

Rethinking Retirement Savings

Many Americans have surprisingly little set aside for retirement. Why, and what can be done to boost their nest eggs?

BY MATTHEW WELLS



How much is enough to live comfortably in retirement? Would \$30,000 a year be enough? Maybe if you live in a low-cost area, and the house is paid off. How about \$15,000? It would be a stretch, at best. Yet recent census numbers indicate millions of Americans over the age of 65 must figure out how to make ends meet on these incomes. A quarter of seniors, almost 14 million retirees, live on only \$15,000, while a little over half, 29 million retirees, live on only \$30,000 a year. For these Americans, the prospects of a comfortable retirement appear uncertain.

According to the Fed's 2022 Survey of Consumer Finances (SCF), just over 54 percent of families have retirement accounts such as IRAs, 401(k)s, 403(b)s, or thrift savings accounts. Among families that do have them, the median value of those accounts in 2022 was just \$86,900 — hardly enough to last the 20 years of an average retirement. This is especially true given that the median retiree spends over 10 percent of his or her income on out-of-pocket medical expenses that aren't covered by Medicare or Social Security. Moreover, for those approaching retirement in the ages 55 to 64, SCF data indicate that those in the 50th percentile, or the middle of the pack, have only \$10,000 saved in those accounts.

To be sure, there are some bright spots in the picture. Andrew Biggs, an economist with the American Enterprise Institute, suggests that Americans are doing well when it comes to retirement. Among other data points, he notes that the elderly poverty rate declined from 9.7 percent in 1990 to 6.4 percent in 2018, and that for those contributing to retirement plans, contributions have increased from about 6 percent in 1975 to over 9 percent in 2021.

But even some of the positives carry some negatives. For

example, the average IRA/401(k) portfolio balance for those nearing retirement, among seniors who have such accounts, increased from \$144,000 in 2019 to \$204,000 in 2022. That is certainly good news, but the same SCF survey indicates these gains were concentrated among higher-income households, while those in the lower 40 percent were worse off. Further, account balances for households ages 45 to 54 did not keep pace with inflation, and 35-to-44-year-olds' household balances declined in nominal terms.

How did it come to be that so many have so little saved for retirement? And what can be done to help more Americans save and retire with financial security?

SOCIAL (IN)SECURITY?

Even after including other potential sources of income like investment accounts, real estate, and businesses, the 2022 SCF results suggest that half of households will have to rely almost entirely on Social Security when they enter retirement. But the average yearly benefit is only about \$23,000 — most likely well below the 75 percent of pre-retirement income financial planners say is necessary to maintain a consistent standard of living in the post-working years.

The program's ability even to provide that modest income is not guaranteed. The 2023 Social Security Trustees Report identifies a shortfall of \$22.4 trillion through 2097, and estimates that it will only be able to pay out 80 percent of scheduled benefits beginning in 2034 unless changes are made to the program. Potential fixes include adjusting the payroll tax structure to generate more funding and increasing the age to qualify for full retirement (currently 67 for those born in

1960 or later) or the maximum benefit (currently 70).

The shortfall can be traced primarily to demographic shifts. In 1935, U.S. life expectancy was just under 62 years, and the fertility rate was 2.1 children per woman. Life expectancy increased steadily over time and was 69.5 by 1957. This was the peak year of the baby boom, and the fertility rate was 3.5 children per woman. Today, Americans live to about 79.3 years, and the fertility rate has dropped to 1.8.

Another way to consider this demographic shift is to look at changes in the old-age dependency ratio, which is defined by the Organisation for Economic and Co-operation and Development as the number of individuals age 65 and over per 100 people of working age, generally 20 to 64. In 2000, the ratio was 20.9; today, it is 32.2. Along with increased life expectancy, the Social Security Administration cites several factors contributing to the changing ratio, including increased female labor force participation and the widespread postponement of family formation, both of which contribute to fewer births.

FLAVORS AND TRENDS OF RETIREMENT SAVINGS

Thus, Social Security benefits are unlikely to fully rescue retirees who don't have enough money salted away. What, then, explains Americans' apparent lack of retirement savings?

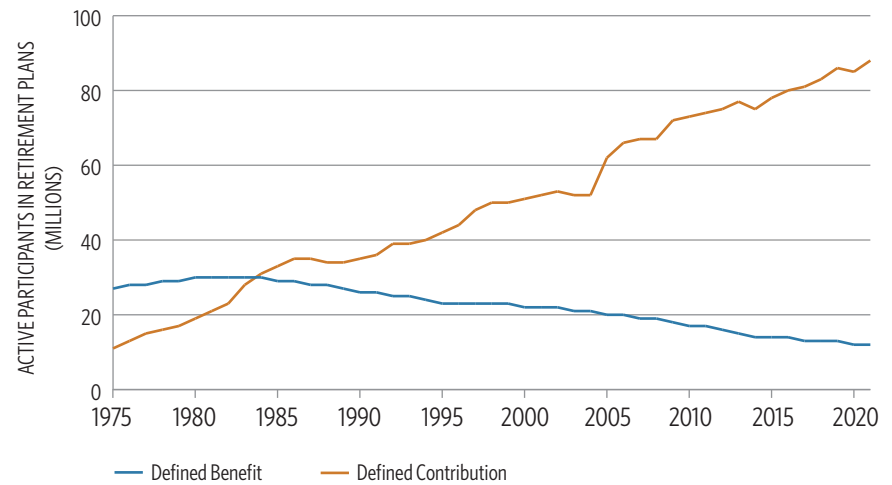
For decades, both public and private sector employers contributed to their workers' retirement through pensions, known broadly as defined benefit, or DB, programs. Under this system, employers pay out a monthly benefit to each retired worker, the value of which is determined by the worker's age, length of service, and final salary. Workers typically must remain with a firm for a certain number of years to qualify for a pension, but if they do, they then receive that benefit for the duration of their retirement.

Defined contribution (DC) plans, on the other hand, are individual accounts funded by the worker's own contributions, employer contributions, or both. Examples of DC plans include profit-sharing plans, 401(k)s, 403(b)s, and employee stock ownership plans. Under these programs, there is no guaranteed income; what is available in retirement is whatever has resulted from those contributions, investment gains and losses, or company earnings. These programs can be sponsored by the employer, or individuals can open their own individual retirement account (IRA). Either way, the workers typically act as their own financial advisors, deciding how much money to put in, and allocating and distributing those funds to maximize returns and hedge against the risks that come with investing.

For the last nearly 50 years, there has been a massive shift away from defined benefit plans toward defined contribution options. In 1975, private sector DB plans had 27 million active participants, whereas private sector DC plans had

A Dramatic Transition in Private Sector Retirement Savings

Active participants in defined benefit and defined contribution plans, 1975-2021



SOURCE: Employee Benefits Security Administration (EBSA 2023). Private Pension Plan Bulletin Historical Tables and Graphs 1975-2021, Table E7 via Economic Policy Institute

only 11 million active participants. In 2021, that number had dropped to 12 million participants for DB plans and grew to 88 million participants for DC plans. (See chart.)

Why the shift? Employers typically cover the entirety of a defined benefit plan, making them more costly. Defined contribution plans are also more predictable and easier to administer, as employer contributions follow a set formula (for example, contributing 3 percent of an employee's salary), and they do not rely on actuaries to develop cost projections of benefits to be paid each year. DB plans, on the other hand, can require employers to make additional contributions in the event of investment losses to meet the benefit amount they had previously agreed on with their employees. The inability for some firms to meet those commitments led to the Employee Retirement Income Security Act (ERISA) of 1974 and the Pension Protection Act of 2006, both of which, among other things, mandated stricter funding requirements to ensure employees receive the benefits they were promised. ERISA also carries additional costs for employers, which may have prompted them to discontinue offering them to new employees.

From the employees' perspective, defined contribution plans also might be preferable because of their portability. Participants can "roll over" their account balances from a previous employer's plan into a new one, allowing them to continue accumulating benefits wherever they work. DB plans lack this portability in large part because the benefit formulas they use only account for a worker's tenure and salary with respect to a specific employer.

While these changes initially might make putting money away for retirement appear easier, there is evidence this transition from DB to DC plans has led to less retirement savings for a significant portion of American workers. The Bureau of Labor Statistics reports that of the 66 percent of private sector workers with access to a DC plan, only about half actively make contributions.

Also, as noted above, anyone can open an IRA regardless of whether their employer sponsors a retirement plan. But data from the Census Bureau indicate that as of 2014, only 22 percent of workers at businesses without pension plans had opened one, and under 8 percent were actively contributing. Managing such plans, and defined contribution plans generally, can be intimidating for employees, which may explain the poor participation rates. Additionally, the census data suggested that with slow earnings growth over time, many workers have found it challenging to set aside funds for retirement, instead opting to use the money for current expenses.

WHY SAVINGS HAVE STALLED FOR SO MANY

A 2023 Congressional Budget Office report estimates that this shift away from DB plans to DC plans accounts for about 20 percent of the increase in wealth inequality from 1989 to 2019. Data from the SCF indicate that in 1989, the median household of those approaching retirement had no money in retirement accounts or DC plans, while those in the 90th percentile had \$161,000. Over time, that difference has increased dramatically. In 2022, the top 10 percent held balances over \$1 million, while as noted earlier, the median household in that age group had balances of about \$10,000.

The disparities in uptake and active contributions to retirement accounts also extend beyond income levels to ethnic groups. While nearly 62 percent of White households have such accounts, a little more than a third of Black households and just over a quarter of Hispanic households contribute to retirement accounts, according to the 2022 SCF.

Monique Morrissey is an economist at the Economic Policy Institute, a progressive think tank. She argues that with the bulk of retirement account activity occurring in the upper income brackets, 401(k)s and other similar retirement accounts have failed to provide most working Americans with adequate savings for retirement and have instead been used by more wealthy Americans primarily as tax-advantaged investment opportunities. She notes that the Treasury Department has estimated contributions to those accounts cost \$138.5 billion in lost revenues in 2021 alone. (Account holders of pretax accounts pay taxes when they withdraw funds in the future, but those will likely be different than what would have been paid in current income taxes.) “If we had taken all the money we had spent on subsidizing 401(k)s, and we just divvied it up among households and invested in Treasury bonds with no employer or employee contributions, most households would be better off,” she argues.

In addition to the changes in the vehicles available for saving, the rising costs of health care have also eaten away at Americans’ savings. Medical expenses rise rapidly with age, as middle-income individuals can expect to pay an average of \$6,000 annually at age 76, and the cost only goes up from there — as much as \$26,000 if they’re fortunate enough to reach 100, according to a 2023 working paper by economists at the University of Minnesota, the University of Cambridge, the Richmond Fed, and the University of Western Ontario. Most of those costs come from needing to pay more for out-of-pocket expenses not covered by Medicare, which provides insurance to Americans ages 65 and older. Those out-of-pocket costs

can go toward prescriptions, hospital stays, home health care, doctor and dental visits, and premiums for any supplemental private insurance and Medicare itself. Medicare also only fully covers the first 20 days of a nursing home stay, a reasonably common medical need for the elderly. Some of these costs are covered by Medicaid, but that program is only available to those with very limited financial resources.

These costs have forced many Americans to make difficult decisions about how they will allocate already scarce financial resources. According to a 2023 Kaiser Family Foundation survey, 36 percent of Medicare beneficiaries indicated that they delayed or went without medical care because of the costs. Households with Medicare also spend a larger share of their budgets, unsurprisingly, on health care than households that do not use Medicare.

The Kaiser Family Foundation also reported that increases in health insurance premiums for working families outpaced increases in workers earnings — and the pace of inflation — between 2003 and 2018, which means less money to put away for retirement. Rising health care costs also impact savings through another, more indirect path: Employers frequently provide health insurance for their employees, and increasing costs likely means less money available to spend on wages and pension or retirement plan investment.

POLICY OPTIONS

Morrissey from the Economic Policy Institute sees Social Security as the best hope for providing retirement security to working Americans. Because those benefits are a function of both what a worker pays in and increases to the cost of living, “the return on Social Security contributions is much more stable and predictable than what you get with a 401(k),” she argues. But even if Congress addresses the shortfall and restores long-term solvency, a 2023 report from Boston College’s Center for Retirement Research suggests that absent major increases in funding, Social Security will replace even less of the 75 percent of pre-retirement income commonly believed to be necessary for maintaining one’s standard of living into retirement. Passing those increases is politically controversial, and would come with their own economic costs, leading policymakers and researchers to look for alternatives that might increase Americans’ ability to save for retirement.

Perhaps the most widely considered options involve expanding access to defined contribution plans, which, as noted, have tended to produce benefits that disproportionately benefit the wealthy. Much of that expanded access is taking place at the state level. Nineteen states and two cities have enacted some form of retirement savings programs for their private sector workers, the most common of which is an auto-enrolled Roth IRA. When an employee begins work, employers deduct between 3 and 5 percent of each paycheck and place it into an IRA, although the contribution can increase incrementally over time. For example, California’s plan starts at 5 percent and an additional 1 percent is added every year until it reaches 8 percent. Like all other IRAs, they aren’t tied to an employer, and individuals can elect to opt out at any time.

In a 2021 working paper, economists at the University of Oregon, the University of Pennsylvania, Boston College, and the Urban Institute evaluated the efficacy of OregonSaves, the state's auto-IRA plan passed into law in 2015. They found that between 2018 and 2020, more than 67,700 workers had accumulated more than \$51 million in investment savings, suggesting auto-enrollment mitigates the barrier of establishing an account. At the same time, the upper bound of the participation rate among eligible workers was only 62.4 percent — well below the rate in firm-sponsored plans. Of those opting out of the program, over 30 percent said that they couldn't afford to save.

Alicia Munnell, the director of the Center for Retirement Research at Boston College, argues for requiring employers to offer plans. "Nothing is going to get better until there's a national mandate that says employers have to either provide a plan or send their employees' contribution to a public version of, say, the Thrift Savings Plan [the defined contribution plan for federal government workers]." She also argues that having access to a plan is more important than the type of plan. Defined contribution plans may even have some advantages over defined benefit plans for workers once they retire. Having stocks and bonds in defined contribution accounts "may be better than having a fixed nominal benefit that just gets eroded by inflation," which might happen under a defined benefit plan.

While legislation at the federal level has yet to be put forward containing such a mandate, the Retirement Savings for Americans Act, introduced originally in 2022, would create a nationwide auto-enrollment program for workers who do not have access to employer-provided plans modeled after Uncle Sam's Thrift Savings Plan. Like other retirement accounts, it would be portable, and offer a variety of investment options tied to workers' estimated retirement dates. To encourage savings, it would also provide certain savers with a 4 percent match by the government through an income tax credit.

A similar matching provision was included in the Secure 2.0 Act, which was signed into law in late 2022. Beginning in 2027, the federal government will match up to 50 percent of a worker's contribution to his or her retirement plan up to \$2,000, a benefit known as the Saver's Match. For example, a worker contributing \$2,000 would see the government also contribute \$1,000. The program is meant to encourage saving among lower- and middle-income Americans; it is available to single tax filers making a maximum annual income of \$20,500 or joint filers making between \$41,000 and \$71,000 and will adjust annually for inflation.

Some academic research has suggested that Americans have historically saved for retirement in an optimal way,

meaning they usually accumulated sufficient wealth to maintain their standard of living. A 2006 paper from the *Journal of Political Economy* using data from 1992 to 2004 showed that over 80 percent of households were saving optimally for retirement during that period, and those who were not were only minimally below their target. Additionally, in a 2015 working paper, RAND economists Michael Hurd and Susann Rohwedder looked at consumption capability, or the extent of one's ability to consume whatever goods and services one wants, as a measure of financial wellbeing rather than income, and found 59 percent of single retirees and 81 percent of couples are prepared for retirement.

While these measures should not be dismissed, many who are still working feel increasingly uncertain about how they will get by in their sunset years. According to the Fed's 2023 Survey of Household Economics and Decisionmaking, 80 percent of retirees said they were doing at least OK financially, but only 34 percent of nonretirees thought their retirement savings plan was on track, down from 40 percent in 2021.

Three long-running trends have been the source of uncertainty in recent decades. First, people are living longer, meaning it is more expensive for society to support lengthy retirements. Second, historically increasing income inequality, whether from lower wages or replacing DB programs with DC plans, means many workers have fewer resources set aside. Third, ongoing increases in the cost of medical care have eaten up larger portions of savings. The government in recent years has paid many of these costs through programs like Medicare, but there are limits to how much of the burden it will carry.

The solutions that have been offered are also controversial. Some object to the prospect of asking people, especially lower-wage earners, or manual laborers, to work even longer while wealthy people at the same age can retire. Voluntary retirement plans can provide opportunities for savings accumulation, but it is hard for people to save for the future when living in an increasingly costly present. On the other hand, public solutions like increasing Social Security and government-funded programs require either higher taxes, more debt, or cuts to other government programs, all of which carry their own costs and organized opposition.

In a recent article, Munnell of Boston College took note of the 2023 SCF finding that 80 percent of retirees reported doing okay when it comes to their finances. While this may be good news, she pointed to another recent finding regarding retirees that might cast a shadow: Their largest regret (52 percent) when it came to their finances was that they didn't save more when they were working. With only 39 percent of today's workers being able to maintain their standard of living into retirement, this cohort of retirees is unlikely to be the last to hold that sentiment. **EF**

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