

Director's Corner

Reform of Social Security will again take center stage as President Bush enters his second term in office. The President suggests that reform of Social Security will be a top priority in the near future. The President's Commission to Strengthen Social Security (PCSS) submitted its final report and recommendations to the President over two years ago, welcoming a period of commentary and discussion. During that time, the research base on this topic has grown. Endorsing the importance of a scientific base for policy decisions, the Social Security Administration continues to support the retirement research centers through the agency's Office of Policy. Retirement Research Consortium (RRC) researchers produce research and analysis that will aid policy makers as they work with the President to develop various reform options.

Implementing a system of individual accounts as part of the reform of Social Security is a topic of special interest from the PCSS report. In each year since the report, the RRC Annual Conference in Washington, D.C. has featured a segment on this topic. In 2002, the Fourth Annual Conference featured a panel discussion on the topic of individual accounts: Alan Gustman of MRRC was Chair; speakers included Kent Smetters, Gene Steurle, Andrew Samwick, and John Shoven. MRRC researcher Olivia Mitchell, member of the PCSS, delivered a luncheon address on the report. At the Fifth Annual Conference in 2003, Associate Commissioner of Social Security James Lockhart chaired a panel discussion focusing on the "nuts and bolts" of individual accounts with speakers William Shipman, Richard Burkhauser, Jeff Brown, and Kent Smetters. At the Sixth Annual Conference held last August, panelists Martin Feldstein, Kent Smetters, Annika Sunden, and Eric

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Engen presented their research findings and policy analysis. These papers and slide presentations are available at the MRRC website. Papers from past Conferences are available there, as well.

Other MRRC research is germane to the topic of individual accounts. Key findings from completed MRRC research projects that are especially relevant for building policy are highlighted in this newsletter. In addition, we are very pleased to announce the research awards (see p. 3) for the current year and to note that, in addition to research on individual accounts, the challenges to public pension systems posed by global aging will continue to be a focus for the MRRC.



John Laitner, Director MRRC

2004 Annual RRC Conference Held in Washington, D.C.

Each year the members of the Retirement Research Consortium (RRC) gather in Washington, D.C. to share and discuss their latest research findings from projects funded by the Social Security Administration (SSA). This year, staff from SSA's Office of Policy worked with the Michigan Retirement Research Center (MRRC) to put together a conference that highlighted current and policy relevant research from all three centers. Other researchers, policymakers, staff members of the SSA and representatives from other government organizations, policy organizations, and the media attended the 2-day conference, held August 12-13 at the National Press Club. Twenty-one presentations addressed various aspects of the conference theme: the Future of Social Security.

To open the conference, greetings were offered by John Laitner, Director of the MRRC, Alicia Munnell, Director of the Center for Retirement Research (CRR) at Boston College, and David Wise, Director of the Retirement Research Center at NBER. Introductory remarks were made by Paul S. Hewitt, Deputy Commissioner for Policy of the SSA. Louis Enoff, Founding Director of IDP Americas, an international development and consulting firm in D.C. and Principal of Enoff Associates, Ltd, offered his reflections on the need for common ground in the Social Security solvency debate.

The first panel featured competing visions of reform proposed respectively by Peter Diamond and Sylvester Scheiber. A report and roundtable discussion was held featuring John Shoven's paper "Has the Unified Budget Undermined the Federal Government Trust Funds?" Kent Smetters and Peter Orszag served as discussants. The keynote address was delivered by Edward Gramlich, who is a member of the Board of Governors of the Federal Reserve System. Bradley Belt, Executive Director of the Pension Benefit Guaranty Corporation, delivered an address as well. Other panel topics included Examining the Case for Individual Accounts, Defining Adequacy: What should Americans be Saving?, Trends in Saving: Should We Worry?, Is Work an Alternative?, and Program Interactions. Papers presented at the 6th annual conference as well as slide presentations are available at the MRRC website under Conferences.



Visit the MRRC website for the
2004 RRC
conference papers, slide
presentations, and text of
speeches made by guest
speakers.

<http://www.mrrc.isr.umich.edu>

The MRRC is pleased to announce the following research awards for 2004-2005.

(UM05-01) Social Security Eligibility, Benefit Levels, and Replacement Rates in the HRS

Olivia S. Mitchell (University of Pennsylvania), John W. R. Phillips (National Institute on Aging), and Sylvester J. Schieber (Watson Wyatt Worldwide)

(UM05-02) Retirement, Saving, Benefit Claiming and Solvency Under A Partial System of Voluntary Personal Accounts

Alan L. Gustman (Dartmouth College) and Thomas L. Steinmeier (Texas Tech)

(UM05-03) Understanding Global Aging

Laurence J. Kotlikoff (Boston University)

(UM05-04) Technological Progress and Worker Productivity at Different Ages

John Laitner and Dmitriy Stoloyarov (University of Michigan)

(UM05-05) Social Security and Retirement Dynamics

Alan L. Gustman (Dartmouth College) and Thomas L. Steinmeier (Texas Tech University)

(UM05-06) Enhancing Data Quality through Longitudinal Imputation: Studies of the Income and Asset Data from HRS and AHEAD

F. Thomas Juster, Dan Hill, Honggao Cao, and Michael Perry (University of Michigan)

(UM05-07) Secure Data Environment and Development of Remote Data Access Facilities

Robert J. Willis and Michael Nolte (University of Michigan)

(UM05-08) Consumption and Economic Well-Being at Older Ages

Michael Hurd (RAND and NBER) and Susann Rohwedder (RAND)

(UM05-09) Planning, Financial Literacy, and Retirement Wealth

Annamaria Lusardi (Dartmouth College) and Olivia Mitchell (University of Pennsylvania)

(UM05-10) The Impact of Misperceptions about Social Security on Saving and Well-Being

Susann Rohwedder (RAND) and Arthur van Soest (Tilburg University, Netherlands)

(UM05-11) The Role of Conventional Retirement Age in Retirement Decisions

Charles Brown (University of Michigan)

(UM05-12) Gender, Marriage, and Asset Accumulation in the United States

Lucie Schmidt (Williams College) and Purvi Sevak (Hunter College, CUNY)

(UM05-13) How to Integrate Disability Benefits into a System with Individual Accounts: The Chilean Model

Estelle James (Hudson Institute)

(UM05-14) Savings, Portfolio Choice, and Retirement

Arthur van Soest (Tilburg University, Netherlands), Arie Kapteyn (RAND), and Constantijn Panis (RAND)

(UM05-15) Personal Social Security Accounts: Quantifying the Macro and Efficiency Effects

Kent Smetters (University of Pennsylvania)

(UM05-16) Changing Health Insurance Options and SSI Participation Among the Elderly

Todd Elder (Institute of Labor and Industrial Relations) and Elizabeth Powers (Institute of Government and Public Affairs)

(UM05-17) Investment Decisions under the Thrift Savings Plan: the Participation Decision

Beth Asch, Julie Zissimopoulos (RAND), and Steven J. Haider (Michigan State University)

(UM05-18) Market and Non-Market Activities of Older Americans

Daniel S. Hamermesh (University of Texas)

Key Findings from MRRC Working Papers with Special Relevance to Reform

UM00-01. Social Security, Pensions, and Retirement Behavior Within the Family-Gustman and Steinmeier. This project examines the labor supply effects of the alternative Social Security policies of 1) dividing credit for earnings evenly between spouses and 2) basing benefits on amounts accumulated in private accounts. Both raise the relative reward to work. At age 65, there may be as much as a 6 percent increase in work force participation under privatized accounts.

UM00-04. Cognition and Wealth: the Importance of Probabilistic Thinking-Lillard and Willis. A large proportion of Americans near retirement age tend to make imprecise probability judgments and this seems related to holding more conservative portfolios. We find that older people and those with less education tend to be less competent at making financial decisions, so they would require additional financial education under a system of private accounts.

UM00-11. Modeling the Macroeconomic Implications of Social Security Reform-Laitner. A model that combines life-cycle and bequest motives for saving can be used to model Social Security reform alternatives. While Social Security private accounts might be desirable on other grounds, this analysis suggests they will probably have little long-run effect on the size of the nation's capital stock.

UM01-01. Dropping Out of Social Security- Smetters & Walliser. Under the standard approach of converting the Social Security system to personal accounts, the government eliminates the payroll tax but keeps paying benefits based on past commitments. To avoid overpayment, the government could allow people to drop out of the system – using general revenues to finance any future gaps between the payroll tax and the benefits payable.

UM01-02. The Social Security Early Entitlement Age in a Structural Model of Retirement and Wealth-Gustman and Steinmeier. Examining the effects of an increase in the early entitlement age to 64 shows that 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 might be substantial.

UM01-05. Transition Paths and Social Security Reform-Laitner. The Social Security system could be transformed to a funded system through the use of government debt. Current retirees will continue to receive Social Security benefits; current workers will stop paying the Social Security tax, receive a lump-sum payment for previous taxes, and start contributing to personal accounts. Contributions to personal accounts will be mandatory. Continuing benefits and the lump sums will be financed with government debt.

UM02-01. The Annuity Puzzle Revisited: Implications for Social Security Reform-Benítez-Silva. Low rates of annuitization can be the result of optimal decision-making by individuals in a life cycle model that accounts for labor/leisure decisions and Social Security. Policymakers considering private accounts for Social Security should pay particular attention to the rules regarding withdrawal of benefits through annuities or lump sums.

UM02-02. Retirement Effects of Proposals of the President's Commission to Strengthen Social Security-Gustman & Steinmeier. The trend toward less work and earlier retirement should continue. Some of the proposals of the President's Commission will provide incentives to delay retirement, which should more than offset this trend.

UM02-06. Personal Accounts and Family Retirement- Gustman & Steinmeier. We simulate a system of personal Social Security accounts based on a 10.6 percent contribution rate over the lifetime. One version allows individuals to make lump sum withdrawals at retirement instead of annuitizing. This program would increase the retirement rates of husbands at age 62 by about 15 percentage points compared to the current system. Adding a lump sum option, by itself, would increase retirements at 62 by about 6 percentage points.

UM02-10. Social Security, Retirement, and Wealth: Theory and Implications-Shapiro & Kimball. A ten percent reduction in Social Security benefits will lead individuals to postpone retirement by one-tenth to one-half of a year. Individuals with greater wealth will be affected less.

UM02-D2. Understanding Individual Account Guarantees-LaChance & Mitchell. Simulations show how much more expensive a guarantee becomes when (1) it promises more generous payments, (2) participants have more flexibility over their investment choices, (3) participants invest over a longer time frame.

UM03-05. The Demand for Guarantees in Social Security Personal Retirement Accounts? -Mitchell & Muermann. This project evaluates how workers might invest their Personal Retirement Account (PRA) funds between safe and risky assets, depending on whether they are offered a rate of return guarantee on the risky asset. Anticipated regret can have a potent effect on investment choices in a PRA. Investors who take regret into account hold less stock if the risk premium is high, but more stocks if the risk premium is low. A rate of return guarantee provided at no cost to the plan participant induces him to hold more stocks, with or without regret.

UM03-Q1. Stochastic Forecasts of the Social Security Trust Fund-Lee, Anderson, & Tuljapurkar. A

combination of raising the payroll tax to 13.4%, increasing the normal retirement age to 69 by 2024, and investing 25% of the fund in equities by 2015 gives the Social Security Trust Fund a 50% chance of solvency through 2077.

PSID Employment, Health and Aging Data Available in Upgraded Online Data Center

The Panel Study of Income Dynamics (PSID) is a longitudinal study that began in 1968 with 5,000 families. Now with 33 waves of data based on 8,000 families and 3,700 heads and wives aged 50 and older, the PSID is well suited to study a variety of retirement and aging-related issues. The PSID contains information on health, wealth, pensions, income, employment, philanthropy, and a number of other domains. The PSID contains hundreds of pairs of adult siblings as well as parent-adult child pairs, which allows inter- and intra-generational analyses within families.

All waves of the PSID data, 1968-2001, are available in the recently updated online Data Center which allows the creation of customized data sets and codebooks.

Features of the new Data Center include:

- ~Automatic merging of multiple waves of PSID and PSID-CDS data with your choice of merging options
- ~Customized codebooks in PDF, HTML, XML, and more
- ~Easy to use data shopping cart system
- ~Save your data sets for sharing with others, or for updating and editing later
- ~Many optional output formats, including Excel, SAS, STATA, SPSS
- ~Search and Browse variables

The Data and Documentation Center is located here: <http://psidonline.isr.umich.edu>

F Y I

Did you know?

Social Security is the major source of income for most of the elderly.

- Nine out of ten individuals age 65 and older receive Social Security benefits.
- Social Security benefits represent 39% of income of the elderly.
- About two-thirds of aged Social Security beneficiaries receive 50% or more of their income from Social Security.
- Social Security is the only source of income for approximately 20% of the elderly.

Social Security provides more than just retirement benefits.

- Retired workers and their dependents account for 70% of all beneficiaries.
- Disabled workers and their dependents account for 16% of all beneficiaries.
- About 91 percent of workers age 21-64 in covered employment and their families have protection in the event of a long-term disability.

An estimated 156 million workers, 96% of all workers, are covered under Social Security.

- 53% of the workforce has no private pension coverage.
- 32% of the workforce has no savings set aside specifically for retirement.

In 1940, the life expectancy of a 65-year-old was 12½ years, today it's 17½ years.

- In 30 years, there will be nearly twice as many older Americans as today – from 36 million today to almost 74 million in 2034.
- There are currently 3.3 workers for each Social Security beneficiary. By 2031, there will be 2.2 workers for each beneficiary.

Source: <http://www.socialsecurity.gov/>

Research Brief

The Social Security Retirement Earnings Test, Retirement and Benefit Claiming

Alan L. Gustman and Thomas L. Steinmeier

There is a great deal of concern that the looming retirement of the baby boom generation and other demographic changes will adversely affect the solvency of the Social Security system. In response to this concern, Congress has taken a number of steps to encourage older Americans to postpone their retirement. Most recently, the Senior Citizens Freedom to Work Act of 2000 (PL 106-182) abolished the Social Security earnings test for those between the full retirement age and 70 years of age.

A major focus of the literature on the retirement earning test has been on the decline in economic activity observed once the earnings test limit is reached – that is, once a person's earnings reach the amount of the earnings disregard after which further earnings reduce current benefits. The finding that economic activity tails off after the earnings test amount is reached has puzzled some analysts. The reason is that those who lose benefits to the earnings test are compensated with higher benefits later on. Because for many between the ages of 62 and normal retirement age the increase in future benefits is actuarially fair, or even better than fair, one might expect the earnings test to have little influence on real economic activity. Yet it clearly does influence economic activity.

Our analysis of Health and Retirement Study data confirms earlier findings in that it also shows a decline in activity after the earnings test amount is reached. Our findings also suggest that abolition in 2000 of the earnings test for those between the full retirement age and age 70 increased full time work. Specifically, among those who were 65 to 67 years-old, and thus benefited from abolition of the earnings test, the ratio of full time workers in 2002 compared to 1998 increased by about 22 percent. In contrast, the ratio of full time workers in 2002 to 1998 who were 62 to 64 years-old, and thus did not experience a change in the earnings test, increased by about 11 percent.

In our analysis, we specify a structural econometric model which explains retirement, saving and, for the first time in this modification of our previous work, the timing of benefit claiming. The model allows three retirement states: full time work, partial retirement, and full retirement. The opportunity set in the structural model we specify includes a myriad of factors that influence retirement behavior. These include wages paid for additional work, the increase in the value of Social Security benefits from additional work, estimated from earnings histories obtained from the respondent's Social Security earnings records, and changes in the value of the pension with additional work, estimated from details of the respondent's pension plan, which was obtained from employers. A preference function is estimated to maximize the probability of observing the retirement, saving and benefit claiming behavior observed, given the constraints represented by the opportunity set. A central role in the preference function is played by the individual's time preference rate, which is estimated based on asset accumulation. Those with high time preference save less for their retirement, view future payments of Social Security benefits less favorably than current benefits, and thus are more likely to apply for benefits early even if there is an apparent actuarial advantage to delaying application. Estimates are based on data for married men from the first six waves of the Health and Retirement Study. The model does a very good, but not perfect job of simulating retirement outcomes and benefit claiming behavior observed in the population.

Once it is estimated, the model is used to simulate the effects of abolishing the retirement earnings test between ages 62 and the age of eligibility for full retirement benefits. Effects on retirement, the timing of benefit claiming, and the value and timing of benefit payments from Social Security are all examined. Abolishing the earnings test is simulated by allowing immediate benefit claiming between the early and full retirement age without reducing benefits in accordance with a person's earnings. For those who have a high discount rate, there will be an interaction between the earnings test, benefit claiming and retirement. Because benefits can be claimed immediately, the opportunity

cost of continued work is reduced. Before the abolition of the earnings test, when earnings exceed the test amount, the current benefits are lost, and the increase in future benefits is inadequate to compensate. Consequently, an individual with a high discount rate may choose to retire rather than continuing at work. After the earnings test is abolished, the same individual is able to continue at work without having to forego the benefit payment, and so may choose to stay at work. The resulting changes in full-time and part-time work, among other things, depend on the distributions of time and leisure preference, as well as the opportunity set, all of which are estimated by the model.

Our empirical analysis suggests that from age 62 through full retirement age, the earnings test reduces the share working full time by about four percent of the married male population, which entails a reduction of about ten percent in the number of married males of that age at full time work. However, abolishing the earnings test would adversely affect the cash-flow of the system. If the earnings test were abolished between early and full retirement age, the share of married men claiming Social Security benefits would increase by about 10 percentage points, and average benefit payments would increase by about \$1,800 per recipient, to be offset eventually by actuarially fair or better than fair reductions in benefit payouts throughout their 70s, 80s and 90s.

One can increase the employment of older persons either by abolishing the earnings test or by increasing the early entitlement age under Social Security. A major difference on the funding side is that abolishing the earning test results in an earlier flow of benefit payments from Social Security, worsening the cash-flow problems of the system, while increasing the early entitlement age delays the flow of benefit payments from the system, improving its liquidity.

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