In late March, the Social Security Board of Trustees released its annual report on the financial health of the Social Security Trust Funds. Many projections remain unchanged from last year’s report. However, the projected long-term status shows some improvement, based largely on methodological changes for projecting aspects of immigration. A key difference is that the projected actuarial deficit over the 75-year long-range period is 1.70 percent of taxable payroll, which is down from 1.95 percent in last year’s report. Despite the slightly improved outlook, clearly reform remains an important public policy matter for current and future lawmakers.

Concerns for overall federal fiscal imbalance loom. There will be greater pressures for government agencies to show that they are efficient. In that light, it is worth noting that the Trustees also report that the cost of $5.5 billion to administer the program in 2007 was a very low 0.9 percent of total expenditures.
With unusually lovely spring weather on our side, MRRC welcomed nearly 60 researchers to its 4th annual research workshop for two days of collegial exchange. MRRC Director John Laitner was very pleased to welcome from the Social Security Administration Jason Fichtner, Associate Commissioner for Retirement Policy, David Pattison, Director of the Division of Economic Research, and Economist Jae Song.

The workshop began with a session on Social Security Programs chaired by John Laitner. Kent Smetters described his work on the Optimal Design of Social Security; Susann Rohwedder presented her paper entitled Individual Responses to Social Security Benefit Cuts; Warren C. Sanderson presented on Anticipating the Next Round of Increases in the Age of Receipt of a Full Social Security Pension; Alejandra Cox Edwards presented her joint work with Estelle James on Work and Retirement Choices of Men: The Impact of Social Security Rules in Chile.

John Karl Scholz next chaired a panel discussion on the Future of Social Security with panelists Joyce Manchester, Kent Smetters, and John Laitner offering insights.

Laitner welcomed special luncheon speaker Guillermina Jasso, Professor of Sociology at New York University. Dr. Jasso described the wide breadth of information available for retirement researchers in the New Immigrant Survey and even provided a glimpse into some of the results one might anticipate. A link to the data is available on the MRRC website under Data Resources (http://www.mrrc.isr.umich.edu/resources/data/).

After lunch, David Pattison chaired a session on Immigration. Emma Aguila presented results from her
work with Julie Zissimopoulos on the Labor Market and Immigration Behavior of Middle-Aged and Elderly Mexicans; and Purvi Sevak presented early findings from her project Immigrant Native Fertility and Mortality Differentials, joint work with Lucie Schmidt.

Jason Fichtner chaired the next session entitled Pensions and Retirement. Motohiro Yogo presented on Portfolio Choice in Retirement: Health Risk and the Demand for Annuities, Housing, and Risky Assets; Olivia S. Mitchell presented her joint work with Raimond Maurer on Asset Allocation and Location over the Life Cycle with Survival-Contingent Payouts; Viviana Vélez-Grajales discussed her work on How Pension Rules Affect Work and Contribution Patterns: The Chilean Case; and Kandice Kapinos presented on Corporate Use of Cash Balance Pension Plans.

The day ended with the first of two sessions on Life-cycle Saving with David Blau serving as Chair. Mark Aguiar presented his joint work with Eirk Hurst on Deconstructing Life Cycle Expenditure; Nicola Fuchs-Schuendeln presented on Evidence on the Life Cycle Model from German Reunification; Amy Rauer discussed early results on her project with Benjamin Karney and Julie Zissimopoulos entitled Marital Histories and Economic Well-being: Preliminary Findings; Nicole Maestas wrapped up the day with a presentation of her work with Xiaoyan Li on Burnout and the Retirement Decision.

The second day began with the second session on Life-cycle Saving chaired by Eric French. John Karl Scholz presented his joint work with Ananth Seshardi Are All Americans Saving Optimally for Retirement; Emma Aguila discussed Pension Reform in Mexico: The Effect of Personal Retirement Accounts on Preparation for Retirement; David Blau presented findings on his work on Pensions, Saving, and Retirement; Helen Levy described her work with Kristin Seefeldt entitled How Do Low-Income Women Think About Retirement?; and Kristin Mammen presented on the Long-term Effects of the Divorce Revolution.

John Bound chaired the first of two
sessions on Health & Disability. Richard Burkhauser presented A Cautionary Tale of Not Being Expected to Work in America: The Relative Economic Fate of Single Mothers and Working Age People with Disabilities Over the last Quarter Century.


Michael Hurd chaired the second session on Health & Disability. Eric French presented on his work with John Bailey Jones on Differential Mortality, Uncertain Medical Expenses, and the Saving of Elderly Singles. Estelle James presented on The Impact of Private Participation on Disability Costs: Evidence from Chile. Max Schmeiser discussed his paper with Richard Burkhauser: The Impact of Fatness on Disability Insurance Application by the Non-Elderly.

A final session entitled Rational Planning was chaired by Bob Willis. Presentations included Financial literacy: An Overview of 3-years of Work by Annamaria Lusardi; Intertemporal Choice Where the Rubber Meets the Road: Evidence from Transaction-Level Data by Jonathan Zinman; and Social Identity and Preferences by Daniel Benjamin.
DECONSTRUCTING LIFECYCLE EXPENDITURE

By Mark Aguiar and Erik Hurst

It is well documented that household expenditures over the lifecycle increase through middle age and then decline sharply thereafter. Household consumption tends to rise from ages 25 to 45 and to fall between ages 45 and 70. This is true for purchases of durable goods, like automobiles and appliances, as well as nondurable goods like food; it also holds after accounting for household size. This finding is somewhat at odds with the life-cycle model, which posits that households should seek to smooth consumption—to acquire and maintain a given standard of living—over the lifecycle. From this perspective, the observed drop in spending heading toward older ages does not make sense. In the Research Brief, we summarize our recent efforts to try to provide some insight into what may be going on. We propose that it is critical to consider how people spend their time, how this relates to spending decisions, and, importantly, how this relationship changes over the life course.

BACKGROUND

This project is third in a series re-visiting consumption expenditures in light of time allocation. In Aguiar and Hurst (2005), we use food diaries to document that declines in food expenditure at retirement do not necessarily imply food consumption declines. In Aguiar and Hurst (2007), we document that shopping intensity for food, and therefore price paid for equivalent grocery items, varies systematically over the lifecycle. Both studies focused exclusively on food expenditures. However, by focusing on food, a relatively small component of non-durable expenditures, our previous work left open the question of whether, and to what extent, these insights were relevant for other types of expenditure and to what extent they were important for explaining the spending profile described above. This work, among other goals, aims to resolve these outstanding questions.

FINDINGS

Using data from the Consumer Expenditure Survey, we decompose nondurable expenditures into more detailed consumption categories. In doing so, we show that there is a tremendous amount of variation across the lifecycle profiles of individual consumption categories.

The entire decline in nondurable expenditure late in the lifecycle is driven by three categories – food, nondurable transportation, and clothing/personal care. Expenditures on these categories are positively correlated with market work. Food is amenable to home production while transportation and clothing are inputs into market work. The remaining categories of nondurable expenditures, consti-
Internet sites offering advice about retirement planning are increasing in number to a dizzying array. Fewer outlets provide information about employer-provided retirement plans. The Internal Revenue Service’s website provides a link called Retirement Plans Community that offers a variety of information for employees participating in their employer’s retirement plan and helpful information for employers.

Recently, they have posted a series of on-line videos on a range of retirement plan topics. These videos can be used in combination with the related web page content to provide both employers and participants useful information for meeting their retirement plan needs. Visit the IRS site for more information on Retirement Plans: www.irs.gov/ep. View the videos by going to http://www.stayexempt.org/ep/managing_ira.html. This will take you to a video about managing your IRA. Once you are there, you will see the other videos that are available on the left side of the page.

• We show that entertainment expenditures and time allocated to entertainment are positively correlated over the lifecycle, suggesting complementarity between time and goods.

• Conversely, food expenditures and time allocated to food preparation are negatively correlated, suggesting substitutability between time and goods.

The model suggests that entertainment expenditures should be relatively stable between ages 43 and 60. Specifically, the model predicts declines in expenditure of 3 percent between age 43 and 51 and an additional 3 percent between age 52 and 60. The data imply respective changes of +3 and -3 percent. The model matches the divergence of food and entertainment expenditures in the latter half of the lifecycle quite well.

The model is less successful in explaining the first half of the lifecycle. In particular, the model predicts that entertainment expenditure should increase by 1 percent between age 25 and 33 and be unchanged between age 34 and 42. In the data, the respective changes are increases of 47 and 35 percent. One way to interpret this failure is through the data on time allocation. The model suggests that agents should delay time spent on entertainment until the complementary expenditure is high, that is delay entertainment time until middle age. The time freed up should instead be allocated to home production, where the margin of substitution between time and goods is high. This is not the pattern observed in the data.

Relative to their 30s and 40s (and to expenditure on entertainment), people in their 20s allocate an abundance of time to entertainment. It is possible that the low level of expenditure while young may be due to liquidity constraints and/or precautionary savings. However, these forces cannot explain why the young allocate so much time to entertainment rather than food production – there is no equivalent constraint on time allocation. This allocation of time may instead reflect the high returns to building social capital for the young and the low returns to home production before the accumulation of a stock of home durables.

CONCLUSION

This paper documents that the hump in lifecycle expenditures on nondurables masks informative variation across individual expenditure categories. In particular, we highlight that food declines relative to entertainment (and several other categories) in the second half of the lifecycle. The qualitative pattern is consistent with a model in which time and good are substitutes for food, but complements in entertainment. Quantitatively, the model closely matches the joint allocation of expenditures and time on food and entertainment in the latter half of the lifecycle. Going forward, any explanation of the lifecycle profile of expenditures needs to match the fact that food expenditures (a necessity) falls during the back half of the lifecycle while expenditure on entertainment (a luxury) rises during the back half of the lifecycle.

Mark Aguiar is Associate Professor of Economics at University of Rochester. Erik Hurst is Professor of Economics at the University of Chicago Graduate School of Business.
Economists often use the concept of rationality in trying to understand economic behavior. Talk about how this orientation informs your thinking and research.

The rational expectations hypothesis states that, in forming beliefs about future states of the world, people use all available information to assess the probabilities of and make the best possible guess about various outcomes. Early research on rational expectations was mainly interested in understanding how people form expectations about macro-level variables, like prices or inflation. In the mid-1980s, researchers began to apply the rational expectations framework to study micro-level variables. Applied to individual level variables, the theory hypothesizes that people have in their head a probability distribution (which will end up coinciding with what we will observe empirically for the population) about a potential outcome, and that they can give you a good guess as to where on that distribution the likely outcome will fall.

One outcome people were studying in this regard was retirement, and the idea was that people form expectations about when they are likely to retire. Most of the literature to that point had focused on the comparison between expectations with outcomes—with what people say they think is going to happen with what actually does happen. The assumption was that if people are forming rational expectations, then they should, on average, be right. If things do not turn out as people expect, then they are irrational. But, of course, for a given individual many things can happen unexpectedly that affect the outcome. In the case of retirement, an unexpected health shock, for example, can lead to an earlier than expected retirement.

Because of the possibility that people are revising and correcting expectations as they go based on new information, Deb Dwyer and I (and others) began to think about how people form expectations over time, and whether or not this process of expectation formation can be considered to be “rational.” Fortunately, longitudinal datasets, like the Health and Retirement Study (HRS), for example, were coming on-line which asked questions about expectations at multiple waves of data collection. MRRC provided support for some of our research in this area (WP 2003-037, WP 2003-059, WP 2003-062), and our more comprehensive article has recently been published in Empirical Economics, after two earlier publications on the topic, one of them dealing with married couples. In the latest publication, using data from two panel datasets and three different types of expectations, we find we cannot reject the rational expectations hypothesis. This means that we can at least continue to rely on rationality, and the strategies used to model it, as a good first approximation to behavior by individual decision makers. I believe we need more realistic economic models, which are likely to be more complex, but also more attentive to details of the process of expectations formation by individuals.

As workers are increasingly exposed to a range of options for financing their retirement, two topics of great interest are annuities and portfolio choice. Describe your work in these areas.

Something that has puzzled economists for a long time is the fact that people do not buy private annuities, despite the fact that they appear to be a good deal. The most simple annuity is a contract which provides a future (constant, in real terms) income stream in return for an initial payment. Rather than
Q: Many American workers claim Social Security retirement benefits at the early retirement age of 62. Talk about your work addressing this “puzzle.”

A: Along with many others, we observed the increasing trend toward claiming Social Security benefits at the early age of 62. Because there is an actuarial adjustment that makes it fair to delay claiming until the age of 65, or the Normal Retirement Age (NRA), economists are puzzled by the trend. In my work with Deb Dwyer and Warren Sanderson on this topic, we began by taking a close look at the incentive structure built into rules for claiming. The earnings test is one such incentive that is actually not well understood, as I had discussed in earlier work. Also, most annuities are quite expensive, and the person may rightly feel that he is giving up too much in order to have a steady income stream. The puzzle may have more to do with pricing of annuities than irrational behavior.

Another somewhat puzzling fact for economists is why individuals who do hold investments are generally very conservative in their portfolio choice. There was a hypothesis in the literature that people who have flexibility in their labor supply, that is, can work more or less depending on their need for income, might be more willing to take greater risks in stock market investments. The idea is that knowing that they can work more serves as a type of insurance against a bad investment outcome. Our MRRC work on this topic, using the HRS, did lend support for this proposition (WP 2003-056). I think it’s quite interesting to consider that people may base investment decisions in part on their labor supply.

Along with many others, we observed the increasing trend toward claiming Social Security benefits at the early age of 62. Because there is an actuarial adjustment that makes it fair to delay claiming until the age of 65, or the Normal Retirement Age (NRA), economists are puzzled by the trend. In my work with Deb Dwyer and Warren Sanderson on this topic, we began by taking a close look at the incentive structure built into rules for claiming. The earnings test is one such incentive that is actually not well understood, as I had discussed in earlier work with Frank Heiland. It is generally understood that if you work too much while claiming Social Security between age 62 and the NRA, your benefits will be reduced. In fact, the government withholds that amount but pays it back to you later when you reach the normal retirement age. Given that, it may make sense to workers to go ahead and claim early, continue working, and be taxed by the earnings test, knowing they will get it back later. But even when we did a good job modeling the incentive structure, there is still this large hump of people claiming at 62 that is not completely explained.
One thing we thought might be important in trying to understand why so many people claim as soon as possible is Americans’ uncertainty about the long-term availability of Social Security benefits. There is certainly a lot of talk in the media about the coming insolvency and the need to address that problem. We think that many people might be thinking “I better get these benefits while I can.” There are good reasons for this. For example, the earnings statement every working American receives from SSA now says they may not be able to pay the full amount in the future but only about 75 cents on the dollar. In our MRRC paper looking at this (WP 2006-134), we find that expectations about potential future cuts in Social Security help to explain early claiming quite well. Once the appropriate earnings test incentives are modeled, and we account for the probability of reforms to the system, an increase in the normal retirement age (NRA) has little effect on claiming behavior, and it can even increase the proportion of individuals claiming before the NRA.

Where are you headed next?

Building on this work that seeks to accurately represent system incentives in understanding people’s behavior, I am interested in investigating knowledge about Social Security rules. It is important for accurate modeling of the system’s incentives to know whether or not people have a full understanding of the program rules. This work would also contribute to the literature on financial literacy by studying the role of people’s knowledge of Social Security rules on their welfare. It is actually an open question as to whether lack of financial information necessarily leads to bad financial outcomes, which may have serious welfare consequences. What if we were to find that people have low levels of information about Social Security program rules and yet still find that they go ahead and claim, more or less, at their optimal time? It could be that, even though they have no prior information, when they get to retirement age, they will look around and see their friends all claiming benefits. Without the benefit of prior knowledge, they will just follow the crowd. So we would be interested in evaluating the welfare cost to individuals of not obtaining information about Social Security Program rules. I would also like to take this opportunity to thank the SSA and the MRRC for their support, which has been very important to my continued research in these policy relevant areas.


Hugo Benítez-Silva is Associate Professor of Economics at SUNY-Stony Brook. His research includes the study of disability and other programs in the United States, dynamic life-cycle models of annuity and portfolio decisions with an emphasis on modeling the effects of uncertainty in wage income and capital investments, retirement expectations, and labor supply effects of early retirement rules. His current work includes estimation of a dynamic structural life-cycle model of retirement and disability, modeling of expectations regarding future reductions of retirement benefits, accuracy of self-reported housing values, welfare effects of having imperfect information of Social Security rules, and the connection between health investments and retirement behavior.
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For the 9th Annual Conference of the Retirement Research Consortium

August 7th and 8th
At the National Press Club in Washington D.C.

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