

Retirement Income for the Wealthy, Middle, and Poor

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Concern about inadequate retirement income is everywhere, yet discussions about financial security in retirement are unfocused when they fail to address distinctions between four groups: the wealthy, the steady-middle, the precarious middle, and the poor.¹ The *wealthy* earn more than adequate incomes during their working years and can save enough that their retirement worries extend no further than estate taxes and status competitions with their wealthier neighbors. The *steady-middle* earn adequate incomes steadily throughout their working years and save enough for adequate retirement income. The *poor* earn inadequate income throughout their working years, rendering them unable to save much for retirement income. The *precarious-middle* consists of two segments: low-earners and high-spenders. *Low-earners* strive to save from low earnings during their working years but their meager savings place them precariously close to poverty. *High-spenders* spend their adequate incomes during their working years, failing to save enough for adequate retirement income.

Retirement income solutions often address the problems of one of the groups with no mention of the problems of the others. Many address “longevity risk,” offering such solutions as annuities whereby retirees receive income for life in exchange for a portion of their accumulated savings. Annuities, how-

ever, offer nothing to the wealthy, who face no longevity risk because their accumulated savings vastly exceed their spending rates, even if lavish. And an annuity solution mocks the precarious-middle and poor, whose meager savings make annuities impracticable.

The savings-to-spending ratios of the steady-middle are high, muting fears of longevity risk even if not silencing them altogether. One steady-middle wrote in a Vanguard blog post, responding to Ameriks [2010]: “I worked after school and weekends as a kid. I also worked summer vacations. Then after the army, I worked for an electric company in Ohio for 40 years with rarely any holidays off... Then I retired at 61 and feel that if I don’t start living now, I will run out of time.”

Savings-to-spending ratios are low among the high-spending segment of the precarious middle. Tom Palome, a 77-year old man, is one. Palome earned a salary in the low six figures during some years but saved little of it. He is now working as a \$10-an-hour food demonstrator at Sam’s Club and a short-order cook at a golf club grill for slightly more than minimum wage. Palome receives Social Security benefits and a small pension from his last corporate job but has no 401(k), IRA, or other savings.²

Another writer on the Vanguard blog belongs to the low-earning segment of the precarious-middle. “All the people doing

well have pensions. We do not. With interest rates low, minimal capital gains, asset base diminished due to market fall—our retirement is financially frightening for now and the next few years, at least. I want to avoid dipping into capital until we're older, if possible. We lived below our means, saved and invested, had no debt, and yet, here we are. [Our] income is 30% less than we and our planner "expected." Health insurance and medical costs take \$15K annually. My parents' generation did so much better..."

Shenita Simon is one of the poor, presented in a PBS Newshour program about efforts to raise the minimum wage. Simon is struggling to make a living in New York City on an \$8-an-hour fast-food wage with no vacation, no benefits, no sick days, and no personal days. She supports a husband who recently lost his job as well as a mother, brother, and three children. The children get three meals a day, said Simon. "And [the only way] my children get three meals a day is because their school provides two meals out of those three meals. If I was to [pay for] three meals a day for my children, we wouldn't make it. We would be homeless [or starving]."³

The lines that separate the wealthy, middle, and poor are not precise because there is disagreement about people's personal responsibility and ability to save. Some viewers of the PBS program classify Shenita Simon as a precarious-middle or perhaps potential stable-middle. One wrote, "But why did she and her husband decide to have another child, when children are obviously a huge cost?" Another suggested that Simon would be able to save some money by cutting expenses. "It is a tough situation for her but why is she buying those expensive disposable diapers and wipes? Why not buy real diapers and wash them like everyone used to do until about 35 years ago? ... and reusable rags being used in the place of wipes saves money. One doesn't need to buy pricey pre-packaged mac and cheese. Buying macaroni in bulk sizes is cheap and using one's own cheese sauce is very simple."

The lines that separate the wealthy, middle, and poor are also not precise because people's subjective assessments of the group to which they belong can be at odds with objective assessments. The 2013 Retirement Confidence Survey by the Employee Benefit Research Institute (EBRI) asked, "How much of your income should you save for retirement?" Almost one in four said they should save 30% or more of their income, one

in five said they should save 14% or less, and almost one in four said that they do not know. "It's an indication of savings illiteracy," said Steve Utkus, head of Vanguard Center for Retirement Research. "My interpretation of that is they're grasping for straws. Individuals, when they know they need to do more of a thing, but they don't know how much or for how long, they just guess." Objective assessments by Vanguard suggest saving 12%–15% of income for retirement, including employer contributions.⁴

A writer in the Vanguard blog illustrates the difference between subjective and objective assessments of group membership: "My husband is 81 years old [and] has been taking RMD [required minimum distribution payments] for years. We bank this distribution each year. I will take my first RMD in 2010 due to [the] grace period in 2009. I will bank this money as we can live without to meet our needs." Objective assessment places this writer in the stable-middle group, perhaps even in the wealthy group, as she and her husband have sufficient income beyond the RMD, enabling them to save their RMD rather than spend it. Yet she assesses herself subjectively as a member of the precarious-middle group. She continued: "Economy dictates scaling down as best we can to conserve for future years. We are okay financially at this point but are frightened by what the future may bring. So life in retirement isn't what it is cracked up to be. Can't chance taking a vacation when the dollars spent may be needed to keep us solvent with ability to pay income taxes and property taxes."

THE ADEQUACY OF RETIREMENT SAVINGS

Poterba et al. [2011] refuted dire claims about a general inadequacy of retirement savings. They found that people barely touched their 401(k), IRA, and other personal retirement accounts in their early retirement years, let alone depleted these accounts. Among people aged 60 to 69, only 7% of households with personal retirement accounts took annual distributions exceeding 10% of their balances, and only 18% made any withdrawals in a typical year. Moreover, withdrawal rates were low between the actual time of retirement and age 70½, when required minimum distributions from personal retirement accounts must begin. Proportions of assets withdrawn from personal retirement accounts remained small even after age 70½. The proportion withdrawn averages 1% to 2% between ages 60 and 69,

rising to about 5% at age 70½, fluctuating around that level through age 85. Indeed, balances in personal retirement accounts continue to grow among people older than 70½ who are still employed.

A similarly sanguine portrait of the financial situation of older people emerges from an examination of housing equity. Venti and Wise [2001] noted that housing equity is the principal asset of a large fraction of older Americans, second only to Social Security, and for some, employer-provided pensions. Yet Venti and Wise concluded that, on average, home equity is not liquidated to support non-housing consumption as people age.

Hurd and Rohwedder [2011a] emphasized that the portrait of the financial situation of older people is not uniformly sanguine. They assessed the economic preparation of people 66 to 69 years old, asking whether their economic resources could support with high probability a life-cycle consumption path anchored at the initial level of consumption until the end of life. Hurd and Rohwedder found that 71% of people are adequately prepared, but they uncovered substantial variation. Whereas 80% of married people are adequately prepared, only 55% of single people are adequately prepared.

People adapt to changing circumstances, including severe economic shocks like the Great Recession, but their flexibility varies. The wealthy and steady-middle have spending flexibility because much of their spending is discretionary. Spending categories showing the greatest declines between 2007 and 2009 include durable goods and housing, where expenditures can be postponed and dining out, for which eating at home is a ready substitute.

The wealthy and middle also reduced their spending in the Great Recession, because it dampened competition for social status. Kamakura and Yuxing Du [2012] found that consumption of luxuries such as jewelry and travel declined in the Great Recession even among those with intact incomes and wealth. They attributed the reduction in consumption of luxuries to a lessening of the intensity of competition for social status that would have otherwise required the purchase and display of status products and services. The poor, however, lack the spending flexibility of the wealthy and middle. Lusardi et al. [2010] found that the Great Recession led to reductions in the use of routine medical care, especially among the poor.

NUDGES, LITERACY, AND SELF CONTROL

Libertarian-paternalism, as described by Thaler and Sunstein [2008], offers a middle way between paternalism and libertarianism. In the context of savings, paternalistic policies mandate specific levels of retirement savings, libertarian policies grant freedom to choose levels of retirement savings, and libertarian-paternalistic policies “nudge” people toward more adequate retirement savings by such means as automatic enrollment into saving programs, without restricting their freedom to refrain from saving.

Nudges proved highly effective in increasing the retirement savings of the stable-middle but have left many precarious-middle and poor behind. Madrian and Shea [2001] found that the nudges of automatic enrollment have markedly increased participation in a defined-contribution plan. Yet, more than 20% of employees with incomes below \$20,000 did not enroll.

Attempts to increase retirement savings by enhancing financial literacy have also left many behind. Lusardi and Mitchell [2005] found that financial illiteracy is widespread: Only half of those older than 50 could correctly answer two simple questions regarding interest compounding and inflation, and only a third correctly answered these two questions and one about asset diversification.⁵ Women, minorities, and those without college degrees are particularly deficient at financial literacy. Financial literacy and retirement planning are interrelated: the financially illiterate are less likely to plan for retirement and less likely to succeed. The poor have relatively little education, let alone financial education. Cole et al. [2012] found that people with relatively little education have a relatively high probability of either bankruptcy or home foreclosure.

The Great Recession prompted calls for financial education as a tool for greater retirement savings and better financial choices. Yet Willis [2011] noted that evidence fails to demonstrate that financial education leads to greater financial literacy, better financial behavior, and improved financial outcomes, citing the work of Cole and Shastry [2008], Willis [2009], and Gale and Levine [2010].

Self-control facilitates savings. Indeed, self-control separates the steady-middle from the high-spending segment of the precarious-middle. Strong self-control helps the steady-middle save during their working years so they have adequate income in retirement, whereas weak

self-control hampers savings among the high-spending segment of the precarious-middle.

The poor do not necessarily lack self control. Shenita Simon described frugal food budgeting such as bags of 99-cent-per-pound chicken that she cleans, skins, and cooks for her family. She also saves bus and subway fare by walking to school and back with her children. But poverty breeds scarcity, as described by Mullainathan and Shafir [2013]. Scarcity overloads a person's cognitive resources and hampers job performance, decision-making skills, and self-control. Scarcity leaves Simon little slack, driving her deeper into poverty. After standing in line for a long time to apply for food stamps, Simon and her husband had to take a taxi so as not to be late at picking up their children from school.

Social Security is often described as a source of retirement income equally available to the rich, middle, and poor. Social Security benefits are indeed progressive, such that those who have contributed little during their working years receive more relative to their contributions than those who have contributed much. Yet the monthly Social Security benefits received by the poor tend to be small, even if high relative to their contributions. A Gallup [2012] poll revealed that Americans underestimate their likely reliance on Social Security benefits. Among non-retirees, 33% expect that Social Security would be a major source of retirement income. But 57% of retirees report that Social Security is a major source of retirement income.

The poor rely on public benefits beyond Social Security. These include cash and in-kind safety net programs, such as Temporary Assistance for Needy Families (TANF), Supplemental Nutrition Assistance Program (often referred to as the food stamps program); the Earned Income Tax Credit; and public health insurance programs, such as Medicaid and Unemployment Insurance. The National Poverty Center [2012] estimated that these programs delivered more than \$300 billion in benefits to tens of millions of low-income households in 2009.

The poor are also aided by charitable organizations and networks of family and friends. Charitable organizations help in job searches, education, skill development, literacy, housing assistance, emergency cash, temporary food assistance, and health care. Families and friends provide crucial support. Nearly 6 in 10 low-income households received help from family or friends, including help in finding a job, paying bills, and providing food, shelter, and child care.

Strong self-control facilitates savings among the stable-middle, but self-control can be excessive, preventing adequate retirement spending from ample savings. Ameriks et al. [2007] identified a large group of people who spend little relative to their savings. A woman who wrote in the Vanguard blog is among them. "I believe one reason many people do not draw on their [savings] when they retire is that they are used to saving," she wrote. "My husband always said he wanted to spend all of his money before he died. Yet after retirement, we only tapped our [savings] to buy a new car for cash... Unfortunately, my very healthy husband suddenly became ill and died four months later of lung cancer. So I guess, in addition to factoring in a long life, we should also consider a life cut short and indulge in a few luxuries."

The stable-middle regulate their spending and saving by strong self-control, aided by nudges. But many of the precarious-middle and poor do not. In Statman [2013], I argued that it is time to switch from nudge to shove and replace libertarian-paternalistic voluntary defined-contribution savings plans with fully paternalistic *mandatory* defined-contribution savings plans. Paternalistic mandatory defined-contributions would constitute a second layer in a three-layer retirement savings pyramid, above the paternalistic layer of mandatory Social Security and below the libertarian layer of voluntary savings.

The mandatory defined-contribution savings plan I proposed draws lessons from mandatory defined-contribution plans already in place or planned for Australia, U.K., Israel, and American universities. It has the following basic features:

1. Combined mandatory contributions by employers and employees amounting to a minimum of 12% of earnings.
2. Administration by companies offering defined-contribution savings plans but with an added central agency to administer plans for employees whose employers do not provide such plans.
3. Default offerings of well-diversified target-date funds set in one-year intervals.
4. Fees not exceeding 30 basis points.
5. No borrowing from savings accounts and no cashing out before retirement age.
6. Enhanced financial literacy through education at high schools and elsewhere as an addition, not a substitute, for the other five features.

One might ask whether it might not be better to expand mandatory Social Security rather than offer defined-benefit or defined-contribution plans, whether voluntary or mandatory. Yet Social Security is an insurance plan more than a retirement plan. When President Franklin D. Roosevelt introduced Social Security he said: “We can never insure one hundred percent of the population against one hundred percent of the hazards and vicissitudes of life, but we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age.”⁶

It seems fair to ask each of us to protect others against the loss of a job and a poverty-ridden old age but not fair to ask each of us to support others by providing ample retirement income. Savers in defined-contribution retirement savings plans, whether voluntary or mandatory, share the common risk that stocks, bonds, and other investments would do poorly and their retirement income would not be as ample as they had hoped. This risk sharing in defined-contribution retirement savings plans is one feature making these plans fairer than defined-benefit pension plans, where some receive full pension benefits in lean times, paid for by others, often through reduced municipal services and higher taxes.

A mandatory defined-contribution savings plan would do much for the precarious-middle, especially their high-spending segment, replacing weak self-control with strong outside control. But mandatory defined-contribution savings plans would be insufficient for the poor, who have little or nothing to save from. Retirement income solutions for the poor would require additional measures, including transfers from the wealthy and the upper end of the steady-middle.

Tax expenditures for voluntary defined-contribution into 401(k), IRA, and self employed retirement plans amounted to \$93 billion in 2012, ahead of tax expenditures associated with mortgage interest deductions. Mandatory private accounts eliminate the need for these tax expenditures as incentives are no longer needed to nudge people toward voluntary defined-contributions. The \$93 billion in tax subsidies can be directed to the poor.

Many are likely to resist cuts in tax expenditures for retirement savings, claiming that cuts would hamper savings. Yet evidence from Denmark suggests otherwise. In 1999 the Danish government reduced by the subsidy paid to high-income savers with retirement

savings accounts. Chetty et al. [2012] found that only 15% of affected savers reduced their contributions but even they hardly reduced their overall savings as 98% of reduced contributions were transferred to taxable savings accounts.

CONCLUSION

Discussions about retirement income are unfocused because they blur distinctions between wealthy, middle, and poor, and between the stable-middle and the precarious-middle. Retirement-income deficiencies are most acute among the precarious-middle and the poor. Mandatory retirement savings plans benefit the precarious-middle by replacing weak self-control with strong outside control, but mandatory retirement savings plans offer little benefit to the poor whose accounts would be contain little or nothing. Help for the poor calls for measures beyond making retirement savings plans mandatory.

ENDNOTES

¹Old-age income might be a more apt term than retirement income as many of the old are not retired, whether by choice or necessity.

²See Hymowitz [2013].

³See Comments, “One Family’s Struggle to Survive on a Fast Food Salary,” PBS Newshour, November 4, 2013. Available at http://www.pbs.org/newshour/bb/nation/july-dec13/minimumwage_11-04.html.

⁴<https://personal.vanguard.com/us/insights/article/utkus-retirement-survey-072013>.

⁵The questions are as follows:

1. Suppose you had \$100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow: more than \$102, exactly \$102, less than \$102?
2. Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, would you be able to buy more than, exactly the same as, or less than today with the money in this account?
3. Do you think that the following statement is true or false? “Buying a single company stock usually provides a safer return than a stock mutual fund.”

⁶Moss [2002, p. 180].

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