The State of U.S. Retirement Security: Can the Middle Class Afford to Retire?

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How has the financial structure of Americans' retirement evolved over the past fifty years?

Retirement security advanced in the postwar decades. Participation in employer-based plans increased from 25 percent of private-sector workers in 1950 to 45 percent in 1970 (public sector workers were already largely covered) (EBRI 1998). Social Security became nearly universal and benefits expanded. The Social Security contribution rate more than quadrupled in the second half of the 20th century to pay for cost-of-living adjustments and other new benefits (Martin and Weaver 2005; SSA n.d.).

The 1980s began a period of retrenchment. Social Security cuts enacted in 1983 gradually raised the normal retirement age, delayed cost-of-living adjustments, and taxed some benefits. Legislation enacted ten years later increased the taxation of benefits. The National Academy of Social Insurance has estimated that the 1983 and 1993 cuts, when fully implemented, will reduce Social Security retirement benefits by 24 percent (Reno 2013).

In the private sector, defined-benefit pensions were largely replaced by defined-contribution plans, shifting costs and risks from employers to individual workers. In 1989, full-time private-sector workers with retirement benefits were divided roughly equally between those with defined benefit pensions and those with defined-contribution plans, including roughly 20 percent who had both. By 2010, 50 percent of these workers had a defined-contribution plan and 22 percent had a defined-benefit plan, including roughly 13 percent who had both (Wiatrowski 2011).

In theory, the shift from defined-benefit pensions to defined-contribution plans could have broadened access by making it easier for employers to offer retirement benefits. However, participation in employer-based plans, which peaked at just over half (52 percent) of prime-age wage and salary workers in 2000, fell to 44 percent in 2012. This occurred even though the Baby Boomers were entering their 50s and early 60s when participation rates tend to be high (Copeland 2013; Morrissey and Sabadish 2013).[1]

An increase in the labor force participation of women and, more recently, older workers helped mitigate the impact of the shift toward a do-it-yourself retirement system. The labor force participation of Americans 65 and older is now higher than it has been in half a century (author's analysis of Bureau of Labor Statistics data). However, working longer is not an option for many older Americans. About 40 percent of workers retire earlier than planned due to poor health, caregiving responsibilities, job loss, or similar reasons (Kingson and Morrissey 2012). Many other older workers continue working under difficult conditions, unable to retire from stressful and physically demanding jobs, or end up among the long-term unemployed.

What have been the recent trends in U.S. retirement assets?

As 401(k)s replaced traditional pensions and the population aged, assets in individual and pooled retirement funds grew faster than income. By 2010, average savings in retirement accounts had surpassed the value of annual household income. However, retirement insecurity worsened as retirement wealth became more unequal and outcomes more uncertain (Morrissey and Sabadish 2013).

Mean household savings in retirement accounts increased from around $24,000 in 1989 to around $86,000 in 2010. However, the growth was driven by a small number of households with large balances. Median savings—the savings of the typical household with a positive balance—peaked at around $47,000 in 2007 before declining to $44,000 in 2010 in the wake of the Great Recession, even as the Baby Boomers were entering their peak saving years (Morrissey and Sabadish 2013).

For many demographic groups, the typical (median) household has *no* savings in retirement accounts, and balances are low even when focusing only on households with savings. For groups for whom there is sufficient data, only white households, married couples, and college graduates are more likely than not to have retirement account savings. Even for these households, savings are very unequally distributed (Morrissey and Sabadish 2013).

Most Americans approaching retirement have little or nothing saved in retirement accounts. In 2010, 40 percent of families in their peak saving years (aged 55-64) had nothing saved in retirement accounts and 10 percent had $12,000 or less according to data from the Federal Reserve Survey of Consumer Finances (Bricker et al. 2012; Rhee 2014). Though the median amount for families with savings was $100,000, this is not even enough to purchase a $5,000 a year joint life annuity starting at age 65 (author's analysis of Bricker et al. 2012).[2]

Home equity and other forms of wealth may also be tapped for retirement. Net worth, like retirement savings, has risen faster than income since 1989 and grown more unequal (Morrissey and Sabadish 2013). Taking into account home equity and other assets and liabilities, median net worth for older families was $179,000 in 2010—close to the median home value (Bricker et al. 2012; U.S. Census 2012).

Retirement account savings are very unevenly distributed. In 2010, a household in the 90th percentile of the retirement savings distribution had nearly 100 times more retirement savings than the median (50th percentile) household, which had a negligible amount. The top 1 percent of households had over $1.3 million in retirement account savings. All told, households in the top fifth of the income distribution accounted for 72 percent of total savings in retirement accounts (Morrissey and Sabadish 2013). Assuming upper-income households receive tax subsidies at least proportional to their share of savings, this suggests that the lion's share of tax subsidies for retirement savings go to high-income households.

Retirement-income inequality has grown because most 401(k) participants are required to contribute to these plans in order to participate, whereas workers are automatically enrolled in defined-benefit pensions and, in the private sector, are not required to contribute to these plans. Higher-income workers are more likely to participate because they have more disposable income and are more likely to work for employers who provide matches (CBO 2013; Morrissey 2009). In contrast, middle- and lower-income workers find it difficult to save for retirement, especially since inflation-adjusted wages for most workers have stagnated over the past four decades. Higher-income households also have a higher investment risk tolerance, allowing them to better take advantage of retirement savings incentives that depend on investment earnings.

Disparities in retirement savings partly reflect differences between workers at different life stages and between those with and without accounts, some of whom may be covered by defined-benefit pensions. However, focusing only on workers in their early to mid-50s with retirement account savings, the mean is still 2.5 times larger than the median. In contrast, defined-benefit pension benefits appear fairly equally distributed among older participants, with the mean benefit only slightly larger than the median benefit (Morrissey and Sabadish 2013).

There are stark differences by race, ethnicity and education. Black workers' participation in employer-based retirement plans, including defined-benefit pensions, used to be similar to that of white workers, but has lagged in recent years. Hispanic workers, who have always had low participation rates, have fallen even further behind. As a result of this and other factors, white households have roughly six times as much saved in retirement accounts as Hispanic and black households. A similar gap exists between college-educated and high school-educated households (Morrissey and Sabadish 2013).

Lower-paid groups are ill-served by a retirement system that shifts costs and risk onto workers, including the risk of outliving one's retirement savings. Women, blacks, Hispanics, and seniors aged 80 and older are more likely to be economically vulnerable in old age, defined as having an income that is less than two times the supplemental poverty threshold (Gould and Cooper 2013).[3] Though women by some measures are narrowing gaps with men, this is mostly because men are faring worse and because married women are less dependent than they used to be on their husbands' benefits. Unmarried people, especially women, tend to be less prepared for retirement than their married counterparts.

The retirement crisis is growing. It is often suggested that future retirees, who are less likely to accrue pension benefits, will have more saved in retirement accounts when they retire than Baby Boomers, many of whom were covered by traditional defined-benefit pensions at some point in their careers. However, the Center for Retirement Research has found that workers today tend to have lower wealth-to-income ratios than earlier cohorts at similar ages, with younger cohorts at greater risk (Munnell et al 2012). Even before the 2008 downturn, wealth-to-income ratios were stagnant despite lower defined-benefit pension coverage, declining Social Security replacement rates, rising Medicare premiums, and other reasons younger workers should be saving more (Delorme et al. 2006). As a result, the Center estimates that 62 percent of GenXers are at risk of seeing a significant drop in living standards at retirement, compared with 44 percent of Baby Boomers (Munnell et al. 2012).

How did the financial crisis and aftermath affect retirement security?

Retirement prospects were hit hard by the collapse of the housing bubble and ensuing Great Recession. The share of households with savings in retirement accounts contracted after the downturn. The drop-off was particularly sharp among older households, a bad sign for Baby Boomers' retirement prospects. Though aggregate savings in retirement accounts continued to grow faster than income, retirement savings grew more unequal and the median account balance declined (Morrissey and Sabadish 2013). Household net worth took an even bigger hit, as the bursting of the housing bubble resulted in a $13 trillion loss of household wealth (Bosworth and Smart 2009).

What roles have homeownership played in the ability of the middle-class to retire?

Historically, most household savings have taken “brick and mortar” form, which had advantages and disadvantages. On one hand, traditional 30-year fixed-rate mortgages were a form of enforced saving and provided many people with secure low-cost housing in retirement. On the other hand, household assets were not diversified. Even before the housing bubble burst, regional declines could result in homeowners facing job loss and collapsing home equity at the same time.

Many families borrowed to buy homes in the bubble years only to find themselves underwater—with negative home equity—after the bubble burst, a situation exacerbated by the disadvantageous terms of many of these loans. This was particularly tragic for minority communities who had earlier been shut out of housing markets. According to a Pew analysis of Survey of Income and Program Participation data, the real net worth of Hispanic and black households fell by 66 percent and 53 percent respectively between 2005 to 2009, compared with 16 percent among white households (Kochhar et al. 2011)

What are the macroeconomic impacts of retirement security issues?

The shift to a retirement system based on individual savings means that workers’ retirement prospects are increasingly affected by shocks to stock and housing markets and broader economic trends.

In the past, cyclical downturns in the economy prompted increases in early retirements, as measured by declines in the share of 60-64 year olds in the labor force. Thus, early retirees made way for younger workers when jobs were scarce. But as 401(k)s have replaced traditional pensions, early retirement is no longer associated with labor market weakness but rather with housing and stock bubbles. Thus, in the late 1990s, when labor markets were tight and the stock market was booming, there was an uptick in early retirement, though the trend toward later retirement resumed after the dot-com bubble burst. Likewise, the labor force participation of 60-64-year-olds continued to climb during the 2008-09 recession (Morrissey 2008).

Social Security and defined-benefit pensions have traditionally acted as automatic stabilizers because benefit outlays increase when older workers who lose their jobs during recessions decide to retire and workers in poor health who cannot find jobs apply for disability benefits. Because retirement benefits are adjusted for earlier retirement, an unemployed worker’s decision to retire early does not have a large impact on Social Security’s finances. However, the drop in payroll tax revenues and increase in disability take-up during the Great Recession did exacerbate Social Security's long-term funding shortfall.

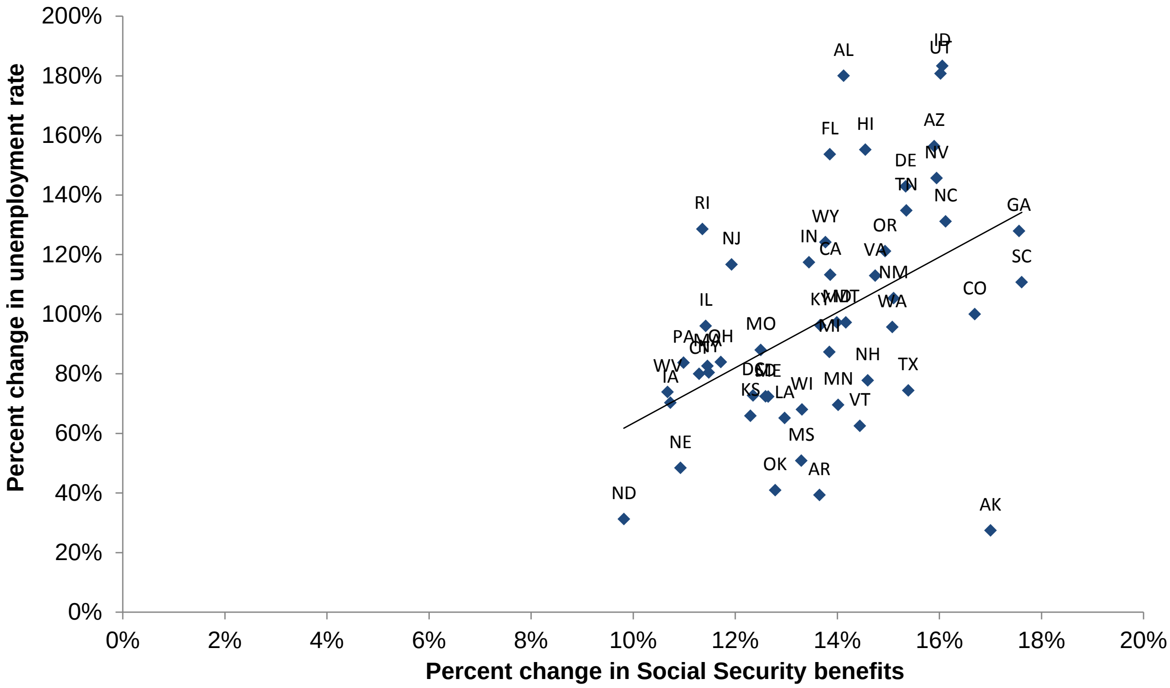
In the last two recessions and weak recoveries, Social Security's helpful countercyclical properties were countered by the procyclical effects of 401(k) plans. Thus, the number of beneficiaries receiving retirement (Old Age and Survivor Insurance) benefits in 2008-2013 was roughly the same as the Social Security actuaries predicted before the recession, though disability take-up increased (author's analysis of the 2007 and 2013 Social Security Trustees reports).

Nevertheless, Social Security prevented the Great Recession from being worse than it would have been in its absence or if benefits had been cut as part of a fiscal "grand bargain." In a recent working paper, Federal Reserve economists William B. Peterman and Kamila Sommer found that Social Security was very effective at mitigating the effects of the recession, particularly for poorer and older Americans (2014). Likewise, Ghilarducci et al. (2011) found that Social Security generally has a positive effect on macroeconomic stabilization, while 401(k) plans exhibit a destabilizing effect on the economy.

These two studies use sophisticated models and statistical techniques to estimate the countercyclical effects of Social Security. However, Social Security's role in cushioning the effects of the downturn is also evident from a simple chart, below, showing a statistically significant correlation between the growth in the unemployment and the growth in Social Security benefits by state.

Social Security benefits as automatic stabilizer

Percent change in Social Security benefits and in unemployment rate by state, 2007-2009



Source: EPI analysis of Social Security *Beneficiaries by State and Zip Code* public data series and Current Population Survey microdata

Social Security is also helpful when the economy faces a chronic demand shortage because it is mostly a pay-as-you go system—redistributing from current workers to current retirees and other beneficiaries—and beneficiaries tend to spend their income more quickly than workers. In comparison, advance-funded pension and savings programs tend to reduce aggregate demand.

What are the major challenges facing Americans in preparing financially for retirement? How well do currently available retirement products, such as IRAs and 401(k)s, meet the needs of consumers? How can they be improved to better meet the needs of today's working families?

401(k)s are an accident of history. In 1980, a benefit consultant working on a cash bonus plan for bankers had the idea of taking advantage of an obscure provision in the tax code passed two years earlier clarifying the tax treatment of deferred compensation and adding an employer matching contribution (Sahadi 2001; Tong 2013). Though 401(k)s took off in the early 1980s, Congress did not intend for them to replace traditional pensions as a primary retirement vehicle, and they are poorly designed for this role. Few people have the math skills, financial sophistication, or time to make sense of often conflicting financial advice and make sound investment decisions. IRAs, primarily composed of funds rolled over from 401(k)s, offer even fewer protections and typically have even higher fees (Munnell et al. 2013).

By limiting the scope for risk pooling and intergenerational risk sharing, the shift from defined-benefit pensions to individual accounts has increased the investment, longevity and inflation risks faced by participants. Individual savers also forgo economies of scale in investment management and administration. As a result, contributions must be nearly twice as high with 401(k)-style plans as traditional pensions to ensure a similar income in retirement (Almeida and Fornia 2008; Morrissey 2009).

Problems caused by the loss of risk pooling are exacerbated by poor decision-making aggravated by a lack of transparency and conflicts of interest. For example, voluntary annuitization introduces adverse selection problems that make it expensive for individuals to hedge longevity risk—a problem aggravated by the difficulty individuals face in navigating tricky annuity markets as well as their tendency to undervalue income streams and underestimate the risk of living well into their 80s or 90s.

Investment risks faced by individual investors are often poorly understood even among supposed experts. Individual investors are often led to believe that bull and bear markets cancel out over time, or that target-date funds shield them from risk. They naively interpret excess returns as a sign of a good investment going forward. They are often lulled into a false sense of security if stock returns are high, fail to rebalance in the wake of rallies, or simply gamble on all-stock portfolios. Risk taking is encouraged by tax subsidies whose value depends on investment earnings, making these particularly ill-suited for lower-income workers, who are rationally more risk-averse. Thus, at the opposite extreme, some individuals choose to invest very conservatively throughout their working lives or lock in low returns by selling in the wake of market downturns.

What role can employers, government, and other parties play to improve retirement security? What specific policies would enhance U.S. retirement security? How are states affected by and working to address retirement security issues?

Our first priority should be expanding Social Security benefits as proposed by Sen. Tom Harkin, Rep. Linda Sánchez, and others. Such measures could replace some of the benefits cut in 1983 and restore the progressivity of lifetime benefits as life expectancy grows more unequal (Morrissey 2013; Waldron

2007). The Harkin-Sanchez bill would also better protect seniors and other beneficiaries from the rising cost of health care and other increases in the cost of living that erode the value of their benefits.

We should also take steps to preserve existing defined-benefit pensions in the public and private sector. Contrary to the conventional wisdom, most public employee pension plans are in reasonable shape despite the effects of the financial crisis. Those that are in the worst shape got that way because elected officials neglected to make actuarially required contributions, so the focus should be on preventing this from happening in the future, not reneging on promises to workers.

Next, we should address some of the worst problems of 401(k)s and IRAs *before* encouraging workers to save more in these plans through auto enrollment and similar measures. The Thrift Savings Plan (TSP) offered to federal workers is sometimes put forward as a model 401(k)-style plan because fees are kept low by pooling assets and investing in low-cost passively managed funds. Participants have limited investment options and are encouraged to convert savings to a low-cost annuity at retirement (Davis et al. 2010).

Though the Thrift Savings Plan is an enormous improvement over 401(k)s available to most private-sector workers, it does not resolve the fundamental problems of market risk and upside-down tax subsidies. In addition, TSP lifecycle funds, which may soon become the default investments, are heavily invested in stock, with an equity allocation ranging from 88 to 54 percent during the accumulation phase (author's analysis of FRTIB n.d.).

At the opposite extreme in terms of risk, the MyRA plan proposed by President Obama would invest workers' savings in a government bond fund similar to the G Fund, the Thrift Savings Plan's current default investment. This low-cost saving vehicle is a convenient and cost-effective way of meeting the needs of the most risk-averse savers, except that account balances must be rolled over to (often high-risk and high-fee) IRAs when they reach $15,000.

Some problems with defined contribution plans may be addressed by making them more like defined benefit pensions. Senator Harkin's USA Retirement Funds, for example, take advantage of risk pooling, economies of scale and professional investment management to provide retirees with secure lifetime incomes. The California Secure Choice Plan is another innovative approach to providing workers who lack access to an employer-based pension with a plan that would shield them from the high costs and risks of 401(k) plans. Neither plan would require employers to take on long-term pension obligations.

Another option is the Adjustable Pension Plan, currently awaiting IRS approval, which would reduce, but not eliminate, employers' long-term risks.

Last but not least, we should reconsider our reliance on tax incentives for retirement saving. This approach is inherently inefficient, because there is no way to guarantee that tax subsidies encourage people to save more as opposed to simply shifting funds to tax-favored accounts. Nevertheless, a refundable tax credit is a more efficient way to encourage voluntary saving than the current system, which actually provides a tax break on investment income.

The Economic Policy Institute's Guaranteed Retirement Account plan proposed converting tax breaks for 401(k)-style plans and IRAs into flat tax credits to offset the cost of new accounts with a modest rate of return guaranteed by the federal government. The plan was designed to improve the retirement security of most Americans without costing taxpayers more than the current system (Ghilarducci 2007).

EPI is working on a variation of the original GRA plan that, like the original plan and the Center for American Progress's SAFE retirement plan, would be a pooled and professionally managed fund that uses a gain and loss reserve to stabilize returns credited to notional accounts (Davis and Madland 2013). Specifically, the aim would be to maximize the share of retirees who achieve a target rate of return while minimizing the share with poor outcomes. In contrast to the SAFE plan, the new "GRA 2.0" plan would smooth cumulative rather than annual returns. Unlike the original GRA plan, the government would not necessarily need to guarantee returns in the "GRA 2.0" model.

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[1] This is based on Current Population Survey data for wage and salary workers aged 21 to 64. Overall participation is even lower: 39 percent of all workers in 2012 (Copeland 2013). An employer survey, the National Compensation Survey, which tends to show somewhat higher participation rates, also shows a declining trend (EBRI, n.d.).

[2] Author's analysis using the Thrift Saving Plan Retirement Income Calculator on March 7, 2014, based on an annuity interest rate of 2.875 percent, a 50 percent survivor annuity, and rising payments to offset inflation.

[3] This is based on Current Population Survey income measures that exclude lump-sum (as opposed to periodic) distributions from retirement plans. However, data from the Survey of Consumer Finances and other sources suggests that retirement account savings for these groups are modest.