Do changes in pension incentives affect retirement?  
A longitudinal study of subjective retirement expectations

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Received 28 April 2002; received in revised form 31 October 2002; accepted 13 November 2002

Abstract

This paper investigates the responsiveness of individuals’ retirement decisions to forward-looking measures of pension accumulations. In contrast to previous research, we use within-person variation in retirement incentives and are able to control for unobserved heterogeneity in tastes for retirement by studying a panel of subjective retirement expectations. We confirm that individuals do respond as expected to pension incentives, even when we control for individual fixed effects. However, the magnitude of these responses differs when estimated from models based on within-person versus cross-sectional variation: the inclusion of fixed effects reduces the response by about half.

\textit{JEL classification:} J2
\textit{Keywords:} Pension incentives; Retirement; Subjective retirement expectations

1. Introduction

Understanding the determinants of retirement from the labor force is crucial for designing retirement programs and public policies that affect older individuals. While there has been much research in this area, virtually all of the existing empirical studies that use longitudinal data have relied heavily on cross-sectional variation in pension incentives, and have paid little attention to the possibility of unobserved heterogeneity in tastes for
retirement that are correlated with both retirement behavior and pension incentives. This paper makes use of repeated observations of individuals’ retirement expectations to investigate the effects of retirement incentives on those expectations, and to evaluate the robustness of the results to controls for unobserved heterogeneity. We confirm that individuals’ retirement expectations respond to measures of forward-looking pension incentives, even after controlling for individual fixed effects. However, the magnitude of these responses differs when estimated from models based on within-person versus cross-sectional variation: the inclusion of fixed effects reduces the response by about half.

The retirement problem does not lend itself directly to approaches based on within-person variation because actual retirement (defined as a permanent exit from the labor force) will be observed only once. Thus, repeated observations of actual behavior will provide limited information about responses to changes in retirement incentives. We are able to estimate the effect of incentives on retirement using within-person variation by examining a different dependent variable: individuals’ subjective probabilities of continuing work beyond age 62, or beyond age 65, from a survey question in the Health and Retirement Study (HRS). The advantage of this measure is that we observe these subjective probabilities at up to four different dates. We combine these expectations measures with self-reported pension data from the first four waves of the HRS. Thus, we can control for any fixed individual characteristics and learn more about the updating of retirement plans in response to new information. While there are certain data limitations associated with relying on the self-reported pension data (that we discuss below), this is a unique opportunity to examine responses to changes in retirement incentives or perceptions of those incentives.

Most longitudinal studies of the effect of pension incentives on retirement behavior use cross-sectional variation as the main source of identification and ignore the likely correlation between pension incentives and tastes for retirement. Even studies that are supposedly based on time-varying incentives are often identified from the cross-section since there is little unanticipated within-person variation over time.

One exception to this focus on cross-sectional variation is Krueger and Pischke (1992) who investigated the labor supply effect of Social Security using cohort analysis within an aggregate panel data set. Their source of within-person variation comes from a natural experiment: a substantial and unanticipated decline in Social Security benefits for those born between 1917 and 1921 (the so-called notch generation), compared with otherwise identical individuals who were born before 1917. They find an insignificant relationship between Social Security wealth and labor force participation for the notch generation and their results suggest that previous measures of a large negative Social Security wealth effect were overestimated. Although they were not able to investigate the role of private pensions or other sources of wealth that affect the retirement decision, their general conclusion is consistent with findings in this paper.

Using more recent longitudinal data from the HRS, Coile and Gruber (2000) have tried to overcome the reliance on cross-sectional variation in retirement incentives by exploiting nonlineairties in the Social Security program rules as their main source of variation in Social Security wealth accumulation. This, they argue, isolates a source of variation in retirement income accumulation that is less subject to bias from omitted unobserved characteristics. However, they do not consider the analogous potential correlation arising
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