

The social security early entitlement age in a structural model of retirement and wealth

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Abstract

A structural life cycle model of retirement and wealth attributes retirement peaks at both ages 62 and 65 to Social Security rules and wide heterogeneity in time preferences. Those with high discount rates often retire at 62. They have few assets and heavily value lost benefits from working after 62, largely ignoring potential increases in later benefits. Declining actuarial adjustments beginning at 65 induce those with low discount rates to retire at 65. Raising the Social Security early entitlement age to 64 induces 5% of the population to delay retiring, shifting the retirement spike from 62 to 64.

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1. Introduction

The most common age of retirement, by a considerable margin, is 62.¹ Perhaps not coincidentally, this age is also the first age at which Social Security benefits can be collected under normal circumstances. It is certainly plausible that these two facts are related. And yet, constructing empirical models to reflect why Social Security early entitlement causes such a spike in retirement is not as easy as it might at first appear.

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¹ Burtless (1999); Coile et al. (2002); Quinn (1999); Congressional Budget Office (1999); Gustman and Steinmeier (2001).

The problem arises because of the way future benefits are adjusted if an individual works beyond the entitlement age. If the individual foregoes benefits because he or she continues to work, future benefits are increased in an amount that is actuarially fair, and in many cases slightly better than actuarially fair. Thus, there appears to be no penalty to delaying the receipt of benefits beyond the early entitlement age, and hence no big incentive to retire at that age.

This difficulty in explaining age 62 retirement has serious and unfortunate implications for analyzing Social Security policy. It is well known that Social Security will face a funding crisis in the next several decades, and there is much debate as to how best to avoid the crisis. One step was taken in 1983 by gradually increasing the Social Security normal retirement age to 67 in the coming two decades, with concomitant reductions in benefits for those who take benefits at the early entitlement age of 62. Some additional proposals under consideration include increasing the normal retirement age further, and some include increasing the early entitlement age, both to encourage individuals to work longer and to avoid having benefits that are reduced too much ([Congressional Budget Office, 1999](#)). The only problem is that no one is quite sure what will happen to retirement if the early entitlement age is increased.

Reduced form empirical work has had at best limited success in explaining the age 62 retirement spike. The early entitlement age has not changed since early retirement was introduced in 1961, so using the early entitlement age as a right-hand side variable is not likely to be useful or even feasible. Measures such as option values or peak values typically are slightly positive up to the early entitlement age, after which they slowly decline toward zero. Either in levels or in first differences, they do not exhibit the sharp spike at age 62 which could explain the spike in retirement. Introducing a binary variable at age 62 can capture the retirement spike, but it provides a tenuous link to economic variables and complicates any policy analysis. For instance, if the early entitlement age were to move to age 64 or 65, it is difficult to say how much retirement remains at 62, how much shifts to intermediate age such as 63, and how much moves to the new early entitlement age.

Current structural models have had only moderately better success. The fact that Social Security is roughly actuarially neutral remains as a problem. Structural or reduced form models can explain the age 62 spike by assuming a high discount rate, but this approach generally means that the model has trouble explaining the smaller retirement spike at age 65. Older models were able to explain the age 62 spike as a reaction to pensions, but recent changes in pensions and pension laws have reduced the impact of pensions at that age. Liquidity constraints are a possibility, but then the question arises as to why individuals on the cusp of retirement would have no assets.

Our approach to this vexing problem is to abandon one assumption made in almost all previous empirical work on retirement. Namely, we will abandon the assumption of a uniform time preference rate across the population. We propose a model of retirement and saving in which individuals have differing rates of time preference. Individuals with high time preference perceive the actuarial adjustments in Social Security to be highly unfair, rather than the actuarial fairness that arises if these adjustments are calculated at the usual interest rates. The fact that additional work requires them to give up substantial benefits with little perceived gain in the future provides them with a powerful incentive to retire when benefits first become available.

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