ECONOMIC POLICY BRIEF

Chairman, Senator Charles Schumer
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MOST BABY BOOMERS ARE SAVING ENOUGH, BUT MANY ARE AT RISK OF SIGNIFICANT SHORTFALLS

As the first wave of baby boomers reaches the traditional retirement age next year, the question of whether workers are preparing adequately for retirement has become more important than ever. Despite numerous media reports on boomers' dire retirement prospects, by various measures the average baby boomer household is on track to retire comfortably. Nevertheless, a significant minority of boomers—particularly those at the bottom of the income and wealth distributions—is at risk of a substantial decline in living standards during retirement. Moreover, the baby boom generation faces a number of uncertainties that may leave them less prepared for retirement than what the data would suggest.

The U.S. retirement system has traditionally been described as a three-legged stool made up of Social Security, employer-sponsored retirement plans, and personal saving. It is important that Social Security and private pension plans remain stable and secure, and that all families, but particularly those with less income and wealth, have the opportunity and incentive to increase their own personal saving.

THE BOOMERS AT RISK OF SIGNIFICANT INCOME SHORTFALLS

Studies that compare projected retirement income with current household income conclude, on the whole, that about half of baby boomer households will be able to retire as planned and maintain the same living standard.[1] Roughly an additional quarter of boomer households may be able to maintain their working-age living standards but that will require them to save a bit more, delay retirement by a few years, or tap into their housing equity to finance retirement spending.[2] The troubling remaining quarter of boomer households are poised to enter retirement with few financial assets and very little private pension wealth.

The households at risk of significant saving shortfalls are generally lower-income with less-educated and lower-skilled workers. Just as today, Social Security benefits will be a significant, and in some cases nearly the entire, source of retirement income for a significant number of these baby boomer families (Figure 1). But even with Social Security, many low-income households will be at risk of a significant decline in their living standards and a potential slide into poverty.[3]

These at-risk families tend to have less access to employer-sponsored retirement plans, which, after Social Security, account for the greatest source of wealth for the typical household approaching retirement. When they do participate either in employer-based or private retirement plans, they usually contribute a lower share of their income than higher-income households. This is in part a function of having less disposable income to save, but it is also driven by the fact that most retirement savings incentives are delivered through the tax system as deductions from income and thus provide minimal benefits to households in the lower (or zero) income tax brackets.

In addition, many means-tested income-support programs—including food stamps, Medicaid, Supplemental Security Income, and cash assistance—have asset rules that sharply limit the amount of savings a family may have to qualify for benefits. As a result, lower-income households who count on such programs as a safety net when their earnings are too low or during periods of unemployment face strong *disincentives* to save for retirement.

ALL BOOMERS FACE A NUMBER OF RISKS THAT MAY NECESSITATE HIGHER SAVINGS RATES

Studies comparing boomers with previous generations at comparable life stages have generally found that baby boomers are doing as well or better in terms of accumulating wealth.[4] Some researchers have concluded that boomers will be better off in retirement than their parents. However, others caution that for various financial, demographic and other reasons, boomers may actually need to save at much greater rates than earlier generations.[5]

The specific factors that may contribute to increased risks for baby boomer retirees include increased longevity, a shift in the composition of employer-sponsored retirement benefits, and a greater concentration of assets in home equity.

Increasing life expectancies mean that boomers should be prepared to finance a longer retirement if, as indicated by surveys, they expect to retire at a similar age as their parents. Uncertainty about increasing life expectancy will also require boomers to save more to protect against the consequences of outliving their assets.

In addition, although boomers have fewer children than their parents, they have tended to delay childbearing. As a result, they will have fewer years to accumulate wealth after their children leave the house and before retirement. Boomers are also likely to face higher college tuition bills, since more of their children are projected to attend college and college costs have increased in real terms.

At the same time, increases in life expectancy and advances in

medical technology that enable frail elderly adults to live at home longer will likely result in a higher proportion of baby boomers providing care for their aging parents compared with previous generations. Caregivers who take time out of the workforce or reduce their work hours to provide care lose out not only on wages but on employer-sponsored retirement benefits as well. These competing work and family demands may leave less room for saving during boomers' peak earning years, when previous generations tended to save the most.

Though the percentage of baby boomers retiring with a pension is not likely to be dramatically different from their parents' generation, the type of pension certainly will be. Twenty years ago, over three-fifths of workers with any kind of pension were in a traditional, defined benefit plan that was managed by their employers and that promised them a fixed lifelong benefit based on their years of service and salary. Now, over two-thirds of private pension participants are in a 401(k)-style, defined contribution plan in which they have the primary responsibility for managing their retirement accounts, and their benefit depends on how much they contribute to the plan and how well their investments perform.[6] Given both the investment risk of low returns and the risk of outliving one's savings during retirement, boomers may have to save more compared with previous generations to insure against the uncertainties inherent in defined contribution plans.

Moreover, the dramatic decline in defined benefit pension plans and substitution of defined contribution plans means that survey data may understate the wealth of previous generations relative to boomers. This is because the value of defined benefit plans is included in surveys measuring savings while the value of defined contribution plans is not.

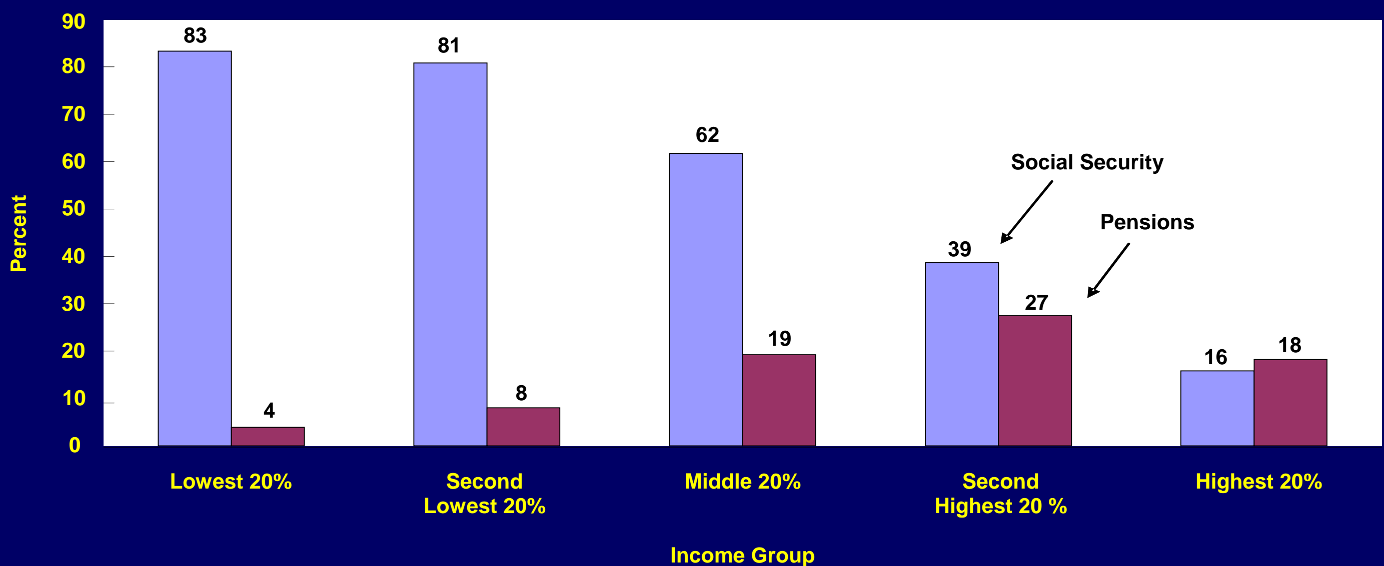
Not only has the share of workers with traditional pensions declined, but so has the share of employers offering retiree health benefits, a trend that is likely to persist given the projected increases in health care costs.[7] The combination of lower rates of coverage and rising health care costs suggest that boomers are likely to require greater amounts of saving to cover insurance premiums and out-of-pocket expenses during retirement compared with previous generations.

Finally, studies have also found that boomers' wealth is also somewhat more concentrated in housing equity.[8] While some retirees may be willing to tap into that equity to finance retirement, others may be more reluctant to sell their homes. Although reverse-annuity mortgages provide an option to draw down equity without selling one's home, their use is not widespread. A greater reliance on housing wealth could leave some boomers vulnerable to fluctuations in the housing market. Boomers who use their housing equity to finance consumption prior to retirement may have little equity to draw upon in an environment with only moderate increases in housing prices.

POLICY PROPOSALS TO INCREASE RETIREMENT SAVING

In addition to making Social Security and private pension plans stable and secure, public policy can create the right incentives for families to increase their own saving. Current saving incentives are poorly designed to help lower-income families, who are the ones most at risk of retiring with insufficient resources.

Planning for retirement always involves risks and unknowns. However, the number of uncertainties facing baby boomers as they prepare for retirement, as well as the sizeable minority of



boomers that are at risk of significant income shortfalls during retirement, reinforces the importance of increasing retirement saving among all workers. Below is a menu of some of the most promising policy proposals.

Expanding Automatic Saving

Roughly half of all workers do not have access to an employer-sponsored retirement plan. While they could participate in an individual retirement account (IRA), most of them do not, in part because saving outside of a regular payroll-deduction framework can be complicated and time-consuming particularly for financially inexperienced workers. The Automatic IRA Act of 2007 (S. 1141, Bingaman) would encourage employers that do not sponsor retirement plans to automatically enroll their employees in IRAs funded through regular direct-deposit payroll deductions. Automatic IRAs would involve minimal administrative or financial burden for employers. For employees, automating participation, contribution and investment decisions would simplify retirement saving. This proposal would build on the success of automatic 401(k) plans, the expansion of which was facilitated by the Pension Protection Act of 2006.

Expanding the Saver's Credit

The federal government spends over $100 billion each year in retirement savings incentives. Yet, because most of the subsidies are delivered through the tax code in the form of deductions, lower-income workers receive relatively minimal incentives to save compared with workers in higher tax brackets. The Saver's Credit, enacted in 2001, was designed to address that disparity by providing a match for retirement saving contributions by moderate- and lower-income workers.

While evidence indicates that the credit has increased retirement saving, the impact of the credit has been limited by its nonrefundability, the sharp phase-down of the credit rate for moderate-income taxpayers, and the fact that the income eligibility limits are not indexed to inflation. Making the Saver's Credit refundable would target the lowest-income workers, who need the most help in saving for retirement, while increasing the income eligibility limits and credit rates would provide greater incentives to millions of moderate-income workers.

Reforming Asset Rules

As indicated above, the asset rules in many means-tested programs may discourage many lower-income workers from saving for their retirement. Excluding retirement accounts from eligibility and benefit determinations would remove that barrier to saving. (It would also reduce administrative costs by simplifying program administration.)

Improving Financial Literacy

Studies have demonstrated that financial literacy is correlated with retirement planning, which is in turn positively associated with greater wealth accumulation upon retirement.[9] Unfortunately, various surveys indicate that many Americans, including baby boomers, are financially illiterate. For example, one survey posed the following compound interest question: "Let's say you have $200 in a savings account. The account earns 10 percent interest per year. How much would you have in the account at the end of two years?" Less than one-fifth of boomers answered correctly.[10] Encouraging employers—and schools—to provide financial education, and specifically targeting such efforts to households at greatest risk of insufficient retirement savings, would help those households better prepare for their retirement.

CONCLUSION

Contrary to media reports about baby boomers' dire retirement prospects, the typical boomer household is saving adequately for retirement. Nevertheless, a significant minority of boomer households—particularly lower-income and less educated households—may be at risk of entering retirement with substantial income shortfalls. Moreover, the uncertainties confronting boomers during retirement may require boomer households to save more than previous generations. In addition to making sure that Social Security and existing employer-sponsored pensions remain secure, promising policy proposals to encourage retirement saving among workers of all ages would help insure boomers against such uncertainties.

ENDNOTES

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