CHAPTER 5

Economic Status of the Elderly

RETIREMENT AS IT IS KNOWN TODAY is a relatively recent phenomenon. In 1900 life expectancy at birth was 46 years for males and 48 for females. While most women did not work outside the home once they married, two-thirds of all men over 65 were still in the work force. Many men retired only because of poor health or company rules, and retirement usually consisted of a few years of declining health. Often the elderly relied on their children for housing and financial support.

Since 1900 the fraction of elderly men with jobs has declined dramatically, while the life expectancy of the elderly (65 and older) has improved substantially. Now, a man who is approaching the end of his working career can expect to spend about 15 years in retirement, a retirement that is often shared by a spouse who also makes a transition from worker to retiree. Because life expectancy has increased more for women than for men in the 20th century, the retirement years have become especially important for women. These are years that women are likely to face alone; two-thirds of women over 75 are widows. Elderly widows rarely remarry and on average they live 16 years beyond their husbands. Higher divorce rates have added to the number of elderly women living alone, so that today only two-fifths of all elderly women live with their husbands.

Resources to support these new retirement patterns rarely come directly from the families of retirees. The elderly receive less than 1 percent of their income from their children, and the fraction of elderly people living with their children has declined sharply. These new patterns are signs of the financial and physical ability of the elderly to live independently; they do not indicate isolation or abandonment. Only about 5 percent of the elderly live in nursing homes and most of the elderly who are not in nursing homes, even most of those over 85, report that they need no help with daily activities.

Although independent, the elderly have strong family ties. A national survey found that four-fifths of the elderly have at least one child and that only 11 percent of the elderly with children had not seen one of their children in the past month. The families of the elderly usually include grandchildren as well as children, and fourgeneration families are becoming more and more common; about half of all elderly people have great-grandchildren. Longer lifespans also mean that the children of the elderly can be elderly themselves; about 10 percent of the elderly have a son or a daughter who is also over 65.

Retirement planning has become increasingly important for the Nation as well as for families. The proportion of the population that is elderly is growing; it will explode as the baby-boom generation retires. In 1900 one person in 25 was 65 years of age or older; today that proportion is one in eight; by 2030 one person in five will be elderly. In about 35 years the United States as a whole is expected to have the same proportion of elderly as Florida does today. In 50 years the ratio of people over 65 to the working-age population will be 2½ times as great as it was in 1950. No other demographic change will influence the Nation in the next 50 years as much as this "graying" of America. Every American and every facet of the society will be affected.

CURRENT FINANCIAL STATUS OF THE ELDERLY

Thirty years ago the elderly were a relatively disadvantaged group in the population. That is no longer the case. The median real income of the elderly has more than doubled since 1950, and the income of the elderly has increased faster over the past two decades than the income of the non-elderly population. Today, elderly and non-elderly families have about equal levels of income per capita. Poverty rates among the elderly have declined so dramatically that in 1983 poverty rates for the elderly were lower than poverty rates for the rest of the population.

These encouraging statistics do not tell the whole story. The elderly are not a homogeneous group. Those with spouses have relatively high levels of family income, especially when leisure opportunities, lower tax rates for the elderly, noncash transfers, and assets are taken into account. A good deal of evidence supports the contention that the elderly with spouses are, on average, more financially secure than the non-elderly. But many of the elderly live alone and these individuals, particularly women, often have very limited financial resources; they are often poor. Poverty rates for elderly blacks and the very old are also high.

Conflicting statements about the economic status of the elderly can sometimes be traced to these differences among the elderly but they also arise for other reasons. The resources of the elderly include income after taxes and assets, as well as transfers both from the government and from families. Many of these resources, particularly those that are more important to the elderly than the non-elderly, are hard to evaluate. In addition, statements about the financial security of the elderly are relative statements; they are based on a comparison of the measured resources of the elderly with the resources of the elderly when they were younger, with other groups, or, in a few cases, with a measure of the needs of the elderly. Different comparisons can lead to different conclusions about the economic status of the elderly as a group.

Many of the measures of the financial status of the elderly can be explained in the context of normal life-cycle patterns of income, consumption, and saving. Labor earnings tend to rise during the working years and then decline sharply after age 60. Consumption levels are more constant than earnings; a typical household borrows early in the life cycle and later begins to accumulate savings during the higher earning years. In the absence of social security payments, retirees maintain consumption by drawing down these savings. Social security changes life-cycle patterns in several ways; social security taxes and benefits can affect saving, retirement decisions, bequest plans, and consumption. The effect of social security on life-cycle patterns depends on many factors, including the degree to which the elderly anticipated actual benefit levels when they were younger.

INCOMES OF THE ELDERLY

Given these normal life-cycle patterns, current income, the most widely used measure of financial status, can be misleading. Income can be low in retirement even when preretirement consumption levels are maintained, because consumption is financed out of savings accumulated during the working years. In addition, relative measures of income depend on the choice of the comparison group. The elderly have relatively low income compared with those near retirement; but they have income levels close to much younger groups. The difference is in part attributable to life-cycle patterns of earnings. These relative measures are also affected by the increase in incomes of successive generations because of economic growth, an increase that tends to work in the opposite direction and depress the income of the elderly relative to the young.

Several of the various measures of relative financial well-being can be illustrated using the before-tax income data in Table 5-1. The income of today's elderly can be compared with the income of the elderly in the past, a comparison of elements in the last column. Since 1950 the mean income of elderly families has gone up more than 80 percent in real terms, and the mean income of the unmarried elderly living in a household without relatives (unrelated individuals) has more than doubled. The income of the elderly can also be compared with the income of the same individuals when they were younger, a measure that depends on life-cycle patterns of income. Table 5-1 can be used to approximate portions of the life-cycle patterns of income for several generations. These life-cycle patterns are traced out for families by diagonal elements in the table. For example, most of the elderly families in 1980 were roughly in the 35-to-44 age bracket in 1950. Thus, the data in Table 5-1 indicate that, on average, elderly families in 1980 had higher levels of before-tax real income than they had in 1950 but lower levels of income than they had closer to retirement. Research based on income data for individual families over time rather than averages has led to the same conclusion—that elderly families have real incomes below levels they attained in middle age but similar to levels attained when the head was younger.

TABLE 5-1.—*Mean real money income before tax (in 1983 dollars) of families and unrelated individuals, selected years, 1950-83*

[Dollars]

Economic group and year	Age (years)				
	25-34	35-44	45-54	55-64	65 and over
Families[1]					
1950	14,910	17,510	18,140	16,900	11,780
1960	20,480	24,130	24,810	22,160	14,740
1970	26,570	31,850	34,810	30,730	18,260
1980	25,760	32,420	36,460	32,890	20,370
1983	24,730	32,460	36,530	32,060	21,420
Unrelated individuals					
1950	8,920	9,280	8,270	6,670	4,150
1960	11,880	13,730	11,230	8,710	5,510
1970	18,640	17,940	15,740	13,070	7,380
1980	16,890	19,730	16,530	13,150	8,640
1983	16,420	20,120	18,200	14,070	10,040

[1] Age determined by age of head of household.

Note.—Money income converted to 1983 dollars using the consumer price index for urban wage earners and clerical workers (CPI-W) and rounded to the nearest $10.

Source: Council of Economic Advisers, based on data from Department of Commerce (Bureau of the Census).

The Table 5-1 data for unrelated individuals cannot be used to trace income patterns over a lifetime because there is substantial movement into and out of this category. In many cases the relatively low income levels of elderly individuals living alone, particularly women, can be explained by the loss of a spouse.

One common measure of relative financial well-being is the average income of the elderly, those currently 65 and over, compared with the average income of adults now aged 25 to 64. This measure is a comparison of one element in the last column of Table 5–1 with the average for the younger groups in the same row. It is influenced by life-cycle patterns of income, by the effect of economic growth on the income of successive generations, and by changes in the age distribution of both the elderly and non-elderly. Since the 1950s the average age of the elderly has increased because the fraction of the very old among the elderly has increased. The average age of the non-elderly has also changed, reflecting low birth rates in the 1930s and the high birth rates that produced the post-World War II baby boom. Given these influences, it is difficult to interpret relative income measures that compare the elderly with the non-elderly and it is not surprising that these measures have fluctuated since 1950. Nevertheless, between 1970 and 1983 the relative status of the elderly improved dramatically (Table 5–2). In 1983 before-tax per capita mean income was virtually the same for elderly and non-elderly families. Two-thirds of the elderly lived in family units. Per capita income ratios are higher than family income ratios because families with an elderly head tend to be smaller than younger families. In 1983 elderly families contained an average of 2.4 persons compared with an average of 3.5 persons for non-elderly families. The elderly to non-elderly income ratios are lower for unrelated individuals because the elderly in this class are frequently older widows, who tend to be the poorest of the elderly.

TABLE 5–2.—*Mean real money income before tax of the elderly and non-elderly, 1970 and 1983*

Economic group	1970	1983
Elderly (65 years and over)		
Family income	$18,260	$21,420
Family income per capita[1]	7,630	9,080
Income of unrelated individuals	7,380	10,040
Non-elderly (25–64 years)		
Family income	$31,050	$30,940
Family income per capita[1]	8,110	8,960
Income of unrelated individuals	15,820	16,900
Income ratios (elderly to non-elderly)		
Family	.59	.69
Family per capita	.94	1.01
Unrelated individuals	.47	.59

[1] Bureau of the Census publications do not include a measure of average family size prior to 1976. The 1970 measures of mean per capita income are estimated from information on the income of families of varying sizes.

Note.—Money income converted to 1983 dollars using CPI–W and rounded to the nearest $10.
Age of family determined by age of head of household.

Source: Council of Economic Advisers, based on data from Department of Commerce (Bureau of the Census) and Department of Health and Human Services *(Social Security Bulletin)*.

The distribution of before-tax income around its mean is very different for the elderly and non-elderly. Although the elderly are less likely to have income below the poverty line, they are more likely to have income below mean levels for their age group. In 1983 most of the elderly (60.8 percent) had before-tax income between $4,000 and $15,000.

This bunching of the income distribution for the elderly below the mean is the result of normal retirement patterns and the social security benefit schedule. Most of the elderly have chosen to retire. That choice reflects the decision to consume more leisure at the expense of income. In addition, social security benefits, a principal source of current income for the elderly, are capped. The maximum benefit was $734 a month for a 65-year old individual who retired in December 1983. With the benefit for a spouse, equal to one-half the primary benefit amount, annual social security payments would amount to $13,217.

Income levels of the elderly have improved both absolutely and relatively in spite of several forces that worked in the opposite direction. The most dramatic of these forces was a decline in labor force participation of the elderly and a simultaneous increase among the non-elderly. The labor force participation rate of elderly males declined from 26.8 percent in 1970 to 17.4 percent in 1983; the participation rate for elderly females declined from 9.7 to 7.8 percent. Among those aged 25 to 54, both male and female, the participation rate increased from 72.0 to 80.1 percent over the same period. Along with increasing income, the elderly have benefited from increasing amounts of leisure over the past few decades on both an absolute and a relative basis.

Demographic factors have also tended to depress the average income of the elderly. The age distribution of the elderly has shifted toward those over 75. Because income typically declines with age and because older generations have lower levels of lifetime income, increases in longevity tend to lower average income levels for the elderly. In addition, the ratio of women to men among the elderly has increased from six women for every five men in 1960 to three women for every two men in 1980. In 1983 mean income for elderly females living alone was equal to 80 percent of mean income for elderly males living alone.

Most income measures, including those in Tables 5-1 and 5-2, are before-tax rather than after-tax measures. The elderly have lower average tax rates than the non-elderly and thus have more to spend out of a given income than the non-elderly. Approximately two-thirds of the elderly pay no income tax. The elderly benefit from several tax provisions. Individuals 65 and older with low incomes receive a 15 percent credit against their tax and all individuals aged 65 and over are entitled to an additional $1,000 exemption. Those over 55 also receive preferential tax treatment on the capital gain from the sale of one principal residence. Social security benefits were not taxed at all before 1984. Now individuals with incomes well above average levels for the elderly must include a portion (up to one-half) of their benefits in taxable income.

Income levels of the elderly have improved despite offsetting demographic trends largely because of increases in social security benefit levels and coverage. Between 1950 and 1983 the fraction of the elderly receiving social security benefits rose from 16 to 94 percent. Furthermore, the average level of nominal benefits went up much faster than the price level during the same period (Table 5-3). Real benefits went up by almost 150 percent. Income levels of the elderly have improved relative to the non-elderly since 1970 because social security benefits increased by 46 percent in real terms while earnings from wages and salaries, the major source of income for the non-elderly, decreased by 7 percent in real terms. Thus, younger families have had to work more to keep up with inflation since 1970; older families have not.

TABLE 5-3.—*Increases in wages, prices, and social security benefits, 1950-83*

Item	Percent change				
	1950 to 1960	1960 to 1970	1970 to 1980	1970 to 1983	1950 to 1983
Median annual wages and salaries [1]	46	58	104	138	451
Consumer price index [2]	23	31	112	156	312
Average monthly social security benefit for retired workers	69	60	189	273	905

[1] Data are for persons 14 years of age and over through 1977 and for persons 15 years of age and over beginning 1978.
[2] CPI-W.

Sources: Department of Commerce (Bureau of the Census), Department of Health and Human Services (Social Security Administration), and Council of Economic Advisers.

Relative trends in the income of the elderly and the non-elderly may be misleading if the two groups typically spend their money in different ways. Typically the elderly spend more of their income on medical care and food and less of their income on transportation and child care than the non-elderly. Different expenditure patterns are not taken into account in the calculation of real income because the same measure of average prices—the consumer price index—is used to adjust dollar income for both groups. Several studies have investigated this issue and virtually all have concluded that the goods typically purchased by the elderly and the non-elderly have experienced similar price increases. In other words, the same index can be used to compare the real income levels of the elderly and the non-elderly. The common perception that the elderly are especially susceptible to inflation is not supported by recent evidence. Social security payments have increased faster than the consumer price index, and that index accurately reflects price increases of the purchases of the elderly.

Current income has been the most widely used measure of financial status out of necessity rather than merit. The economic status of the elderly can be evaluated properly only in the context of needs relative to total resources. Resources include assets, gifts, and other transfers as well as income. But it is very difficult to define needs, and both needs and assets are measured only sporadically.

POVERTY RATES AS A MEASURE OF NEED

The best known measure of need is the official definition of poverty, a standard that takes some of the needs of different types of families into account. Families with incomes below the official poverty level are defined as poor. Benefits in kind are not included in the measure of income.

Poverty rates are lower now than in 1960; they have declined more for the elderly than the non-elderly (Table 5-4). Elderly families now have lower poverty rates than non-elderly families. Most of the elderly poor live alone or with nonrelatives, however. The poverty rate for these elderly individuals living alone (unrelated individuals) is higher than the poverty rate for unrelated individuals between 25 and 64, but the disparity in these poverty rates has declined dramatically. In 1983 the poverty rate for the entire elderly population was 14.1 percent; for the non-elderly, including those under 24, it was 15.4 percent.

TABLE 5-4.—*Percent of the elderly and non-elderly populations with incomes below the poverty line, selected years, 1960-83*

Economic group	1960	1970	1980	1983	1960	1970	1980	1983
	Elderly (65 years and over)				Non-elderly (25-64 years)			
Families	27	16	9	9	16	8	10	12
Married couple families and families headed by a male	26	16	8	7	13	6	6	7
Female head, no husband present	31	20	15	17	44	32	32	36
Unrelated individuals	66	47	31	26	32	20	17	18
Male	60	39	24	22	26	14	14	17
Female	68	50	32	28	38	25	21	21

Note.—Age of family determined by age of head of household.
Source: Council of Economic Advisers, based on data from Department of Commerce (Bureau of the Census).

One major reason that poverty rates have declined for the elderly is the social security system. The average couple's benefit was $744 per month in December 1983, 48 percent more than the poverty line for an elderly family of two. In the same month, the average widow's benefit was $393, which was 98.9 percent of the poverty line for an elderly single individual.

Despite large Federal outlays for the elderly—more than $200 billion in fiscal 1983—measured poverty persists among the elderly because less than 10 percent of these outlays are for programs designed specifically to assist the low-income elderly. Often, the Federal programs that are intended specifically for the poor among the elderly do not provide benefits that are large enough to raise households above the poverty level, even when State supplements are taken into account. About 90 percent of Federal outlays for the elderly are for retirement and health programs that do not have eligibility criteria based upon income or assets—a means test. These programs are important for many of the elderly with low income, but they are not intended specifically for the poor. About half of all elderly households with income below the poverty level receive no means-tested benefits. Some of these households have assets that preclude the receipt of benefits; others may be reluctant to apply.

BENEFITS IN KIND

Income levels and poverty rates do not reflect benefits that are paid in a form other than cash (benefits in kind). One important benefit in kind is medical care. Almost all elderly families are covered by medicare. Federal expenditures on medicare for the elderly were $48.4 billion in fiscal 1983 or nearly $1,800 per elderly individual. In addition, $12 billion in medicaid (about one-third of all medicaid funds) was devoted to the elderly, primarily the elderly in nursing homes. About 16 percent of the elderly (about one-third of all elderly men) are eligible for medical care from the Veterans Administration. A veteran who has reached the age of 65 is now automatically eligible for medical care on request, without regard to financial need, if space is available in Veterans Administration hospitals and nursing homes.

Despite the fact that the elderly have lower poverty rates, elderly households are more likely to receive at least one form of means-tested noncash benefits than the average household. Although elderly households account for 21 percent of all households, they account for 31.5 percent of households receiving housing subsidies, and 29.4 percent of households receiving medicaid, though they represent only 16.8 percent of households receiving food stamps.

In spite of the substantial research on the value of benefits in kind, the results are controversial. In 1983, for example, the poverty rate for elderly people measured on a cash income basis was 14.1 percent. After including food, housing, and medical benefits valued at their full cost in the private marketplace, the poverty rate for the elderly was estimated to be 3.3 percent. Because they are less likely to receive medical benefits, the same valuation would reduce the poverty rate of the population under 65 by much less—from 15.3 percent to 11.1 percent. Debate continues on whether this market measure overstates the value of in-kind benefits. These benefits do provide goods and services that the elderly would otherwise have to pay for out of their cash income, but the recipients of these benefits may not value them at their full cost. Estimates of the poverty rate for the elderly based on cash income plus in-kind benefits vary from 3.3 percent to 9.1 percent for 1983, depending on the assumed level of recipient valuation.

ASSET LEVELS

Many observers have characterized the contribution of assets to the financial status of the elderly as minimal, but the 1983 Survey of Consumer Finances conducted by the Federal Government found that the average asset levels of elderly families were higher than the average asset levels of younger families (Table 5-5). The survey also found that the assets of families in which the family head is 75 or older were slightly lower than assets of families with a family head between 65 and 74. This difference may reflect the fact that assets are used to finance consumption in retirement; the difference could also be attributable to the generally lower wealth levels of older generations. In fact, some recent studies have found that asset levels of the current elderly often do not decline. Many of the elderly continue to save and build up assets. There are several ways to interpret this surprising pattern of saving among the elderly, but it is a strong indication that the elderly who do save have a high level of economic security.

Home equity is the largest asset for most elderly households. Most of the elderly own rather than rent their dwellings, and they have substantial amounts of equity in their homes. The elderly as a group gained disproportionately from the increases in home values that occurred in the 1970s.

Assets are important to many elderly families, but they do not contribute much to the financial resources of families with very low income. Assets are highly correlated with income so that most of the families with low income also have low asset levels. Asset income, including the imputed rental value of owner-occupied housing, amounts to only a few hundred dollars for households that have annual incomes below $5,000.

Elderly individuals with low income generally have had low earnings before retirement because, for the most part, retirement income is related to earnings. Low earnings also limit the ability to accumu-

TABLE 5-5.—*Financial assets and homeownership of households holding such assets, by age group, 1983*

Age of head (years)	Percent of households owning liquid assets	Liquid assets of those holding such assets [1]		Total financial assets of households holding such assets [2]		Percent of households with homeownership	Net equity of homeowner [3]	
		Mean	Median	Mean	Median		Mean	Median
Under 25	81	$1,970	$600	$2,650	$750	10	$18,870	$13,780
25–34	87	4,270	1,200	7,960	1,510	40	32,640	27,770
35–44	91	8,910	3,000	14,410	3,750	66	52,070	40,600
45–54	89	14,830	3,310	23,010	4,130	75	64,470	50,000
55–64	91	25,440	7,430	54,950	9,340	73	73,580	55,000
65–74	88	30,670	9,680	65,340	11,400	69	63,670	45,000
75 and over	86	26,480	7,890	37,060	10,350	57	47,760	40,000
45 and over:								
Head in labor force	93	20,960	6,230	42,790	8,200	76	68,390	53,770
Head retired	86	28,200	6,730	50,170	8,750	69	62,460	44,170

[1] Liquid assets include checking accounts, savings accounts, money market accounts, certificates of deposit, IRA and Keogh accounts, and savings bonds.
[2] Financial assets include liquid assets plus stocks, other bonds, nontaxable holdings (municipal bonds and shares in certain mutual funds), and trusts.
[3] Nonfarm homeowners.

Source: Board of Governors of the Federal Reserve System.

late assets before retirement. Consequently, financial distress among the elderly is not so much a function of aging as it is a function of the factors that lead to low levels of income at all ages. These factors include education, race, and work history. The principal exception to this generalization may be for elderly women who lose a spouse, either through death or divorce. Although the loss of a spouse generally lowers household income at any age, the young and men of all ages usually remarry after a divorce or the death of a spouse; older women usually remain single. Elderly widowed men have remarriage rates that are about seven times higher than those of elderly widows.

SOURCES OF SUPPORT FOR THE ELDERLY

The relative importance of different sources of support for the elderly has shifted considerably over the past few decades. Earnings have decreased in importance with declining labor force participation, while social security, pensions, and assets have increased in importance.

Other sources of support have also changed. Between 1950 and 1970 the percentage of the elderly living with their children declined from 31 to 9 percent. Some of this decrease reflects a shift toward institutional care, but most of it reflects the formation of independent households. The rate of nursing home use by those 65 and over has almost doubled since the introduction of medicare and medicaid in 1966, but it is still quite low—around 5 percent.

Many observers see a causal relationship in these patterns: a cessation of work because of retirement benefits and the substitution of legally mandated intergenerational transfers for transfers within families.

EARNINGS

Earnings, at one time the most important source of income for the elderly, now represent about 15 percent of the money income of the elderly. Earnings have declined as a share of income because of reduced labor force participation and because a higher fraction of elderly workers participate on a part-time basis. In 1960, 35 percent of male workers 65 and over worked on a part-time basis; now almost half work part time. Part-time employment for female workers 65 and over increased from 48 percent to 61 percent over the same period. Most older workers who reduce their work effort below full time have left the job they held in their prime working years, and they generally work at a lower hourly wage rate. The average duration of partial retirement for those who choose to work part time is about 3 years.

The increase in the relative importance of part-time work is clearly influenced by the social security earnings test. Earnings above a limit reduce social security benefits by $1 for every $2 in earnings. The limit increases as retirees grow older and after age 70 there is no limit. The social security test is, in effect, a 50 percent tax on a range of earnings above the limit. To some extent, this tax is offset by increases in future benefits. When other taxes are taken into account, the marginal tax rate on current income can exceed 100 percent for some of the elderly. Consequently, many of the elderly do not work once they have earned the limit. Earnings distributions for the elderly clearly show this phenomenon; annual earnings tend to bunch near the point where the earnings test begins to bind.

New retirement patterns are largely a matter of choice on the part of the elderly, a choice that reflects both an improved financial status that allows them to enjoy more leisure and the incentives inherent in retirement benefits. The view that most of the elderly have been forced to retire by poor health or by mandatory retirement laws is not supported by the evidence. Changes in health do not explain the decline in labor force participation over time. To some extent, the decline in participation can be explained by the fact that the minority of workers with health problems are now able to retire early. This phenomenon is not a significant factor behind current retirement patterns. Most workers now retire between age 60 and age 65. That pattern is explained by economic incentives, not by health.

The explanation for work patterns among the elderly is not found in mandatory retirement rules either. Even before the Congress raised the minimum mandatory retirement age from 65 to 70 in 1978, only a minority of workers were employed in jobs that imposed mandatory retirement, and the vast majority of these workers retired before the mandatory date. Estimates of the percent of workers who retire because of mandatory retirement have been quite small—between 2 and 5 percent. The actual incidence may be even lower now because several States have outlawed mandatory retirement entirely.

There is increasing evidence that the retirement decision is a matter of choice, a choice that is strongly influenced by the economic incentives inherent in both social security and private pensions. Labor force participation has declined as pension benefits have increased. The effect of pensions on labor force attachment can also be observed among individuals in a given year. Even though pension recipients are not forced to stop working, they often do. In 1980 the employment rate for recipients of private, State, and local pensions aged 60 and over was only 56 percent of the rate for the entire population in the same age bracket. Further evidence that the timing of retirement is largely a matter of choice can be found in the distribution of retirement ages: The two peak years of retirement occur at ages 62 and 65. Sixty-two is the earliest age of retirement for social security. The current benefit structure of the social security system discourages work past the age of 65. In addition, 65 is the normal retirement age in most pension plans. After the age of 65, pension accrual frequently ceases. The implication of these suggestive patterns is reinforced by more sophisticated statistical studies. About three-quarters of the variation in retirement ages can be explained by economic variables that measure the level of accrued pension benefits at a given age and changes in income streams that can be anticipated if retirement is postponed.

The decision to retire is clearly influenced by the financial rewards for continued work. These financial rewards include wages and pension benefits. Although workers are less likely to retire when the rewards for continued work are high, they often retire even when retirement means lower income. This choice of leisure over income is influenced by working conditions. Workers in blue-collar jobs, particularly those jobs involving heavy manual labor such as mining and construction, are likely to retire earlier than workers with jobs in retail trade or service industries.

Despite the limited labor force attachment of older workers, surveys find that many of the elderly want to work part time. This is not surprising, given the incentives inherent in the social security earnings test. The fact that more people say they want to work part time than actually do has led to the conclusion that there is a shortage of part-time employment opportunities for older workers that is caused by age discrimination and employer inflexibility over hours. It is unlikely, however, that these factors explain the frequency of part-time work among the elderly.

Wanting a part-time job can mean many things. It usually means a desire for a job with a wage that is sufficient to attract a worker out of retirement. Even though many of the elderly work part time at a reduced hourly rate compared with their preretirement wage, the lowest hourly wage at which workers would be willing to accept a part-time job can be quite high for some older workers. The compensation package for elderly workers frequently includes no retirement benefits. Thus, post-retirement jobs must offer more in wages to make them as attractive as preretirement opportunities. The fixed costs of working may also raise an individual's minimum acceptable wage. A low wage for a few hours a week may not be attractive when transportation, clothing, and other work-related expenses are taken into account. Thus, many workers may be unwilling to work at an hourly rate lower than the rate paid on a preretirement job.

Employers, however, are likely to offer reduced wages for part-time employment for several reasons. Part-time employment for older workers often means a job change either because retirement provisions preclude work with a preretirement employer or because retirees seek a less demanding job once pension benefits have been secured. A job change often means that workers cannot use the same skills they acquired in their career before retirement. In addition, employers often face fixed costs of employment that make one full-time employee more cost effective than two or more part-time employees who work the same total hours. Among these are costs of recordkeeping, performance evaluation, training, some fringe benefits, and some social insurance payments.

As a result, jobs that are available often do not pay enough to attract the elderly. A shortage of jobs exists only in the same sense that would imply a shortage of almost anything with desirable features and an unspecified price. Alleged employer inflexibility in this case is the result of the normal forces that reward efficiency in a firm. Age discrimination is also an unlikely explanation for the scarcity of part-time employment among the elderly. Part-time employment, particularly employment for less than 25 hours a week, is rare among all adult workers.

ASSETS AND FAMILY SUPPORT

Surveys indicate that money income from assets accounts for about 25 percent of the cash income of the elderly. These findings should be interpreted with care because income from assets is often significantly underreported, more so for the elderly than the non-elderly. Assets become more important as a source of income as income rises, accounting for only slightly more than 5 percent for households with income under $5,000 but more than one-third of income for households with income over $20,000.

The major single asset for most of the elderly is their home. Nearly three-quarters of elderly households own their own home; half have complete ownership (no mortgage). Some elderly homeowners have little in the way of other resources, and they may need ways to convert home equity into money income. Reverse mortgages—financial arrangements that provide monthly payments from a bank and reduce home equity—were devised to meet this need. They provide income and a home to elderly individuals as long as they live. The bank takes over the home when the homeowner dies. These and other financial instruments to tap home equity have received a great deal of attention lately, but the actual use of reverse mortgages is rare. Many of the existing schemes are financially unattractive to the elderly because they offer little in monthly income relative to the market value of the home.

Some research has suggested that the reverse mortgage market has not flourished because the elderly have better ways of converting housing into other forms of consumption. Children may support parents so that they are not forced to move out of their homes. This financial support keeps the home in the family so that it can revert to the children as a bequest. In essence, parents borrow from children and secure the loan with their homes. The attractiveness of this arrangement compared with loans outside the family may explain why reverse mortgages are uncommon. Although there is little evidence of these arrangements in income surveys, financial support from children to the elderly may be in the form of gifts in kind or the direct payment of bills; this kind of support is rarely measured as income. In any event, the decline in measured support for the elderly by their children may be explained by their growing financial security, a trend that has reduced the need for both reverse mortgages and transfers from children to elderly parents.

The asset income figures cited above do not reflect consumption that is financed from the sale of assets. A principal rationale for saving is to provide assets that can be drawn down during retirement. But an important consideration for the elderly is the uncertainty surrounding longevity. A plan to draw down assets that is based on average lifespans would require disastrously low consumption in the last years of life under the otherwise fortuitous circumstance of living until age 90. An investment that reduces this uncertainty over the lifespan of the elderly is an annuity that provides a monthly payment as long as the owner is alive. The monthly payment depends on the amount of money invested and the age at which the annuity is purchased. Although it has attractive features, the private annuity market is similar to the reverse mortgage market. Private annuities are rare, and they are often financially unattractive. The availability of social security and pensions may explain the limited availability of private annuities. Because both social security and many private pension benefits are in the form of an annuity, the need for other annuities is reduced.

SOCIAL SECURITY

Social security benefits are the principal source of income for the majority of elderly Americans. Benefits comprise about 40 percent of the income of the elderly, and for 59 percent of the elderly households they make up at least 50 percent of their income. Social security benefit levels and coverage are given in Table 5-6.

TABLE 5-6.—*Social security coverage and benefit levels, selected years, 1950–83*

Year	Percent of population 65 years and over receiving benefits		Average monthly benefits at year-end			
			Current dollars		1983 dollars [2]	
	Social security [1]	Social security and/or supplemental security income [1]	Retired worker	Spouse	Retired worker	Spouse
1950	16	37	$43.86	$23.60	$180.91	$97.35
1960	62	72	74.04	38.72	248.25	129.82
1965	75	82	83.92	43.63	264.10	137.31
1970	86	90	118.10	61.19	302.00	156.47
1975	90	94	207.18	105.19	382.23	194.07
1980	91	94	341.41	171.95	411.07	207.04
1983	94	96	440.77	225.66	440.77	225.66

[1] Includes old-age and survivors' benefits. Disability benefits become old-age benefits beginning at age 65.
[2] Current dollars deflated by CPI-W.

Sources: Department of Health and Human Services (Social Security Administration) and Council of Economic Advisers.

The social security benefit formula has many features that are particularly attractive to recipients. The current formula to determine initial benefits adjusts all previous earnings for average wage increases in the past. In other words, workers are given full credit for productivity gains made by the economy during their working years. Thereafter, benefits are indexed to the overall level of prices, so that the promised benefit stream maintains its purchasing power even in the presence of unexpected inflation. In addition, payments are in the form of an annuity, so that they continue as long as the beneficiary remains alive. Because social security provides excellent protection against the major uncertainties that face elderly Americans, the dollar amount of benefits underestimates their value to the recipients.

To qualify for social security benefits, an individual must have had a minimum level of earnings in covered employment for a minimum number of quarters. The minimum number of quarters has been rising; it was 32 for those turning 62 in 1983. Benefits are financed by a tax on both employers and employees. The benefit payments that are available upon retirement are related to earnings during the working years, and they are adjusted for the age and marital status of the retiree. The relationship between taxes and expected benefits is progressive in the sense that the average rate of return on tax payments is lower for high-wage earners who have contributed relatively more to the system. This intentional redistribution may be offset to some extent by the fact that members of some low-income groups have shorter average lifespans; they are less likely to live long enough to collect large amounts of social security. The redistributive element of social security has recently been strengthened by the requirement that individuals who have substantial alternative sources of income pay income tax on up to one-half of their benefits.

The social security system also redistributes income toward married couples where only one spouse is in the paid labor force, and away from other types of households. Under the current social security law, a couple with one spouse who never works outside the home is entitled to 150 percent of the pension that would go to a single retiree with the same earnings history. Thus, the rate of return on social security contributions is higher for married couples with only one earner than for other households. In many cases, couples with two earners receive little or no extra benefits even though they have paid higher social security taxes; the effective rate of return on their additional taxes is negative.

The large magnitude of social security benefits does not entirely represent a net addition to retirement resources. To the extent that these benefits were anticipated before retirement, individuals may have reduced their own savings. Furthermore, the presence of benefits may induce individuals to work less than otherwise in their later years, and lead family members to contribute less to their support.

The question of whether the social security system reduces private saving for retirement is controversial. Because the system guarantees a certain level of income during retirement, individuals who plan over their entire life cycle might plan to save less during their working years if they anticipate social security benefits. On the other hand, the social security system provides an incentive for people to retire earlier, tending to increase the number of retirement years for which saving must be done and to reduce the number of years over which it can be done. The social security system may also affect the amount of support that the elderly can expect from their own children, offsetting the reduction in required saving. Thus, the net effect on private saving is uncertain.

The possibility that social security benefits may replace private saving does not apply with full force to the current elderly; the major increase in benefit levels enacted by the Congress in the early 1970s was undoubtedly unexpected. Even if a 55-year-old worker responded to these essentially windfall gains by reducing private saving, it is unlikely that the offset would be as complete as is the case of perfectly anticipated benefits. The alternative adjustment—reductions in resource flows from children to parents—is more likely. In some families these flows are reversed; the elderly provide financial support to adult children.

People who retired during the early years of the social security system received very high rates of return on their own contributions because they paid payroll taxes for only a small number of their working years. The system has now reached a mature stage where most new retirees have made contributions for their entire working lives. Even for this currently retiring generation, the rate of return on contributions is quite high, primarily because of the large increase in real benefit levels enacted by the Congress in the early 1970s.

For the present generation of workers, the prospects for earning a high rate of return on contributions are not nearly as bright. Because the ratio of retired individuals to the working population has increased substantially and will increase more when the baby-boom generation begins to retire, maintaining the same benefit schedule requires a continually increasing tax burden on the working population. The current work force is paying now for benefits to today's retirees that exceed their contributions by a substantial amount. The baby-boom generation cannot expect to do nearly as well when it retires.

The fiscal health of the social security system, in both the short term and long term, has recently been a cause of considerable concern. Since 1939 the system has operated on a pay-as-you-go basis, with the benefits for current retirees being financed by taxes on current workers. Beginning in 1975, though, program expenditures exceeded revenues and long-run projections indicated a substantial permanent deficit in the social security trust fund.

These problems were addressed by legislation in both 1977 and 1983. The 1977 amendments raised contribution levels and corrected a flaw in the indexing formula that overcompensated beneficiaries for inflation. The Social Security Amendments of 1983 adopted most of the recommendations of the National Commission on Social Security Reform, which reported its findings to the President in January 1983. The 1983 amendments included provisions for limiting future growth in expenditures and increasing payroll tax revenues so as to ease both the short-term and long-term shortfall. The Social Security Administration now estimates that the old-age, survivors, and disability programs will be in approximate balance over the next 75 years, with surpluses accumulating until about 2020 and being gradually drawn down thereafter. The long-run solvency of the fund depends on the growth of real wages and the growth of the working-age population. There is a great deal of uncertainty over these factors. The medicare program, a social security program that is not included in these estimates, is now projected to have growing deficits well into the next century.

PENSIONS

Pension coverage has grown dramatically over the past three decades. In 1950 about 25 percent of the work force was covered by a pension plan other than social security. Today more than half of all workers are covered. Increased pension coverage has been linked to the tax treatment of pensions, Federal freezes on wage compensation, and a 1948 ruling by the National Labor Relations Board that employers are required to bargain over the terms of pension plans. About 30 percent of the elderly now receive pension benefits, accounting for about 15 percent of income for all elderly persons and about 45 percent of the income of pension recipients. Pensions will become a much more important source of retirement income in the future; more and more newly retired workers will have acquired pension rights because of past increases in coverage. The future role of private pensions will be strongly influenced by the resolution of several current pension policy issues. In order to understand these policy issues, some knowledge of the institutional features of the U.S. pension system is required.

The Private Pension System in the United States

Pension coverage does not necessarily imply actual receipt of a pension. Pension benefits become certain, or vested, only when the age and tenure restrictions specified by the pension plan have been met. There are two distinct types of pension plans. Three-quarters of pension plan participants are enrolled in defined benefit plans that pay a specified stream of benefit payments based on years of employment and earnings. The other type of pension plan, a defined contribution plan, pays benefits that are a distribution of an employee specific investment account that has accumulated through employer and employee contributions. The yearly pension depends on mortality expectations, the contribution rate, and the performance of the plan's investment portfolio. Employees bear the investment risk in defined contribution plans, while defined benefit plans place investment risk on the employer. Blue-collar workers are more likely to have defined benefit plans as are workers in large firms and in unionized firms. Defined contribution plans are more common among professionals and highly paid white-collar workers than among blue-collar workers.

In some instances employees can move between employers and remain in the same plan. These multi-employer plans are established through collective bargaining agreements between two or more employers and a single union. These plans are prevalent in industries where there are many small firms, where employees in an industry are members of a common union, and where the nature of the work frequently shifts employees from one firm to another. Many union workers in the construction, trucking, and garment industries are covered by multi-employer plans.

Regulation of Private Pensions

Along with the growth of private pensions came a growing concern over the ability and willingness of firms to meet their pension promises. In some cases, employees with long service were arbitrarily denied benefits and some defined benefit plans did not set aside enough funds to guarantee the payment of benefits. The well-publicized collapse of some major plans prompted the Congress to enact the Employee Retirement Income Security Act of 1974. This Act, which is usually referred to as ERISA, established participation and vesting standards. The law also established standards for all parties that have control over pension plan assets to ensure that funds are managed in the best interests of plan participants.

ERISA also created a Federal agency, the Pension Benefit Guaranty Corporation to pay benefits when underfunded plans are terminated. The Corporation raises funds through a premium on existing plans and by taking over some of the assets of firms that terminate plans. The premium, which is set by law, is now too low to cover the pension commitments that have been assumed by this Corporation. Legislative initiatives to raise the premium and close some loopholes in current law that have allowed firms to dump pension liabilities on the Corporation have yet to be enacted by the Congress. Currently, the premium is based on the number of employees covered by defined benefit plans and is a flat rate per participant.

The current premium structure does not reflect the risk that a plan will terminate without enough funds to pay benefits. Employers with fully funded plans who pose little risk to the Corporation have objected to higher premiums that are not tied to legislative reform to close the loopholes that have led to abuse. An alternative longer range solution would be to develop a mechanism that would charge a higher premium to firms that are more likely to use the Corporation guarantee. A risk-related premium would have the added benefit of reducing incentives to underfund pension commitments.

Amendments to ERISA established liability rules for employers withdrawing from multi-employer plans. There have been numerous court challenges to the constitutionality of these multi-employer amendments. In some cases, when the owner of a business dies or retires, or when the number of workers employed by the business declines sharply, the firm must make a substantial payment to the pension fund even though pension contributions stipulated in the union contract have always been paid. Some small companies claim that the withdrawal liability is greater than the value of their companies.

The Employee Retirement Income Security Act of 1974 did not change the voluntary nature of private pension plans. No employer is required to have a pension, and a plan may be terminated as long as employee rights to previously accrued benefits are protected. Recently, several firms with defined benefit plans have terminated their pension plans in order to gain access to assets in the plan that had accumulated in excess of liabilities; these plans were overfunded. This overfunding was caused by an increase in the interest rates that are used to measure liabilities and by increases in the value of assets held by the plans. ERISA prohibits the withdrawal of assets from an ongoing plan, but the law allows for the reversion of excess assets to the plan sponsor when a plan is terminated. These rules are consistent with the risk-sharing principles of defined benefit plans. Firms bear the risk of poor portfolio performance in defined benefit plans; they are also legally entitled to investment returns in excess of those needed to pay benefits when a plan is terminated.

Many of the firms that terminated plans to acquire excess assets maintained identical or similar plans after the original plan was terminated. Recent Administration guidelines clarified the obligations of firms in these circumstances. Plan members are protected from any future downturns in the value of assets in the pension fund after excess assets are withdrawn by a requirement that accrued rights to pensions be secured through the purchase of third-party annuity contracts. This ruling was very controversial. Many observers feel that some or all of the excess assets that accumulate in a defined benefit plan should be used for retirement benefits.

Effects of Regulation

As demonstrated in the debate surrounding excess assets, the arguments over the merits of ERISA that preceded its passage have continued. Some see the law as burdensome and unnecessary. Many opponents predicted that the law would lead to massive terminations of pension plans. In fact, pension coverage has grown since the 1974 Act was passed, although at a slower rate than in the previous two decades. Proponents see the 1974 Act as a necessary protection for workers that has had little impact on responsible employers.

Whatever the merits of ERISA, it now governs a major segment of the economy. The amount of funds regulated by the Act is nearly $1 trillion and is projected to grow rapidly. The bulk of these funds is invested in corporate equities and bonds, and the remainder in government securities, mortgages, and other investments. The investment decisions made by the managers of pension plans are important not only because they affect retirement income but also because they affect the allocation of a significant amount of resources in the economy.

There is some evidence that pension funds have experienced low rates of return relative to other invested funds over the past decade. It is possible that the return to pension funds has been reduced by restrictions that ERISA places on investments and by the incentives faced by plan managers. The 1974 Act generally prohibits all transactions between interested parties. These prohibitions may actually deter some investments that are in the plan's best interest. Although exemptions to the prohibited transactions rule can be obtained from the Department of Labor, there have been many complaints that the process limits profitable activities because it is time-consuming and expensive.

The incentives of fund managers have also been questioned. The 1974 Act is interpreted to preclude compensation that is based on the performance of the portfolio under management. Because compensation is based on management fees and transactions costs, fund managers have an incentive to engage in transactions that may not increase the overall profitability of the fund. As pension funds grow in importance, these incentives are receiving increasing amounts of attention.

Rationale for Private Pensions

Why do employers offer pension plans? The tax advantages of pension plans are one explanation, but taxes do not explain the important features of most plans. Tax advantages can be secured through defined contribution plans that have little effect on the decision to remain with the plan sponsor, or defined benefit plans that exert a strong influence on employee turnover. Most workers belong to defined benefit plans; these plans are designed to provide very strong incentives to stay with a firm up to some age and then strong incentives to retire after that. The incentives to retire can peak at 65 or later, but many plans encourage earlier retirement. There is an abundance of evidence that workers respond to these incentives.

The predominance of defined benefit plans indicates that the incentives inherent in these plans are important in explaining their existence. The preference for defined benefit plans is expressed by both employers and employees and demonstrated in the outcome of collective bargaining agreements.

Why do pension plans have these incentives? An answer that is consistent with the evidence is that incentives are needed to ensure that the worker does not stay on past the time when total wages over a career exceed the worker's contribution to total output. Under some wage structures, workers are paid less than the value of their work at early stages of their careers and more than the value of their work at the end of their careers. There are several explanations for the divergence of pay and productivity. Some explanations are based on the fact that employers need a way to encourage highly trained workers to stay long enough to recoup training costs. Other explanations are based on the ability of employers to observe and reward work only after it is completed. In some cases employers may not want to lower the wages of older workers when their productivity begins to decline. All explanations lead to the conclusion that the observed pattern of wages and pensions is more attractive to both the employer and employee than a wage that increases less over a career and is more closely tied to productivity.

Although this wage structure is beneficial to both sides in the employment relationship, it encourages complaints by older workers even though these same workers benefited from the system when they were younger. Workers near retirement may prefer to continue working at high wages and accruing additional pension benefits. The fact that this option is not available has led to complaints that pension systems discriminate against older workers. Demographic trends have focused attention on these complaints because many people believe that the budgetary pressures on the social security system created by the baby boom can be relieved if the elderly are encouraged to work. The elimination of pension incentives to retire is sometimes called pension neutrality. Pension neutrality might seem like a good idea now, especially for today's older workers, but today's younger workers—tomorrow's elderly—could be worse off as a result because pension neutral schemes may preclude the compensation arrangements that are most attractive to both employers and employees. Moreover, pension neutrality might actually reduce rather than increase retirement ages in the future when demographic pressures are even greater. Defined benefit pensions do encourage retirement at some age. But they also postpone retirement before that age. With pension neutrality and the wage patterns that would go with it—

lower wage rates for those past mid-career—workers in the future may well choose earlier retirement dates.

Women and Pensions

The relatively high rates of poverty among elderly single women have focused attention on the pension rights of women. About three-quarters of the difference between incomes of elderly men and women can be explained by pension income.

The financial position of elderly single women is likely to improve in the future for several reasons. Women have entered the labor force in record numbers in the past few decades and, consequently, future generations of elderly women will have more income from pensions. Recent judicial and legislative actions have also affected the retirement resources available to women. A 1983 Supreme Court ruling, for instance, required that pension plans make payments that are based on gender-neutral actuarial tables. Prior to the ruling some plans paid lower monthly benefits to women because, on average, women were expected to collect those benefits for more years. That actuarial adjustment is no longer allowed. The new ruling may increase pension benefits for some women and reduce benefits for some men. Alternatively, lump sum distributions of accumulated assets may increase, depriving some retirees of the advantages of group investment plans.

Recent legislation has also altered the pension rights of women. Under the Retirement Equity Act of 1984, pension plans are required to pay a survivor's benefit to the spouse of any vested plan participant who dies. Prior to the 1984 Act, some spouses received no benefits unless the plan participant was close to retirement age at death. The new law also requires that pension payments after retirement be made to both the plan participant and the surviving spouse unless both spouses elected another option. Previously, retirees could select, without the formal consent of a spouse, a payment plan that provided benefits only while the retiree lived. Monthly payments were higher if this option was chosen, but the spouse received no payments after the retiree died.

In addition, the Retirement Equity Act changed ERISA rules to accommodate what are believed to be normal career patterns of women. Pension coverage now must begin at age 21; the previous minimum was 25. The new law also strengthened the vesting rights of employees who have a break in service with a single employer. The intent of these changes was to increase the pension benefits of women.

The debate surrounding these changes was much like the debate over the Employee Retirement Income Security Act. Some see the changes as valuable protections for women while others see them as intrusive burdens that suppress important economic forces. Proposed extensions of the Retirement Equity Act illustrate some features of this debate. Many supporters of this Act want to require earlier vesting rules and plans designed so that benefits are portable, or easily transferred among employers without loss. At present, most defined benefit plans require 10 years of service before benefits are vested and, even when benefits are vested, inflation rapidly erodes pension rights acquired in a prior job.

But these features of pension plans are not accidental; they were designed to reduce turnover. If employers cannot reduce turnover with pension plans, they may have little interest in providing pensions especially now that individual retirement accounts offer essentially the same tax advantages. Thus, rules that require portability and vesting could increase the pension benefits for workers who are employed in firms that have plans, but they could also reduce the number of firms that offer pensions.

POLICY IMPLICATIONS: PRIVATE AND SOCIAL SECURITY RESOURCES

The economic status of the elderly is likely to improve in the future. Tomorrow's elderly will earn more income throughout their lives than earlier generations, and thus will accumulate more resources for retirement.

A growing fraction of retirement resources will come from private pension plans. The coverage and security of pension plans has increased substantially since 1950. With the vesting and fiduciary standards established by the Employee Retirement Income Security Act and benefits insured by the Pension Benefit Guaranty Corporation, retired workers can be more confident of receiving benefits. Attention is now focusing on policies that may increase the rate of return to pension funds. New tax rules have also made it easier and more attractive to achieve retirement objectives. Foremost is the introduction of individual retirement accounts, which allow immediate tax deductions and tax-exempt earnings for funds deposited in an account that is maintained until at least the age of 59½. The 23 percent across-the-board reduction in marginal tax rates legislated in the Economic Recovery Tax Act of 1981 should also stimulate private saving by increasing the rate of return available to savers. Also important is the effectively tax-free accumulation of assets through pension funds. The objective of all these tax provisions is to induce individuals to voluntarily allocate more of their lifetime resources toward providing an adequate standard of living in the retirement years.

Social security payments per beneficiary will also grow despite the increase in the fraction of the population over 65. Because the current benefit formula gives workers full credit for all the productivity gains made by the economy during their working lives, real benefits per person are scheduled to triple over the next 75 years.

The aging of the population will not go unnoticed. The Social Security Administration projects that in 2040 outlays to support the old-age, disability, and hospital insurance programs of social security will be nearly 25 percent of taxable payroll, compared with 14 percent in 1984. More than half this increase (63 percent) is attributable to increased outlays from the hospital insurance program. Outlays for supplemental medical insurance which are financed primarily from general revenues, are now equal to one-half of outlays for hospital insurance. The rate of growth of supplemental medical insurance suggests that its financing could require the equivalent of another 4 to 6 percent of taxable payroll. These benefits will require a significant tax increase, a substantial reduction in other government services, or an increase in total government indebtedness.

These projections have led many to conclude that private mechanisms for retirement savings must be enhanced to reduce the pressures on both the retirement and medical programs of the social security system. Many proposed changes in the private pension system have been advocated with this objective in mind. Such proposals include mandatory universal coverage, earlier vesting rules, legislation to increase the portability of pensions, and the elimination of private pension incentives to retire. These approaches are unlikely to significantly increase private retirement resources. Because pensions are only one part of a life-cycle retirement plan, a mandated increase in saving through pensions may be largely offset by reductions in other forms of private saving. In addition, many restrictions on pensions may end employers' willingness to offer them, defeating the original objective of the restrictions entirely. Mandatory coverage is not the answer to this problem, however. The firms that do not now offer pensions, particularly small firms in the service sector, would be especially burdened if pension costs were imposed on them. The cost of establishing a pension plan tends to be relatively high for smaller firms, and their generally higher turnover rate adds further to the cost of administering a long-term contractual relationship. It does not make sense to penalize that sector which has provided much of the remarkable employment growth that has occurred in this country. Pressure on the social security system should not be reduced by limiting employment opportunities in a particularly dynamic sector of the economy.

The retirement incentives inherent in social security have also been questioned in light of demographic pressures on the system as a whole. The current social security system discourages work past the age of 65, and it encourages the elderly to seek part-time rather than full-time work. These features of social security were incorporated into the system when it was believed that older workers must be encouraged to leave the labor force in order to make room for new workers. The remarkable ability of the economy to absorb the new workers of the baby-boom generation and the new work patterns of women has refuted this fallacy. The energy and experience of the elderly represent an important national resource, and current policies unnecessarily discourage work even from those who are able and willing to be productive members of the labor force.

Some progress toward reducing the work disincentives in the social security system was made in the 1983 amendments. A modification of the earnings test is scheduled to reduce the implicit tax on earnings over the exempt limit from one-half to one-third starting in 1990. Serious consideration should be given to continuing the scheduled decrease and eliminating the earnings test entirely. Opposition to this proposal is often based on the fear that social security outlays would increase if the earnings test were eliminated. Higher social security payments to those who now work part time would increase social security payments. That increase would be offset to some extent by the additional social security and income taxes paid by all those aged 62 and over who increase their hours of work and by reductions in delayed retirement credits. The net effect on total social security outlays is uncertain. But even if the earnings test does reduce budget outlays, it is still hard to defend. The earnings test reduces the contribution of the elderly to the total output of the economy. It does not make good economic sense to curtail social security outlays by reducing the base that provides for transfers to the elderly.

The 1983 amendments will also reduce the current system's strong disincentives to work after the age of 65 by increasing the amount that is added to monthly benefits when workers postpone retirement. The late retirement benefit will be increased gradually beginning in 1987. When those increases are complete, the additional amount that is given to late retirees will be enough to make up for the fact that benefits begin at a later date. Full-time work after the age of 65 will no longer be penalized. In addition, the age at which the full primary benefit is payable will be raised from 65 to 67 gradually between the years 2000 and 2022. These changes will help to neutralize the impact of the social security system on a worker's decision to retire. The retirement incentives provided by private pension plans—incentives that vary considerably across firms—can be justified on the ground that they create a bond between employers and employees that increases productivity and benefits both parties. This reasoning does not apply to social security. The social security benefit structure should not penalize workers who postpone retirement.

The economic status of the elderly has clearly improved over the past three decades. The elderly can now work less and still enjoy a higher standard of living than the elderly in the past. With good retirement policies that promote the efficient use of all resources, tomorrow's elderly will be even more secure. The 1983 amendments provide a start in improving the efficiency of the social security system. By reducing the current disincentives to work facing the elderly, these changes will reduce their dependence on social security and simultaneously encourage the efficient use of one of the Nation's most valuable resources, the elderly.