distributions sometime in the future. In the meantime, the assets of the plan are permitted to accumulate without current taxation.

### ***How A Defined Benefit Plan Works***

**The promise:** In order to understand how a defined benefit plan works, it is important to focus on two words: “defined” and “benefit”. This type of plan promises to pay participants a certain amount of dollars (i.e., a “benefit”) at retirement calculated under a formula expressly set forth (i.e., “defined”) in the terms of the plan. From a property law perspective, participants receive a right to a future stream of income from a defined benefit plan. They do not, however, have any direct rights with respect to the assets of the plan which provide that income.

The plan formula typically takes into account three factors: age; years of service with the employer; and the amount of wages or salary earned over time. In addition, because the formula must define a benefit payable at retirement age, the plan also defines a date for retirement, usually age 65. The promised benefit is expressed as a stream of income beginning at retirement and paid for life. Benefits paid earlier or later than the defined retirement date are actuarially increased or decreased depending on a participant’s actual retirement age.

**The funding:** A defined benefit plan must accumulate a sufficient pool of assets in order to pay the promised benefits. The pool provides collateral for the promised benefits. In determining how large the pool should be at any point in time, the employer must take into account such factors as the pension benefits already owed to participants, projections of future salary increases, turnover ratios, mortality estimates, contributions, investment earnings and interest rates. Again, no participant has a property right with respect to any assets in the pool or the pool itself. While the pool exists for the purpose of funding participants’ rights to benefits and its assets are held for the benefit of participants, no participant has a direct ownership claim against the pool or any particular asset.

Under the private pension system, the employer sponsoring the plan is required to contribute assets today to fund the benefits promised in the future as well as the benefits currently being paid. The amount that must or can be contributed every year is determined both by actuarial calculations of the funding needs of the plan and the limits imposed by tax law. It used to be common for defined benefit plans to require employees to contribute towards their benefits. Although many plans sponsored by state entities continue to have such a requirement, most plans in the private sector no longer do.

**Distributions:** In a defined benefit plan, the promised benefit must be expressed as a stream of income beginning at retirement and paid for life.<sup>17</sup> Such plans may not pay benefits until the participant “separates from the service” of the employer, i.e., retires or otherwise terminates employment. If a participant terminates employment before the earliest retirement age specified in the plan, he or she may be required to wait until that age to begin receiving benefits. Often these benefits are not adjusted, and their value can be eroded by inflation over time. Such plans may, but are not obligated to, contain provisions enabling them to pay terminated employees the lump sum value of the accrued benefit earned as a “cash out”. The plan can cash out such a benefit without the participant’s consent if its value is small (less than \$5,000) or with the participant’s consent if it is larger.<sup>18</sup> Participants who continue to work past retirement age generally continue to earn pension credit under the plan and have their benefits actuarially adjusted as well to reflect commencement after normal retirement age.<sup>19</sup>

In the private pension system, few defined benefit plans provide for adjustments once benefit payments have begun. According to one report, only 5% of participants in private defined benefit pension plans had automatic cost-of-living adjustments in 1991.<sup>20</sup> Using 1994 data, a study of workers age 40 and over receiving a pension benefit from a private sector plan found that 29% of respondents receive post-retirement benefit increases but that the average annual percentage increase was only 2.1%.<sup>21</sup> Inflation adjustments may be more common in defined benefit plans sponsored by state and local governments.<sup>22</sup> Without such adjustments, the value of the benefit provided by a defined benefit plan can decrease substantially over time.

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<sup>17</sup>In a defined benefit plan, the benefit that a participant accrues must be expressed as an annual benefit commencing at normal retirement age. I.R.C. §411(a)(7)(i).

<sup>18</sup>I.R.C. §417(e).

<sup>19</sup>I.R.C. §411(b)(1)(H).

<sup>20</sup>See Volume II, p. 37.

<sup>21</sup> *New Findings from the September 1994 Current Population Survey*, Washington, D.C.: U.S. Department of Labor, Pension and Welfare Benefits Administration, 1995, pp. 99-100.

<sup>22</sup>See Cynthia L. Moore, *Fighting Inflation: How Does Your COLA Compare, A Compilation of Cost of Living Adjustments from State Teacher Retirement Systems*, Washington, D.C.: American Association of Retired Persons, 1997.

The benefits received from a defined benefit plan are, however, guaranteed to continue for life. The federal government provides an insurance program for benefits promised under defined benefit plans under the Pension Benefit Guaranty Corporation (“PBGC”).<sup>23</sup> The PBGC receives premiums every year from defined benefit plans in return for insurance providing payment of at least minimum benefits when a plan’s assets are determined to be inadequate with respect to its benefit liabilities.

### ***Risks And Rewards Of A Defined Benefit Plan***

Because benefits accrue over time and the value of the annual accrual increases with age in a defined benefit plan, such plans reward the older, longer-service and more highly-compensated employee. In addition, because credit earned under one employer’s plan is not transferable, employees who leave before retirement age have only a frozen benefit under the former plan which decreases in value over time due to inflation. They then must begin to accrue credit all over again in a new employer’s plan. For example, an employee who works twenty years each for two employers with identical defined benefit plans will be less well off at retirement than an identical employee who worked forty years for just one employer. Employees usually also bear the risk that the value of their benefits when paid will erode due to inflation. Employers, however, bear the investment risk in such plans, although such risk, as well the risk to employees that employers will default on their obligations to fund their plans, is mitigated to some extent by the insurance provided by the PBGC.

### ***How A Defined Contribution Plan Works***

**The promise and the funding:** As is the case with a defined benefit plan, the formula for earning benefits is the key to understanding the structure of this plan. The formula of a defined contribution plan, however, does not promise a fixed benefit payable at retirement. Instead, it promises only a contribution by the employer, determined under the plan formula, which is usually made on an annual basis. In addition, a defined contribution plan often permits employees to make contributions, either in the form of after-tax or pre-tax contributions (known popularly as “401k” contributions after the authorizing provision in the Internal Revenue Code) or both.<sup>24</sup> From a property law perspective, participants in a defined contribution plan have rights with respect to the assets of the plan allocated to them, that is, with respect to the contributions made on their behalf and

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<sup>23</sup>See ERISA, Title IV.

<sup>24</sup>A 401(k) plan is a component of a defined contribution plan that permits employees to decide every year how much pre-tax income, within the legal limits, they will contribute. Often, employers will match at least a portion of these contributions. I.R.C. §401(k). See *401(k) Pension Plans: Many Take Advantage of Opportunity to Ensure Adequate Retirement Income*, (Letter Report, 08/02/96, GAO/HEHS-96-176) for a description of the growth in such plans. Until very recently, tax-exempt employers and state and local governments were not permitted to offer such plans. The analog plan for eligible tax-exempt employers has been the salary-reduction, tax-sheltered annuity available under I.R.C. §403(b). State and local governments and tax-exempt employers not eligible under I.R.C. § 403(b) can offer a similar deferred compensation plan under I.R.C. §457.

associated investment earnings. But they do not have rights to any benefit expressed as a future stream of income.

There are many types of defined contribution plans but the most common are the “money purchase” plan and the “discretionary contribution” plan. In the first, the employer promises to make a contribution, usually based on a percentage of pay, to every eligible participant every year. In the second, the employer determines on a year-by-year basis whether and how much of a contribution should be made. This plan used to be known as a profit-sharing plan because the amount of contribution was conditioned on the availability of profits but this requirement no longer applies.

Each participant in a defined contribution plan has an account to which his or share, also determined under the plan formula, of any employer contributions and his or her own contributions are credited. That account is a separate set of assets allocated on behalf of that participant in the pool of assets which fund the plan. Participants always have a property right to the assets held in their accounts which represent their own contributions and their earnings. Those assets can not be reallocated to or used for the benefit of other participants. In addition, once participants have satisfied the vesting schedule of the plan, they also obtain a

property right to employer contributions and their earnings made on their behalf. At any particular point in time, the “benefit” that each participant has earned, and the amount of available retirement income, is merely the account balance, i.e., the sum of those contributions and earnings in his or her account.<sup>25</sup> Therefore, unlike a defined benefit plan which promises a participant a stream of payments beginning at retirement, a defined contribution plan promises only the finite amount of dollars in his or her account at any particular point in time.

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**Example 2:** Let’s say that Bill works for his employer for 20 years. His beginning salary is \$34,217. It increases by 3% every year, and he earns \$60,000 in the year he retires. Every year, his employer contributes an amount equal to 2% of his salary to the plan. Bill’s account earns 5% every year. In the year he retires, Bill’s account is valued at \$240, 982. His account balance at that time is converted into the form of distribution he selects from among those offered under the plan.

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**Distributions:** A defined contribution plan generally permits a participant to obtain a distribution of his or her account in a variety of forms: lump sums, installment distributions or life income forms of payment.<sup>26</sup> Benefits are paid by converting the value of the participant’s account balance into the chosen form of payment. The money purchase plan originated as the defined

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<sup>25</sup>I.R.C. §411(a)(7)(ii).

<sup>26</sup>The Tax Code used to have a highly-technical definition of a lump sum distribution which meant the payment within one year of a participant’s entire interest in related plans sponsored by his or her employer, after 5 years of participation in those plans, and on account of certain events such as death or termination of employment. If a distribution qualified as a lump sum distribution, it could be rolled over to an IRA, thus deferring taxation, or if not rolled over, it could have the benefit of income averaging to lower taxes. Since the early 1990s, rollovers to IRAs have been liberalized to include almost any type of distribution and income averaging has largely been repealed.

contribution analog to a defined benefit plan. In this type of plan, the account balance was traditionally used to purchase a life annuity. This type of plan is still required to offer a life income form as the normal form of distribution. Today other distribution options are common although a married participant must obtain spousal consent to elect an alternate form of distribution. Discretionary contribution plans, including most 401(k) plans, are not subject to these rules, and participants, even if married, are free to choose among the forms of distribution offered under the plan.<sup>27</sup> Distributions are available whenever a participant terminates employment without the age restrictions usually imposed in defined benefit plans. In addition, it is becoming increasingly common for such plans to permit distributions, either as a loan or a distribution on account of hardship, during employment as well.

### ***Risks And Rewards Of A Defined Contribution Plan***

This type of plan benefits longer-service employees because their account balances increase over time with additional contributions and investment performance. But it also benefits employees who don't spend their careers, or even a substantial portion of their careers, with one employer. Most plans permit employees who have satisfied the rules for vesting (which now cannot exceed seven years) to take their balances with them when they leave. Participants in this type of plan bear two primary risks. The first is that accumulations in their accounts will be insufficient to provide adequate retirement income. The second is investment risk. It is possible that their accounts will be poorly invested or will lose value due to financial market fluctuations. Participants also bear some risk of inflation which can presumably be mitigated through appropriate investment strategies. An employer retains no risk under a defined contribution plan once a promised contribution is made unless he or she has assumed investment responsibility for plan assets. If the employer retains that responsibility, he or she will also retain investment risk because ERISA imposes fiduciary liability for the investment performance of those assets. But many plans now are 404(c) plans which permit participants to direct the investments of their accounts. In that case, the employer retains only some residual liability for providing an adequate menu of investment options in the plan. Finally, there is no government program which insures individual accounts against any of these risks.

### **B. The Maintain Benefits Plan**

**How Social Security Works Today:** The MB plan retains the current structure and format of Social Security to a large degree. Because Social Security is the largest government social program with which we are involved throughout our lives, we tend to think of it as a special set of rules too horribly complicated to understand. It's not. Whatever the social policy behind it, it has a relatively straightforward structure. At heart, it's merely a defined benefit plan. Given its mandate to provide a floor of retirement income, however, it differs in important ways, described below, from private sector defined benefit plans.

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<sup>27</sup>I.R.C. §§401(a)(11) and 417.

**The Formula:** Social Security today pays benefits based upon an individual's earning history over a 35 year period. Under the MB plan, the benefit computation period would be extended to 38 years. The amount of "earnings" taken into account every year is subject to a maximum amount (the "Social Security wage base") which is adjusted every year. For example, the maximum amount for 1997 is \$65,400. In addition, because the program is designed to provide a floor of retirement income, it has a formula which pays lower-income workers a greater benefit in proportion to their life-time earnings higher-income workers.<sup>28</sup> Under the benefit formula, the monthly retirement benefit payable at normal retirement age (currently, age 65) depends on a worker's career-average monthly earnings ("AIME"). For a worker reaching 62 in 1997, the monthly benefit is the sum of 90% of the first \$455 of the AIME, 32% of the AIME over \$455 and up to \$2,741, and 15% of the AIME over \$2,741.<sup>29</sup>

**The Funding:** In contrast to the "advance funding" requirement imposed on the private pension system, Social Security is a "pay as you go" system. Employees contribute 6.2% of their after-tax earnings, and their employers an identical amount, up to the taxable wage base each year for the basic Social Security retirement benefits. The MB plan does not propose an increase in this amount.<sup>30</sup> Although the Social Security trust fund is now running a surplus, current contributions have been used to pay current benefits for most of its history.<sup>31</sup>

**Distributions:** Under the MB plan, the current form of distributions would be preserved. In keeping with its structure as a defined benefit plan, Social Security pays benefits in a stream of income for life at retirement. Benefits become payable at normal retirement age which is currently age 65 but is scheduled to increase for later generations.<sup>32</sup> Benefits, actuarially reduced for early retirement, are payable at age 62. In addition, benefits are increased for those individuals who retire after normal retirement age as anyone who continues to work after age 65 receives additional delayed retirement credits up to age 70. Retirement benefits continue to be paid until death. In addition, benefits are adjusted annually for inflation.

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<sup>28</sup>Social Security at present is intended to replace about 56% of pre-retirement income for the low-income worker (earning up to \$12,000 at age 62 in 1997), 42% for the average-income worker (earning up to \$27,000 at age 62 in 1997) and 28% for the worker with maximum earnings (earning at least \$65,700 at age 62 in 1997). Commerce Clearing House, Social Security Explained, 1995, Paragraph 519. In contrast, in Example 1 above, Bill's pension at age 65 replaces about 40% of his final earnings (\$24,000/\$60,000).

<sup>29</sup>Social Security Administration, 1997 OASDI Trustees Report found at [www.ssa.gov](http://www.ssa.gov).

<sup>30</sup>The MB plan holds contribution rates steady provided that the benefit computation period is extended. Volume I, p. 25.

<sup>31</sup>For a full description of the current status of the funding of the Social Security program, see Volume II.

<sup>32</sup>Under current law, normal retirement age is scheduled to rise gradually to age 66 for individuals born between 1938 and 1943 and remain at age 66 for individuals born after 1943. It will then rise gradually again to age 67 for individuals born between 1955 and 1960 and remain at age 67 thereafter. Volume I, p. 21. A majority of the Advisory Council advocated accelerating the rise in the age of eligibility for retirement.

### C. The Individual Accounts Plan

**The Formula and the Funding:** The proponents of this plan propose a two tier system of benefits, the first based upon a defined benefit plan model and the second based on a defined contribution model. The first tier of benefits would be based on the current Social Security formula with the age of eligibility for full retirement benefits raised from 65 to 67 up to the year 2011, followed by a slower increase in line with increases in longevity. The computation period for benefits would be raised to 38 years as well. In addition, the formula would be adjusted downward with the 32% AIME conversion factor gradually lowered to 22.4% and the 15% AIME factor lowered to 10.5%. The effect of these changes would be a gradual decrease in the growth of the traditional Social Security benefit.

A second tier of benefits would also be created by requiring each covered worker to contribute an additional 1.6% of “covered payroll” to an IA.<sup>33</sup> This additional contribution would be held by the government and invested at the direction of the worker in a limited number of investment funds.<sup>34</sup> The contributions and investment earnings would accumulate over time in each worker’s IA.

The proposal estimates that if workers invested their IAs in equities in the same proportion as their 401(k) accounts are currently invested, the income generated from the scaled back tier one benefit and IA accumulations would “on average yield essentially the same benefits as promised under the current system for all income groups.”<sup>35</sup>

**Distributions:** Both first tier and second tier benefits would continue to be distributed in the form of a stream of income for life. At retirement, the balance in the worker’s IA would be converted by the government into a stream of income payable for life in the case of an unmarried worker. A married worker could choose, with the consent of the spouse, either that form of payment or a form that would provide a stream of income for his or her life and a portion, unspecified in the report, of that stream of income would then continue to be paid to the surviving spouse. A participant choosing this form of benefit would receive a reduced sum during life to reflect the promise of continuing income to the surviving spouse. Under the IA plan, the annuity provided from the assets in the IA would be guaranteed for a certain period of time to prevent what is essentially a forfeiture of benefits in the case of the participant’s death shortly after benefits begin to be paid. The current proposal,

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<sup>33</sup>It is unclear what the term “covered payroll” means. If this term is a synonym for the term “taxable wage base” which determines the level of earnings subject to Social Security taxes, it means that a worker earning \$30,000 would contribute, in addition to the regular \$1,860 or 6.2 % of earnings, an extra \$480 or 1.6% of earnings.

<sup>34</sup>The model for the investment choices available under this option is the Federal Thrift Savings Plan which provides a limited number of choices. In comparison to the typical investment choices now offered under similar plans in the private pension system, the Federal Thrift Savings Plan provides a very limited menu. In addition, because of concerns over government intrusion and control over the capital markets, the proponents of this plan suggest that the investment choices be further restricted to index funds only.

<sup>35</sup>See Volume I, p. 13.

however, is to limit that guarantee to only one year's worth of annuity payments which would be paid to the participant's "survivors", a term undefined in the Advisory Council Report.<sup>36</sup>

#### **D. The Personal Security Accounts Plan**

**The Formula and the Funding:** As is the case with the IA plan, the PSA plan proposes a two tier system of benefits. The first tier would provide, when fully-phased in, a universal but small, flat retirement benefit to full-career workers which would be the equivalent of \$410 monthly in 1996. In addition, the increase in the age of eligibility for full benefits would be accelerated as it is under the IA plan. The age of early retirement benefits would also rise in tandem reaching age 65 in the year 2035.

The second tier would be composed of each worker's PSA. A PSA would be funded by reallocating 5% of each worker's current 6.2% payroll tax to his or her account. The PSAs, unlike the IAs described above, would be individually-owned and privately-managed. The federal government would neither hold these funds nor prescribe investment options.

The proposal provides a gradual phase-in period. Workers under age 25 in 1998 would receive only tier one benefits and the balance in their PSAs. Workers age 25 to 54 in 1998 would receive their accrued benefit under the current system, a prorated share of the tier one benefit, and the balance in their PSAs. Current retirees and workers age 55 and older in 1998 would be covered under the existing Social Security system.

The proponents of this proposal suggest that if PSAs are also invested in equities as are IAs, "the combination of the flat benefit payment and the income from their PSAs would, on average, exceed the benefits promised under the current system for all income groups."<sup>37</sup>

**Distributions:** Under the current proposal, individuals could begin distributions from their accounts at age 62. Workers would not be required to purchase an annuity with their accounts but the proposal provides no other details about permitted forms of distribution. Presumably, choice of distribution, like choice of investment, would be left to individuals.

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<sup>36</sup>In the private pension system, such forms of payment, generally known as certain and continuous annuities, are sometimes available when the plan offers, or is required to offer, annuities. The term of the guarantee is generally more generous, and the choice of 5, 10 or 15 year periods is common. As is the case when income is promised beyond the life of the covered worker, the lifetime benefit payable to him or her is reduced to take into account this additional income protection. It is uncertain whether a similar reduction would be applied to the mandatory accounts here. Given the limited guarantee, any such reduction would probably be very small.

<sup>37</sup>See Volume I, p. 13.

## E. Survivor Benefits under Social Security and the Private Pension System

**The Maintain Benefits Plan:** The MB plan would also retain the current structure of survivor benefits.<sup>38</sup> Since 1939, Social Security has provided benefits for certain family members of covered workers.<sup>39</sup> Today, when a married worker begins receiving benefits, his or her eligible spouse is also entitled to begin receiving an auxiliary or spousal benefit equal to 50% of the amount received by the participant. On the death of the worker, the spouse then receives 100% of the amount previously received by the worker. Social Security also recognizes that in many couples both husband and wife are entitled to benefits in their own right. In this case, a “dual entitlement” rule prevails, and each spouse is entitled to receive either his or her own earned benefit or the auxiliary benefit, whichever is higher.<sup>40</sup>

Social Security also provides benefits for certain divorced spouses. A divorced spouse who was married to a participant for 10 years and who has not remarried may receive benefits at age 62, reduced for early commencement, based upon the earnings of his or her former spouse. The divorced spouse’s benefit is also 50% of the former spouse’s benefit but it is payable only if the divorced spouse is not entitled, in his or her own right, to a benefit at least equal to that amount. On the death of the former spouse, the divorced spouse, like a surviving spouse, is entitled to a benefit equal to 100% of his or her former spouses’ benefit. Payment of benefits to a divorced spouse, although derived from the former spouse’s benefit, do not reduce the benefits paid either to the former spouse or his or her current spouse or any subsequent divorced spouse.

**The Individual Accounts Plan:** Under tier one of the IA plan, a spouse would continue to be eligible for an auxiliary benefit when the other spouse retires. However, such benefits would be gradually phased down from the current 50% of the retired worker’s benefit to only 33%. In addition, a surviving spouse’s benefit would be determined as the highest of (1) his or her own tier one benefit, (2) the deceased spouse’s tier one benefit, or (3) 75% of the couple’s combined benefit. The proposal does not state but may assume that divorced spouses would continue to be eligible for benefits based upon a prior spouse’s tier one benefit.

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<sup>38</sup>Many members of the Advisory Council recommended changing survivor benefits by decreasing the dependent spouse benefits to either a smaller fraction or a flat dollar amount and by increasing survivor benefits to the higher of the decedent’s benefit (the present benefit) or 75% of the combined benefit the survivor and dependent spouse were previously receiving. Volume I, p. 19. Some of these changes were explicitly adopted by the other reform proposals.

<sup>39</sup>See *Social Security: Issues Involving Benefit Equity for Working Women*, GAO/HEHS-96-55, 1996.

<sup>40</sup>For example, suppose a husband was entitled to a benefit of \$200 a month based on his own work record and an auxiliary spousal benefit of \$500 based on his wife’s work history (i.e., 50% of her benefit). In this case, his dual entitlement would be his own benefit of \$200 plus the \$300 by which his auxiliary benefit exceeded his own benefit. In effect, he is entitled to the larger of the two benefits, which in this case is the amount of the auxiliary benefit.

Under tier two, only two types of income protection for surviving spouses are provided: (1) continued but reduced payments after the death of the spouse if the survivor annuity form of payment had been elected; and (2) a limited amount of guaranteed income in the event of the death of the covered worker within one year of beginning benefit payments. Apparently, only the spouse of the participant when benefits begin to be paid would be entitled to this income protection. There is no explicit provision for divorced spouses in the proposal. In addition, it is not clear what, if any jurisdiction a divorce court might have over assets in an IA.

**The Personal Security Accounts Plan:** Under tier one of the PSA plan, spouses would receive the higher of their tier one benefit based on their own earnings or 50% of their spouse's tier one benefit. In addition, they would be entitled to the accumulations in their own PSA, if any. A surviving spouse would be entitled to receive 75% of the couple's combined tier one benefits. The proposal does not explicitly state but may assume that divorced spouses would continue to be eligible for benefits based upon a prior spouse's tier one benefit.

There is no explicit provision for surviving spouses within the PSA system. Because there is no annuitization requirement with a PSA, there is no implied spousal protection. A surviving spouse is entitled only to receive his or her own PSA accumulations. The surviving spouse may inherit the remaining PSA accumulation, if any, of the deceased spouse if named in the deceased's will or if state intestacy laws so provide. As is the case with IAs, divorced spouses apparently do not receive any explicit protection under the PSA proposal. Again, it is not clear what, if any, jurisdiction a divorce court might have over assets in a PSA.

**The Private Pension System:** The retirement income protection for spouses provided by Social Security as we know it today is much greater than that provided in the private pension system. In the case of a married participant, defined benefit and certain defined contribution plans are required to provide as the "normal" form of benefit a stream of income for the life of the participant and his or her spouse. Participants may waive this form of benefit and elect another provided by the plan, if the spouse consents in writing. If the spouse does not consent, the plan will pay a retirement benefit to the participant for his or her life and then, upon his or her death, 50% of that amount will be paid to the surviving spouse for life. If a plan is not subject to these rules, and most 401(k) plans are not, the participant is free to elect any form of payment offered under the plan. In these plans, there is no survivor protection except in the case where a participant dies before benefits are paid. In that case, the spouse is the automatic beneficiary of the participant's account unless he or she has consented to the naming of a different beneficiary.

These rules, however, do not apply to plans sponsored by state or local governments. A recent study found that about one-half the states, including such large states as New York and Pennsylvania, do not impose a spousal consent requirement before a plan participant waives survivor benefits.<sup>41</sup> Moreover, although Social Security pays benefits concurrently to both the retired worker and spouse,

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<sup>41</sup>See *Falling Short: A 50-State Survey of Spousal Rights under State Pension Plans*, Washington, D.C.: AARP, 1994.

the spouse receives no independent income from the plan until the death of the participant (provided he or she survives the participant) and then only receives 50% of the previously paid benefit.<sup>42</sup> In addition, the benefit paid to the married participant for life is less than that paid to a similarly-situated unmarried participant because it is actuarially reduced to take into account the promise of income to the surviving spouse.<sup>43</sup>

In addition, the private pension system has no express protection for divorced spouses. In fact, in order to maintain its tax-qualified status, a plan *may not* pay a divorced spouse without first being ordered to do so by a court. A divorced spouse must obtain this special court order, called a “qualified domestic relations order” or “qdro”, requiring the plan to pay a portion of the participant’s benefit to him or her in order to receive a benefit from the plan. The payment of a benefit to a divorced spouse reduces the amount of the benefit payable to the participant and any subsequent spouse. Again, these rules do not apply to pension plans sponsored by state or local governments. About one-quarter of the states lack the legal authority to pay benefits directly to a divorced spouse.<sup>44</sup>

### **III. Theory of Distributions**

As retirement nears, people may review their assets with a new purpose in mind. While their emphasis in earlier years was predominantly on accumulating assets, they now become concerned about managing their assets appropriately as they a major, if not the primary, source of income in retirement. Management requires developing a strategy which maximizes current income without depleting assets prematurely. One common strategy is to shift assets into less risky forms of investment. Such a strategy can be often employed with respect to pension plan assets but depends upon the distribution options available in the relevant plan. The first section below reviews the trend toward choice in forms of distribution from private pension plans. The following section examines such issues as trade-offs between risk, rate-of-return and individual control implicit in these choices. The next section provides a discussion of the special role played by annuities in retirement income. The final section considers the ability of each form of distribution to provide income for survivors.

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<sup>42</sup>Many defined benefit plans offers benefit options which provide additional retirement income to surviving spouses. In many cases, the participant can elect to have his or her surviving spouse receive 2/3, 3/4 or 100% of his or her benefit. Such an election, however, will result in a lower benefit during the joint lives of the couple as the benefit will be actuarially reduced to reflect the additional payments to the spouse.

<sup>43</sup>A very small number of plans provide that if a spouse predeceases a participant he or she will then receive an increased “pop-up” benefit which is not reduced for promised survivor protection. The usual case, however, is that the participant continues to receive the reduced benefit, even though no income will continue to be paid after his or her death.

<sup>44</sup>See footnote 41 above.

## A. The Trend Toward Choice

One of the underlying themes of the current debate over reform of the Social Security system is the role of individual choice and its corollary, individual risk, in retirement planning. The proposed introduction of defined contribution accounts in the IA and the PSA plans reflect the theme of choice. Participant choice has also become a prominent theme in the private pension system. Increasingly, over the last twenty years, the defined contribution plan has become the preferred plan of employers. Between 1984 and 1993, for example, the percentage of employers offering defined benefit plans only decreased from 24 to 9 percent. During this same period, the percentage of all employers that offered only defined contribution plans increased from 68 to 88 percent.<sup>45</sup> Although there are a number of explanations for this trend, including increased regulation of defined benefit plans, lower administrative costs for defined contribution plans, and portability of defined contribution plan benefits, it also reflects a change in philosophy on the part of employers to require employees to take more personal responsibility for retirement planning. In order to encourage such responsibility, employers have increasingly adopted plans which feature employee choice. The structure of a defined contribution plan can accommodate the goals of personal choice and individual responsibility for retirement planning. The structure of a defined benefit plan usually does not.

Defined contribution plans permit, and often require, participants to make choices which will have profound consequences in retirement. Participants now often have choices in terms of contributions. In fact, much of the growth in the defined contribution area can be attributed to the popularity of the 401(k) plan which permits participants to choose when and how much pre-tax income they will contribute to a plan, often with the expectation of a matching employer contribution. Participants increasingly have choices in how their, and often their employer's, contributions will be invested. And participants have always had choices about the form in which they receive a distribution from a defined contribution plan. These choices will have a substantial impact on the benefit ultimately received from the plan by a participant. In contrast, the only choices participants usually have to enhance their benefits under a defined benefit plan are to remain with their employers longer and to earn more money, neither choice being fully within their control.

## B. Characteristics of Distributions

**Risk, Return and Control:** In most pension plans, participants have a choice among several types of distributions. The distribution options will always have trade-offs, and these trade-offs involve risks which may affect the adequacy of retirement income.<sup>46</sup> The first risk is the uncertainty of longevity. Without a guaranteed, lifetime stream of income, people may bear the risk that they

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<sup>45</sup>See *Private Pensions: Most Employers That Offer Pensions Use Defined Contribution Plans*, (Letter Report, 10/03/96, GAO/GGD-97-1).

<sup>46</sup>See, for example, Zvi Bodie, *Pensions as Retirement Income Insurance*, NBER Working Paper No. 2917, April 1989 and David M. Cutler, *Reexamining the Three-Legged Stool*, in Peter A. Diamond, David C. Lindeman and Howard Young (eds.), *Social Security: What Role for the Future?*, Washington, D.C.: National Academy of Social Insurance, 1996.

will live longer than expected and their assets will be prematurely exhausted. Second is the uncertainty regarding the rate of future inflation. People may bear the risk that inflation will be higher than anticipated and erode the purchasing power of any nominal assets held. Under this scenario, an income that appears adequate at the beginning of retirement will erode significantly if not adjustable for such inflation. Third is the uncertainty of investment performance. People may bear the market risk that returns on assets used to produce income in retirement will be less than anticipated, for example, because of poor investments.

Defined benefit plans like Social Security provide protection against longevity risk because distributions are most frequently paid in the form of a stream of income guaranteed for life. Moreover, unlike most defined benefit plans, Social Security adjusts benefits annually providing nearly complete protection against inflation. As under any defined benefit plan, it is the plan sponsor - the employer or, in the case of Social Security, the federal government - that generally bears the risk that assets will not be sufficient to pay the promised benefits. Although, in the private sector, workers covered by a defined benefit plan bear at least the risk that the bankruptcy or other financial failure of their employer will bring their plan under the PBGC insurance program, resulting in some cases in a cut-back of promised benefits. Social Security, at least in its present form, provides insurance for its beneficiaries against three of the primary threats to income security in retirement.

But in choosing between distribution options, people must do more than simply minimize risk. As always, there are trade-offs to be made, and one of these is the standard risk-return tradeoff that is associated with almost all investments exposed to market fluctuations. Besides this, there is the risk-control tradeoff. This can be illustrated by a distribution in the form of a guaranteed, lifetime stream of income which eliminates a retiree's longevity risk but limits liquidity from this part of his or her assets. The next section examines the primary distribution options from the point of view of these tradeoffs.

**Lump Sum Distributions:** The simplest form of distribution and the one that gives the most flexibility and control with respect to asset management in retirement is the lump sum distribution. Under this form, individuals remove all their assets from the pension plan or IRA and place them under their own personal control. At that point, individuals have obtained complete discretion over when and how much of their assets will be converted into current income. They also have retained control of the post-distribution investment of these assets. Individuals remain exposed to the risk of outliving their assets. They can however seek to avoid both the risk of inflation and uncertainty in the real rate of return on their investments by investing those assets in a money-market fund or similar vehicle. But this has a low rate of return. If they wish to shift towards a higher rate of return, they will have to accept more risks of one kind or the other.

**Installment Distributions:** Under this form, individuals attempt to manage their longevity by gradually withdrawing their assets from the pension plan or IRA over a term of years. This option also permits a high degree of control accompanied by a high rate of risk with respect to management of these assets. Essentially, individuals choose a divisor for their account balance and receive a distribution every year according to the selected schedule. The amount of distribution will vary depending on the investment performance of the account. Once distributed, the assets are subject to

the personal control of the individual. Under this form of payment, individuals are constrained from consuming a large proportion of their remaining pension assets during any one payment period but they are free to spend the withdrawal as they choose. The installment schedule is not necessarily irrevocably fixed, although minimum distribution amounts may be required by certain ages under tax rules. Plans often permit participants to terminate payments at any time by taking a lump sum distribution of all remaining amounts. This option fails to minimize longevity risk, has no particular impact on investment risk and succeeds only in moderately reducing the risk of impulsive spending. With poor planning or just plain bad luck, individuals could spend their assets too soon or leave too much unspent at death. In addition, neither the term of years nor the amount of the distribution is guaranteed.

**Annuity Distributions:** In the real world, there are many types of annuities which will be discussed in some detail below. In terms of distributions, the classic form of annuity is the immediate annuity which provides a nominally constant stream of income for life. This type of distribution is the polar opposite of a lump sum distribution. Once an annuity has been chosen, there is no turning back. Its income stream is fixed for the rest of the annuitant's life, constraining impulsive spending while it completely eliminates the risk of longevity. Similarly, the rate-of-return risk on investment is no longer on the individual but on the annuity underwriter. The only remaining risk is the risk of inflation but it is a serious risk, although the recent creation of inflation-protected bonds may help to minimize this risk. Even if inflation is only 3% a year, an annuitant who lives to be 95 will find herself with a real income about 59% less than she started with at age 65.

### **C. Distributions and Survivor Protection**

Neither lump sum nor installment distributions provide explicit protection for survivors. Individuals who select those forms of payment yet wish to provide for a survivor must manage their assets appropriately in order to leave the desired bequest. Single life annuities, however, provide no protection to a survivor. All payments cease on the death of the annuitant. But, in the event some form of survivor protection is desired, annuities can be purchased in a joint and survivor form which provides the survivor with a designated percentage of the original annuitant's payment. Such annuities provide less periodic income than a single life annuity in order to take into account the additional stream of promised payments to a survivor. But if the survivor dies before the annuitant, it is generally not possible to substitute a subsequent beneficiary. In addition, unless the annuity contract has a "pop-up" feature which converts the payment stream from a two life to a single life form, the annuitant usually continues to receive the same reduced amount even though the survivor benefit will not be paid. An annuity for a guaranteed term of years also provides some survivor protection. This type of annuity usually is a single life annuity with the additional feature that if the annuitant dies before a designated term of payments expires, any remaining payments will be made to a named beneficiary. In the event the beneficiary predeceases the annuitant, another beneficiary can be named. As is the case with a joint and survivor annuity, the payments made to the annuitant are less than they would be under a single life form to take into account the guaranteed term of payments.

## D. The Special Case of Annuities

Annuities have traditionally played a special role in providing income in retirement, and Social Security has utilized this form of distribution exclusively since its inception. During that time, the private annuities market has grown in size, complexity and diversity. In preparation for a later discussion of the role that annuities and the private market might play in a reformed Social Security system, this section provides an overview of the distinguishing characteristics of annuities and the private annuities market today.<sup>47</sup>

**What is an annuity?** It is surprisingly difficult to find a single, generally accepted definition of an annuity. The Tax Code definition generally requires that “amounts received as an annuity” (1) be payable in periodic installments at regular intervals over a period of more than one full year and (2) the total amounts payable must be determinable at the commencement of payments directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations or both.<sup>48</sup> Economists use a similar definition but also introduce the concept of a promisor. For their purposes, an annuity is “a promise to pay a given sum each period over a number of periods, the sum in each period being constant.”<sup>49</sup> Black’s Law Dictionary introduces the concept of a promisee in its definition of an annuity as “a right to receive fixed, periodic payments, either for life or for a term of years.”<sup>50</sup> One definition of an annuity is therefore a promise by one party to pay another a stream of payments which is determinable both in amount and duration.

But that definition just reflects one facet of an annuity contract. An annuity contract must also contain some assets which support the promised stream of income. For the purpose of accumulating those assets, an annuity can be defined as merely an investment contract. The emerging legal view is that, even though most annuities are sold by insurance companies, an annuity contract is not a contract for insurance but for investment.<sup>51</sup> As the Supreme Court recently observed, “By making

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<sup>47</sup>The annuities market is generally composed of two different segments: the individual annuity market and the group annuity market. The individual annuity market is composed of contracts designed to cover a single life and is therefore marketed to individuals. Although individual annuities can be utilized in qualified plans and IRAs, they are more popularly marketed to individuals outside the pension plan or IRA context. The group annuity market offers contracts which cover multiple lives and is often marketed to private pension plans, both to provide a means of investing plan assets and paying plan benefits. This discussion will focus on the individual annuities market which is not subject to the special rules of the private pension system. It is also a better model for the annuities that might be available under the IA and PSA plans discussed in the next section of this paper.

<sup>48</sup>Treasury Regulation §1.72-2(b)(2).

<sup>49</sup>David W. Pierce (ed.), *The MIT Dictionary of Modern Economics*, Cambridge, MA.: The MIT Press, 1992.

<sup>50</sup>Black’s Law Dictionary, St. Paul, Minn.: West Publishing Co, 1983.

<sup>51</sup>See Comptroller of the Currency letter dated August 9, 1996 to the Texas Commissioner of Insurance finding that “courts considering the status of annuities as ‘insurance’ have held that annuities are not insurance for purposes of federal tax law, several state tax laws, bankruptcy law and other laws.” Leading treatises on insurance law arrive at the same conclusion. See D. Shapiro and T. Shreff, *Annuities* 7 (1992) (in contrast to life insurance,

an initial payment in exchange for a future income stream, the customer is deferring consumption, setting aside money for retirement, future expenses or a rainy day. For her, an annuity is like putting money in a bank account, a debt instrument, or a mutual fund ... modern annuities, though more sophisticated than the standard savings bank deposits of old, answer essentially the same need.”<sup>52</sup>

Annuities, then, can be defined in two different ways: first, as a stream of income whose duration is fixed; and second, as an investment contract. An annuity contract usually incorporates both definitions. In its accumulation phase, the contract is predominantly a form of investment. Individuals pay premiums or make contributions which increase through investment earnings. In its distribution phase, the contract provides a stream of income. Neither definition depends upon the other. For example, an annuity in the sense of a stream of income can be purchased with a single premium so there is no investment component to the contract. In addition, individuals can also use an annuity contract purely as an investment vehicle with no intention, and no obligation, to convert contract assets into a stream of income.

But these definitions are not sufficient. They fail to explain the process of annuitization, that is, the transformation which occurs when the accumulation phase ends and the distribution phase begins. At this point, the annuity does provide an insurance component, at least in terms of the common understanding of the word “insurance”, if it is in the form of a life annuity. The assets which support the stream of payments are turned over to the insurance company which assumes the obligation of paying income to the annuitant for life along with the risk that the assets will be insufficient to fund the promised payments. The insurance company pools the assets of many annuitants in the expectation that proper management and investment of the pool in combination with anticipated rates of mortality will support the required payments. In exchange for his or her assets, the annuitant receives a contract right to a stream of payments. Annuitants who outlive the payments their assets, managed separately, would have provided are supported by the assets of those who did not. By the process of annuitization, the annuitant has been insured against the risk of outliving his or her assets. This process is unique to annuities and accounts for their special role in providing retirement income. No other financial product has the capacity to provide individuals with insurance against living beyond their means.

**How are annuities purchased?** Individual annuities now available in the private market offer a variety of premium types. In terms of choice, there are two primary types: single premium and flexible premium contracts. In the first case, the annuity is purchased with a single lump sum payment while in the second premiums are paid in over time. In 1995, individual annuity premiums totaled \$99 billion with about \$52.4 billion paid in single premium annuities and \$46.6 billion paid in flexible

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“annuities ... are primarily investment products.”), 1 J. Appleman & J. Appleman, Insurance Law & Practice §81 (1981) (“annuity contracts must ... be recognized as investments rather than insurance.”), and 19 Couch on Insurance 2d (Rev. ed. 1983) §18.2 (“An annuity contract differs materially from an ordinary life insurance contract in that it is payable during the life of the annuitant rather than upon any future contingency, and in many instances it is paid for in a single payment which is not generally regarded as a premium.”)

<sup>52</sup>Nationsbank of North Carolina, N.A. v. Variable Annuity Life Insurance Co., et. al., 513 U.S. 251 (1995).

premium annuities.<sup>53</sup> Annuity contracts are typically sold by insurance companies which can include insurance companies affiliated with mutual fund families. Under recent Supreme Court rulings, national banks have also been permitted to sell annuity contracts.<sup>54</sup>

**What is the investment component of an annuity?** Annuity contracts can be sold as immediate or deferred annuities. If the contract is an immediate annuity, there is no accumulation phase. The premium paid is immediately turned into a stream of income. If the contract is a deferred annuity, there can be a substantial accumulation phase during which premiums are paid and invested.

While in an accumulation phase, annuity contracts can be divided into two general categories: fixed and variable. In a fixed annuity contract, premiums are invested in fixed income instruments which pay a determined in advance amount of interest for a stated period of time. These instruments are supported by the general accounts of life insurance companies which are usually invested in corporate bonds, commercial mortgages and real estate. Return of principal is not generally guaranteed. In a variable annuity contract, assets are generally invested in separate accounts offered by the insurance company. These separate accounts resemble and often are organized legally as mutual funds, that is, they are portfolios of securities managed by the insurance company whose value fluctuates over time with market performance. Variable annuity contracts will often offer a wide variety of such separate accounts with different investment objectives and characteristics to investors. It is also common for such contracts to offer investors a number of fixed income investments as well. From a legal perspective, one of the critical differences between insurance company general and separate accounts is that the general account is subject to the claims of the insurance company's creditors while separate accounts are not.

In recent years, variable annuities have become increasingly popular. Variable annuities now account for more than \$400 billion of the more than \$650 billion of total annuity assets. As a reference point, public and private pension plans held about \$4 trillion in assets. Between 1900 and 1995, variable annuity assets grew by about 300 percent, while direct investments in mutual funds increased by about 150%.<sup>55</sup> Between 1985 and 1995, the share of the individual annuity market held by variable annuities grew from 18% to 53%.<sup>56</sup>

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<sup>53</sup>See Mark J. Warshawsky, *The Market for Individual Annuities and the Reform of Social Security*, Benefits Quarterly, Volume 13, Number 3, 3<sup>rd</sup> Quarter, 1997, pp.66-76.

<sup>54</sup>See Nationsbank at footnote 52 above which permitted national banks to sell annuities as agents without regard to state insurance laws. In 1996, the Supreme Court also ruled that, under a federal statute, national banks may sell insurance anywhere from towns of 5,000. See Barnett Bank of Marion County v. Nelson, 116 S.Ct. 1103 (1996).

<sup>55</sup>P. Brett Hammond, *The Importance of Variable Annuities in Defined Contribution Pension Systems: The TIAA-CREF Experience*, Pension Research Council Working Paper, 1996.

<sup>56</sup>Patrick J. Baker, B. Douglas Bernheim and Michael J. Boskin, *The Economic Role of Annuities*, August, 1997, p. 18.

Annuity contracts typically have a higher fee structure than other financial products which can, at least in part, be explained by the insurance components of the product - such as providing lifetime income or a guaranteed death benefit or return of principal. One source estimates that annuity product fees are on average more than double that of mutual funds.<sup>57</sup> Industry averages indicate that the break-even point for variable annuities versus mutual funds is five years.<sup>58</sup> Many annuity contracts are sold with sales fees or loads and may be subject to state premium taxes. Contracts often include a sliding surrender charge which, like a redemption fee imposed by a mutual fund, is collected if the buyer cancels the contract prematurely. In addition, insurance companies charge annual fees to annuity contracts designed to compensate the insurer for the mortality risk it assumes in guaranteeing annuity rates or a death benefit and the expenses it assumes for guaranteeing that administrative costs will not increase during the life of the contract.<sup>59</sup> Contract maintenance fees may also be charged on a yearly basis. In addition to the fees associated with the insurance wrapper, owners of variable annuity contracts pay the investment management fees and applicable loads of the funds in which they invest. Variable annuity fees can range from 0.29 % to 3.43% annually.<sup>60</sup>

**How are annuities paid?** When a deferred annuity contract enters its distribution phase or with the payment of the premium for an immediate annuity, the contract holder gives up the right to the accumulated assets or lump sum in exchange for a contract right to a promised series of future payments. In many cases, deferred annuity holders can elect a lump sum form of distribution rather than a stream of income. If a stream of income is preferred, the most typical form of payment is a life annuity. Annuities are also frequently paid in a two-life, joint and survivor form. In this form, a certain percentage - usually 50%, 66 2/3% or 100% - of the payment made to the annuitant is provided to the named survivor beneficiary. Annuities with a guaranteed term of 5, 10, 15 or 20 years are often common. If the annuitant dies before the expiration of the guaranteed term, the remaining payments are made to a named beneficiary.

If a stream of income is elected and the contract enters its distribution phase, the insurance company calculates the initial payout amount by taking into account its current payout rates (usually expressed as so many dollars per thousand contributed) and the individual's age and gender. The payout amount can be fixed at the initial rate or can vary over time. The simplest case is a fixed non-participating annuity where the annuitant receives a periodic level nominal payout guaranteed by the

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<sup>57</sup>See Hammond, footnote 55 above, p. 20. It should be noted, in addition, that although annuity products generally charge higher fees than mutual funds they have a tax advantage that mutual funds do not, that is, the inside buildup is not taxed until distributed. See Harold G. Ingraham, *Nonqualified Variable Annuities Versus Mutual Funds*, Journal of the American Society of Certified Life Underwriters and Chartered Financial Consultants, Vol. 50, March 1996 for a comparison between these two types of financial products.

<sup>58</sup>See Thomas F. Streiff, *Mutual Funds Versus Variable Annuities Under the Tax Act of 1997*, National Underwriter (Life/Health/Financial Services), Vol 191, September 1, 1997.

<sup>59</sup>See James M. Poterba, *Annuities: The Evolution of a Private Retirement Alternative*, Chicago, Illinois: Catalyst Institute, February, 1997.

<sup>60</sup>See Hammond, footnote 55 above, p. 20.

insurance company. Insurance companies often offer participating fixed annuities which provide a guaranteed, level, nominal minimum payout enhanced by dividends depending on the performance of the insurance company. As was the case with fixed income investments, these types of annuities are supported by the general accounts of the insurance company. In contrast, under a variable annuity, the insurance company remains ultimately liable to pay the promised benefits but the primary pool of assets supporting the payments is a separate account which is not subject to the claims of creditors of the insurance company or any other separate account.<sup>61</sup> In contrast, when an variable annuity is converted into a stream of income, an annuity holder receives a fixed number of annuity units based upon his or her initial payout rate and choice of investment funds. The amount of any subsequent payout is determined by multiplying those annuity units by their current value and actuarially adjusting the payout for the type of payment stream chosen.<sup>62</sup> Both the participating fixed annuity and the variable annuity payouts attempt, with varying degrees of success, to provide some protection against inflation. While, from the perspective of the individual, a fully inflation-adjusted annuity would be desirable, the private annuity market has not yet made such a product widely available.

The prices charged for annuity forms of payout can vary widely. One analysis of the U.S. individual annuities market found that the actual prices of annuities in the 1980s were about 25% higher than would be explained by prevailing interest and mortality rates.<sup>63</sup> A more recent study found that the payout value per premium dollar has risen by about 13% during the last 15 years. In addition, it suggested that there is a significant difference of about 20% in the prices charged by the 10 highest and 10 lowest insurance companies in terms of payout amount per \$1,000 of premium charged.<sup>64</sup>

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<sup>61</sup>Although the separate account can resemble a mutual fund, at least in terms of its investment objectives, its internal structure is more complicated. At a very simplified level, a mutual fund is merely a segregated pool of assets invested for the benefit of its shareholders. Although it is subject to various tax and securities laws regarding how it may invest its assets, its primary function is to maximize the wealth of its shareholders. An insurance company separate account, on the other hand, has at least two primary functions which may at times be in conflict. Its assets must be invested for the benefit of its unit holders but they must also fund its insurance component so that it can pay promised benefits. For example, because it is an insurance company product, a separate account may be subject to state law reserve requirements. Each separate account may be subject to a requirement that its assets must at least equal its reserves and other liabilities. If assets exceed the required reserves and other liabilities, the insurance company may be permitted to transfer the excess to its general account. In contrast, a mutual fund is not subject to such reserve requirements and its assets are its own property.

<sup>62</sup>See Warshawsky, *op. cit.*, pp. 71-72 for a more extensive discussion of this topic.

<sup>63</sup>See Benjamin Friedman and Mark Warshawsky, *Annuity Prices and Saving Behavior in the United States*, in Z. Bodie, J. Shoven, and D. Wise, Eds., *Pensions in the US Economy*, Chicago: University of Chicago Press, 1988, pp. 53-77.

<sup>64</sup>See Olivia S. Mitchell, James M. Poterba and Mark J. Warshawsky, *New Evidence on the Money's Worth of Individual Annuities*, January 1997.

**Who buys an annuity?** Although the data on this topic don't distinguish between annuity contracts bought either for their investment and for their lifetime income potential, the purchase of an individual annuity contract appears to be a function of age. Individuals aged 45 or more account for over two-thirds of annuity contract purchases.<sup>65</sup> In addition, according to a poll by The Gallup Organization in 1993 to obtain a demographic profile of annuity contract holders, individuals who bought individual annuity contracts had moderate annual household incomes (more than 80% had total annual household incomes under \$75,000) and an average age of 63. Slightly more than 50% were already retired; about 30% were employed full-time. More than 33% did not attend college but an additional 40% were college graduates. Almost 66% were married but 20% were widowed.<sup>66</sup> Three primary concerns underlay the decision to purchase an annuity contract: concern about inflation reducing their standard of living (78%); concern over the costs of a catastrophic illness or nursing home care (66%); and concern about running out of money in retirement.<sup>67</sup>

The data that are available suggest that annuity contracts are purchased more for their investment than distribution features. A recent study found that in 1994 the market for an actual annuity form of income was small. Using data from 81 companies, the study found that only \$3.8 billion from existing deferred annuity contracts was converted into a stream of income in 1994. The average amount annuitized was \$62,100. Sales of immediate annuities which have no investment feature were higher but at \$56 billion represented just 56% of the \$99.3 billion used to purchase individual annuities in 1994.<sup>68</sup>

Other factors support the observation that individual annuities are purchased more for their investment than distribution potential. For example, sales of annuities appear to be responsive to trends in stock prices as well as interest rates. Fixed annuity purchases increase when long-term interest rates are high. Variable annuity sales follow stock price trends.<sup>69</sup> There is also substantial evidence that tax policy has played a major role in the popularity of individual annuities. Such annuities benefit from extremely favorable tax treatment. There is no limit to the amount of money that may be contributed, although such contributions are not deductible when made, and the earnings on such contributions are not taxed until distributed.<sup>70</sup> Distributions from annuities are also not

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<sup>65</sup>See Joseph A. Gareis, *The Annuity Growth Puzzle: How Do All The Pieces Fit?*, LIMRA International, Inc., 1966.

<sup>66</sup>See The Gallup Organization, *Committee of Annuity Insurers: Survey of Non-Qualified Annuity Owners*, January 1994, p. 2.

<sup>67</sup>*Ibid.*, p. 7.

<sup>68</sup>See *LIMRA's MarketFacts*, Life Insurance Marketing & Research Association, Inc., November/December 1995.

<sup>69</sup>See Gareis, footnote 65 above.

<sup>70</sup>I.R.C. §72.

required to begin by age 70½ as is usually the case with pension plans and IRAs.<sup>71</sup> But, when distributions begin, payouts are taxed at ordinary income tax rates, although existing tax rules provide for a recovery of the basis, or the investment, in the contract. There is some speculation that the recent decrease in capital gains tax rates may make direct investment a more attractive alternative to investment through an annuity contract.<sup>72</sup> On the other hand, since the early 1980s, both defined benefit and defined contribution plans, as well as IRAs, have become subject to increasing limits on the amount of contributions that can be made and benefits that can be paid.<sup>73</sup> As qualified plans and IRAs become increasingly ineffective vehicles for tax-deferred savings for retirement, annuities will remain attractive alternatives.<sup>74</sup>

#### **IV. Implementation Issues - Individual Accounts**

This section examines several distribution issues raised by the IA plan. It first examines the plan design in the context of the issues of individual choice and control discussed in Section III above and then focuses in more detail on implementation issues associated with the annuity form of payment prescribed by the plan.

##### **A. The Control/Risk Tradeoff**

Looked at from the perspective of individual control, IAs are not perfectly consistent. Workers have no control as to the level of contributions. A mandatory additional 1.6% of their after-tax income would be automatically deposited in their IAs, although the timing of those contributions has not been fully determined. Workers have control with respect to investments but not very much. The IA plan provides that workers would have “constrained investment choices ... ranging from a

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<sup>71</sup>I.R.C. §§401(a)(9) and 408(a)(6).

<sup>72</sup>See Streiff at footnote 58 above who suggests that the new rates extend the break-even period for variable annuities versus mutual funds from 5 to 8 years. Another study conducted by Price Waterhouse which was recently discussed in *The Wall Street Journal* has concluded that the break-even period is extended by only an additional 1.3 years to average about 4 years. See Bridget O’Brian, *Annuities Watch*, *The Wall Street Journal*, October 16, 1997, p. C22.

<sup>73</sup>See Janice Gregory, *How Companies Might Respond*, paper presented at the 1997 Pension Research Council Symposium, *Prospects for Social Security Reform*, The Wharton School of the University of Pennsylvania, May 12 and 13, 1997 for a description of the inexorable ratcheting down of limits on contributions and benefits under qualified plans since the early 1980s.

<sup>74</sup>See Gareis, footnote 65 above. See also William M. Gentry and Joseph Milano, *Taxes and the Increased Investment in Annuities*, July 1996 and Poterba, footnote 59 above. From a tax policy and retirement income planning perspective, it is difficult to account for the continued favorable tax treatment accorded annuities in an era when almost every favorable aspect of a qualified plan or IRA has been tightened, trimmed, eliminated or prohibited.

portfolio consisting entirely of bond index funds to equity index funds.”<sup>75</sup> Workers have no control, except as to timing, with respect to how their accounts will be paid. When workers elect retirement, no sooner than today’s current age of earliest eligibility for benefits, age 62, their accounts are automatically converted into annuities. Looked at from the perspective of risk, the story is the same. Workers bear the entire risk of the investment performance of their contributions and, therefore, the ultimate size of the annuity purchased with the proceeds of their accounts. But once their accounts are converted into annuities which are indexed for inflation, they are protected against both inflation and longevity risk.

## **B. “Annuities Only” May Be Unpopular**

If the experience of the private pension system is any guide, one problematic feature of the IA plan is its annuitization requirement. This proposal requires that all account balances be converted into life annuities at retirement. The IA proposal then is really an old-fashioned money purchase plan. At retirement, account balances are used to purchase annuities. Today, such a plan in the private pension system would not mandate one form of distribution. Such a requirement seems contrary to the notion of choice implicit in today’s defined contribution plans. Moreover, it is likely that if one form were mandated in a private sector defined contribution plan, it would not be the life annuity. Indeed, it may be a problematic requirement for individuals, not accustomed to an annuity choice or to any constraint on their choice of benefit in their defined contribution accounts provided through work, who may well wonder why their IAs, which look so similar, are treated so differently.

Life income forms of payout are not a common feature of defined contribution plans.<sup>76</sup> Plans that are not required to offer such distributions usually don’t.<sup>77</sup> Given the choice of whether to include annuities as a form of distribution, most employers opt out. Many employers conclude that offering annuities will add an unacceptable level of legal complexity, administrative expense and fiduciary liability to their defined contribution plan.

This is true not so much in terms of the day to day operation of the plan but at the point when a participant elects an annuity. At that time, the plan administrator or other fiduciary must go to the private annuity market to purchase a single premium annuity with all the difficulties that entails

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<sup>75</sup>See Volume I, p. 28. Apparently, the IA plan’s investment choices are modeled on those currently available under the Thrift Savings Plan available to federal workers. Although discussion of these investment options is beyond the scope of this paper, it may be helpful to note that both the IA plan and the Thrift Savings Plan have much more limited choices than are generally now available under plans sponsored by the private pension system. Private sector workers may find such choices unappealing.

<sup>76</sup>It is difficult to obtain data to support this observation which is based on years of experience designing and implementing defined contribution plans and products for private employers to adopt and mutual fund families to offer. Most practitioners and other observers of trends in employee benefit plans would endorse this impression.

<sup>77</sup> Money purchase pension plans are required to offer annuities but discretionary contribution plans which includes most 401(k) plans are not, provided that the surviving spouse is entitled to receive the participant’s account in the event of death. I.R.C. §§401(a)(11) and 417.

(described in Section V.B below). The administrator remains personally liable for the selection of the annuity provider and is open to a charge of breach of fiduciary duty if the participant later becomes dissatisfied with the choice or the annuity provider defaults on its obligation. Even the most paternalistic of employers often prefer to have a participant's benefit distributed outright in a lump sum than risk such extended liability. In addition, because offering annuities in a defined contribution plan is more for the purpose of providing spousal protection than to constrain participant choice, many employers who would accept such fiduciary liability for the benefit of their employees do not wish to do so for their employees' spouses. It is unclear who would provide the annuities mandated by the IA plan, the federal government or private companies under contract with the government. If the federal government becomes the sole annuity provider for IAs, these concerns would not apply.

A life income form of payout is increasingly uncommon among employees as well. Since the early 1980s, employees have increasingly had access to a lump sum form of distribution in their retirement plans. In 1983, 47.8% of participants in work-based retirement plans reported that their primary plan offered a lump sum distribution. By 1988, that figure had risen to 59.9% and, by 1993, it was 71.5%.<sup>78</sup> During that time, the percentage of defined contribution plans offering such a form of distribution increased from 75% to 87%; the corresponding figure for defined benefit plans rose from 58% to 64%.<sup>79</sup> As lump sums have become more available, they have also become the dominant form of distribution. Based on findings from the September 1994 Current Population Survey, the U.S. Department of Labor recently reported that in 1989, 52% of individuals 40 and over who received a pension benefit from a private sector plan received only an annuity form of distribution while 40% received only a lump sum and 8% received both. By 1994, only 38% of such individuals received only an annuity while 51% received only a lump sum and 10% received both.<sup>80</sup>

The statistics cited above are in large part a consequence of the trend away from defined benefit plans where a life income form of payment is the mandatory normal form of distribution to defined contribution plans where it usually is not. But to some degree these changes also reflect individual participant choice. Although it is difficult to find substantiating data on this point, the recent experience at TIAA-CREF is illustrative. TIAA-CREF is the dominant pension system for the education and research communities and is now the world's largest private pension and variable

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<sup>78</sup>*Lump-Sum Distributions: Fulfilling the Portability Promise or Eroding Retirement Security?* Employee Benefit Research Institute, Issue Brief Number 178, October 1996, p. 4.

<sup>79</sup>*Op. cit.*, p. 5. The figure reported for defined benefit plans may be overstated because they characteristically offer very different lump sum distributions from defined contribution plans. Such plans are permitted to cash-out participants without their consent if the lump sum value of their accrued benefit is small. I.R.C. §417(e). In addition, as per participant premiums for PBGC coverage started to rise during the 1980s, many plans began offering consensual lumps sums for somewhat larger amounts, for example, those between \$3,500 and \$10,000 to reduce premium payments.

<sup>80</sup>*New Findings from the September 1994 Current Population Survey*, Washington, D.C.: U.S. Department of Labor, Pension and Welfare Benefits Administration, 1995.

annuity provider.<sup>81</sup> Its market is primarily the tax-sheltered annuity available under I.R.C. §403(b), and it invented the variable annuity product. In most contribution plans, except perhaps where an insurance company is the provider of investment options, the concept of what an annuity is and does arises only when participants choose forms of distribution. In contrast, in a TIAA-CREF plan, participants are continually educated about the purpose of annuities and are encouraged to choose lifetime forms of income. In 1991, TIAA-CREF changed its traditional TIAA retirement annuity contract to permit participants to elect annual transfers of accumulations over a ten year period to other types of retirement investments or in lump sums. From 1991 to 1994, the lump sum option has increased in popularity by 277% for full cashouts and by 300% for partial cashouts.<sup>82</sup>

The advantages of a life income form of payment in retirement are well-known.<sup>83</sup> So how can the growing preference for a lump sum or other form of distribution over a life income stream of payment, if it truly exists, be explained? It's possible that this phenomenon is merely an artifact of the impressive stock market performance in recent years. People may simply feel that stocks are better, even though inherently riskier, investments now and won't be attracted to fixed income, illiquid investments like an annuity, even if adjusted for inflation, until interest rates rise or the stock market stumbles. It may also be the case in the private annuities market that they are poorly advised by their annuity broker. For example, insurance companies operating in New York are not permitted to pay commissions when a deferred annuity is annuitized thus providing no incentive for the broker to advise annuitization. Only about 33% to 50% of the companies operating outside New York pay commissions when a deferred annuity is annuitized.<sup>84</sup> Or it's possible that people view Social Security as their primary source of annuity income and use their private pension dollars to provide more flexible forms of retirement income. People might come to welcome additional annuity income, however, as tier one benefits under Social Security are reduced. It's also possible that this phenomenon is merely an unintended consequence of the defined contribution format and its emphasis on choice. People may prefer to keep their options open and their funds accessible rather than lock themselves into a fixed form of payment.

But it is also possible that there are more fundamental psychological factors at work which may help explain people's preferences for non-annuity forms of distributions. People understand that they have individual accounts and that the assets in those accounts belong to them. They have watched their balances grow from year to year with additional contributions and investment earnings. In many cases, their account balances are their single largest asset. Purchasing an annuity with those funds means converting their familiar defined contribution plan into an individual defined benefit plan. Their assets disappear in exchange for a mere promise of lifetime income. The amount of each payment,

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<sup>81</sup>See Hammond, footnote 55 above, p. 6.

<sup>82</sup>See Research Dialogues, Issue Number 48, New York: TIAA-CREF, July 1996, p. 11.

<sup>83</sup>See Bayer, Bernheim and Boskin, footnote 56 above and Poterba, footnote 59 above.

<sup>84</sup>See footnote 68 above and *LIMRA's MarketFacts*, Life Insurance Marketing & Research Association, Inc. July/August, 1966.

even if guaranteed for life, may seem distressingly small when compared to the account balance. Unless they are truly persuaded of the economic merits of the exchange, they may feel that they have lost more (a sum certain of money) than they have gained (an uncertain, both in terms of ultimate duration and amount, stream of income).

This latter hypothesis finds some empirical support in the work of Tversky, Kahneman, Shefrin, Thaler and others who have studied the psychology of financial decision making.<sup>85</sup> This body of work suggests that people weigh gains and losses and different ranges of probability in terms of investments in surprising ways. In particular, they have found that people are more distressed by prospective losses than pleased by gains of an equivalent amount. In addition, the way in which particular choices are presented and described to people in terms of loss or gain affects individual responses. It may well be that if the benefits of annuities are not well-described to people, they feel that an annuity is a prospective loss rather than a gain.

### **C. The Federal Government as Annuity Provider**

Under the IA plan, the federal government will presumably set the standards for converting account balances to annuities. To the worker, the process should closely resemble what happens today. It is possible that the worker will just begin receiving a single monthly benefit payment on the scheduled date. Even though those benefits will in part be attributable to tier one benefits and in part attributable to the annuitized IA, the Social Security payment itself should look very much like it does today.

From the perspective of the federal government, the process will be very different. The first difficult task will be to determine whether the government will act as annuity underwriter, that is, assume the traditional insurance company role in guaranteeing the payments, or whether it will act only as an agent for the individual worker in purchasing an annuity through the private sector. This second model is common in defined contribution plans when a participant elects an annuity form of distribution. In the case of a small plan, the administrator will purchase an annuity for the participant after receiving bids from a number of insurance companies. In the case of a large plan, such as the Thrift Savings Plan for federal employees, the plan enters into a contract with a single insurance company to provide annuities as requested by participants.

Although either of these arrangements can work well in the private pension system, it is difficult to see how they could work effectively on the scale required by Social Security. In addition, the fiduciary responsibility issues involved in either choosing an annuity for an individual or an annuity contractor can be difficult. Even if the government were involved solely as the intermediary between

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<sup>85</sup>See, for example, Richard H. Thaler, Amos Tversky, Daniel Kahneman, and Alan Schwartz, *The Effect of Myopia and Loss Aversion on Risk Taking: An Experimental Test*, *The Quarterly Journal of Economics*, May 1997; Amos Tversky and Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, *Science*, Vol, 211, January 30, 1981; Richard H. Thaler, *Psychology and Savings Policies*, *The American Economic Review*, Volume 84, May 1994; and Hersh M. Shefrin and Richard H. Thaler, *The Behavioral Life-Cycle Hypothesis*, *Economic Inquiry*, Volume 26, October 1988.

the individual and the actual annuity provider, people might expect the government to serve as the ultimate guarantor of the annuity in the event the annuity provider failed. In that case, where would the funds come from to pay the annuity? The insurance company would already have received all account balances when annuities were initially purchased, and the government couldn't allocate funds from other account balances for this purpose. So even if the government were to privatize the annuity provider role, it might have to implement a Pension Benefit Guaranty Corporation-type program to insure IA annuities. It could probably do this by charging each account balance an insurance premium but that would, of course, reduce the size of the annuity ultimately purchased. In addition, by providing such annuity insurance to the insurance industry much like it provides deposit insurance to the banking industry, the federal government would find itself in the position of ultimate insurance company insurer. This could result in a large federal role in the insurance industry whose regulation is now largely left to the states.<sup>86</sup> So, even if the federal government tried to utilize the private annuities market, it might find that it would still be serving in the role of annuity underwriter rather than merely as an agent.

If the government were instead to act as annuity underwriter directly, other difficult issues emerge. The first issue to resolve would be how the funds received from the IAs should be held. There are three alternatives: (1) within the current Social Security trust fund along with the funds used to pay tier one benefits; (2) within the current Social Security trust fund but in a segregated account; (3) by a separate federal agency dedicated to this purpose; or (4) through contracts. Alternative (1) resembles an insurance company general account while alternatives (2) and (3) resemble a pension plan structure where the assets required to fund benefits must be held in trust and segregated from the general assets of the employer sponsoring the plan. Alternative (1) is plausible but only if the long-term financing of tier one benefits is secure. Otherwise, the proceeds of IA account balances could too easily be used to support tier one benefits. If this were done, the purpose of creating IAs in the first place would be defeated and the financing of IA annuities might also be placed in jeopardy. Alternatives (2) and (3) are equally plausible and practicable. Either would provide a segregated pool of assets dedicated solely to paying annuities from the proceeds of IAs. Under either arrangement, the financial and legal integrity of the pool could be protected so that it was maintained for the intended purpose of financing the annuities required under the IA plan.

A related issue if the government acts as annuity underwriter will be to determine how to set annuity payout rates, that is, to determine how many dollars per \$1,000 in the IA a particular worker will receive. In the private market, annuity payout rates are usually a function of three factors: expenses; interest rates; and mortality assumptions. The government will be paying inflation-adjusted annuities which the private market currently does not. So it will also have to take this factor into account. Presumably the government will be attempting to provide actuarially-fair annuities. Unlike the private annuity market, it will probably at most attempt to recoup its costs but not make a profit.

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<sup>86</sup>The McCarran-Ferguson Act (15 U.S.C. §§ 1011-1015) is a federal law that governs conflicts between federal law and state insurance laws. It was passed to overturn a Supreme Court case holding that Congress has the authority to regulate insurance. In general, it affirms the principle of state regulation of insurance by providing that a federal law may preempt state insurance law only if it is specifically intended to do so by Congress.

Setting the necessary factors is not a difficult process. After all, insurance companies and pension plans do this routinely based upon reasonable actuarial assumptions. But it may be a politically difficult process to determine what are “reasonable” assumptions for a group the size of the population receiving Social Security benefits. For example, should mortality assumptions be allowed to take into account gender differences in mortality? Pension plans may not; insurance companies may.<sup>87</sup> Or should other well-established mortality difference between groups, for example, race-based mortality differences, be taken into account? Setting any of these factors may raise sensitive political issues whose resolution could make the annuitization formula less than actuarially fair.

If the government is to act as annuity underwriter, it must assume responsibility for investing the billions of dollars received from IAs on annuitization. Who will invest these assets and how? In the private sector, the insurance company or pension plan invests the premiums or contributions in order to have sufficient assets to support the payment of promised benefits, to pay expenses and to manage mortality risk. Moreover, in the pension plan arena, favorable investment performance is frequently used to raise annuity payout rates or increase benefits for existing retirees. Two investment models are common; the insurance company generally manages its investments in-house while a pension plan sets an investment strategy and typically hires professional money managers to invest portions of the assets in line with that strategy. But the investment of billions of dollars by the government, whether directly or by private money managers, raises many difficult issues. Even if the pool were to be invested like an insurance company general account or pension plan in relatively conservative and long-term investments such as corporate bonds, commercial mortgages and real estate rather than in equities, the size of government involvement alone may be troubling.

A final difficult task will be to educate workers about how their IAs are converted into retirement income. People have difficulty now in understanding how their Social Security benefits are determined because it is hard to understand how benefits accrue under a defined benefit plan. But at least under the current system the rules determining benefits are relatively uniform. Understanding the actuarial assumptions used to convert an IA into a stream of retirement income may be even more difficult because the rules, expressed through the application of actuarial assumptions, change frequently. And small changes in the prevailing rules can lead to great differences in payout amounts. For example, someone who retires in January at age 64 with a \$100,000 IA may receive a different payout amount from his or her neighbor with identical characteristics who retires in June because interest rates have changed in the interim. Unless people understand the conversion process and learn how to use it to their advantage, for example, by waiting for favorable interest rates to begin payments, they are likely to mistrust it and feel that they have not gotten the full benefit to which they were entitled from their IAs.

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<sup>87</sup>See Arizona Governing Committee for Tax Deferred Annuity and Deferred Compensation Plans v. Norris, 463 U.S. 1073 (1983).

## V. Implementation Issues - Personal Security Accounts

This section examines several distribution issues raised by the PSA plan. It first examines the plan design in the context of the issues of individual choice and control discussed in Section III above and then focuses in more detail on distribution and related implementation issues associated with the plan.

### A. The Control/Risk Tradeoff

Looked at from the perspective of individual control, PSAs are more consistent than IAs. While workers would have no control over how much they could contribute, 5% out of their 6.2% required contributions would be used to fund their PSAs. The PSAs would not be deposited with the government. Instead, they would be “individually owned and privately managed, subject to necessary regulatory restrictions to make sure they were invested in financial instruments widely available in the financial markets and that they were held for retirement purposes.”<sup>88</sup> Workers have almost complete control with respect to investments. Workers can elect to take distributions from their accounts at age 62 or any time thereafter. Workers also have complete control as to how their accounts will be distributed. The PSA plan does not require annuitization. Looked at from the perspective of risk, workers under the PSA plan are potentially fully exposed to inflation, longevity and investment risk.

### B. Distribution Issues

**Issues with Annuities:** In terms of distributions, there are two fundamental differences between the IA and PSA plans: (1) the role to be played by annuities; and (2) the role to be played by the private annuities market. The IA plan does not permit annuities to be used as a form of investment; the PSA plan presumably does. The IA plan requires annuities to be the sole form of distribution; the PSA plan does not. The IA plan places the annuitization process in the hands of the federal government; the PSA plan leaves it in the hands of the private annuities market.

Is the private annuities industry ready to assume the role provided for it in the PSA plan? The answer is probably “yes” when the use of an annuity as a form of investment is considered. The private annuities market does provide a competitive investment product during the accumulation phase of an annuity contract. As Section III.D above has shown, the private annuities market has grown in diversity and complexity in recent years and now offers a wide variety of investment products which are attractive alternatives to mutual funds or other similar investments. The deferred annuity products it offers are more complicated, especially in the case of a variable annuity, than a stand-alone mutual fund, and an investor needs to understand both the underlying investment options and the insurance company wrapper. Until recently, it was difficult for investors to comparison shop annuities. But now there are a number of services, on the web and in print, which provide detailed information about annuity products including about the underlying investment options such as their fees and their recent performance figures as well as the financial status of the associated insurance

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<sup>88</sup>See Volume I, p. 30.

company.<sup>89</sup> While there may be some concern over the higher fees associated with these products, the gap between them and stand-alone mutual funds seems to be narrowing and probably will continue to do so.

But the answer is probably “not quite sure” when the industry’s ability to provide a secure source of retirement income for individuals is considered. As Section III.D above suggests, the private annuities market does not have the same level of public acceptance for providing retirement income as it does for providing investment opportunities. In addition, the process of converting an account balance to a lifetime stream of income can be complicated, and payout rates can vary widely from company to company. If the private annuities market is to provide retirement income on the scale contemplated by the PSA plan, two difficult implementation issues will need to be addressed. The first concerns the conversion process. What information will people need, and how will they get it, to make an informed decision about an annuity provider? The second concerns the industry itself. What happens when an insurance company fails? Given the importance of Social Security benefits as a source of retirement income, is the protection available today sufficient?

In order to resolve the first issue, it is important to understand that choosing among various companies offering annuities priced on a single life basis which is essentially what would happen under the PSA plan can be a difficult decision. Many small defined contribution plans have to do this if they offer an annuity as a distribution option. The plan administrator gets a number of quotes which can provide widely varying amounts of monthly income and then must decide which quote is the best. An individual under the PSA plan would probably have to undertake the same process which can be a complicated and highly-technical process. For example, companies use different mortality tables as part of their underwriting policy, and it is difficult for any one other than an actuary to understand the implications of different tables.<sup>90</sup> At the same time, companies use different interest rate assumptions which can have a dramatic impact on the annuity payout rate offered. Often, the data required to comparison shop an annuity are not readily available. The consumer has to request it specifically from the prospective annuity provider or consult a specialized database providing comparative statistics.<sup>91</sup> This is, of course, not an insurmountable problem. If the PSA

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<sup>89</sup>For example, see the Quotesmith Insurance Price Comparison Service at [www.quotesmith.com](http://www.quotesmith.com) which provides data and sales assistance for annuities offered by 110 insurance companies and the INN Service at [www.insure.com](http://www.insure.com) which uses the Morningstar on-line variable annuities data base to provide inexpensive reports on variable annuities and their underlying investment funds.

<sup>90</sup>For example, The Wall Street Journal recently reported that an 86 year old woman who had inadvertently elected an annuity form of payment and wished to cancel her contract discovered that her insurance company had assumed she would live to be 106 in calculating the amount of her payments. See Ellen E. Schultz, *Annuities Watch*, The Wall Street Journal, October 20, 1997, p. C1.

<sup>91</sup>For example, the author spend many hours reading sample variable annuity contracts from Fidelity and Schwab, learning a lot about the types of investment options, their fees, the insurance company and the available forms of distribution but nothing at all about how balances are converted into annuity forms of payment. The websites listed in footnote 89 above provide a lot of summary information about annuity providers but not about annuity payout rates.

plan were adopted, creating a large new market for individual annuities, it is likely that the insurers would begin providing this information routinely. In addition, the conversion process may become more standardized as the industry becomes more competitive. It is also possible that the federal government could set some of those standards by designating a range of actuarial tables and assumptions as “reasonable” for use with PSA accounts.

Pricing an annuity, however, is only the first step in selecting a provider. An equally important and related issue is determining the quality of the provider. As Section III.D above discusses, the creditworthiness of the annuity provider is a critical concern. Purchasing an annuity form of income is a long-term investment decision. It requires choosing an insurance company which can be counted on for 20 or 30 years of benefit payments. The investment is not diversified; only one insurer can be chosen at a time. In addition, the investment is illiquid; once the annuity provider is chosen and the premium paid, the contract is irrevocable. If the PSA plan is implemented, millions of people will attempt to replace the annuity income now guaranteed under the present Social Security system through the private annuities market. But the guarantees which the private annuities market can now provide for its products are not comparable to those provided by Social Security.

Before the early 1990s, the safety of the private annuity market was not a matter of great concern. But in 1991, state regulators seized several large insurance companies - Executive Life in New York and California, First Capital and Fidelity Bankers in California and Virginia, Mutual Benefit Life in New Jersey and Monarch Life in Massachusetts. Payments to thousands of annuitants were jeopardized. Executive Life annuitants, for example, saw their payments reduced by 30% for many months with no guarantees of any full recovery under the rehabilitation plan put in place. Analysis of these failures has indicated that the regulatory system now in place for life insurance companies has some systemic problems.<sup>92</sup> While risky investments in junk bonds, mortgages and real estate and questionable interaffiliate transactions were the ultimate cause of these failures, investigations also revealed that state regulators had failed for years “to respond to danger signals and did not take timely or forceful action to avert the failures or minimize policyholder losses.”<sup>93</sup> If state regulators failed to perceive these problems, it is likely that the rating systems upon which people rely for information about the quality of an annuity provider were similarly uninformed.

Because the regulation of insurance companies is left to the states, annuitants whose provider has failed are not protected by federal law. They must look for recovery to the state guarantee system that provides some insurance for certain types of policies and contracts. These systems, however, are neither state agencies nor state funded. In most cases, they are merely associations of the life and health insurance companies doing business in a particular state. Guarantee funds are provided through assessments when a member insurance company fails. Coverage varies, depending

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<sup>92</sup>See *Private Pensions: Protections for Retirees' Insurance Annuities Can be Strengthened*, GAO/HRD-93-29, Washington, D.C.: GAO, March 1993 and *Insurance Regulation: Observations on the Receivership of Monarch Life Insurance Company*, GAO/GGD-95-95, Washington, D.C. March 22, 1995.

<sup>93</sup>*Insurance Failures: Regulators Failed to Respond in Timely and Forceful Manner in Four Large Life Insurance Failures*, GAO-T-GGD-92043, Washington, D.C.: September 9, 1992, p. 3.

on the laws of the particular state and on the particular insurance product. Some states cover only state residents, and many states limits their coverage of individual annuities to \$100,000 in present value.<sup>94</sup>

It should be recognized, of course, that most annuitants never experience a loss of income and important reforms have been made to state regulatory systems as a result of these failures. Nevertheless, it is likely that insurance companies will continue to be regulated by the states which all have different standards and procedures. Judging the quality of an annuity provider will continue to be difficult for three primary reasons: (1) inconsistent regulatory oversight of the industry; (2) insufficient public information on the annuity pricing policy and financial stability of individual insurers; and (3) inadequate state guarantee funds for annuitants. In the private pension system, the Department of Labor has responded to the first two problems by promulgating a “safest available annuity” standard.<sup>95</sup> This standard requires plan officials to investigate the financial solvency, claims-paying ability and creditworthiness of each possible annuity provider extensively in order to find the “safest” provider. Mere reliance on ratings systems is insufficient to satisfy this standard. Moreover, the Department of Labor requires the plan to use a qualified, independent expert for advice, unless the employer has the necessary expertise in-house. The private pension system has also had a lot of experience with state guarantee funds in the wake of the insurance company failures of the early 1990s and has recognized their shortcomings. As a result, there are repeated calls for some level of federal protection for annuities provided though the private pension system.

Individuals purchasing an annuity form of income under the PSA plan will confront the same issues faced by large pension plans. But they are not likely to have the same access to information and experts. It is possible that the private sector will develop some information systems which will prove to be adequate for the millions of annuity purchasers under the PSA plan. It is also possible that state regulatory oversight and guarantee funds will be strengthened. But, until that happens, it must be recognized that, under the PSA plan, the private annuities market will not be able to replicate the safety and security of the annuity income now provided by Social Security.

**Issues with Lump Sums and Installments:** Under the PSA plan, an individual may begin withdrawing funds from his or her PSAs at age 62 or any time thereafter. The timing and amount of distributions is left to the individual. He or she may elect to receive a single lump sum distribution or a series of distributions, either sporadically or under a set schedule. The flexibility of distributions inherent in the PSA plan is one of its most attractive features. On the other hand, it’s also one of its most dangerous features. Some people will be able to use it to schedule their retirement income advantageously. Others will be less successful or less lucky and exhaust their funds too soon. Still others will fail to do anything, either by choice or inertia, and leave their PSA funds undistributed at death.

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<sup>94</sup>*Private Pensions: Protections for Retirees’ Insurance Annuities Can be Strengthened*, GAO/HRD-93-29, Washington, D.C.: GAO, March 1993.

<sup>95</sup>See Department of Labor Interpretive Bulletin 95-1.

An interesting feature of the PSA plan is that it does not require that distributions begin by any age or even at all. The IA is not explicit on this point either. But because the only distribution under the IA plan is an annuity which is essentially a “use it or lose it” form of income, people have an incentive to begin distributions at retirement. Under the PSA plan, it is apparently permissible for an individual to let PSA funds accumulate untouched until death. If this is so, it raises an important question about the character of these funds. Is the PSA intended to produce funds for the support and income security of the account holder in retirement? Or is it really just another way to accumulate assets on a tax-favored basis for estate planning purposes?

The Tax Code has settled this question for the private pension system.<sup>96</sup> It has taken the position that the tax deferral benefits conferred upon pension plans, IRAs and other similar retirement vehicles were intended for the primary purpose of helping individuals accumulate funds for retirement income. In order to insure that funds are used for this purpose and not merely accumulated for distribution at death, the Tax Code requires that at least a minimum level of distributions begin, in most cases, no later than by age 70 ½.<sup>97</sup> In the case of a defined contribution plan, the minimum distribution is determined by dividing the account balance at year’s end by the individual’s life expectancy as determined under I.R.C. actuarial tables. If an individual fails to satisfy this requirement, he or she is subject to a 50% excise tax on the amount that should have been distributed in that year.<sup>98</sup> At death, any remaining pension funds are subject to both income and estate tax.

PSAs also benefit from special tax treatment, although it is in the form of a tax exemption for the inside buildup rather than a tax deferral. At death, these funds will therefore only be subject to estate tax. This special treatment raises the issue of whether distributions should be required during retirement. Whether they should be depends the ultimate rationale for the PSAs, that is, whether they are mandatory savings for retirement or just mandatory savings.

**Predictable pressure for pre-retirement access to funds:** Although the PSA plan does not permit distributions to begin before age 62, it is very likely that there will be considerable pressure to include such pre-retirement forms of distribution as loans and hardship distributions. Such provisions are common in defined contribution plans today. There is no single rationale for such distributions. In part, employees tend to view their accounts more like personal checking accounts than as savings for retirement and prefer to have those funds accessible for emergencies or major investments such as the purchase of a home. In part, plan sponsors permit them specifically to encourage plan contributions by employees who are otherwise reluctant to tie their funds up for a long time. Even though many plans include these provisions, their use is subject to certain restrictions. For example, hardship distributions are permitted only in a limited number of situations and with respect to certain types of contributions. There is also a tax cost to each type of

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<sup>96</sup>Annuities are the only tax-deferred retirement planning vehicle which are not subject to these rules. But, as discussed above in footnote 74 above, annuities are a tax anomaly.

<sup>97</sup>See I.R.C. §401(a)(9).

<sup>98</sup>I.R.C. §4974.

distribution. For example, loans which are not repaid to the plan and hardship distributions are subject to tax at ordinary income rates and, in many cases, a 10% excise tax as well. In addition, these types of distributions add to the administrative and compliance burden of the plan. The private pension system provides a model for how such forms of distribution could be implemented. Whether they should be again depends upon the ultimate rationale for the PSAs which will not be subject to the same tax constraints as defined contribution accounts. If the PSAs are intended solely as mandatory savings for retirement, it will be difficult to justify pre-retirement distributions. On the other hand, if the PSAs are just a form of mandatory savings independent of retirement, it will be difficult to prohibit them.

### **C. Regulatory Issues**

Under the PSA plan, the role formerly played by the federal government in investing and distributing Social Security funds is turned over with respect to PSA accounts to the individual and to the private sector. The plan anticipates that new regulation will be required to insure that account assets are appropriately held and invested but it doesn't specify a regulatory framework. Creating that framework is likely to be one of the most difficult issues in implementing the PSA plan. It seems reasonable to assume that the goal is to create a regulatory structure which would protect the rights of workers without undue government involvement. The following discussion addresses some of the basic issues to be considered in developing that structure.

**Who should regulate the PSAs?** At the outset, it should be noted that the Social Security system as we know it today is a model of regulatory simplicity. There is one uniform set of laws, the Social Security Act, which governs the program. Just one federal agency, the Social Security Administration, administers the payment of benefits. In contrast, both private pension plans and IRAs are a regulatory morass. See Table 1 below for a description of the major players and their roles.

**Table 1. Who Regulates?**

	<b>Private Pension Plans</b>	<b>IRAs</b>
Contributions	IRS DOL <sup>99</sup>	IRA trustee or custodian IRS
Investments/ Investment Products	IRS DOL State law <sup>100</sup> SEC <sup>101</sup> State insurance regulators <sup>102</sup> OCC <sup>103</sup> State banking regulators <sup>104</sup>	IRA trustee or custodian IRS DOL SEC <sup>101</sup> State insurance regulators <sup>102</sup> OCC <sup>103</sup> State banking regulators <sup>104</sup>
Distributions	Plan trustee IRS	IRA trustee or custodian IRS
Participant Rights	DOL State law <sup>100</sup>	
Spousal Rights	IRS DOL State law	State law
Tax Treatment	IRS State tax authorities	IRS State tax authorities

Given the role of the private sector in the PSA plan, the current simplicity of Social Security regulation is no longer attainable. As a model, the current complexity of pension plan regulation is undesirable. But much of that complexity may be unavoidable. Millions of PSA accounts will be created, and, inevitably, problems will arise. In some cases, the problem might be that an employer has failed to forward participant contributions. Or disputes might arise over how a PSA is being

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<sup>99</sup>DOL monitors only defined benefit plans that participate in the PBGC insurance program.

<sup>100</sup>State law controls plans not regulated by ERISA, primarily plans sponsored by state or local governments or instrumentalities.

<sup>101</sup>The SEC regulates and monitors mutual funds, private placements, and investment advisers.

<sup>102</sup>The regulation of insurance companies and their products is controlled by the state law of each jurisdiction in which an insurance company does business.

<sup>103</sup>The Office of the Comptroller of the Currency regulates federally chartered banks.

<sup>104</sup>State chartered banks are regulated under state law.

managed. How will these problems be resolved? Should a federal agency, such as the I.R.S., be given responsibility or should it be left to the courts? In addition, in the private pension system, many people forget about their benefits, and the plan has to locate them somehow. This could happen with PSAs as well if people move often or their financial institution merges with another. Who will keep track of participants and their accounts? Or there might be a dispute over investments in the account. Who will investigate charges of fraud or misrepresentation in these cases? Pension plans, IRAs and now PSAs are theoretically simple concepts which require complex systems of implementation. Creating a regulatory structure for PSAs which protects worker rights while minimizing government involvement will be difficult.

**What law controls?** There are essentially three models: exclusively federal law, exclusively state law, or a combination of both. Because pension law is primarily a special case of tax law, and federal tax law affects all individuals, no exclusively state law model exists in this area. Most common is the exclusively federal law model. For example, the private sector pension system, excluding plans offered by state or local governments and their instrumentalities (“governmental plans”), is based on federal law to such an extent that federal law even pre-empts any state law which is found to “relate to” a pension plan regulated by ERISA.<sup>105</sup> The benefits of such a model are that a uniform system of laws prevails, and individuals receive the protections intended by the law, no matter where they live now or where they have lived in the past. Governmental plans, on the other hand, are subject to federal tax law but state law in terms of organization, management and participant rights. This dual law arrangement largely arises out of concerns over federalism and the concept that the federal government should not intrude upon the employer-employee relationship established by state governments. In the Social Security context, this concern doesn’t arise. The program is a compulsory federal program which affects private sector employees as well as many public sector employees. Federal law determines what contributions are required and how they are paid. The rights of individuals to benefits are also controlled by federal law. There is really no state law interest to protect in the Social Security program. Therefore, it seems reasonable to assume that a new set of federal laws would be needed to serve as the exclusive regulatory basis for the defined contribution component of the PSA plan.

**Who holds the assets?** Although the PSA proposal contemplates that these accounts will be “individually owned”, it is difficult to achieve this literally from a legal perspective. It is unlikely that a PSA could have a simple structure like a bank or brokerage account where the individual holds direct legal title to the assets in the account. In the private pension system, including IRAs, an individual does not hold retirement assets in his or her own name. The nominal owner of those assets is always another legal entity, usually a trustee or a custodian, who holds title to the assets for the benefit of the individual. In either case, there is a trust document or custodial agreement which sets forth the rules of the arrangement.

Requiring a PSA to have a trustee or custodian hold the assets has certain advantages. For example, it prevents people from commingling PSA assets with other assets, helping to satisfy the

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<sup>105</sup>ERISA §514(a).

proposal's requirement that PSA assets "be held for retirement purposes". Both private pension plans and IRAs have similar requirements that their assets be segregated from the employer's and the individual's other assets for this reason. It also helps insure that funds accumulated for retirement are distributed only at permitted times. Finally, it can provide important, a private individual can serve as a trustee. In that case, the plan contracts with a financial institution to serve as legal custodian of the assets. The trustee remains, however, legally responsible for the assets. IRAs are more strictly regulated. Only banks and insured credit unions are automatically permitted to serve as trustees. Any other person or entity who wishes to so serve must first obtain the approval of the Internal Revenue Service.<sup>106</sup> The IRA model seems more suitable for the PSA structure than the pension plan model. It would probably be prudent to permit only regulated financial institutions to serve in such a role so that individuals have at least some protection against theft, embezzlement or other misuse of their PSA assets.

**Who controls the assets?** The PSA proposals contemplates that each account will be "privately-managed." Although the meaning of this phrase is not entirely clear, it is most likely intended to mean that individuals retain investment discretion over the assets in their accounts. It is possible to achieve this goal even with a trustee or custodian nominally in control. In that case, the trustee or custodian serves in a "directed" capacity, that is, he or she acts under instruction from the PSA account holder. It should also be possible for the individual to relinquish that discretion. It seems likely that many PSA account holders will prefer professional management of their assets. In that case, it should be possible to structure a PSA account with an active investment role for the trustee or some other investment professional, such as a registered investment adviser, selected by the account holder.

**Should someone be a fiduciary?** Although pension law is primarily a subset of tax law, it also borrows several important concepts from the common law of trusts. One major influence has been the trust law concept of fiduciary duty under which a code of conduct is imposed on those who manage or otherwise have discretion over assets held for the benefit of another. As a theoretical matter, there should be some fiduciary standards applied to PSAs. Millions of PSA accounts will be established, many of them in small amounts and for people not sophisticated in dealing with the financial services industry. In many cases, these accounts will represent the major source of income in retirement. In order for PSAs to function as intended, there should be some standards of care imposed on those charged with the safekeeping of these special assets to protect them from misuse, fraud and abuse. Deciding what standards to apply and to whom they should apply is clearly one of the most difficult implementation issues facing the PSA plan.

Under current law, the most comprehensive rules are found in ERISA which governs most of the private pension system.<sup>107</sup> In general, ERISA requires that each plan have at least one "named"

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<sup>106</sup>I.R.C. §408(n).

<sup>107</sup>Many plans, such as governmental or church plans, are not subject to ERISA. Their code of fiduciary duty is found under state law, in the case of a governmental plan, or under the governing document, in the case of a church plan.

fiduciary who has authority to control and manage the operation of the plan.<sup>108</sup> That fiduciary and others it names or who otherwise become fiduciaries through operation of law are subject to personal liability with respect to their performance of certain duties set forth in ERISA.<sup>109</sup> In addition, they are expressly forbidden from engaging in certain types of transactions (“prohibited transactions”) with plan assets, even if those transactions would financially benefit the plan. They also may not use plan assets for their own benefit or in a way which is adverse to the interests of the plan or its participants.<sup>110</sup> Any one who violates these restrictions must report the transaction to the government, undo the transaction itself and pay a 15% excise tax (100% if not paid on a timely basis) on the value of the transaction, not just on the amount of profit.<sup>111</sup> IRAs which are not generally subject to ERISA have somewhat less strict standards. The governing law is found in the Tax Code which has generally adopted the prohibited transaction rules of ERISA.<sup>112</sup> If an IRA engages in a prohibited transaction, any “disqualified person” responsible for the transaction is subject to the excise tax described above.<sup>113</sup> This tax, however, does not apply to IRA account holders. Their consequence is that they are treated and taxed as if their IRAs had been distributed to them in one lump sum.

Neither the ERISA nor the IRA fiduciary rules seem appropriate for PSAs. ERISA embodies a complex combination of broad fiduciary standards along with extremely specific rules against certain types of transactions. As a result, while there have been instances of financial misconduct with pension plan assets, they are the exception not the rule. But the standards have been elaborated legally on a case-by-case basis which make them difficult to apply broadly. The rules are rigid and highly-technical and do not adapt easily to changes in the financial services industry or its products. In too many cases, they rule out transactions which make good economic sense. In any event, they may make more sense in the pension plan context than in the one worker-one account world of the PSA. The IRA model should be more relevant to PSAs but it is based on a tax regime that doesn’t apply because PSAs would be composed of already taxed and tax-exempt funds. Moreover, the PSA accounts represent Social Security dollars which are intended for retirement income. IRAs, on the other hand, represent discretionary, not mandatory, savings for retirement. A “deemed distribution” in the event of a fiduciary breach just undermines the purpose for which PSAs were created.

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<sup>108</sup>ERISA §402(a)(1).

<sup>109</sup>Under ERISA, a fiduciary is anyone who exercises discretionary authority or control over a plan, its assets, or its management or who renders investment advice for a fee. ERISA §3(21).

<sup>110</sup>See ERISA §§404 and 406.

<sup>111</sup>I.R.C. §4975.

<sup>112</sup>IRAs are not generally subject to ERISA and the fiduciary rules governing their operation are found in the Tax Code under I.R.C. §4975. However, the Department of Labor which is in charge of the parallel restrictions found in ERISA has authority to issue interpretations of that section of the Tax Code.

<sup>113</sup>In the IRA context, a “disqualified person” would usually be a service provider to the account or anyone who has discretion over the management or investment of the assets.

**Who determines what investments are permissible?** Under the PSA proposal, investments are to be limited to “financial instruments widely available in the financial markets.” The proposal does not specify who will determine which instruments are permissible. In the private pension system, there are a variety of model from which to choose. For example, governmental plans are often restricted to permissible investments set forth in state statutes. These lists, however, tend to be excessively cautious. Only in recent years have several states liberalized their statutes to permit equity or foreign investments. They also are infrequently updated because doing so requires a legislative act. This model, while easy to implement, seems too rigid and too subject to government control for PSAs. ERISA, in contrast, just sets forth general standards. Plan assets must be invested for the exclusive purpose of paying benefits and defraying reasonable plan expenses. Investments are required to be diversified in order to minimize the risk of large losses, unless it would clearly be prudent not to do so and must otherwise be invested under the “prudent man” standard.<sup>114</sup> This model seems better suited to pension plans which have large pools of assets and professional management than to PSAs. IRAs represent a third model. There are few direct limits on permissible investments; only collectibles such as art works, rugs, alcoholic beverages, coins or other tangible personal property are expressly forbidden by statute. A violation of the statute is treated as a deemed distribution, and the tax benefits of the IRA are immediately lost. It would be possible for PSAs to have similar restrictions but it is difficult to determine what consequence should be imposed for violations. But IRAs are subject to at least one form of indirect control which might be applicable to PSAs. As discussed above, only certain financial institutions may hold and manage IRA assets. Those institutions themselves are subject to legal restrictions as well as internally-developed standards as to what type of investments they may hold. If PSAs were subject to similar restrictions, the issue of permissible investments could largely be left to the financial markets and their regulators.

## **VI. Other Implementation Considerations**

### **A. Issues of Spousal Protection**

**What is the interest of the spouse?** Sections II.E and III.C above have described in some detail how the reform proposals might change the ways in which Social Security provides income to spouses. It is important to recognize as well that the introduction of IAs and PSAs represents a fundamental philosophical change in the treatment of spouses under Social Security. For almost 60 years, the fundamental unit for the payment of Social Security benefits has been the couple. Married individuals are entitled to receive benefits both in their capacity as workers and in their status as spouses. The prime beneficiary of the current program has been the one-earner couple. Even though that couple has paid Social Security taxes for only one worker, the non-working spouse is eligible for an immediate benefit equal to 50% of the benefit received by the working spouse. Some commentators have argued that the current system unfairly subsidizes one form of household - the

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<sup>114</sup>ERISA §404(a).

one-earner household - to the detriment of working women, both married and unmarried.<sup>115</sup> All three reform proposals recognize the inequities in the current program and provide for less generous spousal benefits to be paid over time. Automatic spousal benefits, however, will continue to be available to couples in the form they are today under the MB plan and in the tier one benefits provided under both the IA and PSA plans.

The introduction of IAs and PSAs changes the fundamental unit for the payment of benefits. Under both of these proposals, the fundamental unit is the worker. The individual worker's contributions fund the account and therefore the benefits payable from that account belong to him or her alone. The IA plan has accommodated the interests of the spouse by providing that benefits will be paid in the form of a joint and survivor annuity, unless the spouse consents to a single life annuity. But the PSA plan provides no role for the spouse in determining how or when benefits will be paid while the worker spouse is alive. On the death of the worker spouse, the plan provides only that the surviving spouse "would be eligible" to inherit any funds remaining in the account. But this language isn't clear. Does "would be eligible" mean that the spouse has an automatic right of survivorship with respect to those assets? Or does it merely mean that the worker spouse, if so inclined, could provide that his or her spouse will inherit them? Whatever those words are intended to mean, they only apply on the death of the worker spouse. The other spouse has no say in the disposition of PSA assets during the lifetime of PSA account holder.

The model adopted by the IA and PSA plans with respect to spouses has long been used in the private pension system. Benefits payable under pension plans belong to the individual plan participant. Those benefits represent deferred compensation for that individual, and the plan does not officially recognize the interests that a spouse or dependent might have. But the private pension system has also recognized the importance that those plan benefits have for the retirement income of the worker's household. When ERISA was enacted in 1974, it used a model similar to that now suggested for the PSA plan. A plan participant could choose a form of distribution without obtaining the consent of his or her spouse. But it soon became apparent that this model did not adequately protect the interests of the spouse. Many were unaware that their spouses had elected a single life annuity and found themselves without adequate funds after his or her death. Others did not know that their spouses had taken a lump sum distribution and spent all their retirement funds. In 1984, the law was changed by passage of the Retirement Equity Act which recognized that spouses should be involved in making choices with respect to retirement income upon which they may rely. Since 1984, most pension plans require participants to obtain spousal consent to the form of distribution elected.

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<sup>115</sup>See, for example, Jonathan Barry Forman, *Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-earner Couples*, 45 Tax Law 916 (1992) and *Social Security: What Can Be Done About Marriage Penalties?*, 75 Tax Notes 270 (1997).

The compromise between the interests of the individual worker and the couple in retirement benefits embodied in the Retirement Equity Act is not contemplated by the PSA plan.<sup>116</sup> The plan assumes implicitly that each spouse will have equivalent opportunities to accumulate assets in a PSA sufficient to provide independently for his or her own retirement needs. But the evidence presented in Section II above suggests otherwise for the foreseeable future. While patterns of men and women's labor force participation and earnings have been converging in successive generations, they have not yet achieved parity. Until they do, it is likely that some recognition of the interests of the couple over that of the individual, whether or not in the form of the spousal consent requirement found in the private pension system, may still be required under the PSA plan.

**What are the rights of a former spouse?** Because Social Security today considers the household to be the fundamental unit for benefit payments, surviving spouses are entitled to receive benefits automatically by virtue of their status as spouses. Divorced spouses married for at least 10 years to a covered worker who have not remarried are also entitled to receive benefits based upon their former spouse's entire work history. Neither the IA nor the PSA plan provides for the interests of divorced spouses. It is likely that introduction of a defined contribution component to Social Security will change the ways in which these benefits are treated on divorce. An IA or a PSA will be a very visible and valuable asset representing funds accumulated during a marriage. The question will soon arise as to whether these assets are marital assets which are subject to division upon divorce. Without an explicit provision to the contrary in the authorizing statute, it is almost certain that a court would answer this question in the affirmative.

The rights of former spouses have been a troublesome issue in the private pension system in large part because the private pension system is governed by federal law while marital rights upon divorce are governed by widely-varying state laws. For many years, the rights of divorced spouses to pension benefits were an unsettled issue under federal law. But with the passage of the Retirement Equity Act in 1974, federal law was changed to permit plans to recognize valid state court orders awarding a portion of a participant's benefits to a divorced spouse, providing the order meets certain requirements.<sup>117</sup> It is usually not difficult for a plan to comply administratively with a proper order which typically requires the plan to prorate the benefit earned during the marriage between the former spouses. In the case of a defined contribution plan, the order will often specify that a portion of an account balance is to be awarded to the non-participant spouse. Unless the non-participating spouse elects to take a distribution of that amount or have it rolled over to an IRA, the plan simply opens an

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<sup>116</sup>It is important to note that the private pension system provides protection only for the "surviving spouse". If a spouse predeceases a participant before benefits begin to be paid, he or she loses any rights with respect to those benefits in terms of approving a form of payment or the ultimate beneficiaries. Until recently, this was an unsettled issue, and there was much litigation when a participant died leaving children from the first marriage and a surviving spouse from the second with the children asserting a claim to benefits accrued during the first marriage. However, the Supreme Court has recently upheld the surviving spouse provision of ERISA by ruling that state community property law, where each spouse has a right to dispose by will of 50% of community property, such as pension benefits, acquired during a marriage, does not supersede ERISA. See *Boggs v. Boggs*, 117 S. Ct. 1754 (1997). This will be a difficult issue for both the IA and PSA plans also.

<sup>117</sup>I.R.C. §§401(a)(13) and 414(p).

account for that individual who then has all the rights, including any rights to choose investments or designate a beneficiary but excluding any right to make additional contributions, of any other participant under the plan.

From a legal perspective, the pension plan model treats divorced spouses more equitably than Social Security does today. This model recognizes that retirement benefits accrued during a marriage are a form of marital property which may be divided upon divorce. Social Security looks only at the current marital status of the divorced spouse. A divorced spouse who is married is not eligible for a divorced spouse's benefit, no matter how long the previous marriage lasted, but may be eligible for a benefit on the current spouse's earnings, no matter how brief the marriage. On the other hand, from an economic perspective, Social Security is a much better deal for the divorced worker. Under the current system, benefits payable to a divorced spouse do not reduce the benefit payable to the primary worker or any subsequent spouse. Under the pension plan model, any benefits set aside for a divorced spouse do reduce the amount of benefits ultimately payable to the participant and any subsequent spouse.

## **B. Protection from Creditors**

**What are the rights of a creditor?** Neither the IA plan nor the PSA plan addresses the issue of creditors' rights against assets accumulated in either type of account. Without some explicit protection in the authorizing statute, it is likely that such assets would be subject to attachment, garnishment or levy by creditors or assignment by account holders in certain circumstances. Trust law, however, has long recognized that certain types of assets such as retirement benefits should be protected from the rights of claims of creditors. A trust document which has an "anti-alienation" provision effectively prevents creditors from reaching a beneficiary's interest in the trust while it also prevents a beneficiary from using trust assets intended to be used for a specific purpose to satisfy debts incurred for other purposes. Social Security today provides such protection for its beneficiaries.<sup>118</sup> The private pension system has a similar provision under federal law, protecting participants from creditors with certain exceptions such as the I.R.S., dependent children and divorcing spouses.<sup>119</sup> IRAs, on the other hand, must rely upon state law to obtain this protection.<sup>120</sup>

Whether IAs or PSAs should be entitled to this protection again depends on their ultimate rationale, that is, whether they are mandatory retirement savings or just mandatory savings. If their

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<sup>118</sup>Social Security Act §207(a).

<sup>119</sup>I.R.C. §401(a)(13).

<sup>120</sup>Anti-alienation provisions are usually effective against creditors with state law claims but some issues remain under other federal laws. In the private pension system, for example, the effectiveness of these provisions under federal bankruptcy law has recently been in dispute. The Supreme Court has recently held that if a plan or an IRA contains such a provision under ERISA its assets are not included in the bankruptcy estate. See *Patterson v. Shumate*, 504 U.S. 753 (1992). But many plans are not subject to ERISA but are required to contain such a provision under the Tax Code. So there is still an open question as to the effective of such provisions in bankruptcy.

fundamental purpose is to provide income for retirement, then it is fair to extend to them the benefits of an anti-alienation clause. Under this standard, IAs would certainly qualify. It is more difficult, however, to make a case for PSAs. As discussed more fully in Section V.B above, it is not so clear that PSAs are dedicated to producing retirement income because there is no requirement that PSAs assets be distributed during retirement. Under these circumstances, it is hard to argue that PSAs should be given greater protection from creditors than is presently available to banking or brokerage accounts.

### **Conclusion**

Using the private pension plan system as a model, this paper has analyzed three recent proposals for Social Security reform from the perspective of distributions. It has focused in particular on two proposals which advocate adding a second tier of benefits through the introduction of individual defined contribution accounts. It has also discussed the role of individual choice, control and risk inherent in such accounts as well as their proposed structure for distributions. It has found that such accounts are theoretically simple concepts which often require complex systems of implementation and has raised some questions regarding the appropriate structure for those accounts and the role to be played by the private sector.