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Retirement Option Decisions for Married Couples

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Abstract

In October 2000 the U.S. Census Bureau announced that in 51% of married couples with children, both spouses were employed in 1998. This number is a significant increase from 33% in 1976. For married women, with or without children under age 18, the labor force participation rate has increased from 32% in 1960 to 62% in 1997.¹ The Census Bureau predicts a continuing trend toward more working mothers, a trend that has serious implications for the retirement planning of married couples.

Under current pension and Social Security laws in the United States, how should married couples exercise their distribution options from their employers' pension plans? What are the optimum decisions for such couples regarding the timing of their Social Security benefit commencement? What are the important variables that govern these decisions?

How can U.S. pension laws be changed to allow more flexibility for couples who need to coordinate benefits from both spouses' retirement plans? How can the Social Security laws be changed to accommodate the retirement and survivor needs of two-worker couples?

Background

U.S. pension laws have many requirements intended to protect the worker's spouse, both during and after employment, and after the worker's death. These laws are premised on the assumption that the spouse lacks any significant earnings or retirement benefits of their own. In most qualified retirement plans, these protections can be waived by the participant, but only with the informed, written consent of the spouse.

The Social Security system also is designed with spousal protection in mind. Over 20% of annual Social Security benefits are paid to surviving spouses and other dependents.² Unlike private retirement benefits, the survivor benefits cannot be waived. The only flexibility is the choice of benefit commencement: as early as age 62 with an actuarial reduction in benefits, or as late as age 70 with an actuarial increase.

Until 1980, fewer than half of married couples had two employed spouses, as determined periodically by the Census Bureau (a "snapshot" view).³ This approach does not capture information about the percentage of couples who have two workers at some time (or times) during their marriage.

The Census Bureau recently announced that the 1998 "snapshot" view of U.S. married couples with children shows that 51% had two workers, the first time that the percentage exceeded 50%.⁴ The Bureau of Labor statistics reported an even higher percentage – 53.2% – for 2000.⁵ A significantly larger percentage of couples, with or without children, may have earned two sets of retirement benefits.

While the census data do not indicate what percentage of couples currently have two sets of retirement benefits, the implications for the future seem clear: there will be even more couples in the future with two workers and more of these couples will have earned two sets of private pension benefits. And, with few exceptions, both workers in these couples will have earned Social Security benefits.

Issues

Under current U.S. pension law, how and when should married couples decide to take distributions from their employers' pension plans? This decision encompasses elements of timing (early versus late, at the same time, or staggered) and form of benefit (lump sums, installments, or annuities). It also depends on the number of plans and the types of plans involved. And it depends on the couple's other assets or sources of income available at retirement or upon death. Some of the important variables are as follows:

- Relative ages of the spouses
- Relative health of the spouses
- Relative benefits of the spouses
- The need for protection of other dependents

Under current Social Security law, how should married couples decide when to begin their respective Social Security benefits? If benefits begin before Social Security retirement age (SSRA), the retirement income test is a factor. Actuarial reduction/increase for benefit commencement before/after SSRA is another factor. Other important variables are as follows:

- Relative ages of the spouses
- Relative health of the spouses
- Relative benefits of the spouses

Should U.S. pension and Social Security laws be changed to better accommodate the needs of two-worker married couples? If so, what are some approaches that Congress can consider?

Analysis of Retirement Options

Assumptions

To simplify the analysis, consider the following matrix of relative earnings, which generates the following nine possible combinations of working couples:

Husband's Annual Earnings	Wife's Annual Earnings		
	<i>Low</i>	<i>Medium</i>	<i>High</i>
Low	LL	LM	LH
Medium	ML	MM	MH
High	HL	HM	HH

We will assume that both workers have earned some retirement benefits through their respective employers. Otherwise, the retirement election for the worker with benefits will be very similar to that of the traditional worker with a non-working spouse. For the general case, we will further assume that both spouses are the same age and that both are in good health. We will also examine departures from these assumptions.

First we will consider the case where both workers have earned benefits under defined benefit (DB) pension plans. We will also look at how their decisions would be affected by the existence of one or more defined contribution (DC) plans or individual retirement accounts (IRAs). Then we will consider couples in which only one spouse has a DB benefit. Finally, we will look at couples who have only DC or IRA assets.

Case One: Both Workers Have DB Plan Benefits

If both workers quit working at their SSRA, what optional form of benefits should they elect under their respective DB plans?

With both spouses the same age and both in good health, mortality data indicate that the wife is expected to outlive the husband by more than six years.⁶ Accordingly, in most cases the wife should elect to take her DB benefit as a single life annuity, regardless of the relative benefit levels of the spouses. The exceptions would be where the husband's benefit level is very low or where the

couple is very risk averse. In these cases, the couple may decide that hedging their bets is more important than optimizing their retirement income.

The husband's election, however, will depend on the couple's relative benefit levels. If the husband's benefits exceed the wife's (the ML, HL, and HM cases), then the husband should elect a joint and survivor annuity. That way the survivor benefits will supplement the wife's single life annuity from her DB plan. Most DB plans in the U.S. offer varying levels of survivor income, typically 50% or 100%. Some also offer intermediate levels, such as 66 $\frac{2}{3}$ % or 75%. The percentage elected should depend, in part, on the adequacy of the wife's benefits.

If the wife's DB plan annuity is sufficient to maintain her standard of living after the husband's death, then the husband could elect a single life annuity without jeopardizing her welfare. This might be the case in the LH, MH, and HH couples.

What election should the husband make in the remaining three couples (LL, LM, and MM)? Under U.S. law, the actuarial reduction to elect the joint and survivor annuity instead of a single life annuity must be based on unisex mortality tables.⁷ Therefore, the reduction will be smaller, compared to gender-based tables, for a husband electing a joint and survivor annuity than for a wife making such an election. So, the husband in the LL, LM, and MM couples should elect the joint and survivor annuity.

In all cases, the couple's choices will depend on the actuarial conversion factors used by their respective DB plans. The plans may use different mortality tables or different interest rates. One plan may use five-year age brackets while the other does not. If possible, the couple should request both sets of conversion factors to see if the actual plan factors would affect their decisions.

By electing to quit working at their SSRA, the spouses can both take an unreduced Social Security benefit. If they do not need the Social Security benefits immediately (because they have other retirement assets), they could postpone one or both Social Security benefits and receive higher benefits because of late commencement. However, they should not delay past age 70, as the delayed retirement credit ceases at that age.

The delayed retirement credit (DRC) warrants some discussion. Congress established the DRC in 1972 and has increased it gradually over the years. It will eventually reach 8% per year of delay for the cohort turning age 65 in 2008.

Although 8% per year is often claimed to be actuarially neutral, a small penalty to the worker remains, particularly at the older ages. A fair actuarial adjustment would require a higher DRC at age 69 than at age 65 because life expectancy declines very rapidly between ages 65 and 70. Accordingly, an 8% increase is close to being actuarially “fair” at age 65, but inadequate at age 68 or 69.⁸

In what cases should the couple elect to quit working earlier than the SSRA?

Surveys indicate that there are two major factors in deciding to retire early. The first of these is having sufficient income and/or assets to allow early retirement and the second factor is being in poor health.⁹ For a couple in good health, the decision to stop working will depend on their financial situation, though other factors may also be present, such as a desire to travel or engage in hobbies or the need to care for elderly parents.

If one or both spouses have a subsidized early retirement benefit under their DB plans, it would be financially advantageous to utilize that subsidy. Such subsidies are still common, to encourage older workers to retire. However, employers are finding it more difficult to retain skilled and seasoned older workers. With an inadequate supply of workers to replace these veterans, employers may eliminate early retirement subsidies in the future.

An additional factor that should influence a couple to quit working before SSRA is the existence of an early retirement “window” in their employers’ retirement plans. Employees who are eligible for such a window generally receive enhanced retirement benefits if they terminate during a limited window period. For example, the window might offer employees who are age 50 or over an unreduced retirement benefit. In virtually every case, a worker who receives an early retirement window offer should take advantage of it. They could still continue working for a different employer, and postpone beginning Social Security benefits.

If neither spouse has a subsidized early DB benefit, then the decision to quit working will depend on the adequacy of their reduced early retirement benefits. For couples with at least one high earner (LH, MH, HL, HM, or HH), combined benefits may be sufficient to permit one or both spouses to stop working. The existence of other assets will also be a critical factor. For example, a couple could live on DC or IRA assets from their employment termination date until they are eligible to start an unreduced DB benefit.

In an early retirement scenario, spouses also will need to decide whether to start their Social Security benefits before SSRA. Although the retirement income test has been repealed for individuals at or over SSRA, it still applies between age 62 and SSRA. If a couple expects any significant earnings before SSRA, they should postpone beginning their Social Security benefits. If they have substantially retired, and have no significant earnings, they could begin their Social Security benefits as early as age 62, but with a substantial reduction for early commencement. For individuals born after 1959, whose SSRA is age 67, the reduction for commencing Social Security benefits at age 62 is 30%. This reduction is roughly equivalent to the actuarial value of the extra benefits received before SSRA. Moreover, quitting work before SSRA also means fewer years of payroll taxes paid. The net effect is that the Social Security system provides an incentive to beginning Social Security benefits early.¹⁰

Some early retirees think they will be better off commencing benefits early, even though their monthly benefit amount suffers a permanent reduction. They believe they can invest part of their benefits and earn a greater rate of return than the Social Security system pays. Instead, they may be better off using other income or assets during the early years and delaying their Social Security benefits to SSRA or later. Studies show that higher medical and disability expenses in the later years of retirement create a potential need for more income than anticipated.¹¹ Plus, increasing longevity may cause many retirees to outlive their other retirement assets, which is another reason to avoid permanently reducing the Social Security annuity through early commencement.

An important factor in deciding whether to start Social Security benefits early is the existence of retiree medical benefits. If our couple has such benefits through one of their employers, then they may not need the additional financial protection of unreduced Social Security benefits. In that case, they should take advantage of the age 62 reduced Social Security benefits, which are slightly subsidized.

What if one or both spouses are not in good health?

The health of the spouses will affect both the timing of their retirement and the form of payment.

The spouse in poor health may be unable to work until SSRA, forcing an earlier retirement. If the health problem reduces life expectancy, then that spouse should elect a lump sum, if one is available. If not, they should elect a joint and

survivor annuity with the highest percentage of survivor benefit offered, or a life annuity with period certain, if available. In either case, the healthier spouse should elect a single life annuity. This could produce a result contrary to the baseline situation, in which the wife should always elect a single life annuity.

If both spouses are in poor health, and lump sums are not available, then a judgment should be made regarding which spouse is likely to live longer. That spouse should elect a single life annuity, and the other should elect a life annuity with period certain or a joint and survivor annuity with the highest percentage of survivor benefit offered.

What if the spouses are not the same age?

A difference in ages will alter the form of benefit decision only if the wife is significantly older than the husband. As in the relative health determination, the issue is which spouse is likely to survive the other. If the wife is more than six years older than the husband, the probability of her surviving longer is less than 50%, and still lower if her relative health is poorer.

A difference in ages can also affect the timing decision. Most spouses quit working at the same time, even when the wife is much younger than the husband.¹² There is little data about the retirement timing of husbands with older wives. However, one study indicates that 75% of older wives quit working before or at the same time as their husbands.¹³

Does it make sense financially for the younger wife to begin her pension payments when the husband does? If she were eligible for a subsidized early retirement benefit, then it would make sense. Without a subsidy, she probably should postpone her benefit commencement to avoid the early retirement reduction, thereby preserving the higher benefit. If other assets permit, she can quit working at the same time as her older husband but postpone the commencement of her benefit payments. Most DB plans in the U.S., however, provide at least a small subsidy.¹⁴

What should the spouses do if they have dependents to provide for after retirement?

Couples with young children or other financially dependent family members, such as adult children with disabilities or elderly parents, may need continuing income to care for such dependents after the couple's death. What decisions should these couples make regarding their retirement benefits?

Choices that maximize their death benefits, such as a life annuity with a period certain, or a joint and survivor annuity with the dependent as the joint annuitant, are best in these cases. Not all employers' plans offer these options. When offered, there are usually restrictions on the percentage payable to the joint annuitant, particularly when the joint annuitant is significantly younger than the participant. Couples who don't have such options available should consider purchasing additional life insurance to provide for the future needs of the dependents.

Case Two: Only One Spouse Has a DB Plan Benefit

The decisions are the same as in the baseline case. First assume that the husband has the DB benefit. As in the baseline case, he should elect the joint and survivor annuity, unless the wife is more than six years older or in poorer relative health. If the wife has the DB benefit, she should elect the single life annuity, unless she is more than six years older or in poorer relative health. However, if other assets are inadequate, the spouse with the DB benefit should elect a joint and survivor annuity, regardless of age or relative health. Otherwise, the spouse who lacks a DB benefit may be left with only Social Security benefits after the other's death.

Case Three: Neither Spouse Has a DB Plan Benefit

The decisions for this situation are actually much simpler because the couple will have more control over the timing of their distributions. If the DC plans do not allow much distribution flexibility, they can take lump sums and roll them over to IRAs. The only factor they cannot control is their longevity; the biggest risk they face is that of outliving their DC or IRA assets.

If one or both spouses are in good health, they should explore annuitizing at least a portion of their DC or IRA assets. Recent work by Moshe Arye Milevsky shows that, for an individual, the optimum time to annuitize is roughly age 80.¹⁵ This age might be later or earlier for a married couple, depending on their relative health and relative ages. Milevsky's research should be expanded to explore the implications for couples.

Changes in U.S. Pension Law

Should U.S. pension law be changed to accommodate the needs of two-worker married couples? If so, what are some approaches that Congress can consider?

Internal Revenue Code (IRC) Section 401(a)(9) forces individuals to begin their retirement plan distributions by age 70½, if they are no longer working. This requirement poses a problem for all retirees, not just married couples, because it causes retirement resources to be taxed and consumed earlier than desired.

Are married couples affected more by this requirement than other retirees? Married couples do have lower mortality rates than individuals in other marital statuses.¹⁶ Accordingly, they will have greater longevity and, therefore, will need a longer retirement income stream. Conversely, they also enjoy better health and may have lower medical expenses later in their retirement years.¹⁷ Overall, they probably don't suffer a disproportionate impact from the minimum distribution requirements of IRC Section 401(a)(9).

IRC Section 401(a)(11) requires that married participants take their benefits in the form of a qualified joint and survivor annuity, with between 50% and 100% continuance. The participant can elect an alternate form, if the spouse provides informed, written consent.

In our baseline case, with both spouses the same age and in good health, the joint and survivor annuity makes sense for the husband's benefit but not for the wife's. She will need the husband's consent to elect the single life annuity. The consent requirement can be a problem in other situations, such as in the cases of abused wives or alienated spouses, but is probably not an onerous requirement for coordinating a couple's payments.

U.S. law requires, generally, that pension plan benefits be paid in the form of a joint and survivor annuity if married, or a life annuity if not married. It also requires that direct rollovers to another retirement plan or IRA be offered in lieu of an immediate lump sum. Other than these requirements, U.S. pension plans do not have to offer any particular forms of benefits or any distribution choices to participants. While lump sums are popular with participants, they don't offer much flexibility in meeting retirement planning needs or in protecting against longevity risk. Their primary value is that they can be rolled over to an IRA. The

IRA can provide timing flexibility but no longevity protection, unless the lump sum is annuitized within the IRA.

Married couples need at least three types of annuity options that are not commonly available within qualified retirement plans in the United States. These are as follows:

- A level income option, allowing spouses to coordinate their respective benefit distributions into a level stream of payments, even if their payments start at different times. Under this option, annuity payments begin at \$X per month for a number of years, and then increase or decrease to \$Y per month thereafter.
- An increasing income option, allowing payments to be indexed, providing inflation protection for the later years of retirement. This option would be valuable for single, as well as married participants.
- A joint and survivor annuity option, allowing designation of non-spouse joint annuitants for couples with dependents who need post-death income.

Congress could consider mandating one or more of these annuity options for qualified DB plans. While benefit mandates are never popular with employers, participants would welcome the enhanced flexibility and improved financial protection these options would offer.

Changes in Social Security

Should Social Security laws be changed to better accommodate the needs of two-worker married couples? If so, what are some approaches that Congress can consider?

Compared to private pensions, Social Security offers very little flexibility. The design is rooted in 1935 reality, giving retirement benefits to the male worker and survivor benefits to the non-working widow. Other than equalizing the treatment of widows and widowers, not much has changed since 1935.

Workers do not have the option of waiving the survivor benefits and taking a larger single life annuity. And workers with working spouses often receive no benefit from the survivor benefits if the spouse has a large enough benefit earned in their own right. Yet, these couples have paid two streams of Social Security taxes, including taxes to provide survivor benefits that they will never enjoy.

A variety of “money’s worth” analyses indicate that two-worker couples receive the least benefit from Social Security relative to the amount of Social Security taxes paid.¹⁸ In essence, two-worker couples are subsidizing the survivor benefits paid to non-working spouses.

The predicament of the two-worker couple cannot be fixed, unfortunately, without some effect elsewhere in the redistribution system. If we allowed two-worker couples to waive their survivor benefits in exchange for higher primary benefits, then the subsidy for non-working spouses disappears.

This author believes that the fair result is for the worker with a non-working spouse to pay for the survivor benefits. Payment could be made through higher payroll taxes, which are difficult to administer, or through an actuarial reduction in the primary benefit, as with private pensions.

A more difficult question is whether the worker with a non-working spouse should be able to waive the spouse benefit and avoid the actuarial reduction. If so, then Social Security fails as a safety net for elderly widows. Clearly, this is not a desirable outcome, given the extreme levels of poverty among that demographic group, even with the existing safety net.

A better approach is to provide the safety net via a different vehicle. In the Canadian system, all residents are entitled to a minimum benefit regardless of earnings or taxes paid. The second layer in the Canadian system is based on earnings credits.¹⁹ The U.S. could adopt a similar system in which any worker (whether or not the spouse has earnings credits) could waive the survivor benefit and receive a larger primary benefit under the earnings-based layer. Whether such a feature is desirable from a social insurance standpoint would depend on the adequacy of the minimum benefit under the first layer.

Congress will be addressing long-term financing solutions for the Social Security system soon. Estimates of the system's financial health have been the focus of attention. The internal equities of the current benefit structure, a structure based on the needs of 1935 workers, have received less scrutiny. For current and future generations of workers, basic fairness demands that two-worker couples receive benefits more commensurate with the payroll taxes they have paid.

Conclusion

The decisions that a two-worker couple faces at retirement are complex, but can be quantified, based on a manageable number of variables. The most important factors are relative ages, relative health, and the relative sizes of the spouse's retirement benefits. Other factors include retirement timing and the types of benefits available.

Currently, U.S. pension and Social Security laws offer limited flexibility to two-worker couples who need to coordinate multiple retirement income streams. Both systems are designed for one-worker couples and need updating for the twenty-first century workforce. Private plans need more flexible annuity options, while Social Security's internal subsidies of one-worker survivor benefits by two-worker couples should be re-examined.

Endnotes

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