STRAIGHT TALK
on Social Security and Retirement Policy

URBAN INSTITUTE

No. 7 • September 15, 1999

THE MANY REINFORCEMENTS FOR RETIRING EARLY

Eugene Steuerle and Christopher Spiro

WITH LONGER LIFE SPANS AND EARLIER RETIREMENT ages, people are spending larger and larger portions of their lives in retirement. Unfortunately, as the pool of retirees swells over the next several decades, the number of workers needed to support them will not keep up. Social Security, with its specified eligibility ages that provide an incentive for retiring with many years of life expectancy remaining, is frequently singled out for blame. Social Security is indeed a contributing factor—and in more ways than just its stated retirement ages—but it is only one of many public and private institutions that encourage people to retire, often prematurely. The following features of Social Security and other institutions hold firm the retirement status quo:

Social Security and Medicare eligibility. The normal retirement age for Social Security and the eligibility age for Medicare are both 65; 80 percent of workers have filed for benefits by the time they reach this age. The availability of early retirement allows people to stop working as early as 62, and the majority of workers (57 percent of men and 63 percent of women) file for benefits at precisely that age. Eligibility rules indicate when to retire—regardless of physical ability—and workers respond accordingly. More people retire at 65 or 62 than at any other age.

Private pension plan eligibility. Private pension plan rules have largely been built around Social Security retirement ages. In fact, many pension plans make retirement possible at even earlier ages by providing income and health care until Social Security and Medicare kick in. Under some pension plans—those that base benefits on the number of years of service and the years of highest salaries—people often become eligible for retirement with 25, 30, or 35 years of life expectancy remaining.

Restrictions on changing private pension plan eligibility. Because it is illegal to take vested benefits away from employees, amendments to pension plans face difficult legal challenges. Even a change that keeps total pension benefits constant—for example, by increasing the retirement age but adding a corresponding increase in benefits to those who retire later—can lead to a legal battle if the change causes, or appears to cause, some employees to lose benefits, even if others gain.

Social Security earnings threshold. Under Social Security, if beneficiaries earn more than a certain threshold, they are penalized with reduced benefits. Despite substantial offsets in terms of higher benefits later in life, this rule sends strong signals to beneficiaries. Consequently, most earn no more than the threshold—or nothing at all.

Medicare as secondary payer. Employers who provide health insurance must cover older employees, even those eligible for Medicare. Thus, older workers in effect lose the value of their Medicare benefits. Because this rule forces employers to provide more compensation to their older employees in the form of health insurance, employers may try to offset its effects by offering less compensation in the form of cash wages. If they succeed, older employees may be unwilling to work for a smaller net reward; if they fail, employers may be unwilling to hire or retain older employees. In either case, this rule encourages people to retire earlier than they would have otherwise.

Benefits. Economists argue that the incentive to retire increases with growing benefits. For a typical baby boom couple, current law promises Social Security and Medicare benefits worth almost $750,000 (in 1999 dollars), in contrast to approximately $100,000 expected by a couple who turned 65 in 1960.

Defined benefit plans. Defined benefit plans typically use length of service multiplied by compensation in high-earning years to calculate the size of payments. According to this method, employers effectively contribute more per year to the retirement of older employees than to younger employees earning the same cash wage—though older employees who work beyond a given eligibility age often have their benefits penalized. Unequal compensation for equal work creates perverse incentives for both employers and employees. An employer may offer early retirement options before retirement benefits peak; an employee will usually not want to work after retirement benefits have peaked.

Seniority pay scales. Cash wages set by private firms may also favor earlier retirement. For example, seniority pay scales are meant to reward experience, but they also make it difficult for firms to scale back salaries to reflect the possible declining productivity of older workers. Rather than adjusting salaries, firms encourage older workers to retire, implying that they have zero productivity when they may have many productive years ahead of them.

Age disparity. In attempting to treat older and younger workers equally, employers may inadvertently contribute to a disparity between them. For example, employers who provide the same health coverage to workers of all ages spend more on older workers, who tend to require more care. If wages are not adjusted downward to reflect this imbalance, older workers will receive a higher total compensation for performing the same jobs as younger workers. This may lead employers to favor a younger workforce or to lose business to firms with a younger workforce, both of which tend to reduce employment among older workers.

Over the years, these policies have shaped our notion of when and how people retire. Policymakers have instigated changes in some of these features: the adoption of a higher normal retirement age for Social Security and the movement toward pension plans such as 401(k) plans that do not have the disincentives of defined benefit plans. However, it will take more time before we see substantial adjustments to the current retirement norm. Because so many features reinforce the idea of early retirement, altering one or two typically has only limited impact.

Eugene Steuerle is a senior fellow at the Urban Institute, where his research includes work on Social Security reform. **Christopher Spiro** is a research assistant at the Urban Institute.

This series is made possible by an Andrew W. Mellon Foundation grant.

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