LEGAL AND INSTITUTIONAL IMPEDIMENTS TO PARTIAL RETIREMENT AND PART-TIME WORK BY OLDER WORKERS

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EXECUTIVE SUMMARY

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Within ten years, baby boomers will begin retiring in large numbers. The United States will lose the services of millions of highly skilled, experienced workers. Because of the baby dearth that followed the baby boom, there will not be many new workers to replace them even as the senior adult population grows significantly. Labor force growth is expected to fall from 1.1 percent per year in the 1990s to 0.36 percent per year in the period 2010 to 2020.

The problem afflicts some professions more than others. There will be a particularly severe shortage of nurses and teachers while the supply of blue collar workers will be much less affected.

The situation could obviously be improved if older workers could be induced to work longer. This should be feasible as improved health has accompanied longer longevity and as jobs that require hard physical labor have declined in relative importance. The attractiveness of working longer could be enhanced if older workers were allowed more flexible work arrangements involving shorter hours and longer vacations.

Unfortunately, there are a large number of legal and institutional barriers to more flexible employment arrangements for older workers. These were not seen to be a problem when there was a positive desire to move people out of the labor force early in order to make room for the hoard of baby boomers working their way up the career ladder. While it was often not appropriate to erect these barriers then, now the imminent, drastic change in demographic conditions creates a much more urgent need for reform. The fact that many strongly follow recent cultural trends toward retiring early limits the extent to which reform can counter the decline in labor force growth, but reform can help and it can greatly increase the welfare of those individual workers who would welcome more flexible arrangements.

One of the most important barriers to longer work comes from privately negotiated defined benefit pension plans. The typical plan may state that the normal retirement age is 65, but a worker starting at age 25 is likely to find that the expected value of the pension accrues most rapidly between ages 51 and 55 under reasonable economic assumptions. Soon after 55, the accrual might actually turn negative. That is to say, the increased pension earned by working an extra year (if any) does not compensate for the fact that the person will get one less year of benefits. This is an important characteristic of many private plans, as well as public plans for teachers, fire personnel, other government workers. Social Security and Medicare benefits play a role as well in encouraging earlier retirement. The early retirement age established under Social Security sets a norm for society and many have suggested an increase in that age as one mechanism for strengthening the sustainability of the system.

Health costs create another barrier to hiring or retaining older workers. The cost for a standard health insurance policy for 55 to 59 year olds can be more than double that for 20 to 44 year olds. Currently, private insurers must pay health costs before Medicare contributes. The cost of hiring those 65 and over could be significantly reduced by removing the federal requirement that Medicare benefits are reduced or cancelled— effectively taxed away—if an employer plan is provided. The cost to the Federal budget would be quite modest.

It will take a 180-degree shift in traditional benefits thinking to reform a decades- old legal and regulatory system in which employers have looked for benefits tools to ease older workers *out* of the workforce. Nevertheless, very significant social and economic benefits would result from converting it into a system that encourages longer work.

There are three basic laws governing employee benefits—the Tax Code, ERISA and the Age Discrimination in Employment Act. Each has features which conflict with the objectives of phased retirement programs, but a major problem involves the complexities and ambiguities that arise when the three laws are combined. A risk averse employer may avoid making special arrangements for older workers because of regulatory uncertainties or a fear of litigation, even though the arrangements might be perfectly legal under a reasonable interpretation. The laws are more constraining with regard to private as opposed to public employees. Deferred retirement option plans are popular among public employers and might be a model for the private sector under a less restrictive set of laws and regulations.

Those laws and regulation have, to some extent, been developed to protect the rights of employees and one must tread carefully in developing reforms. Special provisions allow an innovative phased retirement approach for tenured faculty that could serve as a model acceptable to both employers and employees. Consideration could be given to a number of other policy options - from relatively easy to accomplish regulatory changes to more extensive statutory reforms permitting innovative designs and safe harbor plans for older workers. For example, providing older employees with information about the additional benefits to be gained from an additional year of work could better inform retirement decisions. In addition, statutory changes could enable employers to offer short-term special plans or benefits packages just for phased retirees. In return, phased retirees could be excluded from the non-discrimination testing rules for qualified plans. If phased retirement programs are facilitated, in part, by revisiting the treatment of part-time work under ERISA, the reform could serve as a vanguard for more flexible benefits policies for both older and younger workers.

CHAPTER ONE
Background

Introduction

A demographic clock is ticking. The baby boom generation will soon be retiring. When the alarm goes off shortly after 2010, the U.S. economy will begin rapidly losing productive human capital as skilled and experienced laborers leave the workforce. This loss would not create severe economic problems if there was a large supply of younger workers to replace the retirees. However, fertility rates fell rapidly after the peak of the baby boom in the late 1950s. As a result, the labor force will be almost constant between 2010 and 2030 under current policies, and the minute growth that occurs will be largely the result of immigration and high birth rates among recent immigrants.

If there were public policies and private institutional arrangements that encouraged some baby boomers to delay retirement, the macroeconomic problem could be eased, thus benefiting all Americans indirectly. More important, the increased number of employment options would directly increase the welfare of those older Americans interested in more flexible employment opportunities.

Many baby boomers will welcome retirement after a long career of hard work. It will be difficult to get such people to work longer regardless of how many work disincentives are removed or new incentives created. Moreover, policy changes that allow more flexibility will induce some to leave full-time employment sooner than they would otherwise. But other baby boomers will be quite willing to work longer, if they have the opportunity to reduce their weekly work hours or to take longer vacations. However, today's employers are reluctant to jump through the numerous legal and regulatory hoops in order to provide more flexible employment opportunities, especially since health costs can make it particularly expensive to employ older workers. Some older workers will retire voluntarily, but only because they face defined benefit pension plans that penalize delayed retirement. There are also more subtle institutional pressures to retire at a certain age. There may be social pressures to leave and make room for younger workers, and there may be a widely shared presumption that one's skills and physical stamina decline more rapidly with age than is the case.

Many of the economic and institutional barriers to working longer evolved when there was reason to make room for the giant cohorts of baby boomers working their way up the career ladder. Often, pressures to downsize were much stronger than pressures to retain valuable human capital. Early retirement provided a relatively painless way to shed workers. It was also a time when mandatory retirement was legal, life expectancy was shorter, health at any age was more fragile, and many more jobs were physically demanding.

Much has changed since the Employee Retirement Income Security Act of 1974 (ERISA) and the Age Discrimination Act were enacted and most retirement plans were designed. It is clearly time to reassess the legal and institutional arrangements governing the employment of older workers. These arrangements will not be changed easily, so we need to begin discussing reform long before the baby boomers reach retirement age.

Demographic Trends

Fertility Rates. Fertility rates have varied significantly over the past 75 years. While we may feel complacent now, severe problems are just 10 years away. Today, we are witnessing the retirement of Depression babies. Partly because there are not many of them, the Social Security trust fund is running a large surplus that contributed to the emergence of an overall federal budget surplus from 1998 to 2002. Although the events of September 11, 2001, caused the fiscal situation to deteriorate somewhat, deficits, if any, are likely to remain small relative to those of the 1980s and those that will accompany baby boomers' retirement.

The fertility rate[1] hovered around 2.2 during most of the 1930s and then began a somewhat erratic upward trend that peaked at 3.8 in 1957. Soon after, it fell even more precipitously than it had risen and reached a low of 1.7 in 1976. After the late 1970s, the rate rose a bit and remained slightly above 2.0 during the 1990s.

It is the speed with which the baby dearth followed the baby boom that will cause the ratio of workers to retirees to fall rapidly between 2010 and 2030. The ratio will go from slightly over 3 to only 2.

Life Expectancy. When Social Security was invented, life expectancy at age 65 for a man was about 12 years. By 1950, life expectancy at 65 had risen to almost 13 years and the average age at which a man applied for Social Security was 68.7. Paradoxically, the average age for applying for Social Security benefits fell to less than 64 in 2000 while expected life at age 65 rose to 15.7 years. That suggests that the time a typical man spends in retirement has nearly doubled since 1950. This is despite the fact that people are healthier at every age and the physical demands associated with work have fallen as mechanization has increased and the economy has shifted more toward services.

Health and the Physical Demands Imposed by Work. The health status of the elderly has improved as expected life has increased. Manton, Corder, and Stallard (1997) found that the proportion of those age 65 and over reporting sickness or disability declined from 25 to 21 percent between 1982 and 1994. Steuerle, et. al. (1999), using census and Current Population

[1] The fertility rate is defined as births per woman during child bearing years.

Survey data, show that it is not until age 75 or older that more than 40 percent of the noninstitutionalized population report being in fair or poor health. The same authors estimate that the portion of the total workforce in physically demanding jobs has steadily declined from 20.3 percent in 1950 to 7.5 percent in 1996.

These findings suggest that over time the ability of those over 65 to work has grown, as has the possibility of finding work that is not physically demanding. Later we shall ask whether the desire to work matches the potential to work.

Retirement Trends. Voluntary retirement is a relatively recent phenomenon in human history. Before the Civil War, most Americans worked as long as they were able. However, Civil War pensions, which were almost as universal as Social Security, and the beginnings of corporate and union pensions made retirement possible in the later part of the 19th century. By 1900, about one-third of men age 65 and over were retired. That number had grown to one-half by 1950 and to 84 percent by 1985. Another way of describing the trend is to note that the average age of retirement was 74 in 1910 and 63 in 1998–99 (Burtless and Quinn 2000).

The trend toward earlier and earlier retirement for men appears to have stopped in the mid-1980s.[2] There are a number of possible reasons for this abrupt end to a very long trend: a relatively buoyant economy, the end of mandatory retirement, the end of increases in Social Security benefits relative to average wages, and the replacement of defined benefit pension plans with defined contribution plans. We shall discuss some of these phenomena in more detail later. The main point to be made here is that the fall in the average retirement age over time, the improvement in health, and the reduced physical demands associated with work suggest that in

[2] The labor force participation rate for older women has been on an upward trend, mainly because women of all ages have been seeking work in greater numbers.

theory, at least, there is considerable potential for now increasing the retirement age by removing impediments and improving incentives.

Immigration. Many see immigration as a possible solution to our nation's demographic problems. Immigrants have contributed significantly to our economic well-being over the years, and increases in the inflow could alter the timing of demographic trends. But immigrants age eventually and also tend to use more public assistance per capita than native-born Americans. Moreover, increases in the immigration rate are likely to create social and economic tensions.

In 1998, there were about 425,000 legal immigrants of working age. By comparison, an average of 1.6 million workers age 51 and over said that they retired in 1999 or 2000. Numerous others reduced their hours of work between 1998 and 2000, even though they may not have described themselves as being retired in 2000.[3] The number of those retiring each year or shifting to part-time status will grow rapidly after 2010. Very obviously, inducing a small number of older workers to change their mind about retirement or work longer hours would have a much bigger impact on labor force growth than increasing immigration by a very large percentage. Of course, immigrants are likely to remain in the labor force longer than a typical older reentrant, but it seems clear that immigration would have to rise to politically implausible levels to offset the human capital lost to retirement as the baby boomers age.

Future Labor Force Growth

The demographic trends described above explain why labor force growth has been steadily declining since the 1970s, when baby boomers were pouring into the workforce, and will continue to decline until 2030, when most baby boomers will have retired. The annual rate of

[3] Some may have described themselves as being retired in both 1998 and 2000, even though they worked some hours in both years.

labor force growth between 1970 and 1980 was 2.60 percent, but by the 1990–2000 period it had more than halved, to 1.13 percent per year. If it is assumed that the labor force participation rate will remain constant for all age groups and both sexes, the labor force annual growth rate will fall to 0.88 percent annually for 2000–10, 0.34 percent for 2010–20, and 0.38 percent for 2020–30 (See table 1-1). It will then rise to 0.66 percent for the period 2030–40, when population trends are expected again to approach a steady state.

Falling growth rates for the labor force and a consequent loss of human capital do not in themselves imply a falling standard of living. Indeed, if the physical capital stock grows faster than the labor force, wages and living standards are very likely to rise faster because of a growing relative scarcity of labor. Technological improvements will also improve living standards. However, the extremely rapid growth of the retired population in the early part of this century will slow any improvement in living standards for younger workers. The population age 65 and over is expected to grow 1.3 percent per year between 2000 and 2010, 3.1 percent between 2010 and 2020, and 3.5 percent between 2020 and 2040.

The problem facing younger workers is exacerbated by the fact that the per capita resource needs of the elderly are higher than those of the young because of the need for more medical services. Cutler et al. (1990) estimated that the per capita needs of the population age 65 and older exceed those of the 20 to 64 population by 27 percent and those of people 19 and under by 76 percent. None of this necessarily implies that the living standards of the labor force will decline absolutely. The aforementioned increase in the capital stock and technological improvements will continue to improve before-tax wages. However, it seems almost certain that the rate of improvement in the after-tax living standards of workers will fall far short of what the nation took for granted over the six decades following World War II.

The labor force projections described above assume that both sexes and all age groups continue to participate in the labor force at today's rates. This is clearly unrealistic for women. Younger women are participating in the labor force at a much higher rate than did today's elderly women, and this implies that they will eventually participate more at older ages as well. If it is assumed that future labor force participation rates among women 50 and older decline at the same rate as men's, the decline in labor force growth rates is somewhat ameliorated, but the difference is surprisingly small. The annual rate of growth rises from 0.88 percent to 1.08 percent for 2000–10, rises from 0.34 to 0.38 percent for 2010–20, and remains the same for 2020–30 and 2030–40.

Other adjustments can be justified. For example, Toder and Solanki (1999) adjust for the fact that the labor force in the early part of the 21st century will be older and, therefore, more experienced on average than workers living earlier. This should make these workers more productive. Productivity will also be enhanced, because the labor force, especially its female members, will be better educated on average. Toder and Solanki measure the increase in productivity by the increase in earnings that goes with more experience and education. However, such factors have only tiny effects in the annual growth of the effectiveness of the labor force and in no way change the big picture: the effective labor force will barely be growing between 2010 and 2030, and the effects of greater experience and better education have very little effect, even in the longer run. The cumulative increase in the effectiveness of the labor force because of experience and education is less than 1 percent by 2040.

Offsetting Adverse Demographic Trends through Longer Work

It is natural to ask whether the important demographic trends discussed above can be altered significantly by inducing people to work longer. Toder and Solanki asked what increase in the labor force participation rate of older workers is necessary to keep the ratio of the effective labor force to the total population constant between 1997 and 2040. Their calculations imply that an increase of about 12.5 percent in the rate for people 55 and older would suffice. If the growing per capita resource demands of an aging population—those primarily related to the need for health care—are considered, the task becomes more daunting. These authors estimate that a 31 percent increase in the participation rate of the population 55 and older would be necessary to maintain the ratio of the labor force to the needs-adjusted population.

We have updated the Toder-Solanki calculations for new population projections based on the 2000 census. We also use a different population series,[4] adjust only for probable changes in the female participation rate, and examine the time period from 2000 to 2030. We look at a shorter time period because most of the increase in the ratio of the older population to the total population assumed by the projections will have occurred by 2030.

The results of the analysis are extremely sensitive to the choice of data, the choice of time period, and the nature of adjustments made to the labor force. The sensitivity stems from the fact that we are asking what change in the behavior of the relatively small group of those age 55 and older is necessary to make up for the slower growth rate of the much larger population of younger workers. Thus, relatively small percentage changes in the projections of the younger

[4] Toder and Solanki used the population projections of the Social Security Trustees, whereas we use projections by the Bureau of the Census. The Social Security Trustees are interested in the future population of beneficiaries, so their projections include U.S. citizens abroad and in U.S. territories like Puerto Rico. The Bureau of the Census projections that we use include only people living in the 50 states and the District of Columbia. Our series is geographically consistent with labor force data.

population imply very large percentage differences in the labor force participation rate of the older population necessary to maintain the ratio of the total labor force to the total population.

It turns out that our results are considerably more pessimistic than those of Toder and Solanki. Whereas they estimated that a 12.5 percent increase in the labor force participation of workers 55 and over would maintain the ratio of the labor force to population between 1997 and 2040, our estimate for 2000–30 is 40 percent. This is an implausible increase regardless of the nature of future legal or institutional reforms. If the proportionate increase in the labor force participation rate was the same for all older age groups, the participation rate for the 55 to 64 group would have to rise to levels only slightly lower than those today found in the 25 to 49 age group. Needless to say, the increase needed to maintain the ratio of the labor force to the needs-adjusted population is even more implausible.

There are two very important points to make about these numbers. First, the projections are extremely uncertain. Second, if our more pessimistic numbers turn out to be closer to the truth, it makes it implausible to offset adverse demographic trends completely through later retirement. But that makes it no less essential to strive for improvement. Indeed, the results signal a macroeconomic problem that is even more serious than indicated by Toder and Solanki. And even if it is not plausible to solve the entire macroeconomic problem through later retirement, its effects might be mitigated significantly. Moreover, legal and institutional reforms may result in a very large proportionate increase in the welfare of that subset of older Americans who are now prevented from working by outdated barriers. That would be an important achievement even if only a relatively small portion of the older population is willing to contemplate longer work.

Occupational Considerations

The proportion of the labor force that is over 55 will naturally rise rapidly as the baby boomers age. The process will last until 2020, since the youngest baby boomer reaches age 55 in 2019. However, the aging of the labor force is expected to affect some occupations more than others (GAO 2001). Among executives and managers, the proportion 55 and over is projected to increase from 15 to 23 percent between 2000 and 2008. Among professionals, the increase is 14 to 19 percent. The population of teachers and nurses is aging particularly fast, with the proportion of nurses over 55 going from 12 to 18 percent and teachers from 12 to 18 percent. In contrast, the proportion of blue-collar workers over 55 will grow more slowly, since people in this group retire earlier or shift into white-collar occupations to avoid the harsher physical demands of blue-collar labor (figures 1-1 and 1-2).

The data suggest that executives, managers, and professionals such as nurses and teachers work longer than their counterparts in blue-collar and other white-collar occupations. This is obviously beneficial in that such occupations require a disproportionate amount of human capital and the economy benefits from using the human capital longer. However, when the baby boomers in these occupations eventually retire, the loss of human capital is likely to be more abrupt if retirement policies do not change.

If We Remove Impediments to Longer Work, Will Retirement Behavior Change?

It was earlier noted that many people very much want to retire. Providing some opportunity for more flexible working arrangements would be unlikely to bring them back into the labor force, while others would reduce their hours if given the opportunity to work part-time. On the other hand, many people would welcome the opportunity to work longer, as long as they can reduce the hours worked per week or take longer vacations. It is not easy, however, to determine how many fall into this group.

One useful source of clues is the Health and Retirement Study (HRS), which asks detailed questions about why people with different demographic and economic characteristics retire. A problem with HRS data arises, however, because different people have different notions of what it means to be "retired." Some who are working a considerable number of hours but not full-time consider themselves to be retired.

Table 1-2 examines the numbers of people age 51 and older who retire each year, according to different definitions of retirement. Note how many of these do work some hours. However, only about 516,000 of the 1.9 million part-time older workers work more than 20 hours per week. Later, when discussing legal impediments to work, we will show that it is important legally whether a worker works more or less than half-time.

Table 1-3 examines whether retirement is voluntary or involuntary. About 61 percent of workers age 51 through 54 said that they were forced to retire, while 36 percent said that they wanted to retire. The remainder cited a combination of reasons. As the age of retirement increases, the proportion forced to retire declines steadily until it reaches 33 percent for those age 65 through 67 while the proportion wanting to retire steadily rises.

When asked their reasons for retiring, almost 67 percent of men age 51 through 54 said that poor health was very important to their decision. It is interesting to note that this proportion is somewhat greater than the proportion saying that they were forced to retire. The proportion saying that poor health was very important to their retirement decision goes down steadily as the retirement age increases, while the proportion saying that poor health is not at all important goes up. Poor health is somewhat less important to the retirement decisions of women, but it exhibits the same patterns as retirement ages increase. This suggests the somewhat paradoxical result that it may be easier to induce those retiring later to postpone retirement or work more hours than it is to affect the decisions of younger retirees, simply because the former are in better health.

A problem in interpreting these data is that people saying that they retired for health reasons could say either that they were "forced to retire" or that they "wanted to retire." (The data collected for table 1-3 does not allow one to link health status with the categories "forced to retire" and "wanted to retire".) Presuming that most with poor health would say that they were "forced to retire" and presuming further that a very large portion of those "forced to retire" suffered bad health, it may be necessary to look in the "wanted to retire" population and those working less than full-time when looking for a possible increase in the labor supply.

About 46 percent of those describing themselves as retired said they wanted to retire. The key question is how many of these retirees would have still wanted to retire if a greater array of opportunities had been available. About 1.9 million per year reduced their hours of work. With a greater array of opportunities, they may not have reduced hours as much. These numbers reflect the flows of people into total or partial retirement each year. The total population of those describing themselves as retired and age 53 to 70 in 2000 was 9.1 million. About 14.3 million worked fewer than 20 hours per week.

Although the precise implication of these numbers is somewhat murky, the big picture is clear. There does not seem to be a large enough population of older workers capable of working more hours to counter a large portion of the effects of the demographic trends described earlier, but there are hundreds of thousands whose welfare could be potentially improved by offering a wider array of employment choices.

It is also clear from the HRS that not many have an opportunity for flexible arrangements. In 1998, only 26 percent of full-time employees age 51 through 65 worked for employers who would allow a reduction in hours (table 1-4). Of all the older workers who left their jobs, including both retirees and those taking other jobs, between 1992 and 2000, about 13 percent, or 1.5 million, said that they would have stayed on the job if their employer had permitted them to work fewer hours with correspondingly less pay (table 1-5). On the other side, a substantial number (19 percent, or 2.1 million) working full-time in 1998 for employers that did not allow fewer hours said that they would choose to work fewer hours if permitted. Superficially, it appears as though many more workers would reduce hours than would increase them if given the opportunity. However, the two results reflect responses from very different samples. The former looks at those working in 1998. The latter looks at a sample of those who left work between 1992 and 2000. Moreover, there is no information on how much each group might have changed hours. It is interesting to note that, in general, older job leavers are somewhat more interested in working part-time than younger job leavers. This may confirm the earlier conjecture that when younger workers leave a job, they are more likely to do so for health reasons.

A very different picture of older workers' tastes emerges from a Harris survey that suggests that 95 percent of preretirees wish to continue working in some capacity even if they do not get paid very much. It is possible that their enthusiasm will wane as they look at how legal and institutional constraints have restricted the appeal of those opportunities that are available. On the other side, as rising numbers of workers begin retiring in the next decade, it may be in employers' interest to change compensation practices so as to provide a stronger economic incentive to lengthen full-time work while also encouraging part-time work instead of full retirement.

Another crucial question is whether employers not offering reduced hours would do so if legal impediments were removed. It will be shown later that the most severe restraints are imposed on employers offering defined benefit plans. It is interesting to note in table 1-4 that only 21 percent of older workers are allowed reduced hours where there are defined benefit plans, whereas 25 percent of workers under defined contribution plans have this opportunity, and the portion rises to 34 percent where there is no plan.

How might these ratios change if barriers and incentives were changed? In the very short run, changes might be modest. However, as noted above, the pressure to allow more flexible arrangements will grow as baby boomers begin retiring. It would be unfortunate if employers were unable to respond to this pressure because of outdated legal and institutional restraints.

In the next chapter, we shall examine institutional restraints facing employers and employees in providing flexible employment arrangements for older workers. Some of these restraints have been privately negotiated, such as the disincentives created by the structure of defined benefit pension plans. Others are the result of public policies—for instance, the rules imposed by Medicare. We then go on to examine legal and regulatory barriers that reduce the number of options for providing flexible work arrangements. It must be emphasized that both the private arrangements and the publicly created policies and laws that now discourage longer work were created with the best of intentions when demographic conditions were very different. They must now be reconsidered.

Table 1-1
Unadjusted and Adjusted Labor Force Projections (Annual Growth Rates)

	Annual Growth Rate (% over Period)				Indexed Relative to 2000 (2000 = 100)	
	2000–10	**2010–20**	**2020–30**	**2030–40**	**2020**	**2040**
Unadjusted						
Total	0.88	0.34	0.38	0.66	112.5	124.5
Men	0.89	0.39	0.38	0.66	113.2	125.3
Women	0.87	0.31	0.38	0.67	112.0	124.0
Adjusted						
Total	1.08	0.38	0.38	0.66	115.1	127.4
Men	0.89	0.39	0.38	0.66	113.2	125.3
Women	1.30	0.38	0.39	0.66	117.3	129.8

Table 1-2
Number of Workers Age 51 and Older Who Retire per Year, 1998–2000, under Alternative Retirement Definitions

	Work for Pay and Do Not Describe Self as Retired in 1998; Report Being Retired in 2000	Work for Pay in 1998; Do Not Work for Pay in 2000	Work Full-Time in 1998; Work Less Than Full-Time in 2000	Work Full-Time in 1998; Work Less Than 20 Hours per Week in 2000	Work Full-Time in 1998; Do Not Work in 2000
All	1,629,854	2,197,111	1,901,428	1,385,682	1,198,935
Gender					
Men	925,618	1,087,344	1,014,246	760,167	660,507
Women	704,236	1,109,767	887,182	625,515	538,428
Age in 1998					
51–54	89,043	275,327	278,307	192,709	180,239
55–57	225,885	319,687	385,314	264,178	225,412
58–61	297,333	432,723	398,586	302,334	268,175
62–64	355,585	370,198	383,000	308,217	254,088
65–67	247,834	254,700	206,658	147,782	132,219
68 and older	414,175	544,479	249,564	170,463	138,803
Education					
Did not complete high school	317,315	521,494	389,958	313,189	272,724
High school graduate	588,498	793,969	633,237	480,972	431,278
Some college	354,472	454,681	421,471	304,518	263,745
College graduate	369,570	426,967	456,762	287,003	231,189
Race					
Non-Hispanic white	1,386,489	1,812,609	1,557,307	1,113,773	952,301
Non-Hispanic black	150,473	207,217	174,341	131,804	118,203
Hispanic	53,645	112,397	105,099	85,540	75,875
Other	39,248	64,888	64,682	54,566	52,556

Note: Some totals do not add up to the sum of the cells because of rounding problems involved in blowing up the sample size to approximate the entire population.

Table 1-3

Portion of Retirees Describing Themselves as Voluntarily or Involuntarily Retired, by Age and Gender

	Age					
	51–54	**55–57**	**58–61**	**62–64**	**65–67**	**51–67**
Men						
Forced to retire (%)	65.4	60.3	49.2	42.5	32.4	47.7
Part forced, part wanted (%)	3.2	2.8	7.1	8.1	8.8	6.8
Wanted to retire (%)	31.5	36.9	43.6	49.3	58.9	45.6
Number of observations	78	149	396	263	137	1,023
Women						
Forced to retire (%)	57.0	56.7	47.0	38.9	33.6	46.6
Part forced, part wanted (%)	2.9	5.0	8.1	5.9	11.1	6.8
Wanted to retire (%)	40.0	38.3	44.9	55.2	55.3	46.6
Number of observations	86	177	379	208	95	945
Men and women combined						
Forced to retire (%)	60.9	58.3	48.2	40.9	32.8	47.2
Part forced, part wanted (%)	3.0	4.0	7.6	7.1	9.6	6.8
Wanted to retire (%)	36.1	37.7	44.2	52.0	57.6	46.0
Number of observations	164	326	775	471	232	1,968

Notes: The sample is restricted to men and women who describe themselves as partly or completely retired. Ages were measured the first time respondents described themselves as retired. Some percentages may not add up to exactly 100 owing to rounding.

Source: Authors' tabulations from the 1992–98 waves of the HRS

Table 1-4
Ability to Reduce Hours of Work and Preferences for Reduced Work Schedules, 1998 among Full-Time Wage and Salary Workers Age 51 through 65, by Personal and Job Characteristics

	Employer Would Allow Reduction in Hours (%)	Worker Would Work Fewer Hours If Employer Permitted Reduction (%)
All	26.4	18.9
Gender		
Men	27.2	16.0
Women	25.3	22.4
Age		
51–54	25.5	17.8
55–57	25.8	19.6
58–61	26.7	19.2
62–65	29.6	19.9
Education		
Did not complete high school	27.5	27.5
High school graduate	26.5	26.5
Some college	27.5	27.5
College graduate	25.2	25.2
Pension plan participation		
No plan	34.3	17.8
Any plan	24.3	17.4
Defined benefit plan	20.5	18.4
Defined contribution plan	25.1	24.8
Number of observations	3,944	2,920

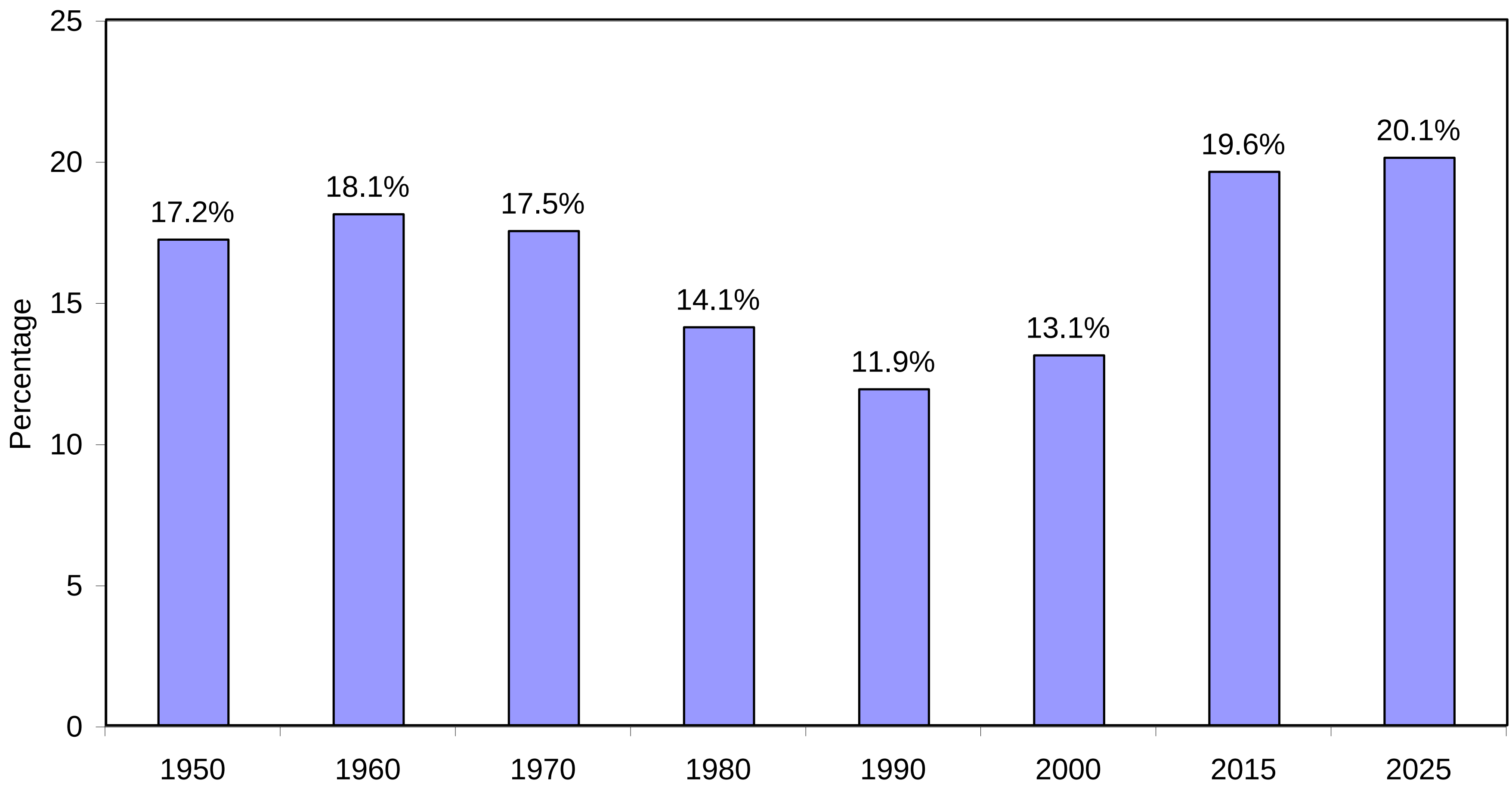
Source: Authors' tabulations from the 1998 wave of the HRS.

Table 1-5
Job Leavers Who Report That They Would Have Stayed on the Job If the Employer Had Permitted Them to Work Fewer Hours with Correspondingly Lower Pay

	Percentage of Job Leavers Who Would Have Stayed	Number of Job Leavers Who Would Have Stayed
All	12.6	1,480,000
Gender		
Men	12.4	722,000
Women	12.8	757,000
Age		
53–54	10.1	102,000
55–57	14.2	300,000
58–61	11.5	360,000
62–64	12.3	307,000
65–67	12.3	196,000
68–70	15.1	83,000
71 and older	15.3	132,000

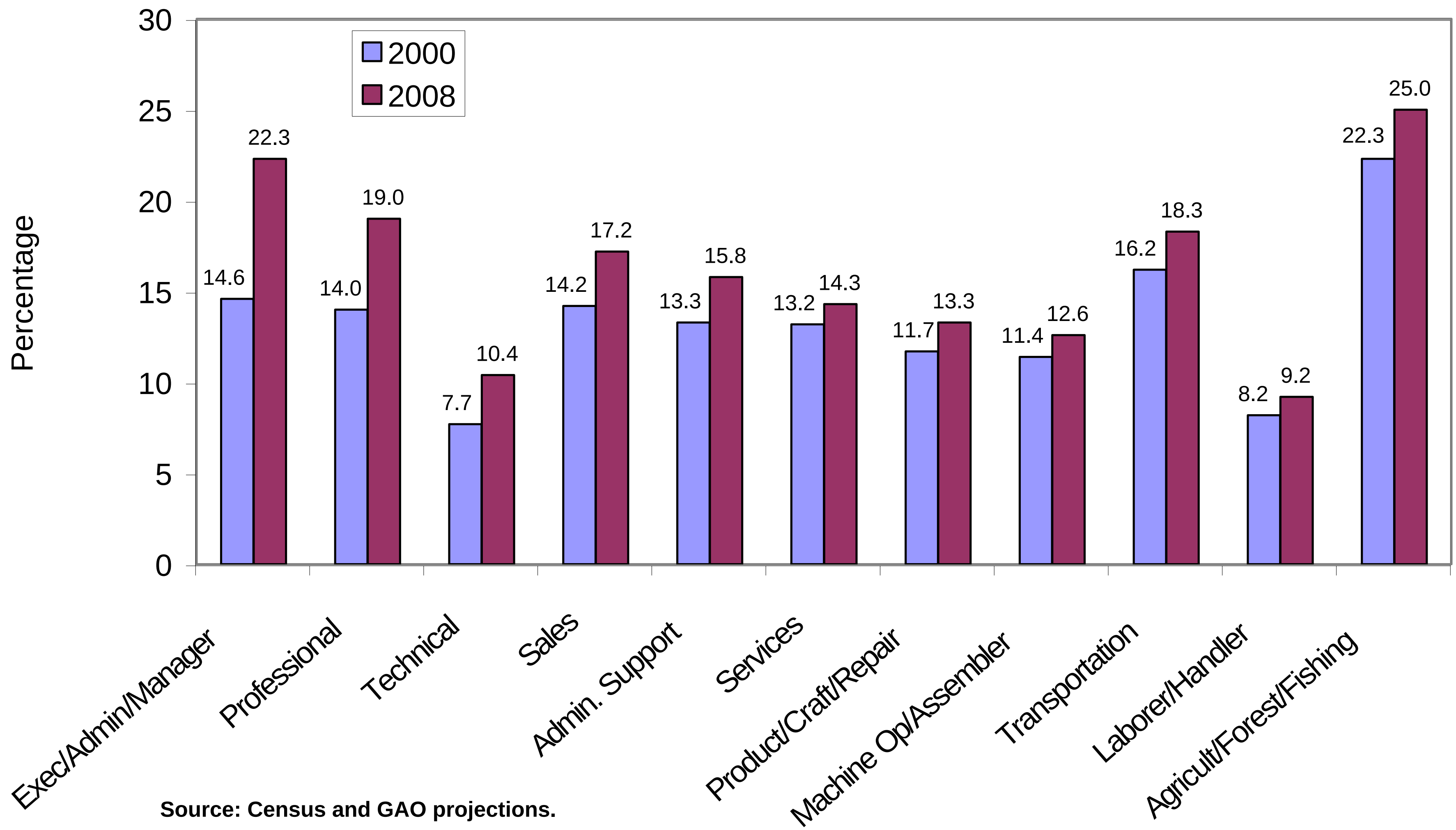
Note: Estimates are based on a sample of 4,054 respondents in the HRS who left their job between 1992 and 2000. Estimates refer to the last separation for those who left more than one job during the period.

Figure 1-1. Percentage of the Labor Force Age 55 and Older, 1950–2025



Source: U.S. Bureau of Labor Statistics.

Figure 1-2. Percentage of Workers Age 55 and Older in Major Occupations, 2000 and 2008



Source: Census and GAO projections.

CHAPTER 2

Economic and Institutional Barriers to Flexible Employment Arrangements

Introduction

Chapter 1 noted that many of the private arrangements and public policies that encourage earlier retirement evolved when there was little reason to be concerned about labor shortages. Baby boomers poured into the labor market in the 1970s and early 1980s, and a growing supply of new and, for a while, comparatively inexpensive female workers allowed firms to retire older male workers at much younger ages (Favreault, Sammartino, and Steuerle 2002; Steuerle and Carasso 2001). However, the United States can no longer count on increased female labor force participation to offset the now-general practice of retiring early. Today's retirement systems encourage retirement so early—really in middle age, if defined by expected life spans—that the typical new retiree can expect to spend close to one-third of his or her adult life in retirement.

Because of the remarkable growth in the number of those over age 55 that will occur as the baby boomers age, the largest untapped source of potential labor in the market economy will not be women but rather individuals who—if they follow the patterns of recent years—would fully retire even though they have 10 to 30 years of remaining life expectancy. As noted in the previous chapter, most in this group report to be in fair, good, or excellent health (Steuerle, et. al. 1999).

In the post–World War II period, the trend toward more years in retirement has been strongly supported by incentives contained in compensation systems. The thinking that went into the design of these plans revolved primarily around how to reward long-term employees and how to make retirement easier and earlier for them. Some plans were also designed to get rid of long-term, high-cost workers without having to fire them. Employing fewer relatively expensive workers, employers could then take advantage of the increase in labor supply of younger workers as baby boomers swelled the ranks of the labor force.

Still, what works well for an average worker in one era often does not work well for a non-average worker, or a different era. Little attention seemed to have been paid to the long-term impact of the incentive structure being created and the resulting biases against work beyond late middle age and against the hiring of older workers. The portion of compensation covered by traditional private defined benefit pension plans, in particular, often creates a powerful incentive for retirement. The incentive for an individual to retire or for an employer to get rid of older workers can also be enhanced by the structure of employer-sponsored health insurance, Medicare, and Social Security.

Employment-Based Incentives for Retirement: The Basic Framework

The employer has an incentive to let a worker go if the worker's total compensation is above the average compensation being paid elsewhere in the market for the same services (all other things, including the worker's productivity, being equal). The firm might respond to this incentive in a variety of ways, both intentional and unintentional. It might offer an early retirement option that, when taking account of the lower cost of hiring a replacement worker, would save it money in the long run. If the firm does not voluntarily rid itself of high-cost labor, it must pay for those additional costs somehow—raising prices on output, losing profits, or paying other labor at below-market compensation rates. In all of these cases, the firm is made less competitive. It may be threatened with consumers buying cheaper products elsewhere, savers investing elsewhere, or workers being less productive. Once that happens, the firm may downsize or even go out of business, in which case workers are let go—often with weakened or even reduced retirement protection.

Alternatively, an employer might shed employees by moving plants to another location. Suppose an employer has a plant in Michigan with an elderly workforce that earns higher-than-average compensation due to high-cost pension accrual rates. The firm might close that plant, while the same firm or some other firm might open a different plant in Kentucky. Newer hires could be hired at market wages and with little of the additional pension or other compensation costs associated with seniority. Older workers in Michigan, even if offered a job in Kentucky, might be reluctant to move for only a few years if they plan on spending their retirement years in Michigan.

When a worker is paid less than the going rate of compensation, on the other hand, then he or she has an incentive to leave the firm—the lower the pay, the less the incentive to work, at least for that firm.

Whether being let go by an employer or resigning, the worker may still attempt to go out in the market and find a job elsewhere. But there is evidence that among older workers, being laid off of one job often leads to retirement. One reason may be that attachment to a firm, especially one worked at for many years, is a common personal trait. Workers with established friendships and comfortable work patterns often are reluctant to set up a whole new network of personal relationships if they are not going to stay in that network for long. For example, a person might plan on retiring from a job at 65, but if circumstances force or encourage retirement at 62, that person may decide to invest those additional three years in building up his or her life and relationships in retirement rather than to take another job temporarily.

To examine incentives for retirement, we attempt to determine those elements of pay that are based on age rather than worker productivity. Ideally, our measure of pay is total compensation, which includes cash and various forms of noncash compensation. If incentives for early retirement are to be avoided, then any worker at any age performing the same job at the same level of skill will be paid the same (Hutchens, 1986). Alternatively, if compensation is related positively to age, independent of the job being performed, then the employer will have an incentive to shed older workers early. On the flip side, if the older worker starts being paid lower total compensation than other workers performing similar work, then that worker has an incentive to retire earlier.

For the most part, we will assume that cash compensation is related to job performance and focus on noncash compensation, particularly in the design of defined benefit pension plans. Sometimes the amount of noncash compensation will be measured as a share of the cash compensation. We wish to explore the extent to which noncash compensation rises and falls in ways that may be independent of the cash compensation and the job being performed. For instance, if two individuals have the same job paying the same cash wage, the employer will have an incentive to encourage the older worker to retire if noncash compensation rises with age.

A few research papers over the past 15 years or so have quantified and modeled the incentive effects of noncash compensation structures—particularly the defined benefit plans of large firms—on the retirement decisions of older workers. The papers explore the costs and benefits of retiring within a certain age range, as seen by both the older worker and the firm. The findings generally suggest that large (Fortune 500) firms tend to set maximum pension payouts for long-term workers in their fifties and that the pension formulas penalize workers who remain on the job past this age range, because the pension is not increased sufficiently to make up for the fact that workers will collect it for a shorter period of time.

Dulitzky (1999) surveys the literature on the effects of early retirement incentives. He examines studies that focus on defined benefit (DB) and defined contribution (DC) private pension plan rules, employer-provided health care, and Medicare provisions and eligibility ages. Kotlikoff and Wise, in a series of papers (1985, 1987, 1989), analyzed the incentive effects of Fortune 500 pension plan provisions (DB plans) and found a significant incentive to retire before age 65 on average, because benefits for later retirees were not increased by an actuarially fair amount. Stock and Wise (1990) and Lumsdaine, Stock, and Wise (1994) show further that the incentive to retire early inherent in private defined benefit pension plans will outweigh the incentive to retire later provided by Social Security's scheduled increases in the normal retirement age. A Hewitt (1997) study and a Mercer Foster Higgins study (2001) each found that firms had increasingly been paring back health care coverage for retired workers over age 65 and for early retirees; this type of shift might induce later retirement.

Note, by way of contrast with defined benefit plans, that many defined contribution plans now contribute a fairly constant percentage of cash wages to an employee's retirement account. In these cases, there would be little disincentive to retain older workers or for such workers to leave the job. These defined contribution plans have grown in relative importance over time. In 1975, DC plans composed only 29 percent of all pension assets, but by 1997 they composed over 50 percent (Munnell, Sundén, and Lidstone 2002). However, workers tend to withdraw savings when moving from job to job: an April 2001 study by the Employee Benefit Research Institute noted that of those pension plan participants removing assets from a previous employer's plan, 57 percent took a *lump-sum distribution*—that is, cashing out the pension's accumulated value when they changed jobs—while the remainder rolled the assets over into an individual retirement account (IRA) or another qualified plan (EBRI 1996). Thus, despite their improved work incentive structure in many cases, these plans have not yet proven to ensure saving and adequate resources in retirement for many middle-income households. Samwick and Skinner however, did simulations of workers through a career and concluded that DC plans may still be superior to DB plans simply because job changes often leave many workers without significant DB benefits in retirement (Samwick and Skinner 1998).

A more recent phenomenon has been the conversion of more traditional defined benefit plans to cash balance plans. These cash balance plans give a worker what is essentially a deposit into an account upon which interest or other earnings would be credited. The deposits are often proportional to wages. This particular structure is relatively new, but significant conversions have taken place in a number of firms. In incentive structure, the cash balance plan is closer to a traditional defined contribution plan even though it technically is a defined benefit plan. Bank of America added the first cash balance plan in 1985, and since then, survey data have suggested that as much as 6 percent of defined benefit plans were cash balance plans in 1997, with a jump to 12 percent by 1999 (Elliot and Moore 2000; Munnell et al. 2002). Copeland and Coronado suggest that perhaps 40 percent of workers in Standard and Poor's 500 firms with defined benefit plans were in firms that had converted at least one plan to a cash balance format (Copeland and Coronado 2002). We suggest that this movement may represent, at least in part, a response to the set of incentives we examine below.

Measuring Retirement Incentives

The measure of pension benefits that we use to examine retirement incentives in DB plans is the pension accrual or the economic value of the benefit accrual, defined here to mean the change in the present value of all future pension benefits by staying on the job one more year.[5] We use a standard mortality table for determining life expectancy and, for these purposes, do not distinguish between men and women. To calculate the pension accrual, we also take as a typical worker someone who starts on the job at ages 25, 30, and 35. In many cases, the results are similar, so we do not present all of them.

To take a very simple case of what one might expect, assume that a plan offers to an employee a pension benefit based upon high salary times 2 percent times years of service, but with a maximum replacement rate of 80 percent (40 years times 2 percent). Suppose also that initial salary is $20,000 at age 25, rising to $44,160 in real terms at age 65, then steady in real terms thereafter. Then at an inflation rate of 4 percent, this worker would get a net additional lifetime benefit of about $1,200 if he or she worked an extra year from age 34 to 35, or about 5 percent of pay. Someone working from age 64 to 65

[5] The meaning of the term "pension accrual" as used in this chapter is based upon but different from the term "accrued benefit" found under ERISA. Under ERISA, an accrued benefit is the value of a participant's earned benefit under a defined benefit plan at a particular point in time expressed in nominal dollars as a stream of income beginning at normal retirement age. Once the accrued benefit has been vested, its nominal value can generally not be lost. In our model, accrued benefits are converted into pension accruals to indicate the difference in the economic value of a particular accrued benefit at different points in time.

would receive about $15,000 in real dollars, or over one-third of his or her annual cash compensation, while someone working from age 65 to age 66 would receive a negative benefit equal to minus 80 percent of his or her prior year's salary, or about minus $35,000 in the absence of other provisions that tend to mitigate losses (Steuerle 1988).

In a typical defined benefit plan of this type, there is a long accrual stage during which an additional year on the job not only increases pension benefits by adding an additional percentage of pay (here, 2 percent of final pay) but raises the value of all previous benefit accruals by a combination of real income growth and inflation. The two typically combine to create rapidly growing benefits with each additional year of work up to some maximum. On the other hand, after one reaches the maximum number of years of service credited or the maximum replacement rate under the plan formula, then one or both of those types of accruals are limited. Moreover, if a worker forgoes annual benefit payments for one year because of staying on the job, then the additional accruals, if any, for the remaining years seldom make up for the fact that the worker receives benefits for one less year of his or her expected life.

Most plans are more complicated than this example. First, the benefit accrual is usually based upon several years of salary, not just one, as is assumed to simplify the example. Second, the percentage factor applied to average salary and years of service sometimes varies with years of service, and plans often provide reduced benefits for those who retire before the plan's normal retirement age. Finally, the plan sometimes contains additional provisions required by law that protect older workers from losing the economic value of their lifetime benefits (although the accrual rate may still be zero, even if no longer negative). The measures of pension accruals in the real plans that we model incorporate all of these details.[6]

We compute pension accruals for DB plans in both the private and the public sector. Data on private-sector plans come from the Pension Insurance Modeling System (PIMS). PIMS is a simulation model developed by the Pension Benefit Guaranty Corporation (PBGC), an agency of the federal government that insures private pension plans. It includes information on about 600 single-employer defined benefit plans. Because the goal of PIMS is to quantify the financial risk and uncertainty facing PBGC, PIMS oversamples large plans and underfunded plans. According to PBGC, the plans modeled in PIMS are somewhat more generous than the average DB pension plan. This is likely due to the oversampling of large plans. Although the dataset includes a wide range of plans currently in use, it contains very few plans from small employers and does not include any multiemployer plans.

We also collect information about pension plans provided to federal government workers and to teachers in California, Illinois, and New York. Federal workers participate in the Federal Employees Retirement System (FERS), which provides pension benefits equal to 1 percent of average final pay for each year of government service. Final pay is defined as the highest three-year average salary. For workers who retire at age 62 or later with 20 or more years of service, the percentage factor increases to 1.1 percent of average final pay.[7] Pension benefits for Illinois teachers equal 2.2 percent of final average salary, times years of service, while the percentage factor varies with retirement age for

[6] The model does not take into account the effect of the suspension of benefit rules found in ERISA § 203(a)(3)(B) on the benefits of workers who continue to work past normal retirement age.
[7] FERS also includes a DC component, the Thrift Savings Plan, which allows workers to make tax-deferred contributions to a retirement savings account, with matching contributions from the government. We did not incorporate this feature of FERS into our calculations.

California teachers and by years of service for New York teachers. In all cases, we ignore additional benefits that might be provided by another defined contribution plan such as the Thrift Savings Plan available to federal government workers.

The Hill-Shaped Benefit Curve

Almost regardless of the employer involved, we have found that traditional defined benefit plans entail a strong hill-shaped curve—with the present value of the pension increasing along a slope that becomes increasingly steep and then, after peaking, suddenly falls rather dramatically, almost as if off of a cliff. More precisely, pension benefits relative to cash compensation start out very low, gradually rise, and then accelerate to a peak. Beyond that peak, they often decline at a fairly fast rate, sometimes becoming negative.

Figure 2-1 shows pension accruals for different types of government plans. The figure covers FERS and New York, California, and Illinois teachers' plans. In Figure 2-2, the calculations are for 340 salary-based DB plans in the private sector. For both these figures, we employed a common set of assumptions: that a worker begins at age 25 and that wages grow at some average rate determined for college-educated male workers as reported in Toder et al. (2002). The real interest rate was set at 3 percent and the inflation rate at 3.3 percent. We have also modeled these plans for workers starting at ages 30 and 35; because of many similarities, we briefly discuss, but do not graphically show, these latter results.

As can be seen, these types of plans often show a peaking of accrual rates in the 51 to 55 age span for the worker starting at age 25. In many plans, one can reach this type of peak by providing 30 years of service. Incentives for the employer to shed workers are especially high by this stage and even in the 46 to 50 age span. However, many workers may not start with a firm until a later age. Separate runs show a similar hill shape, but the peak accruals occur from about age 56 to 60 for the worker starting at age 30 and from about 61 to 65 for the worker starting at age 35.

As can be seen, on average in Figure 2-2, the peak frequently occurs after 30 years of service has been attained. However, this is not always the case. Figure 2-3 shows the distribution of peak ages of accrual for the various private plans for workers starting at age 25—confirming the overall pattern but showing some modest variations.

Underlying these graphs is a set of assumptions that include an increase in cash wages that reflects a rate of growth in both productivity with time (as the economy becomes more productive) and with age. We assumed that real wages grow by about 5 percent per year for workers in their late twenties, by 3 percent for workers in their late thirties, and by less than 2 percent for workers in their fifties, consistent with observed age-earnings profiles for workers with DB plans (Toder et al. 2002). The value of the accrual rate in a given plan formula in these Figures 2-1 to 2-3 is measured as a proportion of a cash earnings or wage. For instance, if the cash wage doubles and the pension accrual (in dollars) doubles, then the accrual *rate* would have been a constant proportion of wages—much as a traditional defined contribution plan might have provided. However, when the accrual rate is increasing, it means that the increase in pension benefits is proceeding faster than the increase in cash wages. In a sense, there is a multiplier effect that derives from the nature of the traditional defined benefit formula: in addition to getting an increase in replacement rate, the higher wage in one year raises the base to which years of service and percentage replacement will apply.

We suggest that these descriptions of the traditional defined benefit pension world illustrate that pay in the form of employee benefits is often related to age, independent of productivity. There is, however, one counterargument to address. Economic theory suggests that total compensation should be related to a worker's productivity. As workers gain experience and become more productive, their total compensation should go up. We reflected this in the assumption of different wage growth at different ages. Since defined benefit pension benefits go up much faster than cash wages, one might be tempted to argue that there is a trade-off. The workers are willing to sacrifice some growth in cash wages for not just a proportional increase, but an exponential increase, in pension benefits. Without this pension increase, cash wages would tend to rise faster. Then there would be no type of age discrimination that tended to make some workers overpaid relative to the market and some underpaid.

The problem with that argument is that it still does not explain the current structure of incentives and pay. Three examples suffice to prove this point. First, if the goal is to increase pension compensation in precisely the fashion implied by these traditional defined benefit plans, then why would the rate of noncash compensation be so heavily dependent upon the rate of inflation? Productivity and inflation are not related. Inflation will not affect the cash wages of, say, a 50-year-old *relative* to a 25-year-old. With the same defined benefit plan, however, the relative accrual rate differs extraordinarily among ages simply because of the rate of inflation. For example, in the simple example provided in the beginning, where a 35-year-old achieved an annual accrual of about $1,200 at a 4 percent inflation rate, the accrual rate would be only about $400 at a rate of 8 percent but over $3,000 if the inflation rate was zero—all for the same given real cash wage (see Steuerle 1988). The extreme sensitivity to inflation can be understood even more easily by imagining a vested 35-year-old switching jobs. At retirement, he or she would get a right to a certain pension from the original employer measured in nominal dollars. The real value of that pension at the time of retirement would depend on the intervening inflation rate.

Second, to believe that the pension compensation scheme exactly matches changes in productivity not reflected in cash wages suggests that this productivity somehow drops off when workers hit some peak, such as 30 years on the job. The negative rate of accrual in many teachers' plans implies that in one year, they have moved from being at peak rates of improvement in productivity to declines of very large magnitudes.

Finally, as we shall show below, the rate of pension accrual differs quite strongly for new employees of different ages who work the same job and gain the same number of years of experience. Moreover, in this case, the age pattern of benefits differs again. Here, accrual rates for pension benefits for, say, five-year workers increase rather consistently with age up to an age like 65 even though for long-term workers we found that accrual rates usually fall toward zero past an age like 55.

In sum, it is indeed possible that some firms might want to pay out a higher proportion of total compensation in the form of pension benefits at later ages. But traditional defined benefit plans operate in such an arbitrary fashion that they would not achieve this result very well, if at all. Again, they might serve the firm well for an average worker, at an average starting age, at an average rate of inflation, at an average rate of wage growth, and with a significant number of years on the job. But few people met such average conditions in the past, and the labor market is so vastly changed today that the plans often don't work even for that illusive average worker.

Health Benefits

Next, we need to consider health benefits. If the cost of providing employee benefits, such as health insurance, for one worker is above the average level received by other workers in the market doing the same job and earning the same level of other compensation, then the employer has an incentive to let go the more expensive worker (Scott, Berger, and Garen 1995).

For our purposes here, we used a national dataset on health expenditures—the 1996 Medical Expenditure Panel (or MEPS), as further developed by John Holahan of the Urban Institute. With this dataset, Holahan was able to calculate average private health insurance costs by age for a worker who had year-round, full-time employment with a firm that provided health insurance. As can be seen in Chart A of Figure 2-4, private insurance health costs rise significantly, from between $500 to $1,000 for workers age 20 to 40 to over $1,500 for workers age 50 to 54 to close to $2,000 for most workers over age 55. Interestingly, these private insurance costs seem to be leveling out by age 55. (The data show a decline for workers age 65 to 69 that may be due to sample size.) Chart B shows total health expenditures per worker, reflecting a more pronounced trend of rising health costs with age. Total worker health costs vary between $1,000 and $1,500 for workers age 20 to 44 but shoot up to $2,700 for the 55 to 59 age band and peak at

$3,500 for the 70 to 74 age band. There is a slight dip in the 60 to 64 age band, but again sampling issues and other factors may be at work here. The calculations are for the worker only; we do not analyze dependent benefits, in part because of the difficulty of attributing costs for many two-earner couples who are dually insured by both their employers.

Comparing the two parts of Figure 2-4 suggests that total insured plus uninsured health costs do not level out in the same way as the private insurance costs but continue to rise after individuals are in their mid-fifties. After the mid-fifties, workers tend to cover a greater share of these expenses through means other than private insurance. For some, more health costs are covered out-of-pocket. For those over age 65, Medicare seems to play an increasing role. We are not sure why provisions requiring Medicare to be a secondary payer when there is employer health coverage do not come more into play here. For full-time, full-year employees covered by employers' private health insurance, most costs should be covered by the employer plan. Historically, then, there seems to be some evidence that employer health plans still shifted some costs to the government, but we are told anecdotally that many firms believe just the opposite. While this issue is beyond the scope of this study, for our purposes it is worth noting that the trend toward higher costs for older workers—at least for some firms—may be the presumption on which employers base their employment decisions.

In any case, the data clearly imply that older workers are more expensive in absolute dollars than younger workers in terms of their health costs. However, the incentives differ from defined benefit pensions in the following respect: there is no large rise in health costs relative to cash wages and salaries for those employees whose productivity increases with time on the job and whose cash wages also increase accordingly (Figure 2-5). More precisely, when we assumed that productivity rose with age when examining pension benefits, there was still a substantial increase in pension costs—over and above the rate of growth of cash wages. In fact, productivity growth can cause problems in the DB pension world because faster wage growth tends to increase the pension accrual rate by making past years of coverage more valuable. In the case of health benefits, however, costs do rise with age in an absolute sense, but not in the same relative sense (in Figure 2-5, the percentage rise health cost is even smaller than the rise in productivity as a worker approaches middle age, although the trend then reverses). Accordingly, the cost of health insurance does not exhibit the same strong incentives, say, for employers to get rid of workers during some rapid accrual stage as do traditional defined benefit pension plans. However, as we shall see below, health benefit packages do contain some perverse incentive effects—in particular, in the hiring of older workers who are without accumulated human capital and are as new to the work as younger workers. In this case, there may be no productivity growth to offset rising health care costs.

Medicare as a Secondary Payer. Complicating our health story is a federal law requiring that employers be the primary health insurer for workers 65 and over, thus displacing Medicare benefits to which individuals are otherwise entitled. As indicated in the data, it is not clear how effectively this provision works, as Medicare seems to be a significant source of payments for health care even for those who work full-time, full-year for employers offering health insurance to their employees.[8] If these data are correct, then costs do not rise as substantially on average for employers as we might otherwise have expected past age 65.

Nonetheless, the Medicare as a secondary payer provision prevents a person working for a firm from getting a benefit to which he or she is otherwise entitled. It is a significant tax on work, at least work at a firm offering such health benefits (which includes almost all large firms [Steuerle and Bakija 1994]). There are ways for an employee to get around this limitation, such as working for small firms that do not offer benefits, or, when possible and legal, converting to a role as a consultant (see discussion in Chapter 3). Nonetheless, such efforts complicate the continuation of work past age 65.

One problem with interpreting data on people over age 65 is that so many people now retire fully by age 62 and few among the rest work as late as age 65. In 2000, only 24 percent of adults age 65 to 74, for instance, were in the labor force (Fullerton and Toossi 2001). If only fairly healthy people stay on the job, and those with the highest health care expenses are most likely to retire earlier, then we have to be careful in projecting the health care costs of future older workers, if there are more of them, by the costs of today's older workers. The relative cost of insuring older workers would rise much more in a world with expanded employment. Hence, the requirement that Medicare be a secondary payer could serve as a much greater tax—and hence barrier to later employment—than is revealed by data on those who currently work full-time in their late sixties and seventies.

[8] Complicating this issue, as discussed below in another context, is that those who work past typical retirement ages may be in better health and thus fail to fall into the small percentage of those who, due to their illnesses, account for a large share of total health care costs (see Mercer, 2001).

Hiring Older Employees

In our previous analysis, we concentrated mainly on incentives for firms to shed longer-term workers and for longer-term workers to leave firms—in both cases inducing earlier retirement (or at least retirement from that job). Labor in a market economy, however, exhibits a fair amount of turnover, so it is important to examine how benefit structures might affect the decision of a firm to hire a new worker who is older or for a worker to take another job. That is, we would like to know how pension and health employee benefits affect the ability or desire of a worker to join one firm after leaving another.

One way of examining this issue is to take a group of workers who are assumed to be equal in all respects except age and who apply for the same job paying the same cash wage. We then want to compare the cost of hiring workers who are different ages according to the types of employee benefits offered.

Figure 2-6 shows the amount of accrued pension benefits for the average worker who works in the pension plans in the PIMS dataset for exactly five years. We use a five-year minimum period to ensure that everyone is at least vested in his or her benefits. Even with vesting, it is quite clear that the younger worker is very cheap relative to the older worker. Someone who works from age 25 to age 30 with a plan accrues very little in the way of pension benefits—an average of 2.1 percent of pay in the 340 defined benefit plans examined. When a young worker leaves a firm, the value of any accrued pension benefits must be discounted by the many years until retirement. That is, the "nominal" value of annual benefit to be paid—for example, the additional percentage of some average salary that would be available upon retirement—is the same for the worker who starts at 25 and the one who starts at 55. But the 55-year-old worker might be eligible to receive the benefits immediately at 60, whereas the 25-year-old who leaves the firm at age 30 must wait another 30 years to get that same annual benefit, which increases with neither inflation nor real income growth over that time period. Hence, the younger worker is much cheaper.

The average accrual rate rises to a range of 8 to 10 percent of pay for workers who work for five years somewhere between the ages of 50 and 65. We did not do projections past age 65, in part because of lack of detail on what other plan provisions might come into play. However, it should be clear that the basic plan provisions of a traditional DB plan would hurt those older workers mainly because they would have fewer years of life expectancy in which to draw benefits, especially when they have to wait five years for vesting to withdraw money (at age 70 or later).

When it comes to health insurance, the difference in health costs for older workers comes into play now in a way it does not when older workers are assumed to have increased productivity because of more time on the job. Since we are assuming the same level of cash wage for all these new employees, the tripling of health costs from younger to older ages shown in Figure 2-4 makes an older employee a less attractive candidate. While these data are for full-time, full-year workers, a similar problem would be present if a firm offered partial payment for health insurance prorated based on the hours of work.

Social Security and Medicare Eligibility

It is well established that Social Security and Medicare serve as significant incentives for retirement (see, e.g., Favreault and Johnson 2002; Johnson 2001). While this study focuses on the private sector, one must always keep in mind that the private sector really follows the public sector's lead, in no small part because the latter provides more pension and health benefits for the majority of people. While the normal retirement age for Social Security is gradually increasing, from age 65½ in 2002 for those born in 1937 to age 67 for those born after 1955, neither the eligibility age for Medicare of 65 nor the early retirement age of 62 has been changed. Today, some 90 percent of workers have filed for Social Security benefits by the time they reach 65. Thirty-two percent of men and 24 percent of women file for benefits at precisely that age (Social Security Administration 2001).[9] Eligibility rules indicate when to retire—regardless of physical ability—and workers respond accordingly. Both the signal of when to retire for public benefits and the level of benefits indicate when to retire for private benefits as well.

Under Social Security, moreover, if beneficiaries earn more than a fairly low threshold between age 62 and the full retirement age, they are hit quickly with reduced benefits. Despite substantial offsets in terms of higher benefits later in life (by some measures, the offset is actuarially fair if one does not take into account additional taxes paid[10]), this remaining earnings test for workers age 62 to the full retirement age sends strong signals to beneficiaries. Consequently, most earn no more than the threshold—or nothing at all. The earnings test for workers beyond the "normal" retirement age has

[9] Note that 42 percent of men and 52 percent of women file for Social Security at age 62.
[10] When taxes are added in, the level of lifetime benefits received by those retiring at age 62 is not actuarially fair. See Steuerle and Bakija (1994).

recently been eliminated, thus removing an important disincentive to work among those few still working beyond that age.

Private plans build both their normal and early retirement incentives around the ages at which people begin to retire on Social Security, almost independent of individuals' capacity to work and productivity. As public benefits have grown with time, moreover, the incentive to retire has increased. Current law promised an average couple retiring at age 65 in 1999 a combined Social Security and Medicare benefit worth about $750,000 (in 1999 dollars), in contrast to approximately $100,000 (in 1999 dollars) expected by a couple who turned 65 in 1960.[11]

Summary

In this chapter we have examined the structure of employee benefits in many firms and found that this structure discriminates against work in older ages. In particular, the defined benefit structure in private and public pension plans generally penalizes employees who work beyond a certain age and increases employers' cost for older workers.

Health benefits, too, discriminate. They are worth more to older workers than younger workers. However, for workers who acquire seniority and experience on the job, the differential between employer health insurance cost for older and younger workers as a percentage of pay would be smaller and in some cases nonexistent. For workers without rising productivity—as might occur in a job that required little training—this offset would not be present and the incentive differential would remain large.

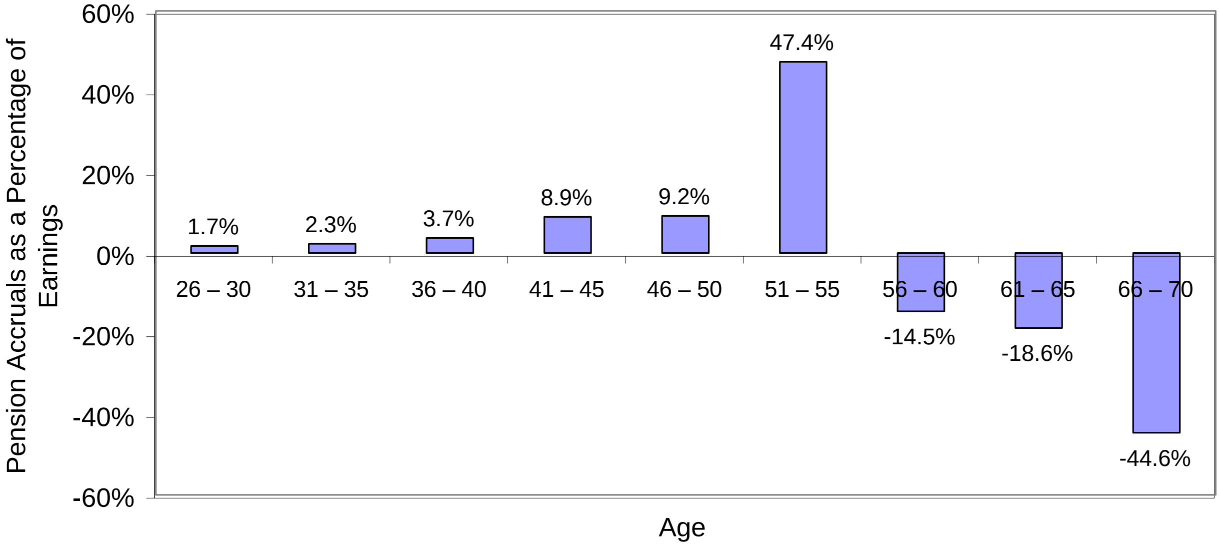
[11] Values are calculated from the Steuerle-Bakija-Carasso Social Security Model, first developed in Steuerle and Bakija (1994).

For both pension and health benefits, we also saw that there were significant disincentives to hire new workers who were older. If they stay on the job for five years, they cost the firms significantly more than younger workers with the same qualifications and skills. In the case of new hires, of course, we no longer can depend upon some past experience on the job to mitigate against a rise in the cost of health benefits for older workers.

Note that many of these effects might be avoided with more flexible compensation structures, especially at older ages. As noted above, the movement toward defined contribution plans and cash balance defined benefit plans has tended to add some flexibility in the pension area, but many workers are still in traditional defined benefit plans, and the DC and cash balance plans have their own sets of issues—including a tendency toward withdrawal of funds before retirement. Greater flexibility in allowing firms to limit their rise in health costs simply because they hire older workers could also make employing older workers more attractive. But there are many legal impediments to conversion as well, as we shall see. Also, adding greatly to flexibility would be elimination of the requirement that Medicare serve as secondary payer. Since so few people now work past 65, the cost would be moderate—estimated at $3.4 billion in 1998, or 1.5 percent of Medicare spending in that year (U.S. House of Representatives 2000).

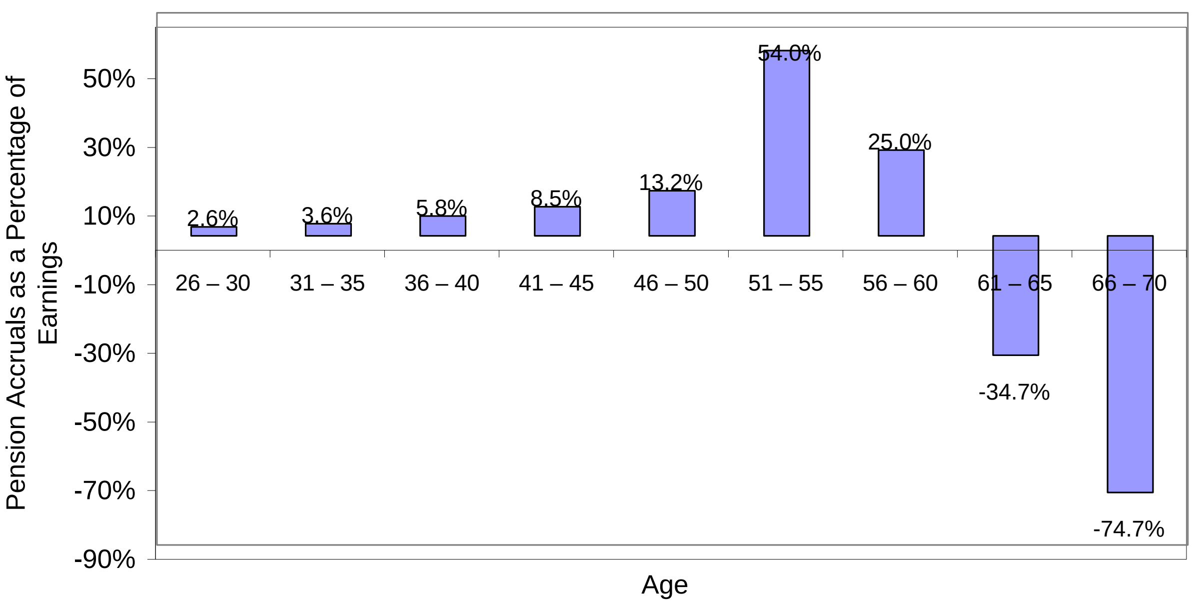
Figure 2-1. Pension Accruals in Various Federal and State Systems

A. Pension Accruals in FERS



Note: Accrual estimates assume that workers join the plan at age 25 and leave at the age that maximizes the present discounted value of pension benefits (or age 70). The analysis assumes that wages grow at the average age-specific rate for college-educated male workers with DB plans as reported in Toder et al. (2002). The real interest rate is set at 3 percent and the inflation rate at 3.3 percent. Estimates exclude accruals from the Thrift Savings Plan.

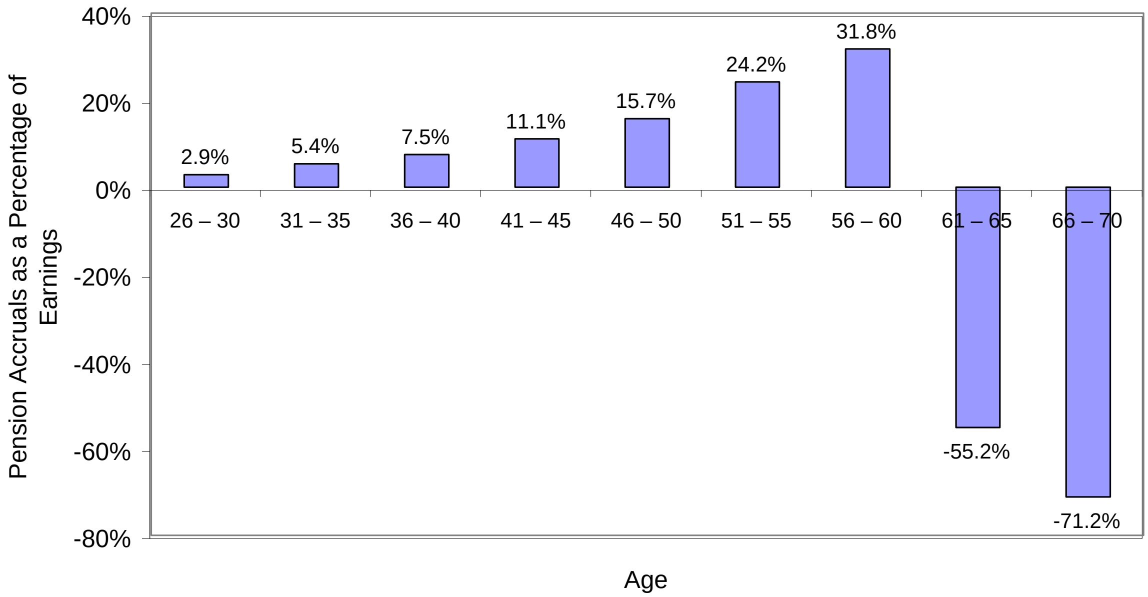
B. Average Pension Accruals for California Teachers



Note: Accrual estimates assume that workers join the plan at age 25 and leave at the age that maximizes the present discounted value of pension benefits (or age 70). The analysis assumes that wages grow at the average age-specific rate for college-educated male workers with DB plans as reported in Toder et al. (2002). The real interest rate is set at 3 percent and the inflation rate at 3.3 percent.

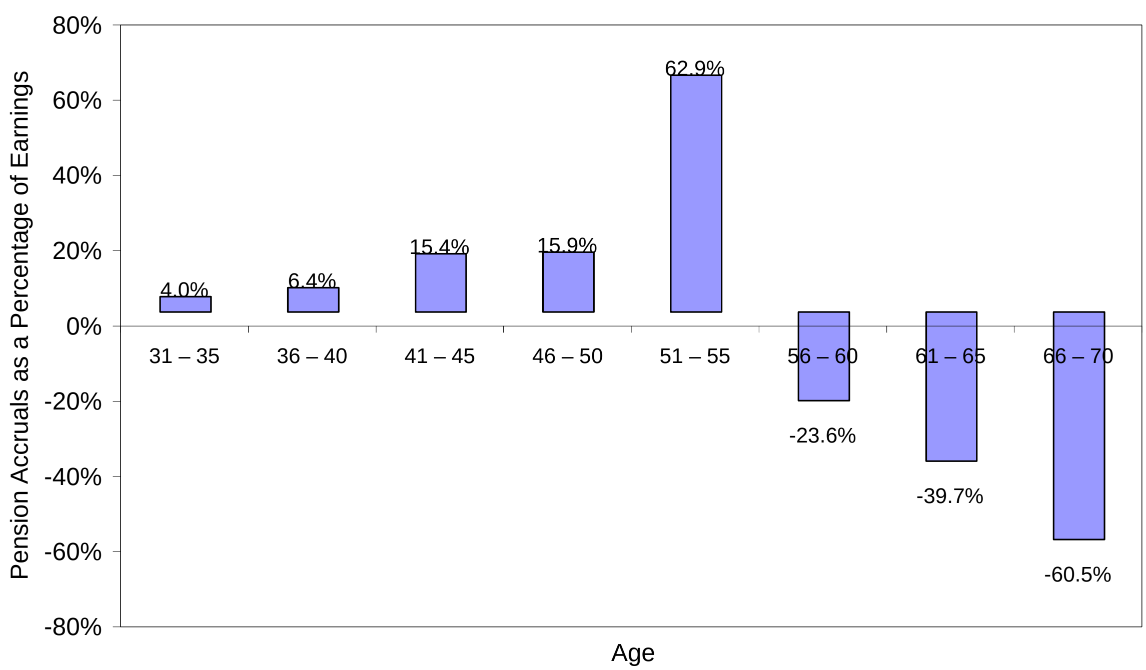
Figure 2-1. Continued.

C. Average Pension Accruals for Illinois Teachers



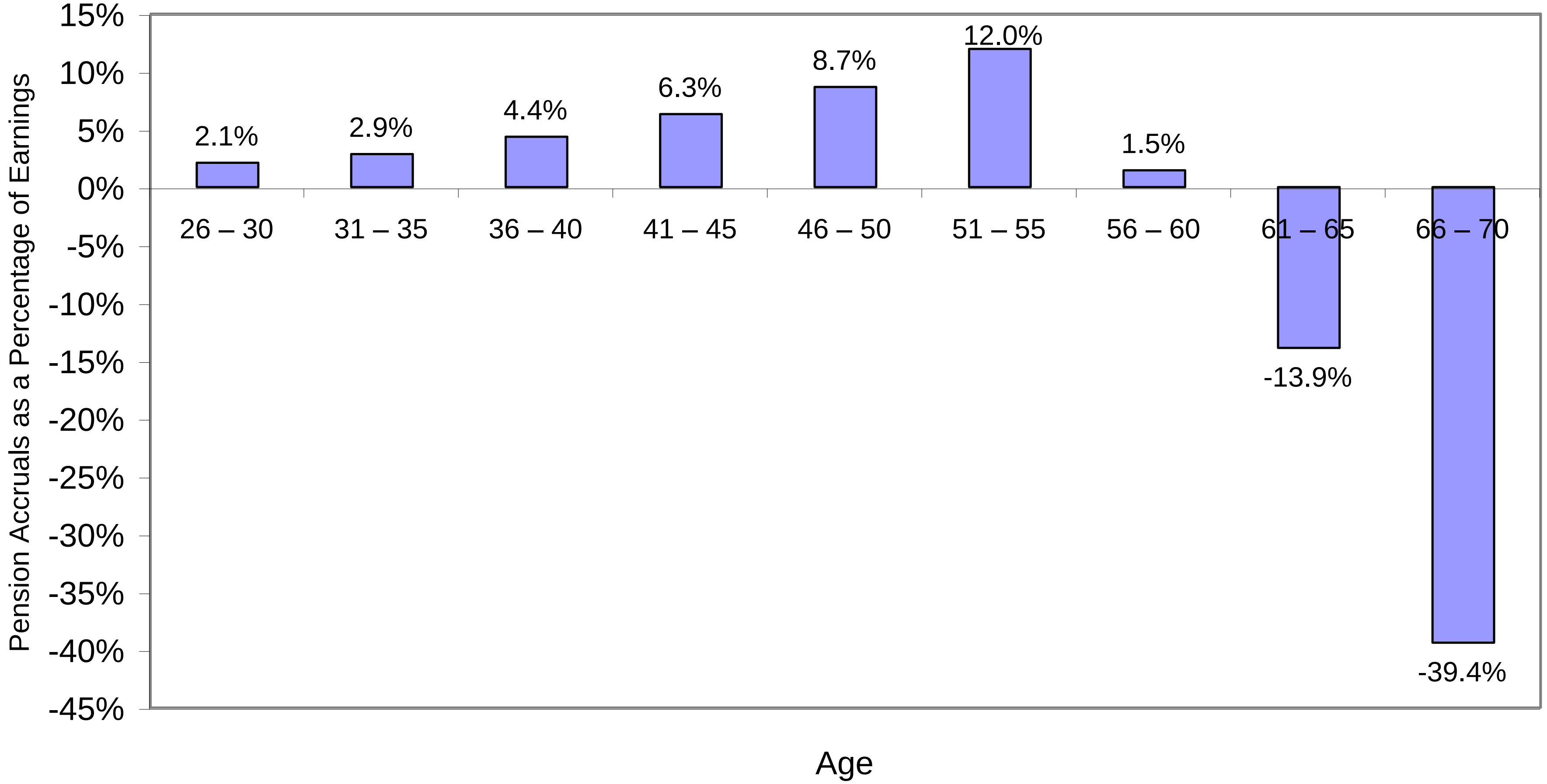
Note: Accrual estimates assume that workers join the plan at age 25 and leave at the age that maximizes the present discounted value of pension benefits (or age 70). The analysis assumes that wages grow at the average age-specific rate for college-educated male workers with DB plans as reported in Toder et al. (2002). The real interest rate is set at 3 percent and the inflation rate at 3.3 percent.

D. Average Pension Accruals for New York Teachers



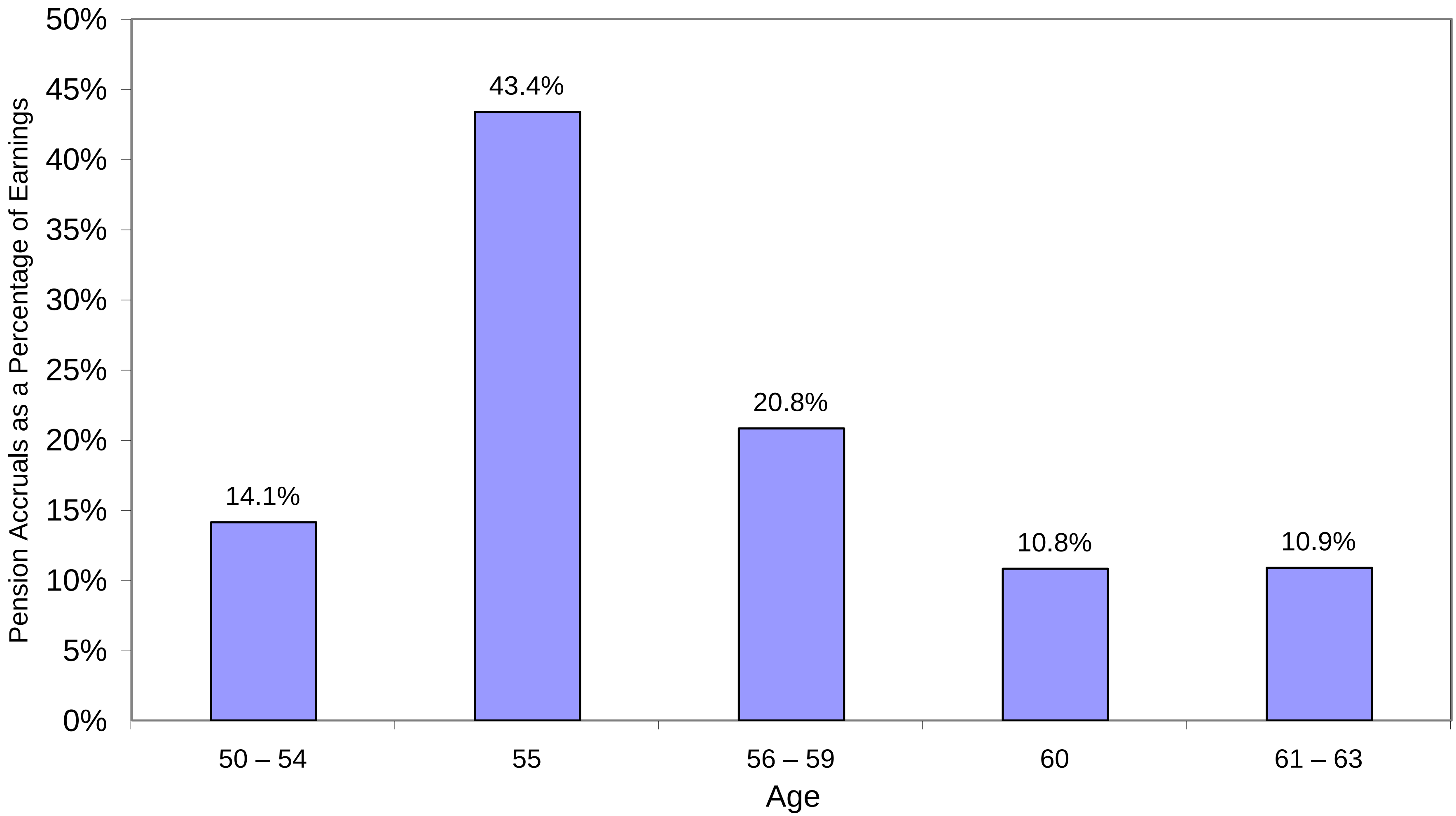
Note: Accrual estimates assume that workers join the plan at age 25 and leave at the age that maximizes the present discounted value of pension benefits (or age 70). The analysis assumes that wages grow at the average age-specific rate for college-educated male workers with DB plans as reported in Toder et al. (2002). The real interest rate is set at 3 percent and the inflation rate at 3.3 percent.

Figure 2-2. Average Accruals in Private DB Plans
(For Workers Starting at Age 25)



Note: The analysis is based on a sample of 340 salary-based DB plans in the private sector. Accrual estimates assume that workers join the firm at age 25 and leave at the age that maximizes the present discounted value of pension benefits (or age 70). The analysis assumes that wages grow at the average age-specific rate for college-educated male workers with DB plans as reported in Toder et al. (2002). The real interest rate is set at 3 percent and the inflation rate at 3.3 percent. Estimates are weighted by firm size.

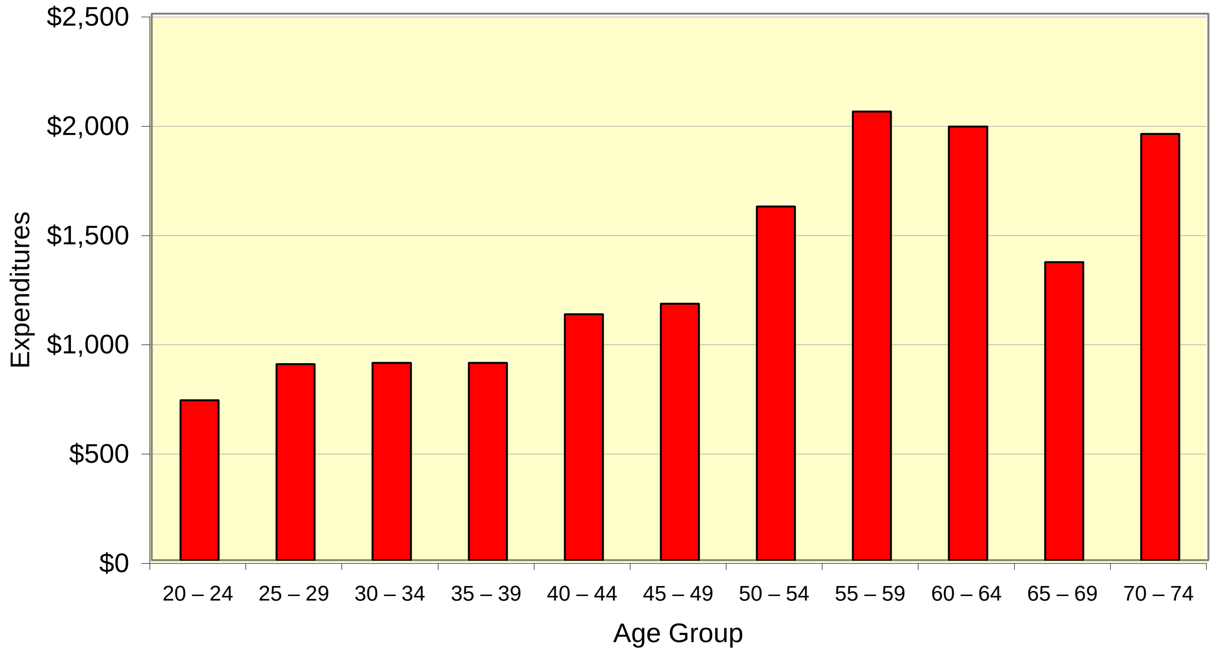
Figure 2-3. Distribution of the Age at Which Pension Accruals Peak, for Private Salary-Based DB Plans



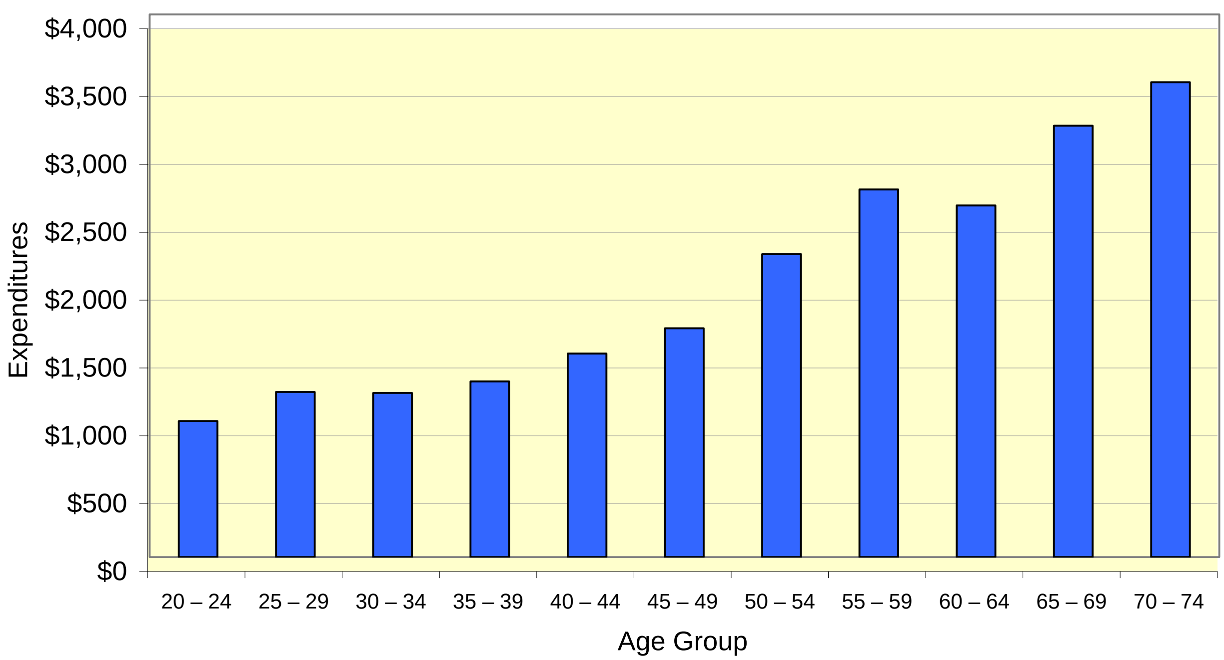
Note: The analysis is based on a sample of 340 salary-based DB plans in the private sector. Accrual estimates assume that workers join the firm at age 25 and leave at the age that maximizes the present discounted value of pension benefits (or age 70). The analysis assumes that wages grow at the average age-specific rate for college-educated male workers with DB plans as reported in Toder et al. (2002). The real interest rate is set at 3 percent and the inflation rate at 3.3 percent. In about 3 percent of plans, pension accruals peak at age 30, when benefits vest. These plans are excluded from the analysis. Estimates are weighted by firm size.

Figure 2-4. Per Worker Health Care Expenditures

A. Per Worker Health Care Expenditures Paid by Private Insurance

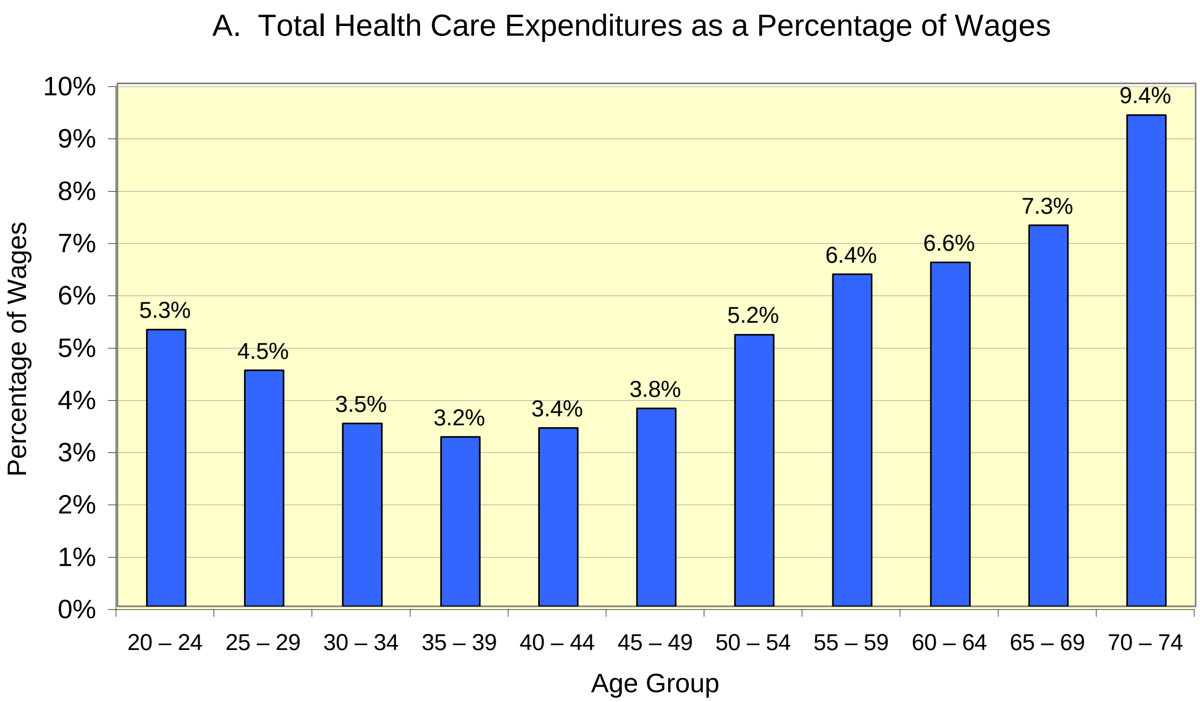


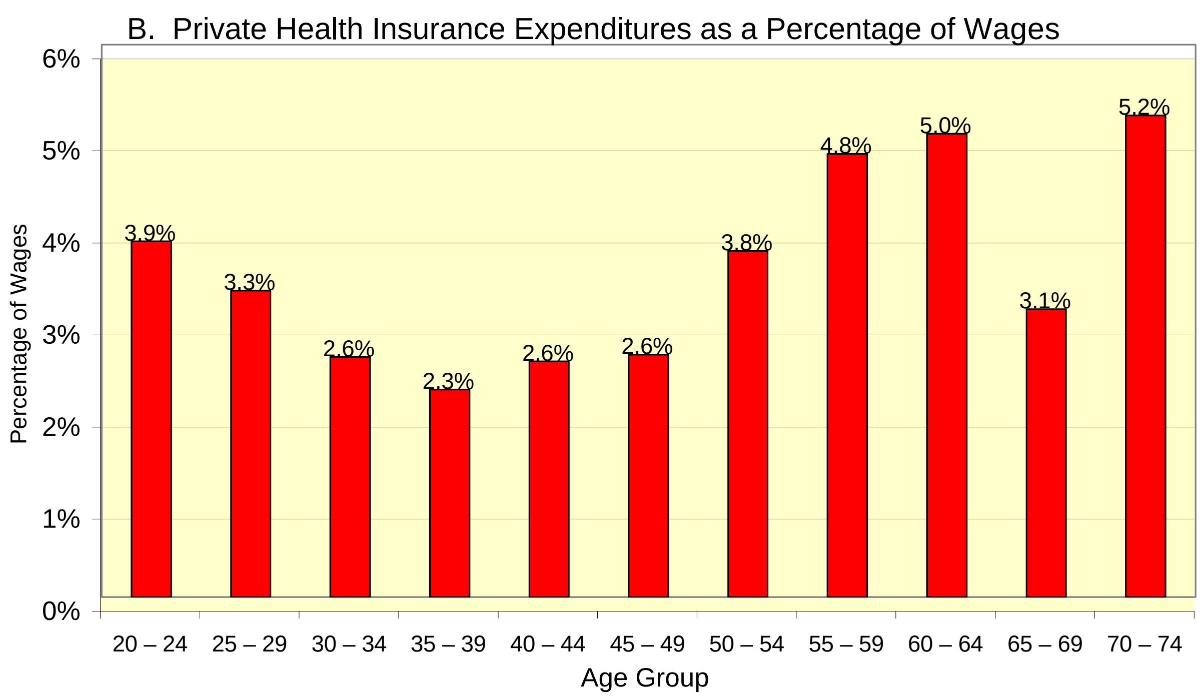
B. Total per Worker Health Care Expenditures



Source: 1996 Medicare Expenditure Panel Survey

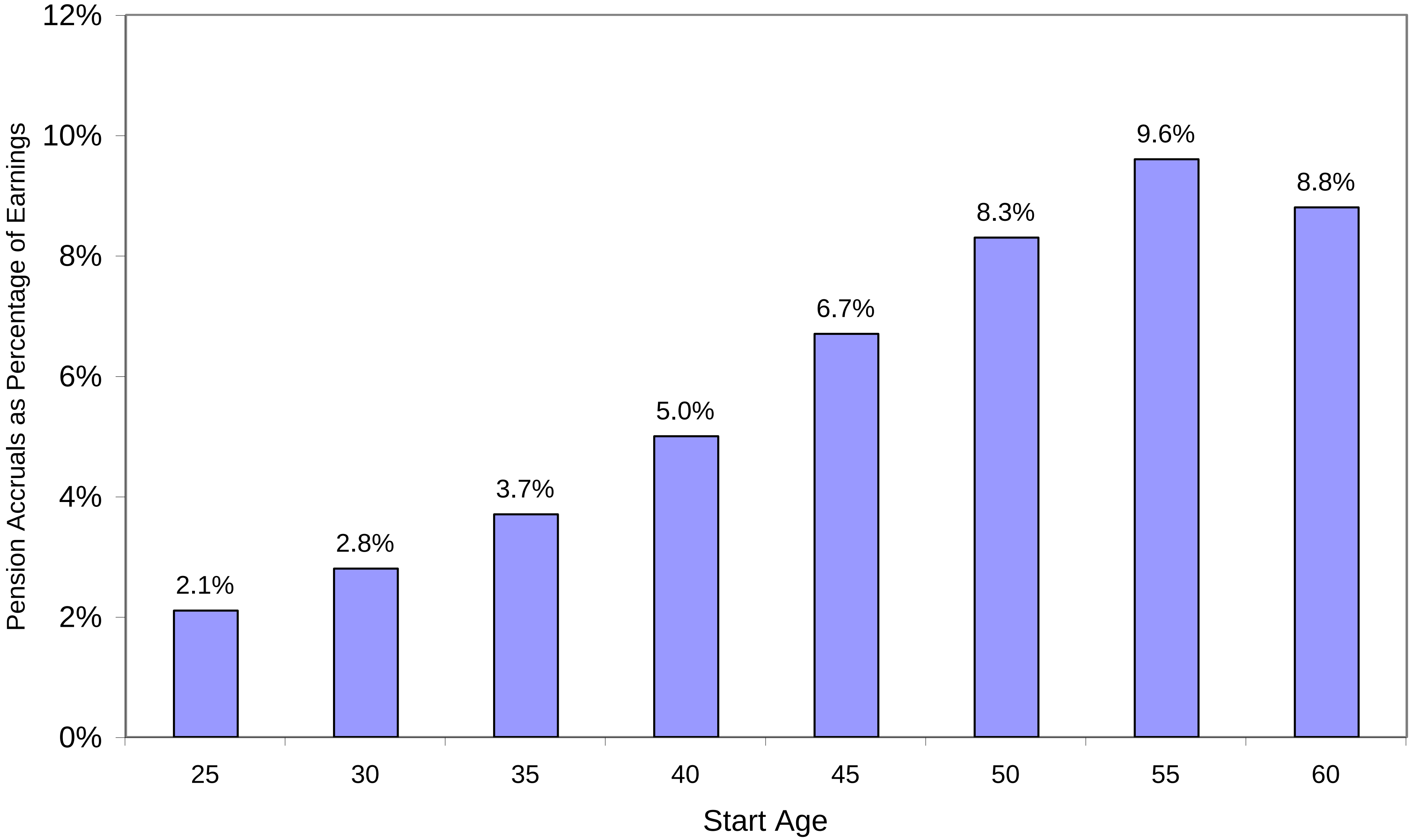
Figure 2-5. Health Care Expenditures as a Percentage of Wages





Source: Authors' calculations based on data from the 1996 Medicare Expenditure Panel Survey and the Bureau of the Census.

Figure 2-6. Average DB Pension Accruals in the Private Sector during the First Five Years of Service, by Start Age



Note: The analysis is based on a sample of 340 salary-based DB plans in the private sector. Accrual estimates assume that workers leave the firm at the age that maximizes the present discounted value of pension benefits, or age 70, whichever comes first. The analysis also assumes that all workers receive a starting annual salary of $35,000 that grows at 5 percent per year. The real interest rate is set at 3 percent and the inflation rate at 3.3 percent. Estimates are weighted by firm size.

CHAPTER 3

Legal Impediments to Partial Retirement

Introduction

The previous chapter described private institutional arrangements and public policies that encourage early retirement and inhibit flexible retirement arrangements that may involve working less than full-time. But if, even in the face of such disincentives, the employer and employee wished to negotiate a more gradual transition out of the labor force, they would face a number of discouraging legal and regulatory hurdles that were created in the past with the best of intentions.

The notion that our laws and regulations should be designed to facilitate phased retirement represents a 180-degree shift in traditional benefits thinking. For decades, employers have looked for benefits tools to ease older workers *out* of the workforce, either to implement downsizing or to make room for the huge cohort of baby boomers who were eager to work their way up the career ladder. Consequently, employee benefit programs incorporate a large legal apparatus designed to influence the departure of older workers from the workforce. This apparatus was constructed over many years as part of a developing consensus over how employer and employee needs should be balanced. There is no similar apparatus for phased retirement programs, and much of the current apparatus is in fact an impediment.

Ideally, a phased retirement program should be a routine employee benefit program that permits employees to adjust their work hours and responsibilities gradually as they transition to full retirement.[12] Its compensation and benefits—both pension and

[12] There are a number of good reports and analyses on the issue of phased retirement (e.g., LaBombarde 2001; Rajnes 2001; Working Group Report on Phased Retirement 2000).

welfare—structure should be flexible. It should provide employers with reasonable and predictable costs, minimal administrative responsibilities, and legal protection against claims for age discrimination. It should enable employees to make an informed decision about participating and maintain current law protections for older workers, particularly for those who must work out of financial necessity.

This chapter examines the legal issues impeding the development of phased retirement programs. The first section describes the three major laws that govern employee benefits and how they conflict with the objectives of phased retirement programs. It also describes how similar issues were resolved when early retirement programs were first developed on a large scale a decade ago. The next section explores the legal issues in the design of phased retirement programs from the perspective of the employer and discusses strategies that appear to be successful although they are available to only some employers. The chapter then reviews phased retirement programs from the perspective of the employee and describes some of their drawbacks. In the final section, a number of policy options for changing current law are considered. The chapter concludes with some recommendations for change—from relatively simple regulatory changes to extensive statutory changes—that could be adopted to accelerate the development of phased retirement programs.

Legal Background

To design a phased retirement program, an employer has to answer three basic questions: How will the work arrangement be structured? Which employees should be eligible? How will employees be paid? An employer's answer to these questions will have important legal implications. Phased retirement programs, with some limited exceptions, will fall within the category of employee benefit programs. By any standard, such programs are heavily regulated by multiple statutes and complicated regulations. The relevant statutes are designed for different purposes, but a common theme—the protection of employees—is prominent in each.

This section briefly describes the major federal laws that control employee benefit plans and their pertinent features for purposes of phased retirement programs. It concludes by illustrating how a similar initiative for early retirement programs might serve as a model for legal changes to spur the implementation of phased retirement programs.

Special Benefits Statutes: The Tax Code and ERISA

Because they receive special tax benefits, employee benefit plans are subject to special rules in the Internal Revenue Code. In addition, they are generally also subject to federal labor law, much of which arose out of the Employee Retirement Income Security Act (ERISA), whose purpose is to secure the benefits promised employees in employer-sponsored plans. Nothing in ERISA or the tax code requires employers to establish benefit plans or mandates the types of benefits those plans must offer. But both statutes play a critical role in structuring the plans of employers who choose to do so.

Not all plans and not all employers are subject to the full array of regulation. The plans sponsored by state and local governments and other public authorities are exempt from ERISA as well as many important tax code rules and are regulated instead by state law (ERISA § 4(b)). A second exception applies to the type of plan. As a general rule, plans that pay health insurance, life insurance, or similar benefits—so-called welfare benefits—are subject to much less regulation and scrutiny than plans that pay retirement benefits. Employers have almost complete discretion over which employees will be covered and what benefits will be offered in welfare plans. In addition, employees have no vested rights to benefits in these plans, so employers are free to change these plans as they see fit. Both the tax code and ERISA provide employers who include welfare benefits in their phased retirement programs with the maximum amount of flexibility.

The opposite is true of retirement plans sponsored by private employers. Their regulatory structure reflects a philosophy that employers should be required to make their plans as uniform as possible and include a broad group of employees. As a result, employer flexibility in retirement plan design is limited. A particular plan must satisfy complicated, mathematical nondiscrimination tests. Exhibit 1 (next page) illustrates some of the constraints imposed on employer discretion in retirement plan design. The rationale for these rules originates in the Internal Revenue Code and reflects the sentiment that the tax benefits available through retirement plans should not disproportionately benefit higher-paid employees.[13] Through the passage of ERISA in 1974 and subsequent legislation, benefits law has increasingly required employers to

[13] These rules were first enacted in the Revenue Act of 1942 in an effort to ensure that a plan would cover a reasonable proportion (a "good group") of an employer's workforce and would not skew its benefits or contributions to owners, executives, and other high-paid employees. These rules have been elaborated upon and increasingly tightened in subsequent amendments to the tax code.

Exhibit 1. Restrictions on Employer Flexibility in Retirement Plans

- A retirement plan may impose only minimum age and service standards for participation.
- A retirement plan must cover a high proportion of low-paid workers.
- A retirement plan may not pay disproportionate benefits to high-paid workers.
- A retirement plan must have standard rules for how all participants will accrue benefits in a pension plan and receive contributions in a profit-sharing plan.
- A retirement plan's other benefits, rights, and features such as loans, forms of distributions, early retirement subsidies, rights to make and receive contributions, and so on must generally be available to all participants.
- A retirement plan must have a standard schedule for vesting.
- A retirement plan may not reduce or eliminate vested benefits.

adhere to rules promoting uniformity and standardization in the treatment of employees and types of benefits offered. As a result, as a general rule, employers find it all but impossible to create benefits specifically for special groups of workers—whether they are older workers, younger workers, or any other category of workers.

Technical tax rules also complicate the regulatory landscape for phased retirement programs. Here the problem is not too much uniformity but too little. Under most scenarios, these programs would anticipate relying on retirement plans to provide supplemental income to part-time retirees. But not all plans are capable of providing this income. Tax law very early on divided the retirement plan universe into two types: pension plans and profit-sharing plans.[14] Today, this distinction has lost most of its popular meaning, as both types of plans provide retirement income. As a legal matter, however, the distinction is still critical, controlling important plan features such as when benefits may be paid. As a

[14] This distinction has existed ever since retirement plans were first invented in the late 1800s. The more or less latest IRS position on this issue was adopted in 1956 and can be found at Treasury Regulation § 1.401-1.

result, this distinction between plan types has a major impact on the design of phased retirement programs.

So-called pension plans are defined in regulations as those intended to pay benefits “over a period of years, usually for life, after retirement” (Treasury Regulation § 1.401-1(b)). They have two basic forms: defined benefit plans, including hybrid defined benefit plans such as cash balance plans, and money purchase pension plans, which are defined contribution plans with a set contribution formula.[15] Profit-sharing plans are now the most common form of retirement plan.[16] Although they were originally created to enable employees to participate in the profits of their employer, employers are no longer required to have profits before making plan contributions. Profit-sharing plans have two basic forms: stock bonus plans, including employee stock ownership plans, and profit-sharing plans, which include the popular 401(k) plan. Profit-sharing plans permit employers, and employees in the case of 401(k) plans, to decide each year how much, if anything, they will contribute, subject to tax code limits.

[15] Recent increases in the deductible limits for profit-sharing plans have reduced the attractiveness of money purchase plans. As a result, few new money purchase plans will be created and many existing plans will be terminated or merged into profit-sharing plans. Pension plan rules, however, will continue to apply to funds originally contributed to money purchase plans. .

[16] Prior to the adoption of I.R.C. § 401(a)(27)(A) in the Tax Reform Act of 1986, employers could make contributions to their profit-sharing plans only in years in which they had profits.

Because pension plans are designed to pay retirement income, their ability to pay in-service benefits to employees is limited. The Internal Revenue Service (IRS) has interpreted the "retirement income" restriction in pension plans to prohibit payment of benefits, other than disability and death benefits, before an employee terminates employment or the plan itself is terminated (Revenue Ruling 56-693, 1956). As Exhibit 2 illustrates, employers have traditionally chosen age 65 as normal retirement age, although the previous chapter and prior studies have shown that the design of defined benefit plans may encourage retirement before the normal retirement age (Dulitsky 1999; Kotlikoff and Wise 1985, 1987, 1989; Stock and Wise 1990). Pension law does not mandate age 65 as normal retirement age but generally does require defined benefit plans to express benefits as an annual amount beginning, for most employees, no later than age 65. Most employers choose age 65 as the normal retirement age in their plans in order to satisfy this rule easily and because, until recently, age 65 was the traditional age for retiring and receiving full Social Security benefits.

Exhibit 2. Pension Plans

- Plans may not pay benefits before "normal" retirement age.
- The employer determines what the normal retirement age is.
- Defined benefit plans are generally required to calculate benefits as beginning at age 65.
- Age 65 used to be the normal retirement age for full Social Security benefits.
- Age 65 is the customary, but not legally required, normal retirement age in pension plans.
- Most pension plans cannot pay benefits to current employees before age 65.

Profit-sharing plans are not prohibited from paying benefits to current employees, and employers can choose to include a number of different distribution options in their plans.[17] The technical rule is that these plans may pay benefits "after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment" (Treasury Regulation § 1.401-1(b)(ii)). Exhibit 3 illustrates the types of distribution options typically available. Tax law, however, does distinguish between contributions made by employers and contributions made by employees and imposes special limits, for example, on 401(k) contributions. A 401(k) plan may not let current employees withdraw their own contributions prior to age 59½. Younger employees may access their own funds only by taking a loan from the plan or by qualifying for a small "financial hardship" distribution in a limited number of circumstances.

Exhibit 3.Optional Rules in Profit-Sharing Plans for Current Employees

- Employees may withdraw employer contributions after two years.
- Employees may withdraw employer contributions after five years of plan participation.
- Employees may withdraw employer contributions at any age.
- Employees may withdraw contributions on account of financial hardship.
- Employees may withdraw contributions to take a loan.
- Employees may not withdraw 401(k) contributions (employee contributions) before age 59½.

Tax law contains an additional disincentive to early participation in a phased retirement program. Employees normally pay regular income tax when they withdraw funds from retirement plans. But current employees who take withdrawals before age

[17] Each distribution option adds a layer of complexity and contributes to the record-keeping burden of plan administration, so few employers permit the maximum number of distribution events in their plans.

59½ pay an additional 10 percent excise tax in addition to regular income tax, unless they lock themselves into withdrawals in the form of lifetime annuity payments (I.R.C. § 72(t)). Employees who *quit* after age 55 and take any form of withdrawal are not required to pay this extra tax.

This combination of plan distribution restrictions and extra tax penalties can make employees reluctant to participate in a phased retirement program with their current employer. For example, in a defined benefit plan, many employees under age 65 will find switching to part-time work in a phased retirement arrangement unattractive because they cannot begin receiving pension payments as supplemental wages until age 65. Employers could, of course, choose a lower normal retirement age to facilitate earlier distributions, but that would accelerate the accrual, and therefore the cost, of benefits for all participants. Some have suggested, however, that liberalizing this restriction to promote phased retirement programs is warranted. Legislation, the Phased Retirement Liberalization Bill, was introduced in a prior session of Congress to permit pension plans to provide in-service distributions after attainment of age 59½ or completion of 30 years of service. By enabling defined benefit plans to make payments to current employees before normal retirement age, such legislation would facilitate phased retirement programs.[18] In a profit-sharing plan, many employees who have not reached age 59½ also have little incentive to stay with their current employer in a part-time work arrangement. If they quit, not only can they get complete access to their own 401(k) contributions as well as their employers' contributions but they also avoid a 10 percent penalty tax on their withdrawals if they are at least 55 years old.

[18] The Phased Retirement Liberalization Bill was introduced in the House of Representatives on July 13, 2000, but was not enacted into law.

As a result, many employees who might otherwise prefer to remain with their current employers in a phased retirement arrangement will find switching to a new employer an attractive option. If their current employer has a defined benefit plan, employees under age 65 who have earned or are close to earning their maximum benefits under that plan may choose to work for a new employer part-time while drawing pensions from their previous employer. If their current employer has a 401(k) plan, employees over age 55 may quit so they can withdraw funds without a tax penalty as needed from their 401(k) accounts rather than waiting until age 59½.

Two issues are raised by the tax treatment of defined contribution plans. First, should we remove the tax penalties for withdrawals by current employees before age 59½? Doing so would be more neutral with respect to the age of retirement and would rationalize the tax treatment of current and former employees. This change might also facilitate the development of more flexible partial retirement arrangements before 59½. However, the tax subsidy provided for retirement savings has a clear purpose. It encourages people to provide for an adequate income for their retirement; allowing early, penalty-free withdrawals would interfere with that goal. In that sense, the philosophy of the tax law is consistent with the philosophy of compelling people to join the Social Security system. Society feels the need to protect itself against people who would otherwise irresponsibly spend too much during their working lives and throw themselves into safety net programs, such as Supplemental Security Income, when they are elderly.

The second question is whether pension and profit-sharing plans should be treated the same way by the tax law. That is to say, both might allow penalty-free withdrawals after age 59½ whether or not the employee continues to work for the same employer. That would appear to be a desirable reform.

Special Protections for Older Workers: The ADEA

Phased retirement programs will inevitably be subject to an additional overlay of regulation under the Age Discrimination in Employment Act (ADEA). From a phased retirement perspective, the ADEA is particularly problematic. It is a highly specialized area of labor law within the family of employment discrimination statutes and is both substantively and procedurally quite different from the tax and labor law familiar to benefits professionals. In addition, it is, however, ambiguous and not well tested when compared to its counterparts in the tax code and ERISA. Its application to employee benefit plans is just beginning to be fleshed out by the courts as older employees begin to assert age discrimination claims against perceived benefit cutbacks.

Nevertheless, the ADEA will play a prominent role in the development of phased retirement programs, because such plans fall squarely within its mandate of protecting older workers. It is just difficult at this time to predict the contours of its role. Court cases, rather than government statutes or regulations, typically shape the evolution of the ADEA. Because age discrimination lawsuits on benefits issues are still in their infancy, it will be many years before there is enough settled case law to measure the influence of the ADEA on employee benefit plans.

The ADEA forbids employers from discriminating against workers age 40 and older with respect to the "compensation, terms, conditions, or privileges of employment, because of an individual's age" or "to limit, segregate, or classify ... employees in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee because of such individual's age" (ADEA § 4(a)). It applies to public and private employers with at least 20 employees. Under a recent Supreme Court case, however, state governments are immune from suits by individual employees under the ADEA (*Kimel v. Florida Board of Regents* 2000). Its primary influence on benefits law to date has been to eliminate rules related to chronological age that used to limit older workers' participation in benefit plans. Exhibit 4 illustrates those rules that apply largely to retirement plans.[19] The ADEA does permit a limited number of age distinctions in employee benefits plans. For example, a retirement plan may set a minimum age for early or normal retirement benefits, and defined benefit plans are permitted to pay subsidized early retirement benefits as well as Social Security supplements (ADEA § 4(l)(1)). In addition, employers have a defense against age discrimination claims when their actions can be justified by the terms of a bona fide employee benefit plan (ADEA § 4(f)(2)(B)). This defense is available, provided that the plan satisfies an "equal cost or equal benefit" standard in the benefits paid to older workers

Exhibit 4. Rules Related to Age

- Employers may no longer require employees to retire.
- Employers are prohibited from discriminating on the basis of age in their benefit plans.
- Life insurance, health insurance, and disability benefits for older workers must satisfy an "equal benefit" or "equal cost" standard.
- A retirement plan may not refuse participation to employees on the basis of age.
- A retirement plan may not stop benefit accruals or contributions because of a participant's age.
- A retirement plan may not decrease benefit accruals because of increasing age.
- A retirement plan must vest participants at the later of age 65 or after five years of participation.

[19] Many of the changes made by the ADEA to benefit law are incorporated into both the tax code and ERISA. Because the IRS, rather than the Department of Labor, typically has jurisdiction over the ADEA-related rules, they will be discussed as tax code rules.

(ADEA § (4)(f)(2)(B)(i)). The Equal Employment Opportunity Commission (EEOC), the agency with regulatory authority over the ADEA, however, has taken the position that the equal cost defense does not apply to retirement plans (EEOC 2000).

But the full implications of this EEOC ruling are not clear, and in general, there continues to be considerable legal uncertainty surrounding the ADEA and its application to employee benefit plans. According to Section 11(l) of the ADEA**,** "The term 'compensation, terms, conditions, or privileges of employment' encompasses all employee benefits, including such benefits provided pursuant to a bona fide employee benefit plan." The ADEA does not, however, elaborate on the meaning of "a bona fide employee benefit plan." It is also silent on when a benefits plan that satisfies all tax code and ERISA requirements may violate the ADEA's prohibition against age discrimination. In some instances, such as the requirement that benefit accruals continue after normal retirement age, the ADEA specifically incorporates related provisions under ERISA and the tax code. But the vast body of employee benefits law is not incorporated into the ADEA. In addition, the EEOC takes the position that "neither [the tax code nor ERISA] is a defense to conduct that is unlawful under the ADEA … because neither *requires* an employer to discriminate on the basis of age. Thus the fact that a plan meets the standards of ERISA or the Internal Revenue Code is typically irrelevant in determining whether the plan is in compliance with the ADEA" (EEOC 2000, p. 8).

Until there is more guidance on the extent to which benefit plans that satisfy the tax code and ERISA must be changed to comply with the ADEA, employers will be reluctant to adopt phased retirement plans, largely because of their legal exposure. In the first major test of age discrimination in pension plans, the U.S. District Court for the

Southern District of Indiana held that the benefit accrual rates in one employer's cash balance plan did not constitute age discrimination. (*Eaton v. Onan Corporation* 2000). This decision does not, however, settle the issue of age discrimination, and more litigation is inevitable. Resolving the issue of age discrimination in pension plans is important not just as a matter of statutory interpretation but because the economic stakes are high for both employees and employers. [20] The potential damages in a case of age discrimination are very significant. In addition to paying employees the benefits they should have received as is required by ERISA, an employer may, under the ADEA, also be required to pay compensatory damages for mental anguish and inconvenience as well as punitive damages for intentional discrimination, attorneys' fees, and court costs.

A Precedent: Early Retirement Programs

One way to illustrate the legal difficulties facing phased retirement programs is to look at a precedent involving nearly identical legal issues. During the recession of the early 1990s, employers wanted to offer early retirement incentives to encourage workers to leave voluntarily through retirement rather than involuntarily through layoffs. These incentives were often structured as "windows" or short-term programs, and employers wanted to have the flexibility to decide which employees would be eligible for the programs. The benefits package often included both enhanced retirement benefits and retiree health benefits.

The legal issues confronting these plans were extremely difficult. Under pension law, how could a plan make a short-term program available to a select group of

[20] Despite a favorable ruling in litigation, the Onan Corporation agreed to pay plan participants $23 million to settle the law suit (Purcell 2002, footnote 34).

employees? On its face, this seemed to violate long-standing pension rules promoting uniform and standard benefits and preventing employer discretion. In practice, these programs would probably violate nondiscrimination rules as well because older, and presumably higher-paid, employees within the plan population could receive more generous benefits. Under the ADEA, how could an employer offer benefits that could be greater for younger workers than older workers in the targeted group? Many employers also required workers accepting special early retirement offers to waive their rights to sue under various employment statutes, including the ADEA. Was this permissible under the ADEA or other benefits law? Under pension law, waivers of benefits have long been subject to special scrutiny. Judges will generally enforce only waivers that can be shown to be truly knowing and voluntary.[21] Under case law, individual waivers would be upheld or not, depending on the facts and circumstances of each lawsuit. As a result, because there were no uniform legal standards for waivers, employers had no advance assurance that their waivers would protect them from lawsuits.

[21] Under a line of cases following *Finz v. Schlesinger* (1992), a judge must review a waiver of ERISA rights in the context of (1) the plaintiff's education and business experience; (2) the amount of time the plaintiff had to review the agreement before signing it; (3) the role of the plaintiff in deciding the terms of the agreement; (4) the clarity of the agreement; (5) whether the plaintiff was represented by or consulted with an attorney; and (6) whether the consideration given was in addition to the employee benefits to which the employee was already entitled by contract or law.

In the end, the legal issues were so complex that they were resolved only through new legislation and regulatory action. The IRS added language to its nondiscrimination regulations setting standards for special early retirement window benefits (Treasury Regulations § 1.401(a)(4)-3(f)(4) and 1.410(b)-5(d)(7)). The ADEA was amended to permit certain early retirement programs and waivers of benefits in those programs (ADEA § 4(f)(2)(B)(ii)). The compromise solution for early retirement programs is illustrated in Exhibit 5. In addition, the ADEA was amended to permit waivers of rights to sue provided they (1) are part of a written agreement specifically listing the claims to be waived; (2) are effective only as to claims available before the waiver is signed; (3) include additional consideration for the employee; and (4) advise the employee to consult with an attorney, give at least 45 days to review the offer, and provide specific information about the program, including eligibility and time limits as well as the job titles and ages of employees covered by the program and the ages of similarly situated employees who are ineligible (ADEA § 7(f)).The compromise resolution of the legal issues surrounding early retirement programs is neither elegant nor simple. It has not eliminated litigation, because there are sometimes allegations of age discrimination, but

Exhibit 5. The Compromise Solution for Early Retirement Plans

- An early retirement plan must be voluntary.
- An employer may set a minimum age or years of service for eligibility.
- The plan may be offered for a limited period of time.
- The plan may be offered to selected groups of employees.
- The plan may not provide lower-level benefits to older employees unless it meets the equal cost or benefits test, provides the subsidized portion of an early retirement benefit, or is a Social Security supplement plan.

the law has generally worked in that early retirement incentive programs are now commonplace and accepted by employers, employees, and courts.

Phased Retirement: The Employer's Perspective

Although phased retirement has become a popular topic, few data are available on the extent of these programs today. Because the programs are not subject to government reporting requirements, there is no systematic information about how many employers are adopting these programs. In addition, little information is available about how employers are structuring the work arrangements, deciding which employees are eligible, or creating pay policies in phased retirement plans. In the past two years, however, there have been some exploratory studies that provide preliminary data. The benefits consulting firm of WatsonWyattWorldwide (WatsonWyatt) recently surveyed about 500 of its employer clients on their phased retirement programs, while the benefits consulting firm of William M. Mercer (Mercer, 2001) questioned over 200 of its clients. In addition, the American Association of Retired Persons (AARP) funded a number of small studies on phased retirement, including a combination of interviews and case studies of about 80 employers (AARP 1999; Mercer 2002; Rappaport 2001; WatsonWyatt 2000a; WatsonWyatt 2000b). Taken together, the three studies suggest that there are several trends.

Employers express interest in phased retirement, but only a small minority currently try to implement it. Only 16 percent of employers in the WatsonWyatt study and 23 percent in the Mercer study offered work options, programs, or plans to ease the transition to retirement. Among the 65 companies interviewed by AARP, about 30 percent offered part-time work or flexible schedules. The studies reveal neither the typical number of hours worked nor common types of flexible arrangements offered by companies. The findings are consistent with the HRS data, discussed in Chapter 1, which indicate that only 26.4 of older workers are employed by firms that allow reduced hours.

There is no uniform model for current employees. Employers use a variety of phased retirement strategies and techniques. These range from part-time work arrangements for individual employees, a common strategy, to formal structured programs for groups of employees, a much less common approach.

Rehiring retirees for part-time and temporary work is the most common arrangement. In addition to or sometimes instead of making phased retirement available to their current employees, many employers hire their own retirees back or hire retirees from other companies for less than full-time work. The WatsonWyatt study, for example, reported that 75 percent of employers with phased retirement arrangements hired retirees as part-time and temporary workers. Among 65 companies interviewed by AARP, over 60 percent hired back retirees. In the Mercer study, 63 percent of the surveyed employers had a policy of hiring retirees, although it is not clear whether these were their own retirees or retirees from another company. Hiring former employees can present some difficult legal issues, discussed later in this chapter, for phased retirement programs.

Private employers lag far behind public and not-for-profit employers in sponsoring phased retirement programs. The WatsonWyatt study reports that employers in education, public administration, and health care offer phased retirement programs most frequently.

Why Creating Programs for Current Employees Is Difficult

The apparent reluctance of employers to craft programs to ease the transition to retirement for current employees has many possible explanations. A large percentage of employers who reported not having a program in the Mercer study felt that phased retirement was not a priority for them (65 percent) or their employees (11 percent). Only 4 percent cited legal complexity as a deterrent. But the numbers alone do not give a true picture. The majority of these same employers do offer phased retirement opportunities—just not through a plan. They prefer to make individual retirement arrangements for selected employees on an ad hoc basis.

From the employer's perspective, this strategy makes a great deal of sense. It achieves the goal of many employers (49 percent in the WatsonWyatt survey and 30 percent in the Mercer survey) to retain employees with specialized skills and expertise. It provides an employer with an opportunity to be creative when deciding how the work arrangement should be structured, which employees should be eligible, and how employees will be paid. It is a perfectly legal way to avoid the hassles of a more structured program—but only up to a point. The ADEA, the tax code, and ERISA regulate only employee benefit "plans," so once an employer arrangement qualifies as a plan it must satisfy all the relevant rules.

Consequently, individual arrangements are a stopgap measure at best. If an employer limits phased retirement opportunities to only a few employees, they will work well. Even if the employer chooses only high-paid executives, individual arrangements are permissible.[22] But if the number of employees grows and the employment

[22] ERISA provides exemptions from its usual requirements for so-called top hat plans that are designed for a select group of management and high-paid employees.

arrangements are sufficiently similar, a series of individual arrangements will at some point become a plan. Unfortunately, at the present time, there are no clear legal rules on when a series of informal arrangements become a plan.[23] Most employers will not even be aware of their potential exposure until they are sued by some disgruntled employee. But at that point they may encounter the full weight of liability under the tax code, ERISA, and the ADEA.

When individual arrangements are no longer practical, what is the next best strategy for an employer? The survey data indicate that many employers take the first step toward a formal phased retirement program by offering reduced hours or work schedules to current employees. This type of arrangement is unlikely to be termed a "plan" under either ERISA or the tax code because neither law regulates the work hours of employees. This is a typical practice adopted by about 60 percent of WatsonWyatt employers, 50 percent of Mercer employers, and 30 percent of the employers interviewed in the AARP study. If this arrangement is made available to a broad-based group identified, for example, by length of service or job level, it should be reasonably free of ADEA issues. If employees merely shift to part-time work with wages and benefits correspondingly reduced, there are few legal difficulties. But merely offering part-time work would be rarely satisfactory for either most employers or most employees. It provides employers nothing extra to offer the employees they most wish to retain, and it gives employees nothing more than they could probably negotiate on their own and very likely costs them some of the welfare and pension benefits they might otherwise receive.

[23] Although ERISA provides definitions for types of welfare and pension plans, it is often left to the courts to determine when a particular arrangement has become a plan. Following the leading case, *Fort Halifax Packing Company v. Coyne* (1986), courts have generally asked the following questions: Is there an administrative scheme requiring employer discretion? Is there a continuing commitment to provide benefits?

As a practical matter, the only feasible strategy for employers who would like to retain large numbers of employees through phased retirement is to create a broad-based formal program. Having a formal plan offers some advantages to an employer. From a legal perspective, it greatly minimizes exposure to liability under state law and ADEA claims.[24] A formal program can be a nightmare to design, however. As was true of early retirement programs before the law was restructured, employers do not have the ability under current law to create flexible, targeted phased retirement programs. Early retirement programs are much simpler from a legal perspective because they are concerned with only exiting employees. Phased retirement programs pose many more complicated issues because they are concerned with employees who are simultaneously continuing and exiting from work. Example 1 illustrates many of the legal obstacles facing an employer trying to tailor a plan to this segment of its workforce.

[24] If the plan is an ERISA plan, it is protected from state law claims under a preemption provision. In addition, an employer can assert a "bona fide benefit plan" defense to claims under the ADEA.

Example 1.
Employer A wants a phased retirement program for current employees. Can it

- **create special increased benefits in its retirement plans just for phased retirees?**
  Extremely unlikely, unless rigorous nondiscrimination tax rules could be satisfied.
- **limit the program to only employees in certain job categories or with designated service?**
  Probably, but if only high-paid employees qualify, its retirement plans may fail tax law coverage and nondiscrimination requirements.
- **require phased retirees to retire fully after five years?**
  Probably not. The ADEA prohibits mandatory retirement.
- **make distributions from a defined benefit plan to supplement pay?**
  Yes, but only at the individual's option and if he or she has reached the normal retirement age (usually age 65) in the plan.
- **make distributions from a defined contribution plan to supplement pay?**
  It depends. No, if the plan is a money purchase plan and the individual has not reached its normal retirement age. Yes, at the individual's option and if the profit-sharing plan has the usual distribution options for employer contributions. No, if the plan is a 401(k) and the individual wants to withdraw his or her own contributions before reaching age 59½, but loans and hardship distributions may be available.
- **stop accruing benefits or making contributions under its retirement plans for phased retirees?**
  Generally not, but there is an exception for individuals who have reached a service limit under a defined benefit plan formula.
- **require phased retirees to waive participation in retirement plans?**
  No.
- **permit phased retirees to choose between retirement plan participation and a higher rate of current pay?**
  No, this is arguably a 401(k) plan in an impermissible form.
- **promise to pay phased retirees more after full retirement but not through its retirement plans?**
  No, this would be a pension plan subject to but also guaranteed to flunk ERISA's funding, coverage, and participation rules and tax code nondiscrimination rules.
- **promise to pay phased retirees more now?**
  Yes

As Example 1 indicates, a formal phased retirement program provides employers with little flexibility. To satisfy a combination of ADEA and tax law concerns, its eligibility criteria must be broad-based. To satisfy ERISA and tax law concerns, retirement benefits must also be broad-based and include those in phased retirement programs. Employers would often like to provide financial incentives to retain employees who might otherwise retire, draw full retirement benefits, and then go to work part-time for a competitor. To be attractive, a program must offer more than part-time pay. But the most convenient sources of supplemental income, the employer's retirement plans, cannot be modified to provide a special supplement to retirement income or make other special benefits available to phased retirees. An employee may prefer additional immediate compensation to higher retirement benefits later, but an employer is not allowed to offer such a deal. Most employers must continue to fund additional benefits in their retirement plans for phased retirees (I.R.C. § 411(b)(1)(H)). While additional cash compensation is legal, this would make an employee very expensive when the additional cash is combined with a mandatory addition to retirement benefits.

The problems posed by retirement plans for phased retirement arrangements are not entirely due to current law rules promoting uniformity and standardization of participation and benefits, although they do play a significant role. Neither are the tax rules controlling the timing of distributions that much to blame. These rules all create disincentives for employers to sponsor and employees to participate in phased retirement programs, but they do not absolutely prevent them. More fundamental and intractable disincentives can be found in the structure of retirement plans themselves, with defined benefit plans being the primary culprits.

Employers have long found defined benefit plans useful as a tool to promote retirement at a predictable age, usually no later than 65 and often much earlier. Defined benefit plans are not age-neutral. Participants typically accrue benefits under a formula that maximizes benefits around normal retirement age for a full-career employee. The tax code does impose certain accrual standards known as “antibackloading” rules to make sure participants accrue a reasonable portion of their benefits earlier in their careers. But, as a practical matter, employees often receive their most valuable benefit accruals earlier than the normal retirement age. The previous chapter showed that once employees are past the age at which benefits accrue most rapidly in typical private defined benefit plans, further accruals provide little, if any, incentive to work longer. Moreover, the majority of plans contain early retirement options that provide a substantial incentive for retirement before normal retirement age. These permit employees to retire at an age earlier than normal retirement age, usually 55 to 62, after completing fewer (generally between 15 and 20) years of service than the number of years required for a full retirement benefit. Early retirement benefits are attractive because they are frequently “subsidized” through the use of favorable actuarial calculations.

Defined benefit plans have these characteristics because for decades employers found them useful devices for rationalizing the retirement process for their workforce. Now that later retirement is an issue, they have a perverse effect because their accrual structure cannot be easily adapted to encourage later retirement. Employers are generally not free to amend their plans to remove or reduce early retirement subsidies because these are “protected” benefits under tax code nondiscrimination rules.

It is also difficult for them to terminate their defined benefit plans and replace them with other plans. Defined benefit plans are expensive to terminate because tax law imposes a 50 percent excise tax on excess assets returned to the employer after all benefits have been paid. Converting them into defined contribution plans is not an option either, because this just results in a de facto plan termination. The only feasible option for employers is to convert their plans into "cash balance" plans that are defined benefit plans with defined contribution features. Participants accrue benefits under these plans through a more age-neutral, front-loaded formula, and few provide early retirement subsidies. But even this option is not easy.

Not all employers will want to make the substantial changes such as developing a new plan formula and funding schedule, redrafting the plan document, informing participants, and obtaining IRS approval a conversion requires. In addition, cash balance plans have achieved a certain notoriety among employees. Older employees, for example, find that the benefits they accrue under the cash balance design are far less than they would have accrued under the defined benefit plan. In addition, many employers add a transitional feature to their plans as part of a conversion that results in a "wear away" of benefits. If so, older employees receive reduced or no "contributions" to their cash balance accounts for several years until the value of any early retirement subsidies accrued under the defined benefit plan has been eroded. Employees have argued that such features constitute age discrimination, and these issues are currently in litigation. Many employers have responded to the controversy over cash balance conversions by adding some additional protections for older workers. Some let employees choose between the new cash balance formula and the old defined benefit formula. Others "grandfather" more of the benefit previously subsidized in the defined benefit plan. If this trend continues, cash balance conversions will become even more common among employers and even more acceptable to employees.

Defined contribution plans, because they are legitimately age-neutral and more front-loaded, do not provide incentives for early retirement that are as powerful as those provided by defined benefit plans. Participants receive contributions based on their annual compensation as long as they continue to work. In some circumstances, defined contribution plans can even contain incentives for continued work. Depending on the demographics of an employer's workforce, defined contribution plans can have an "age-weighted" allocation formula so that older workers receive a higher employer contribution than younger workers. Over the past 10 years, defined contribution plans have become the dominant form of retirement plan. Employers who offer only defined contribution plans—now the majority of employers among those with retirement plans—find phased retirement programs easier to implement, even under the limitations of current law.

Why Hiring Retirees Is Preferred

Many employers have found (or believe they have found) a satisfactory alternative to the difficulties presented by formal programs for current employees. They just hire retirees—their own and those of other companies. Some 60 percent of employers in the Mercer study as well as those interviewed by the AARP reported a policy of rehiring retirees. There are a number of popular arrangements. Many hire retirees for part-time and temporary work. For example, 75 percent of employers in the WatsonWyatt study and 63 percent of employers in the Mercer study who rehire retirees offer a part-time option, and an additional 15 percent of employers maintain a pool of retirees for temporary work. Some 24 percent of employers in the Mercer study will even rehire retirees full-time. Hiring retirees as consultants—without benefits—is also common. Over 60 percent of the Mercer employers who rehire retirees and over 40 percent of the WatsonWyatt employers will use consulting arrangements.

On its face, hiring retirees seems an obvious solution to the problems associated with current retirees. It gives employers an opportunity to attract workers with specialized skills and expertise, usually on a flexible, as-needed basis. It also appears to provide employers with the ability to negotiate employment arrangements that provide flexibility in determining compensation and benefits costs. All in all, it is a win-win situation—but generally only if the retirees are from some other company. For many employers, hiring former employees is hardly trouble-free. The type of arrangement—whether the retiree is hired as an employee or a consultant—largely determines the scope of the difficulties.

When retirees are hired as employees by their former company, the problematic issue is the employer's benefit plans. Again, defined benefit plans are the primary culprits. Defined benefit plans may not pay benefits before termination of employment or attainment of normal retirement age. Many employers adopt a popular strategy to satisfy this rule—the "retire/rehire" scenario. In this case, employees who would like to begin receiving retirement benefits while continuing to work "resign" or "retire" but are soon rehired—sometimes the next day—by their former employer. The law is very clear that employees must truly terminate employment to be entitled to retirement benefits from pension plans before normal retirement age. But the law is very unclear about what constitutes a "termination" of employment that satisfies the rule.[25]

In many cases, employers, particularly small employers, are unaware of this technical legal requirement. Others take advantage of the absence of clear guidelines and bestow retiree status liberally. There is little risk of detection and even less risk of enforcement. Few employees would sue as the arrangement only benefits them, and federal regulators would become aware of the issue only through a detailed plan audit, if even then. On the other hand, the penalty for being caught—possible plan disqualification and loss of tax benefits for all plan participants—is severe. Therefore, many employers are more cautious and require a waiting period before former employees are rehired. In the Mercer study, employers who rehire their own retirees reported requiring a mean waiting period of 5.2 months. Although this is a judgment call, most pension experts would agree that this waiting period would probably satisfy the rule, provided that it was not part of a clearly prearranged agreement.

The "retire/rehire" problem, of course, applies to only an employer's former employees. All retirees hired as employees, however, may pose problems for an employer's benefit plans. Many employers would like to restrict participation by retirees. This is relatively easy to do in welfare plans if employers are careful either to define the category of eligible employees to exclude retirees, where possible, or to keep their hours worked below the minimum required, generally 20 hours a week, for participation. A

[25] There is little IRS guidance on this point. Its most complete explanation can be found in a relatively obscure document, General Counsel Memorandum 38924 (July 26, 1990). This document discusses the legal difference between the terms "separation from service" for purposes of making pension distributions and "separation from the service," a term used to define a lump sum for purposes of obtaining favorable tax treatment for a distribution.

1,000-hour-a-year threshold for participation applies in most retirement plans but is generally effective with respect to only "new" retiree employees.

Although employers are allowed to exclude employees in the above categories from retirement plans and other benefits, most former employees are eligible to resume participation in their employer's plans immediately upon rehire.[26] Including retirees who work part-time in plans is expensive for employers and can pose an administrative burden if the retirees work only sporadically or infrequently. Employers usually still must track the hours of service performed by these retirees to determine whether they are eligible for an additional benefit accrual or a contribution each year.

Many employers prefer to avoid the retiree benefits eligibility issue entirely by hiring them through consulting contracts. A consultant is an independent contractor, not an employee, and is therefore ineligible for employee benefits programs. This solution works well from a legal perspective, provided that the retiree actually is an independent contractor. The difference between an independent contractor and an employee from a legal perspective is a judgment call, but, under IRS regulations, a very important test is whether the individual sets the conditions—how, when, and where—of his or her work.[27] There are no statistics on this point, but it is very likely that many retirees, called independent contractors, cannot satisfy this standard. They typically perform the same job as consultants that they performed as employees and look and act more like employees than not.

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[26] Although an employer may exclude certain categories of employees from retirement plans, the IRS looks with disfavor on any excluded category called "part-time employee" or "temporary employee." It takes the position that these definitions could violate ERISA's minimum service standards for participation. As a result, most employers are not able to exclude retirees from their retirement plans by defining them as part-time. Retirees can be excluded only if they fall into some bona fide employee classification excluded from the plan or fail to satisfy a length of service requirement.

[27] In Revenue Ruling 87-41 (1987), the IRS issued a list of 20 "factors" that are used to determine whether an individual is an employee or an independent contractor.

Until recently, misclassification of employees—designating employees as independent contractors to avoid paying benefits—was not a major legal issue. But it is now a hot topic after several high-profile class-action lawsuits brought by individuals classified as independent contractors who sought retroactive employee status to obtain benefits. The IRS and the Department of Labor have initiated enforcement action against several large employers to obtain benefits wrongly denied and Federal Insurance Contribution Act (FICA) taxes owed to employees misclassified as independent contractors.[28] Hiring retirees as consultants is still an appropriate strategy for the careful employer, but the penalty of worker misclassification—from past FICA payments to retroactive plan benefits—is now high and more certain than in the past.

Why Public Employers Have an Advantage

Since the early 1980s, public-sector employers such as public colleges and universities and offices of state government have been developing phased retirement programs with innovative benefits features. These employers are not subject to the legal constraints of ERISA and much of tax law affecting private employers and so have much more flexibility in creating retirement arrangements.[29] They have long been aware of the problems posed by an aging workforce because their employees tend to remain employees for a long time. State and local governments provide a wide range of benefits to their employees on a uniform basis. Many of those benefits—such as health care—continue for retirees. So state and local governments already have in place many of the

[28] The leading case in this area is *Viczaino et al. v. Microsoft* (1997).
[29] While exempt from much of federal law governing employee benefits, public employers are subject to state statutes that define the benefits they offer. Once implemented, these plans can be difficult to change because it generally requires an act of the legislature to do so.

components of a phased retirement program that private employers typically do not. But state and local governments shared one disadvantage with the private sector—the disincentives to continued employment contained in their defined benefit plans. Taking advantage of their exemption as public employers from many of the more complicated tax and ERISA rules governing benefit plans, they developed a plan, typically called a deferred retirement option plan (DROP), that adds pension incentives to their phased retirement programs (Birley and Eichstadt 1998; Calhoun 2000).

A DROP is a defined benefit plan that has a special defined contribution feature for employees who work past normal retirement age. Example 2 describes the characteristic features of a DROP. Usually, employees cease accruing benefits under the defined benefit plan on a specified date when their benefit is frozen. While they continue to work, the pension they would otherwise have received (if they had retired) is credited to a special account in the plan and earns interest either at an amount stated in the plan or based on the interest earned by the plan as a whole. Many DROPs require an employer contribution to the account as well. In some DROPs, mandatory employee contributions, if required, are also made to the DROP account. When the employees

Example 2. A Typical DROP

Employees enter a phased retirement program. They set a future retirement date. While they continue to work part-time,

- benefit accruals cease under the defined benefit plan;
- benefit payments begin but are held in a separate defined contribution account in the plan; and
- these amounts earn interest and often a cost-of-living adjustment.

At full retirement, employees receive the balance in their accounts in a lump sum as well as annuity payments, usually for life, from the defined benefit plan.

retire, they begin receiving annuity payments calculated on the basis of their frozen benefit under the defined benefit plan. They are also entitled to receive their DROP account funds, which can be paid in a lump sum or installments or used to purchase a larger annuity.

A DROP offers several advantages to employees. It provides them an opportunity to earn additional pension credits in the form of interest after they have “maxed out” under the standard defined benefit plan formula. Even if they have not “maxed out,” the interest credited to their DROP account may be greater than the amount of any additional accrual they would have otherwise received. It also provides them with a large lump sum payment—rarely available under a standard defined benefit plan—upon retirement. At the same time, they continue to be guaranteed their lifetime monthly income from the defined benefit plan. One drawback of a DROP is that it does not provide any pension income while the employee continues to work. So this type of phased retirement program is likely to appeal to only employees who can afford to work part-time because they have other resources.

The advantages to employers are both financial and administrative. DROPs provide employers with more control over increases in benefit accruals and therefore the financial requirements of their plans. Depending on the particular plan, however, cost savings are not guaranteed and plan expenses may in fact increase. Many DROPs also require employees to agree to retire within a stated number of years, usually five, as a condition of entry. So employers also have more information about their future personnel needs while retaining the services of experienced employees for a transitional period. This does not necessarily mean that employers have some discretion over participation in the DROP. Unlike their private-sector counterparts, most public-sector plans cover large groups of employees with few exclusions. Participation in a DROP is typically available to all employees who meet uniform eligibility standards so employers are not guaranteed to retain only the employees they select.

The legality of DROPs is sometimes in doubt. Individual plans may raise questions over whether the DROP accounts satisfy contribution limits or other defined contribution plan rules or comply with the requirement that defined benefit plans provide “definitely determinable” benefits. There are also some concerns about whether the required retirement provision violates rules against mandatory retirement, despite the voluntary nature of DROPs. But DROPs have functioned successfully throughout the public sector for some 20 years, and they are unlikely to be subject to serious legal challenge at this point.

Tax law and ERISA have a number of provisions that prevent private-sector employers from creating DROPs. For example, DROPs are usually unable to satisfy rules on coverage and discrimination because they are not usually available to a broad group of employees. In addition, IRS interpretations of current law make DROPs financially unattractive to some employers. A defined benefit plan under I.R.C. § 414(k) may contain separate accounts that are treated as a defined contribution plan. But while the law provides this mechanism for implementing DROPs, recent IRS interpretations have made it difficult for private-sector employees to do so. The IRS has taken the position that excess assets in defined benefit plans may not be used to fund 414(k) accounts without being treated as a reversion of plan assets to the employer (Private Letter Ruling 9723033, 1997). This means that an employer would have to fund these accounts with new contributions or pay income tax and a 50 percent excise tax on plan assets used for that purpose. As a practical matter, DROPs are not currently available to private-sector employers as a component of a phased retirement program.

Phased Retirement: The Employee's Perspective

Employees are attracted to phased retirement programs for several reasons. Many older workers need to extend their employment because they are not financially prepared for retirement. For others, the financial rewards of work are less important than the personal satisfaction that work can bring. Some value the social interactions of work, and the opportunity to maintain relationships with friends and colleagues is important. Still others enjoy exercising the expertise and skills they have developed over their work lives. For these workers, leaving the workforce entirely is neither desirable nor practical. Phased retirement programs can therefore fulfill a variety of needs—both economic and psychological—for these workers while adding flexibility and a better balance between work and family to their lives.

Even if not motivated by monetary considerations, employees who enter a phased retirement arrangement need to pay close attention to its economics. These arrangements have financial as well as lifestyle implications. Benefits law and therefore benefit plans are full of legal quirks and pitfalls for the unwitting employee. In addition, phased retirement programs have no formal disclosure requirements. For many workers, a phased retirement program may be neither a good idea nor a good deal.

Protecting Pension Expectations

For most employees, the most important consideration is whether a phased retirement arrangement will adversely affect the retirement benefits they will eventually receive. In many respects, the law has built-in protections for older workers. Older workers continue to participate in their employer's retirement plan and receive additional accruals or contributions. Rehired former employees are generally immediately readmitted to those plans. But employees, particularly those in defined benefit plans, should be aware of the following issues.

First, employees who participate in "final average pay" defined benefit plans should not switch to part-time work before reaching normal retirement age. These plans use a formula that bases benefits largely on the average salary earned in the years closest to retirement. Employees who switch to part-time work as they near retirement age lose valuable benefits because their ultimate retirement benefits are calculated on a much lower average salary. The IRS has recently indicated that such reductions may be questionable.[30] But without a firm IRS position on this point, employers will not change this common practice.

Second, many employees rely on benefits from a defined benefit plan to supplement income from part-time work. But many plans, at the employer's option, stop benefit payments to employees who continue to work past normal retirement age or are rehired after payments have begun (ERISA § 203(a)(3)(B)). In the Mercer study, 51

[30] In 2000, Richard Wickersham, a senior IRS representative, stated to an American Bar Association subcommittee meeting that the IRS took the position that a final average pay plan may not reduce the already accrued benefit of an employee whose compensation decreases because this would violate the rule against an accrued benefit's decreasing on account of continued service. Under this position, a phased retiree in a final average pay plan shifting to part-time work would not be at risk for losing already accrued pension benefits. But this position is not well publicized or enforced, and, as a practical matter, many employees in this situation do receive reduced benefits. For an excellent discussion of this issue as well as suggested alternatives, see Scahill and Forman (2002).

percent of employers with defined benefit plans reported stopping benefit payments to employees working after normal retirement age, while 19 percent did not. It is not clear from the study whether employers are formally "suspending" benefits or merely postponing payments until retirement, with adjustments for delayed payment. These issues are extremely technical, and it is difficult to estimate their importance to most phased retirees. It is likely that they will be significant for only employees whose motivation to enter into a phased retirement arrangement is primarily financial. These are the individuals, of course, who most need to protect and enhance their future pension expectations as they continue to work. But these laws—and the plans themselves—are so complicated that it is unlikely that participants will be able to appreciate the difficulty of the choices without individual counseling.

The Drawbacks of Part-Time Work

Pension benefits may be older workers' most valuable employee benefit. Other benefits such as health insurance are also important. Many older workers not yet eligible for Medicare cannot obtain or afford medical insurance on an individual basis. Although some may have coverage through a spouse or from continuation group health insurance through a former employer COBRA or a retiree health plan, the employee benefit of an employer-sponsored health plan will be vital for many.

Employees in phased retirement programs typically receive fewer other benefits than full-time employees, as illustrated in Example 3. In the Mercer study, 35 percent of responding employers reported offering no health benefits to older workers on part-time work schedules, 35 percent offered the same benefits at the same cost, 20 percent offered the same benefits at a higher cost, and 10 percent offered different benefits. In the WatsonWyatt study, nearly 100 percent of employers provided health care, life insurance, and paid vacation benefits to their full-time employees but only 80 percent, 71 percent, and 47 percent, respectively, did so to their phased retirees. Nearly all employers provided disability coverage for full-time employees, but less than 40 percent did so for phased retirees. Many employers who do provide benefits reduce them for phased retirees. WatsonWyatt reported that 66 percent provided reduced life insurance, 47 percent reduced paid vacation, 32 percent reduced disability, and 29 percent reduced health care benefits.

Example 3. Other Benefits Issues of Phased Retirement

Compared to other employees, phased retirees may receive

- no health insurance or more costly health insurance or different health insurance;
- less or no life insurance benefits;
- less or no disability insurance benefits; and
- less paid vacation time.

It is not clear from these studies whether these employers created formal benefits policies for phased retirees or merely treated them as they do other part-time employees. It is well known that part-time employees fare poorly from a benefits perspective. Pension law has the strongest protection for part-time benefits, requiring employers in most cases to cover employees who work at least 1,000 hours a year. But employers are generally free to set any eligibility criteria they like for other non-pension benefits. Those criteria often set at least a half-time standard for participation and exclude various categories of employees such as part-time or temporary workers. Neither the tax code nor ERISA sets explicit coverage or nondiscrimination standards for most welfare benefits. The ADEA does require employers to provide these benefits without regard to an employee's age and establishes an "equal cost or equal benefit" standard for health, life, and disability insurance. But that standard applies with respect to only the benefits provided older versus younger workers. It does not set a standard for part-time versus full-time employees.[31]

An Academic Model of Phased Retirement

Institutions of higher education have been leaders in developing phased retirement programs. These are special programs designed for faculty members who have tenure. When the ADEA eliminated mandatory retirement in 1987, it temporarily provided an exemption for tenured faculty members at academic institutions. Prohibitions against mandatory retirement for faculty did not become effective until 1994; until that time, mandatory retirement at age 70 continued to be permissible. When that exemption expired, the academic community became concerned that many faculty would wish to continue working past age 70. If this occurred, it would hamper their ability to hire new faculty and personnel costs would rise. At the same time, many institutions were concerned about the loss of large numbers of faculty that would soon be reaching

[31] From a pension perspective, employees who work part-time on a weekly basis are treated the same as those who work full-time for many weeks but then take extra vacation time. The general standard is that employers must count, for pension purposes, individuals who work at least 1,000 hours a year. An employee's pattern of work while earning those hours is usually not relevant.

retirement age. The higher education community became interested in formulating a more orderly transition to retirement for its faculty. At the same time, it felt constrained by legal uncertainties about the scope of the ADEA (and its early retirement exception) and therefore was unwilling to create programs without some protection against age discrimination claims.

The result was the Higher Education Amendments of 1998 to the ADEA, which created a safe harbor for age-based faculty retirement incentive programs.[32] The safe harbor permits additional voluntary benefits to be paid, even though based on age, as a retirement incentive, provided that (1) the employer is an institution of higher education, (2) only employees with unlimited tenure are eligible, (3) the benefits are payable upon voluntary retirement, (4) no other age-based reductions or elimination of benefits occurs, (5) the supplemental benefits are in addition to preexisting retirement or severance benefits, and (6) eligible faculty have 180 days to elect to participate.

A recent study by the American Association of University Professors of some 1,400 public and private colleges and universities indicates that the ADEA safe harbor has been extended to phased retirement programs that enable a faculty member to make the transition into retirement over a number of years rather than all at once (Ehrenberg and Rizzo 2001). These help faculty make the transition into retirement through part-time work as well as by continuing part-time work after formal retirement. About a quarter of the private institutions in the study reported having phased retirement programs, representing 50 percent of doctoral degree granting, 33 percent of master's degree, and

[32] This exemption is found in ADEA § 4(m). A fuller explanation of the exemption can be found in Raish 2001.

Example 4. Phased Retirement Programs for Faculty

The faculty member works part-time but may receive

- defined contribution plan contributions based on a full-time salary;
- a full year's accrual under a defined benefit plan;
- enhanced pay (60 percent pay for 50 percent work); and
- full employer contributions for health plan premiums.

31 percent of bachelor's degree private institutions. Parallel figures for public institutions are 31 percent, 23 percent, and 24 percent, respectively.

Faculty phased retirement programs have a number of innovative features, as described in Example 4. Unlike their counterparts among both private and public employers, these plans provide *enhanced* benefits for phased retirement, rather than just a pro rata portion of a standard benefits package or the reduced benefits offered to all part-time employees. In other respects, these programs are similar to those available elsewhere. Some 75 percent establish a minimum age for eligibility, with age 55 being most common, and some 25 percent also establish a maximum age, usually between 65 and 70. Another 75 percent require minimum years of service—between 10 and 20 years—for eligibility. Many plans require participants to agree to relinquish tenure and agree to retire fully at specified dates. Some 16 percent of programs permit faculty to work part-time and retain tenure as long as they wish. But most limit the amount of time tenured faculty can participate in their phased retirement program, with three to five years being a common period.

Institutions with defined contribution plans are twice as likely to offer phased retirement programs as institutions with defined benefit plans. In part, this reflects the difficulties that even these institutions have with providing incentives for continued work through defined benefit plans. But it probably also reflects the fact that many private institutions of higher education offer only defined contribution plans. Tax law permits these institutions to offer a special type of defined contribution plan under I.R.C. § 403(b) that is not subject to the same complicated coverage, participation, and nondiscrimination rules as corporate plans. As a result, academic employers have much more flexibility to tailor the benefits in these plans to select employees, even those that are highly compensated, and apparently many have done so successfully.

Academic phased retirement programs are therefore quite different from those available in the corporate world. For example, they are the only phased retirement model explicitly authorized by law, even though they are just, legally speaking, a special case of early retirement programs. In exchange for this legal certainty, academic employers are required to provide enhanced benefits to phased retirees. No specific benefits are mandated; employers have the freedom to design their own programs. Employees are required to receive full disclosure about the program's features and time to decide whether to participate. Although employers might wish for more tax law flexibility in designing the retirement benefit component of their phased retirement programs, the model now in place has many features the corporate employer might find attractive. All in all, it seems to provide a careful balancing of the needs of both employers and employees. As a result, phased retirement programs, at least for faculty, are becoming accepted in the academic community.

Some Policy Recommendations

In the introduction to this chapter, the following objectives for phased retirement programs were listed: (1) a flexible compensation and benefits (both pension and welfare) structure; (2) reasonable and predictable costs, minimal administrative responsibilities, and legal protection against claims for age discrimination for the employer; (3) full disclosure and informed consent for the employee; and (4) maintenance of current law protections for older workers, particularly for those who must work out of financial necessity. Achieving all these objectives in the current legal climate is not feasible. Benefits law is complicated and rigid and designed to serve objectives that often conflict with the needs of phased retirement programs. Even piecemeal reform will be difficult until there is a consensus on the appropriate scope of these programs and the legal changes required to implement them. There are no easy and simple reforms available that would bring immediate, meaningful progress in the development of phased retirement programs.

The following recommendations, therefore, take an incremental approach. This section first discusses some reforms that could be achieved relatively easily through additional regulatory guidance. Next, it describes some relatively non-controversial statutory changes that have a reasonable chance of passage. More systematic and comprehensive reforms are then considered, using existing early retirement programs as a reference point. Finally, some long-term benefits issues that affect both older and younger workers and require more fundamental reform of ERISA are briefly addressed.

Regulatory Guidance

Regulatory guidance is an obvious starting point for reform. This requires no real changes in law or new legislation. It only requires regulatory authorities to provide more information on their position regarding a particular legal issue. In terms of phased retirement programs, more substantive guidance on the following issues would be invaluable:

When does a bona fide "termination of employment" occur? This is a critical issue for phased retirement programs because it determines when distributions can be made from pension plans. The "facts and circumstances" approach taken by the IRS on this issue is not helpful and has led to widespread disregard of the law. Until employers have some clear guidelines, compliance with this basic benefits rule will be low because there is no real risk of enforcement. The IRS could issue guidance describing a number of "safe harbor" scenarios or discuss more fully the factors employers should consider. This would provide some reassurance and reinforcement for the careful employer while reining in the use of the "retire/rehire" arrangements or inappropriate consulting agreements that are common today.

How is final average pay calculated for part-time employees? This is another point that needs IRS clarification. Phased retirement programs are not attractive to employees in defined benefit plans whose benefits are based in part on their salary averaged over the years closest to retirement. Switching to part-time employment close to normal retirement age will reduce their ultimate retirement benefits. The IRS has recently suggested that it is impermissible to reduce an employee's already accrued benefits in a final average pay plan when compensation decreases. This issue has significance far beyond phased retirement programs. Most benefits practitioners and employers are not aware of this position, and reducing benefits is a common practice. So if this is the IRS's position, it is critical that the IRS disclose and publicize the legal basis for this position. It is hard to overemphasize the importance of additional guidance from the IRS on this issue, which affects not only the qualified status of most final average pay plans but the retirement income of millions of participants.

Statutory Changes

A number of statutory changes have recently been suggested to remove some of the perceived obstacles, largely in tax law, to the development of phased retirement programs. These are relatively non-controversial, but their implications for pension policy over the long term have really not been explored. Some of the alternatives are discussed below.

Permit distributions from pension plans before normal retirement age. The Phased Retirement Liberalization Bill would have repealed the current restriction on distributions before the earlier of termination of employment or normal retirement age in defined benefit plans. In its place, a new rule would permit employees to begin distributions without terminating employment after they reach the earliest of normal retirement age, age 59½, or 30 years of service. This would remove one of the major obstacles to phased retirement programs now present in defined benefit plans. But the bill also raises a number of important concerns because adding a distribution option to a defined benefit plan has financial implications for both employers and employees. Would it apply to only current employees or to terminated vested participants too? What reduction factors would apply to these benefits, and could they be subsidized? What effect would they have on early retirement benefits? Would the bill apply to money purchase pension plans as well? Is it good pension policy to increase the outflow of benefits before normal retirement age? The private pension system already has a problem with "leakage"—that is, with retirement benefits being consumed before retirement.[33] This bill addresses one of the fundamental problems facing phased retirement programs, but it also raises a number of important issues that should be studied further.

Permit distributions from 401(k) plans before age 59½. It is an anomaly of tax law that employees in profit-sharing plans can routinely obtain distributions of their employers' contributions but must wait until age 59½ to access their own. This rule prevents many younger employees from participating in phased retirement programs if they intend to rely on their own savings to supplement their income from part-time work. The rationale for this rule is not quite clear, but it presumably is intended to reduce leakage and to ensure that the tax advantages available under 401(k) plans flow only to long-term savings. Should such goals be embedded in tax law? To some degree, the restrictions reflect the paternalistic worry that people will spend irresponsibly without them. Their removal would encourage earlier transitions from full-time employment to part-time employment and complete retirement. Our focus is on providing more employment flexibility at later ages and, therefore, we do not attach high priority to removing the restrictions at this time. They might, however, be reconsidered at a later date, especially if there is an explicit decision to reduce the tax burden on income more generally and increase it on consumption by treating all savings more generously. In addition, given increased life expectancies, it is perhaps time to reexamine the timing of

[33] There is considerable evidence that many employees who withdraw funds from their employers' retirement plans spend them rather than roll them over into an IRA (Burman, Coe, and Gale 1999; Poterba, Venti, and Wise 1999; Yakoboski 2000).

distributions as a matter of general retirement income policy. It might be more appropriate to raise, rather than lower, the current age for distributions. Considering whether all types of plans should be subject to the same rules is also an important issue.

Liberalize pension distributions after normal retirement age. Under current law, employers control the timing of payments from pension plans. Even if employees work after normal retirement age, they may not be entitled to receive benefits until they retire. In some cases where plans apply the suspension of benefits rules, employees lose benefits if they continue to work, while in other cases employees receive adjusted benefits but only at full retirement. A good argument can be made that after normal retirement age employees who continue to work should have the same access to their benefits as retirees. Implementing such a change requires repealing the suspension of benefits rules, changing rules on the timing of payments, and requiring fair actuarial adjustments for all delayed payments. These changes will increase plan costs for employers. On the other hand, giving employees the option to choose when their benefits begin and ensuring that they are not penalized financially for continued work seem like reasonable steps to take to make work after normal retirement age more attractive.

Provide employees with more benefits information near retirement age. Employers are now required to give employees a great deal of information about their benefits. That information, however, does not necessarily help an employee trying to decide whether to retire. Requiring employers to provide more information that is personalized and targeted to the retirement decision makes sense. For example, it would be helpful to employees if they were told each year how much additional accrual, both economically and under the plan formula, they would receive from their defined benefit plans for an additional year of work. In addition, employees entering phased retirement arrangements should receive full disclosure on the benefits they would be forgoing as well as receiving from continued work. Requiring such disclosure does not impose a large administrative or financial burden on an employer because, in most cases, the information is already available.

Rationalize the penalty tax regime. The tax code imposes a 10 percent penalty tax, in addition to regular income tax, on distributions made before an employee reaches age 59½ (I.R.C. § 72(t)(2)(A)(i)). Exceptions in the rule shield distributions made in the form of annuities, the most common form of distribution from a defined benefit plan (I.R.C. § 72(t)(2)(A)(iv)). Lump sum and installment distributions, the typical forms of distribution from a defined contribution plan, are fully subject to the tax. This rule has two rationales: to discourage leakage, and to raise revenue. In terms of phased retirement programs, it represents another disincentive to participation for younger workers who intend to rely on their defined contribution plans for supplemental income. The issue is identical to that raised by restrictions on 401(k) distributions. Because our focus is not on younger workers, we believe that the penalty tax should be retained for now.

A More Comprehensive Proposal

The regulatory changes proposed above and the ability to receive pensions before the normal retirement age will make phased retirement programs marginally easier for both employers and employees. It is hard to escape the conclusion, however, that explicit statutory authority for phased retirement programs will be required before they can become a routine employee benefit. The age discrimination issues are too difficult, and pension law is too rigid, complex, and counterproductive to allow any easy solutions. In many ways, the difficulties confronting phased retirement programs are very similar to those facing early retirement programs a decade ago. To resolve those issues, all three major benefits laws—the tax code, ERISA, and the ADEA—were simultaneously amended to make early retirement programs feasible. The same could be done for phased retirement programs even though their legal issues are in many respects more difficult. The steps required are described below.

Create a statute authorizing phased retirement programs. Using the present ADEA early retirement statute as a model and taking into account the innovative plan designs now found in DROPs and faculty retirement incentive plans, a phased retirement program statute would

- provide legal protection to employers against ADEA claims;
- ensure the continued qualified status of retirement plans;
- set standards if certain benefits are required to be provided, if any, as well as for any benefit reductions;
- minimize the administrative responsibility of the employer;
- provide disclosure and informed consent standards for employees;
- permit employers to offer short-term plans; and
- provide employers with more flexibility on eligibility, in terms of both age and income.

Permit safe harbor benefits and plans. In addition to providing employers with general legal principles for creating phased retirement programs, the statute could also authorize specific “safe harbor” benefits and plan designs. Safe harbors provide employers with certainty that their plan designs satisfy all legal requirements. This is an important consideration in benefits law, where legal standards are generally extremely inflexible. For example, adding late retirement provisions to a defined benefit plan is currently both legally risky and prohibitively expensive for employers. But a safe harbor authorizing separate benefit accrual standards just for phased retirees might be very attractive to employers. Safe harbors could also be provided for special retirement plans just for phased retirees. In addition, the statute could define a safe harbor basic benefits package that, if made available to phased retirees, would permit employers to exclude them when testing their plans for nondiscrimination under tax code rules. A phased retirement statute with safe harbors represents an opportunity to restore some flexibility to benefits law, provided it authorizes and encourages employers to experiment with innovative benefits packages while safeguarding the interests of employees. Such a statute, for example, could provide safe harbors that

- lessen regulatory restrictions to permit more innovative plan designs such as DROPs;
- permit special plans and benefits packages just for phased retirees;
- add late retirement features to defined benefit plans;
- define a basic benefits package that permits complying plans to exclude phased retirees from tax law nondiscrimination tests; and
- exclude phased retirees from nondiscrimination testing under 401(k) plans.

One drawback to using the current statutes as a model is that both require employers to provide additional consideration such as enhanced benefits to participants. Employers seem to accept this requirement when it benefits highly favored employees such as faculty or reduces their other costs through employment terminations. Employers, however, may not be willing to do this for large numbers of employees who are continuing to be paid while accruing additional benefits. As a result, a phased retirement statute may require a different incentive structure if it is to appeal to employers. On the other hand, many employers might believe that retaining or obtaining experienced, valued employees is worth the price of some additional, not necessarily lavish, benefits, provided employers have some flexibility in designing a benefits package that fits their own needs as well as those of phased retirees.

A Longer-Term Issue

From an employee's perspective, many of the disincentives in phased retirement programs have nothing to do with age and everything to do with part-time status. Part-time workers receive proportionately fewer (if any) benefits—both welfare and pension—than their full-time coworkers. Phased retirees frequently find that by reducing their hours they lose a disproportionate share of their employee benefits. This practice has long been sanctioned by ERISA. ERISA, however, was enacted over 25 years ago, when the model employment pattern was the nine-to-five job and long-term service with a single employer.

Perhaps phased retirement programs can serve as a vanguard for revisiting the treatment of part-time work under ERISA. With respect to pension plans, ERISA has an “all or nothing” standard. In general, employees who work at least 1,000 hours a year are entitled to be eligible for pension benefits. Employees who work less may be and are generally excluded from their employer’s pension plans. Their only alternative for accumulating retirement income is to make their own contributions to an IRA. ERISA fails to provide even a minimum hours standard for health and other welfare benefits. Although many employers do provide these benefits routinely, they also often exclude part-time workers from their health, disability, and life insurance benefit programs. This leaves part-time workers in the position of having to purchase often costly individual benefit policies, if they can even afford such benefits, because they are not permitted access to the less expensive group insurance market.

The labor market has changed a great deal since ERISA was passed. New work arrangements such as flextime, telecommuting, or “just-in-time worker” hiring policies are bringing valuable flexibility to the workforce and the workplace. But ERISA is incapable of addressing the benefits issues posed by such creative work arrangements because its fundamental statutory framework is static, inflexible, and uncreative. Phased retirement programs raise many of the same issues that flexible work policies must confront and so provide a test case for developing a new consensus between employers and employees over the appropriate treatment of less than full-time work. By working through the benefits issues for phased retirees, the development of phased retirement programs—whether by enacting a special statute or by adding flexibility to existing law—should help to modify ERISA to meet the needs of the twenty-first-century workplace.

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