



National Economic Trends



How Important Will 401(k) Plans Be to Baby Boomers?

The benefits of a prosperous society are many and varied. Among them are an ability to live longer and an opportunity to retire earlier. Accordingly, with the baby boomers slated to begin retiring in about a decade, an increasing share of the population will be drawing health and retirement benefits for a longer period of time than ever before.

The U.S. public retirement system, though, can generally only prosper as long as there is a sufficient number of workers to support each retiree. That was mostly the case in the early years of the program, but it will no longer be that way by 2030, when most of the boomers will have retired. Thus, the pending exit of the baby boom generation from the labor force threatens to be a debilitating burden for the taxpayer. Importantly, this future burden stems from the pay-as-you-go arrangement that has been used to finance Social Security and Medicare—what is essentially an intergenerational transfer from the young to the old. According to the 75-year projections published in the 1998 Social Security Trustees Report, the future funding gap between expected program costs and annual earmarked revenues for these two programs combined is expected to be considerable—about 11 percent of future payroll tax revenues using middle-of-the-road cost estimates.

One way to close this gap, of course, is by reducing future real benefits. Another way is by increasing future economic growth, which boosts real tax revenues. Some have estimated that this funding gap could be closed with a permanent 2 percentage point increase in productivity growth. Because a majority of economists probably believe that the former is more likely than the latter, workers should start saving more today to finance a desired level of future consumption

tomorrow—which is really what saving for retirement is all about.

But by and large, the U.S. household saving rate during the past two decades is nowhere near the average that prevailed during the 1950s, '60s and '70s. This might be changing, though, given increased participation rates in defined contribution (DC) plans like 401(k)s. From 1984 to 1994 (the latest data available), the participation rate in 401(k) plans rose from just under 9 percent of the private sector workforce to around 25 percent; the participation rate for all DC plans in 1994 was larger, at 37 percent. The question for policy-makers is whether these plans can provide a backstop that cushions any future reduction in Social Security benefits. This is important because Social Security income currently represents the largest share of all retirement income of those 65 and older, an average of about 40 percent in 1996.

A recent academic study, though, suggests that income from financial assets will be much more important for baby boom retirees than those today.¹ For example, on average an individual who was 37 years old in 1996 and who saved about 9 percent of that income (including the employer match) would end up with a 401(k) account balance of a little less than \$182,000 by age 65 if all of his contributions were invested in a portfolio of stocks that earned the long-run (1926-96) average return. This would be well above the nearly \$103,400 in Social Security wealth that he will have accumulated at that point (both figures are in 1992 dollars). Investing in less risky assets, naturally, would produce smaller account balances. For example, contributions to an account portfolio of corporate bonds would produce a 401(k) balance of about \$50,000, with a mixed portfolio (50/50) producing something in between (\$125,500).

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¹ See Poterba, Venti and Wise, "Implications of Rising Personal Retirement Saving," NBER Working Paper 6295 (November 1997).