REMAPPING DEBATE
Asking "Why" and "Why Not"

Coming Boomer pension cuts: what impact on our economy?

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October 12, 2010 — Over the last two decades, pension cutbacks have left relatively few private sector workers with defined benefit pensions plans. Now, with health and pension funds for state and local government employees said to be facing massive funding shortfalls, many are describing the guaranteed retirement benefits paid to teachers, police officers, street cleaners, and other public workers as overly expensive and sclerotic. These pensions, the argument goes, are unrealistic — they are throwbacks to another era that must now be curbed.

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As Andrew G. Biggs, the chief expert on pensions at the American Enterprise Institute, a conservative think tank, puts it, government workers are enjoying the good life off their neighbors' backs, relying on their employers' questionable accounting practices to downplay taxpayer liabilities. "There is no reason public-sector employees should receive retirement benefits that are either larger or more secure than those received by private-sector workers," Biggs wrote in an April 2010 essay on retirement policy.

One might imagine that policymakers would want to consider thoroughly the societal consequences before adopting (or failing to adopt) measures to effectively put a stake through the heart of the defined benefit plans that many public sector workers have depended upon for their retirement. One might likewise imagine that the impact of past and prospective reductions in the retirement benefits of private sector retirees would weigh heavily in any decisions about the future of pensions. In fact, however, an important question has been notably absent from the debate: With 78 million Baby Boomers heading into retirement over the next 20-plus years, how will cuts in guaranteed monthly pension benefits to both public and private sector workers — in addition to those that have already been implemented — affect the ability of future retirees to engage in economy-sustaining consumer spending?

At every stage of their lives, Boomers, the generation born between 1946 and 1964, have exerted a singular force on the economy. Cradled in the relative prosperity of the post-war years, they graduated from college in higher numbers and earned higher incomes than both their parents and their children. Boomers saved less and spent much, much more. By their sheer numbers and appetites, what Boomers do — how much cash they have in their pockets, and whether they save it or spend it — matters. Consumer spending accounts for 70 percent of economic activity, according to government figures. By 2015, Boomers will account for 40 percent of that consumer spending, according to a 2007 report by McKinsey Associates.

Over the next 20 years, the importance of this outsized generation to the nation's overall economic health will only grow. By 2032, when the last Boomers reach retirement, the population over 65 will have nearly doubled, to 72 million people from 42 million today. In contrast, the 18- to 49-year-old population will grow during that same period by only six percent.

> Over the last 25 years, the share of private sector workers covered by defined benefit plans has fallen by half (from 38 percent to 18 percent).

So why do calls to freeze or cut defined benefits for retirees never address, or even mention, the repercussions of these proposals on consumer spending?

"That's a fascinating question," said Frederick Hess, Biggs' colleague at the American Enterprise Institute, who also opposes defined benefit pensions for civil servants. "It just doesn't come up so much."

If there is one document that can be said to have galvanized public alarm over the state of public pensions, it would be an analysis issued by the Pew Center on the States last February. The study, whose findings were reported by almost every major media outlet and echoed by countless lawmakers and pundits, threw a spotlight on public sector pensions and health benefits for retirees, estimating that these obligations were under-funded by at least $1 trillion. It urged drastic and immediate action to put existing pensions on more solid footing, and to lower future taxpayer obligations by curbing benefits. In state houses across the land, lawmakers are heeding the call.

But another major analysis of the movement in pensions, alarming from a different perspective, drew virtually no notice. The November 2009 study, by researchers at the Social Security Administration and the Urban Institute, modeled the consequences over the next 22 years of eliminating many defined benefit pensions. The report projected what would happen if, over the ensuing five years, all defined benefit plans in the private sector were frozen, and a third of all state and local government plans were also frozen. It then asked: what would that mean for the income of Boomers when they reach the age of 67, between now and 2032?

Overall, the report found that more than twice as many Boomers would lose income than would gain by accelerating the shift from defined benefit pensions, with the biggest losses concentrated among the middle class and Boomers currently in their late 40s and early 50s. Such gains as there would be in retirement income, the government researchers found, would offset only six percent of the losses.

And the study may even have underestimated the impact of adopting the proposals of those who are at war with defined benefit plans. The report modeled the impact of freezing such plans for only a third of state and local government workers; defined benefit critics ultimately would like to do away with guaranteed pensions for all public workers.

Remarkably, the report disappeared into a media and public policy-making void. Not a single newspaper covered the report's projections and, according to Nexis, the news database, they have never come up in public hearings or testimony debating the future of defined pension benefits.

Drawing on more than 100,000 employee records, the report makes its forecast based on the premise that current participants in defined benefit plans would collect benefits based on their previous service, but would not accumulate additional benefits. Based on past practice, the model also assumes that employers would shift their contributions to 401(k) plans. (The assumption may or may not hold entirely true, given that the aim of cutting retirement guarantees is largely to save money.)

Cutting pensions in Utah

Utah, one of 18 states to revamp its pension system since 2005, held a lively, often contentious, debate before moving to end its current defined benefit system for new workers earlier this year. It replaced it with a two-tiered system allowing new hires to choose either a defined contribution or a defined benefit plan. For the latter, the new rules limit the state's contribution to 10 percent of an employee's salary, allow retirement after 35 years' service instead of 30, and lower the maximum benefit to 52 percent of an employee's salary.

And yet, John Nixon, the state budget director, said he does not recall the impact of the changes on consumer spending coming up much in the debates over pension remedies. Nixon had neither heard of or nor seen a February 2009 report by the National Institute on Retirement Security, which uses Census and other government data in 2006 to assess the impact of state and local pension plans on the larger economy.

The study, entitled "Pensionomics," found that every $1 Utah taxpayers spent in public pension benefits spurred $6.36 in economic activity in the state. State and local governments in Utah provided 37,186 retired workers benefits averaging $1,471 a month. These payments, the report found, triggered $1 billion in economic output, concentrated most heavily in retail sales and health care.

Nixon said that lawmakers in Utah, alarmed by a $6.5 billion fall in the pension fund's assets in 2008, focused on the long-term liability to the state of its obligations to retirees, not on the repercussions of possible benefit cuts to the state or local economies — a discussion that usually focuses on a shorter time frame of 12 to 24 months.

"As far as the impact on consumer spending, that's a whole different dialogue," Nixon said.

With 50 to 56 percent of Boomers not in line to receive defined benefit pensions — in part, a result of the abandonment of defined benefit pensions that has already occurred in the private sector — the report found that many Boomer retirees would be unaffected by the changes envisioned in the model. But among those who do receive such pensions, the changes would be substantial. The report broke its findings down by four waves of Boomers, from the eldest, born just after World War II, to the youngest, born in 1964. In each wave, there would be more losers than winners, with the repercussions for the youngest Boomers most severe: 26 percent of them would lose an average of $4,200 in retirement income, while 11 percent would see their incomes rise by an average of $2,800.

The result: a net decline in retirement income among Boomers, in 2010 dollars, of roughly $46.3 billion a year once all Boomers have retired.

Taking the Social Security Administration report, and then drawing on census data to calculate the aggregate net impact on each cohort of Boomers, it appears that the net loss would be $2.9 billion a year among the oldest Boomers, $10.4 billion a year among the group that will turn 67 starting in 2018, $17.1 billion a year for those retiring around 2023, and $17.8 billion for those retiring between 2028 and 2032.

Allowing for deaths as the population ages, Gary Burtless, an economist at the Brookings Institution who helped develop the mathematical model used in the pension study, suggested a graduated formula for calculating the accumulated impact once all Boomers have retired. The result: a net decline in retirement income among Boomers, in 2010 dollars, of roughly $46.3 billion a year once all Boomers have retired.

That scale of loss, said Rodrigue Tremblay, an economist who has written widely of the risk of "stagflation," would weaken the larger economy.

"Because Boomers represent some 75 million consumers, any spending cut by this group will have a profound impact on the overall economy," Tremblay said. "This could precipitate a vicious cycle of slow growth, with fewer jobs for the young." Boomers would not only retire with less disposable income, but — anticipating a less secure retirement — would spend less in the years leading up to retirement.

"Such a shift in pension plans represents, and will represent even more so in the future, a tremendous shift of investment risk

ESTIMATED ANNUAL LOSS PER BOOMER GROUP

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Source: Remapping Debate analysis of Social Security report and Census Bureau data.

from employers to retirees, and will negatively influence the macro economy," Tremblay said, as retirees "spend less and save more to compensate for lower incomes and for a greater expected volatility in their income flows."

Some of the impact might be felt from decisions made by those higher up on the income scale, where losses would be steepest, at $4,600 to $8,000 a year per household. Pam Danziger, president of Unity Marketing, whose clients sell to affluent consumers, warns of a coming "luxury drought" as Boomers leave their peak spending years, winding down into retirement with their confidence shaken, and their share of disposable income weakened from all sides.

But the impact of shaving thousands of dollars off the incomes of Boomer households would be felt beyond the purveyors of $3,000 handbags, said Tremblay, emeritus economics professor at the University of Montreal. Among some, that would mean putting off purchases that are not absolutely essential, eating out less, keeping cars longer and traveling closer to home, if at all.

From the point of view of what public policy makes sense, of course, the Social Security report has to be understood as capturing only part of the shift that has occurred since the 1980s. Over the last 25 years, the share of private sector workers covered by defined benefit plans has fallen by half (from 38 percent to 18 percent). The Social Security report made no comparison between projected retirement

Defending those Utah budget cuts

Daniel Liljenquist, the 36-year-old Republican state senator who spearheaded the pension overhaul in Utah, had not seen the report on Pensionomics, but maintained that claims of multiplier effects are always difficult to gauge.

"I look at that and I think, 'Yeah, most of those studies I've seen, it's always to justify the higher spending on the program they're looking for.'" Liljenquist said.

To make up for the setbacks of 2008, Liljenquist said, analysts calculated that Utah would have to raise its contributions to the state pension system by $400 million a year — which corresponded to 8 to 10 percent of the general and education funds. If the money came entirely from the education budget, Liljenquist told voters, it could pay the salaries of some 8,000 school teachers.

"The question is, what is the opportunity cost of the money? Would it be a higher multiplier effect if we had 8,000 more teachers on the payroll in classrooms? What if we'd put that same money directly into infrastructure improvement, wouldn't that do the same thing?" he asked.

But despite Liljenquist's rhetorical salvo, neither he nor anyone else in the debate was actually proposing to hire 8,000 teachers, or to put the money toward infrastructure.

income had those cuts not occurred and the end point of 2032, but rather treated all of the shift that has already occurred away from defined benefit plans as not constituting "loss" for Boomer retirees. (A 2008 report by the Center for Retirement Research at Boston University has calculated that the typical middle class household lost about 10 percent of retirement income between 1992 and 2004, attributing the loss to the disappearance of defined benefit pensions.)

Scott Hoyt, senior director of consumer economics at Moody's Analytics, offered a different assessment of the projected decline in disposable income derived from the Social Security report. He said the impact of a $46.3 billion loss — which amounts to just under one percent of all consumer expenditures on domestic and imported goods and services — would be complex to gauge, since a dollar taken from seniors in retirement benefits will likely be a gain elsewhere in the economy. But, that doesn't mean there is no net impact.

"You give money to a retired person, it's more likely to get spent than if it goes into corporate profits and is paid out to investors over time," Hoyt said. "So it probably does have a bigger impact on consumer spending if the money stays with retirees."

Biggs, at American Enterprise, said he had previously done his analyses for the Social Security Administration, whose techniques he described as the gold standard of mathematical modeling.

Undoubtedly, he'd seen "The Disappearing Defined Benefit Pension" report?

"Umm," Biggs said. "Can I get back to you on that?"

After looking the study over, he volunteered that he did not consider the findings significant. "Are people being made worse off by this shift? It's not clear that they are," he said.

To illustrate his point, Biggs calculated the percentage decline in income when the elimination of defined benefit pensions was spread out over the entire cohort of the youngest Boomers — including the majority who were never in line to receive such pensions to begin with. By that calculation, he said, the annual loss of income amounted to only 1.6 percent, or $700 per household — a sum, Biggs said, that could be made up by postponing retirement by just a few months.

> "I don't want to focus too much on consumer spending because I think it's a bad measure," Biggs said. "It's entirely overrated."

"I'm having a hard time seeing how any of this makes a difference," Biggs said.

But asked about the impact among those workers who would actually be affected by the proposed changes — crucial, one would think, for weighing whether policy makers should continue to eliminate defined benefit pensions, help them survive or even reverse course to restore them — he acknowledged that the report did show “more losers than winners” when defined benefits were cut. “It’s clearly a more significant impact on the people who are impacted,” he said. “Relative to everybody, it’s not a huge impact.”

“The question is, ‘How much more would we have to subsidize defined benefit pensions to keep them around, and what are you willing to pay?’” he added. “The answer is, ‘Not much.’”

At any rate, Biggs said, he did not consider the consequences for consumer spending important in assessing pension policies. “I don’t want to focus too much on consumer spending because I think it’s a bad measure,” Biggs said. “It’s entirely overrated.” Consumer spending is only important to the economy in the short-term, he added. “Over a longer period of time, you’d prefer higher saving to higher spending.”

Biggs’ view was surprising in view of the fact that, in other spheres, economists at American Enterprise describe increases in consumer spending as key to reviving a stagnant economy.

And, if higher savings are more important in the long term than higher spending, it is not clear how Boomers having lower retirement incomes would facilitate their saving more. Indeed, Biggs did not propose that constricting defined benefit plans would somehow nudge Boomers to towards additional savings. Rather, he predicted, Boomers would work longer to make up for the lost income.

But that is not a solution for everybody, said Keith Brainard, research director at the National Association of State Retirement Administrators. Brainard attributes a nationwide “crisis in retirement” largely to the shift from defined benefit pensions to 401(k) plans, that is stripping away the spending power of Boomers entering retirement. “WalMart can only hire so many greeters,” Brainard said.

Do Boomers save for their retirement?

Utah State Senator Liljenquist was operating under the assumption that, other than public employees. “Everyone else saves for their retirement.”

In fact, according to a 2004 book, Coming Up Short: The Challenge of 401(k) Plans, by Alicia Munnell, director of the Center for Retirement Research at Boston College, 26 percent of people who are eligible to contribute to a 401(k) plan at work do not. And more than half of the people contributing to 401(k)s and other voluntary retirement accounts typically cash out when they leave a job, hatching their nest egg before its time.

Boomers appear to be particularly unprepared for retirement. A third of all boomers have $1,000 or less put aside for retirement, said Matt Thornhill, author of “Boomer Consumer: Ten New Rules for Marketing to America’s Largest, Wealthiest and Most Influential Group.” Some 25 million Boomers have not saved anything at all toward retirement, he added.