Remarks on the Retirement Spending Phase

Before the Senate Special Committee on Aging

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Thank you, Chairman Smith, for the opportunity to discuss the income or spending phase of retirement with members of the Committee. I am reminded by my colleagues at Vanguard that millions of retired Americans are already dealing with the issues of generating income and managing their savings in retirement. But the question will take on greater urgency with the retirement of the baby boom generation, and with the shift of the private-sector retirement system to defined contribution plans.[1] At Vanguard, we have developed some expertise in understanding financial decision-making by individuals, and I thought that I would devote my remarks today to that perspective: of a household making choices at the point of retirement and beyond.

The first decision households face in the retirement phase is not how to spend their assets—instead, it is the decision on when to stop working. For many Americans, there is a real risk of retiring too early. This risk is evident in our own research at the Vanguard Center for Retirement Research, as well as in the Retirement Risk Index recently issued by the Boston College Center for Retirement Research. Delaying retirement by two or three years can dramatically reduce financial risks in retirement. A longer period of work means higher Social Security benefits, more in savings, additional investment returns, and, for those covered by pensions, often a higher benefit. It also means fewer years of retirement spending.

In recent years, there have been several encouraging developments on this question of the timing of retirement. Social Security's normal retirement age is rising to 67, a reflection of longer life expectancies. In the private sector, employers with defined benefit plans have been phasing out incentives for early retirement. The shift to defined contribution plans is also encouraging: DC plan participants typically work several years longer than DB plan participants because DC plans do not have the service-linked benefits of the typical DB plan. Hybrid plans probably have a similar effect.

What else can policymakers do to help? One important direction is to continue support for "phased retirement," which would enable individuals to simultaneously contribute to, and spend from, qualified benefit programs. Working for several more years is one way that the baby boom generation will be able to finance its retirement. We've all heard of the traditional three-legged stool: Social Security, an employer pension, and personal savings. For the baby boom generation, retirement will be built on a new three-legged stool: Social Security, workplace and personal savings, and work.

The second question households face in retirement is how to manage their accumulated resources. We could devote many hours of discussion to the choice between annuity income and asset income. As you know, annuities help protect against longevity risk—the risk of outliving one's savings—while a pool of assets provides flexibility in dealing with unplanned expenses. Most experts agree that households need both. The only point of debate is one of degree: What proportion of retirement savings should be annuitized, and what proportion should remain as a pool of assets? In recent years, it appears that many households have "voted with their feet," finding the cost of longevity insurance in annuities to be too high. Many private-sector DB plan have introduced lump-sum payments. Few DC plan participants take up annuities when they are offered. In the private market for income annuities, purchase rates are low.

Why might retired households prefer asset income over annuity income? One reason is Social Security. Today, Social Security is the principal source of income and the main annuity provider for six out of ten American retirees.[2] Social Security has the benefit of being government guaranteed, inflation indexed and exceptionally cost-effective. Longevity risk is also pooled across the entire nation.

A second reason for the focus by households on asset income is flexibility. A household with a pool of liquid assets is better able to address unanticipated expenses in retirement. These include not only major capital or consumer expenses, but also out-of-pocket medical costs and the cost of nursing home care. A pool of assets can also be invested and grow over time, offering protection against inflation.

There is a third reason that households may prefer asset income. Retirement wealth and financial literacy have been rising, and households are willing to shoulder more responsibility for managing their assets. For middle-income households, the dominant asset holdings are bank CDs and mutual funds; affluent households also own individual stocks and bonds and investment real estate. Households who own these assets rely on regular interest and dividend payments from these vehicles. As long as investors do not spend capital, it is possible to maintain these sources of income indefinitely. In addition, the financial planning community has devised strategies, such as the "4% spending rule," to help individuals draw down their savings.

What can policymakers do to help in the annuity-income versus asset-income decision? At Vanguard, we anticipate much innovation in this area in the coming years—from insurance companies, banks, and asset management firms. On the annuity side, one of the most intriguing ideas is "longevity insurance"—an annuity that pays a benefit only if you live beyond a certain age, such as 85. Some reform could encourage this new type of annuity. Another issue is translating home equity into an income stream. Eighty percent of retirees own their own homes, and policy should do much more to encourage the reverse mortgage market. On the asset income side, a topic worth considering is tax simplification broadly. The tax rules governing different types of accounts and plans, as well as the taxation of Social Security, are simply too complex. One positive step would be eliminating the required minimum distribution (RMD) rules, as the Joint Committee on Taxation has recommended.[3] These rules were designed with the Treasury's revenue stream in mind, not as a long-term pay-down or income strategy for individuals. Eliminating the RMD rules would help retirees, and would assist financial services firms in designing income programs for retirees. Finally, efforts to encourage financial planning and investment advice make sense—to help individuals choose an appropriate retirement date and to develop retirement income strategies.

As I mentioned at the outset, retired households have been making investment and savings choices for years. But now, with the upcoming retirement of the baby boom generation, many more Americans will be called on to make critical choices about generating an income and investing their assets in retirement. By retiring a few years later, and using a mix of annuity- and asset-based income programs, it is likely that many will be able to meet this challenge in the decades ahead.

Endnotes

[1] According to the 2004 Survey of Consumer Finances, about one-quarter (26%) of older retirees (age 75 and older) owned a retirement account, which broadly defined included a 401(k) plan, an IRA or similar account. This figure rises to nearly two-thirds (63%) for those in their prime working years (age 45-54).

[2] According to the Social Security Administration, *Income of the Population 55 or Older, 2004,* 60% of age 65 and older households receive 50% or more of their income from Social Security. Table 6.A1, p.109. For 31% of households age 65 and older, Social Security represents 90% or more of income.

[3] Joint Committee on Taxation, 2001. *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01). See in particular: *Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System,* pp. 194-197.