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CHANGING EMPLOYMENT INCENTIVES AND CLAIMING BEHAVIOR

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The most potent way to enhance retirement security is for people to work longer, or at least delay claiming their Social Security benefit. This response has become increasingly important as the retirement income system is contracting. The amount of pre-retirement earnings Social Security will replace is falling as a result of the increase in the Full Retirement Age (FRA), in Medicare premiums, and in income taxes paid on benefits. In addition, employer plans have shifted from defined benefit pensions to 401(k)s, which too often have inadequate account balances. As a result of the contraction, Americans must push back the age at which they access the system. Only then can they assure themselves a reasonably adequate retirement income, especially as they age and sources of income other than Social Security benefits either decline in real value or disappear entirely.

To the extent that the "early access" problem is voluntary, workers are presumably impaired by myopia, ignorance, impatience, or some other behavioral factor that prevents the likelihood of hardship down the road from influencing retirement and claiming decisions. The proposals presented below address the problem of voluntary "early access." One set of ideas focuses on education, or ways to overcome the behavioral impairments that result in dysfunctional "early access." A second set of ideas focuses on changing the Social Security rules in a way that limits choice but enhances retirement income security. A third set directly addresses increasing the Early Eligibility Age (EEA) in ways that might protect the vulnerable.

Although the Board encouraged participants to think of changes outside of Social Security – in pension regulation, health insurance, and training and education – we have focused on Social Security because we view it as the key to keeping people in the work force longer. Moreover, some other efforts, such as allowing people to reduce their work effort gradually through "phased retirement," may do more harm than good (Gustman and Steinmeier, 2007).

Educational Initiative

A reasonable body of evidence suggests that Americans are unaware of the most basic information needed to make "rational" retirement and claiming decisions. Using questions in the most recent wave of the *Heath and Retirement Study*, Delavande and

Willis (2007) find that over a quarter of all respondents who estimated their FRA and EEA benefits were not aware of the reduction for early claiming. Moreover, among those who were aware of the reduction, estimates of its size varied widely — from less than 60 percent of the FRA benefit to nearly 100 percent. So a serious educational campaign would seem to be in order. Here are three suggestions for such a campaign.

First, a major effort should be launched to educate workers well before they arrive at the Social Security office at age 62. Workers need time to plan – both to remain employed longer as well as to claim benefits later. We at the Center have been thinking of 55 as a good time to inform people of the implications of claiming at different ages. Providing such information for people in their mid-fifties will give most workers a reasonable amount of time to plan. Providing the information any earlier would not be helpful, as most workers in their 50s seem to have a financial planning horizon of five years or less (Haverstick et al., 2007). Thus, we suggest that the Social Security Administration (SSA) introduce a new report sent out to workers at age 55.

Second, all educational materials provided by SSA should emphasize 1) the importance of retirement income security; and 2) the unique value of Social Security benefits in providing such security. This approach involves a rather dramatic shift from the "education" SSA currently offers workers inquiring about the age at which they should claim. Our understanding is that SSA currently frames the decision in terms of the "break-even" age. This formulation ignores the need for an inflation-indexed retirement income that the worker cannot outlive. Framing the claiming decision in terms of the "break-even" age presents the decision as a game. It invites workers to place their bets as to how long they are likely to collect rather than on the unique aspects of Social Security benefits. Moreover, workers tend to be conservative – that is, they tend to think that they will die earlier than they actually will – and this tendency makes early claiming seem more attractive (Society of Actuaries, 2006).

Finally, any educational effort must emphasize the importance of the survivor benefit. The major casualty of claiming too early is typically not the worker but the spouse. When one spouse dies (typically the husband), the household's Social Security benefits decline by one third to one half. Using standard equivalence scales that compare the income needs of one and two-person households, this decline results in a drop in effective income. Other sources of income, moreover, have typically dried up or are much reduced in real terms by the time the husband dies. Discussions of the claiming decision, including discussions presented by SSA, rarely emphasize its powerful effect on the survivor benefit.[1] This failing needs to be addressed.

The heart of the Age 55 Initiative could be a short, attractive, and entertaining *Social Security User's Guide* sent to all 55 year-old workers in Social Security's Annual Report to Participants. The *User's Guide* would give workers the critical information they (and their spouses!) need to make their work and claiming decisions. We envision an approach similar to that adopted in the Center's *Social Security Fix-It Book.* The text would be brief, simple, but precise, presented in a clean and inviting layout, with entertaining and informative illustrations. A fundamental goal of the *User's Guide* would be to inform workers how Social Security benefits differ from retirement income drawn from other sources and that these benefits should be seen as providing basic retirement income security. The *User's Guide* would also explain how work and claiming decisions affect the household's benefits while both spouses are alive and when only one spouse is living. This explanation would include discussions of the critical importance of claiming ages, that the Retirement Earnings Test is not a tax, and that workers should consider retiring and claiming as separate decisions.

The *User's Guide* could be augmented by a computer-based educational planner. The planner could use voice, graphics, and participant interaction to present the material in the *User's Guide* in a short, entertaining format, while allowing workers to test out personalized work-retirement-claiming scenarios. The planner could be distributed on disc within the *User's Guide* or downloaded from the Web. The planner provides hands-on learning, which is far more effective than "book learning" alone, and personalized examples, based on the worker and the worker's spouse's actual earnings records and projected work, retirement, and claiming plans.

Another element in the Age 55 Initiative could be advertising and media outreach to encourage workers to explore the *User's Guide.* Clever and entertaining advertising, similar to that used by the American Savings Education Council to promote saving, could

[1] See http://www.ssa.gov/retire2/applying1.htm; and http://www.ssa.gov/retire2/yourspouse.htm.

focus workers' attention on the *User's Guide* that will arrive in the mail. The advertising could also reinforce key messages presented in the *User's Guide*. In addition to advertising, the Social Security Administration could promote the *User's Guide* through a public relations campaign that includes media appearances and press kits. Because the *User's Guide* would be distributed to a narrow demographic over a short span of time, the advertising and media outreach campaigns could be targeted and cost-effective.

[The Social Security benefit rules are too arcane to be fully explained in a brief overview. So the *User's Guide* would direct recipients to write or call SSA for pamphlets (or go to the SSA website for these pamphlets or explanatory programs) that address benefits for state or local government workers, widows and divorcees, and households with children eligible for dependent benefits. These issues will be included in the computer-based educational planner.]

Raising the Hurdles to Early Claiming

In addition to general education, new procedures could be introduced for married couples that would protect the interests of the surviving spouse. Most married men claim Social Security benefits at age 62 or 63, well short of the age that maximizes the expected present value of the household's Social Security benefits. That married men "leave money on the table" is surprising. It is also problematic. Early claiming seriously undermines the retirement income security of married women by substantially reducing benefits payable to surviving widows. And the low incomes of elderly widows are a major social problem. If married men delayed claiming Social Security benefits, its effect on survivor benefits alone would significantly improve retirement income security.

One approach is to set a condition for early claiming, defined as claiming before the FRA or some other age. The simplest condition is for the husband and wife to sit through a short educational program that explains the implications of the claiming decision, both in terms of the husband's monthly benefit and the wife's benefit once the husband dies. A second and clearly stricter condition is that the higher-earning spouse would need the lower-earning spouse's permission to claim early. This approach would recognize the fact that both spouses have an interest in the claiming decision. Such a condition would clearly generate discussion within the household about the implications of the claiming decision, as well as empowering the lower-earning spouse. And it may well change behavior, just as making the joint-and-survivor option the default in defined benefit plans did (Holden and Nicholson, 1998 and Aura, 2001).

A second approach to protect widows' incomes would preserve the survivor benefit at its FRA value. To do this without increasing Social Security costs, one approach would reduce the monthly benefits claimed prior to the FRA by the higher earning spouse. Estimates of the necessary reductions are presented in Figure 1. (The necessary reductions would be less if the benefits of the lower earning spouse or of all workers were reduced.) If workers view monthly benefits claimed before the FRA as too low, they could work longer and postpone claiming. They would work longer because they would not be allowed to compromise their spouse's retirement income security.

Raising the EEA

The most straightforward response to the problem of early claiming is to raise the Earliest Eligibility Age (EEA). Social Security's retirement age for full benefits is scheduled to increase from 65 to 67 by 2022. But under current law, the EEA remains unchanged at 62. Raising the full retirement age will increase the actuarial reduction for claiming benefits at age 62 from 20 percent to 30 percent. But this increased reduction is unlikely to induce people to claim later given that people's claiming behavior and retirement decision appear more sensitive to the availability of benefits than to benefit amounts (Burtless and Moffitt (1984), Hurd (1990), Gruber and Wise (1998 and 2002)). This reduction raises the concern that workers may myopically claim benefits too early, making it difficult for them to maintain their living standard during retirement. The prospect of future increases in Medicare premiums and out-of-pocket medical expenses imply that this problem will likely grow in importance, especially in the case of widows or widowers relying on survivors' benefits as their primary source of income.

Raising the EEA is a controversial endeavor, however. People are not going to support the proposal on financial grounds because, without any other changes, raising the EEA has virtually no impact on the system's finances. Any additional work brings in some additional payroll tax revenues, but the fact that the benefits were actuarially reduced means virtually no savings on the benefit side. At the same time, however, raising the EEA creates hardships. A significant fraction of individuals will be unable to work past age 62, either because they are in poor health, because their jobs are physically demanding, or because they have been displaced later in life and cannot find work at their age. Therefore raising the EEA would inevitably involve some expansion of the Social Security and SSI disability programs for older workers. Another problem is that a higher EEA would reduce lifetime Social Security wealth for those with lower-than-average life expectancies. Since African Americans and low-wage workers have lower-than-average life expectancies, a higher EEA might be considered unfair.

Raising the EEA, however, seems like an essential step to ensure that older people continue to participate in the labor force. Moreover, raising this official age will not only increase the willingness of workers to supply their labor but also enhance the willingness of employers to hire older workers. A recent survey asked employers about the impact of various characteristics that could affect the productivity of older workers. A major negative factor was the perception that older workers would be on the job for only a short time (Munnell, Sass, and Soto, 2006). To the extent that the likely departure date can be pushed out, employers would be more willing to hire, train, and promote older workers. One way to escape the current EEA stalemate may be to have a different EEA for people in different circumstances.

Link to Years of Covered Earnings

To avoid hurting those unable to work, some have proposed tying the EEA to a worker's quarters of covered earnings. The idea of differentiation based on labor force participation has an intuitive appeal. Those who went to college and thus delayed entry into the workforce usually have a safer working environment, higher incomes, better health, and longer life expectancies, and thus can remain in the labor force more easily. While health status, ability to work, or even level of education are not directly observed by the Social Security Administration, information on earnings and number of quarters of covered earnings is routinely used to determine eligibility and the level of monthly benefits. Thus, such an approach would be easy to implement.

One proposed scheme would give workers an option of retiring at 62 and claiming unreduced benefits if they have spent at least 35 years in the labor force. Everybody else's EEA would be moved to 64. Credit years would be assigned to women to reflect the number of years spent caring for young children. Our analysis, however, found that tying labor force participation to eligibility for unreduced benefits at age 62 would not help those who are in poor health. Unhealthy workers are simply unable to obtain 35 years of labor force participation, while workers in good health satisfy the proposed test for eligibility. Healthy workers, however, tend to postpone claiming and retirement until a later age regardless of the EEA. Thus, tying the EEA to the length of a worker's labor force participation would not help many individuals who are unable to work due to poor health.

Link to Earnings

An alternative is to assign workers an individual EEA based on their average lifetime earnings. An "Elastic EEA" based on lifetime earnings would be effective because workers at risk of hardship and with low life expectancy tend to have low lifetime earnings.

As an example, an EEA based on average indexed earnings (AIE) could be defined for each worker as follows. For workers with AIE equal to or less than 50 percent of national average earnings, the earliest age of claiming would remain 62. For workers with AIE equal to or greater than the national average wage, the earliest age of claiming would rise to 64. For workers with AIE between 50 and 100 percent of national average earnings, the earliest age of claiming would rise by .48 months for each percentage point increase in AIE above 50 percent of national average earnings. For example, a worker with an AIE equal to 75 percent of national average earnings could claim at 63 (25 x .48 = 12 months). Gradually raising the EEA avoids abrupt changes in eligibility in response to minor changes in earnings, dampening the moral hazard that workers would reduce earnings to qualify for benefits earlier.

Each worker's earliest claiming age would be set based on their AIE and the national average wage at age 55. This approach would give workers time to adjust their retirement plans. Also, the AIE does not change much relative to average earnings for men between 55 and 62. So their EEA will generally be much the same whether set at 55 or 62. Notifying workers of their EEA would also function as a "wake-up call" to plan for retirement. And setting the EEA much earlier might not be useful, as most men that age have a financial planning horizon of less than 5 years (Haverstick et al., 2007).

This specification would be reasonably successful in achieving policy objectives for reforming the EEA. As shown in Figure 2, the earliest claiming age would rise to 64 for close to 60 percent of men, with less than 20 percent eligible when they turn 62. The EEA would remain unchanged for most men at high risk of hardship and would rise by less than two years for most of the remainder of the high risk group as well as for most of the moderate risk group (see Figure 3).[2] If this elastic EEA were applied to men in the HRS who claimed benefits before age 64, two-thirds would be required to delay claiming by more than one year. Those allowed to claim at 62, or to wait no more than one year, are clearly less healthy, less wealthy, less educated, and less likely to live past 75 (Zhivan et al., 2008 forthcoming).

The elastic EEA is not perfect. A non-trivial portion of the at-risk population, especially the moderately at-risk population, would not be protected or would be only partially protected. A non-trivial portion of the population identified as *not* "at risk" would also qualify for an early EEA. Moreover, an elastic EEA based on average lifetime earnings is unlikely to work as well for women. Given women's more interrupted employment histories, their average lifetime earnings are unlikely to be as closely associated with factors creating hardship or unfairness should the EEA increase. Nevertheless, an elastic EEA could increase retirement income security for the majority by forcing them to delay claiming, while protecting many vulnerable workers and reducing unfairness. Further research and analysis could produce a more effective elastic EEA.

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[2] Those classified as *high risk* have both a health problem (indicated by self-reported "poor" or "fair" health), a labor-market problem (indicated by peak earnings between age 55 and 59 of less than 80 percent of the average wage when they were 50), and inadequate resources to support themselves without working from 62 to 64 (indicated by financial assets less than two years' average lifetime earnings). Those classified as *moderate risk* have either a health problem or a labor-market problem, but not both, and inadequate resources to support themselves to age 64 without working.

Conclusion

It is important to note that these proposals are not mutually exclusive. For example, an effective educational campaign would make all the rule-change proposals more effective and politically palatable. Making the EEA elastic may also facilitate a quicker rise in the EEA than otherwise possible. But the important point is that changing Social Security is the key to increasing the likelihood of increased employment of older workers.

Not only are changes to Social Security the key to improving retirement security, other efforts – such as the push for “phased retirement” – may do more harm than good. Much of the discussion about working longer has focused on expanding opportunities for phased retirement or part-time employment. Most workers age 55 to 64 say they would like to retire gradually, cutting back their hours rather than retiring “cold turkey” (U. S. General Accounting Office, 2001). So expanding opportunities for such workers to reduce their hours has seemed a reasonable way for such workers to extend their careers. But if the average retirement age is going to increase to 66, most workers age 55 to 64 will need to remain in regular full-time employment. Only if workers are expected to remain in full-time employment longer will workers in their 50s have enough of a “future” in the labor force that it makes sense to invest in skills and relationships that will keep them productive into their mid-60s.

Moreover, initiatives to expand part-time employment at the end of a worker’s career might not be especially fruitful. Relatively few types of production seem suited to part-time work. Most economic activity seems far more efficient when done by teams of full-time workers who are continually present at the same location. Part-time employment is also expensive, in the sense that the employer must spread the costs of recruiting, training, scheduling, supervising, and evaluating workers over fewer hours of labor. Most importantly, a recent study finds that expanding part-time opportunities might not result in increased employment. The study, using a structural model of labor supply, finds that workers would delay retirement and increase employment at older ages, but would also expand part-time work at younger ages, in lieu of full-time employment. The net result would be little change in either “full-time equivalent” employment or retirement income security (Gustman and Steinmeier, 2007).

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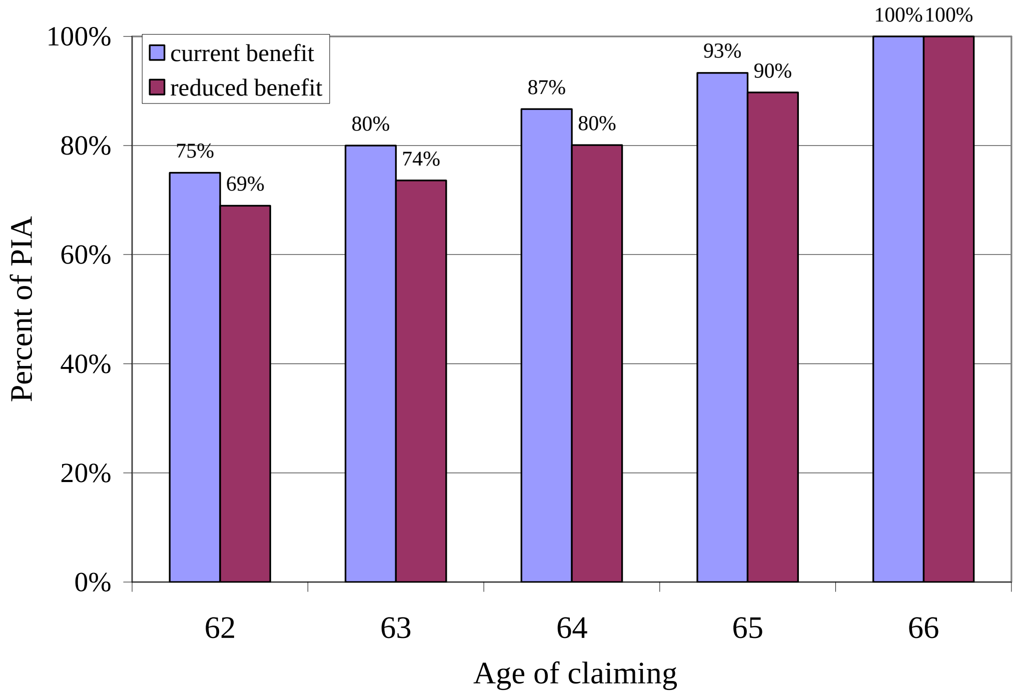
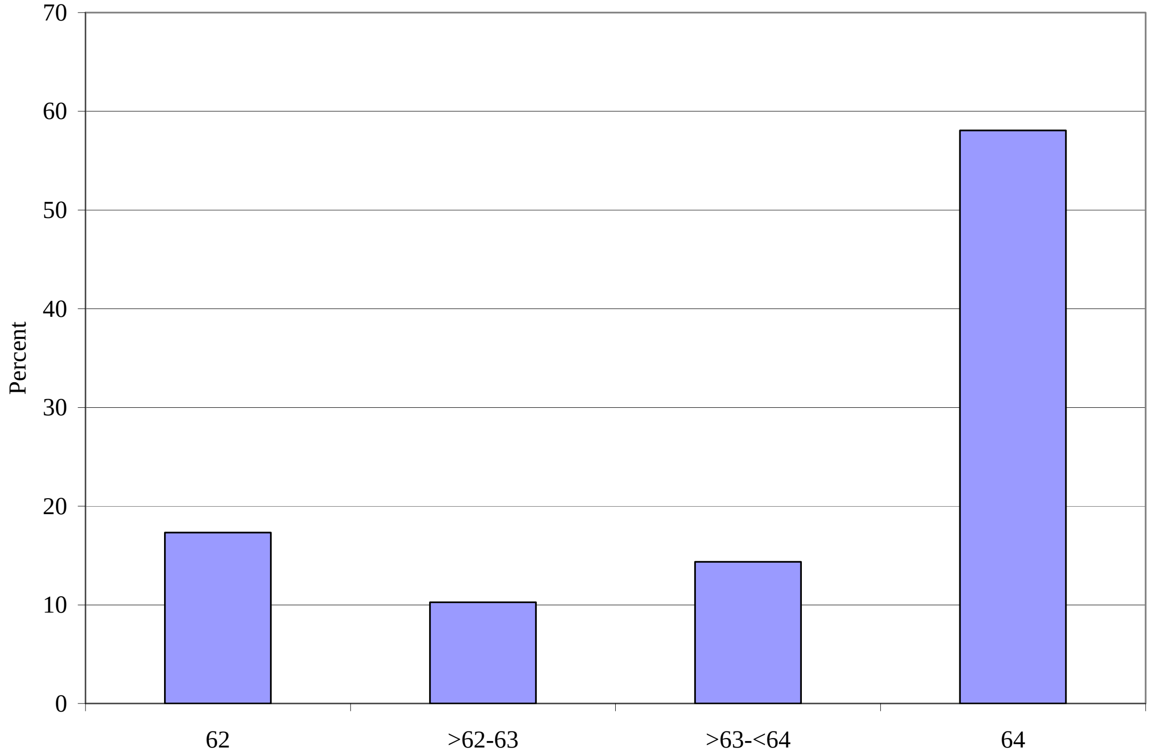
Figure 1. *Early Retirement Benefit Reduction to Preserve Survivor Benefit at PIA (with Full Retirement Age of 66)*



Source: Sass, Sun, and Webb (2008 forthcoming).

Note: Estimates assume all survivor benefits are claimed after the survivor attains the FRA of 66. Under current law, survivor benefits claimed after the FRA cannot fall below 82.5 percent of the deceased spouse's PIA; survivor benefits claimed before the FRA are reduced but cannot fall below 71.5 percent of the deceased spouse's PIA. To the extent that survivor benefits are claimed before the survivor attains the FRA, the required top-up needed to provide a survivor benefit equal to 100 percent of the deceased spouse's PIA, and the reduction in early retirement benefits needed to finance that top-up, would be greater.

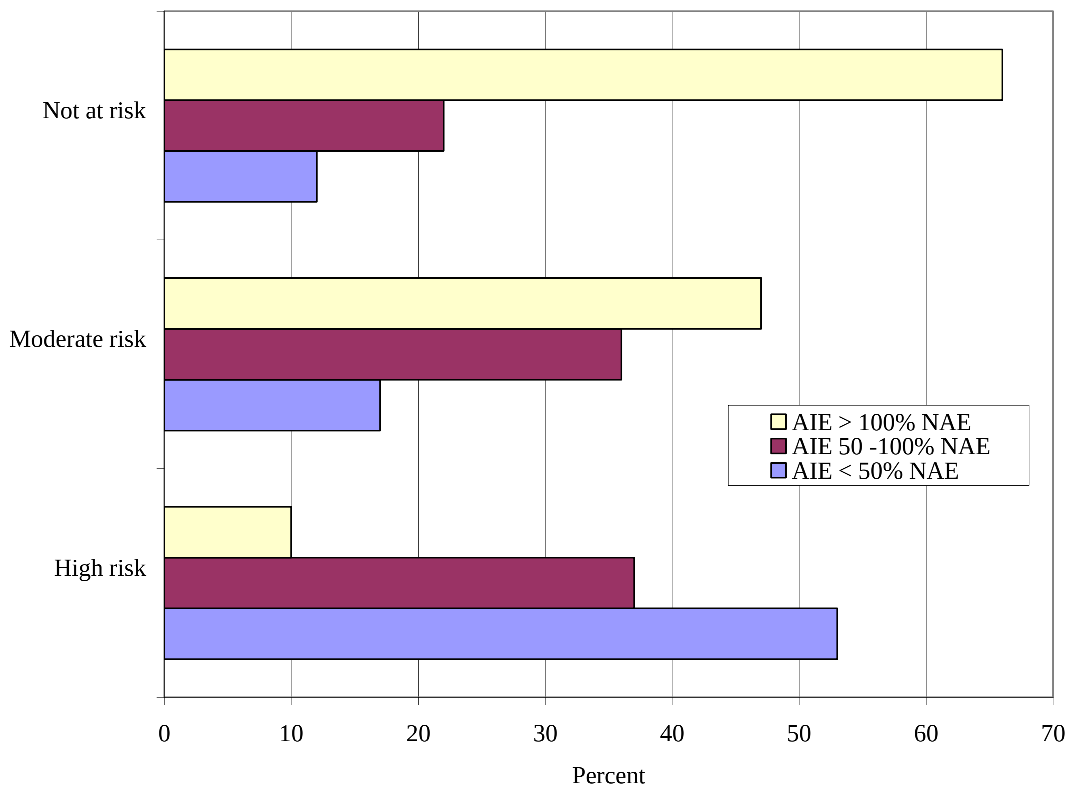
Figure 2. *Distribution of Earliest Claiming Ages under an Elastic EEA**



* The Elastic EEA as specified in the text.

Source: Zhivan et al. (2008 forthcoming).

Figure 3. *Hardship Risk by Average Lifetime Earnings*



Key: Average Indexed Earnings (AIE) as % of National Average Earnings (NAE) when the worker is 55.

Ranges:

AIE	< 50%	NAE
AIE	50 -100%	NAE
AIE	> 100%	NAE

Note: Those at *high risk* of hardship have both a health problem and a labor-market problem and lack the resources needed to support themselves to age 64 without working. Those at *moderate risk* have either a health problem or a labor-market problem, but not both, and cannot support themselves to age 64 without working. Workers *not at risk* either can support themselves to age 64 without working or have neither a health nor a labor-market problem.

Source: Zhivan et al., 2008 forthcoming.