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Not so voluntary retirement decisions? Evidence from a pension reform

Tuulia Hakola[a], Roope Uusitalo[b,*]

[a]*Finnish Centre for Pensions, FIN-00065 Eläketurvakeskus, Finland*
[b]*Labour Institute for Economic Research, Pitkänsillanranta 3A, FIN-00530 Helsinki, Finland*

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Abstract

Firms may encourage their workers to retire early. Experience-rating of early retirement benefits creates incentives for firms to avoid this. We use a pension reform as a natural experiment in order to evaluate the effect of this experience-rating. The key result is that experience-rating of early retirement benefits reduces early exits of older workers.

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1. Introduction

Extensive literature on the effect of the economic incentives on retirement treats the retirement decision essentially as a labor supply issue. Workers who approach the retirement age evaluate their prospective wage and pension streams, and choose the retirement age that maximizes their expected lifetime earnings or utility. Substantial empirical evidence indicates that the incentives provided by the social security systems have an impact on the age of the labor force withdrawal. Pensions that are actuarially

* Corresponding author. Tel.: +358 400842340; fax: +358 9 25357332.
E-mail address: roope.uusitalo@labour.fi (R. Uusitalo).

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unfair encourage early retirement, and countries with more generous social security benefits tend to have a lower average retirement age (Gruber and Wise, 1998).

Employer behavior has received much less attention in the retirement literature. In a pure labor supply model, workers are free to choose the retirement date that is optimal for them. Yet firms may also encourage their workers to retire early. Early retirement can be a "soft" way to reduce or to renew the workforce.

Depending on the institutional setting, firm-induced early retirement can take different forms. Hutchens (1999) suggests that the early retirement provisions of the US Social Security System can be used as a form of unemployment insurance. Since the social security benefits are not experience-rated, early retirement benefits effectively subsidize workforce reductions. Even more explicit subsidies exist in other countries. For example, before a recent pension reform, the long-term unemployed could retire at the age of 60 in Germany.

In this paper, we analyze retirement via long-term unemployment in Finland, where the social security system enables the unemployed to withdraw from the labor market already at the age of 55. This "benefit tunnel" starts off with unemployment insurance benefits and continues with unemployment pension benefits until old-age retirement at the age of 65. An interesting feature of the system is a partial experience-rating of the unemployment pension benefits. Early retirement expenses are therefore partly charged to the employer.

To structure an argument in which both the employer and the employee behavior matter for retirement, we adopt the ideas of Feldstein (1976, 1978), Topel (1984), and Hutchens (1999). Accordingly, we consider retirement as a joint decision by employees and employers. In other words, employees behave as in a labor supply model, and make their withdrawal decisions based on the expected benefits. Employers influence these decisions, because they act as gatekeepers to the unemployment-related benefits. While the employee decisions are influenced by the level and the availability of the benefits, the employer decisions are also influenced by the share of the benefits that is charged to the firm. We therefore expect the early retirement to depend both on the amount of the benefits and the degree of experience-rating of these benefits.

To test this effect, we use data from the pension reform in 2000 in Finland. This reform reduced the unemployment-related early retirement benefits and changed the experience-rating schedule. Both the decrease in benefits and the change in the degree of experience-rating differed across employees and employers. In particular, the decrease in benefits only affected workers who were eligible for extended benefits (those who were older than 55 years of age). Experience-rating, in turn, increased considerably in the largest firms, while it increased less, was unchanged, or even decreased in smaller firms. Since the reform affected different employer–employee categories differently, we can identify the effect of the reform by comparing the changes in the early exit rates in the different categories of worker age and firm size.

Our analysis shows that the experience-rating of the early retirement benefits matters. The reduction in the exit rates was larger in the firms that faced larger increases in the cost of early retirement. This finding has no benchmark in the early retirement literature, but it is consistent with the previous research on the effects of the experience-rating on the entry rate into unemployment (Topel, 1983, 1984; Card and