HOW DO PENSIONS AFFECT EXPECTED AND ACTUAL RETIREMENT AGES?

By Alicia H. Munnell, Robert K. Triest, and Natalia A. Jivan

The trend toward earlier and earlier retirement has slowed and, perhaps, even reversed. A host of explanations are possible: the elimination of mandatory retirement, the cessation of the expansion of Social Security, the reduction of retirement incentives within Social Security, and the changing nature of the private pension system. This paper explores the latter issue – how pension coverage and the type of pension affect the timing of retirement. This paper uses the first six waves of the Health and Retirement Study to investigate the impact of pensions on expected retirement age, on the probability of being retired in each wave given employment in the previous wave, and on the probability of retiring earlier than planned.

Pension coverage would be expected to increase the likelihood of expected and actual retirement. Workers get benefits, and those benefits enable them to retire earlier than they would have been able to without a pension. The story is more complicated, however, because the type of pension also matters. Defined benefit and defined contribution plans have different financial incentives, different ways of paying benefits, and different types of risks. Provisions in many traditional defined benefit plans offer a significant subsidy for early retirement, while 401(k) plans are neutral with respect to retirement age. In defined benefit plans, the employer bears the investment and interest rate risk; in 401(k) plans, the employee bears the risk.

The HRS allowed a detailed analysis of both the effect of pension coverage and of the impact of different types of pensions on retirement behavior. Although pensions are complicated institutions, in virtually every instance the HRS results show pension variables having the predicted effect on expected and actual retirement patterns.

The first part of the analysis looked at expected retirement age for those working in 1992. As predicted, the presence of pension wealth lowers the expected retirement age for those with pensions compared to those without. In addition, the incentives for early retirement under defined benefit plans have an additional large – more than a year – and statistically very significant effect on reducing the expected age further. The additional effects from defined contribution plans are only marginally significant and quite small. Taking the wealth and pension characteristics together, for a worker with no pension coverage the expected retirement age is 64.9 years. For a typical worker with a defined contribution pension, the expected retirement age is 64.6; and for a typical worker with a defined benefit plan it is 63.2 – about one year earlier.

The second part of the analysis considered the effects of pensions on the probability of retiring in one wave given the respondent was working in the previous wave. Here pensions enter in four separate ways. First, consistent with theory, pension wealth increases the probability of retiring. Second, the

early retirement incentives in defined benefit plans (as captured by the pension coverage dummy variable) further increase the probability of retirement. Third, the higher the earnings on the defined contribution assets, the more likely workers are to retire. Finally, the greater the accruals in both defined contribution and defined benefit plans, the lower the probability of retirement. In short, pension wealth encourages retirement but the incentives are much stronger for defined benefit than defined contribution plans. The conclusion that emerges from this section is that pension coverage and type are important determinants not only of expected retirement age but also of actual retirement age.

The results of the third exercise, which explores the reasons for retiring earlier than planned – are perhaps the most interesting. In this case, initial characteristics and shock variables – including the change in defined contribution wealth – are important variables in explaining changes in retirement plans. Pensions are also important here: pension coverage reduces the likelihood of retiring earlier than planned. The intuition is that people covered by pensions are in the position to better plan their withdrawal from the labor force.

The implications going forward are threefold. First, the shift from defined benefit to defined contribution plans will eliminate much of the incentive for early retirement. Second, the apparent decline in pension coverage will mean that a smaller percent of the work force will have the pension wealth that enables people to retire. Finally, the decline in pension coverage will make it more difficult for people to plan when they will be able to leave their jobs.

CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

Fulton Hall 550, 140 Commonwealth Avenue, Chestnut Hill, MA 02467-3808
phone 617.552.1762 fax 617.552.1750 crr@bc.edu www.bc.edu/crr