ICI VIEWPOINTS

JULY 26, 2023

The US Retirement System Is Working

By Peter Brady and Steven Bass

Critics of the current retirement system often claim that Americans have insufficient income in retirement and that the system's voluntary component is failing, leaving retirees too reliant on Social Security.[1] While these assertions are used to justify proposals to overhaul employer plans and individual retirement accounts (IRAs), they aren't supported by data.[2]

Spendable Income Holds Up in Retirement

In a new study looking at Americans' income from age 55 through 72, we found that the typical retiree maintainsmore than 90 percent of their average age 55–59 inflation-adjusted spendable income, thanks to both Social Security benefits and retirement plan distributions.[3,4] Contrary to the conventional wisdom that most retirees rely on Social Security alone, we found that three out of four Americans receive retirement plan distributions at age 72.

How much an individual earns in their working years has a large impact on their sources of income in retirement. Those with the lowest income in their late 50s typically get all their income at age 72 from Social Security benefits. However, the importance of retirement plan distributions increases rapidly as pre-retirement income rises. Outside the bottom quintile of the age 55–59 income distribution, 85 percent of individuals receive income from retirement plans at age 72.

The System Is Working as Designed

The composition of retiree income is driven largely by the design of the US retirement system. Social Security is a mandatory pension with a progressive benefit formula that replaces a much higher portion of earnings for lower-income workers. Income from employer plans and IRAs is meant to supplement Social Security benefits. Not surprisingly, higher-earning workers rely more on retirement plan distributions because Social Security benefits replace a lower share of their pre-retirement earnings.

Although the importance of retirement plans varies with each worker's lifetime earnings, most Americans maintain a high share of their spendable income in retirement. In fact, those who had lower income in their late 50s typically replace a higher share of their spendable income in retirement, despite being more reliant on Social Security. At age 72, lower-income Americans typically have replacement rates above 100 percent, meaning their spendable income in retirement exceeds that of their late 50s. Middle-income Americans also enjoy very high replacement rates at age 72—typically ranging between 90 percent and 95 percent.

Building Upon the System's Success

The combination of mandatory Social Security and voluntary retirement plans has enabled millions of American retirees to maintain the standard of living they had while working. While further reforms to employer plans and IRAs ought to be considered, those reforms should build on strengths of the current voluntary structure. The evidence warrants caution when proposing fundamental changes to a system that works well for most retirees.

What We're Watching Next

We are currently using tax data to measure the income of Americans of all ages. Rather than following a group of individuals over time, the new study will examine the entire US population at a single point in time. This cross-sectional data study will supplement our panel data analysis, with both being part of our larger project examining changes in income over the life cycle.

Notes

[1] Voluntary retirement plans include employer-sponsored defined contribution (DC) and defined benefit (DB) plans as well as IRAs.

[2] See, for example, a series of editorials in *Bloomberg News* in early 2022 (*Bloomberg News*. America's Retirement Crisis Is a Financial Crisis Too, March 28, 2022; Saving for Retirement Is Harder Than It Needs to Be, April 4, 2022; Piecemeal Reform Won't Solve the U.S. Retirement Crisis, April 11, 2022; and How to Fix the Broken U.S. Retirement-Savings System, April 18, 2022).

[3] Part of the IRS Statistics of Income Joint Research Program, the study used tax data to follow individuals born in 1945 from the time they were aged 55 (in 2000)—before they could claim Social Security retirement benefits—until they were aged 72 (in 2017)—after they could claim their maximum Social Security benefits and after they were required to begin taking distributions from employer plans and traditional IRAs. Tax data allowed us to accurately measure changes in the amount and composition of each individual's income over this age range.

[4] Retirement plan distributions include income from IRAs, employer-sponsored DC and DB plans, and annuities. Spendable income is money individuals have left over after paying taxes and saving for retirement.

Peter Brady is a Senior Economic Adviser at ICI.

Steven Bass is an Economist at ICI.
