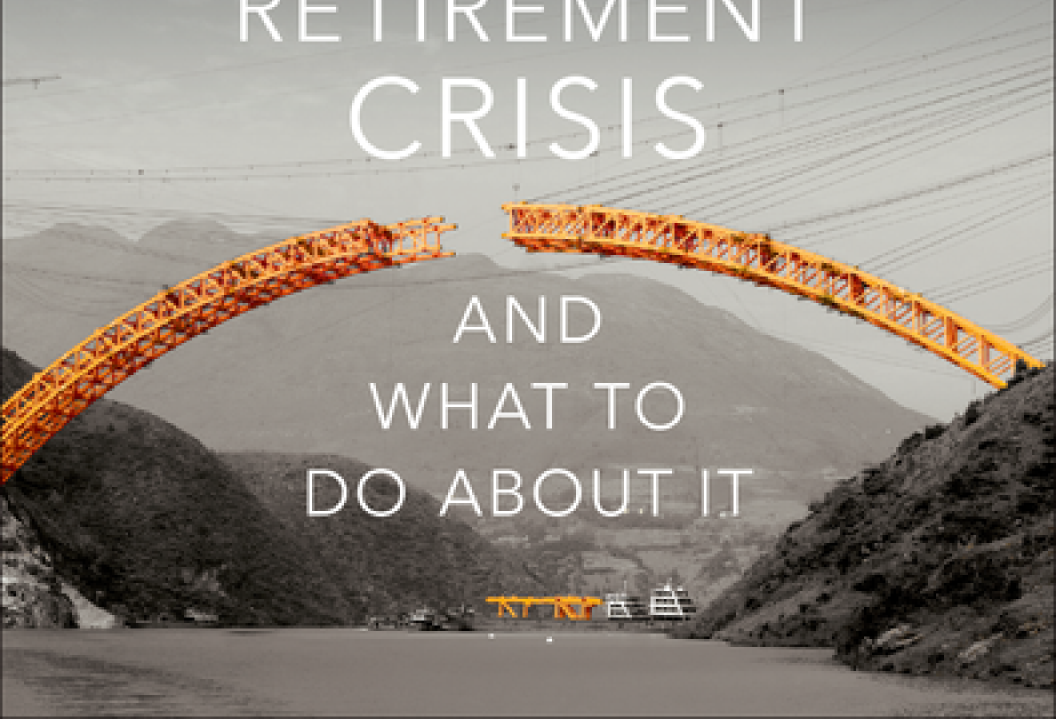
CHARLES D. ELLIS, ALICIA H. MUNNELL,
*and* ANDREW D. ESCHTRUTH

# FALLING SHORT

## THE COMING RETIREMENT CRISIS AND WHAT TO DO ABOUT IT



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# INTRODUCTION

Just 30 years ago, most American workers were able to stop working in their early sixties and enjoy a long and comfortable retirement. This "golden age" of retirement security reflected the culmination of efforts that started more than a century ago when employers first set up pensions. Gradually, over decades, we built an effective system with Social Security and Medicare as the universal foundation and traditional pensions—where the employer was responsible for all the saving and investment decisions—providing a solid supplement for about half the workforce. The increasing provision of retirement support allowed people to retire earlier and earlier.

This brief golden age is now over. Because of economic and demographic developments, our retirement income systems are contracting just as our need for retirement income is growing. On the income side, Social Security is replacing less of our preretirement income; traditional defined benefit pension plans have been displaced by 401(k)s with modest balances; and employers are dropping retiree health benefits. On the needs side, longer lifespans, rising health care costs, and low interest rates all require a much bigger nest egg to maintain our standard of living. The result of all these changes is that millions of us will not have enough money for the comfortable retirement that our parents and grandparents enjoyed.

If we do not recognize that we are veering off the road and take corrective action soon, millions of retirees will find that they are too old to return to work *and* have too little in savings—with no one to turn to for help. If we fail to recognize the problems and provide sensible solutions—now, when we can—history will judge us harshly. Millions of retirees will ask: "Why didn't anybody warn us?" Or, "You could see it coming! Why did you fail to do what was needed to be done to protect us?"

We hope this book—a little like Paul Revere's famous ride in 1775—will help raise the alarm and get government leaders, corporate executives, and individual workers thinking and talking about how to solve America's impending retirement crisis. We propose a number of specific and doable adjustments to get us back on the road and heading safely to our intended destination.

To provide a brief, but complete, guide to our retirement security challenge, this small book tackles three big questions: How did we get where we are? How bad is the problem? And what can we—as individuals and as a nation—do about it? The short answers are provided in this introductory chapter. But you will want to read the rest of the book for the full story.

At one level, our retirement problem is simple: we need more income, but we will get less from traditional sources. We need more because we are living longer while today's average retirement age is 64 for men and 62 for women.[1] As a result, the average man will spend 21 years in retirement, the average woman 23 years, and couples will face a significant probability of one member living into the nineties. We also need more income because out-of-pocket health costs are high and rising. And interest rates, which determine how much income we can draw from our nest eggs, have fallen to historic lows.

While we need more spendable income, we are now getting less from Social Security and employer pensions. Under current law, Social Security replacement rates are being gradually reduced as the so-called Full Retirement Age rises, Medicare premiums are taking a bigger bite of benefit checks, and more people are subject to taxes on their benefits. In addition, the shift to two-earner households is reducing replacement rates further. Moreover, Social Security faces a long-term deficit, so benefits could be cut even further to restore balance.

On the private employer side, traditional pensions are rapidly disappearing, replaced by 401(k) plans.[2] While these plans could be an effective way to save if structured appropriately, today they are clearly falling short. These plans shift all risks and responsibilities from the employer to the individual, and most of us are not well prepared for this burden. We make mistakes at each step along the way. The result is that most 401(k)s have only modest balances, which will produce far too little retirement income. For households nearing retirement with a 401(k), the typical total is only $111,000—including any assets that were rolled over into IRAs.[3] That $111,000 may seem like a lot to many, but it means less than $400 per month in retirement (adjusted annually for inflation) to supplement Social Security benefits that cover a shrinking share of our preretirement income. And those with a 401(k) are the lucky ones; half of today's private sector workers don't have any employer-sponsored retirement plan.

The one small bright spot in this gloomy picture is that many of us are saving through our house with each monthly mortgage payment, and we could tap this home equity in retirement to help pay the bills. But, even counting home equity, most of us do not have nearly enough. For example, to maintain their standard of living, a typical couple needs savings of 6 to 11 times their earnings (depending on when they retire) to supplement Social Security. But a typical household's current savings at retirement are much less than half that amount!

So what can we do—as individuals and as a nation? There are only three options. The first is to simply accept that we are going to be poor in retirement. The second is to save more while working, which means spending less today. The third is to work longer, which means fewer years in retirement. Those are our *only* options.

Every specific idea for solving the retirement income problem, whether it appears here or elsewhere, falls under one of these three options. For example, reducing Social Security benefits means living on less in retirement. Expanding participation in 401(k) plans means saving more. And explicitly recognizing that 70 is Social Security's *real* retirement age means encouraging people to work longer.

This book focuses on solving the retirement problem through a combination of working longer and saving more. (Living on a little less in retirement may, in the end, also be necessary, but it should not be our goal.) Achieving these aims will require a broad effort by individuals, by businesses, and by our government. Fortunately, we have both the ability and the financial infrastructure to meet the retirement challenge.

Let's start with working longer. Many of us are healthier and have less physically demanding jobs than our parents and grandparents. And we are living much longer. So stretching out our work lives is a sensible option. And the payoff is eye-popping! Individuals who delay receiving Social Security benefits from 62 to 70 increase their monthly benefits by a full 76 percent. Government could send a clear signal about the importance of working longer by vigorously promoting age 70 as the new 65. It should also consider raising Social Security's Earliest Eligibility Age from 62 to, say, 64.

(At the same time, we need to find a solution for those of us who simply cannot work longer due to health problems or outdated job skills.) Publicly encouraging longer work lives would signal to employers that older workers would be sticking around and, thus, would increase employers' willingness to hire, train, and promote them. For our part, as workers, we should do what we can to show our employers that we are hustling to keep up our technical skills.

On the saving front, we should first fix Social Security. Benefits are already shrinking relative to earnings, and additional cuts could cause steep drops in living standards and higher poverty. For that reason, reforms should lean much more toward higher revenues than lower benefits. And, to temper the need to raise payroll taxes, we should consider shifting the costs of the system's legacy burden to the personal income tax and perhaps investing part of trust fund assets in equities.

The next step is to boost our savings in 401(k)s through evolutionary improvements within the current structure. The key lever is to expand the use of the automatic 401(k), a model that is a proven success. Under this automatic approach—unless employees choose to opt out—they participate in the plan, their contributions rise each year until they reach a specified level, and their savings are invested in a balanced investment portfolio that can rely on index funds with low fees. If workers don't like one or more of the automatic provisions, they can opt out and make different decisions. But experience shows that most people are happy to stay where they are put. While the government currently *encourages* employers to adopt this auto-401(k) strategy, this approach has met with only limited success. We wish that all companies would adopt this successful model voluntarily but, given experience to date, we think the time may have come to make the automatic provisions *mandatory* and extend them to all employees, not just new hires.

As part of the evolutionary approach to boosting retirement saving, we need to solve the pension coverage gap for the half of workers without a 401(k) plan, perhaps by providing an "auto-IRA" at either the federal or state level or automatically enrolling all uncovered workers in President Obama's new "MyRA." Our retirement system will never be complete until all workers have an automatic saving option to supplement Social Security.

A key advantage to the evolutionary approach is its reliance on our existing programs and financial arrangements rather than trying to build a new system. However, some experts prefer starting over with a fresh approach. These "big bang" proposals, which feature universal accounts with low-cost investing and a reduced role for employers, are also discussed.

The final piece of the saving puzzle is the house. Most of us think of our house as a last-resort emergency fund—perhaps to pay for nursing home care—not as a source of day-to-day funds. And, if there's no emergency, we plan to pass it on to our kids. But the house is a big source of saving for most of us and often the *only* saving for those of us without a 401(k). Many of us will need to use our home equity to help pay the monthly bills in retirement, so we should consider tapping it through downsizing or taking a reverse mortgage.

That's it: work longer, fix Social Security, save more through 401(k)s, and consider using home equity. These steps are all doable, and they should all seem familiar. Working is something we've been doing all of our adult lives; we just have to plan to keep doing it longer than our parents did. Social Security has been, and should continue to be, the cornerstone of the system. Our 401(k)s can be made much better just by following the successful "automatic" model already in use. While the fixes for both Social Security and 401(k)s will require us to contribute more when we are working, lowering our spending somewhat now will give us a more realistic standard of living that is easier to maintain when we retire. And using our home equity to address important needs, such as renovations or college costs, is second nature for many of us. We just have to think of "retirement security" as an important need as well.

The bottom line is that a long retirement is expensive; it is difficult to prepare for because we are increasingly on our own; and, without making changes, we are not going to have nearly enough in savings. This discussion does not pit the old against the young, grandparents against their grandchildren. We all belong to families where we care about the generations ahead of and behind us. Rather the discussion is about what each of us should do when we are young and working so that we will have enough money when we stop working and about how the system could be better designed to help us in that effort. The world has changed, so we must adapt if we are going to have a decent retirement.

# [2]

# HOW DID WE GET HERE?

The story behind our current situation starts in the late nineteenth century with the emergence of retirement—a brief retirement—as a distinct part of life. From that point, the nation engaged in a century-long effort to ensure that people could retire with adequate income. This process proceeded in fits and starts, with many adjustments over time in response to unanticipated consequences or unexpected needs. By the late twentieth century, however, these collective efforts culminated in a brief "golden age," when many American workers retired with confidence in their financial security. But now, the promised benefits have become unsustainable and our retirement income system is coming up short, with many of us facing a serious mismatch between our retirement needs and retirement resources.

This chapter provides critical context for understanding why it is either not feasible or, in some cases, desirable to go back to the past. Instead the system needs to continue to evolve to meet the needs and challenges of today and those foreseeable over the coming decades.

## THE EMERGENCE OF "RETIREMENT"

Retirement as a distinct stage of life is a fairly recent innovation.[1] Up to the end of the nineteenth century, most people worked for