

Lifetime Annuities for US: Evaluating the Efficacy of Policy Interventions in Life Annuity Markets

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Executive Summary

Low personal savings rates coupled with an ongoing shift of the retirement planning landscape from traditional pension plans to retirement plans based on personal accounts have raised significant concerns about the adequacy of the retirement system for Baby Boomers and future generations. In the past, public policy has focused on creating and expanding 401(k) and IRA plans that encourage workers to increase their retirement savings. Another crucial consideration for ensuring the adequacy of retirement funds is the disposition of that savings upon retirement. Economists have long appreciated the important role that life annuities have to play at this stage. Unfortunately, they have also noted a disturbing paucity of participation in annuity markets [what experts call the “annuity puzzle”], a paucity that has the potential to seriously undermine the well-being of future retirees as they reach advanced ages. Particularly since the government implicitly serves as a provider of last resort for the elderly, it may be desirable for public policy to encourage the increased utilization of these important markets. To this end, several new policy initiatives have proposed targeted incentives designed to increase annuitization.

This paper discusses general issues in designing policies to encourage annuitization and analyzes one existing proposal, the Lifetime Pension Annuity for You Act of 2005 (H.R. 2951 introduced by Representative Earl Pomeroy on June 16, 2005) (Similar proposals include the Retirement Security for Life Act of 2005 (S .381 and H.R. 819) introduced on February 15, 2005

by Senators Gordon Smith and Kent Conrad and Representative Nancy Johnson.). Depending on the source of funds used to purchase the annuity, this proposal would exempt either 25% or 50% of annuity income from taxation, up to \$5000 for individuals or \$10,000 for couples. Using “dynamic programming” techniques taken from the economics literature and a representative distribution of retired households taken from the Health and Retirement Survey, this paper analyzes the impact of this act on annuitization behavior of households with different levels of retirement preparedness as well as the revenue consequences of introducing it. The main findings suggest that:

- (1) The act would reduce insurance loads in annuity markets by as much as 8 percentage points.
- (2) The act would increase annuitization levels by an estimated average of approximately \$50,000 per retired household.
- (3) The increase in annuitization would occur at modest revenue costs, on the order of 10-15 cents per dollar of additional annuitization.

The analysis shows that existing proposals similar to Lifetime Pension Annuity for You Act of 2005 can substantially increase annuitization for retirees with income tax liability and sufficient assets to annuitize. These proposals can help to develop annuity markets and promote a desirable behavioral response among households. However, lower income retirees with no income tax liability may benefit from another type of proposal such as a refundable tax credit (RTC). A RTC could provide a strong incentive to annuitize for retirees who have little or no taxable income. Our results suggest that both approaches have merit and that both may be needed in order to achieve politically attractive solutions to encourage greater use of annuities, especially immediate annuities. For example, a RTC could be added to the Lifetime PAY proposal.