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Introduction

Every morning more than 100 million Americans wake up and head out to work. They grab a bite, get the news, then turn their attention to the issues they'll face that day. At times, however, it becomes necessary to look beyond this workaday routine and deal with issues that could disrupt one's life if not addressed. This is one of those times, and the issue is retirement.

A wake-up call regarding one's retirement should come as no surprise. The press is filled with calls to fix Social Security, shore up employer pensions, and make 401(k) plans work better. Indeed, Social Security benefits—relative to earnings—are declining. Employer pensions have become increasingly scarce. And 401(k) balances are generally inadequate. At the same time, longevity is steadily rising. The retirement challenge is typically framed as a financial problem, requiring more saving and better asset management or cuts in promised benefits. The challenge, however, is in many ways better framed as an employment problem.

According to the standard life-cycle model, rational actors respond to a rise in longevity and decline in Social Security and employer pensions in three ways. They spread the burden across the life cycle by consuming less and setting aside more of their income while working; they remain in the labor force longer; and they live on less in retirement. But the baby boom generation has not set aside more of its income while working. Nor do subsequent cohorts seem to be saving much more. This lack of saving puts more weight on the other two responses: working longer and consuming less in retirement. A failure to work longer shifts the entire burden to lower retirement consumption, implying a steep reduction in living standards upon exiting the labor force. Alternatively, the most effective lever for securing a comfortable retirement, especially for the baby boom generation now at the cusp with little opportunity to save, is to remain in the work force longer.

At first blush, it may seem strange to say: "You need to reduce your retirement to ensure your retirement." But it's not nearly as bad as it sounds. Because life expectancy has increased dramatically over the past several decades while the average age of retirement has fallen, working longer does not mean having fewer years in retirement than workers earlier in the postwar era. The working-longer prescription is not about no retirement at all; it's about beginning your retirement somewhat later.

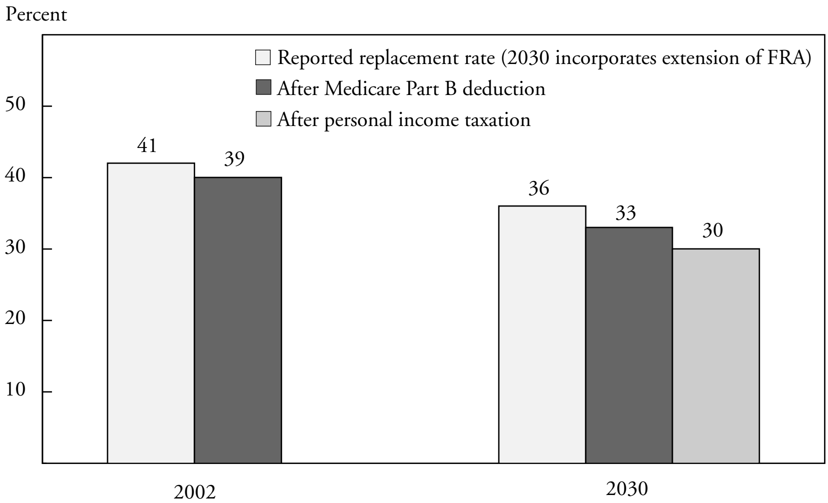
Spending a few additional years in the labor force can make a big difference. It directly increases current income; it avoids the actuarial reduction in Social Security benefits; it allows people to contribute more to their 401(k) plans; it allows those plans to accumulate more investment income; and it shortens the period of retirement. By and large, those who continue to work until their mid-60s or beyond should have a reasonably comfortable retirement.

Working longer, however, will not be simple. It requires thought and planning on the part of individuals. It also requires employers to retain, train, and even hire older workers. Government also has a role to play. And the sooner everybody realizes that staying in the labor force is the best way to ensure a secure retirement, the better.

The Retirement Income Challenge

The major reason that people have to work longer is that the retirement income system is contracting. This system—Social Security and publicly subsidized and regulated employer-sponsored plans—is the major source of support for people as they withdraw from the labor force and as earnings decline.[1] But Social Security and employer-sponsored retirement income plans will provide relatively less in the future than they do today. Employers have also backed away from offering retiree health insurance, leaving households exposed to rapidly rising health care costs. In addition, life expectancy is rising: for men, life expectancy at age 65 was less than fifteen years in 1980 but in 2020 is projected to be nearly eighteen years. Workers in the future

Figure 1-1. *Social Security Replacement Rates, Medium Earner, 2002 and 2030*



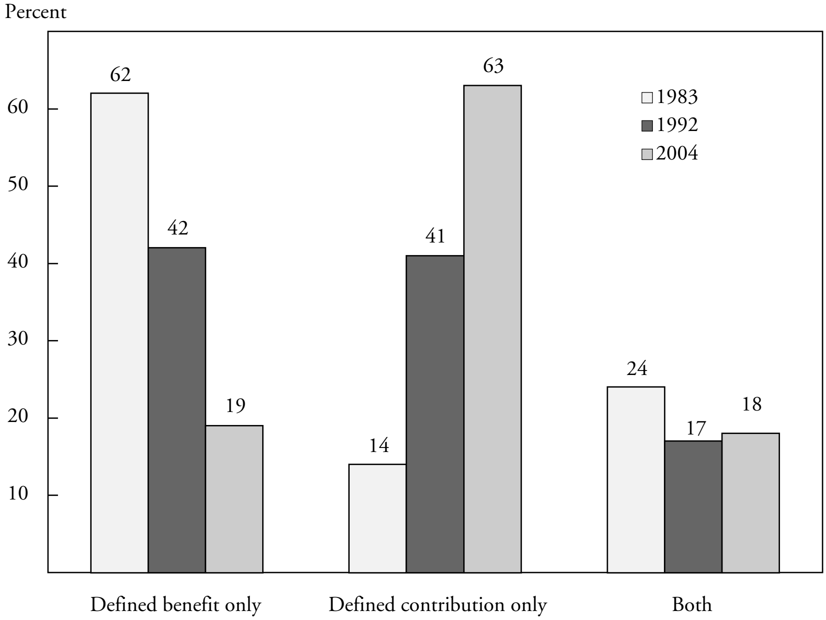
Source: Authors' calculations based on Munnell (2003).
FRA = full retirement age.

will thus need more resources, not fewer, if they continue to retire at the same ages as they do today.

The Outlook for Social Security

At any given retirement age, Social Security benefits will replace a smaller fraction of preretirement earnings than in the past. Today, the hypothetical average earner retiring at age 65 receives benefits equal to about 41 percent of previous earnings. After payment of the Medicare part B premium, which is automatically deducted from Social Security benefits, the replacement rate is 39 percent. But under current law Social Security replacement rates are scheduled to decline for three reasons. First, the full retirement age is currently in the process of moving from 65 to 67, which is equivalent to an across-the-board cut.[2] Second, Medicare part B premiums are slated to increase sharply due to rising health care costs.[3] Finally, Social Security benefits will be taxed more under the personal income tax, as the exemption amounts are not indexed to inflation. These three factors alone will reduce the net replacement rate for the average worker who claims at age 65 from 39 percent in 2002 to 30 percent in 2030 (figure 1-1). This percentage does not include premiums for the part D drug benefit, which will also claim an increasing share of the Social Security check. Nor does it include any addi-

Figure 1-2. *Wage and Salary Workers with Pension Coverage, by Type of Plan, 1983, 1992, and 2004*



Source: Munnell and Sundén (2006) based on the U.S. Federal Reserve Board (1983, 1992, 2004).

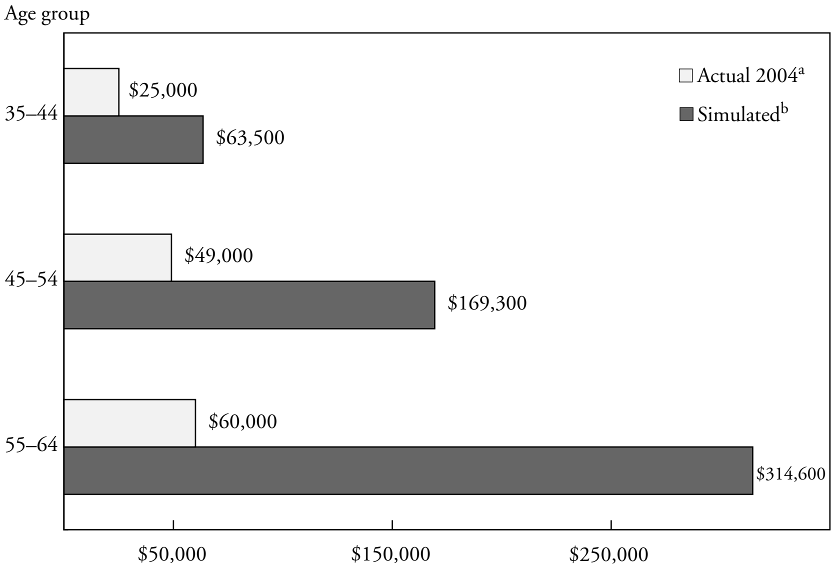
tional benefit cuts enacted to shore up the solvency of the Social Security program.[4]

The Outlook for Private Sector, Employer-Sponsored Pensions

With a diminished role for Social Security, retirees will be increasingly dependent on employer-sponsored pensions. At any moment in time, however, less than half of the private sector workforce ages 25–64 participates in an employer-sponsored plan of any type. This fraction has remained virtually unchanged since the late 1970s and is unlikely to improve.[5] Since pension participation tends to increase with earnings, only middle- and upper-income individuals can count on receiving meaningful benefits from employer-sponsored pension plans.

While the level of pension coverage has remained flat, the nature of coverage has changed dramatically. Twenty-five years ago, most people with pension coverage had a traditional defined benefit plan that pays a lifetime annuity at retirement.[6] Today the world looks very different (figure 1-2). Most

Figure 1-3. *Actual and Simulated Accumulations, 401(k) and IRA Plans, by Age Group, 2004*



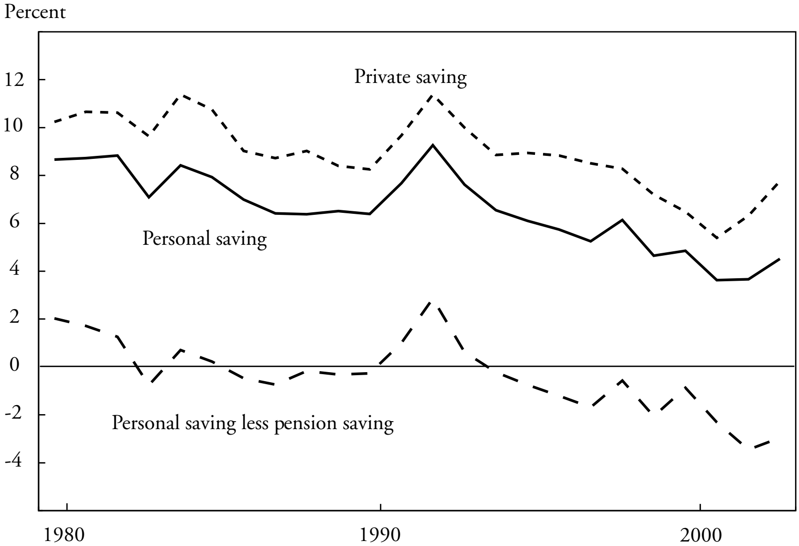
Source: Munnell and Sundén (2006).

a. Figures from U.S. Federal Reserve (2004).

b. Assumes that the worker's earnings rise with the growth of average wages in the economy and with the rise and fall of earnings across the typical worker's career. The worker begins contributing 6 percent of earnings to a 401(k) at age 30, gets an employer match of 3 percent, and 401(k) balances earn 4.6 percent above inflation. At age 64, the last year before retirement, the worker earns $58,000 and ends the year with a 401(k) balance of $380,000, 6.5 times final earnings.

people with a pension have a defined contribution plan, typically a 401(k) plan, which is like a savings account.[7] In theory workers could accumulate substantial wealth in a 401(k) and offset the decline in both Social Security and employer-provided pensions. Simulations suggest that the worker in the middle of the earnings distribution, who contributes regularly throughout his work life, should end up at retirement with about $300,000 in his 401(k) or individual retirement account (IRA). (Most IRA assets are rolled-over balances from 401(k) plans.) This amount, when combined with Social Security, could easily provide an adequate retirement income. But reality looks quite different. The Federal Reserve's 2004 Survey of Consumer Finances reports that the typical household head approaching retirement (ages 55–64) had combined 401(k) and IRA balances of only $60,000.[8] Nor do younger cohorts seem to be on track to accumulate sufficient wealth to support themselves in retirement (figure 1-3).[9]

Figure 1-4. *Private Saving Rate, Personal Saving Rate, and Rate of Personal Saving Less Pension Saving, Working-Age Population, 1980–2003*



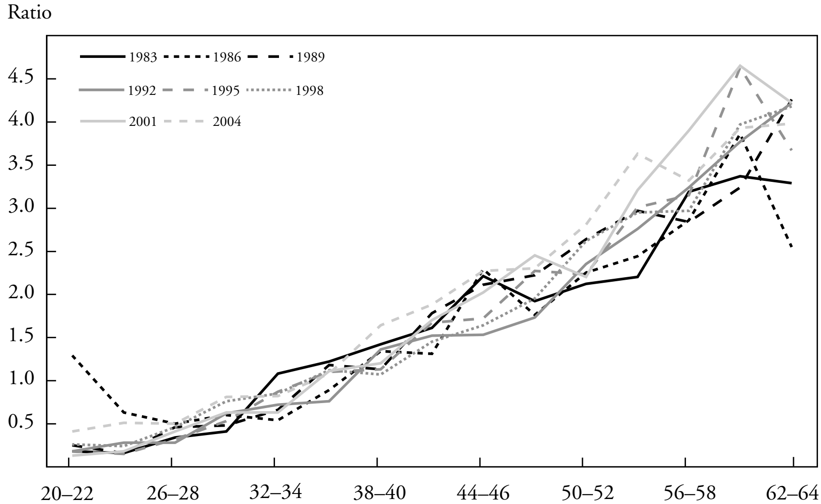
Source: Munnell, Golub-Sass, and Varani (2005).

The Outlook for Individual Saving

Given the decline in Social Security and employer-provided pensions and the rise in longevity, the standard life-cycle model would expect the working-age population to decrease the share of income it consumes and increase the share it saves. This saving does not have to be in a 401(k). Workers could set aside more of their income for retirement in bank deposits or investments in businesses, securities held outside a retirement account, home equity, or investment real estate. But a study estimating saving by the working-age population, based on the U.S. National Income and Product Accounts, shows that this has not occurred.[10] Both the personal saving rate of the working-age population, which includes 401(k) saving and employer contributions to defined benefit pension plans, and a broader private saving measure, which includes business saving (retained earnings) by businesses owned directly or through equities, have declined. The study also finds that virtually all personal saving occurred in pension plans and that saving outside such plans, in recent years, has actually been negative (figure 1-4).

This disconcerting finding is corroborated by a study based on the Survey of Consumer Finances. It finds that median household wealth, excluding

Figure 1-5. *Ratio of Wealth to Income in the Survey of Consumer Finances, by Age Group, Selected Years 1983–2004*



Source: Authors' update from Delorme, Munnell, and Webb (2006) based on U.S. Federal Reserve Board (1983–2004).

Social Security and employer-defined benefit pensions, has remained remarkably constant relative to household income (figure 1-5). Households have not increased their accumulation of wealth to offset the demise of employer-defined benefit plans or the scheduled reduction in Social Security replacement rates.[11]

Retiree Health Insurance

The preceding discussion focuses on the decline in cash benefits. Employers have also cut back on postretirement health care benefits. Between 1989 and 2006 the percentage of large firms offering such benefits dropped from 66 percent to 35 percent.[12] The decline in participating firms actually understates the extent of the cutback, because the generosity of the benefits has also been reduced. In response to the rising costs of health care, employers have increased retiree premium contributions, copayments, deductibles, and out-of-pocket limits. Moreover, many of those providing postretirement health benefits today have terminated such benefits for new retirees. Thus workers will need more income than they did in the past to cover health care costs that were previously borne by the employer.

In summary, the outlook for retirement income for future retirees is dismal.[13] People are not going to be able to continue to retire at age 63—the average retirement age for men today—and maintain their preretirement living standards over an increasingly long period of retirement. Moreover, dramatically rising health care costs are going to erode already diminished pension income.[14] Working longer is the obvious solution for the baby boom generation, which has little time to accumulate more retirement savings. Even if saving rates in subsequent generations increase, working longer will continue to be an effective lever for securing a comfortable retirement.

Will We Have to Work Forever?

Future retirees need not panic. Although the replacement rate reductions are significant, a few years of work can make retirees in 2030 as well off as those in the current generation. In other words, working longer does not mean working forever.

Each additional year in the workforce increases income directly through earnings from work and investments. It also actuarially increases Social Security benefits by 7–8 percent a year and produces a similar increase, on a risk-adjusted basis, on income from balances in 401(k) plans. The implications on the need for retirement savings are striking.[15] The Congressional Budget Office estimates that in 2004 a married couple earning in the middle of the income distribution could reduce the assets needed to achieve their target replacement rate from $550,000 if they retire at age 62 to $325,000 if they retire at age 66 and to $130,000 if they retire at age 70.[16]

So, how much longer do most people need to work? The easiest calculation is the required response to the increase in the full retirement age. By definition, a worker in 2030 will have to work until age 67 to receive the same replacement rate as a worker retiring at 65 today.[17] Similarly, those who would have chosen actuarially reduced benefits at age 63 in 2002 will have to delay claiming benefits to age 65 in 2030 to receive the same replacement rate.

With a simple model, it is possible to calculate the increase in required work life to offset the projected increase in the Medicare premium and taxation of Social Security benefits.[18] In 2030 the reduction from the Medicare part B premium can be reversed in about six months, and that from taxes can be reversed in about thirteen months. To compensate for all the foreseeable changes to the Social Security replacement rate, workers will need to extend their work lives by about four years.

Workers who reach retirement with significant assets in their 401(k) plans or other accounts will have to work less than four years to offset the projected reductions in Social Security replacement rates. The reason is that additional years of work, assuming financial assets are left untouched, increase the ultimate annual income that can be derived from 401(k) accumulations. Part of the increase comes from the additional investment income.[19] The other part of the story is that by working longer, expected years in retirement decrease, raising the income available for each retirement year.[20] To make income from 401(k)s comparable with Social Security benefits, which are indexed for inflation, 401(k) proceeds would be used to purchase an inflation-indexed annuity. Thus a medium earner who reaches age 63 with 401(k) assets that could buy a real annuity that would produce a replacement rate of 20 percent will only need to work for about twenty-eight months to offset reductions in Social Security. This increase is significantly less than that for workers without financial assets, because the additional income from the 401(k) assets makes up for some of the loss.

The important message is that continued employment means two to four more years of work to maintain today's level of income replacement. This prescription is equivalent to moving the current average retirement age—the age at which half the cohort is out of the labor market—from 63 to about 66. Interestingly, 66 was the average retirement age for men in 1960. This book explores the potential for making such a change.

Organization of the Book

This book is organized around the notion that working longer requires older workers to be healthy enough to work and willing to work. But the decision is not one sided. Employers also have to be willing to hire them. Since both sides of this equation appear uncertain, the question is what individuals, employers, and the government can do to make continued employment more likely.

To set the stage for labor supply decisions, chapter 2 explores whether future generations of workers will be healthy enough to work beyond the current retirement age of 63. Intuitively, people's health affects their ability and desire to work, an intuition that is confirmed by a substantial body of research. People's health can also affect their attractiveness to employers. This chapter explores the extent to which health today compares to health in 1960, when the retirement age for men was 66.

Certainly life expectancy for both men and women has increased since the 1960s. But the relationship between increases in longevity and improvements in health is complicated. If medical advancements keep frail people alive, the overall health of a population can look like it has deteriorated. Indeed in the 1970s, when health trends appeared to be worsening, experts accepted the outcome as the "failure of success." Therefore, it is important to look closely at health trends for both older people (those 65 and over) and for older workers (those 55–64). The trends for these age groups are likely related because presumably if those 65 and over are healthier, those 55–64 should also be healthier.

The evidence suggests that the health of older people, as opposed to older workers, showed little improvement in the 1970s, mixed results in the 1980s, and marked improvement since the 1990s. The improvement for older workers most likely began earlier, in the 1980s. Today, the health of older workers appears to be at least as good as it was forty years ago. And today's jobs are less physically demanding. Thus if half of the male population was healthy enough to work until age 66 in 1960, the same percentage should be able to do so today. Two notes of caution are needed. First, 15–20 percent of the older population will not be able to work that long. Second, some studies suggest that the improvements seen to date may not continue and might even reverse.

Given that improved health should enable most people to work longer, chapters 3 and 4 turn to the question of whether older men and older women are likely to want to work. It is necessary to deal with men and women separately, because women's work patterns reflect the increasing participation of cohorts over time as well as the factors that affect retirement behavior. Putting the two together muddies the waters.

Some indication that older men might be willing to work longer comes from the fact that the century-long downward trend in their labor force participation has clearly ceased and that participation has actually been rising for much of the population since the mid-1990s. The question is whether this recent upward trend in participation will broaden and continue.

Some key changes in the nation's retirement income system should encourage greater labor force participation by older workers going forward. Social Security replacement rates at any given age are falling. And retirement income from employer-sponsored plans at any given age is also likely to fall, given rising longevity and the meager balances in the now dominant 401(k)s. The "income effect" of such reductions should increase labor force participation. In addition, changes in Social Security and the decline in traditional defined benefit pensions have essentially eliminated subsidies for early retirement and penalties for later retirement. The "substitution effect" of these changes—raising the cost of retirement relative to work (to its actuarially appropriate level)—should increase participation.

Impediments still remain, however, to the continued employment of older workers. The most important is the availability of Social Security benefits at age 62. Even today, with the elimination of the earnings test after the full retirement age and an actuarially fair delayed retirement credit, the majority of workers continue to claim their benefits as soon as they become available. Another important factor is the increased mobility of older workers, which exposes them to the vagaries of the labor market. Extended and difficult job searches as well as the prospect of low wages may cause many older workers to simply give up. Moreover, older people have a strong preference for part-time work and flexible schedules, which to date employers have been reluctant to accommodate.

On balance, the evidence suggests that work rates for both those aged 55–64 and those 65 and over should continue to increase. By 2030 these rates may even exceed official government projections. But they are unlikely to reach 1960s levels, given the increase in wealth since then (some of which workers want to spend on more leisure at the end of their work life) and the availability of Social Security benefits at age 62. Further, the nature of employment for older workers may be less than optimal, at least in financial terms. It would probably be best if older workers remained in their career job. But the trend toward shorter tenures suggests that more and more older workers will end up in short-term, spot-market jobs. These jobs will pay less. The good news is that many workers who have moved into such positions report that their jobs are more enjoyable.

Chapter 4 investigates the likelihood of increased labor supply of older women. Women have a lot to gain by working longer. Today nearly 30 percent of elderly nonmarried women, who represent a majority of households at older ages, are classified as poor or near poor. Some of these women were nonmarried and poor as they entered retirement. But many were married and suffered a large drop in income when their spouse died. Thus women would be better off if they had their own Social Security earnings record and employer pension benefits. Moreover, given the importance of joint decision-making for couples, the continued employment of married women may be the best way to keep their husbands working, thereby ensuring the largest Social Security benefit for their husband and the largest widow's benefit for themselves.

In some ways, the work prospects for older women look fairly bright. Labor force participation of women in their prime years has risen significantly. Increasingly their work decisions and careers look more like those of men. And early baby boomer married women claim they are going to retire more than a year later than their immediate predecessors. Indeed, the changing incentives in the retirement income system should encourage more employment for both men and women. But good plans often go awry. Given their weaker attachment to the labor force, smaller financial incentives, and tendency to coordinate retirement with their—typically older—husbands, the challenge for women to join and stay in the labor force is greater than that facing men.

So assume that more older workers will want to work. Will employers want to hire them? This question is the subject of chapter 5. The advent of retirement and the long decline in the age of retirement were to a significant degree the result of employer decisions. Employers dismissed or eased out older employees whose strength and acuity had declined and created mandated retirement policies that forced workers out at a specified age. Large employers, and employers with a unionized workforce, offered pensions to facilitate orderly exits and then sweetened the benefits to induce even earlier separations. And employers rarely hired older workers except for a narrow subset of jobs. Presumably, employers found it unprofitable to retain older, higher paid, and relatively less educated workers when a large supply of younger, cheaper, and better educated workers was available.

Similarly, going forward, employers will employ older workers if it is profitable to do so—if the value of what they produce is greater than what they are paid. So chapter 5 compares trends in productivity with the cost to the employer as people age. The evidence suggests that productivity from ages 55 to 70 at best remains level but in all likelihood falls. Declining physical strength, stamina, and agility, factors that are much less significant than in the past, still impair the productivity of some older workers. Older workers generally retain job knowledge and the ability to do what they did in the past, but cognitive flexibility and the ability to learn decline. Most older workers have sufficient mental agility to learn and adapt if given the necessary training, but few get trained, and many fail to learn and adapt on their own.

While the productivity of older workers remains level or falls, the compensation employers pay older workers generally remains level or rises over time. Wages, the largest component of compensation, tend to be "sticky" downward. Employers generally avoid cutting an employee's wage, as this creates various personnel management problems. Thus the wages of longservice workers are typically high. Further, the cost of traditional defined benefit plans and health insurance unquestionably rises with age.

In recent surveys, employers claim they are reasonably comfortable with the productivity-compensation trade-off for the older workers they currently employ, but they are not keen on retaining those who want to stay on beyond the company's traditional retirement age.

Many observers say employer attitudes will change. Today's older workers are in many ways more capable than those of the past (for example, they have more education), and work is less physically taxing. The shift from defined benefit pensions to 401(k)s has eliminated a major financial impediment to the employment of older workers. Many observers also say that employers face the prospect of labor shortages and the loss of valuable institutional knowledge when the baby boom generation retires, which will make older workers much more attractive. But the shift away from career employment also suggests a decline in the value that employers place on institutional intelligence. And employers face a global supply of labor in today's economy that far offsets the slowing of labor force growth as the baby boom generation retires.

The conclusion that emerges from chapters 2 through 5 is that most people will be healthy enough to work longer, some older people will want to work longer, but employers may be lukewarm about employing older workers. Chapter 6 explores what can be done by individuals, companies, and the government to improve the outlook.

The most important change that can occur at the federal government level is to increase the earliest eligibility age (EEA) under Social Security. Raising the EEA is charged with controversy, since it does little to improve Social Security finances, has the potential to disadvantage short-lived people (a large percentage of whom are minorities), and requires some provision for those in their early 60s who are either physically incapable of working or who cannot find a job.[21] Yet without an increase in the EEA, most workers will continue to claim benefits at age 62 and to retire early.

A host of other changes could also be helpful. These include making Medicare, rather than the employer, the primary payer for the health costs of workers 65 and over; perhaps increasing the number of years in the Social Security benefit calculation from thirty-five years to forty, giving workers an incentive to work longer to avoid a cut in benefits; and eliminating payroll taxes for workers age 62 and over. At the state level, programs that help match older workers with new jobs could be extremely valuable.

For older individuals, the most important change is to recognize that working longer is the key to their financial security and to then devise a plan and stick to it. Currently, workers say the right thing but do not follow through. Year after year in EBRI's Retirement Confidence Survey, workers respond that they plan to work to age 65. But year after year, they retire at 62. Things happen as workers get older. Their health deteriorates. They get a new young boss whom they don't like and, seeing that Social Security benefits are available, retire earlier than planned. They endure a horrible business trip, decide they never want that kind of experience again, and quit. In other words, employees are buffeted by events that change their target date of retirement. If instead they were committed to a later retirement, employers might also be more likely to invest in them through training and promotion.

On the employer side, companies will have to adapt to an older workforce. Older workers have different sets of skills than younger workers; they are better with people and at operating well-developed systems, while younger workers are better at physically demanding tasks and in developing innovative technologies. So employers will need to adjust their operations as older workers make up a larger share of the labor pool. They will also need to adjust their compensation systems so that compensation costs, especially the cost of health insurance, do not price older workers out of a job. Employers also need to provide more opportunities for older workers to upgrade their skills.

Chapter 7 concludes that the continued employment of older workers looks like so many other economic challenges facing Americans. The people who will most need to work longer—namely, lower-paid workers who will depend primarily on a contracting Social Security system—will be the ones most likely to be in poor health or with limited job prospects. Higher paid workers, those most capable of saving on their own, will likely be the ones to stay in the labor force. Indeed, studies show that higher income, better educated workers are responsible for the reversal in labor force participation rates among older men. Thus working longer may be the prescription for the bulk of Americans. But thought needs to be given to ensure that those at the low end of the pay scale also have a secure retirement.

Finally, the shift to 401(k) plans and the increased mobility of older workers also means that retirement is going to become a much messier process than it was in the past. With mandatory retirement, both parties knew that, as of a certain age, the relationship would end. Employers also used traditional defined benefit plans to structure an orderly departure. No such structure exists in a 401(k) environment. Employers face the prospect of workers with declining productivity and inadequate 401(k) balances hanging on much longer than desirable. Employers will need new tools, including an orderly severance process, to manage an older workforce. Without such tools, employers will avoid older workers. Severance could be structured using carrots, such as a generous retirement package, or a stick, such as some form of mandatory retirement. Of course, the latter would be extremely controversial. But it is important to recognize that, in the absence of employer-defined benefit plans, the structure that eased employees into retirement no longer exists. Without such a structure, employers could become quite reluctant about employing older workers.