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## Is Social Security Unsociable to Annuities?

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By Kerry Pechter      Thu, May 8, 2014

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*Virtually all American retirees already own a pension that's more generous than any retail annuity could ever be: their Social Security benefits. But how much does the entitlement "crowd out" demand for retail annuities? The answers may surprise you.*

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If Uncle Sam began making and selling an inexpensive national automobile—a people's car analogous to the minimalist Volkswagen beetle of the 1930s—would it “crowd-out” demand for privately manufactured automobiles?

The logical answer might be: Sure, but only among people who drive the cheapest, most basic privately-manufactured cars; people who drive luxury cars like a Lexus, Cadillac or BMW wouldn't be affected at all.

Here's a related question: Does the availability of Social Security benefits displace or “crowd out” the demand for individual income annuities among U.S. retirees?

On the one hand, the Boomer retirement wave has clearly stoked demand for retail guaranteed income products. Annual sales of income annuities (immediate and deferred) breached the \$10 billion barrier for the first time in 2013. Sales of fixed indexed annuities with living benefit riders also boomed last year.

But while interest in annuities is seasoning slowly, like hickory-smoked barbecue, interest in Social Security has suddenly caught fire. Advisers and their clients are talking about “claiming strategies,” and using new-fangled calculators to “optimize” their benefits. Experts like Alicia Munnell at the Center for Retirement Research at Boston College have recommended “buying an annuity from Social Security” by delaying benefits until age 70 and living on other savings in the meantime. (Today's low risk-free interest rates and high Social Security deferral “credits” are helping create an arbitrage opportunity, in a sense.)

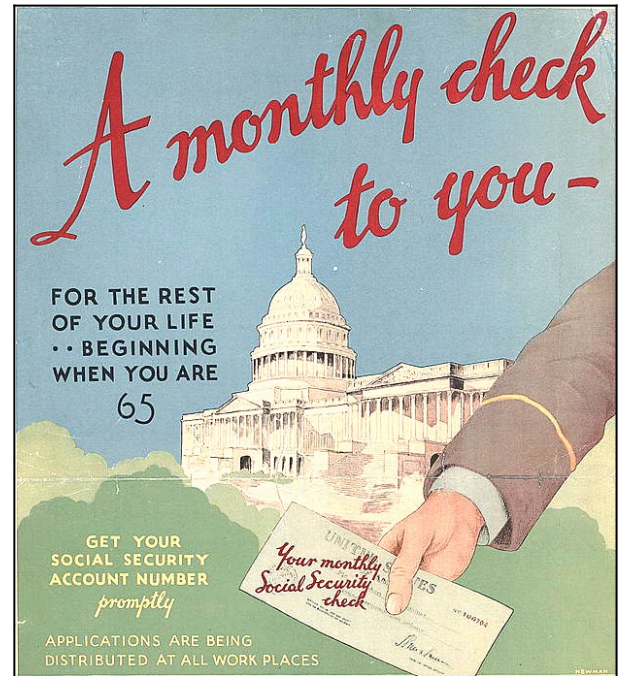
The Social Security crowd-out question has no single or simple answer. Lots of factors impinge on demand for private annuities besides Social Security. But it seems safe to say that annuity issuers who want to forecast the potential market for guaranteed income, as well as policymakers who are trying to decide how best to alter Social Security, should all be wondering to what extent our public and private sources of retirement income work in concert—or compete.

### **Yes and no**

The short answer to the crowd-out question is “Yes, but not entirely.” The longer and unsurprising answer is, “It depends.” It depends partly on whether you're emphasizing Social Security's relative “replacement rate” or the absolute size of the benefits.

Social Security replaces more of the pre-retirement income of middle and low-income workers than of high-income workers. In that sense, like income tax rates, it's “progressive.” Depending on the yardstick you use, Social Security, when claimed at the full retirement age, replaces 57-65% of a low-income worker's pre-retirement income, 42-48% of a middle-income worker's pre-retirement income, and 35-40% of the

income of a worker at the top of the Social Security wage scale, according to the Center for Retirement Research at Boston College. Conventional wisdom calls for a 70% to 80% income replacement rate in retirement, so Social Security fulfills at least half of that.



You might conclude that Social Security satisfies most of the average person's need for so-called income flooring in retirement, just as the pre-war VW bug fulfilled the average person's vehicle needs. But what about the many advisors' clients who earn much more than the FICA limit (\$117,000 in 2014)? For workers accustomed to grossing \$20,000 to \$50,000 per month, and expecting to need 80% in retirement (\$16,000 to \$40,000 per month), Social Security income might replace only part of their need for safe income. The amount would depend on perceived need, debt load or risk tolerance.

"There's no question that the presence of Social Security crowds out some of the demand for private annuities that would exist in the absence of Social Security. But the replacement levels are sufficiently low that it shouldn't completely crowd out private annuities, especially for people in the upper and even the middle part of the income distribution," said Jeff Brown, a University of Illinois economist.

"Public social security (SS) systems, providing mandatory annuitized benefits, crowd out private markets," wrote Israeli economist Eytan Sheshinski in his 2007 book, *The Economic Theory of Annuities*. "However, the SS system in the United States provides *replacement rates* (the ratio of retirement benefits to income prior to retirement) between 35% and 50%, depending on income (higher rates for lower incomes). This should still leave a substantial demand for private annuities."

### **Present value of Social Security**

But if you ignore the replacement percentages and focus on two other numbers—the maximum benefits under Social Security and the estimated present value of those benefits—it's hard to imagine anyone

needing more annuitized wealth than can be gotten from Social Security.

For instance, a middle-class couple, claiming at ages 64 and 70, might easily receive \$4,000 in monthly Social Security benefits, or \$48,000 a year before taxes and Medicare B premiums. As a retail joint-life annuity, even without inflation protection, that income stream would be worth about \$800,000, according to [immediateannuities.com](http://immediateannuities.com). If that's equal to or greater than the couple's total household wealth, do they really need to annuitize more?

That's how an economist or an advisor who looks at the entire "household balance sheet," might see it. "I'm not sure I would use the phrase 'crowd out,' to describe Social Security's effect on demand for guaranteed income," said Moshe Milevsky, the York University finance professor who writes, consults and teaches retirement finance.

"But I certainly agree that many Americans are over-annuitized because Social Security is such a large portion of their income and balance sheet, and it's hard for the private sector to offer a *real* inflation-indexed annuity at the same prices."

Other economists who have studied and written about retirement finance for many years suggested in a recent paper that Social Security is probably why most middle-class households don't buy retail annuities.

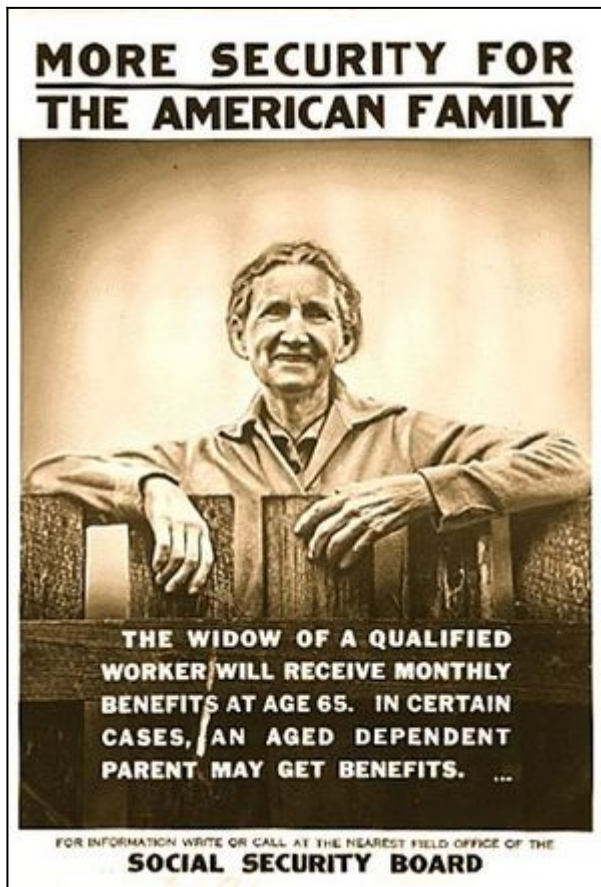
"Old age insurance benefits from Social Security are the major source of retirement income for most retired households," wrote Raimond Maurer of Goethe University in Frankfurt, one of three authors of a paper published in the March issue of *Review of Finance*. They found the Social Security spousal benefit to be generous; Germany's old age pension offers no such feature, Maurer told *RJJ*. In Maurer's description, Social Security in the U.S. sounds less like a pre-war Beetle and more like a 2014 Audi.

"In practice, [Social Security] benefits... which are comparable to a joint and survivor annuity, are well balanced for a couple and provide relatively generous survivor benefits in the range of one-half to two-thirds of the previous income. ... For retired couples with moderate financial wealth, purchasing additional annuities in the private market only provides marginal welfare gains. This might explain why so few households participate in the private annuity market and therefore—at least in part—the annuity puzzle," the German economists wrote.

### **Like a nice restaurant**

Some believe that the availability of Social Security crowds out private annuities in another way—by making them more expensive. "The equilibrium price of annuities is about 14% more than it would have been otherwise in the absence of Social Security," writes Arizona State University economist Roozbeh Hosseini in a paper published on March 20.

In his view, Social Security drives up the cost of private annuities by worsening the effect of "adverse selection"—the tendency for healthier, longer-lived people to buy private annuities. Because Social Security is mandatory, Hosseini writes, and requires all American workers, regardless of health status or life expectancy, to participate, it reduces its own vulnerability to adverse selection.



But by satisfying the need for guaranteed income among less healthy (and often lower-income; unfortunately the two go together) people, it only shifts that problem to the private annuity market, he claims. "In the presence of Social Security, 47% of the population (those with higher mortality) are not active in the market. These individuals get more annuitization than they need from Social Security.

"On the other hand, individuals with lower than average mortality, expecting longer life spans, accumulate more assets and have higher demand for annuities. These individuals purchase annuities in the market. However, since higher mortality types (good risk types) are not in the market, the equilibrium price of annuities is about 14% percent higher than it would have otherwise been in the absence of Social Security."

Not everyone agrees, at least not entirely. "Perhaps those 'low life expectancy retirees' would decide *not* to buy an annuity," Milevsky told RIJ. For them, voluntary private annuities are, on average, even more expensive than they are for people with high life expectancies. Even without considering the possible effect of Social Security, retirement experts like Wade Pfau of The American College, and George A. (Sandy) Mackenzie, editor of *The Journal of Retirement*, have estimated the implicit load on private income annuities to be 10% to 15%, thanks to costs and adverse selection.

(That's not a reason to avoid income annuities, Mackenzie wrote in his 2006 book, *Annuity Markets and Pension Reform*. Just as relatively expensive fire insurance is still much cheaper than the cost of replacing a burnt-down house, even an expensive life annuity is still much cheaper than self-insuring against

longevity risk.)

Social Security is “clearly a substitute” for private annuities, and therefore crowds them out, says economist Eugene Steuerle, a senior fellow at the Urban Institute. But Social Security has also stimulated demand for private annuities, he believes.

More so than defined benefit pensions, Social Security created the modern concept of retirement for middle-class Americans, Steuerle told *RIJ*. Before Social Security, millions of people reached age 65 with nothing in the bank, so they kept working. Social Security enabled them to retire. The larger supply of retirees naturally generated more demand for additional sources of retirement income, such as private annuities.

“It’s like what happens when a restaurant opens in a nice neighborhood without restaurants. Other new restaurants follow, and they benefit from each other,” Steuerle told *RIJ* this week. At the same time, the growth of retirement savings in 401(k) plans and rollover IRAs has given millions of people the wherewithal to buy additional income. And while only 10% or 20% of them might actually buy annuities, “Twenty percent of a big pile is more than 20% of a small pile,” he added.

### **DB pensions leave a vacuum**

What will happen when defined benefit pensions finally disappear, and no one enters retirement with a DB annuity? Will people buy private annuities to supplement Social Security instead? Annuity manufacturers may hope so, but the market dynamics are not so simple.

For people who have DB pensions, familiarity with guaranteed income evidently tends to foster demand for more. “Our research suggests that the presence of guaranteed income creates demand rather than suppresses it,” said Ross Goldstein, a New York Life managing director, told *RIJ*.

New York Life, the leading seller of income annuities, paid out more than \$1 billion to about 129,000 contract owners in 2013. The average monthly payment was \$682, with 60% receiving under \$500 a month, 24% receiving \$500 to \$1,000 a month, and 16% receiving over \$1,000. About half the \$1 billion went to people ages 80 and older, over 30% to people ages 70 to 79 and nearly 20% to people ages 65 to 69. “It looks a lot like the distribution of income in the United States,” Goldstein said.

As an example of a typical prospect, Goldstein suggested a couple with \$500,000 in savings and \$40,000 in Social Security and/or pensions, who might boost their guaranteed income to \$45,000 or \$50,000 a year buying an income annuity with a chunk of savings. The move would reduce principal, but in a single, deliberate coup. It would also reduce the future temptation or need for piecemeal or panicky withdrawals from the remainder.

The disappearance of DB pensions could open up demand for retail annuities. But it would also reduce the number of people who have first-hand knowledge of the rewards of guaranteed income, Goldstein suggested. Most 401(k) participants will need to be taught to think of turning their savings into annuities, an educational process that has barely begun.

Even if the absence of DB pensions does inspire the public to buy retail annuities—an idea that annuity marketers constantly pitch—the substitution rate “won’t be dollar for dollar,” Brown told *RIJ*. Steuerle agreed. “The decline of DB pensions might help but it won’t be a one-to-one substitution,” he said in an interview.

That leaves the ultimate question: What happens if Social Security benefits shrink, either through means-testing, or less generous indexing, or in terms of replacement ratios, as a result of declining payroll tax revenue? Will that compel millions of people to convert at least part of their IRA or 401(k) money to retail or institutional annuities? Annuity manufacturers are praying for just such an outcome.

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