

Study Suggests Lump-sums Would Reduce Social Security Liability

February 19, 2008 (PLANSPPONSOR.com) – A new study released by the National Bureau of Economic Research (NBER) reports that most respondents to an experimental module in the 2004 Health and Retirement Study (HRS) indicated a preference for exchanging Social Security's lifelong annuity payment for a lump-sum payment combined with a reduced annuity benefit.

According to the NBER study authors, this was the finding across virtually every demographic subgroup in the sample. The authors claim the findings mean most individuals do not appear to value annuities as highly as standard economic models would suggest and do not perceive compulsory annuitization as welfare-enhancing as standard life cycle theory suggests.

If these indications are true, the authors say it suggests that one potentially feasible path to reducing the long-term liabilities facing the U.S. Social Security system would be to allow individuals to voluntarily convert part of their Social Security annuity to a lump-sum at less-than-actuarially favorable rates. "Even in the presence of (mild) adverse selection, our results suggest that such a voluntary approach could reduce net liabilities of the Social Security system," the NBER paper says.

The authors said specific findings negate theories on why some groups of individuals are particularly averse to annuities. People in the early 60's preferred the annuity benefit more highly than younger workers; those in poor health or with worse-than-average survival expectations were significantly more likely to prefer the lump-sum; and more highly-educated individuals preferred the lump-sum.

In addition, the authors said, conditional on education, more financially sophisticated individuals preferred to annuitize. Factors that had limited or no influence over the annuity versus lump-sum choice, despite the prominent role played by some of these variables in theoretical models, included risk aversion, sex, marital status, income, wealth, having a pension plan, and having children.

The authors noted that individuals who place a higher probability on the outcome that future Social Security benefits will be cut were more likely to choose the lump-sum option, suggesting that individuals do discount future benefits for political risk.

The NBER paper suggests the findings of the responses of 1,000 HRS participants included in the 2004 experimental module cast doubt on three leading hypotheses regarding individual preference for annuities:

- The fact that a majority of individuals prefer the lump-sum even when the annuity is actuarially-fairly priced suggests that the presence of high loads in the private market is not the primary cause of limited annuitization.
- The fact that individuals prefer the lump-sum even though the Social Security annuity is annually indexed for inflation, suggests that the lack of inflation-protection in the private annuity market is not the primary culprit of limited annuitization.
- Because individuals were (hypothetically) giving up half of their Social Security in order to gain access to the lump-sum, leaving them with only \$6,000 per year in annuity income, suggests that high levels of pre-existing annuitization is not the primary driver of limited annuity demand.

The NBER paper is "Who Values the Social Security Annuity? New Evidence on the Annuity Puzzle," by Jeffrey R. Brown, Marcus D. Casey, and Olivia S. Mitchell.