University of Michigan Retirement Research Center

October 2008 Volume 9 Issue 4

QUARTERLY *Newsletter*

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DIRECTOR'S CORNER

John Laitner

The MRRC is very pleased to announce its new research projects for 2008-2009 (listed in this newsletter). This launches our third 5-year cycle of generous support from the Social Security Administration. The Michigan Retirement Research Center is delighted to continue its participation in the innovative Retirement Research Consortium public/private research cooperative agreement.

As the MRRC has developed an infrastructure of scholars, it has sought to sustain a balance of stability and growth. Each year, SSA communicates a list of priority research areas to the members of the RRC. The list typically includes a wide range of topics. As its base of scholars has grown, the MRRC has been able to expand the breadth and depth of its engagement.

One particular focus of the MRRC is measuring the adequacy of household resources for retirement. The Health and Retirement Study (HRS) is, of course, a premier data set for investigating this topic, and the MRRC has many ties to the design and collection of this survey. A tremendous strength of the HRS is that it can be linked to Social Security earnings records for approved projects, allowing researchers to use actual earning realizations in their retirement models. In this *Newsletter*, Professors John Karl Scholz and Ananth Seshadri discuss their innovative work on retirement well-being, which makes use of these data.

FOR YOUR INFORMATION:

When to Start Receiving Benefits

The Social Security Administration has recently released a two-page Fact Sheet detailing the important things to consider when deciding when to begin receiving Social Security retirement benefits. The publication emphasizes the fact that your monthly payments can differ substantially depending on when you start receiving them and also describes in detail how the decisions of married couples influence each other. The publication also explains how Social Security calculates your benefits if you decide to continue working after you begin receiving benefits. We are also reminded to sign up for Medicare three months before turning age 65, regardless of when we decide to receive retirement benefits.

View the Fact Sheet here http://www.socialsecurity.gov/pubs/10147.html#yourdecision.

DETERMINANTS OF RETIREMENT SECURITY

The 10th Annual Conference of the Retirement Research Consortium was held in August at the National Press Club in Washington DC. With the conference's growing popularity, attendance this year was well over three hundred. The conference, Determinants of Retirement Security, was organized this year by the Center for Retirement Research at Boston College in consultation with the RRC. Its theme addressed challenges and potential solutions to retirement security.

Acting Deputy Commissioner Jason Fichtner delivered welcoming remarks. Congressional Budget Office Director Peter Orszag deliverd a luncheon address on Thursday. On Friday, Henry Aaron of the Brookings Institution chaired a luncheon panel on the Future of Medicare with panelists Marilyn Moon of the American Institutes for Research and Gail Wilensky of Project Hope.

Over the two days, researchers from each of the three consortium centers presented papers on current projects, all of which are funded by SSA. The topics covered in the eight panel sessions included papers on the impact of pre-retirement patterns on retirement incomes, factors influencing the timing of retirement, trends in asset allocation, adequacy of retirement resources, and consumption in retirement. The second day held presentations from the Sandell Scholars as well as a panel on program interactions and a panel examining the safety net for older workers. Papers presented at the conference, along with Powerpoint presentations are available on the MRRC website. (www.mrrc.isr.umich.edu)

National Press Club
Washington, D.C.

MRRC NEW AWARDS

The MRRC is Pleased to Announce the Following Research Awards for 2008-2009

Reconciling Findings on the Employment Impact of Disability Insurance.
John Bound and Timothy Waidman

How Common is Parking Among SSDI Beneficiaries?
Deborah Peikes and David Stapleton

Adjusting Social Security Unfunded Liability for Risk.
Laurence J. Kotlikoff

What Replacement Rates Should Households Use?
John Karl Scholz and Ananth Seshadri

Buffering Shocks to Well-Being Late in Life.
Matthew D. Shapiro

Models of Endogenous Retirement and the Labor Supply Effects of Social Security.
Richard Rogerson

401(k) Plan Investment Efficiency: Who Are the Winners and Why?
Olivia S. Mitchell and Ning Tang

The Level and Risk of Out-of-Pocket Health Care Spending.
Michael Hurd and Susann Rohwedder

How Do Pension Changes Affect Retirement Preparedness?
Alan L. Gustman, Thomas L. Steinmeier, and Nahid Tabatabai

Financial Literacy and Financial Sophistication: Evidence from the 2008 HRS.
Annamaria Lusardi

Social Security Literacy and Retirement Well-Being.
Hugo Benítez-Silva, Berna Demiralp, and Zhen Liu

Market-based Guarantees in Investment-linked Pension Payout Programs: Pricing, Risk Management, and Financial Well-being for Retirees.
Raimond H. Maurer

Earnings and 401(k) Contribution Profiles of Three Cohorts: Evidence from Social Security Records.
Marjorie Honig

Economic Hardship Among the Elderly: How Important is Failure to Take up Public Programs?
Helen Levy

Work Disability and Labor Force Status in Europe and the US.
Arie Kapetyn , James Smith, and Arthur van Soest

International Comparisons: The Effect of Policy on Work, Disability and Wealth.
Pierre-Carl Michaud, Michael Hurd, and Susann Rohwedder

Investor Behavior and Fund Performance under a Privatized Retirement Accounts System: Evidence from Chile.
Petra Todd and Elena Krasnokutskaya

Geographical Proximity and Intergenerational Transfers.
Robert A. Pollak

Marriage and Savings Over the Lifecycle.
Julie Zissimopoulos

UNDERSTANDING THE FINANCES OF LOW-INCOME FAMILIES

BY HELEN LEVY AND KRISTIN SEEFELDT

There are many important unanswered questions about work, savings and retirement among economically vulnerable families. To begin to address some of these questions, we interviewed 50 low-income women living in Detroit. Qualitative research like this, that relies on semi-structured interviews, can make substantive and methodological contributions that complement the insights from existing theoretical and empirical models. In particular, open-ended conversations with respondents have the potential to generate new hypotheses about behavior and to determine whether existing large-scale surveys are systematically overlooking important information. This Briief summarizes the findings from part of this investigation that focused on saving behavior and thoughts about retirement.

HOW DO LOW-INCOME WOMEN THINK ABOUT RETIREMENT?

In a standard economic model, households save for a number of reasons, the chief of which may be to finance retirement. Savings rates are low for all Americans but are often especially low or even negative for low-income families. What exactly are these households thinking about retirement? Do they think about retirement? If so, when do they think they will retire, and what is it they plan to live on?

We find that the great majority of low-income households think about retirement, often worrying about it quite a bit. Some respondents who are unemployed or having only sporadic participation in the labor force say that having no job from which to retire makes it difficult for them to think about or plan for retirement.

Among those who think about retirement, most plan to retire when they become eligible for Social Security benefits or a private pension (for the few respondents in our sample who have these). Even when respondents do not know the age at which they will be eligible, they say that this is when they intend to retire; respondents who name a specific age choose the age at which they believe they will be eligible for benefits. Respondents are reasonably well-informed about their Social Security benefits, reading the statements they get from the Social Security Administration and, in some cases,

SSA WEBSITE HAS NEW LOOK

The Social Security Administration (www.socialsecurity.gov) recently rolled out a new look for its website that greatly enhances the site's user-friendliness. The new home page features a useful 2-minute video that explains several of the site's key features. The video highlights three things you can do on the website (file on-line for retirement benefits, get information on applying for disability benefits, and requesting a Social Security card) but emphasizes that there are many more functions available on-line.

You can also subscribe to Social Security eNews by clicking the link in the upper right hand corner of the new home page that says "Receive updates by email." Or go to the following link to subscribe on-line. http://www.ssa.gov/enews/

expressing concern about the future of the system.

Overall, the results paint a picture of low-income households who think about their retirement even though day-to-day financial burdens may make significant retirement saving unrealistic.

SAVING AMONG LOW-INCOME WOMEN: MOTIVATION AND OBSTACLES

We next turn to questions related to potential motivations and obstacles to saving. What do respondents believe their own motivations for saving to be? Do they have plans to save, or have they abandoned hope of saving? How does saving for retirement figure into their planning? If they have goals that they fail to meet, why do they fail?

In spite of a great deal of interest in understanding the determinants of savings rates, particularly for low-income households, almost no research has asked members of those households what they think is going on and how they think about saving (or not).

We find that these households wish that they could save, and say that they plan to do so in the future when they hope to have more income. They identify many motives for saving, including the desire to have a cushion in case of the unexpected (a precautionary motive), wanting to put their children through college, saving up for a house or car. A few respondents mention wanting to start a small business. Some see this saving as complementary to retirement saving, since they plan to supplement their retirement income (which will in most cases be only what they receive from Social Security) by running a small business like a Laundromat or a catering business.

Very few respondents volunteer "retirement" as a motivation for saving although when we ask specifically about retirement planning, the majority of our respondents say that they think about retirement and would like to save for it. In fact, a significant minority of our respondents are saving for retirement through either 401K plans or employer-provided pensions, although the amounts in 401K do not seem to be large. A number of respondents have been forced to dip into 401K savings to pay living expenses during a long unemployment spell or in order to help friends or relatives.

In fact, friends and family surface as a major obstacle to saving for our respondents. Those who have liquid assets are asked for help. Conversely, many of our respondents are the beneficiaries of gifts or other support (such as free housing) from friends and relatives.

These complicated patterns of resource-sharing have clear benefits for the low-income population overall, providing a mechanism for smoothing consumption analogous to consumption insurance in developing economies. At the same time, however, they imply that significant asset accumulation is unlikely unless these assets are illiquid – for example, employer-provided pensions.

Helen Levy is a Research Assistant Professor at the University of Michigan's Institute for Social Research. She is also an Assistant Research Scientist in the School of Public Health at the University of Michigan.

Kristin S. Seefeldt is a Research Investigator at the University of Michigan's Program on Poverty and Social Welfare Policy and the Assistant Director of the National Poverty Center, both within the Gerald R. Ford School of Public Policy.

WHAT'S NEW AT THE HRS?

The HRS 2006 Core Final Release (Version 1.0) is now Available

The HRS 2006 Core Final Release contains data for 18,469 respondents, in 12,605 households. The data collection period for HRS 2006 was March 2006 through February 2007. The HRS Online Concordance has been updated to reflect the content of this release.

Note: Be sure to check the HRS File Merge Cross-Reference Table for up-to-date information on the restricted data merge status of this data set.

The HRS Cross-Wave Master ID File (Final, Version 4.0) is now available.

The Master ID File includes information from 2006. The purpose of the HRS Master ID file is to simplify the process of merging HRS files. The HRS uses two ID variables in combination to uniquely identify individuals: HHID and PN. Ideally, these would be fixed at entry into the study and never need to be changed. They would be identical for a single individual in every wave and in the Tracker file. In practice, a small but non-negligible number of individuals have had changes in their HHID or PN variables. Therefore this file creates wave-specific HHID and PN numbers that match identically to IDs on each wave, paired with the current tracker HHID and PN.

IT'S EASY TO ESTIMATE YOUR FUTURE SOCIAL SECURITY BENEFITS

Getting a personalized online estimate of your future Social Security retirement benefits is now easier than ever before thanks to the launch of the new Retirement Estimator at www.socialsecurity.gov.

The Retirement Estimator is a planning tool that allows you to get an immediate and personalized estimate of your potential Social Security retirement benefit.

Visit www.socialsecurity.gov/estimator. To get an estimate, you'll need to enter your first and last name, date of birth, Social Security number, mother's maiden name and place of birth. If the information matches Social Security's records, the Retirement Estimator combines this information with the information that Social Security has on record, including your yearly earnings, to provide a quick and reliable online benefit estimate.

The Retirement Estimator is convenient. Since it is tied to your actual Social Security earnings record, there is no need to manually enter years of earnings information. The Retirement Estimator is also interactive, allowing you to compare different retirement options by changing your "stop work" dates or expected earnings.

The Retirement Estimator is secure. To protect your privacy, only your benefit estimates are provided online. The Retirement Estimator does not reveal any personal information, such as your address, earnings or other information.

When you visit Social Security's website at www.socialsecurity.gov to see the new Retirement Estimator, take a few minutes to become familiar with the many other online services – including applying online for Social Security retirement and disability benefits.

Q&A

John Karl Scholz and Ananth Seshadri discuss their MRRC-supported research

Q: What motivates your longstanding research interest in retirement resource adequacy?

A: You can't help but get the impression reading the financial press – whether Fortune or Forbes Magazines or even reporting in the Wall Street Journal – that Americans are preparing poorly for retirement. This view is supported by anecdotal evidence (we see a lot of activity at the shopping malls) and by low observed personal saving rates, as measured by the National Income Products Accounts (NIPA) ratings. So the prevailing wisdom is that people aren't saving enough. This is also manifest in policy discussions. There are many tax preferences granted to saving, presumably to help people prepare adequately for retirement, for example, 401(k)s, IRAs, and other pension plans. There is always some interest in trying to expand these tax preferences, generally justified by calling attention to the precarious state of Americans' retirement planning. One of us (Karl Scholz) did some earlier work with William Gale looking at a period (1981-86) when tax-favored IRAs were available to all taxpayers reagrdless of income levels. Gale and Scholz found that these incentives did very little to increase household saving. The money that went into these accounts was largely money that would have been saved otherwise or money that was shifted from one tax-favored account to the tax-favored IRA. So one motivation for our interest in the degree to which Americans are preparing well for retirement is that it ties into tax policy debates about the wisdom of expanding tax preferences for saving.

We began working with our student, and now friend and Urban Institute colleague, Surachai Khitakatrkun using the rich data provided by the Health and Retirement Study (HRS). We saw an opportunity to take a new approach to assessing the degree to which people are preparing well for retirement by taking seriously the implications of an augmented life-cycle model. The intuition of the life-cycle model is that households want to try to try to equate the discounted marginal utility of consumption across periods, meaning, loosely, that they try to equalize the well-being they receive from the last dollar they spend each period of their lives. We augmented the simple life-cycle model to account for the possibility of uncertain earnings, uncertain health shocks in retirement, and uncertain life expectancy. We looked at the implications of that model for what households should be doing to prepare for retirement. Specifically, we used the model to evaluate what households should be saving (and consuming) under any outcome given the three types of uncertainty that we can account for in the model: lifespan, earnings, and health shocks.

Once we have the decision rules for households that tell us what they optimally should do, we can compare that to what they actually do. Through procedures established at the University of Michigan and the Social Security Administration, we were able to get actual earnings realizations that households in the HRS had. With the optimal decision rule for any realization of earnings and the earnings that households actually received, we can calculate the household's optimal consumption (and saving) in each period, which then allows us to calculate their optimal wealth holding at the time we observed them in the HRS in 1992. Given the assumptions of the model (most importantly, the coefficient of relative risk aversion, discount rate, and the real rate of return), these optimal targets are the amount of net worth – excluding Social security and defined benefit pension wealth – that the household should have accumulated to maximize its lifetime well-being.

When we do that exercise, we find two very interesting things. The first is that the HRS cohort born between 1931 and 1941 is overwhelmingly at or above their optimal wealth target. That is a surprise given the gloom and doom scenario commonly portrayed in the financial press. The second is that the outcome of that model fits the data remarkably well. This is somewhat at odds with at least one current of thought in the literature that suggests people's behavior is not forward-looking, as our behavioral model would suggest.

Q: Are younger people saving less?

A: A question arises as to whether it is just that cohort – born and raised during the depression – who is saving well. Is this behavior somehow unique to them? There's a strong presumption out there that younger people are behaving less responsibly that their elders. So the work we currently report on looks at a broader range of age groups in the HRS. This is where the value of the HRS is really manifest. We were able to compare across several birth cohorts to see if the results from our earlier work still hold. We looked at two generations born before the original HRS cohort, the original HRS cohort, and two generations born after, the so-called War Babies (born 1942 to 1947), and the Early Baby Boomers (born 1948 to 1953). And our benchmark year is 2004, rather than 1994.

When we examine the implications of the augmented lifecycle model for this broader set of households, we find that our earlier results still hold. Households in every birth cohort were overwhelmingly at or above their optimum wealth targets. For the youngest group, the numbers were slightly less favorable. But even so, only 10% of that cohort fell short of their optimum target. We think the evidence is quite strong that Americans born before 1954 were accumulating sufficient wealth to maintain their accustomed standard of living in retirement, at least as of 2004. It remains to be seen how the financial market disruption in 2008 will affect our views.

Q: What impact do children have on household savings?

A: The kids puzzle derives from the juxtaposition of a number of observations. First, our own analysis suggests that Americans are largely on target for achieving retirement living standards that are consistent with their pre-retirement living standards. Second, a casual look at data on asset balances (whether from the HRS data or data from the Survey of Consumer Finances) suggests that people have not accumulated very much financial wealth. Third, conventional financial planning advice suggests that replacement rates - the fraction of pre-retirement income that should be replaced by retirement income - should be anywhere between 75 and 90 percent. Those three observations do not square up very well, and the question is, what's going on? In addition, the distribution of wealth is much more dispersed than earnings. Explaining this discrepancy has been a challenge in the field.

It turns out that children have an important and underemphasized role in understanding the distribution and dispersion of net worth in our society. We can illustrate the finding by giving the example of two couples, who are otherwise identical, but one has five kids and the other has no kids. The couple with five kids is eating peanut butter, and the couple with no kids is going to restaurants. That has really important implications for accumulation of retirement resources. It takes far fewer resources to maintain the living standards of the husband and wife with the five kids after the kids have left the house than it does for the couple with no kids. Children literally eat up a large share of household resources. Once they have left the nest, the wealth needed to maintain the living standards of the adults remaining in the household is substantially less than what is needed for the childless couple.

To study carefully the effects of children, we extended the model we had developed by incorporating endogenous fertility, which means we actually model the decisions people make to have children, in addition to the life-cycle consumption problem. We do that because some of the policy experiments that we're interested in running, like altering the transfer system, may have implications for fertility.

Q: Where are you headed next?

A: There are a lot of questions raised by our research to date that we find really fascinating. Rather than setting an arbitrary retirement wealth target, our research derives model-based estimates of optimal wealth targets. However, it's very hard, outside the model, to translate the results to something that might be useful to people. We are interested in translating these model-derived wealth targets into a sensible set of rules that people can use when thinking about their retirement planning.

Farther off in the future, we are interested in trying to evaluate the impact of rising health care costs on personal saving. You might expect to see a higher level of precautionary saving as people anticipate large out-of-pocket expenses related to health shocks late in life. There's quite a bit more to do to look systematically at how health shocks can affect people's consumption and saving behavior.

John Karl Scholz is a professor of economics at the University of Wisconsin - Madison, where he specializes in public economics. In 1997-98 he was the Deputy Assistant Secretary for Tax Analysis at the U.S. Treasury Department, and from 1990-91 he was a senior staff economist at the Council of Economic Advisors. He directed the Institute for Research on Poverty at UW-Madison from 2000-2004. Professor Scholz has written on the earned income tax credit and low-wage labor markets. He also writes on public policy and household saving, charitable contributions, and bankruptcy laws. In 2007, he received the TIAA-CREF Paul A. Samuleson Award for Outstanding Scholarly Writing in Lifelong Financial Security (with Ananth Seshadri and Surachai Khitakatrakun).

Ananth Seshadri is a professor of economics at the University of Wisconsin-Madison, where he specializes in Macroeconomics and public finance. He has written on the causes and consequences of demographic change and the effects of technological change in accounting for various demographic patterns. His research has appeared in leading economics journals, including The American Economic Review, Review of Economic Studies, and the Journal of Political Economy. He was awarded a research fellowship from the Alfred P Sloan Foundation in 2006. In 2007, he received the TIAA-CREF Paul A. Samuleson Award for Outstanding Scholarly Writing in Lifelong Financial Security (with John Karl Scholz and Surachai Khitakatrakun)

THE MICHIGAN RETIREMENT RESEARCH CENTER IS SUPPORTED BY A COOPERATIVE AGREEMENT WITH THE SOCIAL SECURITY ADMINISTRATION (10-M-98362-5-01).

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