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Economic Research:

Pensions: Can We Ever Retire?

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Pensions: Can We Ever Retire?

Americans at the leading edge of the postwar baby boom will hit 65 next year. But will they ever be able to slide into retirement? Declining wealth, stemming from lower stock prices and falling home values, has hurt older households. In fact, Americans lost 18% of their net worth in 2008, and the decline disproportionately hit the households of those nearing retirement. But even before the asset bubble burst, Americans looked ill-prepared for retirement.

The Center for Retirement Research (CRR) at Boston College estimates that 43% of Americans are "at risk," meaning likely to be unable to maintain their current standard of living in retirement. The good news is that they seem to understand their situation. But the bad news is that they don't seem to be doing much about it, whether through saving, paying off debt, or taking advantage of the preretirement investment opportunities available to them.

Americans are not financially prepared to stop working. Indeed, many households have no real retirement plan at all. The average American family has not saved enough, and at a time when they should be free of burdens such as mortgages, many preretirement households still have a high level of debt. Unsurprisingly, American workers now have far less confidence than they did in 2007 that they'll have sufficient funds for their golden years, according to the Retirement Confidence Survey conducted by the Employee Benefits Research Institute and Matthew Greenwald & Associates in April 2010. Even more households say they have no savings.

Projections for federal entitlements such as Social Security and Medicare indicate both will run out of money sooner than expected—well within the lifetimes of most boomers. Historically, most Americans have relied on the government to fund their retirement, but they're also losing confidence in Social Security and Medicare, according to the survey.

The first wave of boomer retirees is already too close to retirement to be able to make up for lost saving and investment opportunities. Younger Americans will have to rethink their retirement strategies. Alicia Munnell and Steven Sass put the likely answer to this problem right in the title of their recent book, "Working Longer: The Solution To The Retirement Income Challenge" (Brookings Institution, Washington, D.C., 2008). Three years ago, the average American expected to retire at age 63; now that's 65, according to the Retirement Confidence Survey. One-third of Americans now plan to continue working after age 65, and even more might have to because of inadequate retirement savings. The percentage of workers who say they have postponed their expected retirement age in the past 12 months is 24%, with the largest portion citing the poor economy as the primary reason.

We're Too Poor To Retire

Most Americans in the pre-retirement age group haven't saved enough money to provide for an adequate retirement. At the end of 2007, the median household in the 55-to-64-year-old age group had total financial assets of only $72,400, according to the 2007 Survey of Consumer Finances (SCF), which the Federal Reserve conducts every three years. Based on the performance of financial markets over the past three years, that number is probably now down to $65,000.

Fortunately, wealth is beginning to recover from the 2008-2009 bear market. Total household net worth has risen to $54.6 trillion (492% of disposable income) in the first quarter, according to the Federal Reserve's Flow of Funds accounts, up from $48.3 trillion (448% of income) one year ago. However, it's still far below the $64.4 trillion (650% of income) at the end of 2007.

The SCF gives little reason for optimism. Even in the pre-retirement age group (ages 55-64), only 58.4% of families saved any money in 2007, just slightly above the national 56.5% ratio. The median net worth for this cohort was $253,700, but most of it is in the family home, which has declined in value and, in any case, is not a liquid asset. These households are much richer than the national median of $120,300, but they're not rich enough to live in comfort for 20 years of expected retirement.

And We're Scared To Stop Working

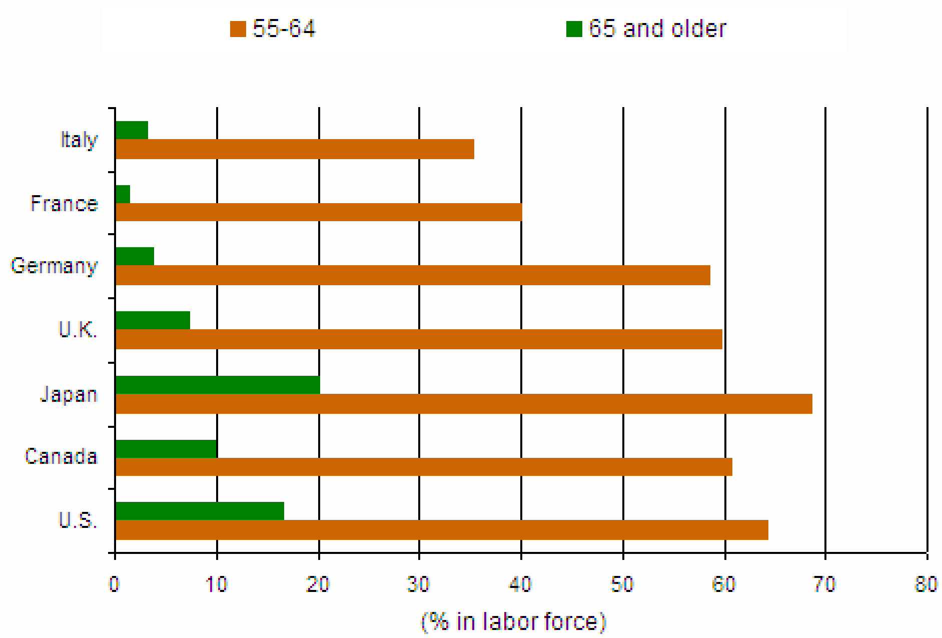
Although Americans continue to be concerned about their ability to afford retirement, few are making an effort to prepare for it. The percentage of Americans who are very confident of being able to live comfortably through retirement is only 16%, up from 13% in the 2009 survey but below the percentages in any of the surveys before that. In contrast, 36% of Americans are "not too confident" or "not at all confident" about retirement. Fewer workers are saving for retirement: Only 60% said that they or their spouses had put away money for that purpose in the past year, down from 65% in 2009. In addition, 43% of respondents said that they had less than $10,000 in savings, excluding the value of their home or defined benefit pension plans. Only 11% reported more than $250,000 in savings.

Older workers have more assets than younger workers, as one would expect, with 71% of workers in the 25-to-34 age bracket reporting savings of less than $25,000, compared with only 42% of those aged 45 and older. At the other end, 18% of workers over the age of 45 reported assets above $250,000 compared with only 4% of those aged 25-34. This pattern is consistent with the 2007 SCF.

The national income data do show some improvement in saving behavior. The saving rate hit a record low of 1.7% in 2007. It has now doubled, to 3.4%, in the first quarter. However, before 1990, the U.S. saving rate averaged 9%, and given current longevity, even that rate might not be enough to support 20 years of retirement.

Americans are working longer than most of their overseas competitors, reflecting in part the weaker pension programs. In the U.S., 64.5% of people aged 55-64 participate in the labor market, exceeded only by New Zealand (73.3%), Sweden (73.0%), Norway (70.0%), and Japan (68.8%). In the European Union, only 49.9% of people in that age group are in the labor force. The contrast is even greater for people aged 65 and older, with 16.8% of Americans still in the labor force compared with 4.4% in the EU. Only in Japan (20.2%) is the ratio higher than in the U.S.

Labor Force Participation For Older Workers



Source: Organisation for Economic Co-operation and Development.

The Government Can't Afford For You To Retire

Most Americans rely on Social Security and Medicare for their primary support in retirement. The 2009 projections by the trustees of the Social Security and Medicare trust funds indicate that both funds will run out of money even sooner than the 2008 report estimated. The Social Security trust fund is in better shape than Medicare, with revenues still exceeding benefits by a comfortable amount. Unfortunately, the wave of baby boomer retirements will change that picture. The new trustees report expects the surplus to continue until 2015 but move into deficit thereafter.

An increase in the average retirement age could help extend the period of surplus, but probably not by much. If workers delay retirement, they will continue to pay taxes into the system and not take money out, but when they do retire, they'll also get higher benefits. So that option offers a net improvement in the trust fund results, but the change only postpones the problem.

Projections are for the trust fund to run out of money in 2037. This would be a more meaningful date if the fund had any funds in it. However, it contains only Treasury securities, which are essentially promises from the government to pay itself. This amounts to funding your IRA by filling a cookie jar with IOUs from yourself. The stream of revenue is real, but the IOUs are—at best—only a moral promise to keep paying benefits.

Medicare is in far worse shape than the social security trust fund. The Medicare Hospital Insurance fund is already running a deficit, and the trust fund (again, only a notional entity) will run out of money in 2017 under current projections. Any decision by workers to delay retirement has even less impact on Medicare than on Social Security. It would increase revenue but would have little impact on benefits because Americans become eligible for Medicare at age 65 even if they're still working (though those with employer-provided insurance still will use that rather than Medicare).

The new health reform bill will affect the Medicare estimates. The bill reduces the reimbursement rates for Medicare, but it's unclear how effective that measure will be. There is a risk that doctors will simply refuse to treat Medicare patients unless they receive compensation that's more similar to what they get for treating private patients. In the past, Congress has usually blinked and raised reimbursement rates despite promises to control them.

Is Retirement A Late-20th Century Artifact?

The answers to the retirement dilemma won't be easy. Humans have a tendency to ignore the future, especially when thinking about it causes pain in the present. Spending money is more fun than saving it. Retirement seems a long way off when you're in your 30s, raising children, buying your first house, and still paying off your student loans

The best solution might well be the one many say they're adopting: working longer. Through history, people didn't stop working until they were unable to work. When the Social Security Act of 1935 set the retirement age at 65, life expectancy at birth was 62 years; today, it's 78. At age 65, today's average male can expect to live another 18 years, and the average woman 20 years. The idea that older workers are entitled to leisure as a reward for 40 or so years of work really didn't become prevalent until the 20th century, mostly after World War II (coinciding with the rise of golf as a sport). Perhaps Americans might have to shift their thinking and realize that 20 years of retirement after 40 years of work is too much, and that they might have to work well past 65.