WHAT LESSONS CAN THOSE SEEKING TO NARROW THE RACIAL RETIREMENT INCOME GAP DRAW FROM ACADEMIC RESEARCH?

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ABSTRACT

Financial provision for retirement is often characterized as a three-legged stool, comprising Social Security, employer-sponsored retirement plans, and private savings. This essay reviews the literature on the racial retirement savings gap, shows how Black and Hispanic households are disadvantaged, and proposes interventions that would improve their financial preparedness for retirement. This essay argues that the three-legged stool is no longer a suitable metaphor for retirement saving because middle-class households of all races save little outside their retirement plans. In addition, households lack an effective means of converting retirement savings into a lifetime income. The literature suggests that households in general, and Black and Hispanic households in particular, would benefit from the following: financial products that enabled them to delay claiming Social Security, improvements in access to employer-sponsored retirement plans, wider adoption of auto-enrollment and defaults into life-cycle funds, introduction of employer-sponsored programs to encourage rainy-day saving, promotion of annuitization within retirement plans, and underwriting of annuities based on zip codes.

INTRODUCTION

In 2019 the median net worth of non-Hispanic Black households was $24,100, compared with $36,050 for Hispanic households and $189,100 for non-Hispanic white households, with only a slight narrowing of the Black-white gap but a more significant narrowing of the Hispanic-white gap over the previous 30 years (Board of Governors of the Federal Reserve System [Federal Reserve Board] 2020). But, when assessing the adequacy of retirement resources, what matters is not the racial wealth gap, but rather whether household resources are sufficient to achieve some target level of post-retirement income. The exercise involves determining a target and then investigating whether and why minority households are less able to achieve that target.

I choose to compare Black and Hispanic households with white households—not because other minorities, such as East and South Asians, are less important, but because they are too diverse and the sample sizes in commonly used micro datasets are too small to make meaningful statements. I rely mainly on the findings of previous research but supplement those findings with my own analyses of the University of Michigan Health and Retirement Study, a large nationally representative panel survey of older Americans (University of Michigan n.d.).

The remainder of the essay proceeds as follows: The first section outlines alternative retirement income targets and assesses racial disparities in shortfalls relative to those targets. The next section explores reasons that Black and Hispanic households are at greater risk of having inadequate retirement savings, and discusses ways in which Social Security, employer-sponsored retirement plans, housing, and annuity markets disadvantage Black and Hispanic households. Finally, the essay concludes with policy recommendations.

ALTERNATIVE RETIREMENT INCOME TARGETS AND RACIAL DISPARITIES IN SHORTFALLS

One approach to measuring racial disparities in the adequacy of retirement income is to compare the shares of Black, Hispanic, and white households with retirement incomes below some decency threshold, for example 200 percent of the federal poverty level ($17,420 for a two-person household in 2021). An alternative approach is to compare the shares of retired households that are unable to maintain their pre-retirement standard of living. I adopt this latter yardstick, although I recognize that it may classify lifetime low earners as saving adequately for retirement even though their projected retirement income will be less than 200 percent of the federal poverty level. I take the view that the goal of a retirement system should be to enable middle-class households to maintain their living standards in retirement and that the needs of households with very low lifetime earnings are better addressed by the social safety net than by the retirement savings system.

Black and Hispanic households have lower median incomes than white households ($40,720 for both Black and Hispanic households versus $69,230 for white households in 2019) and therefore need to accumulate smaller nest eggs in order to achieve the same replacement rate (i.e., post-retirement income as a percent of pre-retirement earnings) (Federal Reserve Board 2020). Households with lower labor market earnings receive larger Social Security benefits as a percent of their pre-retirement earnings due to the progressivity of the Social Security benefit formula, further reducing the amounts they need to accumulate in order to achieve target replacement rates. Although the low levels of both earnings and, especially, wealth of Black and Hispanic households are indicative of wider problems in American society, those low levels may nonetheless be sufficient to permit them to maintain their standard of living in retirement.

Researchers differ in their assessments of the adequacy of retirement savings. The more sanguine argue that households need lower incomes after the children have left home and in retirement, and that they should do what little retirement saving is required late in their careers. They also adopt an ex-ante test of savings adequacy, examining whether savings decisions were appropriate, irrespective of whether households are subsequently pushed off course by, for example, involuntary job loss (Scholz, Seshadri, and Khitatrakun 2006). This study finds most households are saving adequately, and finds only a small correlation between race/ethnicity and savings adequacy. To the extent that Black and Hispanic households are less well prepared, it is due to the correlations between race/ethnicity and educational attainment and lifetime earnings.

The less sanguine assessments adopt an ex-post definition of savings adequacy—in other words, they examine whether households have saved enough to achieve a targeted replacement rate; consistent with other research, those assessments do not assume that households increase their savings after the children have left home (Dushi et al. 2015; Munnell, Hou, and Sanzenbacher 2018). The Munnell, Hou, and Sanzenbacher study shows that Black households are less well prepared than white households but that the preparedness gap had narrowed from 10 percentage points in 2007 to 6 percentage points in 2016. Importantly, the narrowing of the preparedness gap is not the result of greater wealth accumulation by Black households. Instead, it is due to decreases in labor market earnings by lower-earning Black households that have resulted in increases in their projected Social Security replacement rates relative to their now lower earnings. The study also reports a dramatic increase in the white-Hispanic financial preparedness gap from 9 percentage points in 2007 to 13 percentage points in 2016 due to the concentration of Hispanic homeowners in the states that suffered most from the bursting of the housing market bubble.

Given the lack of evidence of an increase in savings after the children leave home, I take the view that most households are under-saving and that Black and Hispanic households are at greater risk than white households of having inadequate savings. Furthermore, I consider that Munnell, Hou, and Sanzenbacher (2018) likely understates the plight of lower-earning Black households. Black workers are more likely than white workers to work in physically demanding jobs that result in both early retirement and a cessation of retirement saving prior to the authors' assumed retirement age of 65.

WHY BLACK AND HISPANIC HOUSEHOLDS ARE AT GREATER RISK OF HAVING INADEQUATE RETIREMENT SAVINGS

Middle-class households depend on Social Security, employer-sponsored retirement plans, and housing to maintain their standard of living in retirement. Households rarely tap housing equity except as a response to a health shock or the death of a spouse. But home ownership frees households from the obligation to pay rent. Lower-income households are less likely to own a home or to have a retirement account, and tend to depend mainly on Social Security for their post-retirement consumption. Financial assets outside of retirement accounts are significant only for those in the upper middle class and above. Annuities are an important but extremely under-used means of ensuring that retirement savings last a lifetime. I consider Social Security, employer-sponsored retirement plans, housing, and annuity markets in turn, and show how Black and Hispanic households are disadvantaged.

SOCIAL SECURITY

Black and Hispanic retirees are more dependent on Social Security than are white retirees, reflecting both lower lifetime earnings and lower financial and housing wealth. By design, the Social Security retired worker benefit formula provides larger replacement rates to workers with lower lifetime earnings, a disproportionate share of whom are Black or Hispanic.

Nonetheless, Social Security disadvantages Black households in two specific ways. First, Black workers are more likely than white workers to work in physically demanding jobs that take a toll on their health and result in early retirement. In consequence, on average, Black workers claim retired worker benefit at younger ages than whites, resulting in a reduction in their monthly benefits. In one sense, the reduction in benefits is fair, because it is set at a level that preserves the expected present value of lifetime benefits, at least for workers with population-average mortality. But if we think of Social Security as a program designed to provide income to those no longer able to work, then the actuarial reduction penalizes those in physically demanding jobs whose bodies wear out ahead of schedule. This disadvantage also applies to Hispanics.

The second way that Social Security disadvantages Black households is through the operation of spousal and survivors benefits. Social Security provides a spousal benefit which, if claimed at the spouse's full retirement age (66 years and two months for the 1955 birth cohort, increasing to age 67 for those born 1966 or after), equals one half of the other spouse's "primary insurance amount" (i.e., benefit payable at their full retirement age). A lower-earning spouse receives the greater of their spousal benefit and a retired worker benefit based on their own contributions. On the death of a higher-earning spouse, the lower-earning spouse can switch from his or her own spousal or retired worker benefit to a survivors benefit equal in most cases to the higher-earning spouse's retired worker benefit. Although the Social Security program is gender neutral, in most cases the survivors benefit is paid to widows, reflecting gender differences in earnings and longevity and typical age differences between husbands and wives. The problem is that Black women are less likely to qualify for spousal and survivors benefits due to lower marriage rates. Marriage rates among Black, white, and Hispanic women are strongly correlated with socioeconomic status. But, even controlling for socioeconomic status as measured by educational attainment, which is a measure of socioeconomic status and class position, Black women have significantly lower marriage rates than white women (see table 1). In contrast, Hispanic women's marriage rates more closely resemble those of white women.

It can be argued that Black households are further disadvantaged because the lower life expectancy of Black households reduces both the expected present value of their lifetime benefits and the rate of return they earn on their contributions (Coronado, Fullerton, and Glass 2011). But rate-of-return calculations take no account of the value of the insurance that Social Security and other annuities provide against the risk of outliving one's wealth so that the assessment of disadvantage depends on whether the yardstick is the cost of the program or the benefit to the participant. Even those at lower risk

TABLE 1: *Marital Status of Women Aged 51–62, 2016*

	Married	Partnered	Separated/ Divorced	Widowed	Never Married
BLACK	*Percent of Total*				
Less than high school	25.2	8.4	34.1	5.3	27.0
High school/some college	33.7	5.0	25.6	7.7	28.1
College	43.7	3.7	26.3	4.0	22.3
NON-BLACK HISPANIC	*Percent of Total*				
Less than high school	53.5	8.6	22.6	7.3	8.1
High school/some college	57.0	4.9	21.5	7.3	9.4
College	60.2	6.5	23.8	0.1	9.4
NON-HISPANIC WHITE	*Percent of Total*				
Less than high school	50.0	7.5	25.1	7.5	10.0
High school/some college	66.0	4.4	18.5	4.2	6.9
College	72.1	3.7	13.0	2.8	8.3

SOURCE: Author's calculations.
NOTE: Health and Retirement Study (University of Michigan n.d.) respondent level sample weights.

of surviving to advanced ages will value the insurance Social Security provides against the financial consequences of survival. I discuss the impact of mortality differentials in more detail in the section below on annuity markets.

In contrast, Hispanics enjoy lower mortality than more economically advantaged non-Hispanic whites, although mortality rates vary considerably by nativity and country of origin, which is evidence of the pitfalls of treating racial and ethnic categories as homogenous (Fenelon, Chinn, and Anderson 2017).
Hispanic immigrants are, however, disadvantaged relative to immigrants from Western Europe in that they are not covered by Social Security totalization agreements that help fill gaps in benefit protection for workers who have divided their careers between the United States and another country (Social Security Administration n.d.). And, unless they work off the books, unauthorized workers—a disproportionate share of whom are Hispan-

ic—contribute to Social Security without accruing benefits (Goss et al. 2013).

EMPLOYER-SPONSORED RETIREMENT PLANS

In theory, a lifetime of contributing to 401(k)–type plans should provide households with more than sufficient wealth to provide an adequate replacement rate. But to enjoy an adequate replacement rate in retirement, households must be eligible to participate, choose to participate, contribute an adequate amount, invest appropriately, not take pre-retirement withdrawals, and then convert their accumulated wealth into a lifetime income. In any case, only about half the workforce are offered these plans by their employers. A lot can and does go wrong, and the evidence suggests that Black households experience greater difficulty in navigating the system. Although studies have quantified the relative contributions of the above factors toward explaining why retirement plan balances fall below potential (Biggs, Munnell, and Chen 2019), they do not examine the effects of race. Instead, we must rely on studies that focus on specific aspects of the wealth accumulation process. These studies show that Black and Hispanic workers are less likely than white workers to be covered by an employer-sponsored retirement plan (Johnson 2020). The Black-white gap is modest (52 versus 60 percent), and the Hispanic-white gap larger (37 versus 60 percent); part of these gaps reflect racial differences in full- or part-time status and firm size. Black households are also more likely than white households to make pre-retirement withdrawals from their retirement accounts (Ghilarducci, Radpour, and Webb 2019).

Retirement resources are often characterized as a three-legged stool comprising Social Security, income from employer-sponsored retirement plans, and private savings. Few middle-class households save much outside of their retirement plans so the three-legged stool is at best a two-legged stool. But the three-legged stool is no longer a suitable metaphor for retirement saving because, in a defined contribution retirement plan world, households lack an effective means of converting accumulated retirement savings into a lifetime income. The inability to convert accumulated wealth into lifetime income adversely affects Black and Hispanic households, whose smaller retirement asset balances leave them with less room for miscalculating post-retirement drawdown.

HOUSING

A full discussion of the ways in which Black and Hispanic households are disadvantaged in the housing market is beyond the scope of this essay. I refer interested readers to Johnson (2020). The factors referenced in that paper contribute to racial differences in the share of pre-retirees owning a home (see table 2). Both theoretically and empirically, the relationship between home ownership and saving in financial assets is complex (Chetty, Sándor, and Szeidl 2017). If housing simply displaces financial wealth in the household's portfolio, lower home-ownership rates may not adversely affect financial preparedness for retirement. But for many

TABLE 2: *Share of Homeowner Households by Race and Education, 2016*

NON-BLACK			
Education	*Black*	*Hispanic*	*White*
Less than high school	23.7	41.8	45.2
High school/some college	45.0	58.0	68.1
College	51.2	66.7	85.2

SOURCE: Author's calculations.
NOTE: Health and Retirement Study (University of Michigan n.d.) respondent level sample weights.

low- to moderate-income households, wealth accumulation in housing may not displace other savings. First, many low to moderate earners accumulate few financial assets regardless of whether they are home owners, so there is little savings to displace. Second, both retirement account contributions and asset allocation are strongly influenced by the retirement plan default contribution rate and asset allocation rather than by a rational calculation of the total amount of financial and housing wealth needed to finance post-retirement consumption.

ANNUITY MARKETS

Annuities enable households to exchange a lump sum for a lifetime income, insuring them against the risk of outliving their wealth. For most households, annuities are actuarially unfair—the expected present value of the stream of income payments, discounted by a rate of interest and the probability of surviving to receive the payments is less than the premium paid. Actuarial unfairness arises mainly because insurance companies must set prices that reflect the low mortality of households that actually buy annuities.[1] On average, Blacks have shorter life expectancies than whites, and thus face a greater degree of actuarial unfairness (Brown 2002).

This being said, models of asset drawdown in retirement show that racial and socioeconomic mortality differences have a negligible effect on the value households should in theory place on annuities (Brown 2003) and that even households with high mortality would benefit from annuitization (Gong and Webb 2008). The explanation is that even individuals at high mortality risk cannot predict their death date and should value the insurance that annuities provide against the risk of outliving their wealth. The calculations overstate the impact of differential mortality because the highest mortality group—Black men with less than a high school education—possess little annuitizable wealth.

With the exception of a small market for medically underwritten annuities, annuities are priced based on age, gender, and product type.[2] Many Black (and indeed other) households would benefit from pricing based on other risk factors. Pricing based on race is unlawful, but US insurers could adopt the United Kingdom's practice of pricing annuities based on zip code, which is a strong predictor of socioeconomic status and thus longevity.

Annuity prices exhibit considerable dispersion (Mitchell et al. 1999).[3] I am unaware of any research investigating whether Black households pay higher prices for annuities. But Black households often pay higher prices for other financial products and it would not be surprising if they were also disadvantaged in the annuity market.

CONCLUSIONS AND POLICY RECOMMENDATION

This essay examines the impediments to Black and Hispanic households maintaining their living standards in retirement and does not address the broader question of racial disparities in lifetime earnings. Many factors affect Black, Hispanic, and white households alike, but Black and Hispanic households face particular challenges. This section considers possible policy interventions.

SOCIAL SECURITY

Family structures have changed enormously since Social Security was established in 1935. Today's Social Security is arguably out of step with the needs of the modern family (Stanfield and Nicolaou 2000). The need for Congress to act in the next decade to correct Social Security's fiscal imbalance provides an opportunity for reform. But reform is difficult: it either creates losers who will object or is prohibitively expensive. I propose

1. Insurance companies face administrative costs and must earn a profit, but costs and profits contribute far less to actuarial unfairness. Estimates are somewhat sensitive to whether the annuity income stream is discounted at a Treasury or corporate bond interest rate.
2. Following the Supreme Court decision in Arizona Governing Committee v. Norris (1983), annuity rates in employer-sponsored retirement plans must be gender neutral. This decision does not apply to annuities purchased within IRAs.
3. Their finding of price dispersion has been replicated in many other studies. The amount of the financial loss is unclear because insurers do not share data on transaction volumes by price point

three simple reforms; the first two are relatively low cost and the third is free.

First, policymakers should consider the appropriateness of the penalty for early claiming. This penalty is greater than actuarially fair for those who actually claim early (Dushi, Friedberg, and Webb 2021), a disproportionate share of whom are Black and Hispanic. A reduction in the penalty would increase the benefits of those forced to claim early but could harm those who might be incentivated by a reduction in the penalty to retire prematurely. The reduction could be financed by a reduction in the "delayed retirement credit" (i.e., the increase in monthly benefits for those who delay claiming after their full retirement age), which Dushi, Friedberg, and Webb (2021) show is more than actuarially fair to those who actually delay. Second, policymakers could also consider increasing the Social Security "special minimum benefit" (Congressional Research Service 2020; Johnson 2020). Finally, insurance companies should promote temporary annuities in both the individual and plan sponsor markets as a means by which households can bridge the gap between retirement and delayed claiming of Social Security.

EMPLOYER-SPONSORED RETIREMENT PLANS

Insights from behavioral finance have led to the widespread adoption of auto-enrollment and auto-escalation, leading to high levels of participation at all income levels, while life-cycle funds ensure appropriate investment allocation. But, for many households, retirement savings also serve as rainy-day funds and are depleted before retirement. One solution would be to promote separate or standalone emergency fund savings through payroll deductions (Beshears et al. 2020). In the absence of widespread adoption of such accounts by at-risk households, stricter limits on pre-retirement withdrawals might discourage participation and cause hardship among those experiencing economic shocks.

Plan design has placed less emphasis on drawdown in retirement than on accumulation. Although annuitization enables households to enjoy higher post-retirement income than can be achieved through a drawdown of unannuitized wealth, few households annuitize. Black households may be especially wary of annuitization, given lower levels of financial knowledge and fear of financial predation. A partial solution is for plan sponsors to promote annuitization through plan defaults. The problem is that, by the time of retirement, the horse has bolted, and most retirement assets are held within IRAs and thus outside of employer influence (Munnell and Webb 2015). This problem will be overcome only if financial advisors become more willing to promote annuities.[4]

HOUSING

I refer the interested reader to the extensive list of policy options outlined in Johnson (2020).

ANNUITY MARKETS

As mentioned above, plan sponsors should consider promoting annuities as a default option within retirement plans and offering temporary annuities to bridge the gap between retirement and delayed Social Security claiming. Insurers should consider pricing annuities based on the annuitant's zip code.

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4. More research is needed on why annuitization rates among advised clients are not higher. It may reflect their clients' greater-than-average wealth, advisors' fear that clients might not be receptive, lack of knowledge, and perhaps a desire to preserve assets under management.

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