McKinsey Global Institute

Talkin' 'Bout My Generation: The Economic Impact of Aging US Baby Boomers

Executive Summary

June 2008

McKinsey&Company

McKinsey Global Institute

The McKinsey Global Institute (MGI), founded in 1990, is McKinsey & Company's economics research arm. MGI's mission is to help business and government leaders develop a deeper understanding of the evolution of the global economy and provide a fact base that contributes to decision making on critical management and policy issues.

MGI's research is a unique combination of two disciplines: economics and management. By integrating these two perspectives, MGI is able to gain insights into the microeconomic underpinnings of the broad trends shaping the global economy. MGI has utilized this "micro-to-macro" approach in research covering over 15 countries and 28 industry sectors, on topics that include economic productivity, global economic integration, offshoring, capital markets, health care, energy, demographics, and consumer demand.

MGI's research is conducted by a group of full-time MGI fellows based in offices in San Francisco; Washington, DC; London; and Shanghai and led by MGI's director Diana Farrell. MGI project teams also include consultants drawn from McKinsey's offices around the world and are supported by McKinsey's network of industry and management experts and worldwide partners. In addition, MGI teams work with leading economists, including Nobel laureates and policy experts, who act as advisers to MGI projects.

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Preface

Talkin' 'Bout My Generation: The Economic Impact of Aging Baby Boomers is the result of a yearlong study by the McKinsey Global Institute (MGI) in partnership with McKinsey's Consumer Insight Practice. The work builds on previous MGI work on the impact of demographics on national economies, as well as MGI's work on shifting patterns of consumer demand in the world.[1] This study presents new data and analysis on how the Baby Boomers, one of the largest US birth cohorts relative to population in the last century, will shape the US economy over the coming decades as they age and retire.

In November 2007, we, along with our colleagues David Court and John E. Forsyth, published an article "Serving Aging Baby Boomers" in *The McKinsey Quarterly*, highlighting results of this research from the perspective of businesses seeking to serve an aging population of consumers.[2] In that piece we focused on the significant opportunities as well as the challenges this demographic shift presents for companies serving aging consumers. In this report, we take a different perspective. Here, we focus on the question of what impact the aging of the Boomers will have on the overall US economy, and what actions policy makers and business leaders must begin to take now to minimize the risks to the economy posed by this demographic transition.

David Court, a McKinsey director in Dallas and global knowledge leader for the Consumer Insight Practice; Eric Beinhocker, a senior fellow with MGI in London; and John Forsyth, an expert principal with the Consumer Insight Practice in

1 See McKinsey Global Institute Reports: The Coming Demographic Deficit: How Aging Populations Will Reduce Global Savings, December 2004; *From* 'Made in China' to 'Sold in China': The Rise of the Chinese Urban Consumer, November 2006; *The* 'Bird of Gold': The Rise of India's Consumer Market, May 2007. They can be found at http://www.mckinsey.com/mgi/

2 David Court, Diana Farrell, and John E. Forsyth, "Serving Aging Baby Boomers," *The McKinsey Quarterly,* November 2007.

Connecticut, worked closely with me to provide overall leadership on both stages of this project. The project team for this report was managed by Ezra Greenberg, an expert with MGI in Washington, DC, who also led the economic analysis and modeling efforts, and it included Jonathan Ablett of the North American Knowledge Center; Suruchi Shukla, a McKinsey consultant from the Asia House office in Frankfurt; Geoffrey Greene, an external adviser to MGI on econometric modeling; and Nell Henderson, an MGI senior editor in Washington, DC.

This report built upon our earlier work. That project team was managed first by Vanessa Freeman, a consultant in McKinsey's London office and then by John Chao, a consultant from McKinsey's Houston office. The market research was led by Lora Chajka-Cadin, an expert with McKinsey's Consumer Insight Practice in Boston. We were supported by a superb team that included Vivek Banerji, Matthew Klusas, Mette Lykke, Jeongyeon Shim, and Ned Welch.

We also received valuable input and guidance from a number of senior McKinsey partners who committed their time to serve on a steering committee to review the work. They include Blair Crawford, Martin Elling, Dave Elzinga, Betsy Holden, David Hunt, John McPherson, Michael Patsalos-Fox, Tim Welsh, and Michael Zea.

Our team benefited substantially from interviews and discussions with a number of experts, including Alicia Munnell and Anthony Webb of the Center for Retirement Research at Boston College, and Martin Neil Baily of the Brookings Institution.

Finally, we would like to thank several members of MGI's professional staff who contributed their efforts to this project: Tim Beacom, for his research assistance; Rebeca Robboy, MGI's external relations manager; and Deadra Henderson, our practice administrator. We also thank Anthony Lee of the North America Financial Services Practice, and the superb staffs of McKinsey's North American Knowledge Center, the McKinsey Knowledge Center in India, and the production and technical services of the Firm.

Our goal with this and other MGI reports is to provide business leaders, policy makers, and other decision makers with facts and insights that lead to better understanding of key trends in the global economy. As with all MGI projects, this research is independent and was not commissioned or sponsored in any way by any business, government, or other institution.

Diana Farrell
Director, McKinsey Global Institute
June 2008
San Francisco

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Executive Summary

America's "Baby Boom" generation has dominated the US economy for more than a quarter-century. Our research shows that the nearly 79 million Baby Boomers have earned record levels of income, generated great wealth, and spurred economic growth. But they have also spent at record levels, failed to save, and accumulated unprecedented levels of debt. Now, as the oldest Boomers near retirement, we estimate that approximately two-thirds of Early Boomer households, who are aged 54 to 63, are financially unprepared for retirement—that is, they have not accumulated enough savings to maintain their lifestyle as they age. And many of them do not realize they are ill-prepared. Meanwhile, their predicament is worsening with the fall in home values and stock prices that began in 2007.

The Boomers' aging also will be felt throughout the economy. As the Boomers grow older, they will work and spend less, slowing real GDP growth to a more modest pace than in recent decades: from the 3.2 percent average annual rate enjoyed since 1965 to 2.4 percent over the coming three decades. While the bursting of the housing bubble and resulting credit crisis have raised concerns about economic performance in the short term, the coming retirement of the Baby Boomers will pose challenges to the US economy for more than three decades.

But our research also shows that these challenges can be met. Our analysis shows that enabling the Boomers to work later in life would significantly benefit both individual households and the broader economy. By increasing the median retirement age by about two years—from 62.6 today to 64.1 by 2015—the share of unprepared Boomer households could be halved from 62 percent to 31 percent. And the additional workers would boost real GDP growth.

The Boomers have been adaptable and innovative throughout their lives and are already starting to redefine aging and retirement. Our survey of Boomers facing retirement shows that most expect to work later in life. However, there are also many barriers to doing so. These range from the costs of America's health care system, to unintended consequences of labor laws and pension regulations, to corporate attitudes toward older workers. It is essential that policy makers and business leaders work together to remove these barriers and prevent the Boomers' retirement from becoming a multi-decade drag on US growth.

These conclusions are supported by a yearlong research project conducted by the McKinsey Global Institute (MGI) in partnership with McKinsey's Consumer Insight Practice. The research included construction of a database of US household financial data cut by age, income, and wealth from 1962 through the third quarter of 2007; the creation of an econometric forecasting model that projects Boomer and other cohort household finances to 2035; a survey of over 5,100 households of Boomers and the Silents (the generation that preceded the Boomers), and 32 in-home ethnographic interviews with Boomer households approaching or just past retirement. We briefly outline the findings from this research below. Readers interested in the full results and analyses are directed to the main chapters of the report, while those interested in our methodology, assumptions, and data sources are directed to the appendixes.

BOOMERS HAVE ENJOYED RECORD EARNINGS—BUT EIGHTY PERCENT OF THEIR GAINS ARE FROM ONETIME FACTORS

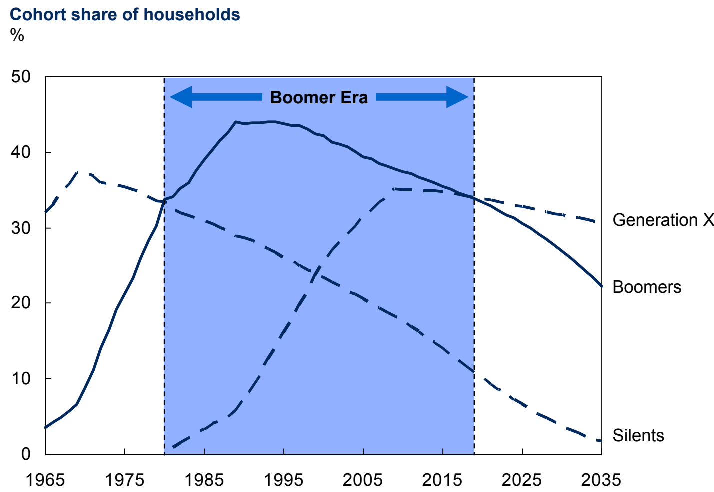
The Baby Boomers have had an outsized impact on the US economy since their birth in the postwar period from 1945 to 1964. At 45 million households strong, they have accounted for the greatest share of earnings and consumption in the economy since 1980. We project that their era of economic dominance will last until 2019 (Exhibit 1).

The Boomers have earned more at every age in real terms than previous generations. Exhibit 2 compares Boomer earnings by age with those of the Silent generation, the cohort that preceded the Boomers. We project that the Boomers' earnings will peak in 2015 for the Early Boomers (born from 1945 to 1954) at $90,000 per household, and in 2025 for the Late Boomers (born from 1955 through 1964) at $106,000.[1]

1 All income, net worth, and spending figures are expressed in 2000 dollars. Our econometric model captures 100 percent of household income and spending in the economy. Following national accounting standards, we include income and spending provided in-kind to households. See Chapter 1 and Appendix B for more details.

Exhibit 1

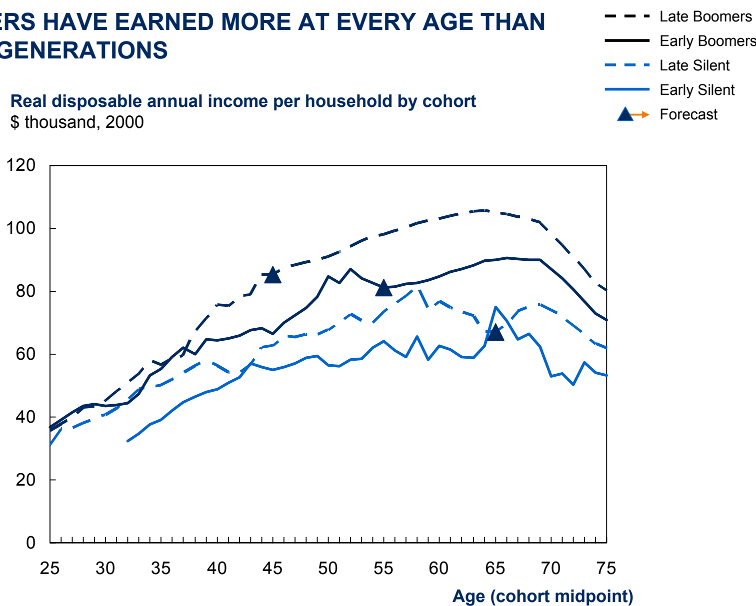
THE SIZE OF THE COHORT HAS CREATED A "BOOMER ERA" FROM 1980 TO 2019



Source: McKinsey Global Institute US Consumer Model, v7.2

Exhibit 2

BOOMERS HAVE EARNED MORE AT EVERY AGE THAN PRIOR GENERATIONS

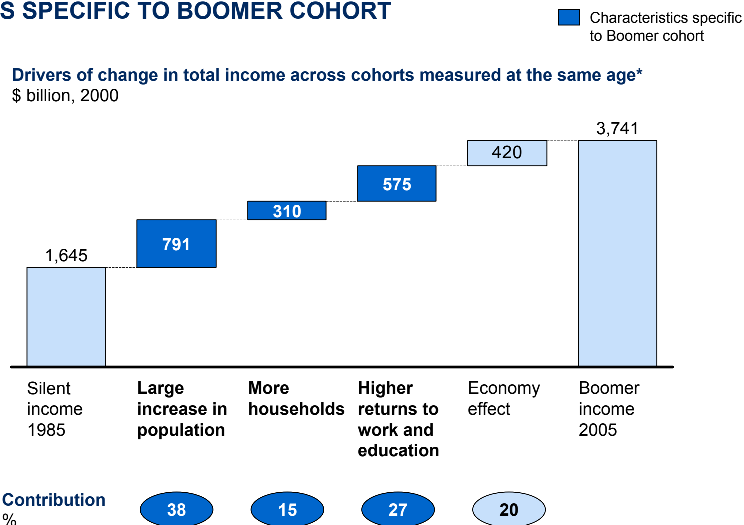


Source: McKinsey Global Institute US Consumer Model, v7.2

Looked at in aggregate, the Boomers have earned more than twice as much as the Silent generation during the same age span (Exhibit 3). But our analysis shows that 80 percent of the Boomers' increased earnings was driven by three specific onetime factors that are not likely to be repeated for future generations.

Exhibit 3

EIGHTY PERCENT OF BOOMER INCOME GROWTH DUE TO ONETIME FACTORS SPECIFIC TO BOOMER COHORT



* Decomposition compares 10-year cohorts at the same age: Early Boomers vs. Early Silents at age 55; Late Boomers vs. Late Silents at age 45. Age refers to cohort midpoint.

Source: McKinsey Global Institute US Consumer Model, v7.2

First is the sheer size of the Boomer cohort. The Boomers increased the size of the US labor force, boosting output and pocketing the income associated with that growth. If we assume that on average the Boomers lived as did the previous Silent generation, with the same number of adults and the same income per household, the simple fact that there were more of them would account for 38 percent of their increased aggregate income.

But the Boomers also earned more because they lived very differently than the Silents. One key difference was that Boomer women poured into the workplace at rising rates, further boosting the size of the labor force. This change was closely linked to a set of social trends: The Boomers have married and had children later in life, have divorced at higher rates, or have chosen not to marry at all. As a result, the Boomers are now divided into a larger number of smaller households than in previous generations, with fewer adults per household. More households for this generation meant more earners. Assuming that the Boomers had the same average income as the Silents, this shift provides a second explanation for the Boomers' greater collective income and accounts for 15 percent of the difference.

Third, and finally, the Boomers have enjoyed greater returns to both education and work than did the previous generation, which boosted their average household income. They became more educated than previous generations, in large part because of the educational gains by Boomer women. And they did so at a time when the labor force was shifting from industrial work to service and knowledge jobs, increasing the returns to education. They were also better able than other cohorts to capitalize on changes in the economy stemming from productivity growth, technological innovation, and globalization during this period. We estimate that higher returns boosted aggregate income by 27 percent.

The remaining 20 percent of their income gains is due to factors not specific to the Boomers—it is the gain they received by benefiting from economic growth at least as much as did everyone else over this period.

None of the three factors driving differential growth in Boomers' income is likely to be repeated. It is unlikely we'll see another cohort as proportionally large as the Boomers for some time to come. Likewise, the social trends that have increased household numbers seem to have largely played out and stabilized. Finally, female educational attainment and workforce participation also appear to have peaked.

Thus, while future generations will likely see real income increases due to productivity growth and other fundamental economic factors, these gains are unlikely to occur at the pace enjoyed by the Boomers.

THE MISSING PEAK—DESPITE HIGH INCOMES, THE BOOMERS HAVE FAILED TO SAVE

But just as the Boomers have been record earners, they have also been record spenders and borrowers. The Boomers have been the major spenders in the economy since the mid-1980s, and they have spent more in real terms at every age than previous generations. The Boomers' spending spree has helped drive consumption to account for more than 78 percent of GDP growth in the United States from 1995 to 2005 versus 64 percent two decades earlier.

But what has really separated the Boomers from previous generations has been their failure to save. Historically, households have followed a life-cycle pattern where they have modest savings in their early years when their incomes are low; then they accumulate savings in their peak earning years, typically their forties and fifties; and then they draw down those savings in retirement in their sixties and seventies. Exhibit 4 shows this savings life cycle for the Boomers versus the Silents. Both the Early and Late Silents show a distinct savings peak during their

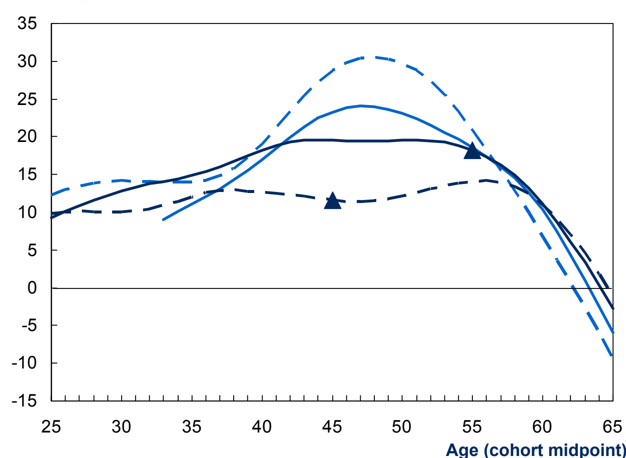
high-earning years. But the peak is missing for the Early Boomers, and the Late Boomers appear to be on an even lower savings trajectory. Our analysis shows that the Boomers' missing savings peak accounts for most of the collapse in the US household saving rate from its peak of over 10 percent in the mid-1980s to around 2 percent today. In 2005, the Boomers had 47 percent of national disposable income but contributed only 7 percentage points to national savings. At the same point in their life cycle in 1985, the Silents contributed twice as much to national savings despite controlling proportionally far less income.

Exhibit 4

BOOMER SAVING RATES HAVE NOT PEAKED DURING PRIME EARNING YEARS LIKE PREVIOUS GENERATIONS

Late Boomers
Early Boomers
Late Silent
Early Silent
Forecast

Saving rate by cohort, household balance sheet measure
% of disposable income



Source: McKinsey Global Institute US Consumer Model, v7.2

Our analysis highlights two critical reasons for this missing peak in Boomer saving—the "wealth effect" from asset appreciation and increased access to credit. First, financial market innovations in the 1980s and '90s turned more Americans into both investors and borrowers. During the Boomers' lifetimes, mutual fund penetration among 50- to 59-year-olds has climbed from 14 percent of households to 64 percent. When Boomers saw their stocks and home values soar during this period, they felt emboldened to spend more, and thus save less than they would have otherwise—the so-called wealth effect. Our analysis shows that almost half of the increase in net worth for Early Boomers has come from asset appreciation, whereas at the same age the Silents relied on saving to increase their net worth (Exhibit 5).

At the same time, the Boomers borrowed more. The share of households with mortgages almost doubled, and the percentage with revolving credit increased by

25 percent. The net effect is that the Boomers are carrying far more debt later in life than previous generations. The Boomers have nearly 1.5 times the amount of liabilities, and their average liability-to-net worth ratio is 54 percent higher than the Silents at the same age. This is even before the full effects of the housing market decline have played out.

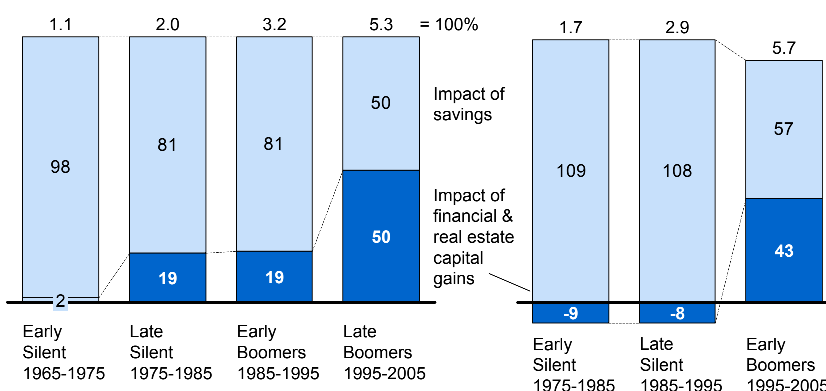
Exhibit 5

BOOMERS HAVE BENEFITED DISPROPORTIONATELY FROM ASSET APPRECIATION

Change in household net worth at the same age*

$ trillion, 2000; %

Cohort ages 35-45 **Cohort ages 45-55**



* Age refers to cohort midpoint.
Source: McKinsey Global Institute US Consumer Model, v7.2

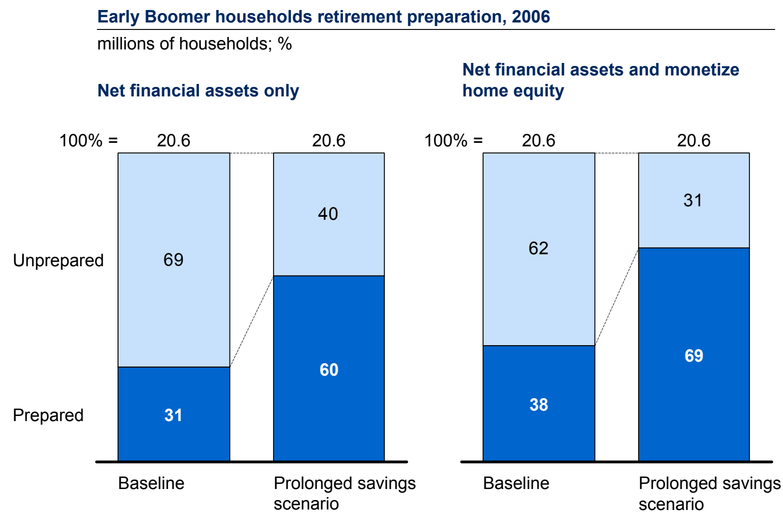
TWO-THIRDS OF BOOMERS ARE UNPREPARED FOR RETIREMENT

We estimate the net result of the Early Boomers' weak saving is that approximately two-thirds of these households are unprepared for retirement—that is, they will not be able to sustain approximately 80 percent of their spending as they age.[2] Even if we allow that these households can tap their home equity, the proportion of prepared Early Boomer households is no higher than 38 percent (Exhibit 6). Thus, without major changes in behavior, about two-thirds of Boomer households are heading for sharp drops in their lifestyle.

This result may be surprising to some because both aggregate and average real net worth are higher for the Boomers than for the Silent generation. But the aggregate and average figures are held up by a concentration of Boomers who are indeed very rich. For example, Early Boomers with net worth above $125,000 in 2005 owned 42 percent of total cohort net worth, versus 36 percent for Early Silents at the same age.

2 See Chapter 4 for more details on our approach to defining retirement preparedness.

Exhibit 6



Source: McKinsey Global Institute US Consumer Model, v7.2; US Aging Consumer Survey, 2007

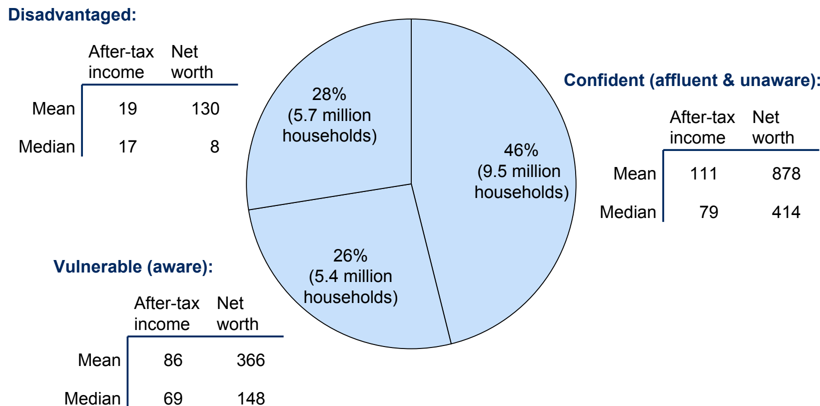
Looking more closely across the distribution of income, one sees that many middle-income and even upper-income families will struggle to maintain their lifestyles. Less than half of Early Boomer households earning $60,000 to $90,000 per year are prepared for retirement, even if home equity is included. Of course, lower-income families will face the greatest difficulties—just 18 percent of households earning less than $30,000 per year are prepared for retirement (25 percent if housing equity is included).

In our survey, we found that many unprepared households are worried about their financial future but that many others are unaware of their situation. We concluded that the Boomers, in facing retirement, could be divided into three distinct attitudinal groups—the *confident*, the *vulnerable*, and the *disadvantaged* (Exhibit 7). These groups broadly correlated with the economic condition of the households in them, but had a number of specific characteristics:

- **Confident**—This group accounts for almost half of Boomer households, and they believe they are well-prepared financially for the future. This is the richest, healthiest, best educated, most married, and most optimistic group. However, there are two types of confident households that share similar attitudes and aspirations but have different financial means. The "affluent confidents" have the wherewithal to fulfill their aspirations, while the "unaware confidents" share these aspirations but do not have the resources to meet them.

Exhibit 7

BOOMERS FALL INTO THREE ATTITUDINAL GROUPS



Note: Boomers aged 50-61 when surveyed used as a proxy for total Boomer cohort.
Source: McKinsey Global Institute US Consumer Model, v7.2; US Aging Consumer Survey, 2007

- **Vulnerable**—This group accounts for a little more than a quarter of the total. These households have lower income than the confidents and less than half the net worth. They also tend to have lower education levels and a lower likelihood of being married. Nearly 70 percent of these households are unprepared for retirement—but they are aware of their predicament. The vulnerable households have worries about their finances, their health, and the danger of loneliness in retirement. Many are frustrated with their lives and pessimistic about the future and do not believe they can count on family or the government to bail them out.

- **Disadvantaged**—A little more than a quarter of Boomer households falls into the disadvantaged category. These Boomers have had low incomes throughout their lives and are the least educated, least likely to be married, and the most likely to have the poorest health. They worry about the affordability of health care and whether government programs will be there to support them. More than three-quarters are unprepared for retirement.

WORKING TWO YEARS LONGER CAN SIGNIFICANTLY BOOST BOOMER PROSPECTS

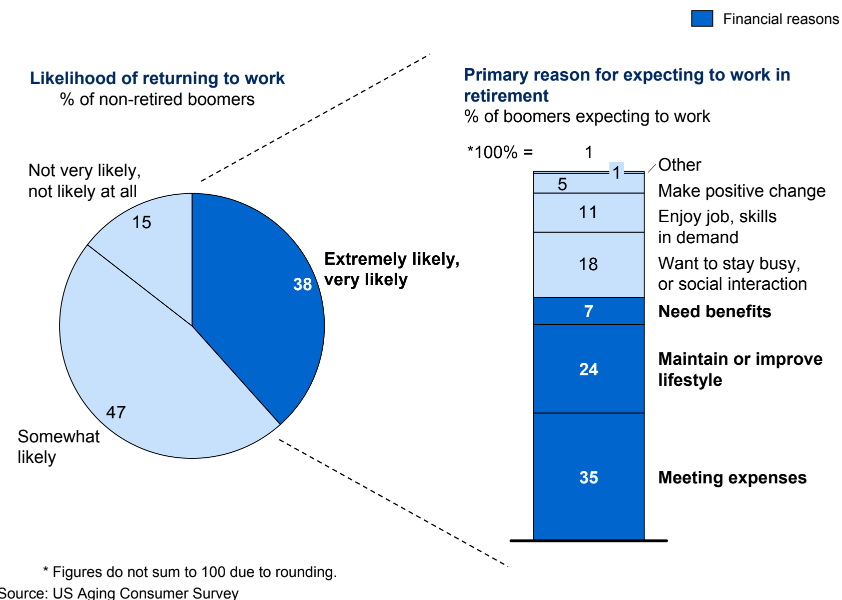
Despite the stark predicament of many Boomer families, it is not too late to take action. The Boomers will have to postpone retirement to finance it—working longer to build the savings they will need. Our analysis shows that if Early Boomers

can continue to accumulate assets for an extra five years, shifting the average point at which they begin to draw down their assets from age 65 to 70, the number of unprepared households would be cut by about half (see Exhibit 6). We estimate that this would require their median retirement age to rise from 62.6 today to 64.1 by 2015—an increase of about two years.

An increase in the median retirement age of this magnitude may not sound like much, but this is a number that has shifted slowly: Over the three decades from 1970 to 2000, the median retirement age declined by the same amount. So the challenge is to reverse that trend, but at a much more rapid pace.

Such change is very possible. Life expectancies are increasing. Our survey shows that most Boomers are aware that they will need to do some kind of work past the traditional retirement age. As Exhibit 8 shows, 85 percent of Boomers think it is at least somewhat likely they will continue to work. Two-thirds of those most likely to keep working foresee themselves doing so primarily for financial reasons.

Exhibit 8



* Figures do not sum to 100 due to rounding.
Source: US Aging Consumer Survey

Clearly, working longer will not be enough to ensure that all unprepared Boomers can maintain their living standards in retirement. First, even if Boomers work longer, roughly a third are still not prepared for retirement. Of this group, half have annual incomes below $30,000 and about three-quarters have incomes below $60,000. Ninety-five percent of the unprepared households have net worth lower than $100,000.

Second, not all of those saying they intend to work will be able to do so. Many will be unable to keep working because of health problems or other age-related difficulties. Our survey found that half of the Boomers who have retired early did so for health reasons. A significant majority of those who retired for health reasons are in vulnerable or disadvantaged households, precisely those who most need to keep working. Also, nearly half of Boomers are in physically demanding occupations such as construction, production, and some service jobs that may make it necessary for them to switch jobs, which is difficult later in life.

But policy makers and business leaders must act to enable those who can work longer to do so. Working longer is also the best answer for the economy as a whole. To make up the savings gap, the Boomers also could begin sharply cutting their spending. However, as Exhibit 9 shows, this would dampen overall economic growth. Working longer, on the other hand, would boost labor force participation, thereby increasing output growth. Enabling Boomers to work longer would add more than $12 trillion to US GDP over the next three decades—an amount equivalent to one year of GDP today.

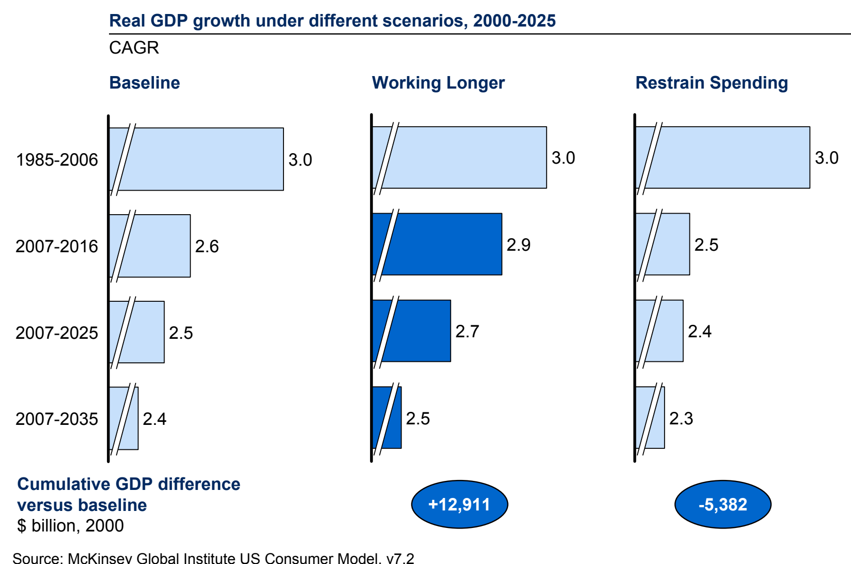
Although there would be clear benefits to enabling the Boomers to work longer, there are significant legal and institutional barriers that need to be overcome. They include a variety of disincentives for both employers and older workers. Government policy makers and businesses should make several specific changes. They include:

- **Reallocating health insurance costs for older workers.** Insurance costs climb with age, creating a disincentive for businesses to retain or hire older workers. And although Medicare covers retirees aged 65 and over, the program covers little or none of the health care costs of employees at this age if they work for companies providing insurance. The issues of insuring older workers have been largely ignored in the debate over health reform, but they require attention and action.

- **Enabling businesses to offer flexible work arrangements to mature workers.** Many Boomers say they are willing to keep working if they can do so part time, or work from home, or gradually reduce their hours and pay. Such programs are already widespread in government and educational institutions, but businesses have held back partly out of concern they might violate federal laws on taxes, pensions, and age discrimination. Policy makers should amend these laws to remove such concerns. Businesses then should offer more flexible work arrangements. Workers, in turn, will have to be flexible on pay and benefits.

- **Reforming private pensions and Social Security to remove disincentives to working longer.** Many defined benefit pension plans calculate benefits according to formulas that encourage workers to retire early. Businesses and unions should rewrite the rules to remove disincentives to working longer. Similarly, lawmakers should change the way Social Security retirement benefits are calculated to reduce disincentives to working more than 35 years.

Exhibit 9



Early Boomers, aged 54 to 63 today, who are unprepared for retirement will have to rely primarily on working longer to bolster their finances. But the Late Boomers, aged 44 to 53, have more time to also boost savings by trimming their spending. They should do so, but they need help. Lawmakers should reform and simplify the tax code to increase incentives to save. More businesses should offer employee savings programs, such as 401(k) plans and individual retirement accounts (IRAs) with "automatic" features, such as automatic enrollment, escalation of savings rate over time, and investment into diversified portfolios.

Even with all these actions, many Boomers will rely on Social Security and Medicare in their senior years. Policy makers will have to find ways to sustain these programs, at least for the most disadvantaged households. Otherwise, we will see a resurgence of poverty among the elderly—precisely the problem these programs were created to eradicate.

These changes can be made. But all of the parties involved—government, employers, unions, and the Boomers themselves—will need to act.

• • •

With the impending retirement of the Baby Boomers, the United States is facing a multi-decade economic challenge. However, the Boomers are also a resilient and innovative generation that has lived through and driven major social and technological changes. The Boomers who currently lead our businesses and political institutions need to reinvent retirement and create a more flexible labor market that enables and encourages this generation to work and save later in life.

The Boomers in their sunset years face a choice. They can leave the economic stage as the generation that had it, spent it, and left holes in the US economy for future generations to fill. Or they can be the generation that reinvented America throughout their lives.

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