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Longevity and Retirement Policy: Modernizing America's Retirement Programs to Keep Pace with Longevity

Executive Summary

The cost of retirement benefits is closely linked to the longevity of retirees. As life expectancy increases, so do the financial resources needed to fund pension plans, assuming a fixed retirement age. Increases in life expectancy should prompt periodic reexamination of retirement policy, which results in bringing retirement policy into line with changing circumstances.

Retirement policy affects labor policy. In deciding when to retire, workers are influenced by the availability of retirement benefits and by how much those benefits are increased if employees' continue to work after benefits are first available. The availability of health benefits in retirement can be even more important than cash benefits.

For employers with traditional defined benefit pension plans, the higher costs associated with increases in longevity may be a factor in the decline in defined benefit plans. For employees, increasing longevity may have resulted in a redefining of retirement as a gradual process that can occur over a number of years, instead of a one-time, all-or-nothing event. Although gradual retirement has benefited employers and employees alike, current laws and regulations present significant obstacles.

The American Academy of Actuaries' Retirement Security Principles Task Force developed this issue brief to examine the effect that increased longevity could have on benefit adequacy in retirement. This issue brief considers retirement options available to workers. It also considers policy options available to policy-makers.

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Background

Demographics

In 1940, when Social Security first paid monthly retirement benefits and the number of private pension plans was just beginning to grow, individuals reaching age 65 lived, on average, for another 13 years. Furthermore, many workers entered the labor force at age 18, immediately after graduating from high school. These individuals could expect to work for 47 years before attaining "normal" retirement age. When planning for retirement, therefore, a pension plan could anticipate that contributions needed to finance 13 years in retirement could be made over a 47-year period. The number of years spent in retirement for a full-career worker was about 28 percent of the number of years spent in the labor force.

Fast forward to 2006: the demographics of pension planning have changed significantly. Approximately two-thirds of eligible non-disabled workers claim Social Security retirement benefits at age 62 rather than 65, and they enter the labor force at a later age, often at age 21 or even older, rather than age 18. This leaves about 40 years of work before an expected retirement at age 62, at which point remaining life expectancy is approximately 20 years. Therefore, when planning for retirement now, a pension plan can anticipate about 40 years of contributions for a full-career worker to finance about 20 years of retirement. The number of years spent in retirement is about 50 percent of the number of years spent in the labor force. As the length of the retirement period has increased, the way people spend it has changed as well. Many people retire from one job and collect benefits but continue to work in another job, either full-time or part-time.

Thus, from 1940 to 2006, the ratio of the number of years spent in retirement to the number of years spent in the labor force has increased from 28 percent to 50 percent, a 79-percent increase in 66 years. This 79 percent also reflects the increase in contribution rates that would be necessary to finance the same level of benefits in 2006 as in 1940. Because this increase in the contribution level is not affordable, the trend among pension plans in recent years has been to reduce the level of retirement benefits. Social Security is accomplishing this by increasing the normal retirement age gradually from 65 to 67, as mandated by legislation enacted in 1983. This change results in greater actuarial reductions — and therefore smaller benefits — for workers who claim retirement benefits at age 62, as most do.

The increasing willingness of older workers to remain productive can be seen from the trend in labor-force participation rates for workers over age 65. For men, labor-force participation rates for those aged 65-69 reached a low of 24 percent in 1985 and climbed back to 33 percent by 2003 (the most recent year for which data are available). Similarly for women, labor-force participation rates for those aged 65-69 reached a low of 13 percent in 1985 and climbed to an all-time high of 23 percent by 2003.

Assuming that the economy continues to grow and levels of net immigration do not change dramatically, the increasing desire of employers to retain older workers can be inferred from the expected impact of the large cohort of baby boomers retiring in the near future. The societal reasons for employment of older workers link to the need for workers, talent shortages in specific occupations, and the interests and needs of these workers. Over the next 10 years, the number of workers paying Social Security taxes is expected to increase by 9 percent, from 159 million to 173 million. It will take almost 30 years thereafter for a similar increase. This dramatic slowing of labor supply growth will put increasing pressure on employers to try to retain older workers.

From the employee perspective, the demographic reality of spending more years in retirement should raise concerns about the adequacy of retirement benefits, especially when considering early retirement options. When employees work longer, they are more likely to have the necessary financial resources in retirement because:

- They have more years to save or earn benefit credit in traditional defined benefit plans, and more years to accumulate investment assets in defined contribution plans;
- Assets from lump sums can be used more rapidly because the period of time over which they will be used is shorter;
- Benefits that are paid as annuities will start at a later date, and early retirement reductions, if any, will be smaller;

- They face less concern about inflation eroding the real value of their benefits during a long period of retirement.

Ultimately, a worker's decision to continue working past normal retirement age, or at the very least, until normal retirement age, can have a significant impact on the adequacy of benefits in retirement.

Retirement Ages in Pension Law

Because the U.S. Congress intended private pensions to be used for old-age income support, the ages at which benefits can commence are limited by minimum and maximum age requirements. Age 62 is the minimum age at which Social Security retirement benefits can be received. In 401(k) plans, workers can take their benefits starting at age 59½ without a 10-percent tax penalty that is levied, with certain exceptions, when benefits are taken at younger ages, even if they are still working for the sponsoring employer. They can receive these benefits penalty-free as early as age 55 if they have stopped working for the employer providing the plan. At age 59½, workers can receive benefits from an Individual Retirement Account (IRA) or a Roth IRA without penalty. The majority of workers in defined benefit pension plans can receive benefits at a retirement age of 55.

Social Security's normal retirement age is gradually increasing from 65 to 67. After attaining normal retirement age, beneficiaries can collect Social Security benefits and work without losing benefits under the retirement earnings test. The retirement earnings test, which causes a loss of $1 in Social Security benefits for every $2 in earnings over a modest exempt amount ($12,480 in 2006), does not apply at normal retirement age or older.

Even though the normal retirement age for Social Security is no longer 65, it is still a key age in the retirement income system. It is the age at which most people qualify for Medicare health insurance benefits and old-age poverty benefits from the Supplemental Security Income (SSI) program. A private-sector pension plan must begin paying benefits by age 65 to eligible participants who are no longer working (if the normal retirement age is not earlier). In private sector defined benefit plans, the Employee Retirement Income Security Act (ERISA) has been interpreted as setting a maximum normal retirement age of 65.

Age 70½ is the maximum age to which employees can delay receiving pension benefits, unless they are still working at the firm sponsoring the plan. (Substantial owners must begin taking benefits at age 70½ whether or not they continue to work.) It is also the maximum age limit for making contributions to a traditional IRA, although there is no age limit for contributions to a Roth IRA.

Incentives to Retire at a Specific Age

Despite the demographic challenges for employers and employees when considering retirement options, private-sector pension plans, and even Social Security, offer a number of incentives for early retirement.

Employer-sponsored pension plans

Early retirement features in defined benefit plans, including early retirement windows and payment of unreduced benefits at an early age, provide an incentive to retire early, particularly when early retirement benefits are heavily subsidized. With respect to early retirement windows, if there is a pattern of windows being periodically provided, employees will wait for them and time their retirement accordingly. (Early retirement windows are special incentives that encourage retirement at a specific point in time, such as cash bonuses and/or improvement of pension benefits.)

However, depending on how benefits are adjusted for work after retirement, a defined benefit plan may also offer incentives to work beyond normal retirement age. For example, a full actuarial increase after normal retirement age provides some incentive for participants to continue to work. Another incentive is that defined benefit plans generally do not (and cannot) restrict work at other employers, and some do not even restrict work at the same employer. Many employees choose to retire from a long-service employer, collect benefits, and continue to work at a different job or as a rehired retiree. This is a gradual form of retirement that can be mutually beneficial to employees and employers.

Defined contribution plans also offer incentives to continue working. Account balances continue to grow as an employee continues to work, and usually new contributions can be made to the plans. Research has shown that employees with only defined contribution plans retire later than those with defined benefit plans. However, if a plan is changed and employees are given a limited time to retire under the old plan, this creates a powerful incentive to retire during the limited period.

Social Security

As noted, Social Security retired-worker benefits are payable beginning at age 62 for workers with 10 years of work covered by Social Security. Prior to the attainment of normal retirement age, a retirement earnings test reduces benefits by 50 percent of earnings in excess of a modest exempt amount ($12,480 in 2006) from employment or self-employment. Eligibility for these benefits is a strong incentive for retirement, whereas the retirement earnings test is a strong disincentive to work and earn more than the earnings-test exempt amount. However, benefits for people who continue working past age 62 are increased to offset the benefits lost by postponing retirement.

Beginning at normal retirement age, the retirement earnings test no longer applies, so for people who do not claim benefits before normal retirement age, Social Security provides no further disincentive to continue working. Of course, by that time, most people have already claimed Social Security benefits and have at least partially retired.

Medical benefits

If an employer offers medical benefits to active employees and not to retirees, it provides a strong incentive for employees to continue to work until Medicare eligibility at age 65, or at least until COBRA benefits are available to bridge the gap to Medicare eligibility. (COBRA provides former employees and retirees with a continuation of health care coverage at group rates on a temporary basis.) The importance of this issue depends on whether a spouse or other family member has family medical coverage.

Retiree medical coverage at younger ages before Medicare eligibility serves as yet another enabler of early retirement. If the cost to retirees is low then retiree medical coverage offers some incentive to retire early. However, if the health care program for retirees is less attractive than for actives, it will be a disincentive to early retirement.

Policy Options

As average life expectancy increases, the cost of traditional retirement benefits, absent a corresponding change in retirement ages, will grow steadily. Both men and women are living longer, and women, with their greater longevity and increasing years of work, are more heavily represented among retired workers than in the past. Women often collect benefits as spouses of workers. Increasing longevity affects the cost of retirement benefits offered by employers, the resources that individual workers need to maintain their standard of living in retirement, and the pool of potential workers available to employers. Longevity also affects the cost of government-sponsored programs such as Social Security and Medicare.

Policy-makers may want to consider at least three different potential goals in this area:

- Focus on a system that works well for individual workers, ensuring that an adequate income will be available when they retire;
- Increase the flexibility of the system for both workers and their employers — making it easier for workers to tailor their working careers and retirement planning to meet their individual needs and preferences and for employers to manage their labor and benefit costs;
- Better balance the cost and benefits of our retirement income system across generations.

The policy options presented below would provide more incentives and fewer disincentives for workers to delay retirement and continue accumulating retirement savings. We are not necessarily advocating any of the possible changes noted below.

Role of the government

- *Remove barriers to progress.* To allow some of the pension plan revisions noted above, federal pension laws and regulations would require changes. Regulations related to the Age Discrimination in Employment Act (ADEA), although generally outside the scope of this issue brief, should be clarified. For example, it would be very useful if the regulations included extensive illustrations showing phased retirement approaches that the regulators believe do not violate ADEA. This would permit employers to fashion innovative programs with less doubt as to their acceptability. In addition, the statute itself should be reviewed to ensure that it does not put up unnecessary barriers to innovation.

- *Offer carrots and sticks.* To encourage pension plan revisions, federal regulations regarding tax treatment and PBGC costs could be amended. For example, IRS rules could disallow qualified plans that let workers retire "too early" unless the employer has a necessary business purpose or the employee is disabled. Any incentives and disincentives would have to be designed carefully to avoid unintended harm to the private pension system.

- *Provide a level playing field.* Some older companies have a high cost structure related mostly to the size of their retired populations, who are receiving guaranteed benefits under defined benefit plans and other traditional benefits. Where possible, any legislated changes should reflect the current and future obligations of such employers.

Government should encourage employers to retain older workers

As baby boomers prepare to retire, employers will be looking at the potential for a significant loss of knowledge and experience, and may seek to retain many of these workers. Making the following changes to defined benefit plans, could encourage the retention of older workers:

Government Rules Affecting Retirement Plan Design

As a matter of social policy, our tax structure provides powerful incentives for employers to maintain broad-based employee retirement plans. From the standpoint of taxpayers as a whole, these plans create a lot of value to society, but in trade for their value, these incentives are expensive. Tax rates could be somewhat lower if the incentives did not exist. For this reason, tax policy includes rules designed to ensure that retirement plans eligible for the incentives provide benefits on a fair and equitable basis. For example, there are rules designed to control:

- Discrimination against lower paid workers;
- Discrimination against older workers;
- Dissipation of retirement savings before retirement time;
- Delays in commencing benefits upon retirement;
- The extent to which benefits are extremely high, whether or not discriminatory;
- The extent to which the benefit program fails to reflect the needs of non-working spouses;
- The extent to which earned benefits can be lost, even if the loss constitutes a tradeoff mutually agreeable to participant and employer; and
- The extent to which the sponsoring employer can exercise participant-by-participant discretion regarding optional benefit payment dates and forms.

These rules are administered primarily by the Internal Revenue Service (IRS), the Department of Labor, and the Equal Employment Opportunity Commission. While generally desirable, the rules can sometimes have unintended and undesirable consequences. This can be especially true if a rule that Congress articulates in very broad terms becomes the subject of detailed and formulaic interpretation by an administrative agency.

In considering optional solutions to the problems described in this issue brief, it is important to determine the extent to which an option may conflict with an existing rule. In some cases, it may be desirable to militate for modification of the existing rule — either by Congress or by the relevant administrative agency.

- In private retirement plans, the customary normal retirement age of 65 could be raised, either by ad hoc plan changes or by indexing the age to reflect past experience in longevity. This change may require a change in pension law. At the same time, the early retirement age could be increased along with the normal retirement age.

  While raising the normal retirement age may allow employers to retain workers, the issue of how such a change would affect employees in physically demanding jobs or those with poor health, but not eligible for disability benefits, must be addressed. According to a 1986 Social Security Administration report, fewer workers are expected to be in physically demanding jobs — approximately 7 percent to 9 percent in 2020 as opposed to the 11.4 percent in 1982. For the purposes of Social Security, gradually relaxing the eligibility criteria for disability benefits, which is already done for beneficiaries at older ages, addresses the concern to some degree. A flexible employer-sponsored defined benefit system, which could provide benefits tailored to the individual aspects of each company's work force, may also resolve some of the concerns associated with this segment of the work force.

- Defined benefit plans often provide subsidized early retirement benefits for employees who have long service, are in physically demanding jobs, or are involved in plant shutdowns. Such benefits commence before normal retirement age with little or no reduction to reflect the earlier and longer payout, and may be accompanied by bridge benefit payments until Social Security begins. In many cases, these benefits serve an important purpose in managing the work force, but in other cases they may force out valuable employees. The problem is that these plans offer the subsidized benefits to others workers as well.

- Cash balance and pension equity plans could serve as alternatives to traditional defined benefit pension plans. The costs of such plans are fairly level over an employee's career, not back-loaded as in a traditional plan, and thus do not pose a barrier to hiring and retaining older workers. With cash balance plans, however, care should be taken to ensure that older workers would not be adversely affected by a sharp reduction in future benefit accruals occurring during a conversion from a traditional defined benefit plan to a cash balance plan.

Government could change Social Security and Medicare

- Although Social Security's normal retirement age now is gradually rising from 65 to 67, it could be extended beyond 67 by a schedule or by indexing it to longevity. Social Security's early retirement age of 62 has long served as an important benchmark for retiring. Raising it to keep pace with the normal retirement age, for example, by making benefits formerly payable at 62 not payable until an older age, could have a powerful effect on all retirement program costs. Of course, should directly increasing the retirement age not be acceptable to the general public, as an alternative, changes in the benefit formula can achieve similar objectives.

- To encourage employment of older workers, Medicare could be made the primary health care coverage beginning at age 65, regardless of employment status. Note that increasing Medicare's eligibility age would not result in substantial cost reductions because people in their mid-60s have relatively low Medicare expenses.

Government should encourage workers to delay retirement

Given the demographic realities that people are living longer and spending more time in retirement, pursuing a new vision of retirement as a process rather than a single event is critical. Defined benefit plans can be modified, with the encouragement of favorable IRS rulemaking, to allow workers more flexibility, essentially allowing them to delay their retirement.

- Many retirees would continue to work with current employers on a reduced work schedule — often referred to as phased retirement — if IRS rules made this more feasible. Such a policy would slow the loss of institutional knowledge held by older workers, while recognizing that retirement can be a process that allows both employers and employees to benefit.

- Defined benefit and disability plans enable workers in physically demanding jobs and those unable to work because of impairment to choose an early retirement. Flexibility stemming from a more affordable defined benefit system will allow employers to design plans that fit the needs of these workers while also meeting business needs.

Conclusion

Demographics have changed substantially since 1940 when the average life expectancy after retirement was 13 years. In addition, people are starting work later in life and ending it earlier. Currently, due both to longer life expectancy and earlier retirement, people are more likely to spend 20 years in retirement. Despite these changes, laws and regulations have not kept pace. They do not reflect the desire of employers to retain older workers or the desire of employees to continue working, either on a full-time or gradually reduced schedule.

To accommodate the needs of employers and employees, we have outlined a number of ways that employers could retain older workers. These include: raising the early retirement age; altering the use of subsidized early retirement; and, subject to protections for older workers, using plan designs such as cash balance and pension equity plans that provide flexibility. Employees could delay retirement, through phased retirement programs. The government can facilitate a new environment for both, with necessary changes in relevant laws and regulations.

The Academy's Retirement Security Principles Task Force encourages policy-makers to consider the needs of employers and employees in light of increasing life expectancy and to develop a national retirement policy that will enhance the financial security in retirement of all Americans.