



The Social Security Early Entitlement Age in a Structural Model of Retirement and Wealth

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IB 2002-029
November 2002



Executive Summary

Thirty years ago, the most common retirement age was 65. Today it is 62, with 65 as a secondary peak. While there are several good reasons why we see a decrease in retirement at age 65, explaining the new peak at 62 is more difficult. Although the fact that eligible workers can begin claiming Social Security retirement benefits at age 62 is a large part of the explanation, there are strong incentives to continue working. Workers can only claim partial benefits at age 62 but many would receive substantially higher benefits if they delayed claiming for a few years. Despite better than actuarially fair increases for many from postponing benefit claiming at 62, many workers retire at 62.

The difficulty in understanding retirement at age 62 makes the analysis of some Social Security reforms very difficult. Increasing the early entitlement age is one reform proposed to address the impending Social Security funding crisis. A serious problem is that we do not know how retirement ages will change given this reform. An important concept that has been over-looked as a possible candidate for understanding the retirement spike at 62 is people's desire to have what they want now rather than later, called a time preference. Moreover, time preference is not evenly distributed throughout the population. Some people are savers and others are not. That is, some people have a high taste for saving and would save for their old age even at very low interest rates, while others would require a much higher return if they are to forego current spending and increase saving. In this *Issue in Brief*, we demonstrate that to understand retirement behavior, and in particular the observed peak in retirement at 62, one must un-

derstand saving behavior. Contrary to the predictions of simple retirement models, many who retire at 62 instead of 65 have saved less than those who delay their retirement. Because we have no actual experience with changes to the early entitlement age, our analysis employs a policy experiment in which we explain the current peak with an econometric model, and then use that model to estimate what the effects might be of increasing the age at early entitlement from 62 to 64. We find that this change will shift about 3/5 of the bunching of retirement ages from 62 to 64.

How Do Time Preferences Work?

Typically time preference is thought to be the same for all workers. More realistically, it varies from person to person. Moreover, a large group of workers may have high time preference while another significant group may have low time preference. Allowing it to vary across individuals resolves some problems and makes our model more realistic. First, workers who have a high time preference and are considering retiring at 62 will understand that their benefits would be increased substantially if they delayed their retirement, but because of their “I want it now” attitude, they will devalue the increase in benefits from delaying retirement. This helps us understand why so many people collect benefits at the earliest opportunity. Second, they are not likely to have saved much, and will not be able to retire before age 62. And third, difference in time preferences allows us to explain the huge differences we find in wealth among households with similar lifetime incomes. Those with a high time preference are more likely to spend as they earn and to save very little for the future.

Data

The data used in this study come from the Health and Retirement Study (HRS), a nationally representative sample of households that contains at least one person born between 1931 and 1941. The study was started in 1992 and conducts interviews every two years. The last year for which data are available is 2000. Because of the differences between men and women and married and single in retirement patterns, the present analysis is focused on married men only.

A portion of these data are linked with Social Security earnings records which allows us to calculate potential streams of earnings and benefits that a worker would accrue by working to different ages in order to predict retirement. We also have information on how much workers have saved, or their assets, which allows us to calculate a variable for time preference on the assumption that those with a high time preference will have lower assets at an older age than those with a low time preference. We also account for age, year of birth (cohort), health status, the value of other pension benefits, and how pension benefits vary with age of retirement.

Summary of Major Findings

- The majority of people value their future well-being sufficiently, so that they save enough for the future
- However, close to 30% of people seem to have an “earn-it-and-spend-it” mentality and have not saved any assets at all.

- Considering the effects of age on retirement decisions, we find that the value of leisure in retirement increases by almost 8% per year of age.
- Poor health has about the same effect on retirement as being four years older, but year of birth has almost no effect on retirement.
- Using the above results and the current retirement age of 62, we run our policy experiment by simulating data to see how well our model predicts the observed retirement ages.
- Our simulation produces two spikes in retirement at ages 62 and 65, which are the main features of the current pattern.
- Other models cannot explain the peak in retirements at 62 and the peak at 65. They can only explain one or the other.

Because our model more accurately replicates the current retirement patterns than others, and in particular the spikes in retirements at both ages 62 and 65, our next simulation results are more credible than others.

We run the simulation again, increasing the early retirement age to 64.

- We find a decrease in the retirement at age 62 by almost 5% (from 8.1 to 3%)
- We now observe a significant spike in retirement at age 64.

- People with pension plans and working spouses, who would have enough money to retire at 62, also delay their retirements to 64

Some people simply cannot afford to retire until Social Security benefits become available. In addition, people who face severe liquidity constraints would probably continue to work beyond age 64, because of future increases in the social security benefits (recall that the benefits increase as people postpone retirement). However, because we observe workers with other resources--who could afford to retire at 62-- shifting to 64, we attribute the changes in retirement ages to the differences in time preferences. People who value today's welfare relatively more than tomorrow's welfare likely retire when the Social Security benefits become available, because for them an increase in the future benefits from delaying retirement is not so important. After an increase in the early retirement age from age 62 to age 64, they simply choose to retire at age 64. Since people who value today's welfare relatively more tend to have low savings, it does make sense that these individuals now choose not to retire at age 62. The remaining peak we observe at age 62 is probably accounted for by effects of rules governing other pension plans.

Conclusion

Using the existing retirement models, we cannot explain the observed retirement peaks at both ages 62 and 65, and have greatest trouble explaining the retirement peak at 62. Without understanding this retirement pattern, we cannot credibly predict and discuss the effects of Social Security reform plans, for example, an increase in the early entitlement age. To solve this problem, we suggest analyzing retirement and saving together. Doing so, we have demonstrated that we can generate the retirement peaks at ages 62 and 65 in simulation. We also run simulations to study the effects of an increase in the early entitlement age to 64. In our experiment, when we change the early entitlement to 64, approximately 3/5 of the bunching at age 62 moves to age 64. This result indicates that the financial effects on the Social Security system of increasing the early entitlement age may be substantial.

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This work was supported by a grant from the Social Security Administration through the Michigan Retirement Research Center (Grant # 10-P-98358-5). The opinions and conclusions are solely those of the authors and should not be considered as representing the opinions or policy of the Social Security Administration or any agency of the Federal Government.

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The Michigan Retirement Research Center is supported by a grant from the Social Security Administration (grant number 10-P-98358-5).