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Ways and Means Committee, Subcommittee on Social Security
Administrative Issues with Individual Accounts in Social Security

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Chairman McCrery, Ranking Member Levin, and members of the Subcommittee, thank you for this opportunity to testify on behalf of the National Women's Law Center.

My testimony will focus on the administrative and implementation issues that would arise at the point that money is to be paid out of private accounts created as part of Social Security. So far, most of the discussion of administrative issues has focused on how a new system of accounts would be created, how money would get into the accounts, and how investments during the working years would be managed. Far less attention has been paid to questions of how, if, and when money would be paid out from accounts to workers and their family members.¹

The administrative issues that arise at the payout phase are critically important. If private accounts are supposed to make up for reductions in Social Security benefits that now provide basic income security for tens of millions of Americans and their families, a key question is, how can the proceeds of an individual account be converted into a secure, equitable, and adequate source of income for workers—and their spouses and children—when workers retire, die, or are disabled?

My testimony first discusses some of the issues that arise with payouts at retirement to an individual worker, then moves to some of the even more complex issues that arise because Social Security is a family insurance plan, not just a worker retirement program.² The questions raised are difficult, and the tradeoffs presented are inevitable and painful, because an individual account simply cannot substitute for the range of insurance protections that it is possible to provide for workers and their families through Social Security.

¹ This testimony is informed by my work as a member of the expert study panel convened by the National Academy of Social Insurance to examine issues relating to the payment of benefits from individual accounts, two years of discussion with the thoughtful and knowledgeable experts on the panel and the NASI staff, and the report issued by the panel earlier this year: Reno, Graetz, Apfel, Lavery and Hill, eds, National Academy of Social Insurance, *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy* (2005) [*Uncharted Waters*]. However, I am testifying today solely on behalf of the National Women's Law Center.

² For more information about the family insurance benefits that Social Security provides, and their special importance to women, see Testimony of Nancy Duff Campbell, Co-President, National Women's Law Center, to the Subcommittee on Social Security, Committee on Ways and Means (May 17, 2005) [*Campbell Testimony*].

There may be a temptation to think that resolving these issues can wait, because the retirement of workers who establish an account would be several years away. But that would be a serious mistake. Workers will need to know what the payout rules are before they can make a decision about whether or not to contribute to a private account. Well before they reach retirement age, some workers will divorce, some will become disabled, some will want access to the funds in “their” accounts, and some will die—all events that require decisions about payouts from private accounts, decisions that will have serious consequences for the wellbeing of Americans who rely on the safety net that Social Security provides for them and their families.

How Will Private Accounts Provide Secure Lifetime Income to Individuals When They Retire?

When a worker retires, dies, or becomes disabled, Social Security provides the worker and eligible family members with benefits that cannot be outlived, are adjusted annually for inflation, and do not fluctuate with the financial markets. In contrast, private accounts represent a limited pool of assets; retirees will face the challenge of deciding how to manage whatever they may have accumulated in an account to provide for their own retirement security, possibly for the financial security of a spouse or children, and for other goals. Administrative issues and financial risks do not end when a worker reaches retirement age. Retirees must make decisions in the face of multiple uncertainties: how long they or a spouse might live, how much prices will rise, and how the financial markets will perform.

The challenges of managing private savings throughout retirement are not limited to accounts created within Social Security. But the stakes are higher—and the issues more complex—if private accounts are being relied upon to help make up for reductions in the basic income that Social Security provides to workers and their families.

- *How will workers be protected against outliving the assets in a private account?*

With a plan that cuts Social Security benefits and relies on private accounts to provide basic income security to retirees for the rest of their lives, Congress will have to decide whether, when, and to what extent to require workers to purchase a life annuity to insure against the risk of outliving the assets in the account and becoming impoverished in old age. Alternatives to life annuities have been suggested as a way of preventing workers from exhausting their accounts too quickly, such as taking phased withdrawals over the period of their projected life expectancy. However, phased withdrawals do not provide the assurance of lifetime income; indeed, as the Congressional Research Service notes, on average, about 50 percent of those opting for phased withdrawals will live longer than expected and exhaust the funds in an individual account.³ Making the purchase of a life annuity mandatory, at least to assure income up to some specified level, would reduce income insecurity; broaden the annuity pool and increase annuity payments on average; and reduce marketing expenses.⁴

³ Laura Haltzel, Congressional Research Service Report, *Social Security Reform: President Bush's Individual Accounts Proposal* 7 (April 25, 2005).

⁴ See *Uncharted Waters*.

But requiring the purchase of an annuity poses tradeoffs. An annuity requires payment up front; once it is purchased, the assets used to buy it are no longer available. An annuitization requirement would reduce the risk of outliving assets, but also would reduce the control and choice workers could exercise over the accounts. An annuitization requirement also could eliminate the possibility of a bequest; the Bush Administration estimates that under its plan, 15 percent of all retirees and 30 percent of retirees with lower lifetime incomes would have to spend all the assets in their accounts to bring the combination of reduced Social Security benefits and payments from the account up to the poverty level for their lifetimes, leaving nothing in their accounts for discretionary spending or a bequest.⁵

- *Will discrimination on the basis of gender be prohibited in annuities purchased from private accounts?*

Social Security pays monthly benefits on a gender-neutral basis. In contrast, in the private annuity market, if a man and woman purchase a life annuity with the same amount of money at the same time, the woman will get lower monthly payments for life.

Federal law already bans differential pricing and benefits in group annuities or pensions that are part of an employment relationship.⁶ If Congress creates private accounts as part of Social Security, it must prohibit gender discrimination in annuities marketed to those with private accounts. An effective prohibition on discrimination will require more than passing legislation; regulatory oversight be needed to avoid the design and marketing of annuity products specifically to men or women to avoid the effect of the uniform pricing requirement.⁷

- *How will annuities from private accounts provide protection against inflation?*

Social Security provides payments for life that are adjusted annually to keep up with increases in the cost of living. No private annuities currently offer full protection against inflation, and experts believe they are unlikely to evolve without the substantial involvement of the federal government, even if the market for private annuities expanded with the establishment of private accounts.⁸

- *How will workers be assured that annuity payments from a private company will continue for life?*

A person who purchases a life annuity pays the price up front, in exchange for a contractual promise to make payments for the life of the purchaser (and survivor, in the case of a joint and survivor annuity). The purchaser counts on the company providing the annuity to make good on the promised payments for years to come.

⁵ Associated Press, "Survivor Benefits Face Cut, Official Says," (May 12, 2005).

⁶ See, e.g., *City of Los Angeles Department of Power and Water v. Manhart*, 435 U.S. 702 (1978).

⁷ See *Uncharted Waters* at 78-80.

⁸ See *Uncharted Waters* at 85-86.

Today, life annuities are provided by life insurance companies that are regulated by the states. States are responsible for setting solvency standards, monitoring compliance with those standards, and providing some protection in case an insurance company defaults. Every state has a “guaranty fund” to deal with defaults—but unlike the Federal Deposit Insurance Corporation, which ensures bank deposits, or the Pension Benefit Guaranty Corporation, which ensures defined benefit pensions, state guaranty funds are not pre-funded at all.⁹ In the event of a default, states make assessments against other companies doing business in the state. States also make their own rules about who is protected, and to what extent, by the state guaranty.¹⁰ For example, a retiree who purchases an annuity from a company doing business in state A, then moves to State B, may not be entitled to payments from State A’s guaranty fund if the company defaults.¹¹ The risk that a large insurance company will default is not hypothetical, as the case of the Executive Life Insurance Company of California and its New York subsidiary shows; as this case also shows, policy holders may suffer substantial losses in case of default.¹²

If Congress creates private accounts that are designed to replace Social Security income, the federal government will have to intervene in the annuities market, and probably act as guarantor, to make sure that Americans get the payments they are counting on. But Social Security already provides annuities that are adjusted for inflation, nondiscriminatory, and secure; it would be far more efficient and effective simply to protect and strengthen Social Security.

- *When will retirees be required to purchase the annuity?*

Investment risk does not end when a worker has stopped contributing to an account is ready to start drawing retirement income. Indeed, converting account assets to a life annuity magnifies market risk. The lifetime income that an annuity provides will be determined by the value of the assets and interest rates at the moment of conversion—and these can fluctuate greatly over short periods of time. The drop in the stock market and interest rates between 2000 and 2003 meant that a retiree purchasing an annuity in 2003 would have 60 percent less income than a retiree who purchased an annuity in 2000—after a lifetime of making similar contributions and investment choices.¹³

These market fluctuations are a source of concern—and hardship—for workers in or near retirement who look to their IRAs or 401(k)s to supplement their Social Security benefits during a market downturn. When private accounts are expected to replace part of the basic income provided by social insurance system, the risks are even greater.

In Chile, interest rates fell dramatically in 1996 and 1997, greatly reducing the lifetime payments workers would get from their accounts. Under Chile’s partially privatized system, which requires workers to annuitize their accounts when they claim retirement benefits, workers who had

⁹ *Id.* at 76-82.

¹⁰ *Ibid.*

¹¹ *Ibid.*

¹² *Ibid.*

¹³ Calculations by Gary Burtless, Senior Fellow, Brookings Institution, quoted in Julie Kosterlitz, “Cracking the Nest Egg,” *National Journal* (April 22, 2005).

planned to retire—some of whom had already been pushed out of their jobs when they reached retirement age—were simply told, “Don’t.”¹⁴ In the United Kingdom, protests by workers who were required to buy annuities under the UK’s partially privatized system at a time when interest rates (and thus annuity payments) were down led the government, in 1994, to allow workers to defer their annuity purchase until age 75.¹⁵ But many workers don’t have sufficient other resources to meet their needs while they wait for market conditions to improve. And there is no guarantee of improvements in the short term; indeed, in 1999, *The Financial Times* reported that the income obtainable from a private account had dropped 16 percent in the course of a year.¹⁶

Giving workers flexibility in the timing of an annuity purchase raises new issues and administrative challenges; indeed, an extended time frame could essentially negate an annuitization requirement. Many workers would be unable to get by on their greatly reduced Social Security benefits while they wait for market conditions to improve; but, if they are allowed to start withdrawing assets from the accounts while they wait to annuitize, there will be less left in the account to assure lifetime income for workers and their spouses.

Deciding when to annuitize carries lifetime financial implications; to take advantage of the added flexibility, workers will need additional financial counseling (not that investment counselors are necessarily successful at predicting short-term changes in asset values and interest rates). Gradual annuity purchases could spread the risk of interest rate fluctuations over a longer period—but would not eliminate the risk, and would add to administrative costs and make payment levels uncertain.¹⁷

Workers deciding when to annuitize could be subject to conflicting family pressures: children and other possible heirs may seek to delay the purchase of an annuity which would leave little or nothing for them to inherit; a spouse concerned about the depletion of assets may prefer the purchase of a joint and survivor annuity. And workers with lower-than-average life expectancies would probably seek to delay the purchase of an annuity as long as possible; life annuities are not a good deal for people with shorter life expectancies. But if individuals with shorter life expectancies can effectively opt out of the annuity pool by delaying the purchase of an annuity for years, those who purchase annuities can expect lower payments.

How Will Private Accounts Help Make Up for Cuts in the Family Insurance Benefits that Social Security Provides?

The various family insurance benefits that Social Security provides, and their importance—especially to women and their families—are described in the May 17, 2005 testimony to this Subcommittee by Nancy Duff Campbell, Co-President of the National Women’s Law Center. Her testimony also explains why private accounts cannot match the benefits that Social Security provides not just for retired workers, but for workers if they are disabled, and for the spouses and children of workers when workers retire, die, or are disabled.

¹⁴ *Ibid.*

¹⁵ *Ibid.*

¹⁶ *Ibid.*

¹⁷ *Uncharted Waters* at 70.

The best way to protect the safety net that Social Security provides for women and their families is to reject plans that would create private accounts out of Social Security, and work instead to strengthen and improve Social Security.

However, if this Subcommittee is considering private accounts plans, it must consider how the rules governing the payouts from private accounts might mitigate—or exacerbate—the harm to family members and disabled workers from the plan’s cuts to Social Security benefits—even though it will be impossible to protect them fully.

- *Will married workers be required to purchase a joint and survivor annuity?*

Social Security assures the spouse of a retired worker a benefit equal to 50 percent of the worker’s benefit; it assures the surviving spouse a benefit of 100 percent, assuming both spouses retire at full retirement age. Divorced spouses and divorced surviving spouses, if married to the worker for at least ten years, are entitled to the same benefits as current spouses. Social Security spousal benefits are paid in addition to the worker’s benefit; they do not reduce the benefit that the worker, or the current spouse (or ex-spouse) of the worker receives.

Because Social Security spousal benefits are calculated based on the worker’s Social Security benefit, cuts in Social Security benefits for retired workers mean cuts in spousal benefits as well. Private accounts plans may cut spousal benefits twice: first, as part of a general benefit reduction applicable whether or not a worker has chosen to contribute to a private account (even if these cuts are designed to exempt workers with very low earnings, widows with very low income may face benefit cuts, because their benefits are based on the record of a worker who had earnings above the minimum level). Second, if a plan cuts benefits specifically for workers who contribute to a private account, benefits for the retired spouse and widow of a worker who contributes to an account are also likely to be cut further.¹⁸

In view of the importance of spousal benefits to women, now and in the future, it is disturbing that the Administration has so far failed to say whether its private accounts plan would require married workers to purchase a joint and survivor annuity to help make up for reductions in Social Security spousal benefits. Without such a requirement, a married worker (call him Michael) could convert all the assets in his account to a single life annuity, leaving his widow (call her Sarah) with nothing from the account: no household income from his annuity payments, no survivor payments for herself, and no inheritance. Yet she may be facing a deep reduction in her Social Security benefits specifically because Michael contributed to a private account.¹⁹

In addition to deciding whether to require the purchase of joint and survivor annuities, Congress also must decide their size and form. What percentage of the payment to the annuity purchaser should be required to be provided for a surviving spouse: 50, 67, 75 or 100 percent? A higher survivor benefit means more income security for the widowed spouse—but lower payments

¹⁸ See *Uncharted Waters* at 174; no private accounts plan with an offset applied it only to the accountholder’s benefit.

¹⁹ For a further discussion of how annuitization choices could affect benefits for a couple, see Campbell Testimony.

when both are alive. If the spouse is several years younger, payments during the life of the annuity purchaser would be lower still.

Requiring survivor annuities will provide additional protection to surviving spouses, but they cannot respond to changes in marital status as Social Security can. Someone who enters retirement as a single individual, purchases a single life annuity, then marries, cannot change it to a joint and survivor annuity. Someone who is widowed or divorced shortly after retirement cannot change a joint and survivor annuity to a single life annuity with higher payments. And whether one is widowed right before or after annuitization could make a big difference in what the widowed individual receives.²⁰

- *Will waivers of the right to a joint and survivor annuity be permitted?*

There is no procedure in Social Security for a spouse, surviving spouse, or divorced spouse to waive the right to spousal benefits. Nor is there any need for such a waiver procedure; because the payment of spousal benefits in Social Security does not reduce benefits for the worker or current spouse, the issue does not arise.

Federal law requires that, in defined-benefit pension plans, the default pension payment to a married worker must be in the form of a joint and at least 50 percent survivor annuity, unless the spouse consents, in writing and before a notary, to a less generous or no survivor annuity.

In the context of retirement plans that are designed to provide tiers of income on top of the basic Social Security benefit, allowing for informed waivers of the right to a joint-and-survivor payment balances the competing goals of protecting the rights and needs of spouses and giving couples flexibility to make the financial arrangements that best meet their goals. The spouse with the right to a survivor payment may have other financial resources available, or both spouses may prefer to receive higher income when both are alive, even at the risk that the surviving spouse will only have Social Security to rely on.

However, in the context of a plan that cuts basic Social Security benefits, waivers would raise more difficult issues. The benefit cuts under some proposals could leave many workers with retirement income far below scheduled benefit levels, even if they maximized the payments from a private account by purchasing a single life annuity.²¹ Providing a survivor annuity for a spouse would reduce the worker's benefits even further. Workers might pressure their spouses to waive the survivor benefit; even without undue pressure, some spouses might waive their right to a survivor benefit to ensure a modest income for the couple now—and worry about the future later. If waivers are permitted, information about the options and their implications would need to be provided to both spouses, adding to administrative responsibilities and costs.

²⁰ *Uncharted Waters* at 62-66.

²¹ See Campbell Testimony.

- *Will workers be able to leave the account to anyone, or will surviving spouses have the right to inherit?*

The President has said repeatedly that under his plan, workers could leave an account to anyone, never suggesting that a surviving spouse would have the right to inherit. The Administration also has confirmed that its proposal would reduce benefits for widows and surviving children.²² Congress must decide whether a surviving spouse will have a right to inherit account assets, and the nature of that right. Would it apply to all the assets in the account? Could it be waived?

Other questions would arise if a spouse inherits account assets, whether by right or designation. If a worker died young and left the account to his widow, would she have immediate access to whatever small amount the account might contain to help support her family and supplement their reduced survivors' benefits? Or would she have to save them for her own retirement, as several plans propose? With Social Security, a widow is eligible for benefits based on the deceased husband's work record both while she is raising their children and at retirement—but funds in a private account can only be used once.

If account assets went to someone other than a surviving spouse, would those heirs have immediate access to the funds they inherit?

Would children have any inheritance rights in a parent's account, especially if a private accounts plan cuts their survivor benefits? If the children live in a different household than the widowed spouse—a not uncommon situation—how would their interests be balanced? What would happen if a child made a claim after all the assets in an account had been distributed—as could happen, if the deceased parent had not had contact with the child for several years? Would all children have inheritance rights, or only minor children and disabled adult children entitled to benefits on the parent's work record? If the latter, would the child's share be related to the number of years the child would be reliant on reduced survivor benefits, so that a toddler or disabled adult child would be entitled to a greater share of a parent's account than a school age child? These questions highlight the impossibility of expecting a private account to make up for cuts in the life insurance benefits that Social Security provides to surviving spouses, surviving divorced spouses, and children.

If a plan provides that workers must pay back the money they contributed to a private account, with interest, out of a reduction in their Social Security benefits, would the widow inherit this debt along with any assets in the account? If so, would other heirs have the same obligation? Transferring a debt along with account assets would greatly diminish the value of any inheritance; in fact, if the account has done very poorly, the bequest could be a net liability. On the other hand, Social Security's finances will suffer if funds diverted from Social Security to private accounts are not reimbursed by those who benefit from them.

²² Associated Press, "Survivor Benefits Face Cut, Official Says," May 12, 2005.

- *How would accounts be divided at divorce?*

Social Security provides benefits for divorced spouses and divorced surviving spouses who have been married for at least ten years. Benefits for divorced spouses are calculated in the same way as benefits for spouses and surviving spouses, based on the full work history of the higher-earning spouse, not just the earnings during the period of the marriage.

The question of how accounts should be divided at divorce raises fundamental legal questions.²³ If private accounts are considered “property,” they might be subject to state laws concerning marital property—which differ between community property and common law states, and among the states in each group. This would lead to different rights for spouses in community property and common law states, and for couples or individual spouses who move from state to state. Congress could create a uniform system of federal rules governing the division of accounts at divorce and other spousal rights issues—or explicitly certain issues to the operation of state law—but it must explicitly resolve the issue of whether state or federal law will govern.

There are several possible approaches for dividing accounts between spouses.²⁴ One approach would involve contribution splitting during marriage—that is, contributions to accounts made by either spouse during the marriage would be shared equally between the spouses’ accounts. Because contributions would have been shared at the front end, there might be no further division of account assets at divorce. Another approach would divide the assets that accumulated in the accounts during the course of the marriage equally between the spouses. Or this 50-50 division could be the default, but other allocations could be allowed by agreement of the parties or a court order.

If a plan provides that workers must pay back the money they contributed to a private account, with interest, out of a reduction in their Social Security benefits, Congress also must decide if and how the debt, as well as account assets, should be divided at divorce.²⁵

Implementing a system for dividing private accounts at divorce, even one that calls for the automatic 50-50 division of accumulations during the marriage at the time of divorce, will require new reporting, verification, and dispute-resolution mechanisms well beyond those needed to administer the current Social Security system. Social Security needs to review evidence of marriage, marriage duration, and divorce only at the point an individual applies to receive Social Security benefits as a divorced spouse or divorced surviving spouse. Approximately 100,000 new applications for Social Security in 2001 involved evidence of divorce—but that is just one-tenth of the roughly one million divorces that occur each year in the United States.²⁶

Benefits for eligible divorced spouses are based on the full work history of the higher-earning spouse, so Social Security needs no additional information to calculate benefits for an eligible divorced spouse. To divide contributions and accumulations during only the period of the

²³ For an explanation and further discussion, see *Uncharted Waters* at 120-137.

²⁴ Six options are identified in *Uncharted Waters* at 127.

²⁵ See *Uncharted Waters* at 178-179.

²⁶ *Uncharted Waters* at 133.

marriage would require historical records of year-by-year (or quarter-by-quarter) contributions and investment earnings, along with evidence and dates of marriage and divorce.

For the entity administering a system of private accounts to obtain reliable information about marital status is no simple matter; no national registry of marriage and divorce information currently exists.²⁷ Creating such a registry would require new resources and raise new confidentiality issues. Individuals could be asked to report changes to their marital status. But accountholders might fail to report a marriage, because they would prefer that a spouse not receive funds at their expense. Social Security minimizes conflicts and disputes, because the payment of benefits to a divorced spouse does not reduce payments for the worker or his or her current spouse.

Once an account is divided at divorce, the assets are gone. The spouse who is the net loser in the division will have less in an account to supplement reduced retirement benefits or provide for children or a new spouse.

- *What if only one spouse participates in a private account?*

If participation in a private account is voluntary, there will be spouses who have made different decisions with respect to participation. Such differences cannot be eliminated by requiring married couples to make the same choice (and deciding whether participation or nonparticipation is the default if they cannot agree). Many Americans enter the labor force before they get married, and, under some plans, would make an irrevocable choice at that time; new marriages and remarriages would produce additional mismatches.

Conclusion

This testimony raises some important issues about the critical payout phase of a private accounts plan.²⁸ Some of these questions have been raised before—but many still have not been answered by the Administration. Before this Committee considers proposals that would radically change a program on which millions of Americans rely, it must address the fundamental questions: how would an account that fluctuates with the market provide a secure, basic retirement income, and how would an individual account make up for reductions in the family insurance benefits that Social Security provides.

²⁷ See *Uncharted Waters* at 134-135.

²⁸ For a further discussion of these issues, and the many issues concerning payments to people with disabilities and their families which this testimony does not address, see *Uncharted Waters*.