Research Roundup

By Kerry Pechter *Thu, Nov 30, 2017*

We summarize five papers: "The Sustainability of U.S. Household Finances," "The Great Debt Boom: 1949-2013," "Living Below the Line: Economic Insecurity and Older Americans in the States, 2016," "Building Emergency Savings Through Employer-Sponsored Rainy Day Accounts," and "Dodged a Bullet? 'Rothification' Likely to Reduce Retirement Saving."

A new batch of retirement research papers arrives here every week. Some of the articles fall into our wheelhouse—retirement financing. Periodically we glean them for insights and then condense them for our audience of advisors, plan providers, academics, insurers, asset managers and marketers.

Our latest Research Roundup includes summaries of five recent research articles. Two of the articles, "The Sustainability of U.S. Household Finances" and "The Great Debt Boom: 1949-2013", help explain why most Americans, including the affluent, aren't well prepared for retirement.

A third article, "Living Below the Line: Economic Insecurity and Older Americans in the States, 2016," helps define and quantify "basic" and "essential" expenses in retirement. The last two articles address the topics of "rainy day funds" (a part of financial wellness programs) and "Rothification," a federal revenue-generating idea that most 401(k) industry lobbyists despise.

Sustainable consumption in retirement

The finances of almost half of American households are unsustainable, if sustainability means that a household can consume at its current rate through its remaining working and retirement years without running out of money, according to research by Steven M. Fazzari of Washington University and two Federal Reserve economists, Daniel H. Cooper and Barry Z. Cynamon.

Baby Boomers, as a group, appear to be at very high risk. In a presentation at the Tipping Points II Conference in New York last June, the authors showed that more than 90% of Baby Boomer-led households were financially sustainable in the early 1980s. But that percentage dropped steadily over the next 30 years, to 31% in 2012.

Their study showed a decline in consumption sustainability over the life cycle for even the higher-income households, except for the highest one percent. Indeed, between 1983 and 2013, those in the 91st to 99th income percentile saw the largest drop in percentage of sustainable households, to 47% from 81%.

The economists created a metric they called Consumption at Risk (CAR). It is the percent of current consumption that households would have to cut in order to live within their means—that is, if they were forced to consume at a sustainable rate. Among financially unsustainable houses, the CAR in 2012 was just over 30%.

The researchers expect that many Boomer householders will have to work in retirement if they want to consume at current rates. “For the sustainability share in 2012 to be the same as in 1988, households that planned to smooth their consumption through retirement in 1988 would need to plan to cut their retirement consumption in half by 2012,” they wrote in an October 2016 paper, “The Sustainability of U.S. Household Finances.”

From Levittown to McMansions, a story of debt

Even the rich in America, on average, are borrowing and spending at a rate that they won’t be able to sustain for their entire lives, according to “The Great American Debt Boom 1949-2013,” a September 2017 paper by three German economists. Almost all of us are over-borrowed and, ipso facto, under-saved.

The personal debt load carried by Americans has grown more than six-fold since 1949, from 15% of GDP to 100% of GDP, write Moritz Kuhn, Moritz Schularick and Ulrike Steins of the University of Bonn. Generally, the upper-middle class has over-borrowed on real estate, the middle-class for tuition and the lower-middle class just to make ends meet.

The big story is in real estate. From 1949 to the 1970s, during what might be called the Levittown boom, broader home ownership drove the rise in household debt, as the parents of Boomers eschewed urban apartments for sheetrock homes on half-acre tracts in the suburbs.

Later, as interest rates fell and the stock market rose, lending practices loosened. The McMansion boom arrived. Members of the upper middle class were able to finance much larger homes and take on unprecedented debt. Except for the subprime lending phase, this was a period of “intensive” rather than “extensive” borrowing.

People born between 1915 and 1924 tended to start deleveraging at about age 45, but younger people have not “reduced their indebtedness as they grew older,” the authors write. For Boomers born between 1945 and 1964, “mean debt-to-income ratios even increased with age.” That may be the essence of our looming “retirement crisis.”

‘Basic’ expenses in retirement? About $40,000

When estimating your retirement cost-of-living, can you draw a line between “essential” and “discretionary” expenses? Advisors often ask that question and most people have difficult answering it.

At the Gerontology Institute at UMass Boston, economists have created a benchmark called the Elder Economic Security Index Standard, which they claim represents the amount of monthly and annual cost of basic expenses in retirement for singles and couples over age 65.

They put the basic required income for a single person over age 65 at $20,000 to $31,000 a year ($1,700 to $2,600 a month) and for a couple at $31,000 to $41,000 a year ($2,500 to $3,500 a month). Homeowners with mortgages have the highest expenses, followed by renters and homeowners without mortgages. Spending on entertainment, travel, restaurant meals, or the cost of anything else beyond essential needs is not included.

These figures are published in “Living Below the Line: Economic Insecurity and Older Americans in the States, 2016,” by Jan Mutchler, Yang Li, and Ping Xu of the Center for Social and Demographic Research on Aging, Gerontological Institute, McCormack Graduate School of Policy and Global Studies, University of Massachusetts-Boston.

One interesting artifact of the study: Very few retired couples are truly poor, by federal poverty standards. They’re roughly half as likely as single people to be economically insecure. Very few retired couples—no more than 6.2% (in Mississippi) and only 2.6% in Vermont—have incomes below the official U.S. poverty line.

The forecast for “rainy day” accounts

Proposals for “financial wellness” programs within 401(k) plans sometimes include an emergency fund or “rainy day” fund. If participants had a source of ready cash, the theory goes, they wouldn’t need to take hardship withdrawals or to borrow from their accounts. It would be easier for them to keep their savings “on track.”

The details, however, can be devilish. The obstacles and uncertainties that face plan sponsors or plan providers who contemplate adding a rainy day fund are explored in an October 2017 research paper aptly called, “Building Emergency Savings Through Employer-Sponsored Rainy Day Accounts.”

The paper was produced by A-list retirement researchers: John Beshears, David Laibson and Brigitte Madrian of Harvard, James Choi of Yale, and the duo of Mark Iwry and David John, who co-created the “auto-IRA” model on which state-sponsored workplace IRA plans in California and Oregon are based.

The researchers considered three potential designs for a rainy day fund: an after-tax employee contribution account within a 401(k) plan; a Roth IRA inside a 401(k) plan (aka a “deemed” Roth IRA); and an account that would live at a bank or credit union and would, if regulations allow, feed excess emergency savings back into a 401(k) plan.

Clearly, many uncertainties still exist. The paper focuses on the many questions that would face the sponsor of such a program–about how to invest the contributions, how large the fund should be, how to make sure the accounts are enhancing long-term retirement savings instead of cannibalizing them, and so forth.

The data points to a huge need for rainy day funds. “Forty-six percent of U.S. adults report that they either could not come up with $400 to cover an emergency expense” without borrowing or selling something, the authors write. “Among households whose head is age 61-70, median liquid net worth is $6,213, while the 25th percentile is $1.”

The case against 'Rothification'

The Center for Retirement Research (CRR) at Boston College opposes "Rothification" of 401(k) plans. Its economists consider the idea, only recently shelved by Congress, to be a revenue-generating "gimmick" rather than a good-faith attempt to improve the retirement system.

"Many better options exist if Congress wants to focus on improving the retirement system," write CRR director Alicia Munnell and staff economist Gal Wettstein in a brief entitled, "Dodged a Bullet? 'Rothification' Likely to Reduce Retirement Saving."

A switch to Roth 401(k)s would reverse the current system, in which contributions are tax-deductible and withdrawals in retirement are taxed as ordinary income. Eliminating the tax deduction for contributions to 401(k) plans, Munnell and Wettstein claim, might have unpleasant unintended consequences, like eliminating an important incentive to save.

For the present, Congress has dropped its original Rothification proposal, which would have cannibalized the 401(k) system for near-term tax revenue in order to pay for the large corporate tax cuts. But that's not very comforting, since it means that they don't intend to update the flawed 401(k) system, which covers only about half the U.S. workforce at any given time and has no provision for income-generation in retirement.

Munnell and Wettstein recommend making auto-enrollment and auto-escalation of the default contribution rate mandatory. "Changes are also required on the draw-down side so that retirees do not either spend their money too quickly and outlive their savings or spend it too slowly and deprive themselves of necessities," they write. "And expansion of coverage is needed for the half of private sector workers who have no employer-sponsored retirement plan at work."