

Labor market shocks and retirement: Do government programs matter?

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Abstract

This paper argues that labor market conditions are an important and often overlooked determinant of retirement transitions. In our analysis, we examine how the unemployment rate affects retirement and whether the Social Security (SS) system and Unemployment Insurance (UI) system influence how older workers respond to labor market shocks. We use pooled cross-sectional data from the March Current Population Survey (CPS) in our analysis. We find that downturns in the labor market increase retirement transitions and that the magnitude of this effect is comparable to that associated with moderate changes in financial incentives to retire and to the threat of a health shock facing older workers. Interestingly, retirements only increase in response to an economic downturn once workers become SS-eligible, suggesting that retirement benefits may help to alleviate the income loss associated with a weak labor market. We also estimate the impact of UI generosity on retirement and find little consistent evidence of an effect. This suggests that in some ways SS may serve as a more effective form of unemployment insurance for older workers than UI.

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1. Introduction

While a worker's choice of retirement date has a substantial impact on his or her finances and overall well-being, there is little cause for policy makers to concern themselves with the timing of retirement if these decisions represent utility-maximizing choices by rational agents. In reality, however, there may be several reasons for policy makers to focus on retirement decisions. First,

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workers may face shocks late in their career, such as the onset of a health problem, that prevent them from retiring at their chosen date. Second, government programs such as Social Security may inadvertently distort workers' retirement decisions. Third, workers may be hampered in selecting the best possible retirement date by myopia or lack of information. Each of these scenarios will have important and different implications for the design of optimal government programs for the retirement-age population.

Within this framework, much of the existing literature on retirement has focused on the effect of poor health or lack of access to health insurance and the effect of Social Security and private pensions on retirement. Yet just as an older worker may experience a health shock that limits his ability to work as long as planned, so too may he become unemployed and find himself constrained by poor labor market conditions from working until his preferred retirement date.¹ If labor market shocks are an important phenomenon for older workers, then it may be desirable to design government policies to protect them from experiencing their full negative effects.

Several studies have established that job loss is relatively common for older workers and has long-lasting consequences on employment and wages, as reviewed subsequently. Certainly, job loss is more common during a recession. From this, one could infer that retirement may be cyclically sensitive, but no previous study has tested this proposition directly.

In this paper, we go beyond the previous literature in two ways. First, we directly estimate the cyclical sensitivity of retirement transitions. Besides formally documenting this relationship, this approach allows us to compare the magnitude of the estimated effect of a labor market downturn on retirement to that of factors more commonly studied. Such a comparison can help policy makers determine whether labor market factors should be taken into consideration in the design of retirement policies. We implement this approach by estimating the relationship between the state-level unemployment rate and retirement, using pooled cross-sectional data from 25 years of the March Current Population Survey (CPS).

Second, we investigate whether government programs matter in how workers' retirement behavior responds to labor market shocks. Past research has not examined this issue. We begin by exploring the role of Social Security (SS). Though SS is traditionally viewed as a source of support for retired and disabled workers, it may serve as an additional source of income support for older workers who lose their jobs. To explore this, we examine how the effect of unemployment on retirement varies by age, as any sharp break at age 62 is likely attributable to workers becoming eligible for SS. Finally, we consider whether more generous Unemployment Insurance (UI) benefits reduce the likelihood of retirement transitions, making use of state-level variation in UI benefit levels and eligibility rules. More generous UI benefits are expected to reduce the probability of retirement transitions, as UI may allow workers to delay retirement for the period that benefits are available or for even longer if they find new jobs while on UI.

We have two principal findings. First, we find that the unemployment rate has a positive and significant effect on retirement transitions: an increase in the unemployment rate of 3 percentage points, which corresponds roughly from moving from the peak of an expansion to the trough of a recession, raises the retirement hazard for workers aged 55–69 by roughly 5%. The magnitude of

¹ The constraint that workers face during an economic downturn may be twofold. One obvious problem is the greater likelihood of job loss. Alternatively, workers may experience wage cuts even if they do not lose their jobs. Either mechanism may lead workers to retire. Although the wage effect is a theoretical possibility, in practice it seems unlikely based on past research regarding the cyclicity of real wages. Given the nature of the estimated responsiveness of wages to the business cycle (Devereaux, 2001), the retirement elasticity with respect to the wage would have to be enormous to generate a significant retirement response. In the remainder of the analysis, we focus on the employment effects associated with a weak labor market.

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