CENTER *for* RETIREMENT RESEARCH *at* BOSTON COLLEGE

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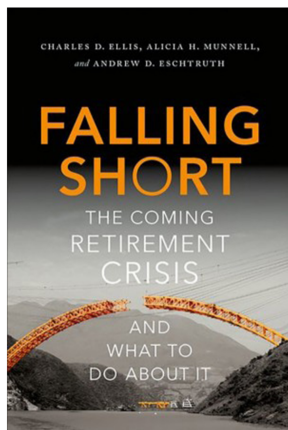
FALLING SHORT: THE COMING RETIREMENT CRISIS AND WHAT TO DO ABOUT IT

By Alicia H. Munnell*

Introduction



Today's workers face a brewing retirement income crisis. Economic and demographic changes have transformed the retirement landscape, systematically shifting risk and responsibility away from government and employers to individuals. As a result, about half of working-age households are "at risk" of being unable to maintain their pre-retirement standard of living in retirement. Fortunately, the tools to fix the problem are at hand. And the sooner action is taken, the easier it will be to shore up the nation's retirement security.

This *brief*, adapted from a new book, proceeds as follows.[1] The first section assesses the trend in retirement preparedness over the past three decades and reports the percentage of today's working-age households that are unprepared. The second section details the reasons underlying the problem. The third section discusses specific solutions to head off a crisis. The final section concludes that longer worklives, more saving, and more effective use of households' assets are essential to restoring retirement security to our nation, and policymakers have a critical role to play in achieving this goal.

What We Know About Retirement Preparedness

One potential sign of trouble is the trend in the amount of wealth that working-age households have relative to their income. Figure 1 on the next page shows these wealth-to-income ratios from 1983-2013 using data directly from the Federal Reserve's *Survey of Consumer Finances* (SCF). The striking fact about this figure is that the lines are bunched very closely together. This pattern may seem comforting as it appears that households in each year of the survey have accumulated similar amounts of wealth relative to their incomes. However, many things have changed since 1983, each of which should have caused people to save more.

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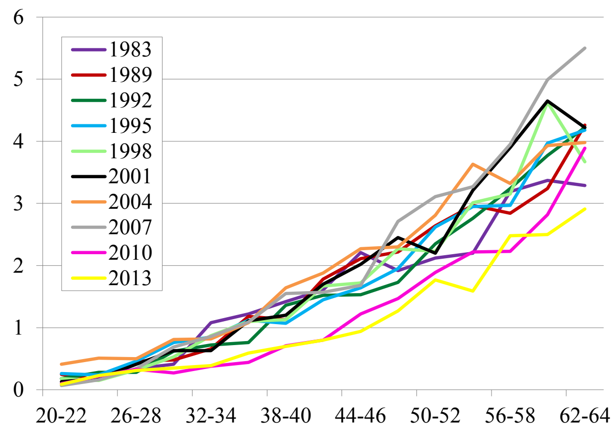
Figure 1. Ratio of Wealth to Income by Age from the *Survey of Consumer Finances*, 1983-2013



Source: Author's calculations based on U.S. Board of Governors of the Federal Reserve System, *Survey of Consumer Finances* (1983-2013).

- Life expectancy has increased, so workers should be accumulating more assets to cover a longer period in retirement.
- Social Security replacement rates – benefits as a share of pre-retirement income – are declining, which increases the need for retirement saving.
- Employer retirement plans have shifted from defined benefit, where accruals of future benefits are not included in the SCF wealth measure, to 401(k)s, where assets *are* included. This shift from unreported to reported assets should have increased the wealth-to-income ratio.
- Retiree out-of-pocket health costs have been rising, again increasing the need for more wealth at retirement.
- Real interest rates have fallen substantially since 1983, so more wealth is needed to generate a given stream of income.

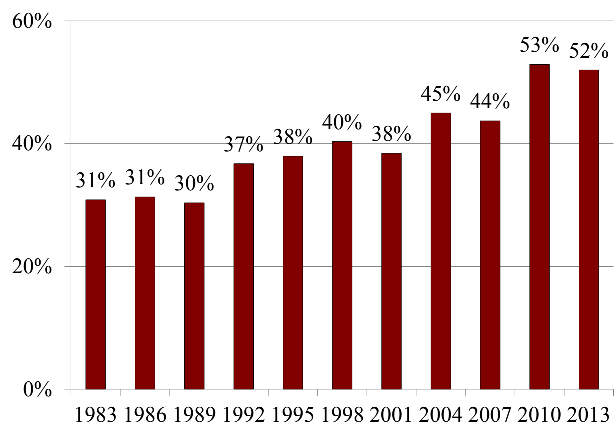
As a result of these factors, the stability of wealth-to-income ratios over the 1983-2013 period clearly indicates that people are less well prepared than in the past. If they were over-prepared in the past, they could be fine today. But if they were not over-prepared in 1983, then they are falling short today.

To address the adequacy of retirement preparedness, the Center for Retirement Research at Boston College has developed a National Retirement Risk Index (NRRI), which relies on data from the SCF.[2]

The NRRI compares projected replacement rates for working-age households ages 30-59 to target replacement rates that permit them to enjoy the same consumption before and after retirement. The Index measures the percentage of all households that fall more than 10 percent below their target.

The most recent NRRI results show that about half of all households are at risk, up from about one third in 1983 (see Figure 2). So the problem is widespread and, consistent with the earlier data on wealth-to-income ratios, it is getting worse over time.

Figure 2. The National Retirement Risk Index, 1983-2013



Source: Munnell, Hou, and Webb (2014).

Why Are So Many Households Unprepared?

Why do Americans face such a serious retirement income problem today when recent generations have retired in relative comfort? The reason is that baby boomers – and those who follow – will need more retirement income, but will receive less support from the traditional sources of Social Security and employer defined benefit plans.

Retirement Income Needs Are Growing

Today's workers will need more income because lifespans (and retirement periods) are getting longer, health care costs are rising, and interest rates are very low.

First, the length of retirement depends both on when people retire and on how long they live in retirement. After declining for many decades, in the mid-1980s the average retirement age stabilized and then gradually increased from 62 to 64 for men. However, the latest evidence shows little change in average retirement ages over the past several years, suggesting the trend toward later retirement may be running out of steam.[3] Meanwhile, life expectancy at 65 is continuing to rise steadily (see Table 1). On balance, the retirement period has been getting longer over time, from 13 years in 1960 to about 20 years today for men.

Table 1. Life Expectancy at Age 65 for Men and Women, 1960, 1980, 2000, and 2020

Year	Men	Women
1960	13.2	17.4
1980	14.7	18.8
2000	17.6	20.3
2020	19.7	22.0

Source: U.S. Social Security Administration (2014).

Second, while retirees have health insurance coverage through Medicare, they still face substantial out-of-pocket costs for premiums (Parts B and D), deductibles, and co-payments. These costs have grown rapidly over time and equal about one-fifth of retirees' income.[4] For individuals who require more than a brief stay in a nursing home, long-term care costs represent an additional expense.

Third, real interest rates have fallen dramatically since the record highs of the late 1970s and early 1980s. Today's rates continue to hover around historic lows of 1 percent. Therefore, retirees need a much bigger nest egg than in the past to generate a given amount of income.

Traditional Sources of Retirement Income Are Shrinking

Both Social Security and employer-sponsored retirement plans will provide less support than in the past. This trend is especially worrisome because people save virtually nothing outside of these two vehicles. The one bright spot is home equity, which could be tapped for day-to-day retirement consumption, but generally is not.

Social Security. Social Security benefits are the foundation of the retirement income system. But, under current law, these benefits are already shrinking in their ability to replace pre-retirement income.

First, the gradual rise in the program's "Full Retirement Age" from 65 to 67 is cutting benefits across the board. For those who continue to retire at 65, this cut takes the form of lower monthly benefits; for those who choose to work longer, it takes the form of fewer years of benefits. For the typical earner who retires at 65, the replacement rate will drop from about 40 percent today to 36 percent once the transition is complete.

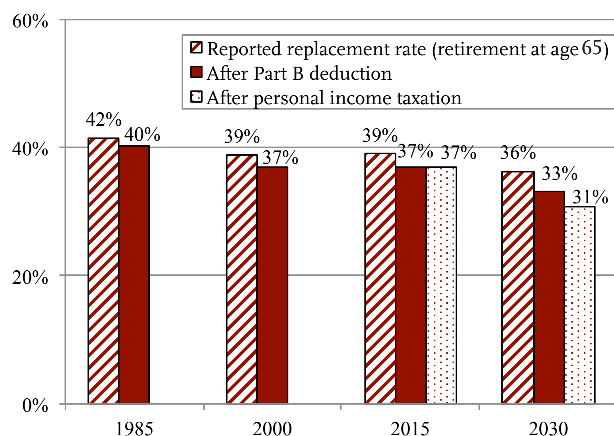
Second, Medicare premiums, which are automatically deducted from Social Security benefits, are rising faster than benefit levels. As a result, Part B premiums alone are estimated to increase from 5.4 percent of the average Social Security benefit for someone retiring in 1990 to 10.4 percent for someone retiring in 2030.

Third, more benefits will be subject to taxation under the personal income tax. Individuals with more than $25,000 and married couples with more than $32,000 of "combined income" pay taxes on up to 85 percent of their Social Security benefits. In 1985, only about 10 percent of beneficiaries had to pay taxes on their benefits, but the percentage of people subject to tax has been increasing over time because these thresholds are not indexed for growth in average wages or even inflation. Today, almost 40 percent of households pay taxes on their benefits, and by 2030 more than half of households are expected to be subject to this tax.

The combined impact of these factors will reduce Social Security replacement rates for the average worker retiring at 65 by nearly a quarter – from a net 40 percent in 1985 to 31 percent by 2030 (see Figure 3 on the next page).

And these reductions are happening without any changes in current law. If benefits are cut back further to address Social Security's long-term financial shortfall, replacement rates will drop even more.

Figure 3. Social Security Replacement Rates for Average Earner Retiring at Age 65, 1985, 2000, 2015, and 2030



Source: Author's calculations from Centers for Medicare and Medicaid Services (2013); and U.S. Social Security Administration (2013).

Employer-Sponsored Retirement Plans. With declining replacement rates from Social Security, employer-sponsored retirement plans become much more important. Unfortunately, at any given time, only about half of private sector workers are participating in any employer-sponsored plan, and this share has remained relatively constant over the past 30 years. The lack of universal coverage means that many American workers move in and out of plan participation and a significant percentage will end up with nothing but Social Security.

For those lucky enough to work for an employer providing a retirement plan, the nature of these plans has changed dramatically from defined benefit plans to 401(k)s. This shift means that the employee rather than the employer makes all the decisions *and* bears all the risks. Not long after the advent of 401(k) plans, it became clear that participants were accumulating only modest balances in these accounts.

As a result, in 2006 policymakers tried to make 401(k)s function more effectively through reforms included in the Pension Protection Act (PPA). The PPA encouraged 401(k) plan sponsors to adopt automatic mechanisms that have proven effective at boosting participation (auto-enrollment) and contribution rates (auto-escalation). However, the effects of the PPA appear to have played themselves out, and today less than half of plans have auto-enrollment and a much smaller fraction have auto-escalation.

As a result, 401(k)s are still far short of being a broadly effective retirement savings vehicle.[5]

- About 20 percent of those eligible *still* do not participate in their employer's plan.
- Contribution rates fall short of what most workers will need in retirement, and only about 10 percent of participants make the maximum contribution allowed.
- Many individuals invest in mutual funds with high fees, which can substantially shrink their assets over time. For example, an additional 100 basis points in fees over a 40-year period reduces final assets by about one fifth.
- About 1.5 percent of assets each year leaks out of 401(k) plans when participants cash out as they change jobs, take hardship withdrawals, withdraw funds after age 59½, or default on loans.

As a result, in 2013, the typical working household approaching retirement with a 401(k) had only $111,000 in combined 401(k) and IRA balances (see Table 2). This amount translates into less than $400 per month, adjusted for inflation, which will not provide a sufficient supplement to Social Security benefits.

Table 2. 401(k)/IRA Balances for Median Working Household with a 401(k), Age 55-64, by Income Quintile, 2013

Income range (quintiles)	Median 401(k)/IRA balance	Percent with 401(k)
Less than $39,000	$13,000	22%
$39,000-$60,999	53,000	48
$61,000-$90,999	100,000	60
$91,000-$137,999	132,000	65
$138,000 or more	452,000	68
Total	111,000	52

Source: Author's calculations from U.S. Board of Governors of the Federal Reserve System, *Survey of Consumer Finances* (2013).

What Can Policymakers Do?

While the retirement challenge is enormous, the tools to head off a crisis are available. And changes can be made within the existing retirement system, so they are both easier to explain to the public and to implement. The way forward is to convince households to work longer, help them save more, and encourage them to consider tapping their home equity. Policymakers could take several actions to help solve the problem.

Work Longer

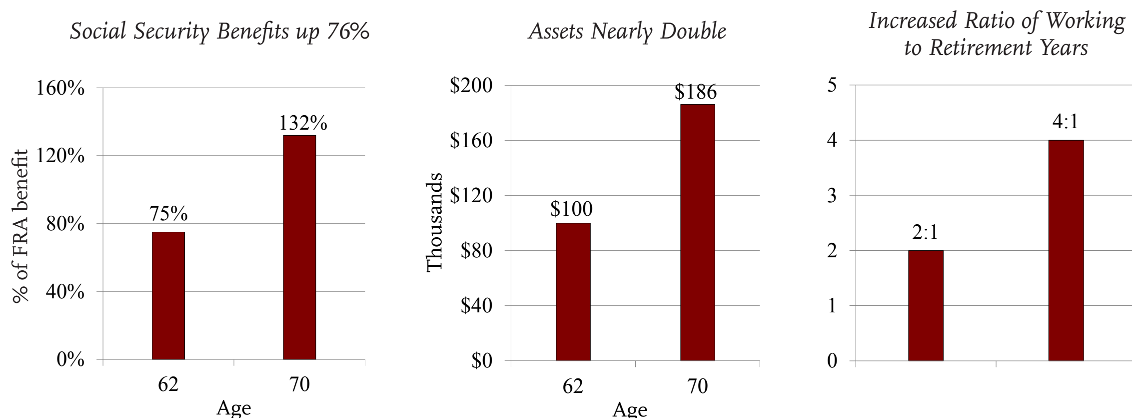
The working longer prescription is not about working forever. It is about delaying retirement in order to ensure financial security once work ends. Working longer makes an enormous difference (see Figure 4). First, it increases the size of an individual's monthly Social Security check by 7-8 percent for each year of delay. The difference between claiming at age 62 and age 70 is an eye-popping 76 percent. And maximizing Social Security benefits is particularly important because they last a lifetime, include spousal protection, and are inflation-indexed. Second, working longer allows people to contribute more to their 401(k) and provides more time for assets to grow; between ages 62 and 70, a typical individual's 401(k)/IRA assets are estimated to nearly double. And, third, working longer substantially shrinks the number of years over which an individual needs to stretch his retirement nest egg.

The working longer message will require a concerted educational campaign. In terms of current guidance to the public, the Social Security Administration (SSA) still tends to focus attention on the traditional statutory "Full Retirement Age (FRA)," which is now 66 (gradually rising to 67). But, with the phase-in of an actuarially fair Delayed Retirement Credit in 2008, the FRA concept has become outdated. The simple fact is that monthly Social Security benefits are highest at age 70 and are reduced actuarially for each year they are claimed before age 70.

To help Americans make well-informed decisions about when to retire, the SSA could emphasize in its public communications that age 70 is the most appropriate age to target. Such a shift in the agency's educational efforts – away from the emphasis on the statutory FRA – along with a clear explanation of the benefits of working longer could have a significant impact over time on the way Americans think about their retirement.

It is important to recognize that not everyone will be able to work longer. Some workers are not physically capable of delaying retirement. But the majority of American workers who can delay retirement should do it. And while it is not realistic to think that everyone will work until 70 – recall that the current average retirement age for men is only 64 – even working a few additional years will go a long way to boosting retirement security.

Figure 4. Impact of Working Longer on Social Security, 401(k)/IRAs, and the Retirement Span



Source: Author's calculations.

Save More

The prescription to save more has three components: 1) maintain Social Security by increasing revenue to solve the long-term shortfall; 2) make 401(k)s more effective by requiring all plans to be fully automatic and curtailing leakages; and 3) ensure that *all* workers have access to an employer-based savings plan.

Maintain Social Security. Social Security currently faces a 75-year shortfall equal to 2.9 percent of payroll. Given that Social Security replacement rates are already shrinking under current law, it is important to maintain benefit levels rather than cutting them further to close the shortfall. Any such cuts would only increase the need for individuals to save on their own to avoid falling short in retirement. Instead of cuts, the system needs more revenue.

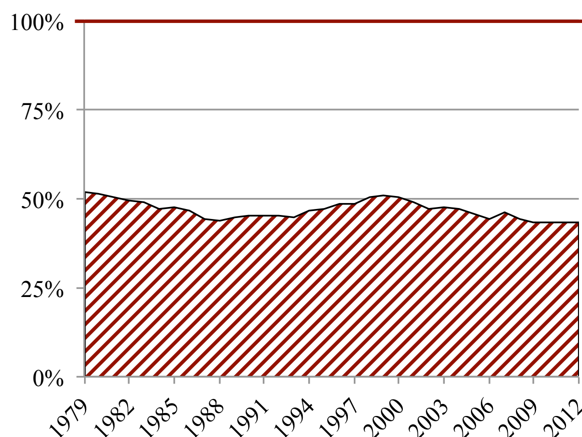
Social Security revenue can be increased in several different ways. Traditional options are raising payroll tax rates and/or raising the cap on taxable payroll above today's ceiling of $118,500. Both these options should be considered. In terms of the payroll tax, eliminating the program's 2.9 percent deficit would require increasing the tax rate by 1.45 percent of wages for employees and 1.45 percent for employers. It is worth pointing out that Congress temporarily cut payroll taxes by 2 percentage points in 2011 and 2012 and then restored the cut in 2013, and no one noticed. Other alternatives for increasing revenue include shifting the burden of financing Social Security's start-up costs to general income tax revenues and investing a portion of the trust fund in equities. These ideas are more complicated and controversial, but could be part of the mix if policymakers would like to take part of the burden off payroll tax increases.

Make 401(k)s Fully Automatic. 401(k)s are not currently an effective savings vehicle for many workers. But their shortcomings can largely be addressed. The most important policy change would be requiring all 401(k)s to be fully automatic, while continuing to allow workers to opt out if they choose. Plans should automatically enroll *all* of their workers – not just new hires – and the default employee contribution rate should be set at a meaningful level and then increased until the combined employee contribution and employer match reach 12 percent of wages. The default investment option should be a target-date fund comprised of a portfolio of low-cost index funds.

Separately, the problem of 401(k) leakages needs to be addressed. Possible changes on this front include tightening the criteria for hardship withdrawals so that these withdrawals are limited to unpredictable emergencies; raising the age for penalty-free withdrawals from 59½ to at least 62; and prohibiting cash-outs when switching jobs. These changes would go a long way to making 401(k)s a more robust mechanism for retirement saving. Participants could retain access to their funds through loans.

Cover Those Without a Plan. The half of private sector workers who are not currently participating in an employer-sponsored retirement plan (see Figure 5) need an arrangement that makes saving easy and automatic. State and federal policymakers have proposed a variety of ways to achieve this goal. At the state level, eight states – Illinois, Massachusetts, Oregon, Maryland, California, Minnesota, Connecticut, and Vermont – are in various stages of exploring ways to expand access to retirement plans. At the federal level, several proposals have been suggested, including auto-IRAs. The best bet would be to adopt an approach that covers everyone without a plan, uses automatic enrollment, and relies on low-cost investment options.

Figure 5. Percentage of Private Sector Workers Ages 25-64 Participating in an Employer-Sponsored Pension, 1979-2012



Source: U.S. Census Bureau, *Current Population Survey* (1979-2012).

Consider Home Equity

Many households have a little-recognized asset that they could turn to for income in retirement – the equity in their home. Generally, retirees think of their home equity more as an emergency reserve rather than a potential source of retirement income. However, given the challenge of ensuring retirement security, this view may be a luxury that many can no longer afford. If households do not have enough from Social Security and their 401(k) assets, they should consider tapping their home equity by either downsizing or taking a reverse mortgage.

Downsizing provides extra funds that can be used to generate retirement income and also cuts expenses for utilities, maintenance, and property taxes. A reverse mortgage allows retirees to stay in their home while accessing their equity; and the loan does not have to be paid back until the homeowner moves, sells the house, or dies. Recent policy changes by the Department of Housing and Urban Development have strengthened the agency's HECM program, which is the dominant vehicle for reverse mortgages.

As with working longer, policymakers could help educate consumers about the downsizing and reverse mortgage options. Americans need to recognize that their home equity can make a big difference to their retirement security.

Conclusion

The retirement income landscape has been changing in a way that systematically threatens the retirement security of millions of Americans. It is past time for our nation to fully recognize and adapt to the new environment. Federal policymakers could take the lead in ushering in the necessary changes that will promote longer worklives, more saving, and the use of home equity. The changes outlined in this *brief* are all doable adjustments that build on our existing retirement systems. There is no time to waste, so let's get started.

Endnotes

1 Ellis, Munnell, and Eschtruth (2014).

2 For details on the NRRI methodology, see Munnell, Hou, and Webb (2014).

3 Munnell (2015).

4 Kaiser Family Foundation (2011).

5 Munnell (2014).

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