Are Boomers Headed for Retirement Disaster?

Crunching the numbers—and assessing the wild cards—of the retirement savings problem

By Michael Fink
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Is America on the brink of a retirement disaster? Baby boomers are chugging their way toward retirement and many see a train wreck ahead. So how bad is it?

Answering these questions depends a bit on optimism or pessimism about the future. You can count me on the pessimistic side, but that doesn't mean I'm pessimistic about all boomers. I'm just pessimistic about the ones who are probably least likely to see a financial advisor.

America is in the midst of a brave new experiment in self-funded retirement income. Well, sort of. In Social Security, we still have the largest forced annuitization program in the world. Beyond Social Security, however, we're relying on individuals to create their own retirement security.

The share of near retirees with defined contribution (DC) assets rose from 12% in 1983 to over 60% today. Despite the majority having DC assets, only 31% of workers were participating in DC plans in 2008. One of the most striking facts of the defined contribution era is the disparity between haves and have-nots. A pension system forces everyone to save for retirement and then replaces a significant share of their income. Add on Social Security, and there aren't many have-nots among those who also have a generous employer pension.

A DC system forces workers to choose how much to save and how to invest. Some save more, some don't save enough, and a lot of workers don't save anything. According to 2010 Fed data, about 45% of American workers aren't currently saved for retirement.

In actual numbers from the Employment Benefit Research Institute, the median employee in the top 10% of wealth has about $200,000 saved for retirement compared to $22,000 for a middle class employee. The median worker with an income over $100,000 has saved about $100,000, but the average is $360,000. That means that there are some higher-income workers who are saving a lot, but most workers aren't saving enough. In fact, only 64% of workers between the age of 55 and 64 have saved an amount equal to one year of income.

Now let's not get too overly sentimental about the old pension era days. In 1980, the proportion of American workers who participated in a defined benefit pension plan was only 38% according to the Social Security Administration. That meant the rest had to fend for themselves in a world without organized employer-sponsored DC savings plans.

The majority retired with a pension, but that pension wasn't always substantial for workers who changed jobs over time. We shouldn't fall victim to pension nostalgia—Social Security has been, and will continue to be, the foundation of retirement income for the elderly (it is currently 39% of total income for those 65 and older).

Disparate Impact

Ironically, boomers in the bottom quintile of lifetime income are far less likely to have a defined benefit (DB) pension (25%) versus boomers in the top income quintile (58%). Mix this disparity in pension income with a disparity in DC assets and you can begin to see where the crisis is going to hit.

There are really two groups who appear most vulnerable. The first are private sector lower middle class workers who may have benefitted from union-negotiated pensions (rates of union membership have dropped by 45% since 1980). Compared to public sector working class employees who are far more likely to receive a pension, today's less educated private sector worker often arrives at retirement with little savings.

The second group is higher-income private sector workers who simply do not save enough. Although middle class workers have saved much less, they are able to replace a much larger share of their income with Social Security. Higher-income workers who haven't saved a significant amount are likely to experience a much larger drop in spending at retirement.

A recent study by the National Institute on Retirement Security finds that only a quarter of workers in the lowest income quartile even have a retirement account versus 90% in the highest quartile. Owners of a retirement account have between five and seven times the non-retirement wealth of those who don't own a retirement account within the same age group. This means that those with the most non-retirement wealth also have the most retirement wealth. By far.

One of the reasons lower-income boomers are so unprepared for retirement isn't because they are irresponsible. It's because our DC system provides a much greater retirement saving incentive to higher-income workers. In a chronically underappreciated 2003 study, Boston University professor Laurence Kotlikoff and Cato Institute senior fellow Jagadeesh Gokhale measured the relative benefits that the defined contribution system provides workers at different income levels.

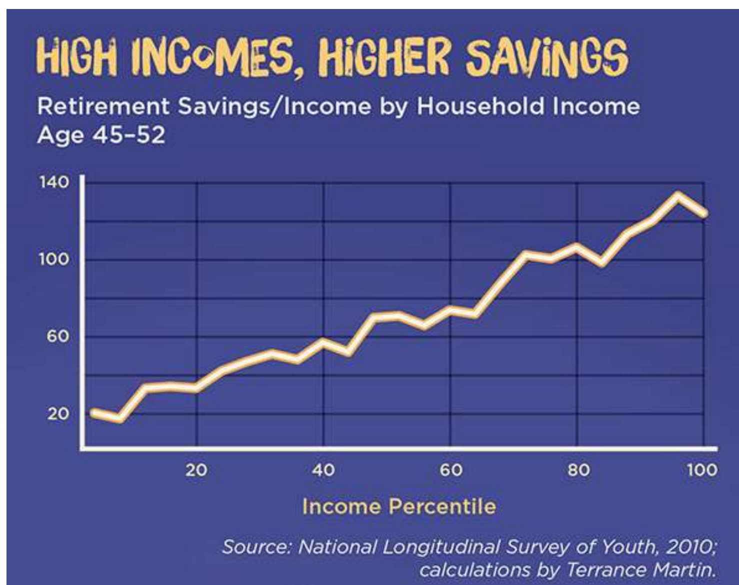
Once you include the myriad tax issues (it is mind-bogglingly complex) related to retirement savings and eventual distribution as income, the relative benefits of sheltered saving increase with income. In fact, at incomes of $50,000 and below, the benefit from sheltered saving in present value terms is actually negative or close to zero. The benefit rises with income and then

begins to fall at very high incomes as sheltering opportunities go away. That's a big reason that, among employees eligible for an employer DC plan, 92% making over $100,000 a year participate compared to a minority of employees in low income categories.

So our tax system is giving the upper middle class a very strong incentive to save for retirement. But it isn't doing much to help the lower middle class. The fact that the DC system isn't very equitable is a problem that, unfortunately for readers and advisors, will likely lead to curbs on sheltering options as the government looks for ways to increase revenue in the future. Enjoy it while it lasts.

Measuring the Problem

It seems as though every month brings a new study that points out the shocking percentage of Americans with inadequate retirement savings. According to the newest EBRI Retirement Readiness study, only 57% of baby boomers have saved enough to “cover average expenses and uninsured health care costs.” Once you take into account Social Security, any existing defined benefit distributions, DC and IRA assets and home equity, a big chunk of Americans haven't saved enough.



Some older academic studies were a little more optimistic. They simply looked at existing defined contribution savings and inflated their values by a conservative real return of 8% on stocks and 2% on bonds. With no expenses or fees. And no 1.5% investor underperformance from poor market timing. It's hard to imagine how boomers have fallen behind these realistic expectations.

A new study by Ohio State University professor Sherman Hanna and doctoral student Kyoung Kim asks whether those who haven't saved enough for retirement are actually aware that they’re falling behind. It's not surprising that lower levels of education and financial sophistication are associated with needing a reality check. Another big predictor was those who expect to retire before age 62. Americans in general need a big dose of reality about retirement age. It's hard to

fund a 30-year retirement with a 40-year career in the current low-yield environment without being a miser.

A recent paper written by me and Terrance Martin, professor at the University of Texas-Pan American, finds that estimating how much workers will need to save for retirement can have a big impact on retirement savings. Simply going through the process of figuring out how much they have and what they'll need forces them to face reality. We also find that those with a financial advisor who calculated retirement needs had saved 2.5 times more for retirement, even after controlling for income.

In addition to retirement age and asset return expectations, the other retirement adequacy wild cards are the appropriate income replacement rate and health care costs. It's easy to create the perception of a retirement crisis if retirees have to replace an unrealistically high percentage of their pre-retirement income. I'm going to save this discussion for a future column, but my own research says that we might tend to go overboard. Replacement ratios of 80% are nuts if a worker was already saving 15% of their income, has paid off a mortgage and the kid's college education, no longer pays 6.2% OASDI and 1.45% Medicare, can drop term life insurance and disability, and faces reduced taxation on Social Security benefits.

The real wild card is health care expenses. A sensitivity analysis by EBRI shows that unexpected health care costs can have an even larger impact on retirement readiness than assumptions about asset return, longevity or reductions in Social Security. A quick look at the Medicare Trust Fund shows that it's projected to run out in 2026, resulting in a 13% decline in projected benefits. EBRI estimates that today's average retiree would need over $100,000 to have a 90% chance of meeting health expenses in retirement.

So are Americans ready for retirement? Many with higher incomes who regularly participate in DC plans have benefitted from the world of tax sheltered savings. But a significant percentage of Americans, particularly those with less education, financial literacy and income, are falling behind.

For those facing a train wreck, there aren't any easy answers. The first step may be helping workers gain a more realistic idea of how much they need to save. Creating a retirement income plan for a client can have the dual benefit of increasing awareness and building a regular savings strategy. It can also help them make reasonable decisions about when to retire. The best prescription for preventing the wreck might be a well-placed warning flag.