OnTheRecord

A Conversation with **Anil Kumar**

Baby Boomers Face a Changing Retirement Landscape

Many baby boom era workers, those born between 1946 and 1962, count on various retirement benefits accumulated during their working years to ensure adequate resources as they grow older. A man turning 65 today can expect to live to age 83; a woman to age 85, according to Social Security Administration data. One in 10 will live past age 95.[1] Dallas Fed economist Anil Kumar discusses the retirement outlook for baby boomers and growth of 401(k)-type retirement accounts.

Q. How has the retirement outlook for baby boomers changed over the past 30 years?

A. One can look at how the situation has evolved by comparing how older members of the baby boom generation are doing relative to those who came before them. Recent studies comparing the wealth of the different groups show that the leading edge of the baby boom generation, which is starting to retire, has on average accumulated roughly as much wealth as those six to eight years older, at the same point in their lives. One study compared the total net worth of baby boomers between 40 and 55 years old in 2001 to groups of the same age in 1983 and 1989 and found little evidence that the boomers were worse off.[2] Though findings differ, the studies lead to the conclusion that, contrary to some analysts' arguments, boomer wealth hasn't deteriorated relative to those who preceded them. It will be interesting to see how succeeding generations fare.

Q. What happened to the employer-sponsored, defined-benefit plans common before 1980 that promised a regular monthly payment to retirees?

A. The popularity of traditional defined-benefit plans has waned since the IRS clarified rules for the now more common defined-contribution plans, such as the 401(k), in 1981. By then, structural changes in the labor market encouraged the trend toward 401(k)-type plans. A long-term decline in manufacturing and an emerging service sector increased workforce mobility and heightened the need for more portable retirement benefits. Technological change through the 1980s and 1990s, led by the emergence of personal computers and later the Internet, also contributed to workers' skills becoming increasingly transferable across companies. The developments reduced the need to reward long tenure through defined-benefit pensions based on years of service at the company and the worker's final salary. Under defined-benefit plans, job jumpers were penalized for not staying at one place long enough to obtain retirement benefits. A secular decline in unionization of the U.S. workforce also contributed to a diminished role for generous pension plans, prevalent among union workers.

As defined-benefit plans grew more difficult to administer and operate, many firms abandoned them. Retirement benefits became problematic when plans weren't in a position to make promised payments. If a defined-benefit plan is inadequately funded, the employer can freeze benefits or, in times of financial distress, even terminate pensions and turn them over to the Pension Benefit Guaranty Corp., a federal agency that assumes payment liability, often at pennies on the dollar. This occurs most often during economic downturns, when many companies have had to switch to defined-contribution/401(k) pension plans. These cost-structure considerations aren't limited to the private sector. Many state and local governments' defined-benefit plans pose particular underfunding concerns after officials made unsustainable pension promises to employees, leaving taxpayers on the hook.

Q. What role does Social Security play for retiring baby boomers?

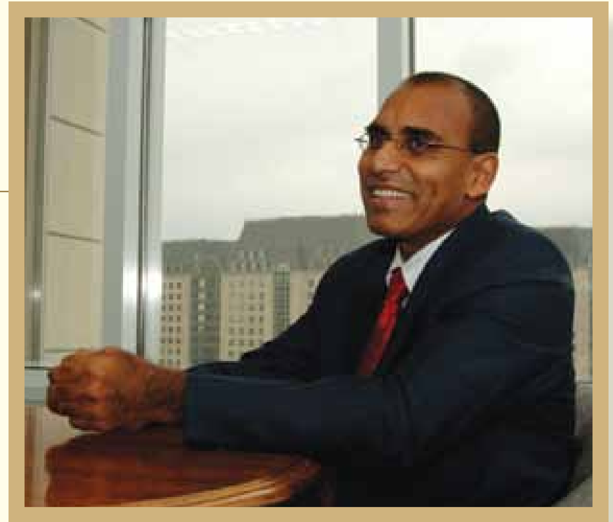
A. Social Security remains the foundation of seniors' retirement income. For about one-third of retirees—including many receiving few or no pension benefits—Social Security accounts for more than 90 percent of income. As the statutory age for receiving full Social Security benefits rises to 67, Social Security will replace a smaller portion of preretirement earnings for low-income workers—49 percent by 2025, compared with 54 percent now.

More troubling, perhaps, is the projection in the 2010 Social Security Trustees' Report that the trust fund is on a pace to become insolvent by 2037, when it will provide just 76 percent of promised benefits. While Social Security will continue playing a central role in workers' retirement income, questions about future benefits will prompt boomers to increasingly rely on personal savings and pensions.

Q. What are the drawbacks of a greater role for defined-contribution plans, such as 401(k) plans, in retirement income? What are the benefits?

A. With 401(k) plans, employees make elective pretax contributions to their personal accounts. The company may match a portion of a worker's contribution. In a typical 401(k) plan with employer payment, the firm matches 50 percent of a worker's contribution up to 6 percent of pay. A central feature of a defined-contribution/401(k) plan is that the employee essentially controls the account and makes all investment decisions.

"A long-term decline in manufacturing and an emerging service sector increased workforce mobility and heightened the need for more portable retirement benefits."



The worker bears the investment risk, the inflation risk (that returns won't meet or exceed the cost of living) and the longevity risk (outliving available funds). There is also the issue of "leakage"—in some instances before retirement, the 401(k) provides an enticing source of cash that can be spent, with income tax penalty, leaving little or nothing for later.

When workers change jobs, they typically get a lump sum distribution of their 401(k) balances from their previous employer. Many may be tempted to spend the lump sum, rather than rolling it over into an Individual Retirement Account or other qualified retirement vehicle.

Compared with defined-benefit plans, participation in 401(k) plans isn't automatic, and about 30 percent of workers don't enroll. Recent research has emphasized behavioral aspects, such as procrastination and inertia, as reasons why workers forgo the plans, often failing to take advantage of employer contribution matching and, thus, leaving money on the table.

Also, workers are exposed to investment risk. What if they make mistakes by investing too much or too little in equities or too much in the employer's company stock? Overconcentration in such shares can be financially devastating if the firm goes bankrupt and the shares lose all their value. Employees need to guard against this "Enron Effect," which wrecked thousands of workers' savings when that company collapsed in 2001.

Despite the challenges, 401(k) plans offer many benefits. They don't involve the significant job-change risk associated with defined-benefit plans. Defined-contribution/401(k) plans are portable, less affected by time spent with a single employer and highly suitable for an increasingly mobile workforce. They are also fully funded as opposed to defined-benefit plans that can suffer underfunding. Also unlike defined-benefit plans, 401(k)s don't provide powerful incentives to retire at a certain age and, therefore, can encourage additional years at work, a desirable goal considering the need to finance more years of retirement because of increasing life expectancy.

Q. How did the Pension Protection Act of 2006 improve 401(k) plans?

A. To overcome some of the problems with employer-backed pensions, Congress passed the Pension Protection Act in 2006. Besides tightening funding requirements for underfunded traditional defined-benefit plans, the act removed legal barriers to firms implementing automatic participation in and contributions to 401(k) plans for new employees. Workers can, of course, opt out of the plan at any time. Once an employee is in, the act provides guidelines for administering automatic contributions, which may escalate to as much as 10 percent of pay.

The legislation also addressed concerns that employee 401(k) investment selections may be inadequately diversified. The act created a default investment option that includes target-date funds that automatically rebalance to more conservative holdings as a worker approaches retirement. The act also required that companies allow diversification out of holdings of the sponsoring firm's stock. Finally, the act lowered legal barriers that limited the advice pension plan managers may provide participants.

Q. What have we learned about defined-contribution plans during the economic downturn?

A. The financial crisis in 2008 exposed 401(k) retirement assets to their stiffest test ever. There was general concern that panicked workers nearing retirement would lose money by moving out of equities near the bottom of the market. Some of these worries appear overblown. Vanguard and Fidelity Investments, two of the largest retirement fund managers, reported that most defined-contribution/401(k) account holders didn't bail out of equities. Vanguard data found that only 16 percent of account holders moved their plan assets from one investment option to another in 2008. There was little evidence of panic trading.

Q. What do the changing trends in retirement income mean for the overall economy?

A. Looking at the ratio of pension wealth to combined wage and salary income suggests that the emergence of defined-contribution/401(k) plans may have increased savings. Private pension wealth as a percentage of private sector wages rose to about 200 percent in 2009 from 46 percent in 1980. Although we don't know exactly how this figure would have changed without the defined-contribution/401(k) plans, it seems to indicate that their growth since the 1980s played a role—a tentative sign that retirement prospects have improved in the past 30 years.

According to classical economic models, a dollar in pensions or Social Security should reduce other saving by an equivalent amount, leaving the overall amount set aside unchanged.

However, in practice, pensions don't appear to crowd out other savings, dollar for dollar, and can, therefore, boost the overall saving rate.[3] Higher saving provides funds for investment and leads to greater economic growth.

Notes

[1] See www.socialsecurity.gov/planners/lifeexpectancy.htm.

[2] "The Retirement Wealth of the Baby Boom Generation," by Edward N. Wolff, *Journal of Monetary Economics*, vol. 54, no. 1, 2007, pp. 1–40.

[3] "Pensions and Household Wealth Accumulation," by Gary Engelhardt and Anil Kumar, *Journal of Human Resources* (forthcoming).