

# **Retirement Income Challenges in the Twenty-First Century**

Statement of

Richard W. Johnson  
Director, Program on Retirement Policy  
The Urban Institute

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Chairman Nelson, Ranking Member Collins, and Members of the Committee, thank you for the opportunity to testify today about the challenges confronting our retirement income system. As you know, ongoing social, economic, demographic, and policy changes are transforming the way Americans prepare for retirement and raising concern about the economic well-being of future retirees. One of the most important trends has been the shift away from traditional employer-sponsored pension plans in the private sector. A generation ago most people working at large firms could leave their retirement planning on auto pilot, because their employers guaranteed retirees lifetime income streams based typically on how much they earned near the end of their careers and how long they worked. Today, those traditional defined benefit pension plans have largely been supplanted by 401(k)-type plans that enable workers to set aside part of their paycheck in tax-deferred savings accounts, generally supplemented by employer contributions. These do-it-yourself retirement plans can generate substantial retirement income only if workers choose to make significant contributions to their accounts each pay period, invest the funds prudently, resist the temptation to dip into their accounts before they retire, and manage their funds wisely after they retire. The evidence suggests that for most Americans 401(k) plans have fallen short so far (Munnell and Sunden 2005). In 2010 the median value of retirement accounts held by households ages 55 to 64 totaled just \$100,000 (Bricker, Kennickell, Moore, and Sabelhaus 2012), which would generate a lifetime income stream beginning at age 65 of only about \$500 per month.

Other changes create additional challenges. The recent increase in Social Security's full retirement age effectively cut payments to all new beneficiaries. More cuts may be needed to improve the system's long-run finances. As people live longer, their retirement savings must last longer. Yet, wages for the majority of male workers have stagnated over the past few decades, leaving fewer financial resources that can be set aside for retirement. Unusually low interest rates have depressed investment returns for those who do save, and the prolonged housing slump has reduced home values, the largest asset held by most retirees. Many older people who lost their jobs during the recession are still out of work, destroying their ability to save for retirement and forcing many to dip into their savings much earlier than expected. And sharp swings in the stock market have added to the uncertainty surrounding retirement security. These developments have left many Americans uncertain about whether they will be able to enjoy a comfortable retirement (Helman, Adams, Copeland, and VanDerhei 2013).

Other trends, however, have brightened the long-term outlook for retirement security. Women are now working and earning more than in earlier generations, partly offsetting men's declining labor market fortunes. Women's higher earnings boost family incomes and enable women to amass Social Security credits and 401(k) accounts in their own names. Because Social Security benefits are partly tied to the growth in average earnings across the workforce, strong wage growth among the nation's top earners has boosted Social Security payments to beneficiaries at all income levels, despite the sluggish earnings growth among low- and moderate-wage workers. Americans now in their fifties and sixties are better educated than ever and healthier than in the previous generation. As a result, many older people are working longer, earning more over their careers, and saving more for retirement. And many Baby Boomers benefited from the run-up in housing values and the stock market during the 1990s and the late 1980s, so many still have substantial wealth despite the recent market crashes.

For the past decade researchers in the Urban Institute’s Program on Retirement Policy have been disentangling these contradictory trends to project the economic well-being of future generations of retirees. Our projections are based on DYNASIM3, the Institute’s unique microsimulation model. It takes baseline data from a large, nationally representative survey of Americans and uses hundreds of equations describing such processes as marriage formation and dissolution, fertility and mortality, employment and earnings, savings behavior, program participation, and disability to age that data year by year. DYNASIM3 currently projects such outcomes as labor force participation, health and disability status, the components of household wealth (including home equity, retirement accounts, and other financial assets), and the components of household income (including earnings, Social Security benefits, and asset income) through 2087.<sup>1</sup>

Our latest results show that median retirement incomes will continue to rise in inflation-adjusted terms for generations retiring through the 2030s. Incomes will increase at older ages because women are earning more than ever before, offsetting much of the earnings losses experienced by many men; productivity gains have increased average wages in the economy, a trend that we project will continue; and many people are delaying retirement and working longer.

Nonetheless, many challenges remain. In particular, increasing shares of Americans will see their living standards fall as they enter retirement, because retirement incomes are not projected to keep pace with the earnings received by the working-age population. Although the growth in the projected number of retirees whose incomes will fall short may not qualify as a looming crisis, it is nonetheless a worrisome trend. More troubling is the projected rise in out-of-pocket health and long-term care costs, which could undermine retirement security for many seniors.

## **How Much Income Will Future Retirees Receive?**

Our projections show that inflation-adjusted retirement incomes will generally increase over the coming decades. Median per capita household income at age 70 will total about \$46,400 (measured in constant 2013 dollars) for those born between 1970 and 1974, who will turn 70 between 2040 and 2044 (figure 1). This estimate is 14 percent higher than the corresponding projection for adults born between 1950 and 1954 and 28 percent higher than the corresponding projection for those born between 1940 and 1944.

Future retirement incomes will rise despite the much-discussed erosion in traditional employer-sponsored pension coverage. According to our projections, defined benefit pension wealth—the present value of the expected stream of future benefits—for those receiving payments will fall from \$158,000 (in constant 2013 dollars) for those born between 1940 and 1944 to \$81,000 for those born between 1970 and 1974 (figure 2), a 49 percent drop. This decline stems from the reduction in the number of years workers will spend in jobs providing traditional pension coverage. The loss of traditional pension benefits will be partially offset by an increase in 401(k) account holdings. The median real value of these defined contribution

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<sup>1</sup> For more information on DYNASIM3, see Favreault and Smith (2004) and Smith (2012).

retirement accounts among those with accounts at age 70 will rise from \$84,000 in constant 2013 dollars for those born between 1940 and 1944, to \$119,000 for those born between 1970 and 1974, a 42 percent increase. Yet despite the growth in 401(k)-type accounts, median real wealth from both types of employer-sponsored retirement plans will drop. The share of adults with wealth from either type of plan will hold steady at about 65 percent, but median real wealth among those with some holdings born between 1970 and 1974 will fall about 19 percent below the median value of their counterparts born 30 years earlier.

Why then will retirees generally receive more income over the coming decades, even after adjusting for inflation? The improvement stems from women's movement into the labor force, productivity growth, and the increase in working lives.

**Increase in women's employment and earnings.** One of the most important developments in the labor market during the second half of the twentieth century was the movement of women into the labor force. Between 1948 and 2012, the labor force participation rate for women ages 25 to 54 increased from 35 to 75 percent.<sup>2</sup> Working women have also earned more over time. Between 1950 and 2010, median inflation-adjusted annual earnings for employed women ages 50 to 54—when wages and salaries typically peak—increased 234 percent (figure 3). By contrast, employed men's median earnings increased only 161 percent over the same period, although working men still earned nearly 50 percent more than working women in 2010. The gender disparity in earnings growth has been particularly stark over the past 35 years. Between 1975 and 2010, real median earnings fell 11 percent for men while increasing 38 percent for women.

Women's employment gains will substantially improve their own retirement security, which depends largely on earnings received earlier in life. As women's lifetime earnings grow they will receive more Social Security benefits, they will accumulate more wealth in their employers' retirement plans, and they will be able to set aside more money in other savings vehicles. In fact, we project that median real per capita household income at age 70 will be 38 percent higher for women born between 1970 and 1974 than for their counterparts born 30 years earlier. By contrast, men's median real per capita income at age 70 will increase just 20 percent over the next 30 years. The gender gap in age-70 per capita household income will shrink to 10 percent among those born between 1970 and 74, compared with 22 percent for those born between 1940 and 1944.

**Productivity growth.** Technological advances generally raise worker productivity over time, which typically translates into higher wages and salaries for workers. Between 1951 and 2007 (before the Great Recession began), wages (as measured by Social Security's national average wage index) increased at a compound annual growth rate of 4.9 percent, while prices (as measured by the consumer price index) increased at a compound annual growth rate of only 3.8 percent.<sup>3</sup> As average real wages increase, incomes tend to grow faster than prices and living standards improve. Of course, some workers do not experience wage gains even when the average wage in the economy rises. Indeed, as noted earlier, median earnings for men ages 50 to

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<sup>2</sup> This estimate is based on the author's calculations from the Bureau of Labor Statistics (2013b).

<sup>3</sup> These estimates are based on the author's calculations from the Bureau of Labor Statistics (2013a) and Social Security Administration (2013).

54 grew more slowly than inflation over the past 35 years. However, because the Social Security benefit formula uses changes in the national average wage to index workers' earnings over the course of their careers, overall wage growth will increase Social Security benefits even if an individual's real wages remain flat.

A simple example illustrates this point. Consider a woman born in 1951 who works every year from age 25 to 61 and begins collecting Social Security benefits in 2013 at age 62. Assume she earns \$10,000 at age 25 and that her earnings increase each year at the rate of inflation, so she would earn \$40,350 in 2012 at age 61. Measured in 2012 inflation-adjusted dollars, she earned \$40,350 throughout her career. However, the Social Security Administration uses the national average wage index, not the consumer price index, to adjust the earnings she received earlier in her career. Because average wages grew faster than inflation, her early career earnings enter the benefit formula at much higher values. For example, Social Security values her age-25 earnings at \$46,583 and her age-31 earnings at \$50,163. If average wages in the economy grew only at the rate of inflation, she would receive a monthly Social Security benefit of \$1,135 at age 62. Because average economy-wide earnings actually grew much faster, Social Security will instead pay her \$1,250 per month at age 62, or 9 percent more.

**Longer working lives.** Another reason why retiree incomes will grow over time is because people are working longer. After falling for much of the twentieth century, older men's labor force participation rates have been increasing rapidly over the past 20 years. Between 1948 and 1993, participation rates for men ages 65 and older fell from 47 to 16 percent. By 2012, however, they had rebounded to 24 percent. Participation rates have grown especially rapidly in recent years for men ages 65 to 69, increasing from 25 percent in 1993 to 37 percent in 2012, a 48 percent relative increase. . Women are also more likely now to work at older ages. Between 1993 and 2012, the share of women participating in the labor force grew from 16 to 28 percent, a relative increase of 75 percent.

As people work longer, they are collecting Social Security retirement benefits later. Only 45 percent of men born between 1943 and 1944 (who turned 62 in 2005 and 2006) began collecting Social Security at age 62, the first year benefits are available (figure 4). By comparison, 57 percent of men born between 1930 and 1934 began collecting Social Security at age 62. More women also waiting to collect their Social Security benefits. Only 50 percent of women born between 1943 and 1944 began collecting at age 62, down from 62 percent among those born between 1930 and 1934.

Working longer and delaying retirement substantially increases financial resources in old age. Extending the work life boosts lifetime earnings, increasing Social Security credits and providing workers with additional resources that they can save for retirement. Working longer also shrinks the retirement period, so retirement savings do not have to last as long. Workers who delay the age at which they claim Social Security benefits will receive higher monthly payments even if they do not work while waiting to collect. Social Security actuarially adjusts the retirement benefits it provides, reducing monthly payments for those who retire early and increasing payments for those who delay so that lifetime payments are approximately equal no matter when beneficiaries begin collecting. For example, those who collect at the earliest eligibility age of 62 now receive just 75 percent of the full benefits they would receive if they

wait until age 66—the full retirement age—to begin collecting benefits. Monthly benefits increase 8 percent for each year that beneficiaries claim take-up beyond the full retirement age (up to age 70). One study found that working one additional year would increase annual retirement income by 9 percent, while working five additional years would increase annual retirement income by 56 percent (Butrica, Smith, and Steuerle 2006).

## **Can Future Retirees Maintain Their Pre-Retirement Income Levels?**

Will future generations have sufficient income to live comfortably in retirement, even though we project that median income at age 70 will increase over time? Although there is much debate about how much retirement income is necessary, a 75 percent replacement rate is often used as an adequacy rule of thumb, based on the assumption that spending declines in retirement, especially since retirees do not pay payroll taxes or save in retirement accounts.<sup>4</sup> Others argue that retirees need at least as much income as they had before retiring to cover rising medical costs, as prices and health care use increase (VanDerhei 2011).

Figure 4 shows the projected share of adults with age-70 incomes insufficient to replace 75 percent of their age 50 to 54 earnings. As with our income projections, these estimates assume that people use 80 percent of their retirement accounts and other financial assets to purchase actuarially fair annuities. We find that the share of adults who will be unable to replace at least three-fourths of their pre-retirement earnings will increase from 25 percent for those born between 1940 and 1944 to 30 percent for those born between 1970 and 1974. This projected deterioration in retirement preparedness may not be dramatic enough to qualify as a retirement crisis, but it is a worrisome trend that merits some policy response.

## **Will Health and Long-Term Care Costs Undermine Retirement Security?**

Older Americans devote a substantial portion of their incomes to health care. Although Medicare covers nearly all adults ages 65 and older, premiums, deductibles, and holes in the benefit package leave many older Americans with substantial out-of-pocket expenses. Half of all Americans ages 65 and older spend more than 12 percent of their incomes on health care, and half of those with incomes below 200 percent of the federal poverty level spend more than a fifth of their incomes on health care (Johnson and Mommaerts 2009). Out-of-pocket health care spending by older Americans is projected to rise in coming decades as health care costs continue to grow. In 2040, health care costs are projected to consume more than 20 percent of household income for about 7 in 10 adults ages 65 and older in the bottom two-fifths of the income distribution (Johnson and Mommaerts 2010).

The prospect of becoming disabled and needing expensive long-term care is perhaps the most significant risk facing older Americans. One estimate indicates that 7 in 10 Americans who survive to age 65 will eventually need long-term services and supports, and 1 in 5 will need help for five or more years (Kemper, Komisar, and Alecxih 2005). Most will receive informal help

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<sup>4</sup> See Scholz and Seshadri (2009) for a discussion of replacement rates.

from family and friends, often creating significant financial, physical, and emotional burdens for their helpers. About 53 percent of people caring for their frail parents are employed full time, and another 10 percent are employed part time (Johnson and Wiener 2006). About 11 percent of children caring for parents are ages 30 to 39 (Johnson and Wiener 2006), a life-course stage when many people are raising young children. Another 68 percent of caregivers are in their 40s and 50s, ages when many people still have dependent children at home. Overall, 37 percent of caregivers have children under age 18 (National Alliance for Caregiving and AARP 2004). Care responsibilities often interfere with paid employment. About 57 percent of employed caregivers report that they sometimes have to go to work late, leave early, or take time off to attend to their care duties, and 17 percent said they had to take a leave of absence (National Alliance for Caregiving and AARP 2004).

However, increasing numbers of older Americans will receive home care from paid helpers, especially as family caregivers become less available because future generations of older Americans had fewer children than the current generation and middle-aged women are now working more than in the past (Johnson, Toohey, and Wiener 2007). Many older adults will also end up in nursing homes. Despite long-term declines in nursing home admission rates (Bishop 1999), a recent study concluded that the chances of receiving nursing home care at some point after age 50 still exceeds 50 percent (Hurd, Michaud, and Rohwedder forthcoming).

Long-term care costs are prohibitive. The latest estimates from the 2012 MetLife Mature Market survey indicate that a year of nursing home care in a semi-private room now averages about \$80,000 nationwide, with average costs as much as 75 percent higher in certain parts of the country (MetLife Mature Market Institute 2012).

The United States lacks a system to adequately finance these costs. Standard health insurance plans do not cover long-term care, and Medicare covers long-term care only in special circumstances. Only about 12 percent of adults ages 65 and older have private long-term care insurance (Johnson and Park 2011), and there are signs that this private market is shrinking. As a result, long-term care costs can quickly deplete household savings. According to one study, married women typically forfeit about \$40,000, more than one-third of their wealth, when they enter nursing homes (Johnson, Mermin, and Uccello 2006). Single women forfeit about \$20,000, or about percent of their wealth. Many long-term care recipients, especially those with extended nursing home stays, end up going on Medicaid (Wiener et al. 2013), which requires that beneficiaries surrender nearly all of their income and wealth. The Kaiser Commission on Medicaid and the Uninsured (2013) estimates that Medicaid covers 41 percent of the nation's long-term care costs, costing taxpayers about \$140 billion in 2010.

Taken together, health and long-term care costs often deplete older Americans' financial resources near the end of life, when many people receive expensive care. Out-of-pocket health and long-term care spending averages \$38,688 for individuals and \$51,030 for couples in the last five years of life (Kelley et al. 2013). One in 10 individuals incur out-of-pocket costs in excess of \$89,106 during the last five years of life. These expenses exceed total household wealth for 25 percent of cases and total non-housing wealth for 43 percent of cases.

## Key Policy Challenges

These predicted outcomes for the typical boomer mask significant differences across groups. Those with limited education will have less retirement income and will rely primarily on Social Security. Also the gap between the rich and poor is striking. For example, boomers in the top income quintile will accrue more than 100 times the financial wealth and 10 times the per capita annuity income held by those in the bottom income quintile.

How boomers really fare in retirement will hinge on several unknowns. How much will stocks and bonds earn over the coming decades? Will more boomers than we expect end up working well into old age? Will a significant share end up dipping into their housing wealth? Will Congress cut boomers' Social Security? And perhaps most important, how much will boomers need to spend on health and long-term care? One estimate suggests that out-of-pocket medical costs will consume 15 percent of income for the median boomer retiree, up from 10 percent for the pre-boomer retirees—which suggests that boomers will need more than their predecessors to enjoy a comfortable retirement. A benchmark of 75 percent of preretirement income may no longer be adequate.

The projections lead to some important policy implications:

- Boomers, especially those with limited education and income and those who are divorced, are widowed, or never married, will continue to rely primarily on Social Security. Policymakers need to ensure the system's long-term financial health.
- Boomers should be encouraged to work as long as they can. Policymakers and employers need to recognize the importance of jobs for older adults, promoting retraining and flexible work schedules that can accommodate their needs.
- Boomers should be encouraged to annuitize some of their retirement accounts and savings when they retire to boost their incomes and produce a guaranteed income stream until death. Policymakers should consider reforms that make annuities more attractive and increase trust in these products.
- A significant share of boomers will reach age 70 with very little retirement income. Policy remedies such as modernizing the Supplemental Security Income program and boosting minimum Social Security benefits would help the most vulnerable retirees for little cost.

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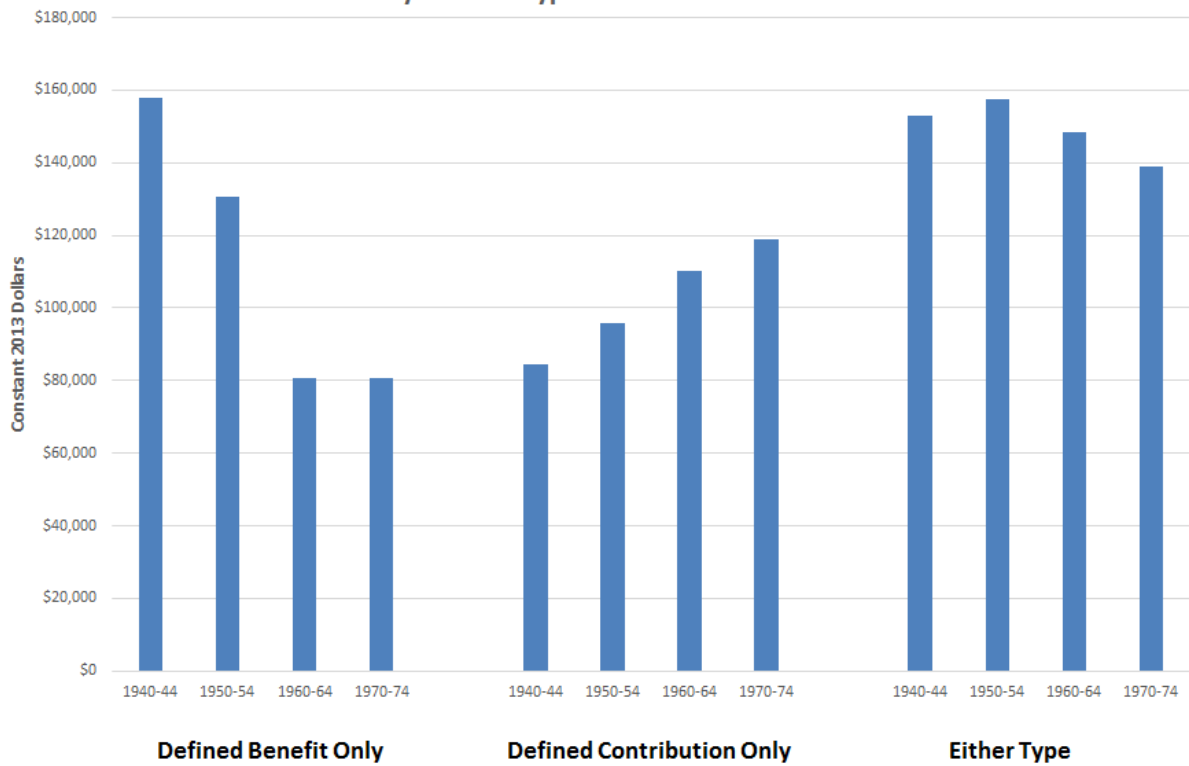
**Figure 1. Median Real Annual Per Capita Household Income at Age 70,  
by Birth Cohort (2013 Constant Dollars)**



*Source:* Urban Institute estimates from DYNASIM3, run 848.

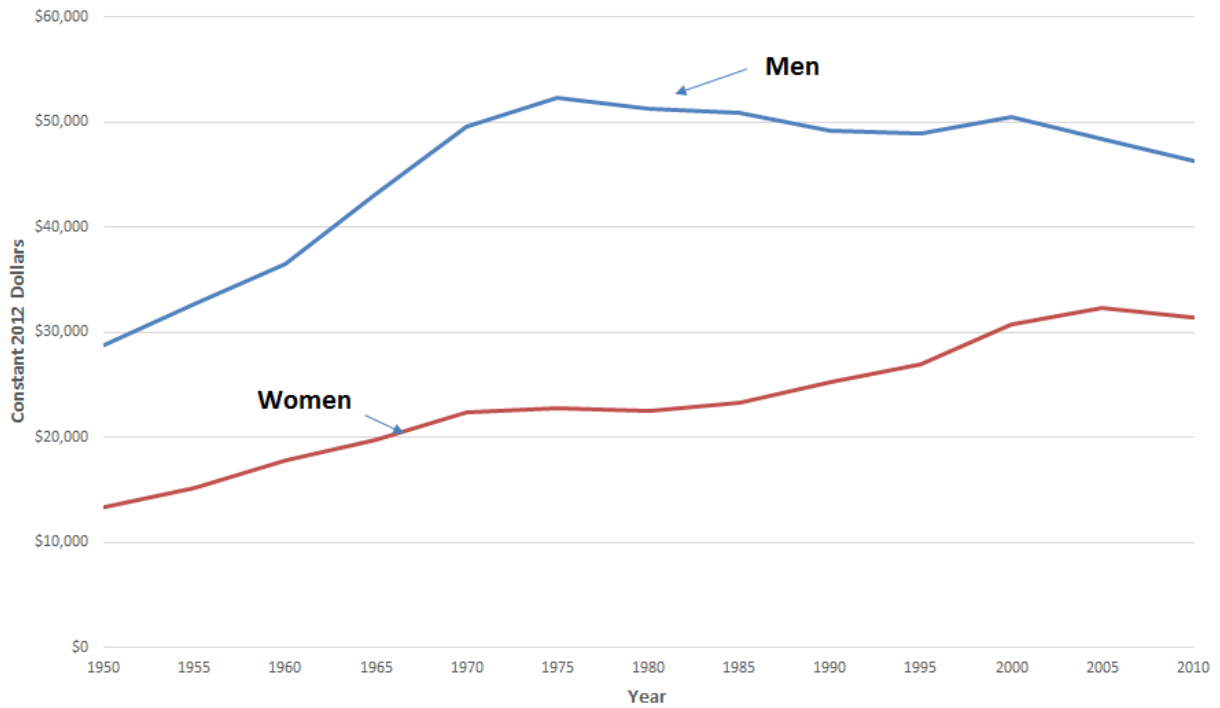
*Note:* Estimates assume that 80 percent of financial assets are annuitized at age 70.

**Figure 2. Median Real Pension Wealth at Age 70 Among Those with Wealth,  
By Pension Type and Birth Cohort**



Source: Urban Institute estimates from DYNASIM3, run 848.

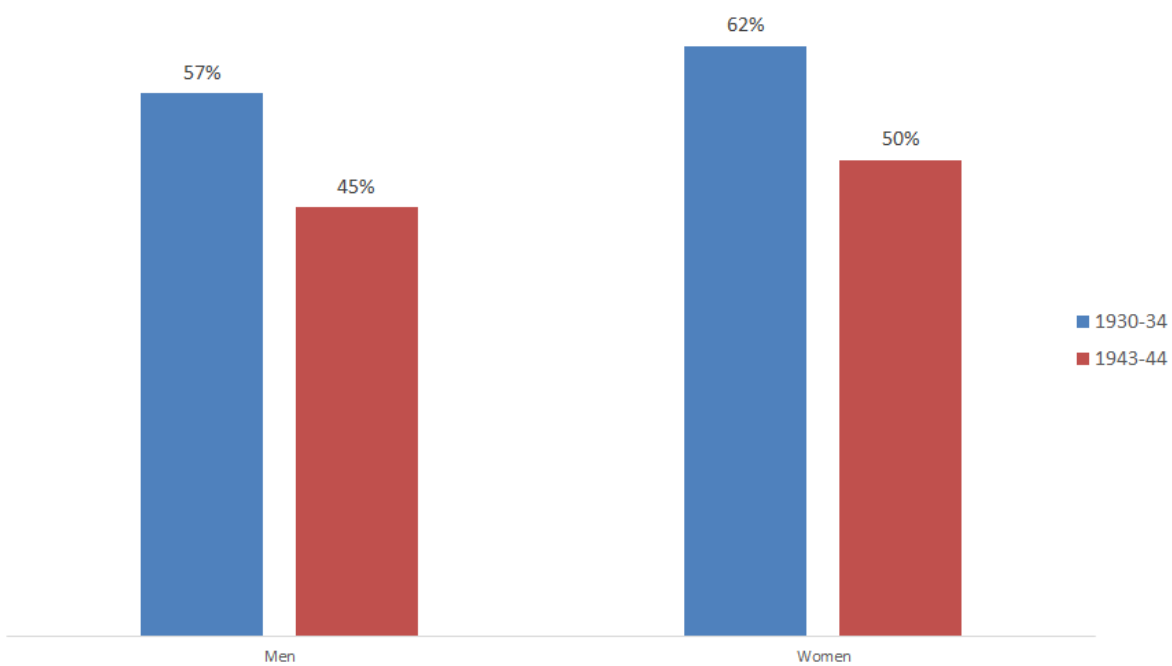
**Figure 3. Median Real Annual Earnings for Workers Ages 50 to 54,  
by Gender and Year**



*Source:* Author's computations from Social Security Administration (2013).

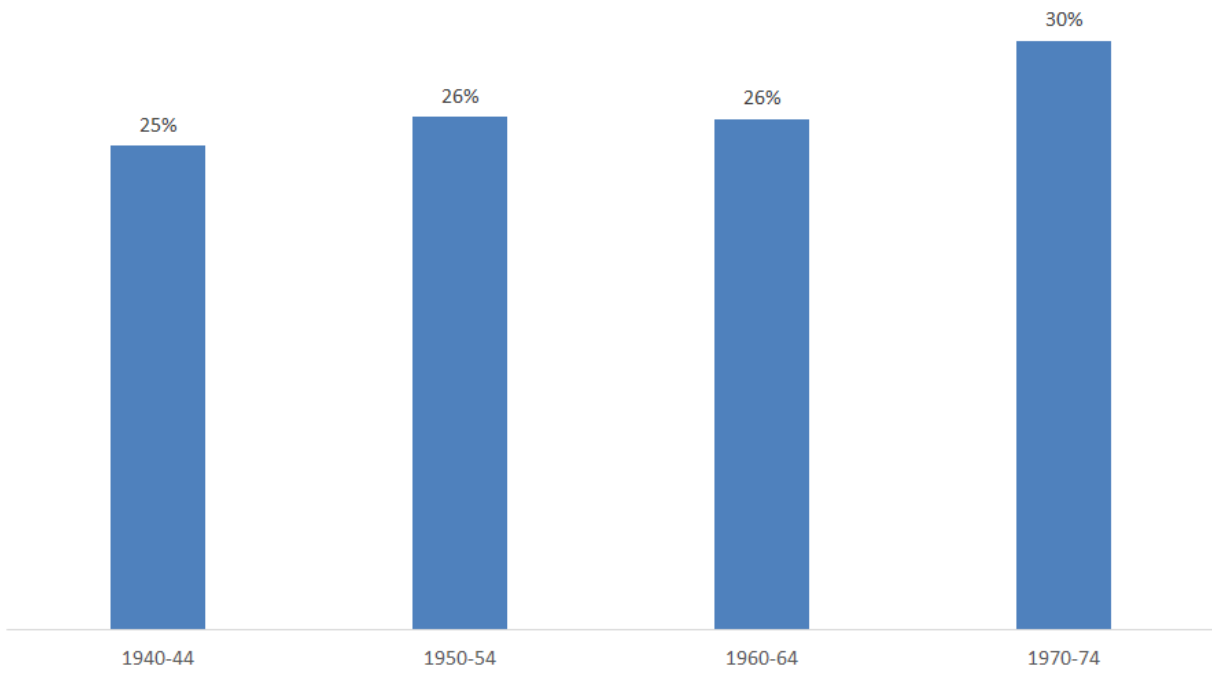
*Note:* Estimates are restricted to men and women with positive earnings.

**Figure 4. Percentage of Men and Women Claiming Social Security Retirement Benefits at Age 62, by Birth Cohort**



Source: Johnson, Smith, and Haaga (2013).

**Figure 5. Percentage of Adults Whose Projected Age-70 Income Will Replace Less than 75% of Their Age 50-54 Earnings, by Birth Cohort**



Source: Urban Institute estimates from DYNASIM3, run 848.

Note: Estimates assume that 80 percent of financial assets are annuitized at age 70.