Social Security Could Provide Cheaper and Better Annuities Than the Private Sector

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MarketWatch Blog by Alicia H. Munnell

Alicia H. Munnell is a columnist for ***MarketWatch*** and director of the Center for Retirement Research at Boston College.

Let's offer workers a public option for their 401(k) saving!

At a recent **Brookings Institution forum** on the decumulation of wealth in 401(k) plans, **Dick Thaler**, a behavioral economist and Nobel laureate, suggested that workers be allowed to send the Social Security Administration a portion of their 401(k) savings in exchange for an annuity. The amount eligible for annuitization could be capped at $250,000 or even $100,000 – the median balance for workers with 401(k) holdings.

I've always thought that the government could play a useful role in the annuity market by eliminating many of the problems that make the private provision of individual annuities expensive, complex, and risky. Individuals with 401(k) balances simply cannot go out and purchase the same annuity that they would have received under a traditional defined benefit plan for a number of reasons:

- Annuitization under a traditional defined benefit plan is generally mandatory, so everybody participates. When annuitization is voluntary, only those who expect to live for a long time are likely to find the product attractive. This "adverse selection" significantly increases the cost per dollar of annuity income.

- Administrative and marketing costs are significantly higher when annuities are purchased one-by-one rather than in bulk, as done under a defined benefit plan.
- Participants must now also worry about when they purchase an annuity. Payments will be high when interest rates are high and low when they are low. That is, in a 401(k) environment, the interest rate risk shifts to the individual participant.
- Finally, if individuals have to shop for annuities on their own, they will have to consider the health of the insurance company.

If the goal is to encourage annuitization, the product must be made as cheap, easy, and safe as possible. In my view, the government has several potential advantages here:

- The government could lower administrative costs dramatically by pooling large numbers of participants.
- The government does not need to include a buffer in the price to cover the tail risk that a cure for cancer suddenly increases life spans by 5 years.
- If lower costs increase participation, adverse selection would also be reduced, thereby further improving the payout per dollar of premium.
- The government could adopt some procedure to smooth out payments over time so that different cohorts did not end up with dramatically different payout rates.
- With the government as the provider, concern about the solvency of the insurance company also disappears.
- Finally, the government already offers inflation-indexed annuities (i.e., Social Security benefits).

Let me make two friendly comments to Thaler's proposal. First, people don't like annuities, so they may not be thrilled by access to even the really cheap inflation-indexed annuities provided through Social Security. The only way to get widespread participation would be to have a default whereby, for example, 50 percent of a worker's 401(k) holdings are automatically transferred to Social Security up to a cap of, say, $100,000.

Second, the staff of the Social Security Administration has been cut repeatedly, even in the face of the retirement of the Baby Boom. Between 2010 and 2018, SSA staff fell by 12 percent, while the number of retirement beneficiaries increased by 20 percent. If Congress were to make the wise decision to allow people to buy into Social Security, it would need to ensure that the agency has the staff to take on this broader mandate.