University of Michigan Retirement Research Center

POLICY BRIEF

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Beyond the Golden Age of Retirement*

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INTRODUCTION

The Social Security Program was established in 1935 to provide income maintenance for retired American workers. Over the years from 1935 to 1975, program coverage expanded and new program elements were added. During the 1940s, the employer-based pension movement that had begun in the late nineteenth century began to expand rapidly. Together with other important developments in government and private policy (such as employer-provided health insurance for retirees), these programs made for a "golden era" for American retirees.

The mid-1970s through the end of the century was a period of transition from the golden era to what we see today. One very significant step in this transition was the realization by employers that they could let employees make pre-tax contributions to defined contribution retirement plans and engage employees more directly in financing their own retirement. Through the 1980s the magnitude of retirement benefit obligations began to come into focus while health costs were exploding, making health benefit plans, especially those for retirees, far more burdensome than most employers had ever anticipated.

By the 1990s, there was a an increasing awareness that the baby boom generation was going to make claims on the public retirement system far in excess of the revenue streams feeding it. While some retirement policy analysts were raising growing concerns about the direction the pension system was headed, booming financial markets in the late 1990s led many to perceive the move toward the new world order was okay. The retirement phenomenon, largely a vestige of the last half of the twentieth century, seemed to be alive and well as we approached 2000.

The new millennium brought with it a cold dose of reality. Financial market turmoil taught defined contribution participants that their retirement balances do not always increase in value. It taught defined benefit plan sponsors that offering a pension required periodic contributions to the plan, a lesson that many had forgotten over the prior 15 years. In the meantime, the cost of employer-sponsored retiree health benefits had shriveled this element of the system to near extinction. The newly realized cost of pension sponsorship, the legal challenges to hybrid pensions[1] adopted during the prior 15 years and policymakers' failure to clarify the regulatory landscape led many employers that had continued to sponsor a pension to freeze them in the early 2000s. Amidst a growing level of angst about retiree health costs, policymakers concluded they had to add a pharmaceutical benefit to the Medicare program. Despite this seeming bolstering of the retirement safety net, there was growing awareness that our retirement system was badly out of balance. We now appear to implicitly understand that the golden era of retirement may be history yet we have not embraced the reality that follows.

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In this Policy Brief, we will show that continuing down our current path in regard to retirement policy has the potential to reduce standards of living for large segments of our population. While this analysis does not explore the range of distributional implications that are associated with its conclusions, it begins the process of explaining why we need to rethink the policies that had come to fruition at the end of the twentieth century.

RETIREMENT PLAN OPERATIONS WITHIN THE ECONOMY

Funded retirement plans are intertemporal transfer mechanisms. In these plans, workers, or their employers for them, lay aside a portion of their earnings during workers' careers to accumulate until retirement when the assets are used to finance consumption needs for the remainder of life. Pay-as-you-go retirement plans are intergenerational transfer mechanisms. In this case, workers contribute to the plan while working to support contemporary retirees. By contributing to the system during the working career, workers earn rights when they retire to have the next generation support their consumption needs. The theory is that when workers pay the payroll tax to support such systems, they forego consumption at the time with the implied understanding that they will be repaid when they reach retirement age.

From the perspective of the worker, the accumulation of pension rights through a pay-go Social Security system is no different than accumulating wealth through personal savings or a funded pension. The operations of the two types of plans are summarized from a worker's perspective in Table 1. In both cases, the worker gives up consumption during the working career and stores the value of that foregone consumption in a personal retirement portfolio that is cashed in to support consumption during the retirement period.

Table 1: Pension Operations from a Worker's Perspective under Alternative Financing Mechanisms

	Pay-as-you-go plans	Funded Plans
Workers	Contribute taxes from wages	Save from wages to buy assets
Net effect while working	Reduces consumption during work life	Reduces consumption during work life
Retirees	Receive benefits from workers current taxes	Receive interest and sell assets to workers
Net effect while retired	Use benefit income to finance consumption	Use asset income to finance consumption

Source: Developed by author

The suggestion that these two types of plans are essentially the same in terms of their consumption effects from a worker's perspective is not to suggest that they may have very different real and perceived legal and political risks associated with them. In terms of the dynamics of an individual accruing benefit rights during a working career and receiving benefits during retirement, there is little practical difference. Indeed, there have been many economic analyses of the economic status of individuals approaching retirement that have treated Social Security wealth, pension and retirement plan savings and other personal wealth as equivalent. [2]

While there is virtually no difference in the deferral of consumption from the working period to the retirement period in a pay-as-you-go pension versus a funded one from the worker's perspective, they do present different risks to workers.

The main challenge is that the baby boomers will be cashing out their funded retirement plan accruals at the same time they are collecting on the consumption loans (Social Security benefits) that they made during their working lifetimes. Both are going to put added financial demands on subsequent generations of workers that exceed anything we have experienced thus far under the maturing retirement system. While the differences in the risks posed by the alternative approaches to retirement financing may be important for retirement income security of today's workers nearing retirement, the simultaneous claims that will be made by the pay-as-you-go and funded elements of the retirement system on workers' productivity has received little scrutiny.

CASHING OUT THE BABY BOOMERS' RETIREMENT CLAIMS

The Congressional Budget Office (CBO) projects sharply rising costs of federal programs that are a part of our retirement system. Medicaid, Medicare, and Social Security cost the federal government the equivalent of 9.0 percent of GDP in 2007. By 2020, the cost of these programs is projected to climb to 13.1 percent of GDP and by 2030 to 18 percent of our domestic output. In addition to the direct claims that retirees make on the economy through federally financed programs, they also finance a portion of their retirement consumption through private retirement benefits that they receive and other household assets that they own. Figure 1 shows that employer-sponsored retirement plans have paid out benefits in recent decades that are of similar magnitude to the level of benefits paid by Social Security and are trending recently to regularly exceed Social Security benefit distributions.

It seems reasonable to assume that the accumulated wealth of retirees is generating an added consumption claim on the economy that is at least equivalent to the benefit levels being provided by Social Security. If the scenario depicted in Figure 2 plays out, retiree consumption (including claims on the economy from private retirement plans, Medicare, Medicaid, and Social Security) will more than double from around 13.2 percent of GDP this year to 26.8 percent by 2035. The fundamental question such a diversion of GDP to the nonworking adult population raises is what sort of a burden it will impose on the workers who have to produce the output to meet these retirees' needs at the same time they are trying to meet their own consumption needs and those of their families. Can workers actually deliver the level of benefits that is implied in Figure 2 and still continue to increase their own standards of living somewhat in lock-step with the added contributions they make to national output due to improvements in their own productivity rates? Alternatively, if workers cannot realize some improvement in their own standard of

Figure 1: Retirement Benefit Distributions by Social Security and Employer-Sponsored Retirement Benefit Programs

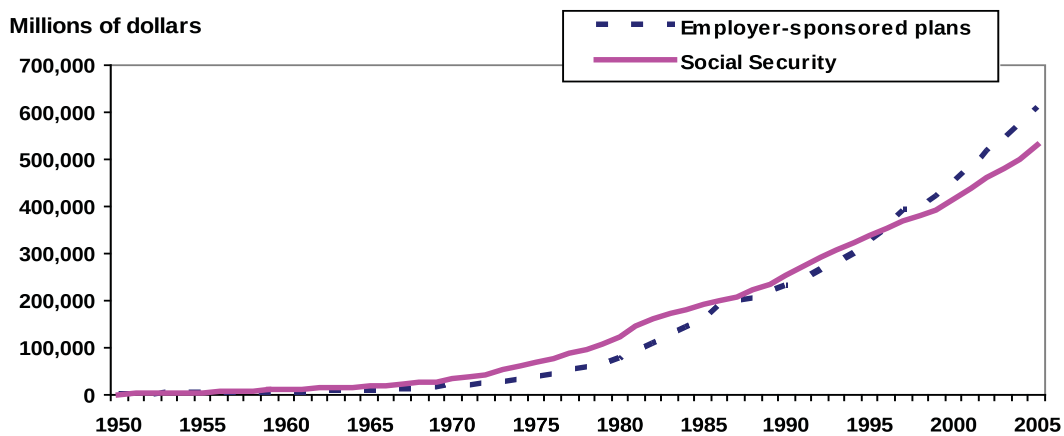

Figure 2: Total Retirement Income Claims on the Economy

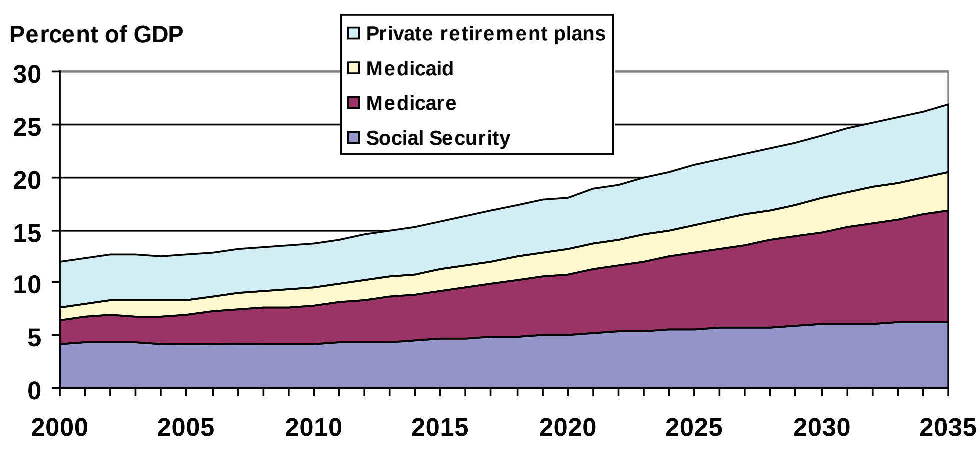

Table 2. Percentage of Mean Disposable Income of People Ages 65 to 74 in 1995 Compared to:

People of Ages	51 to 64	41 to 50
Canada	86.9	86.6
Germany	84.4	78.2
Italy	78.7	78.1
Japan	79.6	81.8
Netherlands	80.7	78.9
Sweden	76.1	80.3
United Kingdom	74.1	65.0
United States	79.9	83.6

Source: OECD, Ageing and Income (Paris: OECD Publication Service, 2001), p. 22.

Table 3: Cost of Providing Workers Retiree Health Insurance and Saving for an Adequate Retirement Income as a Percentage of Wage or Salary Income

Date of Retirement	Age	Remaining expectancy	Pension cost as % of pay	Health insurance as % of pay	Cost of health & saving
1960a	65	14.3	3.2 %	1.2 %	4.4 %
1960b	65	14.3	4.3	1.2	5.5
2005	65	18.8	4.9	9.1	14.0
2005	62	21.2	7.0	9.1	16.1
2005	58	23.4	10.2	9.1	19.3
2005	55	25.8	13.0	9.1	22.1
2030	65	19.7	5.7	17.9	23.6
2030	62	22.1	7.7	17.9	25.6
2030	58	25.3	10.9	17.9	28.8
2030	55	27.9	13.8	17.9	31.7

Source: Computed by the author as described in the text.

living in accordance with their added productivity, is it fair to saddle them with the cost of the programs?

IMPLICATIONS OF THE CURRENT COURSE

In order to assess the implications of current policy on workers who will be in the workforce over the next quarter century or more, we need to understand the claims that will be made on them as the baby boomers pass into retirement. For this analysis, we assume that retirement expectations and the general pension environment remain at the current status quo.

The analysis presented here focuses on a hypothetical worker who starts working at age 22 at an initial salary of $30,000 per year. We assume that the individual works steadily until retiring. We assume he or she receives pay increases of 4 percent per year and returns on retirement savings of 7 percent per year. We assume, at retirement, the individual will receive a pension that will provide a flat-dollar benefit throughout the remainder of the retiree's lifetime.

In 1960, the typical pension was designed to wrap around Social Security and provide a combined benefit of roughly 65 percent of final pay for a worker who retired at 65.[3] Assuming that the worker started with the company at 22 and stayed until retirement, funding his pension would have cost the employer about

3.2 percent of pay per year. Employer contributions for health benefit plans that year were 1.2 percent of workers' cash pay. By the end of the 20th century, most pension analysts estimated that retirement income needed to be around 75 to 80 percent range percent of final pay for workers to maintain their achieved standard of living during retirement. Some argue that this replacement rate may be too high. However, Table 2 shows that it is in line with the relative disposable income of the retiree population to that of the working age population across a range of developed economies.

The cost of workers' need to save in order to provide a total retirement benefit replacing 75 percent of preretirement earnings, including Social Security, plus providing workers with health insurance, is shown in Table 3. For a worker who wanted to retire at age 65 in 2005, this cost was approximately 14 percent of his pay. For a worker who wants to retire at that age in 2030, the figure is 23.6 percent of pay.

SOCIAL SECURITY COSTS RISING

For a worker retiring in 1960, the 1959 Social Security payroll tax would have been 2.5 percent on earnings up to $4,800 with the employer paying a like amount. In keeping with the presumption that the employee bears the incidence of these charges, the total payroll tax would have been 5 percent of covered pay. Over most of this worker's career, the combined payroll tax would have been 2 percent of pay. Add that to the 3 or 4 percent of pay the individual would have had to save out of his or her own pay to cover a pension and you can see the cost of retirement seemed pretty reasonable. The reason retirement financing was so reasonably priced was because the initial Social Security benefits were heavily subsidized and reduced the cost for employers for financing a total benefit package that covered the income target levels discussed earlier. [4]

For the younger worker who is planning to retire in 2030, the recent trends will continue. By 2029, the Social Security actuaries estimate that the cost of providing the benefits embedded in current law will be 16.4 percent of covered payroll. Today, 97 percent of the revenue supporting the Social Security program comes from the payroll tax. By 2016, that will drop to approximately 95.4 percent. Even assuming that as much as 10 percent of total revenue for OASDI in 2029 comes from the taxation of benefits, it will mean that the payroll tax will be claiming at least 15 percent of pay by the time our 2030 retiree gets to the end of his or her career. The cost of combined Social Security benefits and the worker's own saving to provide for an adequate retirement income will range from 20 to 30 percent of payroll. And here, we are only talking about the cash benefits to support retirees' consumption needs. Add health care financing to the picture and the outlook turns considerably gloomier.

Table 4: Payroll Costs of Workers Covering Their Own Health Insurance and Retirement Savings Needs as Well as Covering Their Share of Social Insurance

		Workers' costs associated with:				
Date of retirement	Age at retirement	Own retirement saving	Own health insurance	OASDI benefits	Medicare & Medicaid	Total
		(Workers costs are shown as a percentage of pay)				
1960b	65	4.3	1.2	5.0	0.0	10.5
2005	65	4.9	9.1	12.4	4.9	31.3
2005	62	7.0	9.1	12.4	4.9	33.4
2005	58	10.2	9.1	12.4	4.9	36.6
2005	55	13.0	9.1	12.4	4.9	39.4
2030	65	5.7	17.9	15.0	13.8	52.4
2030	62	7.7	17.9	15.0	13.8	54.4
2030	58	10.9	17.9	15.0	13.8	57.6
2030	55	13.8	17.9	15.0	13.8	60.5

Source: Derived by author as described in the text

WORKERS' INSURANCE COSTS: YESTERDAY, TODAY AND TOMORROW

In Table 3, we explored the costs that different cohorts of workers have faced or will face in meeting their own retirement savings goals and financing their own health insurance. On top of those costs, they also pay the Social Security payroll tax to finance the benefits for current retirees and a large share of the costs associated with providing Social Security beneficiaries with medical insurance coverage.

Table 5: Projected 401(k) and Social Security Wealth by Lifetime Earnings Level for Workers Retiring in 2030

Earnings decile	401(k) wealth	Social Security wealth	Ratio of 401(k) to SS wealth
1 (lowest)	$1,372	$102,849	0.013
2	21,917	135,160	0.162
3	47,770	152,228	0.314
4	120,706	182,193	0.663
5	272,135	244,926	1.111
6	390,004	272,811	1.430
7	508,402	313,610	1.621
8	647,329	339,660	1.906
9	622,449	362,066	1.719
10 (highest)	895,179	387,493	2.310

Table 4 shows the results of adding these costs. For a worker who wants to retire at age 65 in 2005, the total cost will be approximately 30 percent of his pay. For a worker who wants to retire at that age in 2030, the figure jumps to 52 percent of pay.

THE DIMINISHING PIE

Some analysts believe that rising worker productivity and the attendant growth in real incomes associated with it can help to explain why our society spends so much on health care goods and services. While that contention may be true up to a point, the continued growth of health costs at rates beyond those that apply to other fundamental economic variables portends trouble. Excessive health cost inflation in combination with growing longevity but a reluctance to increase the span of the working life may bring a totally new era to our society—namely one where hard work and improving productivity simply leads to a declining standard of living for the working masses and their dependents.

Assuming conditions as outlined above are in effect, the worker aspiring to retire at age 55 and saving accordingly, disposable income will peak in 2018 and then decline thereafter. The story is only marginally better for the person willing to work until age 65. In that case, disposable income peaks in 2025 and then begins a gradual decline. Between 2005 and 2025, this latter worker would receive only 17 percent of the marginal benefit of his or her improved productivity.

While it is hard to argue against workers reaping some considerable reward for their added productivity contributions, there is another perverse side to this story. The actuaries for the Medicare program estimated that in 2006, the average beneficiary spent 42 percent of his or her monthly Social Security benefit to cover Medicare premiums and out-of-pocket health care expenses. By their projections, a decade from now, the average beneficiary who encounters average costs under the Medicare will be spending 50 percent of his or her Social Security benefit to cover health care expenditures. By 2030, a person in this position will need to spend nearly two-thirds of his or her Social Security benefit on Medicare premiums and out-of-pocket expenditures for health consumption alone.

Throughout this discussion we have focused on the implications of the retirement system's evolution from the perspective of an average worker. The growing claim of health costs during retirement will increase the need for workers to save in the future. The analysis presented here masks the distributional consequences of the story. Table 5 shows the projected Social Security and 401(k) wealth of the cohorts of people reaching retirement age in 2030. It is clear that people at the lower earnings levels are at the greatest risk for potentially declining standards of living if health care costs continue unchecked. Subsequent work is needed to expand the current analysis to focus on the full range of distributional implications that are implied by the story developed here.

CONCLUSION

The golden age of retirement has

past. Our retirement system is woefully under funded to deliver the level of economic welfare that many people expect from it. Some prognosticators suggest that all we have to do is rearrange our economic activities to spur greater economic growth in order to address this problem. The reality is that economic growth is tied to increased growth in the labor force and to higher levels of worker productivity. Unless we change the work behavior patterns of the adult population, our demographic structure will mean that labor force growth rates will drop to near zero in the 2010s. Achieving higher levels of productivity than we have realized historically is not an easy task. If it were, we would have already adopted policies to do so. Even if we can achieve higher levels of productivity, much of workers' productivity improvement is already scheduled to be siphoned off to support the higher dependency levels related to our aging population. Increasing cost of health services worsen the situation.

If most American workers continue to retire by the time they are in their early 60s, we face the prospect of many workers being so burdened with retirement costs that they will not realize any of the fruits of improving productivity over their working lives. Part of the solution here has to be to keep workers in the workforce and off the benefit rolls longer than has been the recent experience. Raising eligibility ages under Social Security and Medicare will have three beneficial effects. It will give workers a longer time to contribute to their retirement security thus reducing the rate at which they have to contribute. It will simultaneously reduce the length of the retirement period and the amount of resources that are needed to sustain a level of welfare after the work career has ended. Finally, it will reduce the tax burden required to support the dependent older population.

In the case of health care, the cost of insurance coverage and out-of-pocket expenditures for the delivery of care tend to be relatively fixed across the income spectrum. That means that the cost outlays faced by individuals whose income is below average will be larger relative to income than those whose income is higher. For workers with earnings below average, the prospect of continued rapid escalation in their health costs will have an equally pernicious effect on their preretirement economic welfare.

We live in a society facing many political challenges. No one can discount the importance of debate about our national policy response to the terrorist threats that we face. No one can deny the importance of assuring the soundness of our national physical infrastructure when we see pictures in our newspapers of major interstate highway bridges collapsing under the load of rush hour traffic. There are millions of worthwhile claims on our immediate attention. But if we fail to look a short distance in the future at the economic implications of our deteriorating retirement system, we run the risk of allowing the greatest single threat to American prosperity overtake us because of inattention.

Any political leader who wants to represent the American people owes them an explanation of his or her view of this problem and how to deal with it. The American people, including the younger members of our society, deserve a clear and comprehensive discussion about the challenges we face because of population aging, the options to deal with them and the intent of would-be office holders in how they will move the policy process forward when they assume office. Declaring the intent to appoint another commission is not a satisfactory answer for how would-be national office holders will deal with this vitally important issue.

NOTES

[1] A number of employers who had converted their traditional pension plans to cash balance or similar forms

[2] See for example, James F. Moore and Olivia S. Mitchell, "Projected Retirement Wealth and Savings Adequacy in the Health and Retirement Study," in Olivia S. Mitchell, P. Brett Hammond and Anna Rappaport, eds., Forecasting Retirement Needs and Retirement Wealth (Philadelphia, University of Pennsylvania Press, 2000) and James Poterba, Steven Venti and David A. Wise, "New Estimates of the Future Path of 401(k) Assets," (Cambridge, MA: National Bureau of Economic Research 2007), NBER Working Paper 13083.

[3] See Dan M. McGill, Kyle N. Brown, John J. Haley and Sylvester J. Schieber, Fundamentals of Private Pensions (Oxford: Oxford University Press, 2004), Chapter 16 for a full discussion about retirement income goal setting used in the design of employer-sponsored retirement plans.

[4] Ibid.

ABOUT THE MRRC

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