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WHO NEEDS MORE STEADY INCOME IN RETIREMENT--AND WHAT COULD BE DONE ABOUT IT?

On June 10, MRRC researcher Olivia S. Mitchell participated in a conference at the National Press Club sponsored by the Retirement Security Project. The conference topic was "The Automatic Revolution: Changing How America Saves." Dr. Mitchell's presentation focused on retirement system payouts and was titled "Who Needs More Steady Retirement Income and What Could Be Done About It?"

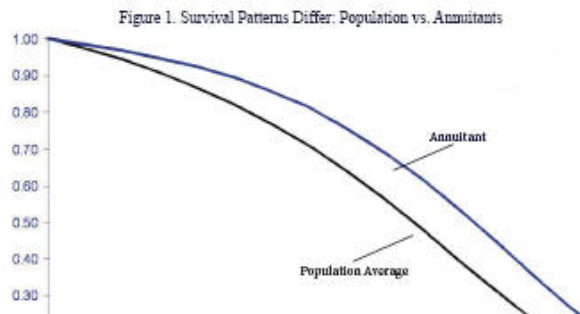
She began by offering the definition of a payout annuity as a mechanism for converting a lump sum of money into periodic payments that can last a specified period of time or until death.

Annuities help to protect individuals against the possibility of outliving their retirement assets. They may be especially valuable to risk-averse retirees who have a high degree of uncertainty about their longevity.

The value of annuities depends on a host of factors. In weighing the potential value of annuitizing, the individual must weigh the cost of the premium against her expected longevity. She must consider her need and/or desire for larger amounts of cash on hand in or to be able, for example, to leave a bequest or to pay for long-term care. Other considerations include her other wealth holdings as well as the tax status of the annuity benefits.

Given all of the potential benefits of annuities, it is somewhat puzzling that rates of private annuitization in the US are so low. Dr. Mitchell suggested that there are reasons for policymakers to be concerned about this, but also reasons that it may not be so worrisome. For example, Social Security benefits represent more than half of overall retirement income for the majority of the retired population. Perhaps these resources are adequate for retirement consumption. Also, home ownership is widespread and represents de facto annuitized consumption. Medicare and Medicaid cover most of retiree medical costs. Lastly, it seems that many people have a desire to keep their assets liquid.

On the other hand, policymakers should be concerned about low rates of annuitization, in that looming Social Security and Medicare/Medicaid insolvency could undermine these systems' ability to make good on future retirement promises. Home values are in decline and reverse mortgages, as a means of annuitizing housing wealth, are not widely utilized. In addition, there are issues within the insurance market. Annuity products are complex and hard for people to understand. For those who do take advantage of these products, there is the potential for adverse selection. Indeed, Figure 1 shows that those who do purchase annuities are likely to be much longer-lived than those who do not.



Finally, Mitchell acknowledged that there is a problem with poor information. International research shows that many people have difficulty making a good guess at their own survival probabilities. Even those who are in their 60s make bad estimates overall. Men at this age underestimate their life expectancy by an average of 2.83 years, women by 4.62 years.

So what is the practical upshot? To be attractive to potential buyers, annuity products must be designed to:

1. Permit partial annuitization. This would allow additional liquidity for those needing home care or long-term care or for those who desire to leave a bequest;
2. Be tax sensible. Currently, taxes on annuity benefits rise once the retiree exceeds her life expectancy, which is unlikely to be a good time to raise her tax rates;
3. Integrate with means-tested benefits. For instance, people with steady incomes – even if they are low – during retirement may have a harder time qualifying for Medicaid and subsidized Medicare Part D benefits;
4. Permit a retiree facing a severe health shock to scale up the benefits to cover in-home or long-term care.

In summary, according to Dr. Mitchell, there is much more work to be done to better understand the process of annuitization in the US, and much more that could be done to educate the public about the potential benefits and pitfalls of protection against outliving one's resources. Related to the latter, there is beginning to be discussion about whether federal insurance regulation of annuity providers would meet consumer needs better than the current piece-meal state-level regulation. A review of the international annuity scene suggests that the US annuity market may be behind the curve. For instance, in the UK and Germany, mandatory deferred annuitization is required (by age 75 and 85, respectively), and Singapore has recently announced it will implement mandatory deferred annuity as well. And Chile and Mexico have devised an on-line bidding process for retirees to get competitive bids for lifetime payout products.

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