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Why baby boomers will need to work longer

Most US baby boomers are not prepared for their retirement, and neither are the US and world economies. Boomers can help mitigate the consequences by remaining in the workforce beyond the traditional retirement age.

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The twilight of the US baby boom generation is approaching, and with it deep, structural economic shifts whose impact will be felt for decades to come.[1] New research from the McKinsey Global Institute (MGI) shows that there is only one realistic way to prevent aging boomers from experiencing a significant decline in their living standards and becoming a multidecade drag on US and world economic growth. Boomers will have to continue working beyond the traditional retirement age, and that will require important changes in public policy, business practices, and personal behavior. These adjustments have become even more urgent with the recent financial turmoil, which has sharply reduced the home values and financial investments of millions of boomers just as they approach retirement.

Underlying the need for change is a reversal of trends that have been in operation since the 1960s. For decades, boomers swelled the ranks of the US labor force, driving up economic output as they earned and consumed more than any other generation in history. Now, as the boomers age and retire, US labor force participation rates are declining. Without an unexpected burst of productivity growth or a significant upsurge in investment per worker, the aging boomers' reduced levels of working and spending will slow the real growth of the US GDP from an average of 3.2 percent a year since 1965 to about 2.4 percent over the next three decades. That long-term growth rate is 25 percent lower than the one the United States and the world have long taken for granted.

MGI research highlights a further problem: two-thirds of the oldest boomers are financially unprepared for retirement, and many are not even aware of their predicament.[2] This lack of sufficient resources will not only mean a less comfortable retirement for tens of millions of households but also depress spending in the overall economy.

Yet the boomers' retirement need not be such a major dislocation. We estimate that a two-year increase in the median retirement age over the next decade would add almost $13 trillion to real US GDP during the next 30 years while cutting roughly in half the number of boomers who would be financially unprepared for retirement.

Our research shows that many boomers actually do want to continue working. Nonetheless, a number of institutional and legal barriers—health care costs, labor laws, pension regulations, and corporate attitudes toward older workers—could prevent them from prolonging their careers. Overcoming these barriers will require the government to reallocate health insurance costs for older workers, businesses and boomers to agree on more flexible work arrangements, policy makers to reform private pensions, and Social Security to remove disincentives to remaining in the workforce.

We reached these conclusions by combining three complementary research methods. First, MGI surveyed 5,100 households with members aged 50 to 70 to better understand and compare the attitudes of boomers and members of the previous ("silent") generation toward aging, retirement, saving, consumption, and work. Second, we assembled a comprehensive database of boomer household finances and collected similar data for the preceding and following generations. Third, we used the survey and the database to build an economic model that projects boomer household finances through 2035 and to study how their evolution would affect the wider economy. (For details on the research methodology and results, see "Talkin' 'bout my generation: The economic impact of aging US baby boomers.")

Last year, MGI and our colleagues in McKinsey's marketing practice drew on this research to show business leaders how they should prepare for the changing needs of older boomers.[3] In this article, we examine the implications for the living standards of boomer households and for the economy as a whole.

Notes

[1] We define baby boomers as people born in the years from 1945 through 1964.

[2] For both the baby boomers and other generations, we distinguish between the early members (born during the first ten years) and the late members (born in the subsequent decade).

[3] See David Court, Diana Farrell, and John E. Forsyth, "Serving aging baby boomers," mckinseyquarterly.com, November 2007.

One-time factors that boosted boomers' incomes

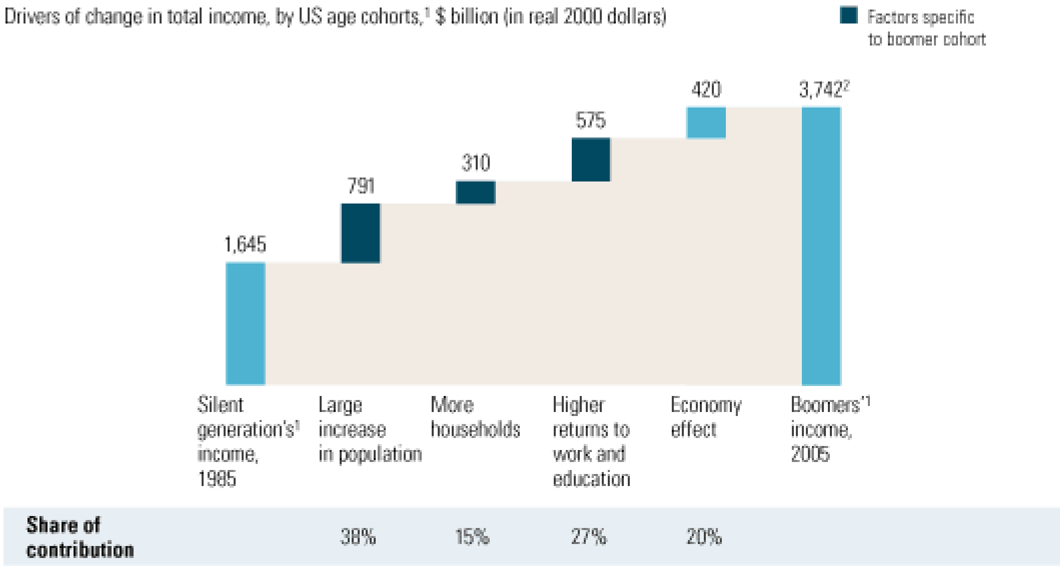
The basic facts about the baby boomers are well known. This age cohort (79 million strong) ranks as the richest in US history; is 50 percent larger than the silent generation, which preceded it; and represented, at the time of its birth, a larger share of the US population than the succeeding cohorts

(Generation X and the Millennials) did at the time of theirs.[4]

Far less well understood are the reasons for this generation's economic success. Boomers have collectively earned more than twice as much as members of the silent generation did at the same age—$3.7 trillion versus $1.6 trillion. Our research shows that 80 percent of the difference resulted from three factors quite specific to the boomers. (The remaining 20 percent reflected economic growth from which the boomers benefited as much as other generations did over their working lives.)

The first exceptional source of these income gains was the boomer cohort's sheer size, which raised output and growth rates. Second, the boomers lived quite differently from the way previous generations did. As women poured into the workplace and social mores changed, boomers married and had children later, as well as divorced and remained single at higher rates. These changes in turn raised the number of households and therefore the number of wage earners relative to the total population. Third, boomers had higher returns to both education and work at a time when the labor force was shifting from industrial to service and knowledge jobs. In particular, the boomers' higher levels of education enabled them to capitalize over the course of their careers—to a degree greater than other generations did—on economic changes stemming from productivity growth, technological innovation, and globalization.

In all likelihood, the factors driving the boomers' exceptional income growth won't recur. Subsequent generations, though large in numbers, represent a smaller share of the total population; the size of households has stabilized; and gains in educational attainment and the workforce participation rates of women have largely topped out.



[1]Silent generation = people born between 1925 and 1945; boomers = those born from 1945 through 1964. Age refers to cohort midpoint.
[2]Figures do not sum to total, because of rounding.

Source: McKinsey Global Institute analysis

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[4] Members of the silent generation were born in the years from 1925 to 1945, Generation Xers from 1965 to 1984, and the Millennials from 1985 to 2004.

The implications for growth

The aging of the boomers won't just slow income growth. As the population ages, fewer people will be working. The result will be falling labor force participation rates, which are a critical factor in determining GDP growth (economic output is largely a function of the labor and capital available in an economy and of its productivity in using those inputs).

When the boomers first began entering the US workforce, participation rates rose significantly, from 59 percent in 1965 to 65 percent by 1985, peaking at 67 percent from 1995 to 2000. This surge contributed significantly to the 3.2 percent average annual real GDP growth that the United States enjoyed from 1965 to 2006.

Labor force participation has declined to 66 percent today and is headed, according to our research, toward 60 percent by 2035—a level not seen since the 1960s. If labor productivity and capital growth continue on current trends, declining labor force participation will knock real GDP growth down to 2.6 percent from 2007 to 2016, to 2.4 percent from 2017 to 2026, and to 2.2 percent from 2027 to 2035. A slowdown of this magnitude would represent a structural shift for the US economy and leave it with growth rates typical of Europe's in recent decades.

Source: 2007 McKinsey survey of aging US consumers; McKinsey Global Institute analysis

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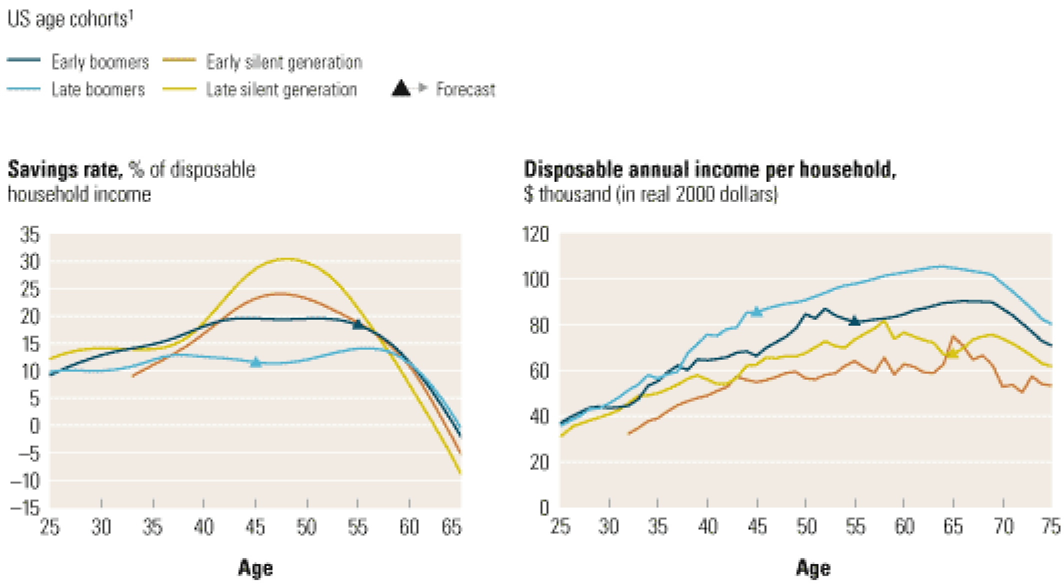
Lifetime savings and earnings patterns

The fact that boomers have consumed more and saved less during their working lives than previous generations did compounds the demographic challenge for the US economy. Typically, households accumulate savings at an accelerating rate, reaching a peak during their prime earning years. They subsequently draw down those savings in retirement. The collective savings rate of the boomers, however, didn't peak during their prime earning years. In fact, the missing boomer peak accounts for most of the collapse in the US household savings rate from its high of more than 10 percent, in the mid-1980s, to about 2 percent today.[5]

This dramatic change in savings behavior had a number of causes. Soaring stock markets and home prices made the boomers feel richer and thus diminished any sense of urgency they might have felt to save. The increased availability of credit and low interest rates made it easier to borrow. And boomer attitudes toward savings were different from those of the silent generation, born amid the deprivations of the Depression and World War II. Even before the recent credit crunch, the boomers' ratio of debt to net worth was 50 percent higher than the silent generation's at the same age. Sharply declining house prices have caused this measure of boomer indebtedness to surge.



[1]Silent generation = people born between 1925 and 1945; boomers = those born from 1945 through 1964; early = those born in first 10 years, late = those born in subsequent decade. Compares 10-year cohorts at same age: early boomers vs early members of silent generation at age 55; late boomers vs late members of silent generation at age 45. Age refers to cohort midpoint.

Source: McKinsey Global Institute analysis

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[5] In 2005 the boomers had 47 percent of all disposable income but contributed only seven percentage points to overall household savings.

Unprepared and unaware

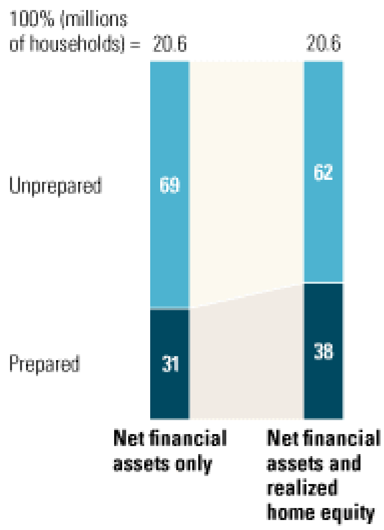
The low savings rate and extensive liabilities of the boomers have left about two-thirds of them unprepared for retirement. We reached this conclusion by assessing the level of postretirement income and assets that the boomers would need to maintain 80 percent of their peak preretirement spending.[6] This analysis—based on net financial assets such as bank deposits, stocks, and bonds, minus credit card balances, car loans, and other nonmortgage debt—indicates that 69 percent of the boomers are not prepared to maintain their lifestyles. The inclusion of home equity, whose value is declining in many regions below the levels prevailing when we undertook our analysis, only reduces the proportion of the unprepared to 62 percent.

This lack of financial preparation will affect not just the poor, who have always struggled with retirement, but large numbers of middle-class Americans as well. Less than half of boomer households earning $60,000 to $90,000 a year are prepared, even if home equity values before the credit crunch are included in their assets.

Many are not even aware of their predicament. In our survey, about half of boomer households expressed confidence in their financial future. But by our calculations, less than half of those confident households are adequately prepared.

The boomers have always been an adaptable generation, and there's no reason to believe that their resourcefulness will disappear as they age. Still, the sheer number of unprepared, unaware boomers suggests that many of them face a difficult economic adjustment in the years ahead.

Early boomer[1] households' retirement preparation, 2006, %



[1]Boomers = those born from 1945 through 1964; early = those born in first 10 years of that span.
Source: 2007 McKinsey survey of aging US consumers; McKinsey Global Institute analysis

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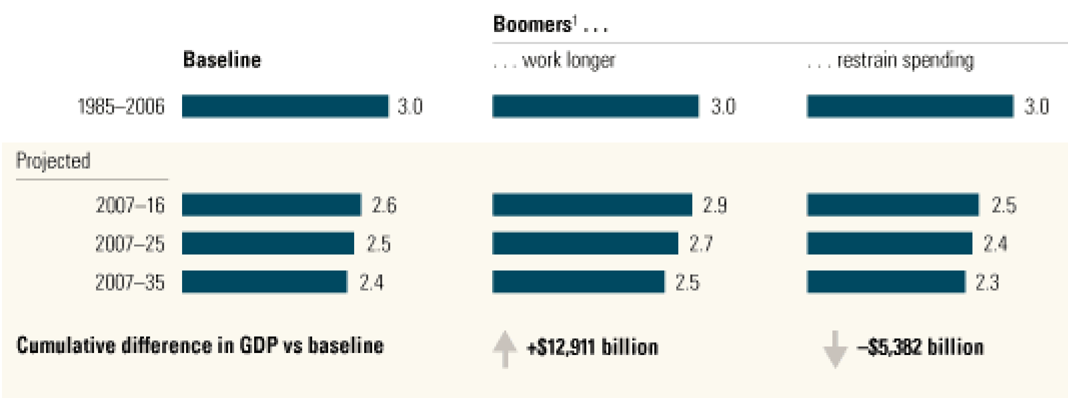
6 The figure of 80 percent is based on our model of life cycle spending patterns. This model shows that for the average early boomer, spending roughly doubles from the ages of 30 to 55, peaks at age 62, and then drops by about 20 percent over the course of retirement.

Working and saving longer

The single most important step that unprepared boomers can take to improve their financial well-being is to postpone retirement and the draw-down of their savings. If they worked long enough to increase the median retirement age from 62.6 today to 64.1 by 2015, they could continue accumulating assets longer and avoid tapping them until age 70. That combination would dramatically reduce the share of unprepared households—to 40 percent, from 69 percent, if households don't tap their home equity, and to 31 percent, from 62 percent, if they do. Although that increase in the median retirement age may not sound like much, it typically shifts slowly; in fact, it took three decades (from 1970 to 2000) to fall by the same amount. The challenge now is to reverse that trend, but much more rapidly.

Higher rates of labor force participation as a result of longer careers would also significantly raise overall growth in the economy, generating $12.9 trillion more in GDP from now until 2035 than would occur otherwise. Household savings in this new scenario would rise by $400 billion, increasing the overall savings rate to 5.4 percent by 2022—a jump of roughly three percentage points. Furthermore, boomers would pay more taxes and could delay drawing down government retirement benefits, therefore helping to ease the impact of aging on both Social Security and Medicare.

Real GDP growth in United States under 2 scenarios, compound annual growth rate (CAGR), %



[1]Boomers = people born from 1945 through 1964.
Source: McKinsey Global Institute analysis

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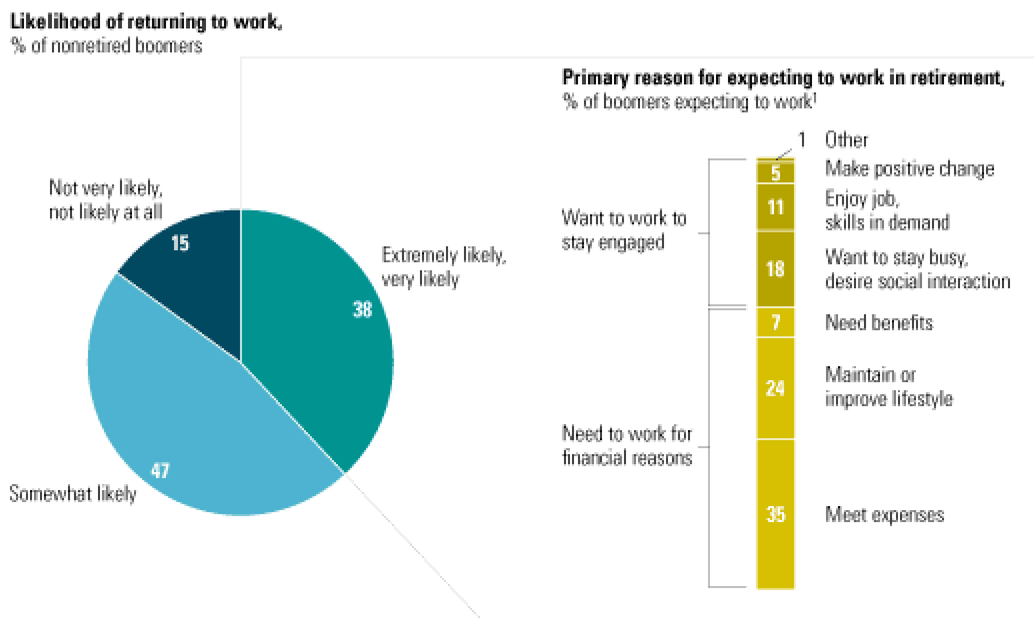
Willing but unable to work?

Eighty-five percent of the boomers we surveyed said that it was at least somewhat likely that they would continue to work beyond the traditional retirement age. Nearly 40 percent said that it was extremely likely, and of those, two-thirds emphasized financial reasons. This finding suggests that one explanation for the confidence of unprepared boomers is the belief that they will continue to earn a living longer than previous generations have.

Yet not all those saying they intend to work will be able to do so. Our survey found that half of the boomers who have retired early did so for health reasons. A majority live in lower-income, less-prepared households—precisely the people who most need to remain employed. Many boomers aren't knowledge workers: nearly half have physically stressful manufacturing, transport, and construction jobs, which they will have difficulty keeping later in life.

Finally, even those who maintain their health and want to continue working will find it difficult, as significant legal and institutional barriers remain. Policies related to insurance and Medicare, pensions and Social Security, and employment practices make it harder for businesses to employ older workers and for older workers to embrace longer careers.



[1]Figures do not sum to 100%, because of rounding.

Source: 2007 McKinsey survey of aging US consumers

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Encouraging longer working lives

By adjusting policies affecting older workers, leaders in government and business can help boomers and the economy as a whole address the challenges of the coming transition. Policy makers and executives should pay particular attention to three critical priorities.

Reallocating health insurance costs

Health insurance costs rise with age, creating a disincentive for a business to retain or hire older workers. The situation becomes more complicated when they reach age 65. Unlike retirees, employees that age and older do not receive full Medicare benefits if they work for a company that has more than 20 people on staff and provides health benefits. The employer is viewed as the primary provider of coverage, and Medicare offers coverage only for services not included in the employer’s plans. The reluctance of companies to bear health insurance costs thus impedes the hiring of older workers. Offering full Medicare coverage to all people age 65 and older, regardless of employment status, would eliminate this disincentive. Although taxes to finance Medicare would rise, the added tax revenue from older workers remaining in employment would partially offset that increase. The broader economy would gain from having more older workers.

Enabling businesses to offer flexible work arrangements

Many boomers say they are willing to continue working if they can do so part time, work from home, or make arrangements that would cut their hours and pay gradually. Government and educational institutions use such practices today; businesses have held back, partly out of concern that they might violate federal laws on taxes, pensions, and age discrimination. Policy makers should act to alleviate such concerns. Meanwhile, businesses must develop an integrated strategy to employ mature workers—a strategy centered on more flexible arrangements. Workers, in return, will have to be flexible about pay and benefits.

Removing disincentives in Social Security and private pensions

Although the Pension Protection Act of 2006 and recent modifications to Social Security have reduced some disincentives for working later in life, further reform is needed. Under current law, for example, the one-third of boomer households covered by defined-benefit plans can begin receiving pensions at the age of 59.5 if the wage earner in the household stops working. Continued part-time work delays the start of eligibility for receiving pension payments until age 62. Lowering that age would reduce this disincentive.

Similarly, lawmakers should examine the way Social Security retirement benefits are calculated. Currently, payments to retirees are based on their 35 highest-earning years. The practical implication is that working longer typically provides only a modest increase in benefits, yet workers continue to pay the full payroll tax during later years. An alternative would be to base benefit calculations on a longer time period, such as 40 years, after which workers would no longer owe payroll taxes. That kind of change would create a stronger financial incentive to continue in employment.

In short, demographics need not be destiny. Government and business leaders who start acting now to change policies and practices can lessen the negative impact of the boomers' aging and help tens of millions of households enjoy a more secure retirement. The boomers have reinvented themselves and society throughout their lifetimes. They can reinvent aging and retirement too. Q

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Eric Beinhocker is with the McKinsey Global Institute, where **Diana Farrell** is the director and **Ezra Greenberg** is a consultant.

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