Older Americans' Economic Security

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Do Annuities Help Older Adults Manage Their Spending?

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For the first time in history, many older Americans will likely retire with large stockpiles of money and will have to determine how to carefully manage these assets. Our study results suggest that converting retirement wealth into an annuity that guarantees a lifetime income may help retirees manage their spending and ensure they will not outlive their savings.

What are Annuities?

Annuities are financial instruments that convert wealth into a guaranteed stream of lifetime income. The annual income generated depends on the age at which the annuity begins and on current market interest rates.[1] Although annuities provide insurance against outliving one's resources, few retirees purchase them. Today's retirees typically rely on lifetime payments from traditional defined-benefit (DB) pensions and Social Security—which represent 55 percent of total wealth for typical married adults and 59 percent of total wealth for unmarried adults—to finance their retirement.

So far this strategy has served most retirees well, since only one-third of those married and one-quarter of those unmarried have financial assets of more than $100,000 per person. However, this is likely to change in the future due to the decline in DB pensions and the growth in Individual Retirement Accounts (IRAs) and defined-contribution (DC) pensions, which include 401(k) plans.

Traditional DB pensions, common for yesterday's retirees, provide lifetime annuities beginning at retirement and promise benefits typically as a multiple of years worked and earnings received near the end of the career. DC plans in which employers (and generally employees) make contributions to a retirement account in the participant's name, often specified as a particular share of salary or a given dollar amount, are now the most common type of retirement benefit. At retirement, workers receive the funds that have accumulated in their accounts. Most employers do not offer annuities to their DC plan participants, and although they can use the proceeds to purchase annuities in the marketplace, only 4 percent of workers in DC pension plans convert their account balances into annuities when they leave their employers (Hurd, Lillard, and Panis 1998; Johnson, Burman, and Kobes 2004). With DC plans replacing DB plans in the private pension system, more older Americans will enter retirement with large account balances and fewer will have DB payouts.

The Impact of Annuities on Spending

The IRA and pension trends described above could have profound effects on spending patterns in retirement. Older adults run the risk of spending too quickly and depleting their assets before they die, or they may spend too slowly and not enjoy as comfortable a retirement as they could afford.

In our analysis of data from a nationally representative survey of older Americans, we find no evidence that adults ages 65 and older are afraid to draw down their assets to finance consumption. That is, retirees with larger unannuitized account balances spend more than other retirees—even after controlling for income, wealth, and other personal characteristics.

When the share of wealth in annuities declines by 10 percentage points, total household spending increases by 3 percent for married adults and 4 percent for unmarried adults. Discretionary expenditures are more responsive to the degree of annuitization than are basic expenditures.

Discussion

If employers continue to abandon traditional pensions for 401(k)-type pensions, and if policymakers adopt some privatization of the Social Security system, future retirees will likely hold more of their wealth in unannuitized assets. The results of our study suggest that these developments may promote even more spending of retirement resources, which is especially dangerous for low-income seniors.

The trend away from DB pensions toward DC pensions could increase discretionary spending by as much

FIGURE 1. Impact of Different Annuitized Wealth Scenarios on Predicted Per Capita Household Discretionary Expenditures for Adults Ages 65+ Who Collect Social Security

Source: Authors' calculations.

DB = defined benefit

DC = defined contribution

as 3 percent for married adults and 11 percent for unmarried adults (figure 1). By comparison, if Social Security were partially privatized, and retirees did not annuitize their account balances, discretionary spending could increase by as much as 2 percent for married adults and 8 percent for unmarried adults.

Although the results indicate that older adults with little annuitized wealth spend more than others, understanding the net effect on their retirement security is more complicated. On the one hand, they are at greater risk of outliving their assets and becoming poor at older ages. On the other hand, they may be better able to pay for unexpected consumption needs in retirement because they can draw down their assets as necessary. Some balance between annuities and unannuitized savings may be the right answer for future retirees. It will be important to monitor consumption paths and the spend-down of assets over time to fully evaluate the effect of annuitization on retirement well-being.

Notes

This brief is adapted from *Annuitized Wealth and Consumption at Older Ages* by Barbara A. Butrica and Gordon B. T. Mermin (2006, The Urban Institute).

1. Most annuities offer protection for a spouse, a guaranteed payout period for survivors, and other options that also affect the annual income stream.

References

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