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A Crack in the Nest Egg: Are Americans Doing Enough to Save for Retirement?

May 2009

"The message that I want to leave is that we need more *organized retirement saving. A declining Social Security system and fragile 401(k) plans will not be enough for future retirees."*

—Congressional testimony by Alicia H. Munnell, director of the Center for Retirement Research at Boston College

Until recently, soaring stock prices and housing values made scores of Americans feel more affluent, and thus many lacked any sense of urgency to save for retirement. The current financial market downturn has reversed much of these gains in wealth, leaving many workers unprepared for retirement. Making matters worse is the dramatic shift from defined-benefit pension plans to defined-contribution plans[1]; this shift has exposed individuals to a greater amount of risk associated with market downturns. These developments question whether individuals are doing enough to plan and save for retirement.

Individuals typically judge the adequacy of their retirement nest egg by calculating what percentage of preretirement earnings can be replaced; this is known as the "replacement rate." The key question is whether accumulated personal wealth, coupled with benefits from Social Security and traditional defined-benefit pension plans, replaces enough income to maintain a retiree's standard of living. Many complex factors are used to determine the appropriate replacement rate, but most experts agree that retirees need to replace 70 percent—or more—of their preretirement earnings to live comfortably.

The Social Security Administration points out that for the average worker, Social Security is intended to replace just 40 percent of prior earnings. Even with a defined-benefit pension plan providing guaranteed retirement income, Americans will have to rely heavily on their retirement plan contributions or personal wealth to adequately replace income beyond their working life.

Yet, Americans nearing retirement appear to have done little to accumulate savings in retirement accounts (either individual retirement accounts (IRAs) or defined-contribution retirement plans). According to the Federal Reserve's 2007 *Survey of Consumer Finances* (*SCF*), in households where the head of household was age 55 to 64 years, only 60.9 percent had retirement accounts. Furthermore, among households with savings in retirement accounts, the median account balance was just $98,000.

Of course, not all retirement savings are held in retirement accounts. A recent study provides evidence that, even when other household assets are accounted for, many Americans still are not saving enough. Munnell et al. (2009) project household replacement rates with *SCF* data. Even if individuals work until age 65 and use all financial assets—including the value of their homes—to cover expenses in retirement, 61 percent of households are "at risk" of not maintaining their standard of living. In addition, their analysis shows that younger workers are even more "at risk" than those nearing retirement. The estimated share of early baby boomers—those born between 1948 and 1954—who have an inadequate retirement income is 51 percent. This share rises to 61 percent for those born between 1955 and 1964 and then to 68 percent for those born between 1965 and 1974.

Recent declines in financial markets have made the situation worse. The lesson here is twofold: First, not saving enough during your working years is hazardous. Second, younger workers and those in their prime earning years should start saving more *now* for times ahead when Social Security and a traditional pension may not provide adequate retirement income.

—By Christopher J. Martinek, Senior Research Associate, Federal Reserve Bank of St. Louis

[1] In "defined-benefit pension plans" (what might be called "traditional" pension plans), the employer manages the plan's investments and guarantees a specific retirement benefit to the worker. In "defined-contribution plans" (such as 401(k) plans), the individual worker manages the plan's investment and receives a benefit based on the size of contributions and the performance of investments over the years.

Recent Articles and Further Reading on Retirement Savings

"The Effects of Recent Turmoil in Financial Markets on Retirement Security," Testimony before Congress by former director of the Congressional Budget Office, Peter R. Orszag, October 7, 2008.

Orszag provides a detailed analysis of recent financial market turmoil and its effects on pension plans, household assets, and retirement behavior.

"Retirement Savings and Decision Errors: Lessons from Behavioral Economics," by Philip Armour and Mary C. Daly, Federal Reserve Bank of San Francisco *Economic Letter*, No. 2008-16, June 6, 2008.

With the advent of the 401(k) plan, more responsibility has been placed on individuals to plan their retirement portfolios. The authors describe how human instincts may lead to less-than-optimal investment decisions and how policy can be used to avoid these outcomes.

"Retirement Outlook Drops to Record Low," by Anne Tergesen, *Wall Street Journal*, April 14, 2009.

This article highlights results from the most recent *Retirement Confidence Survey* administered by the Employee Benefits Research Institute.

Free Data Sources and Reports

Data: *EBRI Databook on Employee Benefits*
Description: This frequently updated book contains data from multiple sources covering a broad range of retirement benefit topics.
Published by: Employee Benefit Research Institute
Location: http://www.ebri.org/publications/books/index.cfm?fa=databook

Data: Center for Retirement Research at Boston College Data
Description: Provides access to data used in publications from the Center.
Published by: Center for Retirement Research at Boston College
Location: http://crr.bc.edu/data/index.php

Report: "Retirement Savings and Household Wealth in 2007"
Description: This report, by Patrick Purcell, a specialist in income security at the Congressional Research Service, summarizes data on retirement savings accounts and household wealth from the Federal Reserve's 2007 *Survey of Consumer Finances*.
Published by: Congressional Research Services
Location: http://assets.opencrs.com/rpts/RL30922_20090408.pdf

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