Testimony of Dean Baker

Before the Senate Special Committee on Aging

Hearing on "Boomer Bust? Securing Retirement in a Volatile Economy"

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Thank you, Chairman Kohl and Ranking Member Martinez, for inviting me to share my views on the impact of the current economic crisis on the elderly with the committee. My name is Dean Baker and I am the co-director of the Center for Economic and Policy Research (CEPR). I am an economist and I have been writing about issues related to retirement security since 1992.

I will focus my comments on the main findings of a new report that the CEPR is putting out today. This report updates an earlier set of projections on the wealth of the baby boom cohorts that CEPR had done last summer. These projections are based on data from the Federal Reserve Board's 2004 Survey of Consumer Finance (SCF).[1]

The full report is available at CEPR's website (www.cepr.net), but some of the highlights are:

1) The median household with a person between the ages of 45 to 54 saw their net worth fall by more than 45 percent between 2004 and 2009, from $150,500 in 2004, to just $82,200 in 2009 (all amounts are in 2009 dollars). This figure, which includes home equity, is not even sufficient to cover half of the value of the median house in the United States. In other words, if the median late baby boomer household took all of the wealth they had accumulated during their lifetime, they would still owe more than half of the price of a typical house in a mortgage and have no other assets whatsoever.[2]

2) The situation for older baby boomers is similar. The median household with a person between the ages of 55 and 64 saw their wealth fall by almost 38 percent from $229,600 in 2004 to $142,700 in 2009. This net worth would be sufficient to allow these households, who are at the peak ages for wealth accumulation, to cover approximately 80 percent of the cost of the median home, if they had no other asset.

3) As a result of the plunge in house prices, many baby boomers now have little or no equity. According to our calculations, nearly 30 percent of households headed by someone between the ages of 45 to 54 will need to bring money to their closing if they were to sell their home. More than 15 percent of the older baby boomers, people between the ages of 55 and 64, will need to bring money to a closing when they sell their home.

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[1] We used the 2004 SCF, because the micro data from the 2007 is not yet available. This analysis, by my colleague David Rosnick and myself, is available at http://www.cepr.net/documents/publications/baby-boomer-wealth-2009-02.pdf.

[2] These calculations exclude wealth in defined benefit pensions.

These calculations imply that, as a result of the collapse of the housing bubble, millions of middle class homeowners still have little or no equity even after they have been homeowners for several decades. These households will be in the same situation as first-time homebuyers, forced to struggle to find the money needed to put up a down payment for a new home. This will make it especially difficult for many baby boomers to leave their current homes and buy housing that might be more suitable for their retirement.

The crash of the housing bubble and the subsequent collapse in the stock market has left the baby boom cohorts very poorly prepared for retirement. Since the vast majority of the members of these cohorts do not have traditional defined benefit pensions, they were forced to rely on their homes and defined contribution pensions as their main sources of wealth in retirement. These assets proved not to be safe mechanisms for preserving wealth.

The plunge in house prices has been especially devastating both because it was by far the largest source of wealth for most baby boomers, and also because of the high leverage in housing. The fact that housing is highly leveraged is, of course, a huge advantage to homeowners in times when prices are rising. If a homeowner can buy a $200,000 house with a 20 percent down payment, and the house subsequently increases 50 percent in value, the homeowner gets a very high return, earning $100,000 on a down payment of just $40,000.

However, leverage also poses enormous risks. In this case, if the home price falls by 20 percent, then the homeowner has lost 100 percent of her equity. This is exactly the sort of situation confronting tens of millions of baby boomers at the edge of retirement. As our analysis shows, millions of baby boomer homeowners have just witnessed the destruction of most or all of the equity in their homes.

The main lesson from the experience of the last two years is that family wealth is subject to much greater risk than had been generally appreciated. Even after the stock market crash of 2000-2002, most families continued to underestimate the risk associated with holding stock. Clearly they were encouraged in this attitude by many professional investment analysts who promoted stocks as financial assets that were associated with relatively little risk if held for a long enough period of time. While the market could always rally and reverse much or all of its decline over the last 18 months, there are few investors who would be prepared to take that bet at present.

Even more striking was the failure to recognize the risks associated with home ownership. Very few homeowners understood that their homes could lose much of their value. They planned their consumption and saving with the assumption that their house price would continue to appreciate, or at least not decline in value.

While this is a reasonable assumption in most times and places, it clearly was not a reasonable assumption in the first half of this decade, as house prices were rising at prices that vastly outpaced the rate of inflation in large parts of the country. While it should have been easy for analysts to recognize that house prices in many areas had risen to

levels that were far out of line with incomes and rents, few economists or housing analysts either noticed this imbalance or bothered to issue warnings to current and future homeowners.

As a result, most homebuyers felt that they were being perfectly rational in buying a home at a bubble-inflated price. Similarly, tens of millions of homeowners felt little qualm about either borrowing directly against the bubble equity in their house or not saving for retirement because the growing equity in their home made such saving unnecessary.

As a result, the crash of the housing bubble caught most homeowners by surprise. The loss of much or all of a family's equity would be difficult for any family, but for those who are near retirement it presents a special hardship. Few of these families will have enough years in the labor market to offset more than a small portion of these losses with additional saving. They will be forced to either work later in their lives than they had expected and/or have a lower standard of living in retirement than they had become accustomed to in their working years.

The sudden collapse in the wealth of baby boomer households shows the need for establishing more secure savings vehicles for the country's workers. Traditional defined benefit pension plans shield workers from the sort of market fluctuations that decimated the value of 401(k) and other defined contribution plans in the last two years.

However, defined benefit plans are rapidly dwindling in the private sector. Many of the plans that are still surviving are also struggling as a result of the recent downturn in the market. Employers will find it very costly to restore these plans to proper funding levels. In some cases the burden will be too great and companies will end up declaring bankruptcy and turning their pension liabilities over to the Pension Benefit Guarantee Corporation.

This suggests a vacuum that can usefully be filled by a government-managed pension plan. The government could, at very little cost and risk, make available a system that provided a guaranteed return on a modest voluntary investment. For example, if the government guaranteed a 3 percent real rate of return on an investment of up to $1,000 or 3 percent of a worker's wage, it would be sufficient to provide an annuity of $4,200 for a worker at age 65. This would be a substantial supplement to the Social Security benefits for low- and moderate-income workers.

However, even if Congress acted immediately to establish a pension system that allowed for more secure retirement savings, this would provide little help for most baby boomers, who will not be in the labor force long enough to get much benefit from this system. The baby boom cohorts will be even more dependent on their Social Security and Medicare benefits than the generations that preceded them. They were the victims of the largest intergenerational transfer of wealth in the history of the world, as they disproportionately incurred the loss of $8 trillion in housing wealth and $7 trillion in stock wealth.

Their children and grandchildren will in a perverse way be the beneficiaries of this loss, since they will be able to buy the country's stock of housing and corporate capital at prices that are 30-50 percent less than what they would have faced just two years ago. While there is nothing we can or should do to reverse this enormous intergenerational transfer, Congress can act to protect the social insurance programs on which the baby boomers will be dependent. Social Security and Medicare have long been the bedrock of the country's social safety net. They will be more important than ever as the baby boomers enter their retirement years.