

Are Retirees Falling Short? Reconciling the Conflicting Evidence

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A fundamental question in the retirement area is whether people will have adequate retirement income to maintain their pre-retirement standard of living. Existing studies offer conflicting assessments; some indicate a serious problem while others present a more optimistic view. This paper explores why assessments differ. It covers four areas: 1) evidence on the trend in households' wealth-to-income ratios by age; 2) research on whether households can meet replacement rate targets; 3) alternative research using an optimal savings model; and 4) the ability of retired households to maintain initial retirement consumption over time. Our conclusion is that the optimistic views of retirement preparedness depend crucially on assumptions about behavior that may not reflect real world activity or on a snapshot of consumption levels that are unsustainable in the long run. Thus, our best assessment is that retirees are falling short and will fall increasingly short over time.

Wealth-to-Income Ratios Show Declining Preparedness Over Time

While the *adequacy* of current saving may be open to question, the *trend* in retirement saving relative to income is not. Data from the *Survey of Consumer Finances* (SCF) for 1983-2010 can be used to plot the ratio of net wealth to income, by age. In these ratios, wealth includes all financial assets, 401(k) accumulations, and real estate less any outstanding debt; and income includes earnings and returns on financial assets. Importantly, wealth excludes defined benefit pension plans and Social Security.

This exercise shows that the above ratios have remained very stable over time, suggesting that succeeding birth cohorts are less prepared for retirement because five major developments require them to accumulate more wealth relative to their income to meet any given replacement rate target. First, life expectancy has increased. Second, Social Security replacement rates have declined as the Full Retirement Age has increased and fewer households rely on the spousal benefit. Third, fewer households will receive income from defined benefit plans. Fourth, out-of-pocket medical costs have increased. Finally, real interest rates have declined, so more wealth is required to produce any given level of income. If households were over-prepared in the past, they may be fine today. But if they were only adequately prepared in the past, they are falling short today.

Failure to Meet Replacement Rate Targets

Two studies, using a similar methodology, assess whether today's working households will meet target replacement rates; both studies find that roughly half of households will fall short in retirement. The first study, which produces the National Retirement Risk Index (NRRI), uses SCF data to calculate the percentage of working-age households whose projected replacement rates fall short of targets that will permit them to smooth consumption over their lifetimes (Munnell, Webb, and Golub-Sass 2012). Projecting replacement rates involves two calculations: estimating how much income households will have at age 65; and estimating their pre-retirement income. To determine the share of the working-age population "at risk" of being unable to maintain their consumption in retirement, the study then compares the projected replacement rates with target replacement rates. A household is classified as at risk if its projected replacement rate falls short of its target by 10 percent or more. The study finds that, in 2013, 52 percent of households aged 30-59 were at risk of falling short. A second study obtained similar results using data from the *Health and Retirement Study* (HRS) (Munnell, Orlova, and Webb 2013).

The Optimal Savings Alternative

In contrast to the replacement rate studies, Scholz and Seshadri (2008) find that only small percentages of HRS households had saved less than optimal amounts, given assumed preference parameters, based on an intertemporal optimization model. In contrast to the NRRI calculations, Scholz and Seshadri assume that households optimally plan to reduce consumption when the children leave home and optimally choose declining consumption during retirement, reflecting the declining probability of being alive at older ages. Adjusting the targets in the NRRI study to reflect the Scholz and Seshadri assumptions reduces the percent of 51-61 year olds "at risk" in 2004 from 35 to 11 percent, close to the Scholz and Seshadri estimate. It is unclear which set of assumptions is more plausible. Do parents cut back on consumption when their children leave home, or do they spend the slack in their budgets? Do households spend less as they age from choice, or because they cannot spend what they do not have?

Sustainability of Initial Retirement Consumption

The final analysis turns to households' ability to maintain consumption after retirement. Hurd and Rohwedder (2013), using the HRS's *Consumption and Activities Mail Survey* data from 2001-2007, find that households experienced only small declines in consumption immediately on retirement. We use the same data to investigate whether these households can maintain such consumption over time. The results show that households with the average income and consumption in each of the bottom six deciles of the income distribution will not have enough to maintain their first year's consumption. If people do not tap home equity via a reverse mortgage, this shortfall continues higher up the income scale. The study also finds a sharp 27-percent decline in total spending over the 6-10 years following retirement among those who retired. By contrast, median spending among those who did not retire remains relatively constant. Although the sample sizes are too small to say anything definitive, the study shows that spending by households with insufficient resources to maintain pre-retirement consumption throughout their retirement declined by 30 percent compared to 18 percent for those with sufficient resources.

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