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Baby Boomer retirement security: The roles of planning, financial literacy, and housing wealth☆

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Abstract

We compare wealth holdings across two cohorts of the Health and Retirement Study: the early Baby Boomers in 2004, and individuals in the same age group in 1992. Levels and patterns of total net worth have changed relatively little over time, though Boomers rely more on housing equity than their predecessors. Most important, planners in both cohorts arrive close to retirement with much higher wealth levels and display higher financial literacy than non-planners. Instrumental variables estimates show that planning behavior can explain the differences in savings and why some people arrive close to retirement with very little or no wealth.

JEL Classification: D91; E21

Keywords: Wealth holdings; Housing wealth; Lack of planning; Literacy; Cohorts

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1. Introduction

The standard economic model of wealth accumulation posits that consumption decisions are made in a life-cycle framework, where consumption-smoothing requires one to save during the working years to support consumption after retirement.[1] Specifically, this framework models the consumer as maximizing his discounted lifetime expected utility such that consumption flows and wealth stocks at each point depend on his permanent income, i.e., anticipated lifetime resources, as well as preference parameters. To do so, the consumer must understand present discounted values, the difference between nominal and real amounts, and be able to project expected future labor income, pensions and social security benefits, retirement ages, and survival probabilities, among many other factors. These requirements are inherently complex and demanding.

Our goal in this paper is to evaluate how successfully individuals plan for retirement, whether financial literacy is associated with better planning, and whether retirement preparedness is associated with these behaviors. Specifically, in what follows, we provide new evidence regarding people's economic knowledge and planning, and how these are associated with saving behavior. The analysis uses two cohorts of data from the Health and Retirement Study (HRS) in 2004 and 1992 to evaluate wealth on the verge of retirement. Three questions are of central interest:

1. What do the level and composition of wealth tell us about the financial position of the Baby Boomers compared to prior cohorts?
2. Are more sophisticated and financially literate individuals more likely to plan for retirement?
3. Does planning affect wealth accumulation?

To address these issues, we first assess the level and distribution of wealth holdings of Baby Boomers on the verge of retirement, along with those of a comparable age group in 1992. Looking at both cohorts, we find that the median Boomer has more wealth than its precursor cohort a dozen years before, but those in the lowest quartile are less well off. We also show that housing equity is a key component of retirement assets, though the concentration of wealth in one asset leaves many Boomers vulnerable to fluctuations in the housing market. Holders of stocks, IRAs, and business equity are concentrated in the top quartiles of the wealth distribution. We next assess alternative explanations for differences in household wealth, focusing on respondents' planning efforts and the financial literacy they bring to solving the retirement problem. We show that financial literacy influences planning behavior and that planning, in turn, increases wealth holdings, even after controlling for many sociodemographic factors. Inasmuch as planning is an important predictor of saving and investment success, we believe we have identified an important explanation for why wealth holdings differ so much across households, and why some people enter retirement with very low amounts of wealth.

2. An overview of pre-retirement wealth

Our analysis draws on the Health and Retirement Study (HRS), a rich and detailed nationally representative survey of Americans over the age of 50 (and their spouses of any age).

[1] See Browning and Lusardi (1996) for a review.