

Proposal
to present a paper called

Tax Incentives for Annuitization – Direct and Indirect Effects

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Alexander Kling*

Institut für Finanz- und Aktuarwissenschaften, Ulm, Germany
phone: +49 731 5031242, fax: +49 731 5031239
a.kling@ifa-ulm.de

Andreas Richter

Professor, Chair in Risk & Insurance
Ludwig-Maximilians University Munich, Germany
phone: +49 89 2180 3755, fax: +49 89 2180 993755
richter@lmu.de

Jochen Ruß

Managing Partner
Institut für Finanz- und Aktuarwissenschaften, Ulm, Germany
phone: +49 731 5031233, fax: +49 731 5031239
j.russ@ifa-ulm.de

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* Contact author

Abstract

In many countries, tax incentives exist for annuitizing benefits from an old age provision contract. In Germany, for instance, a strong tax incentive was introduced in 2005 for annuitizing money that has been accumulated within an insurance contract.

There are, of course, several reasons why the government may choose to provide tax incentives for annuitization. Primarily, such incentives are implemented in order to encourage individuals to hedge against the risk of outliving their money. Particularly in times when in many countries, benefits from state funded pension systems are being reduced, these incentives seem to be necessary in order to stimulate demand. Whereas empirical studies seem to confirm that the money's worth of an annuity in many situations is typically high enough to make purchasing this product attractive for an individual, real world markets so far show surprisingly little demand for annuities. Reasons for this, as discussed in the literature, include adverse selection, precautionary savings for compensating income risk by factors such as health problems, and inner-family risk-sharing.

Whilst tax incentives can stimulate demand for annuities, there may also be undesired effects in markets where only standard annuities (as opposed to enhanced or impaired annuities) exist. In standard annuities, annuity providers use average mortality rates to determine the annuity that will be paid out for a given premium. As a consequence, such standard annuities provide a good value for money only for people with at or above average life expectancy. With enhanced or impaired annuities, insurers attempt to offer the same value for money to all clients: at the start of the contract for immediate annuities or at the end of the accumulation period for deferred annuities, the condition of the insured is assessed by some form of individual underwriting. The underwriting results are converted into individual mortality probabilities that are then used in the pricing of the annuity contract.

We analyze the financial consequences of tax incentives for annuitization from the perspective of the insured and the insurer. We model heterogeneity among the insured through a simple frailty model for individual mortality.

We find that the critical frailty factor below which annuitization is optimal decreases significantly if tax incentives for annuitization are introduced. Analyzing a pool of insured, we find that, all other things equal, tax incentives for annuitization result in a significant increase of the insurer's profit since less healthy individuals also annuitize, i.e. adverse selection effects become smaller. However, the problem that different insured get a different value for money is even increased by tax incentives.

If enhanced annuities are introduced, the percentage of insured who should annuitize further increases. Adverse selection is further reduced and everybody gets a similar value for money from annuitizing. However, the first of the three effects is only present if the quality of the underwriting is rather high.