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Efforts to reverse the trend toward early retirement among U.S. workers may be hampered by employees' preferences to retire before age 65 and employers' interests in adjusting the labor supply to meet their needs.

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Trends and Issues in Early Retirement

- The labor force participation rate for men aged 55–64 has fallen since 1970 from 83 percent to 67.2 percent in 1989 and from 43 percent to 45 percent of women aged 55–64.
- Nearly one-half of all male workers and nearly 60 percent of female workers begin receiving Social Security at age 62, the earliest age possible.
- In 1988 almost three-fifths of participants in defined benefit pension plans sponsored by medium-sized and large establishments could receive normal retirement benefits before age 65, although they often had to meet minimum service requirements.
- Less-than-full actuarial reductions and other subsidies in employer-sponsored pension plans may cause a peak in pension accruals and thus may encourage retirement at a particular age. One study examined characteristics of about 1,500 defined benefit pension plans and found that benefit accruals generally peaked at the age of early retirement eligibility.
- Employers may offer enhanced early retirement benefits to reduce their work force in lieu of layoffs. Such incentives may persist because both employers and employees may prefer earlier retirement. In one survey, nearly two-thirds of employers offering incentives found that more employees accepted the early retirement incentive plan than the employer anticipated.
- Fifty-seven percent of retirees aged 55–64 and 67 percent of nonretirees aged 55–64 had employer-based health insurance in 1987. Both retirees and nonretirees were about equally as likely to have coverage from some source.
- The Labor Department estimates that the labor force as a whole will grow more slowly, increasing 1.2 percent annually between 1988 and the year 2000, compared to an annual growth rate of 2.0 percent in the previous 12 years. Slower growth in labor supply may require older workers to remain employed longer.

◆ Introduction

Public policy interest in early retirement derives from concern about the ability of the U.S. economy to support larger numbers of retirees with the resources produced by a proportionately smaller number of workers. Public obligations to provide benefits to early retirees are limited because Social Security does not provide retirement benefits before age 62 and most other public programs are not available until age 65. Nevertheless, earlier retirement is an issue for public programs because it reduces the earnings base that supports Social Security and Medicare spending for older retirees.

A more productive work force could afford increased transfers to retirees while maintaining or improving living standards. But productivity growth has slowed since the early 1960s. Annual productivity growth in goods-producing industries fell from an average of 2.6 percent in 1960–1969 to 1.0 percent annually in 1970–1979. In 1980–1986, this downturn reversed, with productivity growing an average of 2.9 percent annually. However, productivity growth declined more rapidly in service-producing industries, from an annual average of 2.8 percent between 1960–1969 to 1.3 percent in 1970–1979 and to 0.9 percent in 1980–1986 (Davis, 1989).

Employer-sponsored pension and welfare benefit managers also must finance their obligations to retirees. Private employer pension plans are expected to be prefunded (that is, to have funds set aside to meet future obligations), but state and local government employer pensions are not. Both public and private employers also face substantial unfunded liabilities for retiree health benefits—an estimated $241 billion for private employees and $158.1 billion for public employees. Because Medicare pays for most of the medical care needs of retirees aged 65 or over, early retirees account for much of this unfunded liability.

Employers' retirement policies reflect their interest in adjusting their labor supply to meet current and future needs. Some employers—particularly those who are downsizing or facing new competition—have offered subsidies to encourage workers to accept early retirement rather than lay them off. However, there is concern that these early retirement incentive programs may reflect discrimination against older workers in addition to exacerbating the trend toward earlier retirement.

Empirical evidence reviewed in this *Issue Brief* indicates that most people retire because they have the means in personal assets and public and private benefits to support themselves without working. Data on the length of job search suggest that retirement age people may be less able than younger people to increase their earnings to meet unforeseen needs. They may then be more likely to depend on public programs or past employers to provide them with retirement benefits.

This *Issue Brief* examines why policymakers are concerned about the early retirement trend and reviews data on historical trends toward earlier retirement and retiring workers' resources. It also discusses employers' interests in providing early retirement options. Finally, it examines the implications of public policies to reverse early retirement trends and to respond to concerns about how early retirement affects retirees' welfare.

◆ Background Data and Analysis

Explaining Retirement

Although this *Issue Brief* refers to any retirement before age 65 as early retirement, the age of normal and early retirement varies among employee benefit programs. The Employee Retirement Income Security Act of 1974 (ERISA) requires private pension plans to set the normal retirement age—that is, retirement with full pension benefits—at no later than age 65. Many pension plans have reduced the age for normal retirement to less than age 65 and allow younger people to retire with a reduced benefit to reflect the longer period during which benefits are paid.

Because individual preferences vary, retirement ages will vary depending upon predicted future earnings, pension accruals, Social Security benefits, and preferences for leisure. A person might choose an optimal age of retirement by weighing the benefits of the income from continuing to work and increases in future income from accruing greater pension benefits against the costs of forgoing the increased leisure of retirement and the cost of forgoing future pension accruals. To be realistic, the decision should account for risks, including uncertain future income, inflation, and premature death. However, testing whether people account for these risks would be mathematically and empirically difficult (Fields and Mitchell, 1984).

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Group insurance through an employer is usually the most affordable source of health insurance coverage for early retirees and may be an important variable in the retirement decision.

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Better data on health insurance coverage might also help explain the retirement decision. Since Medicare, the federal health insurance for retirees, is not available to people under age 65 unless they are disabled,[1] employer-sponsored health insurance in retirement can be a significant source of income security for early retirees. Even though early retirees as a group are probably healthier than people aged 65 or over, the risk of medical need increases with age. Early retirees without health insurance may be vulnerable to costly medical expenses. Individually purchased health insurance can be expensive, may restrict coverage for certain services, and may be unavailable for people with preexisting medical conditions. Group insurance through an employer is usually the most affordable source of health insurance coverage for early retirees and may be an important variable in the retirement decision. However, no empirical literature is available to test this hypothesis.

Another theory explains the trend toward earlier retirement in terms of firms' resource needs. Increased productivity increases income, and people with greater income seek more leisure. Although workers might prefer to enjoy more leisure during their work lives, the characteristics of most firms' production processes cannot efficiently accommodate shorter work weeks or longer vacations. Since World War II, average weekly working hours have remained fairly constant. Demand for more leisure may be expressed in the form of shorter work lives, that is, earlier retirement (Ippolito, 1988). A variation of this theory suggests that people choose earlier retirement rather than greater leisure during working years to preserve their health in retirement (Wolfe, 1985).

An additional factor in earlier retirement could be that investments in job skills and technical training may depreciate more rapidly with the accelerating pace of innovation. At some point in their work lives older workers may find it unprofitable to continue reinvesting in their job skills because they have progressively shorter periods to earn a return on these investments. Thus it may be optimal for individuals to work more intensely early in their careers and to retire earlier. Furthermore, if predictions that future jobs will require greater training and technical skills hold true, future cohorts of older workers may face a greater incentive to retire at younger ages (Ippolito, 1988).

Demographic Changes

The changing demographic composition of the United States portends that future generations will bear increased costs from earlier retirement. Because people

[1]People under age 65 with end-stage renal disease (irreversible kidney failure) are also eligible for Medicare coverage, although they are not disabled in the strict sense used by the Social Security Administration to determine eligibility for most other disability benefits.

are living longer,[2] the elderly represent a growing proportion of the population. During the next 40 years, the ratio of children under age 18 and adults aged 65 or over to people of primary working age (ages 18–64) will decline gradually as the baby boom enters its prime working years and then increase as the baby boom enters retirement (chart 1).[3] Changes in births or mortality may modify the predicted dependency ratio, but dramatic shifts are unlikely.

[2]In 1987 life expectancy at birth reached 71.5 years for men and 78.4 years for women.

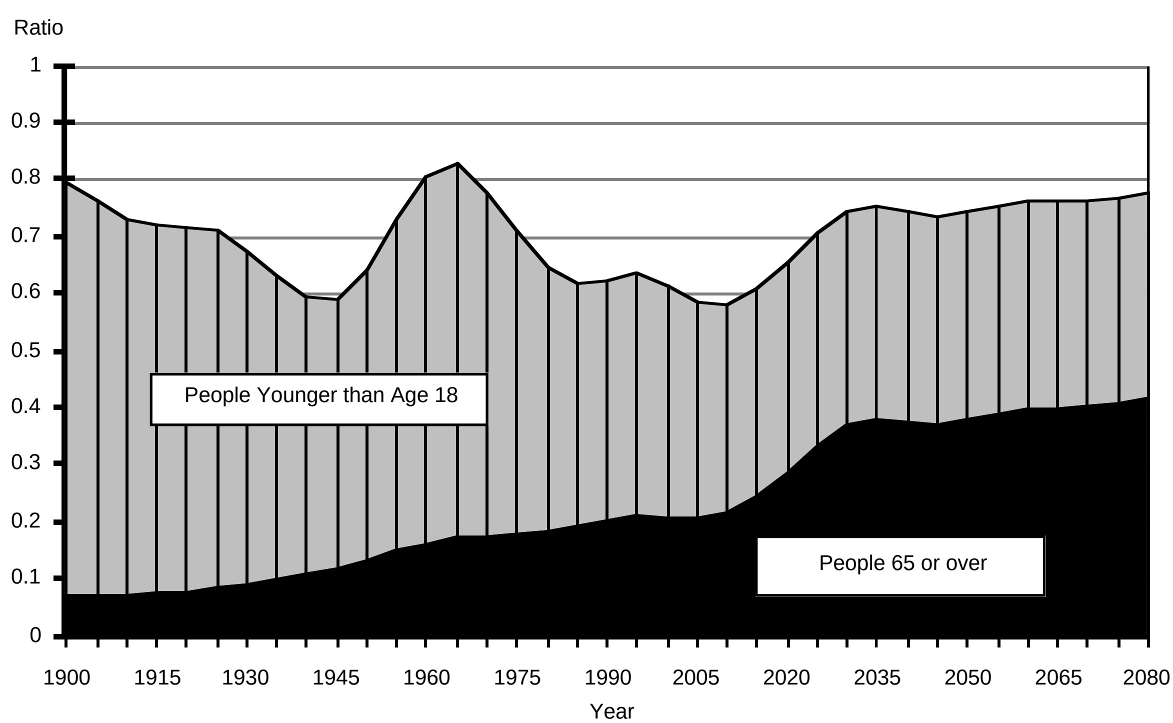
[3]Although referred to as a "dependency ratio" and suggesting potential future burdens, this ratio stylizes the extent of dependency across generations. It does not account for employment among those of "dependent" age; the lifetime accumulation of assets (including vested pension rights) which can support retirement; disability between 18 and 64 years of age; and early retirees (Friedland, 1990).

With earlier retirement, the burden of support implied by the dependency ratio increases. How much of a burden the retirement of the baby boom will be depends on future productivity growth and the relative cost of supporting elderly baby boomers, compared with supporting children. Although a more productive future economy could afford significant increases in the cost of supporting retirees (Crown, 1987), sustaining high levels of economic growth over the next 60 years is problematic. Public and private policymakers have begun to confront the likelihood that supporting increased numbers of retirees will require that the economy grow at a significant rate.

Moreover, the change in the composition of dependents from children to predominantly older people suggests that different support mechanisms may be

Chart 1

Ratio of People of Prime Working Age to People Not of Prime Working Age, by Age Group, 1900–2080



Source: Employee Benefit Research Institute chart based on U.S. Bureau of the Census data and projections.

needed. While members of the baby boom generation were supported as children by transfers of resources within families, in their retirement their support will largely come from their own resources and transfers from workers. The relative proportion of support that should come from each of these sources may be a subject of public policy debate in coming decades.

Measuring Retirement

Because individuals' definitions of retirement vary, data on who is retired, how many people retire each year, and how retirement behavior has changed over time are not definitive. Many people consider themselves to be retired after they have ceased working at the job in which they spent the preponderance of their career, even though they may continue working at part-time, seasonal, or other secondary employment. Nevertheless, several indirect measures show an increasing trend toward earlier retirement.

The labor force participation rate is one such measure. Because some people not participating in the labor force may never have participated, it would be incorrect to consider them retirees. Conversely, retirees who may be working part-time are included among labor force participants. However, declining labor force participation in a particular age group over time, particularly when labor force participation among younger groups remains relatively high, suggests that increasing numbers of nonparticipants are retirees. The labor force participation rate of men aged 55–64 has fallen substantially since 1970 from 83 percent to 67.2 percent in 1989 (table 1). By comparison, the labor force participation rate among men aged 45–54 declined from 94.3 percent to 91.1 percent over the same period.

Among women, the movement from unpaid household labor to the paid labor force appears to have outweighed incentives to begin retirement earlier. In 1970, 43 percent of women aged 55–64 worked for pay or were looking for such work; in 1989, the proportion was 45.0 percent. However, the increase in the number of working women aged 55–64 was not nearly as rapid as it was for women aged 45–54, whose labor force participation rate grew from just over one-half in 1970 to more than two-thirds in 1989.

Table 1
Labor Force Participation Rates of Older Americans, by Sex and Age, Selected Years, 1970–1989, and Projections for the Year 2000

	Men Aged:			Women Aged:		
Year	45–54	55–64	65 and older	45–54	55–64	65 and older
1970	94.3%	83.0%	26.8%	54.4%	43.0%	9.7%
1975	92.1	75.6	21.6	54.6	40.9	8.2
1980	91.2	72.1	19.0	59.9	41.3	8.1
1981	91.4	70.6	18.3	61.1	41.3	8.0
1982	91.2	70.2	17.8	61.6	41.8	7.9
1983	91.2	69.4	17.4	61.9	41.5	7.8
1984	91.2	68.5	16.3	62.9	41.7	7.5
1985	91.0	68.0	15.8	64.4	42.0	7.3
1986	90.1	67.3	16.0	65.9	42.3	7.4
1987	90.7	67.6	16.3	67.1	42.7	7.4
1988	90.9	67.0	16.5	69.0	43.5	7.9
1989	91.1	67.2	16.6	70.5	45.1	8.3
2000	90.5	68.1	14.7	76.5	49.0	7.6

Source: Data from 1970–1989 are U.S. Department of Labor tabulations of the Current Population Survey, as reported in *Employment and Earnings* (January 1990 and January 1989), and in U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States,* various years (Washington, DC: U.S. Government Printing Office). Projections for the year 2000 are from Howard N. Fullerton Jr., "New Labor Force Projections, Spanning 1988 to 2000," *Monthly Labor Review* (November 1989): 3–12.

The labor force as a whole is expected to grow more slowly, increasing 1.2 percent annually between 1988 and the year 2000, compared with an annual growth rate of 2.0 percent during the previous 12 years. This slower growth in labor supply may encourage employers to keep older workers employed longer. The U.S. Department of Labor predicts the declining labor force participation rate among men aged 55–64 will reverse itself slightly in the next few years and reach 68.1 percent by the year 2000 (Fullerton, 1989). The participation rate of women aged 55–64 is also expected to increase during the next decade, reaching 49.0 percent in the year 2000.

Another measure of retirement is the age at which people begin to draw benefits from Social Security. The average age for workers to begin receiving Social Security retirement benefits has declined almost continuously over the last 50 years (table 2). Since Social Security does not allow people to receive retirement benefits until age 62, the average age of Social Security eligibility does not by itself define retirement. Some people may retire earlier than age 62 and support themselves with savings, private pensions, and supplemental earnings until they become eligible for Social Security. Nevertheless, trends in Social Security recipiency also suggest earlier retirement. Most men and women now begin receiving Social Security benefits before the normal retirement age of 65. In fact, nearly one-half (48.2 percent) of all male workers and nearly 60 percent of female workers begin receiving benefits at age 62, the earliest age possible.

Health Status and the Decision to Retire

The relative importance of health status and economic factors in explaining early retirement is still controversial. Most researchers attribute the increased rate of early retirement to greater preferences for leisure and the increasing availability of Social Security and other pension income (Parnes, 1988). Lower mortality rates and increasing life expectancy suggest that retirees are becoming healthier. Nonetheless, reduced mortality rates may not improve individuals' willingness or ability to work. One hypothesis argues that more people are left disabled as medical advances save them from what once were fatal illnesses. Some researchers suggest that increasing disability leading to withdrawal from the labor force explains part of the trend toward earlier retirement.

While most cases of early retirement decisions appear to be voluntary, some may be motivated by health problems. Controlling for the effects of wages, pensions, Social Security, and other financial variables, health status explains about one-fourth of the variation in retirement age (Fields and Mitchell, 1984). Health status data, although flawed, show increasing health problems for the retirement age population.[4] Disability from chronic conditions among the population aged 45–64 increased from 1957 to 1981 (Verbrugge, 1984), and the proportion of working-age people (those aged 18–64) who are unable to work has increased 50 percent since 1957 (Chirikos, 1986). In 1981, 1 out of 7 men aged 55–61 said he was unable to work because of ill health, compared with 1 out of 11 in 1969. Among men aged 62–64, inability to work increased from 1 in 6 in 1969 to 1 in 4 in 1981 (Crimmins and Pramaggiore, 1988). Ycas (1987) found health status deteriorated among those aged 55–70 at the beginning of the period from 1969–1981 but improved during the latter part of that period. Other analysts acknowledge the growth of disability but contend that working ability among nondisabled older Americans is improving (Baily, 1987).

Changes in mental health over a worker's lifetime may also affect the decision to retire early. Data from the National Institute of Mental Health (NIMH) show that mental health variables better explained the decision to retire than did variables measuring economic or physical health (Mitchell and Anderson, 1989). This result

[4]Testing the hypothesis of deteriorating health among retirees is difficult because of a lack of data on objectively measured health conditions among people over time. The only survey that is nationally representative and is conducted regularly is the National Health Interview Survey (NHIS). It asks people to assess their own health, list their health conditions, and asks whether they are fit enough to work. As a result, data on population health may be affected by changes in peoples' attitudes toward illnesses and in their willingness to work, increased availability of disability pensions, changes in the macroeconomy that make workers prefer to declare disability rather than search for marginal jobs, and other factors. Furthermore, the NHIS survey questions have changed over time, and some analysts believe these changes have significantly distorted the apparent trends in measured health status. In addition, the NHIS interviews people residing in the community, and changes in the demand for nursing home and other institutional care may influence the prevalence of disabled people in the community.

Table 2
Average Age[a] for Retiring Workers to Initiate Social Security Benefits, by Sex, Selected Years, 1940–1988

	Age	
Year	Men	Women
1940	68.8	68.1
1945	69.6	73.3
1950	68.7	68.0
1955	68.4	67.8
1960	66.8	65.2
1965	65.8	66.2
1970	64.4	63.9
1975	64.0	63.7
1976	64.0	63.6
1977	64.0	63.6
1978	63.9	63.8
1979	64.0	63.6
1980	63.9	63.5
1981	63.8	63.6
1982	63.7	63.4
1983	63.7	63.4
1984	63.7	63.4
1985[b]	63.7	63.4
1986[b]	63.7	63.4
1987[b]	63.6	63.3
1988[b]	63.7	63.3

Source: U.S. Department of Health and Human Services, Social Security Administration, *Social Security Bulletin, Annual Statistical Supplement, 1989* (Washington, DC: U.S. Government Printing Office,1990).

[a]For 1940–1984, average age is based on retiree's age during the year that Social Security benefits began. For 1985–1988, retiree's age is based on age during the month that Social Security benefits began.

[b]Estimated average based on 1 percent sample of Social Security beneficiaries.

may be explained by the low quality of economic and physical health measures in the NIMH data; however, the study suggests that better data may confirm the influence of mental health on the retirement decision.

Sources of Retirement Income

Pensions and Social Security make up a rising proportion of retirees' income, enabling them to maintain their income relative to other age groups in spite of reduced earnings. Total income for households headed by people aged 55–64 and those aged 65 or over grew from 1968 to 1984 relative to income for households headed by people aged 35–44, but the earnings of these older groups relative to the younger group fell substantially. The share of total monetary income attributed to the 55–64-year-old group was about the same in 1984 as it was in 1968, but their share of total earnings fell almost 10 percent (Boskin et al., 1985). The decline in the proportion of earnings attributed to these age groups probably reflects falling labor force participation rates. By contrast, the share of Social Security income received by households in the group aged 55–64 increased substantially, averaging about 12 percent in the period from 1968 to 1972, reaching nearly 16 percent at its peak in 1978 and declining thereafter to from 14 percent to 15 percent (Boskin et al., 1985).

The Social Security Administration has found similar declines in the importance of earnings to people aged 55–64 (Grad, 1988; Grad and Foster, 1979). Between 1976 and 1986, the share of total income from earnings received by single individuals or married couples with one member aged 55–61 declined from 83 percent to 80 percent and for those aged 62–64 it fell from 67 percent to 61 percent.

In 1986, 23 percent of married couples with at least one member aged 55–61 received retirement benefits other than Social Security, 12 percent received benefits from private pensions or annuities, and 11 percent received benefits from public employee retirement systems. Among married couples with at least one member aged 62–64, 40 percent received retirement benefits other than Social Security, 26 percent received benefits from private pensions or annuities, and 17 percent received benefits from public employee retirement systems. For unmarried individuals aged 55–61, 17 percent received pension income, 11 percent received benefits from private pensions or annuities, and 7 percent received benefits from public employee pensions. Of single people aged 62–64, 27 percent received retirement benefits, 16 percent received benefits from private sources, and 11 percent received benefits from public sources (Grad, 1988).

Among people commencing Social Security retirement benefits in 1982, about one-fourth had stopped working before age $61\frac{1}{2}$. This group was less likely than groups who retired after age $61\frac{1}{2}$ to receive employer pensions, but lower pension recipiency among retired women explained most of this difference. Pension benefits for male Social Security beneficiaries declined with the age at which they stopped working. The median pension for men who retired before age $61\frac{1}{2}$ was about 40 percent higher than that of men who stopped working at age 63 or over, suggesting that those who expect larger pension benefits may choose to retire earlier. However, when both men and women are considered, people retiring before age $61\frac{1}{2}$ tended to have lower Social Security benefit levels, lower total incomes, and lower asset levels than those who retired later or continued to work (Packard and Reno, 1988).

◆ Retirement Programs

Social Security

Some analysts argue that the structure of Social Security benefits creates incentives for early retirement. The benefit received at retirement depends on age and earnings in the highest-paid years of work. At age 62, a covered worker can elect to receive 80 percent of the full retirement benefit available at age 65. For each month after age 62 that a worker postpones benefits, the 20 percent reduction decreases 0.56 percent (or $6\frac{2}{3}$ percent per year). If the worker delays receipt of Social Security benefits past age 65, the benefit is increased 3 percent each year the initial benefit is postponed up to age 70.

Most studies have concluded that this benefit structure creates insufficient incentive to continue working. Although benefits are increased if they are postponed past age 65, the credit for delayed retirement is less than actuarially fair; that is, the present value of total benefits received is reduced because of the shorter period over which they are likely to be collected (Fields and Mitchell, 1987). Most people would receive greater benefits from Social Security by retiring by age 65. Although some workers may choose to accumulate more credits for their highest-paid working years because the benefit formula is based on earnings from the years closest to retirement (Herz and Rones, 1989), this effect does not appear to be strong enough to outweigh incentives to cease work before age 65.

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Another disincentive to continue labor force participation is that beneficiaries younger than age 70 are subject to an earnings test. Beginning in 1990, Social Security benefits are reduced by one dollar for every three dollars of earnings exceeding an annual limit ($9,360 for beneficiaries aged 65 or over).[5] Retirees with substantial pension incomes, Social Security benefits, and savings may not have incentives to work anyway, and analysts believe that the earnings test by itself has a limited effect on work effort. But a relatively small group of retirees (about 2 percent of retirees aged 65–69) appear to limit their work effort to avoid losing Social Security benefits, and these people are most likely to increase their labor force participation as a result of a change in the earnings test (Leonesio, 1990).

The Social Security Amendments of 1983 will increase the normal retirement age incrementally from 65 to 67 by the year 2012, reduce the early retirement benefits payable at age 62 from 80 percent of the full retirement benefit to 70 percent, and increase the credit for delayed retirement by one-half of one percentage point every other year, or from 3 percent to 8 percent per year after the year 2007. Although these changes make the

[5] In previous years benefits for retirees aged 65–69 were reduced one dollar for every two of earnings that exceeded the annual limit. For retirees aged 62–64 benefits continue to be reduced by 50 percent for earnings exceeding an annual limit of $6,840 in 1990.

Social Security benefit formula actuarially more fair, analysts have estimated that they are of insufficient magnitude to have a major effect on retirement decisions (Fields and Mitchell, 1987).

Employer-Based Pensions

Employer-based pensions can facilitate workers' withdrawal from the labor force, including some workers who may not yet be eligible for Social Security benefits. Employer pensions fall into two categories: defined contribution and defined benefit plans. Defined contribution plans create different retirement incentives than defined benefit plans. From the perspective of the employee, the defined contribution plan is essentially a savings vehicle and provides no incentives to retire at any particular age. The defined contribution account allows a worker to accumulate assets that may be sufficient to support retirement at an early age, but the worker need not attain any particular age to use those assets in retirement.

Although defined contribution plans have no intrinsic retirement age, the differing tax treatment of benefits from defined contribution plans at different ages may influence the retirement decision. Defined contribution plans commonly distribute assets to their participants in the form of lump-sum distributions. Before age 59½ the recipient may be subject to a 10 percent penalty tax on the lump sum (in addition to regular income tax). Therefore, participants planning to take such distributions may face an incentive to delay retirement age until 59½. On the other hand, the defined contribution plan participant can avoid the penalty by rolling the distribution into a qualified annuity rather than receiving it as a lump sum.

In a defined contribution plan the employer makes a specified periodic contribution to the employee's pension account. Some plans accept employees' contributions. Investment gains or losses in the plan are credited to the employee's account; the employer bears no investment risk. In addition, defined contribution plans tend to have shorter vesting periods and service requirements than defined benefit plans.[6] Once vested, the value of the employee's pension assets is not contingent on how long he or she remains with the firm. As long as the employee actively participates in the plan, he or she can continue to accumulate assets.

Defined benefit plans promise a specified benefit on retirement, typically based on the employee's earnings and length of service, for the life of the employee or a surviving spouse. Because increases in the employee's salary with continued work can raise the amount of pension benefits attributable to past service, the value of pension benefits accrued each year increases as the worker approaches retirement, a phenomenon known as "backloading".[7]

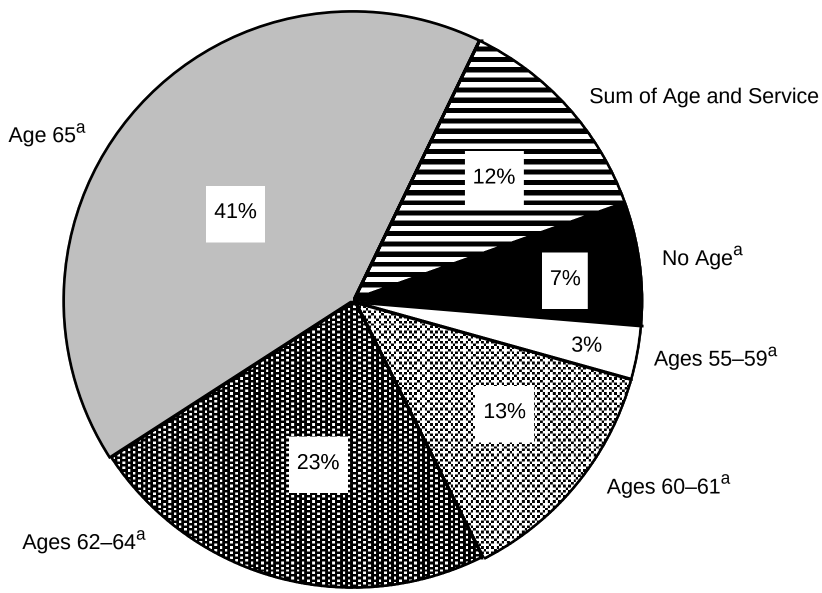
Typically, employer plans calculate early retirement benefits as a percentage of the accrued pension benefit that would have been paid at the normal retirement date. The pension benefit is actuarially reduced to reflect the participant's longer benefit payout period and lost investment earnings on plan assets. A full actuarial reduction gives full recognition to the longer payout period and lost investment earnings (McGinn, 1988).

In 1988, 41 percent of participants in defined benefit pension plans sponsored by medium-sized and large private establishments were in plans requiring them to wait until age 65 to commence receiving normal retirement benefits (U.S. Department of Labor, 1989). However, to commence receiving full benefits before age 65, participants often had to meet minimum service requirements (chart 2). Early retirement was allowed in most large employer-sponsored defined benefit pension

[6]Amounts attributable to employees' contributions must be immediately vested.

[7]A career-salary-average plan instead of a final-salary plan substantially reduces this effect (Clark and McDermed, 1988). All years of earnings are counted in the career average plan. In a final-salary plan, early years of earnings are dropped from the averaging period so the salary average rises more rapidly and pension accruals increase more rapidly with continued employment.

Chart 2
Prevelance of Normal Retirement Ages and Provisions among Defined Benefit Plans Sponsored by Medium-Sized and Large Private Establishments, 1988



Source: Employee Benefit Research Institute analysis based on data from U.S. Department of Labor, *Employee Benefits in Medium and Large Firms, 1988* (Washington, DC: U.S. Government Printing Office, 1989).
[a]May require a minimum service period.

plans after attainment of a specified age and sometimes after completing a minimum period of service (chart 3). Nearly three-fifths of participants in medium-sized and large employer pension plans could begin receiving reduced early retirement benefits at ages 55–59 after 10 years of service or less.

Less-than-full actuarial reductions and other subsidies, combined with backloading, may cause a peak in pension accruals and thus may encourage retirement at a particular age.[8] Although the Omnibus Budget Reconciliation Act of 1986 (OBRA '86) established that private pension plans cannot cease benefit accruals for people who continue to work after normal retirement age, caps on the years of service that can be counted toward a pension and on total benefit levels may also cause benefit accruals to peak. Kotlikoff and Wise examined characteristics of about 1,500 defined benefit pension plans and found that benefit accruals generally peaked at the age of early retirement eligibility (Kotlikoff and Wise, 1989). Employees in such pension plans have a disincentive to continue working until normal retirement age.

A defined benefit plan participant who is offered the opportunity to cash out the value of the annuity promised by a defined benefit plan could effectively side-step the retirement age incentives normally associated with retirement age provisions of defined benefit plans, and instead face the same tax incentives as a defined contribution plan participant receiving such a distribution. However, the backloading feature of defined benefit pension plans remains an influence on the retirement age decision.

[8]Section 415 of the Internal Revenue Code may place limits on these subsidies (McGinn, 1988).

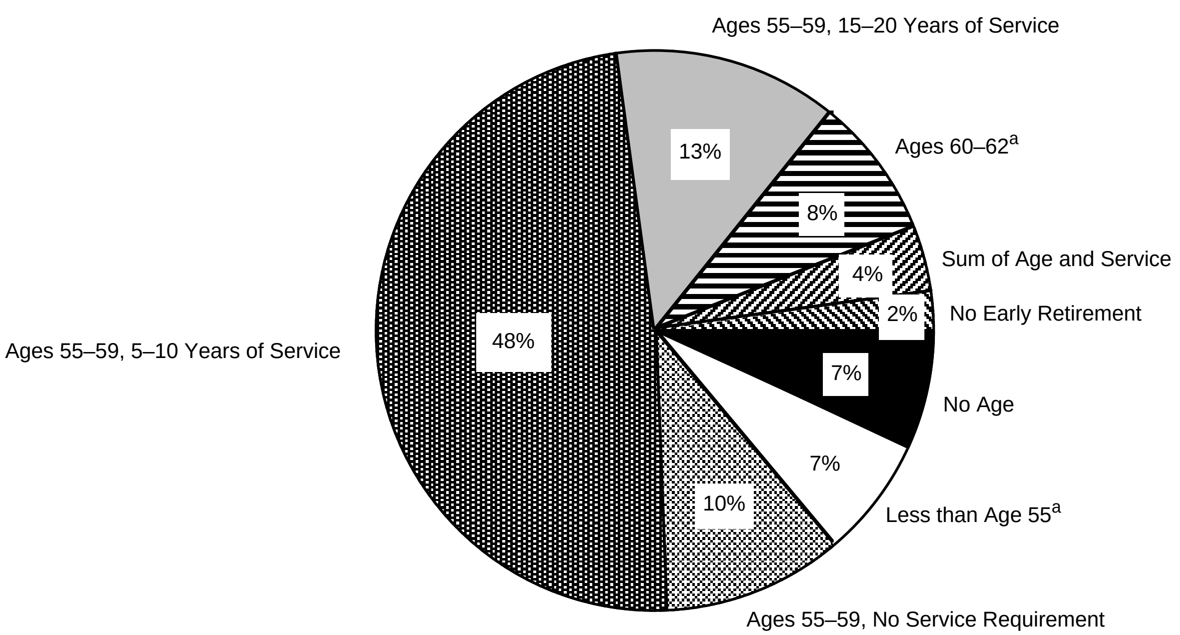
During limited "window periods," employers may offer enhanced early retirement benefits to reduce their work force in lieu of layoffs. To encourage early retirement, employers may offer cash bonuses, additional age and service credits necessary to qualify for a larger pension, and continued insurance benefits. In the last six years, 44 percent of a sample of 145 companies offered early retirement window plans (Towers, Perrin, Forster, and Crosby, 1990). In 1986, 24 percent of larger employers in a limited private survey offered early retirement incentives (Charles D. Spencer and Associates, 1987).

Early retirement incentives in employer pensions may discourage longer work lives, but these incentives may persist because both employers and employees may prefer defined benefit pension plans that allow earlier retirement. In one survey, nearly two-thirds of employers offering incentives found that more employees accepted the early retirement incentive plan than the employer anticipated (Charles D. Spencer and Associates, 1987).

Pension plans that subsidize early retirement may be the rational outcome of a compensation bargain. Labor economists suggest that employers and employees implicitly or explicitly negotiate terms for compensation in which compensation may begin at low levels but is expected to rise over time, given satisfactory performance by the worker. The age of pension eligibility may be an element in this contractual arrangement, allowing compensation to grow until a mutually agreeable retirement age (Lazear, 1983). Employers and employees may prefer this long-term arrangement rather than face the risks of job loss and employee turnover. Employers dislike high turnover, particularly when their production process requires specialized

Chart 3

Percentage of Participants in Defined Benefit Plans Sponsored by Medium-Sized and Large Private Establishments, by Provision for Early Retirement, 1988



Source: Employee Benefit Research Institute analysis based on data from U.S. Department of Labor, *Employee Benefits in Medium and Large Firms, 1988* (Washington, DC: U.S. Government Printing Office, 1989).
[a]May require a minimum service period.

training. Long-tenure workers are rewarded by higher pension benefits than workers who move from job to job. Employees may be willing to undertake this "firm-specific" training only if they are assured of secure long-term compensation.

While many larger private companies offer both defined benefit and defined contribution pensions, the majority offer defined benefit plans as a primary retirement plan. However, an increasing number of employees have defined contribution plans as their primary retirement plan. Participants in primary defined contribution plans grew from 3.9 million in 1975 to 13.4 million in 1987, while participation in defined benefit plans grew more slowly, from 26.8 million participants in 1975 to 28.3 million participants in 1987. Some employers are replacing defined benefit plans with defined contribution plans; participation in primary defined benefit plans actually fell since 1980, when there were 29.7 million participants (Piacentini and Cerino, 1990).

Growth in defined contribution plans suggests that employers and employees value the opportunity to accumulate tax-deferred savings. Coverage under 401(k) plans—one type of defined contribution plan—as a primary pension plan has been greater among workers in smaller establishments and among those with lower earnings (Salisbury, 1989). Because defined contribution plans are more neutral regarding the age of retirement, a decreasing proportion of pension plan participants may face incentives to retire early under defined benefit plans. Under both defined benefit and defined contribution plans, an increasing trend to provide lump-sum distributions of accrued pension benefits before retirement may reduce future retirement income if this money is used for current consumption rather than for retirement savings (Piacentini, 1990). These trends are too recent to have had a measurable effect on early retirement, but they may also reduce the incentives for future generations to retire early.

By contrast, mandatory retirement rules probably had little influence on the trend toward early retirement. Before the 1988 amendments to the Age Discrimination in Employment Act (ADEA) eliminated mandatory retirement rules for most workers, mandatory retirement was forbidden before age 70. However, only about 25,000 to 49,000 men and 16,000 to 28,000 women were estimated to have been affected by mandatory retirement in 1985 (Andrews, 1986).

Health Care Coverage

Owing to the growth in health insurance coverage among retirees, by 1987 people aged 55–64 were less likely than younger age groups to be without health

Table 3
People without Health Insurance Coverage, by Sex and Age, 1982 and 1987

	1982				1987			
	18–24	25–44	45–54	55–64	18–24	25–44	45–54	55–64
				number				
Total	7,685	8,852	2,472	2,687	6,114	11,424	2,716	2,419
Men	4,138	4,823	1,089	986	3,378	6,546	1,261	1,042
Women	3,547	4,029	1,383	1,701	2,736	4,878	1,455	1,377
				percentage of population				
Total	26.8%	13.1%	11.1%	12.2%	23.7%	14.8%	11.4%	11.2%
Men	29.5	14.7	10.2	11.2	26.8	17.3	11.0	10.2
Women	24.2	11.7	12.0	14.5	20.7	12.4	11.9	12.0

Source: EBRI tabulations of the March 1983 and March 1988 Current Population Surveys.

insurance (table 3). Retired nonworkers aged 55–64 obtained coverage from different sources than nonretired people, but in 1987 both groups were about equally likely to be insured (table 4). By comparison, in 1982, 15 percent of near-elderly retired nonworkers and 11 percent of workers aged 55–64 were without health insurance. By 1987, retirees aged 55–64 were more likely to have public coverage and less likely to have private coverage than nonretirees.[9] Employers covered substantial numbers of both retirees and nonretirees. Fifty-seven percent of retirees and 67 percent of nonretirees had employer-based insurance in 1987 (Custer, 1990).[10]

Substantial numbers of active workers expect to receive health coverage in retirement from their employers. In 1988, more than one-half of workers aged 40 or over were in employer-sponsored health plans that enabled them to continue coverage in retirement (table 5). Older workers report coverage in retirement more frequently than larger employers report offering coverage to workers of any age. In 1988, 45 percent of full-time employees of larger firms with health insurance had retiree coverage at least until age 65, and 36 percent of employees had this coverage past age 65 (U.S. Department of Labor, 1989).

The Financial Accounting Standards Board (FASB) is expected to require companies to begin acknowledging their unfunded future liability for retiree health care benefits on their income statements and balance sheets. Consequently, companies may seek ways of reducing these liabilities. Health plans that require contributions to the cost of coverage in retirement are likely to become more common. Nearly one-half of workers with retiree health insurance are now required to contribute to the premiums for retiree coverage (U.S. Department of Labor, 1989). Even though only about one-third of all retirees with employer-provided health insurance are aged 55–64, a disproportionate share of corporate retiree health liability is applicable to early retirees, because most acute medical costs for people older than age 64 are paid by Medicare (Chollet, 1989).[11] Other approaches to reducing employers' liability include

Table 4
Health Insurance Coverage for the Population Aged 55–64, by Retirement Status, 1982 and 1987

Coverage	1982 Retired	1982 Nonretired	1987 Retired	1987 Nonretired
Population (in thousands)	4,651	17,331	5,537	16,103
Private Coverage				
Total	67%	81%	74%	82%
employer-based	26	62	57	67
direct	15	46	40	47
indirect	11	15	17	20
other private[a]	46	26	17	14
Public Coverage				
Total	30	14	29	13
Medicare	18	5	14	5
Medicaid	7	4	7	4
Champus[b]	11	6	12	6
Uninsured	15	11	12	11

Source: Employee Benefit Research Institute tabulations of the March 1988 Current Population Survey.
Note: Percentages may not sum to 100 because the categories are not mutually exclusive.
[a]May include duplicate coverage from an employer.
[b]Civilian Health and Medical Program of the Uniformed Services.

[9]Although employer-based coverage appears to have more than doubled among the near-elderly retired, much of this difference results from changes in the questionnaire between 1983 and 1988. In the 1983 CPS health coverage from a former employer, i.e., retiree health coverage, was coded as other private coverage, while in 1988 retiree health coverage was included in employer-provided coverage.

[10]Estimates from the National Medical Expenditure Survey were that 68 percent of retirees aged 55–64 had employer-sponsored health insurance in 1987 and may include people who were employed after retirement (Monheit and Schur, 1989).

[11]Neither Medicare nor private insurance provides substantial funding for the chronic medical care or long-term care of older Americans. Most long-term care costs are paid out of pocket by patients and their families, with the remainder predominantly financed by Medicaid (Friedland, 1990).

Table 5

Health Care Coverage in Retirement of Full-Time, Full-Year Workers Aged 40 or over, 1988

	Total	Aged 40–54	Aged 55–59	Aged 60–64	Aged 65 or over
			in millions		
All Full-Time Workers	26.2	19.2	4.1	2.3	0.6
Group health coverage continues throughout retirement	13.7	10.0	2.1	1.2	0.4
Group health coverage ceases on attaining age 65 or Medicare eligibility	0.5	0.3	0.1	0.1	a
Group health coverage continues during retirement or period exceeding 36 months (not contingent on age or Medicare eligibility)	0.2	0.2	f a	a	a
Group health coverage does not continue	4.1	2.8	0.7	0.5	0.1
Don't know	7.5	5.8	1.1	0.5	0.2
			percentage		
All Full-Time Workers	100.0%	100.0%	100.0%	100.0%	100.0%
Group health coverage continues throughout retirement	52.3	52.3	51.8	52.1	56.2
Group health coverage ceases on attaining age 65 or Medicare eligibility	1.9	1.5	3.2	3.6	a
Group health coverage continues during retirement for period exceeding 36 months (not contingent on age or Medicare eligibility)	0.9	1.0	a	a	a
Group health coverage does not continue	15.8	14.8	18.2	19.8	17.6
Don't know	28.7	30.1	26.0	23.3	23.9

Source: Preliminary Employee Benefit Research Institute tabulations of the August 1988 Current Population Survey.
[a]Number too small to be statistically reliable.

setting a fixed employer contribution to future retiree health benefits, varying medical benefits with length of employment, and establishing savings vehicles for employees to fund their own retiree health benefits.

◆ Policy Issues

Changes in Social Security

The Social Security system depends on obtaining sufficient revenue from active workers' payroll taxes to fund the benefits received by retired workers. The 1983 Social Security Amendments were intended to finance a decrease in the ratio of active workers to retirees by increasing taxes, building a surplus in the trust funds that would later be depleted, and adjusting benefits for future workers. However, Sen. Daniel Patrick Moynihan's (D-NY) proposal to return Social Security to pay-as-you-go financing (S. 2016) may lead Congress to reassess the role of Social Security in financing the baby boom's retirement. His proposal only affects the tax rate and the trust fund buildup, not current benefit formulas and incentives for retirement. But increasing the ratio of active workers to dependents by discouraging early retirement is another way of improving the Social Security system's financial solvency.

Changes in Social Security to encourage earlier retirement include making benefits available at later ages, postponing the normal retirement age past age 67, or modifying or eliminating the Social Security earnings test to encourage greater labor force participation. S. 1823, proposed by Sen. Lloyd Bentsen (D-TX), would increase the 1990 earnings limit for retirees aged 65 or over by 25 percent to $11,700 and lower the effective tax rate to 25 percent on the first $5,000 of earnings above the limit. Other bills propose to eliminate the earnings test entirely, but the potential loss in federal revenue from eliminating this test may preclude serious consideration of these proposals. Most of these proposals eliminate the earnings test only for retirees aged 65 or over, leaving the test for early retirees unchanged.

While removing the earnings test might give Social Security recipients more flexibility to adjust their income, some argue that a reduced earnings test would benefit those who would have worked anyway, usually relatively healthy, well-off Social Security beneficiaries, without fostering significant new labor force participation. Those who limit their earnings so as not to exceed the exempt amount (an estimated 174,000 people aged 65–69) could increase their work effort if the earnings test is liberalized (Leonesio, 1990). However, those who currently earn more than the exempt amount and accept reduced benefits could work fewer hours without a loss in income. While an argument for eliminating the earnings test might be made on equity grounds, removing the test would raise current benefit payments more than it would add to revenue from increased work (U.S. Department of Health and Human Services, 1989).

Employer Pension Policy

Recent policy toward employers' use of early retirement incentives has focused on whether or not such incentives circumvent laws forbidding age discrimination. ADEA prohibits employers from discriminating against any person in hiring, job retention, compensation, or terms of employment because of age. However, section 4(f)(2) of ADEA allows employers to make some age distinctions in providing benefits (for example, to use a seniority system) if it is "not a subterfuge to evade the purposes of the act." Although ADEA now forbids mandatory retirement,[12] pension plan provisions may encourage early retirement of older workers.

Early retirement provisions that have been an integral feature of a plan have generally not been considered discriminatory. Even when early retirement benefit reductions are less than actuarially "fair" and thus subsidize early retirement, one could argue that a subsidy for early retirement does not deny anyone's rights since normal retirement benefits are granted in accordance with ERISA regulations and the choice to accept early retirement is voluntary. However, age discrimination considerations sometimes arise in connection with special early retirement windows used by employers to reduce their work forces. Because these opportunities may be offered when a company is downsizing and employees may believe that layoffs are imminent, their acceptance of early retirement might be seen as being given under duress.

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In the wake of the *Betts* decision, employers attempting to reduce the size of their work forces might offer different incentives to a younger group of retirement-eligible employees than to those already near normal retirement.

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Some employers have asked that employees who accept early retirement windows sign a waiver forgoing their right to bring a complaint against the company later under the provisions of ADEA. In a recent survey of companies that sponsored special early retirement programs, 30 percent reported requiring their employees to sign a waiver as a condition for receiving enhanced early retirement benefits. Other companies did not require waivers, saying that exit incentive programs were voluntary and that they thought employee relations would be adversely affected by such a requirement (U.S. General Accounting Office, 1989).

In June 1989, the U.S. Supreme Court ruled in the case of *Ohio Public Employees Retirement System v. Betts* that section 4(f)(2) of ADEA exempts benefit plans from age discrimination liability. Unless a plaintiff shows

[12]A special provision allowing mandatory retirement at age 70 for tenured faculty is scheduled to expire in 1993.

that a plan was developed to further some nonbenefit-related discriminatory purpose (that is, it is a "subterfuge" to discriminate in hiring or compensation), benefit plans may have wide latitude to tailor benefits to age. Adopting a narrow interpretation of section 4(f)(2), the Supreme Court overruled a proposed Equal Employment Opportunity Commission (EEOC) regulation allowing age-based distinctions within employee benefit plans only to compensate for the different costs of providing benefits for employees of different ages.

In the wake of the *Betts* decision, employers attempting to reduce the size of their work forces might offer different incentives to a younger group of retirement-eligible employees than to those already near normal retirement. Given that employers usually budget a fixed amount for a work force reduction incentive, greater numbers of workers may leave voluntarily if specific benefits can be targeted to people within particular age ranges or windows. Older workers may find enhanced pension benefits to be more attractive, while younger workers—who would be concerned about a transition to another job—might value greater severance benefits. Employers have used early retirement incentive plans that enhance pension income for older workers but provide them no severance pay. Other plans have offset pension payments against severance benefits or delayed pension payment until severance payments were exhausted (Labor Policy Association and ERISA Industry Committee, n.d.).

Legislation (H.R. 3200 and S. 1511, the Older Workers Benefits Protection Act) to overturn the *Betts* decision would codify the proposed EEOC regulation that differential costs are the only justification for age differentials in benefit plans. A controversial provision would require that employers demonstrate that unequal benefits are the result of equal spending for each type of benefit. Employer groups have lobbied for the ability to demonstrate nondiscrimination by equalizing total spending for early retirement benefits for all employees and have offset spending for benefits that are more costly for older workers by reducing other benefits. The American Association of Retired Persons (AARP) argues that tailoring benefits to employees' ages is discriminatory and inequitable, and advocates that the same expenditures for each benefit be provided workers at any age (American Association of Retired Persons, 1990). AARP argues that coordinated pension and severance pay plans violate the intent of ADEA by assuming that an older employee is less interested in obtaining a new job than a younger employee.

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An employer may prefer that a long-tenure employee leave if the company has amortized the investment in hiring and training the employee and if the employee's compensation exceeds his or her productivity.

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S. 1511 would allow severance benefits to be offset only against the value of a specified set of retiree health care benefits. It also includes a provision to regulate employers' use of waivers of age discrimination claims, including a requirement that employers reimburse employees for part of the cost of legal counsel consulted before signing waivers. The House bill would permit no offsets of any kind and require cost justification on a benefit-by-benefit basis.

The debate over *Betts* raises a larger issue about the appropriateness of using early retirement programs to ease the dismissal of redundant employees. An employer may prefer that a long-tenure employee leave if the company has amortized the investment in hiring and training the employee and if the employee's compensation exceeds his or her productivity. If profitability can be improved by encouraging employees nearing retirement age to take early retirement, then employers will do so, unless the costs of the early retirement incentives exceed the benefits.

The persistence of early retirement incentive programs thus depends on whether older workers are more or less productive relative to younger workers. Since young workers gain skills on the job, productivity may increase with age. Improved judgment and experience may also enhance productivity. On the other hand, physiological changes associated with aging (such as the onset of chronic health problems) may reduce physical capacity. Workers' preferences may change over their work lives as they stop supporting dependent children (Andrisani and Daymont, 1987).

If employment is viewed as a long-term contract, then compensation at any point in time may not reflect the worker's actual productivity. Benefits that cannot be adjusted to individual workers' productivity could make the hiring and retention of older workers more costly and may discourage employers from hiring and retaining them.

Work force reduction plans affect younger employees who are released, for although they retain any vested pension rights, they may have lower pension wealth at retirement (Andrews, 1987; Clark and McDermed, 1988). Benefits are usually fixed in nominal terms and do not increase with inflation or with growth in wages. Furthermore, because workers do not have the option of transferring their accrued service credits to their new employers when they change jobs, with each new job they must begin to accrue pension credits based on zero years of service. The lack of portability of service credits causes a loss in pension wealth with job changes (Clark and McDermed, 1988).[13]

[13]Portability to eliminate all pension losses associated with job changes would be extremely difficult to achieve, because: 1) pension plans are diverse and matching job service credits would be complex and administratively costly; and 2) Someone must bear the cost of providing the increased benefit to the job loser. Making benefits for new workers equal to those of the single-job worker would require that either the new employer incur higher costs for a new employee who had been covered by a pension or the former employer make an additional contribution into the pension account of the departing worker (Clark & McDermed, 1988). One could argue that severance payments compensate at least partially for this loss in pension wealth.

Encouraging Longer Work Lives

Continuing reductions in labor force participation rates notwithstanding, surveys of the attitudes of younger retirees suggest that many would like to return to work (Andrews, 1986). A recent survey sponsored by the Commonwealth Fund estimated that about 1.1 million men aged 55–64 and women aged 50–59 currently not working would be willing to enter the labor market (Louis Harris and Associates, 1990). The survey disputes the Department of Labor's estimate that only 630,000 people in this age group were in the labor force but not working.

Public policy may consider the labor market's ability to absorb potential older workers, because early retirement decisions may be difficult to reverse. In recent years, the United States has experienced relatively low unemployment rates, and older men and women in the labor force have had unemployment rates consistently below national averages. In the first quarter of 1990, only 3.5 percent of men and 3.3 percent of women aged 55 or over in the labor force were unemployed, compared with an average of 5.2 percent among all workers aged 16 or over. However, the consequences of job loss are more serious for older workers than for younger ones. Unemployed older men and women tend to have lengthier job searches than younger workers (U.S. Department of Labor, 1990). Under adverse economic conditions, when reductions in pay and duration of unemployment are greater, early retirement incentives are more likely to be offered.

◆ Summary and Conclusion

Increased retirement income from public and private sources appears to have been the main cause of an increasing trend toward early retirement. Benefit provisions allowing early retirement may reflect employer and employee preferences for relatively short work lives rather than more frequent periods of leisure during a lengthier work life.

One cost that may not have been adequately considered in this compensation bargain may be the cost of health care in retirement. Until the proposal by FASB to require accrual accounting for the health insurance liability of retirees, many employers had not focused on the cost of their promises to provide this coverage. Some employers may cease offering retiree health care benefits for future retirees, increasing demands for health care from public-sector programs. On the public-sector side, although early retirees do not raise expenditures for Medicare and Social Security directly, their departure from the work force may make financing benefits for retirees aged 65 or over more difficult.

However, future declines in the number of new entrants into the labor force may increase demand for labor and lead employers to increase incentives for older workers to stay on the job longer. Reductions in the prevalence of retiree health benefits have the same effect as reducing retirement compensation and increase incentives to remain employed, at least until becoming eligible for Medicare.

Greater prevalence of defined contribution plans as primary pensions could reduce the proportion of people facing incentives to retire early in defined benefit plans. At the same time, if defined contribution plans allow some people to accumulate greater assets for retirement, they might retire earlier than they would otherwise have. The net effect on retirement trends may be difficult to establish, because these trends are too recent to have generated any data.

Changes to laws and regulations affecting early retirement have been proposed as a way to reduce perceived age discrimination and encourage older workers to stay employed longer. However, reducing employer flexibility in structuring compensation may interfere with the ability of employers and employees to negotiate a compensation package that reflects changing needs over the course of a work life.

In any case, policymakers might desire to improve the ability of people to choose freely between retirement and work. Attempts to encourage a longer working life might be framed as an effort to encourage flexibility in retirement to supplement resources and account for unanticipated changes in resource needs.

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