DOES SOCIAL SECURITY DISCOURAGE WORK?

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One of the most remarkable demographic changes in the United States and the rest of the industrialized world during the post-war period has been the trend toward earlier retirement. Older workers, especially men, are leaving the labor force much earlier than they used to. In the U.S., both Social Security and the private pension system have grown at the same time. An important question is whether these phenomena are linked, whether Social Security and private pension plans are discouraging work and influencing the retirement decisions of older Americans. The evidence suggests that they are.

A closely related issue is the long term fiscal stability of the Social Security system. Currently legislated future Social Security taxes are insufficient to pay for promised future benefits, and some combination of increased taxes and reduced or delayed benefits will be necessary to restore fiscal balance. An important question is how changes in Social Security rules will affect the labor supply decisions of future workers.

In this paper, we first outline recent retirement trends in the U.S. and abroad, and discuss the determinants of the individual retirement decision, focusing on financial factors. We argue that there are strong incentives to retire (disincentives to continuing work) built into Social Security and many private pensions, that the size of these incentives can be large, and that individuals respond to them as expected. We then ask why these incentives were created; were they intentional, or an unintended consequence of policies with other goals? By reviewing the historical development of the U.S. system, we will argue that they very much were intentional - a primary goal was to move older workers out of the labor force. Finally, we discuss the future of retirement, and suggest that the current incentives, even if they made sense in the past, may be inappropriate for the labor markets of tomorrow.

Postwar Retirement Trends

1. United States

Labor Force Participation. A remarkable demographic development has occurred in the U.S. and in other developed nations during the last several decades. Older workers, especially men, have been leaving career jobs and often the labor force as well at younger and younger ages. In 1950, for example, nearly half of all American men aged 65 and over were in the labor force; today, fewer than 1 in 6 are.

The early retirement trend can be seen in detail in **figure 1**, which shows labor force participation rates (that is, the proportion of the population either working or actively looking for work) for 5-year cohorts of older American men over the past three decades. The long-term pattern is clear. The percentage declines since 1964 are about 30, 40 and nearly 50 percent for men aged 60-64, 65-69 and 70+ respectively. For the younger two groups, men aged 50-54 and 55-59, the declines are unmistakable though less dramatic - decreases of 7 and 14 percent.

Figure 1 also suggests that these long term trends may have come to a halt. For all the male cohorts shown, participation rates have changed very little since the mid-1980s. There are several possible reasons for this. During the second half of the 1980s, the American economy was recovering from a severe recession; the nation's unemployment rate declined from almost 10 percent in 1982 to near 5 percent in 1989, and has remained in the 5-7 percent range since then. Workers, including older workers have seen improved job opportunities. Second, people are living longer and are often healthier at any given age. Finally, work disincentives built into our public and private pensions systems may be declining, a point which is the focus of discussion below.

For women (**figure 2**), the trends are very different because two offsetting phenomena are at work. People are retiring earlier, but women, especially married women, are more likely to work than before. For the oldest two female cohorts (aged 65 and older), the resultant trends are flat; for the younger two groups, the latter trend dominates, and participation rates are on the rise. For the middle group, women 60-64, the long term trend is flat, but there has been a noticeable rise during the past 5 years.

More detailed data for older men illustrate another interesting point. **Figure 3** shows participation rates since 1968 for men aged 60 through 65, by individual age. The long-run trend and its recent demise are seen again, as is the increasing importance of retirement at age 62, the earliest age of eligibility for Social Security retirement benefits. In 1968, the largest behavioral change (the largest gap at the left of figure 3) appeared between ages 64 and 65. Now, the biggest jump occurs between ages 61 and 62. A large gap at 65 still remains, but much of the labor force withdrawal has already occurred by then. Single age data for women are similar - the behavioral change at age 62 is slightly larger than at 65.

<u>Part-time Employment</u>. Not only do Americans retire earlier than they used to, but those who do keep working often work part-time. As seen in **figure 4**, the prevalence of part-time work rises dramatically with age. Although fewer than 7 percent of men aged 25-59 in the nonagricultural sector work fewer than 35 hours per week, 16 percent of those aged 60-64, 42 percent of those 65-69 and well over half of the men aged 70 and over do. There is a noticeable increase between those aged 60 and 61 (12% part-time) and those 62-64 and therefore eligible for Social Security retirement benefits (21% part-time).

For women, part-time work is more prevalent at all ages - about 20 percent of employed women aged 25-59 work part-time. But a third of women aged 60-64, 57 percent of those aged 65-69 and two thirds of the women aged 70 and over work part-time. The increase at age 62 is even more pronounced - the proportion part-time jumps from 28 percent at ages 60 and 61 to over 40 percent among those 62-64. The vast majority of the older Americans who work part-time say they are doing so voluntarily.

Over the past 2 decades, the importance of part-time work in America has increased slightly. Among older workers, however, the increases in the proportion working part-time have been significant, from 38 (in 1970) to 48 percent for men aged 65 and over and from 50 to 60 percent for women this age. In this sense, the long term early retirement trends may be continuing still, not through labor force departure, but rather through the reduced hours of those still employed.

The Retirement Transition in America. Considerable recent research has focused on the nature of the retirement transition in America. Using the Social Security Administration's Retirement History Study (RHS), which followed a sample of over 11,000 older Americans from 1969 until 1979, researchers have shown that a substantial number of older Americans did not follow the stereotypical retirement route even back in the 1970s; that is, they did not leave the labor force completely when they left full-time status on their career jobs (see Quinn et al. 1990, chapters 5 and 6). Gradual or partial retirement is an important phenomenon in America. Among wage and salary workers, for example, more than a quarter did not retire completely in one move. A few them dropped to part-time status on their career jobs, but most found new jobs. Among the self-employed, who have more control over the amount and kind of work they do, only half went directly from full-time career work to complete retirement. Of those who kept working, half moved to part-time hours on the same job, and the other half found a new job.

Most of those who changed jobs moved to a new occupation and industry, and the majority moved down the socioeconomic ladder - from skilled to unskilled and from white collar to blue collar. There was some weak evidence that those at the ends of the economic spectrum - the rich and the poor - were the most likely to stay in the labor force after leaving their full-time career jobs. One reasonable hypothesis is that the poor do so because they have to, lacking pension coverage and personal savings, and often eligible for only modest Social Security benefits, while the rich do so because they want to, enjoying interesting jobs with important non-pecuniary benefits (ibid.).

Christopher Ruhm (1995) has updated our knowledge of the retirement transition using data from a recent Harris poll of older Americans. Comparing men aged 58-63 in 1969 (from the RHS) with men the same age in 1989 (from the Harris survey), he found that employment rates at each age had dropped over these 2 decades. This is consistent with the aggregate data discussed above. He also confirmed that there are now much larger labor force participation declines at ages 60 and 62 than there used to be. In 1969, the employment rate dropped by only 2 percentage points between ages 59 and 60, and by 5 points between ages 61 and 62. In 1989, however, the analogous declines were 13 and 18 points. These abrupt changes at these particular ages suggest that pension and Social Security eligibility are influential retirement determinants; 60 is a popular age for employer pension eligibility, and age 62 is the earliest that one can claim Social Security retirement benefits.

Ruhm also found that partial or gradual retirement is widespread. Between 30 and 40 percent (depending on age) of those aged 58-63 and employed in 1989 were working on a post-career "bridge" job, and these proportions were higher than they were in 1969.

Research has shown that retirement routes in America are many and varied. The stereotypical transition - directly from full-time work to full-time leisure - is only part of the story. Many Americans keep working after they leave their career jobs. This transition often involves part-time employment, usually on a new job and in a new line of work. One explanation for this phenomenon is that Social Security and pension incentives encourage it.

As we will see below, America is aging. Retirement issues will become more and more important over time, especially as the baby-boomers approach retirement age. When and how older Americans decide to leave the labor force will have profound effects on future labor markets and on our massive Social Security system.

2. Other Developed Nations

Labor Force Participation. The United States is not alone. The trend toward early retirement has occurred in all industrialized nations, although the magnitude and timing of the declines has differed from country to country.

The Organisation for Economic Co-operation and Development (the OECD) recently completed a major study of retirement in the developed world. Researchers calculated the proportion of men and women aged 55 and over who were working, from the late 1960s through 1990. In the United States, for example, this "employment rate" for men dropped from 53 to 37 percent - a decline of nearly a third (OECD, 1992, table 5.2). The male decline was near 40 percent in Australia, (West) Germany, Ireland, Italy, Spain and the United Kingdom, and near or over 50 percent in Finland, France and the Netherlands. In Canada and Japan, where the declines were only about 15 percent, the same phenomenon occurred, though in more modest proportions.

The evidence is more mixed for women aged 55 and over. In Canada and Sweden, female employment rates increased by 20 percent (ibid., table 5.3). They changed little in Australia, Italy, Japan and the United States. In the other countries, they declined noticeably, although almost always by less than they did for men in the same country.

In summary, employment among men aged 55 and over in the industrialized world has declined significantly in a relatively short period of time. Among even older men, those 65 and over, work is now the rare exception, not the rule. In Japan, the one outlier here, more than a third of these older men still work. In Sweden and the U.S., about 1 in 6 do (in the U.S., nearly half did in 1950). But in most industrialized countries, fewer than 10 percent of men aged 65 and over are working, and in many, such as France, Germany and the Netherlands, it is closer to 5 percent.

Why Do Americans Retire When They Do?

Decisions about when and how to retire are complex. Many factors are important, including individuals' physical and mental health, attitudes toward work and leisure, job opportunities and characteristics, and finances. Researchers have investigated the importance of these and other factors in two ways, by direct inquiry (asking people why they retired when they did), and by using complex behavioral models to predict statistically who retires and who does not. Health factors tend to be prominent when people are asked directly, although some researchers fear that the importance of health may be overstated here, since some respondents may use it as a socially acceptable reason for retirement. In the more complicated behavioral work, the role of financial incentives plays the dominant role.

Here we concentrate on these financial factors, particularly on the impact of Social Security and employer pensions on individual retirement decisions. These retirement programs have two types of economic effects. They sometimes increase the wealth of individuals, by paying out benefits that exceed the value of the contributions made. If wealthier people tend to retire earlier, because they can afford to, then this windfall gain would encourage the early retirement we have seen. In addition, however, Social Security and pensions can alter a worker's compensation in subtle ways. As we will see, they can impose surreptitious pay cuts on older workers. If compensation influences work decisions, then this is likely to affect when people choose to retire.

1. Social Security Wealth

The simplest economic explanation for the post-war early retirement trend is that we have grown wealthier over time. Therefore, we can afford to start work later, work fewer hours per year, and retire earlier than we once did. Recent cohorts of retirees have enjoyed a generally robust economy and dramatic increases in the value of their real estate holdings. In addition, their wealth has been further augmented by the Social Security system, because the benefits they are receiving, in aggregate, vastly exceeded a fair return on the contributions made by them and their employers (Burkhauser and Warlick, 1981; Moffitt, 1984; U.S. House, 1991, App. H; Steuerle and Bakija, 1994, Ch. 5). Up to now, Social Security has been a very successful "chain letter", with a large number of workers generously supporting a relatively small number of recipients.

Although common sense suggests that there should be a link between wealth gains and earlier retirement, it is difficult to prove empirically. It is true that the largest declines in the labor force participation rates of American men aged 60 to 64 occurred after the age of earliest Social Security eligibility was reduced from age 65 to age 62 (in 1961), and after very large increases in real benefits were legislated (1969-1972). Some researchers (e.g. Hurd and Boskin, 1984) have attributed most of the decline in elderly labor force participation to increased Social Security generosity. On the other hand, aggregate Social Security wealth rose dramatically in the 1950s, when coverage was increased significantly, and there was no dramatic early retirement trend then (Moffitt, 1984). Recent research suggests that the Social Security wealth impact, though important, has been modest. Jerry Hausman and David Wise (1985) and Richard Ippolito (1990) estimate that Social Security may account for about one-third of the participation decrease over time.

2. Retirement Incentives

But Social Security is very important in another way. It alters the pattern of compensation with age, and eventually results in pay cuts for older workers. Many employer pension plans do the same thing, and the combined effect can be substantial.

Both Social Security and employer pensions promise a stream of benefits once certain age, service and/or retirement conditions are met. Social Security retirement recipients must be at least 62 years old, have 40 quarters of covered employment and earn less than a certain amount.

Pension rules are many and varied, but most plans require departure from the firm (and sometimes from the industry) before benefits are paid.

What is the economic value of one's retirement income rights? Since they promise a stream of future income, with dollars coming at different times, they are best summarized by the present discounted value of the expected benefits. This is nothing more than the stock of wealth today which, if invested, could provide the promised benefit stream. For example, with a 5 percent annual interest rate, $100,000 in wealth can provide an income flow of $5,000 per year, forever. Even less could provide $5,000 for a limited expected life span, because the capital can be dispersed too. Any stream of future incomes can be described by its present discounted value (its asset or wealth equivalent) today. A major advantage of this is that alternative streams, with different amounts coming at different times, are easy to compare once they are summarized in today's dollars - the bigger pile is worth more.

When one delays receipt of retirement benefits by staying on the job after the age of eligibility, two things happen. The bad news is that the worker foregoes current pension income; the good news is that, given Social Security and most pension rules, future annual benefits will be higher because of the delay in receipt. The choice is not between claiming a pension and not claiming one. Rather, it is between two different pension streams - one starting sooner, with smaller annual amounts, and another beginning later (say, after another year of work) but with higher benefits per year. Which stream is worth more? It depends on whether the future increments (the <u>increases</u> in future benefits caused by the additional year of work) are enough to compensate for the year of pension benefits foregone. If they just compensate, then the present discounted values are the same, and the pension is called actuarially fair. From a pension perspective, it does not matter whether the benefits are first claimed now or a year from now, since the total values over the expected lifetime are the same. If the future increments exceed the benefits foregone, then one gains twice by working another year, through the paycheck and through the increase in pension or Social Security wealth (called pension accrual). But if the future increments are worth less than the benefits initially foregone, then pension accrual is negative (the present discounted value declines) and one loses expected lifetime retirement income by continuing to work. In this case, one's true compensation for the year of work is less than it appears to be; it is less than the paycheck by the amount of the wealth loss incurred.

Considerable research has shown that this last scenario describes many American retirement plans. At some age, workers who stay on the job begin to lose retirement wealth and thereby suffer a subtle pay cut. For Social Security, this occurs at age 65, when the delayed retirement credit (the percentage increase in future checks for each year's delay of benefit receipt) falls from about 7 percent to only 4 percent, which is less than actuarially fair. One would have to live at least 25 years to recoup the benefits foregone. It is more difficult to generalize about pensions, since they are so many and varied, but research suggests that the lifetime value of defined-benefit pension streams (those pensions whose rules promise a specific benefit at retirement) often peak at the earliest age of eligibility. After that, pension wealth often declines for those who stay on the job, encouraging workers to leave the firm and claim benefits before that happens.

Lawrence Kotlikoff and David Wise (1987) studied the accrual patterns of over 1,000 defined-benefit private pension plans, and found that "...for a large proportion of the plans, the accrual rate after (the age of early retirement) is very negative. It would not be unusual for the reductions in pension benefit accrual after the age of early retirement to be equivalent to a 30% reduction in wage earnings." More recently, Olivia Mitchell (1992) reports that in 1989, two thirds of those workers whose benefits were reduced for early retirement faced reduction factors that were less than actuarially fair, encouraging workers to claim them as soon as they were eligible. Viewed from the other end, the rewards for working beyond early retirement age (which is the same as the annual penalty for retiring early) were insufficient to compensate for the benefits foregone. Retirement incentives and work disincentives are two sides of the same coin.

The Social Security earning restrictions (at age 65) apply to any earnings; the pension regulations (at various ages) nearly always apply just to earnings on that particular job. This may help explain the phenomenon of "bridge jobs" between career work and complete labor force withdrawal. When a pension penalizes continuation on one job (say, at age 60), a reasonable strategy is to leave that job and claim the pension at the optimal time (before the wealth declines), then work for several more years, often part-time, on a new job. Many Americans do just this, and, given Social Security changes underway (see below), there is reason to believe that this phenomenon may be even more important in the future.

Financial incentives imbedded in pension programs, then, can penalize workers who stay on the job too long. We are not arguing that workers must pay to work (that is, that their net compensation is negative), but only that their net pay is less than it used to be, because the paycheck is partially offset by pension and/or Social Security wealth losses. Empirical evidence suggests that workers behave as though they understand these incentives (see Quinn, et al., 1990, chapter 3). The larger the potential wealth losses from continued employment, the more likely workers are to leave their career jobs and often the labor force as well.

This can be seen in simple frequency distributions for retirement ages, which show big spikes at ages 62 and 65, important ages for Social Security and many employer pensions (see Figure 3, above; Hurd 1990; Leonesio 1990), and in distributions of the actual earnings of those receiving Social Security benefits, which tend to cluster just below the amounts at which benefits start being reduced (Burtless and Moffitt, 1984; Leonesio, 1991). It also shows up in a great deal of sophisticated econometric work in which measures of these incentives consistently show up as statistically significant determinants of the timing of individual retirement decisions.

3. Mandatory Retirement

Mandatory retirement once covered nearly half of American workers, and many chose to retire at that age, usually 65. Federal legislation first delayed the earliest allowable age of mandatory retirement from 65 to 70 (in 1978), and then eliminated it altogether for most American workers (in 1986), primarily on age equity grounds. Because of the popularity of retirement at age 65 when it was the most common mandatory retirement age, many thought that this legislation would induce a significant change in retirement behavior. This did not happen, and the financial incentives described above are a primary reason why. Mandatory retirement without pension coverage was rare, and the pension (and Social Security) financial incentives tended to go into effect at the same age as mandatory retirement. The carrots and the stick all worked together to induce the desired behavior - departure from the career job at a specific age. The stick was then outlawed, but the carrots remained, and continued to do the job. Research suggests that at least half of what looked like a mandatory retirement effect was in fact due to the simultaneous financial incentives (Burkhauser and Quinn, 1983).

4. Is Retirement Voluntary Or Involuntary?

Workers today appear to have much more choice about when to retire than they once did. Older Americans today are richer than prior cohorts, more are eligible for pensions, and mandatory retirement is no longer a factor.

In questionnaires in the 1940s and 1950s, nearly all retirees said that they had retired because of poor health, a layoff or a mandatory retirement age (Quinn, 1991). Very few claimed to have retired voluntarily, in good health and with a job opportunity at hand. By the 1960s and early 1970s, 20 to 30 percent said they retired because they wanted to, and the proportion who did was correlated with the size of their potential retirement benefits. By the early 1980s, more new Social Security beneficiaries appeared to be retiring voluntarily than involuntarily. In 1982 , a third said that they wanted to retire, compared to a quarter who named health as the primary reason. The proportion voluntary rose with age (up to 65), and was much higher for those eligible for a pension.

An understanding of the financial incentives and other factors that many older workers face, however, blurs the distinction between voluntary and involuntary. Many Americans confront increasingly unattractive labor market options as they age. As we have seen, for many, net compensation on career jobs eventually declines as Social Security and/or employer pension wealth diminishes with additional work. In addition, continued employment on the career job may not be guaranteed, not because of mandatory retirement, but because of the threat of corporate downsizing and layoffs. Work on a new job, if available, usually pays much less than the career employment did. Faced with these options and uncertainties, many workers leave their career employers when their pension plans suggest they do, and many then leave the labor force as well. Is this voluntary? Yes, in that they chose to accept the pension and leave the firm, given the terms, conditions and likelihood of continued employment that they faced. But no, in that more preferable options (continued employment at prior rates of compensation) may have disappeared as they aged.

Why Do These Retirement Incentives Exist?

Research indicates that Social Security and many employer pensions discourage work at some point, and that these financial incentives do influence retirement behavior. While public officials and private employers have had many objectives in establishing these programs, one goal has been to encourage older workers to leave the labor force. The labor supply effects have been intentional.

1. The Pre-Social Security Era

Prior the Social Security Act of 1935, few workers were covered by pensions. As a result, more than 60 percent of men over age 65 were employed in 1930, and many more moved in and out of the labor force. Only the "wealthiest, the sickest, or the few guaranteed income" retired permanently (Haber and Gratton, 1994: 105).

Although private pension coverage had increased during the 1920s, being covered by a pension plan was no guarantee that a worker would receive a pension, for most plans included disclaimers stating that workers had no pension rights (Quadagno, 1988). Even employers who intended to meet their pension obligations found that the aging of the labor force and the increase in average wages, which determined pension benefits, seriously depleted company pension funds. Further, the financial success of the companies underwriting these plans fluctuated with the state of the economy (Schulz and Myles, 1990). As early as 1929, many firms abandoned their pensions as too costly. The Great Depression further drained the trust funds established to pay pensions, and the rise in bankruptcies eliminated pensions for thousands of workers (Latimer, 1929).

Before 1935, then, pensions did little to discourage labor force participation among older workers. Few workers were covered by private pensions, and many of those who were covered never received benefits. Even fewer received pensions from state pension programs, which were meagerly funded and granted only to the most destitute.

2. The Social Security Act of 1935

In 1934 President Roosevelt appointed a Committee on Economic Security (CES) to prepare an economic security bill covering both old age and unemployment (Kingson and Berkowitz, 1993). In planning an old age insurance program, the CES members chronicled the unfavorable position of older workers. Because mechanization favored younger workers, they noted, it had become increasingly difficult for workers over age 45 to maintain their skills and stay employed. Especially in heavy manufacturing industries, older workers were often unable to keep pace with the demands of machines. Not only were older workers at greater risk of becoming unemployed than younger workers, but their spells of unemployment were longer. The Depression only exacerbated their problems (CES, 1937).

The CES relied on three arguments to justify the intrusion of the federal government into the labor market. First, after long years of productive labor, workers had earned the right to rest. Second, advanced age made older workers incapable of performing productive labor. Third, an older man who continued working prevented "a younger man from filling his place and gaining occupational skill, experience and promotion" (CES, 1937: 137). As Senator Robert Wagner explained during the debates prior to the Social Security Act, "The incentive to the retirement of superannuated workers will improve efficiency standards, will make a new place for the strong and eager, and will increase the productivity of the young by removing from their shoulders the uneven burden of caring for the old" (Graebner, 1980: 185). Thus, justification for a national program of old age insurance was based on the ideas that older workers should be able to retire with some base of economic security and that encouraging retirement would enhance employment opportunities for younger workers.

In 1935 Congress passed the Social Security Act. It included a program of Old Age Insurance (OAI) for workers in certain industries, funded by a payroll tax on both employers and employees, Unemployment Insurance, Old Age Assistance for the aged poor, and Aid to Dependent Children for single and widowed mothers. Workers retiring under OAI were subject to a very strict "earnings test": a person lost all Social Security benefits during any month he or she earned $15 or more (a 100% benefit reduction rate after the exempt amount). The purpose of this earnings test was to encourage retirement and open the job market for younger workers. As one CES member explained, "the interest of Mr. Roosevelt was with the younger man.... That's why that little ridiculous amount of $15 was put in...Let him earn some pin money but it had to be on retirement" (Graebner, 1980: 186).

3. Expanding Social Security Coverage

Initially, old age insurance benefits were so low and coverage was so limited that few workers could retire. Gradually, however, Congress improved benefits and added new categories of workers, increasing the inducements to retirement.

Congress first amended the Social Security Act in 1939, adding benefits for spouses, widows and dependent children. Then, during the 1950s, average benefits were increased by 80 percent and compulsory coverage was extended to new categories of workers, including farmers, most self-employed and others outside the industrial or commercial labor force. The extended coverage meant that more workers would be eligible for Social Security, and as more covered workers reached 65, more were drawn out of the labor force.

In 1956 a program providing a disability pension at age 50 was added. Disability was defined as the "inability to engage in substantial gainful employment with a condition expected to last at least 12 months" (Nash, Pugach and Tomasson, 1988: 16). Disability insurance initially did little to encourage retirement, however, because the rigid eligibility rules made it difficult for disabled people to qualify for benefits. This is less true today. Recent literature suggests that the decision to apply for disability benefits is just not a function of health conditions, but is influenced by the generosity of benefits and the ease of access (Quinn and Burkhauser, 1994). Some older workers with health conditions can work, if they have to, but would prefer to be on disability benefits. In such cases, the existence of disability programs can discourage work, and may have contributed to the dramatic declines in older labor force participation rates.

Amendments to the Social Security Act in 1956 allowed women to retire at age 62 with reduced benefits (80% of the age 65 "full" benefits). In 1961, in the midst of a recession, this early retirement option was extended to men. According to a proposal from the Kennedy administration, the early retirement provision "would help primarily that group of men who because of ill health, technological unemployment, or other reasons find it impossible to continue working until they reach 65." As Congressman Charles Vanik stated, "If two million male workers eventually retire under this program, two million job opportunities will be created, and unemployment will be reduced" (quoted in Kingson and Berkowitz, 1993: 48). Others viewed this proposal as a means of reducing high unemployment by redefining some of it as early retirement.

Beginning in 1968, real Social Security benefits were increased in four of the next five years, with the 1972 increase building in regular cost-of-living adjustments (Derthick, 1978; Myles, 1988). From 1975 to 1979, benefits were erroneously indexed to both wages and prices, resulting in a "double" upward adjustment of benefits, a mistake that was later corrected. In total, these policy changes, coupled with general increases in the level of earnings on which benefits were calculated, led to a 51 percent increase in real average Social Security benefits during the 1968-1977 period (Hurd, 1990).

Until 1983, the Social Security system expanded in ways that encouraged retirement at age 65 and early retirement at 62. Then the direction of incentives began to shift. In 1983, in response to improvements in longevity and rising costs, Congress legislated an increase in the normal retirement age from 65 to 67 (to be phased in very gradually in the next century) and an increase in the penalty for early retirement at 62 (eventually, from 20 to 30% of the "full" amount). The amendments also increased the delayed retirement credit for those who first claim benefits after age 65. These measures will gradually reduce the Social Security work disincentives, by increasing both the penalty for early retirement and the reward for delayed retirement. In addition, the earnings test has been continually liberalized. In 1995, the earnings test reduces Social Security benefits by 50 cents for every dollar earned over $8,8,160 for recipients aged 62-64, and 33 cents for every dollar earned above $11,280 for those aged 65-69. These exempt amounts are indexed annually. At age 70, the earnings test no longer applies.

An interesting question is whether the liberalized Social Security earnings test, the elimination of mandatory retirement and the increases in early retirement penalties and delayed retirement rewards are sufficient to counter the long term retirement trend noted above. Simulations based primarily on the retirement behavior of older workers in the 1970s (those in the Retirement History Study) suggest that these changes will tend to delay retirement, as expected, but that the magnitudes of the delay will tend to be modest, on the order of months, not years (Quinn, et al., 1990). One reason is that early retirement is also encouraged by the incentives in private pensions, and these are not directly affected by the Social Security changes discussed above. On the other hand, aggregate data suggest that the long term early retirement trend among men has tapered off and perhaps has ended, and these policy changes may be partially responsible.

4. Early Retirement and Private Pensions

Social Security was never designed to stand alone as an income source for retired workers. Rather, it is supposed to serve as a first tier, to be supplemented by employer pension benefits and private savings. As Social Security developed, it became integrated in complex ways with the merging private pension system.

During the Depression, most employers opposed the idea of a national old age pension. To encourage business support for the Social Security Act of 1935, employers were allowed to deduct their OAI contributions as a nontaxable business expense and to reduce their pension costs by integrating Social Security benefits with existing firm plans (Jacoby, 1993). Instead of increasing the total income of pensioners by adding Social Security to their benefits package, however, many companies reduced the firm's contribution to the total retirement benefit (Dyer, 1977). For workers with private pension coverage, Social Security was one part of a benefit package. Because few workers were covered by private pension agreements, most had only Social Security for retirement income.

The connection between Social Security and private pensions was strengthened in 1948 when the National Labor Relations Board ruled that pensions were a negotiable item in collective bargaining agreements.

Immediately, the large industrial unions began demanding private pensions as part of the wage package. In 1949 the Ford Motor Company agreed to provide company-financed pension of $100 a month to retired workers at age 65 with 30 years of service. The $100 was only partly financed by the auto company, since the pension was integrated with Social Security. This program set a pattern for the industry, and soon all Big Three auto companies had similar pensions for their workers (Quadagno, 1988). The concept spread to other industries and by the late 1950s over half of all unionized employees were covered by integrated pension plans. These private pensions provided a significant income supplement for workers, increased their retirement income benefits and facilitated their departure from the labor force.

Shortly after early retirement benefits were added to Social Security, the private sector followed suit. In 1964 the first early retirement provisions appeared in the auto industry, allowing auto workers to retire with reduced benefits at age 60 if they had at least 10 years of service and at age 55 with at least 30 years of service. The key to early retirement provisions was the availability of "supplemental" benefits, an additional benefit paid until the worker was eligible for Social Security at age 62. To qualify for the supplemental benefit, the worker had to agree to limit earnings in retirement. The early retirement program outlined in the UAW contract was therefore aimed not only at early retirement from the auto industry itself, but early retirement from the labor force as well (Barfield and Morgan, 1969: 166). Early retirement benefits stabilized retirement income by providing workers who retired <u>before</u> 62 with income equal to what they would receive once they reached the Social Security eligibility age (Schulz, 1991).

While national data on the availability of early retirement plans are difficult to obtain, a 1984 survey of executives of 363 companies found that nearly two-thirds had early retirement provisions, either with unreduced pension benefits, usually at age 62, for employees who met age and service requirements, or reductions that were less than actuarially fair, often at age 55 (Quinn and Burkhauser, 1990: 314).

During the 1973-74 and 1981-82 recessions and periodically since then, many companies have added "sweeteners" to the usual early retirement benefits. These early retirement incentive programs (ERIPs) extend retirement opportunities to otherwise ineligible workers to increase the rate of retirement when a company needs to downsize its work force. For example, when oil prices were declining in 1986, Exxon Corporation offered immediate retirement to its employees aged 50 and over who had more than 15 years of service. The offer was open for about a month, and granted credit for an extra three years of service in calculating retirement benefits (Meier, 1986). Because these benefits are available for a short defined "window" of time and restricted to a portion of the firm's labor force, the cost to the employer is limited (Meier, 1986). Sweeteners, like supplemental early retirement benefits, have encouraged the trend toward early retirement.

5. International Patterns

In other developed countries as well, early retirement has been encouraged through a variety of government programs, including social security, unemployment and disability insurance. Much of the stimulus to encourage early retirement has been driven by efforts to alleviate high unemployment during the post-OPEC period of slow economic growth (Guillemard, 1991a).

France represents an extreme example of the international trend toward early retirement. The decline in labor force participation among those aged 55 to 64 has occurred mainly since 1970, largely the result of changes in the French pension system and the expansion of unemployment benefits.

Unlike the American Social Security system, the French public pension system was designed to keep older workers in the labor force to offset the labor shortages following World War II. The legal age for full retirement benefits was 65, although a worker could retire at age 60 with a half pension. Those who continued working past 65 received a pension increment of five percent a year. Later, as the labor shortages disappeared and unemployment rose, the age of eligibility for full pensions was reduced from 65 to 60. However, there remained a large pool of unemployed workers aged 55 to 59. The decline in their participation rate was facilitated by the unemployment program.

In 1972 France established a guaranteed income plan that provided compensation for workers over age 60 who had been dismissed from their jobs. The regular program of unemployment benefits covered workers until they reached age 60. Since the unemployment benefits exceeded those provided by the national pension program, they encouraged retirement (Guillemard, 1991b). During the late 1970s a dramatic increase in unemployment further reduced job opportunities for older men. By the 1980s an unemployment program that was originally designed to compensate wage earners for short periods of joblessness had assumed responsibility for covering jobless aging workers for as long as five years or more. It became a <u>de facto</u> old-age fund (Guillemard, 1991b: 139). Then in 1983 the unemployment compensation program was expanded to include workers who had resigned from their jobs. As a result, labor force participation among men aged 55 to 59 dropped from 83 percent in 1970 to only 67 percent by 1988 (Guillemard, 1991b).

In the Netherlands high unemployment during the 1970s and 1980s was managed by expanding disability programs. By 1985, 42 percent of those age 60 to 64 and 33 percent of those 55 to 59 participated in a disability scheme (DeVroom and Blomsa, 1991). A similar though less extreme use of disability pensions to facilitate early retirement for workers aged 55 to 59 has occurred in Germany (Jacobs, Kohli and Rein, 1991). Initially, disability was defined in strictly medical terms. Any individual who was capable of working even part-time was ineligible for a disability pension. Because part-time work was scarce for older workers, however, two court decisions in 1969 and 1976 allowed part-time workers to receive a full disability pension. These decisions encouraged early retirement among men and women 55 to 59, who are ineligible for other forms of support. In 1985, an important legislative change made it more difficult for older workers to retire through the disability system and coincidentally, participation rates among men and women began to increase.

Germany has also provided an opportunity for the long-term unemployed to retire. Any 60-year-old man with a work history of at least 15 years who has been unemployed for at least 52 weeks within the past year and a half is eligible for this benefit. This provision has no effect on women, however, because women are allowed to retire at age 60 anyway (Jacobs, Kohli and Rein, 1991).

In Great Britain, the main vehicle for encouraging early retirement was the Job Release Scheme (JRS). Implemented between 1977 and 1988, a period of increasing unemployment, the JRS allowed specific categories of older workers to retire early if the vacancy could be filled by an unemployed person (Laczko and Phillipson, 1991). Workers who were ineligible for the JRS had to rely on social assistance or unemployment benefits if they became unemployed before they became eligible for state pensions (age 65 for men and age 60 for women).

Unlike in Germany, labor market options are not considered when awarding a disability benefit in the U.K. The benefit is solely based on health, and a physician determines whether a worker is capable of working. Disability benefits are higher than those received by the unemployed and are paid until age 70, whereas unemployment benefits are only paid for one year. Not surprisingly, the growth of unemployment in Britain has been accompanied by an increase in older workers claiming disability benefits (Laczko and Phillipson, 1991).

Although rates of labor force participation among older workers vary across nations, most developed countries have used some form of welfare or social insurance program to encourage retirement. These include straightforward pension programs, as well as disability and unemployment benefits. Regardless of the specific programs and incentives employed, the general result has been a decline in labor force participation, even among workers younger than traditional retirement age.

Retirement in the Future

In this article, we have argued that government programs such as social security, disability and unemployment insurance, whose primary function is to cushion earnings losses following these events, can also influence labor supply decisions. Older workers respond to the financial incentives inherent in unemployment and retirement income programs, and the generosity of disability programs can induce some workers to stop work and apply for disability benefits. In addition, we have argued that these labor market effects are generally not unintended or unexpected consequences, but rather are usually intentional. It is not surprising that, in the depths of the Great Depression, U.S. policy makers hoped that the new programs being contemplated would remove some of the vast numbers of unemployed from the labor force. In more recent years, Europeans have been active in redesigning their programs' eligibility criteria and generosity in response to changes in unemployment. Workers respond to the incentives they face, and policy makers have used this fact to influence labor force participation decisions of specific groups.

In anticipation of the significant demographic changes ahead, societies must ask whether their current programs remain appropriate. In the U.S., because of rising Social Security costs and the potential of future labor market shortages, many think that post-war retirement trends should be reversed, and that older workers should be encouraged to stay in the labor force longer than they now do. Given increases in longevity, this could be done without decreasing the proportion of life spent in retirement.

A major impetus for these concerns is that the industrialized world is aging. For example, the number of Americans aged 65 and over will more than double during the next four decades, while the number aged 55 to 64 increases by two-thirds. This is the aging of the baby-boom generation. In stark contrast, the number of Americans under age 18 will decline slightly over the next 40 years, while the population under 55 increases by only 1 percent (U. S. Bureau of the Census, 1989, table F, middle series; U. S. Senate, 1990, Chap. 1). As a result, the percentage of Americans aged 65 and over will increase from under 13 percent today to about 22 percent by

2030 (U. S. Bureau of the Census, 1989, Table G). A third of all Americans will be 55 and older, and the median age will rise from 33 to 42.

The combination of fewer younger Americans entering the labor market and fewer older Americans staying in it could create labor shortages in the future. If this happens, one response is to encourage Americans to work longer, utilizing their labor market experience for a few more years. The same types of incentives that have induced older workers to leave in the past could be used to encourage them to stay in the future. Employers could structure wages, pensions and other forms of compensation and provide hours flexibility to induce older workers to stay on board. As we have seen, there are several changes already underway which move in this direction.

Mandatory retirement has virtually been eliminated, and Social Security work disincentives are being diminished. The exempt amount under the Social Security earnings test increases annually, and there is frequent discussion about eliminating it altogether. In addition, the age of normal retirement is scheduled to increase from age 65 to 66 by the year 2005 and eventually to 67 by 2022, and there is talk of speeding accelerating this transition. To receive any given retirement benefit from Social Security, one will have to work longer. This can also be viewed as a benefit decrease, which it is - at any given age, one will receive less than one would have previously. Finally, the delayed retirement credit, currently 4.5 percent per year of benefit delay after the age of normal retirement, will slowly increase to 8 percent by the year 2010. When it does, the average worker who continues to work beyond the normal retirement age will no longer lose Social Security wealth by doing so. The net result of all this is a lower benefit schedule and one that is closer to age-neutral. Compared to the present system, this will encourage workers to stay on the job longer than they do now.

Among employer pensions in the U.S., there is a trend away from defined benefit to defined contribution plans. The former, as explained above, frequently encourage early retirement by decreasing the pension wealth of those who stay on the job too long. Defined contribution plans, in contrast, are really just saving accounts with tax advantages. They contain none of the work disincentives mentioned above. This trend may also encourage longer work lives.

Some argue the these changes do not go far enough, and that we should contemplate further delays in the normal retirement age (for example, to age 68 or 70) or delays in the earliest age of Social Security eligibility, currently 62. The latter, we think, would have dramatic effects on retirement trends, since many Americans now retire at age 62 voluntarily, in good health and with good job opportunities, and could easily work longer. Of course, for some, with poor health, poor job prospects and little retirement income, this is not true, and a delay in the age of earliest eligibility would impose a serious hardship. An important question is whether this problem is best handled with the early retirement age for all workers, or with more targeted programs such as Disability Insurance or Supplementary Security Income.

In summary, recent research on retirement has made several things clear. Many public and private policies, here and abroad, discourage work by the elderly. Older workers seem to understand and respond to the incentives they face. In the past, these incentives have induced older workers out of career jobs and often out of the labor market as well. There is no reason why they cannot be equally successful at the reverse - encouraging workers to stay active in the labor market longer than they currently do. Given the demographic changes on the horizon, this may be just what we need.

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