Older workers: employment and retirement trends

As members of the "baby-boom" generation begin to retire and collect Social Security, pension, and other benefits, many changes to both the public and private retirement systems may occur, such as raising the ages of eligibility, creating more flexible pension plans, and introducing "phased retirement"

Patrick J. Purcell

Patrick J. Purcell is a social legislation specialist at the Congressional Research Service, U.S. Library of Congress.

Deciding when to retire is a choice that will affect an individual's economic circumstances for the rest of his or her life. In addition to affecting the lives of individuals, the retirement decisions of older workers have an impact on the Nation's economy. The number of people retiring each year affects the size of the labor force, which has a direct impact on the economy's capacity to produce goods and services. Other things being equal, fewer retirements in any given year would result in a greater supply of experienced workers available to employers and fewer people relying on savings, pensions, and Social Security as their main sources of income. Consequently, changes in the age profile of the population and in the average age at which people choose to retire have implications for both national income and the size and composition of the Federal budget.

To understand the factors that affect the retirement decision, one must first know what it means to "retire." Retirement is most often defined with reference to two characteristics: nonparticipation in the paid labor force and receipt of income from pensions, Social Security, and other retirement plans. An individual who does not work for compensation and who receives income only from pensions, Social Security, and financial assets would meet this definition of retirement; an individual who works for compensation and receives no income from pensions or Social Security would not meet this definition.

Between these two extremes, however, are those who might be considered retired under one definition but not the other. For example, individuals who have retired from careers in law enforcement or the military—both of which typically provide pensions after 20 years of service—often work for many years at other jobs, while at the same time also receiving pensions from prior employment. In such cases, having retired from a particular occupation does not necessarily mean that one has retired from the workforce. On the other hand, many people who retire from full-time employment continue to work part time to supplement the income they receive from pensions and Social Security. If the majority of their income is provided by Social Security, pensions, and savings, economists typically classify them as retired, even though they continue to engage in paid employment. As these examples suggest, not everyone who receives pension income is retired, and some who work for pay actually are retired.

This article begins by describing the change in the age distribution of the U.S. population that will occur between 2000 and 2010 and summarizing the historical data on the labor force participation of older workers. This discussion is followed by an analysis of recent data from the Current Population Survey on employment and receipt of pension income among persons aged 55 years and older during the mid- to late 1990s. Employment trends among older workers are then discussed in the context of data from the Social Security Administration on the proportion of workers who claim retired-worker benefits before the full retirement age (currently age 65). The final section of the article discusses recent proposals to promote "phased retirement" through amendments to the sections of the Internal Revenue Code that govern the taxation of pension income.

The aging labor force, 2000–2010

As members of the baby-boom generation—persons born between 1946 and 1964—approach retirement age, the demographic profile of the American population will undergo a profound change. According to the Bureau of the Census, the proportion of the U.S. population aged 65 and older will increase from 12.6 percent in 2000 to 20.2 percent by 2030.[1] The age profile of the *working-age* population, however, already is undergoing a substantial shift toward a greater number of older workers and a relative scarcity of new entrants to the labor force. In 2000, the oldest baby boomers will be aged 54 years, while the youngest members of the group will be aged 36 years. These 78 million individuals today make up approximately 55 percent of the U.S. population aged 25 to 54. Their sheer numbers suggest that the impact on labor markets could be substantial if this generation chooses to retire earlier (or to remain in the workforce longer) than did previous generations.

The data presented in Table 1 show how the age profile of the U.S. population will change over the next 10 years. According to the Bureau of the Census, the number of Americans aged 25 years or older will reach 178 million in 2000. Over the next 10 years, this number will increase by about 10 percent to 195 million. Over that same period, however, the number of persons aged 25 to 54—the ages when labor force participation rates are at their highest—is projected to increase by only 1.5 million (1.2 percent). At the same time, the number of persons between the ages of 55 and 64 is projected to increase by 11.3 million, or more than 47 percent. In other words, while the number of persons aged 25 to 64 is expected to increase by about 12.8 million over the next 10 years, almost 90 percent of this increase is projected to occur among persons aged 55 to 64.

Table 1. U.S. Population aged 25 and older by age and sex, 2000, 2010

[Numbers in thousands]

Age and sex	2000	2010	Level change	Percent change
Total				
25 years and older	177,594	195,067	17,473	9.8
25 to 34 years	37,234	38,291	1,057	2.8
35 to 44 years	44,659	38,520	–6,139	–13.7
45 to 54 years	37,030	43,565	6,535	17.6
55 to 64 years	23,962	35,284	11,322	47.2
65 years and older	34,709	39,407	4,698	13.5
Men				
25 years and older	84,586	93,116	8,530	10.1
25 to 34 years	18,535	18,990	455	2.5
35 to 44 years	22,181	18,993	–3,188	–14.4
45 to 54 years	18,092	21,325	3,233	17.9
55 to 64 years	11,433	16,922	5,489	48.0
65 years and older	14,345	16,886	2,541	17.7
Women				
25 years and older	93,008	101,951	8,943	9.6
25 to 34 years	18,699	19,301	602	3.2
35 to 44 years	22,478	19,527	–2,951	–13.1
45 to 54 years	18,938	22,240	3,302	17.4
55 to 64 years	12,529	18,362	5,833	46.6
65 years and older	20,364	22,521	2,157	10.6

SOURCE: Jennifer Cheeseman Day, *Population Projections of the United States by Age, Sex, Race, and Hispanic Origin: 1995 to 2050, Current Population Reports*, Series P-25-1130 (Bureau of the Census, 1996).

Table 2. Labor force participation rates by age and sex, 1950–2008

Year	Men			Women		
	25 to 54 years	55 to 64 years	65 years and older	25 to 54 years	55 to 64 years	65 years and older
1950	96.5	86.9	45.8	36.8	27.0	9.7
1955	97.4	87.9	39.6	39.8	32.5	10.6
1960	97.0	86.8	33.1	42.9	37.2	10.8
1965	96.7	84.6	27.9	45.2	41.1	10.0
1970	95.8	83.0	26.8	50.1	43.0	9.7
1975	94.4	75.6	21.6	55.1	40.9	8.2
1980	94.2	72.1	19.0	64.0	41.3	8.1
1985	93.9	67.9	15.8	69.6	42.0	7.3
1990	93.4	67.8	16.3	74.0	45.2	8.6
1995	91.6	66.0	16.8	75.6	49.2	8.8
1998	91.8	68.1	16.5	76.6	51.2	8.6
1999	91.7	67.9	16.9	76.8	51.5	8.9
2008[1]	91.3	69.4	17.8	79.7	57.7	9.1

[1] Data for 2008 are from the Office of Employment Projections, Bureau of Labor Statistics.

Labor force participation rates

The labor force participation rate—the percentage of a given population that is either working or looking for work—varies by age and gender. Moreover, within specific age and gender categories, the rates have changed over time, as workers have responded to various economic developments, and as societal values regarding the employment of women and the retirement of older workers have changed. Also, as the United States has moved from a largely manufacturing-based economy to one in which producing and distributing *information* is perhaps the most important industrial activity, there has been an increase in demand for highly educated workers, and relatively less demand for workers who can perform physically demanding labor. At the same time that the economy has been producing jobs for workers of more varied physical abilities, the two-earner couple and the "working mom" have become the rule, rather than the exception they were 30 or 40 years ago. With near universal coverage by Social Security and widespread participation in pensions and retirement savings plans, more workers can anticipate retirement as an opportunity for leisure and recreation, rather than as a time of financial dependency on their children.

Men aged 55 years and older are much less likely to participate in the labor force today than were their counterparts half a century ago.[2] According to data from the Current Population Survey (CPS)—a monthly survey conducted by the Bureau of the Census for the Bureau of Labor Statistics (BLS)—in the 1950s, about 5 in 6 men aged 55 to 64 participated in the labor force—that is, they were either working or actively looking for work.[3] (See table 2.) By the 1990s, only 2 in 3 men in that age group participated in the labor force. Most of the historical decline occurred over a relatively brief period, from about 1970 to the mid-1980s. Among men 65 and older, the decline began earlier, but it appears to have ended around 1985. Between 1950 and 1985, the labor force participation rate for men 65 years and older fell from 46 percent to about 16 percent. Since the mid-1980s, labor force participation rates among men aged 55 to 64 years have remained in the range of 66 percent to 68 percent, while the rate for those aged 65 and older has remained between 16 percent and 17 percent.

From 1950 to the present, women's labor force participation rates have moved steadily upward. Among women aged 55 to 64, the rate rose from 27 percent in 1950 to 45 percent in 1990, and 52 percent in 1999. Among women 65 and older, however, the labor force participation rate has changed very little over the last 50 years, remaining between 8 percent and 11 percent over the 1950–99 period.

The stability of labor force participation rates among men aged 55 years and older since the mid-1980s is likely attributable to several factors. First, Social Security coverage has been expanded and now covers virtually all private sector nonfarm employment in the United States.[4] The earliest age of eligibility for Social Security retired-worker benefits was set at age 62—in 1956 for women and in 1961for men—and has not changed since. Second, in the private sector, the expansion in pension coverage that occurred in the 1950s and 1960s had ended by 1980—about half of all workers were covered by a pension plan in 1996, virtually the same percentage as were covered in 1980. Finally, most traditional defined-benefit pension plans have minimum-age and length-of-service requirements that must be met before pension benefits can be paid. These provisions, in effect, establish a minimum age below which retirement is not a viable option for most workers. According to the BLS Employee Benefits Survey, more than 90 percent of employees in medium and large firms who had pension coverage in 1997 were covered by a plan with a minimum age requirement for retirement benefits, and more than 80 percent of these workers were covered by plans that had a minimum retirement age of 55 years or older.[5]

Recent employment trends

Data from the March CPS indicate that, from 1994 to 2000, employment increased among both men and women aged 55 to 64.[6] (See table 3.) Moreover, the increases occurred among both 55- to 61-year-olds, who are not eligible for Social Security retirement benefits, and 62- to 64-year-olds, who are eligible for reduced Social Security benefits. The employment–population ratio—the proportion of a given population that is employed—among men aged 55 to 61 rose from 68.5 percent in March 1994 to 73.3 percent in March 1999, before declining to 71.3 percent in March 2000. Among those aged 62 to 64, the ratio rose from 40.9 percent to 47.1 percent over the same period. The employment-population ratio also increased for women. Among 55- to 61-year-olds, it rose from 53.3 percent to 58.0 percent over the period, and among 62- to 64-year-olds, it increased from 31.2 percent to 34.6 percent.

Much of the increase in employment among persons aged 55 years and older during the mid- to late-1990s probably was due to the strength of the economy during these years. Between 1993 and 1999, for example, the unemployment rate for workers of all ages declined from 6.9 percent to 4.2 percent. Over the same period, the Nation's real gross domestic product (GDP) grew at an average annual rate of 3.7 percent.[7] It is possible, however, that at least part of the increase in employment was due to the trend of workers choosing to remain in the labor force rather than taking early retirement, as well as the effects of long-term trends away from *defined-benefit* pension plans, which often include early-retirement subsidies, toward *defined contribution* plans, which are age neutral in their design. The Employee Benefits Survey, for example, indicates that between 1993 and 1997, the proportion of full-time employees in medium and large private establishments who were covered by a defined-benefit pension plan fell from 56 per-

Table 3. Employed persons aged 55 years and older by age and sex, 1994–2000

[Numbers in thousands]

Age and year of survey	Men					Women				
	Population	Employed		Percent employed:		Population	Employed		Percent employed:	
		Total	Percent of population	Full time	Part time		Total	Percent of population	Full time	Part time
55 to 61 years:										
1994	7,047	4,828	68.5	90.7	9.3	7,676	4,089	53.3	73.1	26.9
1995	6,993	5,035	72.0	91.5	8.5	7,716	4,196	54.4	74.1	25.9
1996	7,409	5,349	72.2	91.2	8.8	7,947	4,314	54.3	74.5	25.5
1997	7,523	5,404	71.8	90.6	9.4	8,142	4,582	56.3	77.1	22.9
1998	7,855	5,664	72.1	91.4	8.7	8,515	4,896	57.5	77.7	22.9
1999	8,174	5,990	73.3	91.7	8.3	8,743	4,904	56.1	76.8	23.2
2000	8,204	5,849	71.3	92.3	7.7	9,041	5,240	58.0	77.2	22.8
62 to 64 years:										
1994	2,869	1,172	40.9	76.1	23.9	3,129	975	31.2	60.6	39.4
1995	2,879	1,206	41.9	79.0	21.0	3,162	975	30.8	58.3	41.7
1996	2,681	1,159	43.2	77.8	22.2	3,044	968	31.8	59.3	40.7
1997	2,733	1,255	45.9	79.2	20.8	3,069	1,047	34.1	62.5	37.5
1998	2,812	1,283	45.6	80.9	19.1	3,065	1,040	33.9	61.2	38.8
1999	2,785	1,297	46.6	78.4	21.6	3,199	1,102	34.4	60.1	39.9
2000	2,927	1,380	47.1	77.9	22.1	3,209	1,109	34.6	61.3	38.7
65 to 69 years:										
1994	4,225	1,056	25.0	57.9	42.1	5,365	891	16.6	37.4	62.6
1995	4,395	1,169	26.6	54.7	45.3	5,263	919	17.5	36.3	63.7
1996	4,522	1,237	27.4	56.7	43.3	5,224	865	16.6	40.4	59.6
1997	4,321	1,150	26.6	56.8	43.2	5,180	936	18.1	42.1	57.9
1998	4,286	1,085	25.3	57.0	43.0	5,075	941	18.5	44.5	55.5
1999	4,298	1,136	26.4	55.7	44.3	5,022	941	18.7	40.9	59.1
2000	4,376	1,330	30.4	60.5	39.5	4,976	983	19.8	44.2	55.8
70 years and older: .										
1994	8,493	953	11.2	49.7	50.3	12,678	682	5.4	32.9	67.1
1995	8,607	970	11.3	44.9	55.1	13,001	650	5.0	30.4	69.6
1996	8,738	989	11.3	44.2	55.8	13,174	681	5.2	30.3	69.7
1997	9,083	1,063	11.7	45.7	54.3	13,294	639	4.8	32.8	67.2
1998	9,238	970	10.5	48.0	52.0	13,484	740	5.5	31.9	68.1
1999	9,429	1,030	10.9	44.8	55.2	13,646	807	5.9	35.0	65.0
2000	9,510	1,169	12.3	48.5	51.5	13,759	816	5.9	36.4	63.6

SOURCE: Author analysis of the annual income supplement to the Current Population Survey.

Table 4. Population aged 55 years and older by age, sex, and pension receipt status, 1994–2000

[Numbers in thousands]

Age and year of survey	Men			Women		
	Population	Pension recipients	Percent	Population	Pension recipients	Percent
55 to 64 years:						
1994	9,916	2,351	23.7	10,805	1,336	12.4
1995	9,872	2,303	23.3	10,878	1,316	12.1
1996	10,090	2,279	22.6	10,991	1,164	10.6
1997	10,256	2,177	21.2	11,210	1,287	11.5
1998	10,667	2,152	20.2	11,580	1,253	10.8
1999	10,959	2,195	20.0	11,943	1,403	11.7
2000	11,131	2,174	19.5	12,250	1,439	11.7
65 years and older:						
1994	12,717	6,299	49.5	18,043	5,259	29.1
1995	13,001	6,108	47.0	18,264	5,252	28.8
1996	13,260	6,206	46.8	18,398	5,025	27.3
1997	13,404	6,316	47.1	18,474	4,933	26.7
1998	13,524	6,317	46.7	18,559	5,114	27.6
1999	13,727	6,457	47.0	18,668	5,186	27.8
2000	13,886	6,358	45.8	18,735	5,513	29.4

NOTE: Retirement plans may include a traditional pension, a retirement savings plan, or both.

SOURCE: Author analysis of the annual income supplement to the Current Population Survey.

cent to 50 percent. At the same time, the proportion of employees in these firms who were covered by defined-contribution plans rose from 49 percent to 57 percent.[8]

Pensions among older workers

An important consideration for an individual deciding whether to retire from the workforce is whether the sources of income available in retirement will be adequate to maintain his or her desired standard of living. Table 4 shows the proportion of men and women aged 55 and older who reported in the CPS that they received pension income of some kind during the calendar year prior to the survey. In this table, "pension income" includes employer-sponsored pensions (including military retirement), veterans' pensions, and periodic payments from annuities, insurance policies, individual retirement accounts, 401(k) accounts, and Keogh plans for the self-employed.

Not surprisingly, the proportion of men and women who receive income from a pension or other retirement plan increases with age. In 1999, only 20 percent of men aged 55 to 64 received any income from a pension or other retirement plan; among those 65 years and older, however, 46 percent had income from private pensions or retirement savings plans. The patterns among women are similar: only 12 percent of 55- to 64-year-old women received income from private pensions or retirement savings plans in 1999, while 29 percent of those aged 65 years and older received such income.

The proportion of men aged 55 to 64 years who were receiving pension income declined from 24 percent in 1993 to 20 percent in 1999. Over the same period, the proportion receiving pension income fell from 50 percent to 46 percent among men aged 65 and older. The proportion of women aged 55 to 64 years with pension income was more stable, at 11 percent to 12 percent throughout the 1993–99 period. Among women 65 and older, 29 percent received income from private pensions and retirement plans in 1999, the same percentage as in 1993.

Work by Pension Recipients. Among men aged 55 to 64 who received income from a private pension or retirement savings plan during 1999, about 37 percent were employed either full or part time in March 2000—an increase of more than four percentage points over the comparable rate in 1994, when it was 32.5 percent. (See table 5.) Relatively few men aged 65 or older who receive income from private pensions and retirement savings plans also engage in paid employment: only 10 to 12 percent were employed, on average, over the 1994–2000 period. Women who receive pension income are even less likely than men to be employed. Among 55- to 64-year–old women who received income from a private pension or retirement savings plan in 1999, just 31 percent were employed in March 2000. Among women aged 65 years and older, only 6 to 8 percent, on average, were employed during the 1994–2000 period.

Social Security retirement benefits

Currently, the age of *full retirement* under Social Security is 65 years. Retired-worker benefits are first available at age 62, but benefits that begin before the full retirement age are subject to a permanent actuarial reduction equal to approximately 0.6 percent for each month below age 65. A worker retiring at age 62 would receive benefits equal to 80 percent of the amount he or she would have received at age 65. As a result of the Social Security Amendments of 1983 (P.L. 98–21), the full retirement age is being increased to 67 incrementally over a 22-year period. Reduced benefits will continue to be available at age 62, but when the full retirement age reaches 67, the benefit payable at 62 will be 70 percent of the amount that would have been paid if not for the reduction for early retirement.

Most people choose to begin receiving Social Security retirement benefits before age 65. The data presented in Table 6 show that approximately 75 percent of men and 80 percent of women who began receiving benefits between 1989 and 1998 applied for benefits before age 65. Among women, this percentage has remained steady over the past decade,[9] while among men, there was a slight increase in the proportion of applicants younger than 65 years.

The data presented in table 3 indicate that the proportion of 55- to 64-year-olds engaged in paid employment rose steadily through the mid- to late-1990s. The data also show, however, that a much smaller proportion of 62- to 64-year-olds were employed than among those aged 55 to 61. One reason for the sharp decline is that age 62 is the earliest age of eligibility for Social Security retirement benefits.[10] The availability of (actuarially reduced) benefits at age 62 allows many people who otherwise would have continued working to retire from the labor force.

The Social Security system also can affect the decision of when to retire from the labor force through the *delayed retirement credit* and the *earnings test*. The delayed retirement credit provides a permanent increase in benefits for workers who delay receipt of Social Security benefits until after age 65—thus creating an incentive for older workers to remain in the labor force in order to receive full benefits. The earnings test reduces the Social Security benefits of recipients under the normal retirement age whose earnings exceed specific thresholds.[11] For example, a Social Security recipient under age 65 in 2000 can earn up to $10,080 without having his or her benefit reduced, but benefits are cut by $1.00 for each $2.00 earned in excess of that amount. This creates a financial incentive for these individuals to keep their earnings below the threshold. Congress has at times altered both the delayed retirement credit and the earnings test to encourage workers to stay in the labor force.

Retired worker beneficiaries as a percentage of each age category. If more workers chose to delay receipt of Social Security benefits until age 65, this delay would eventually show up as a declining percentage of 62- to 64-year-olds who are receiving such benefits. The data presented in table 7 show that there was a decline of about two percentage points between 1995 and 1998 in the proportion of men aged 62 to 64 who were receiving benefits. This coincided with the rising employment–population ratio among men in this age group. The lower rate among 62- to 64-year-old men during this period may have been caused by robust economic growth, or it may reflect a trend toward later retirement, independent of

Table 5. Employment among retirement income recipients aged 55 years and older by age and sex, 1994–2000

[Numbers in thousands]

Age and year of survey	Men			Women		
	Pension recipients	Number employed	Percent employed	Pension recipients	Number employed	Percent employed
55 to 64 years:						
1994	2,351	763	32.5	1,336	369	27.6
1995	2,303	864	37.5	1,316	410	31.2
1996	2,279	831	36.5	1,164	324	27.8
1997	2,177	832	38.2	1,287	416	32.3
1998	2,152	778	36.2	1,253	363	29.0
1999	2,195	870	39.6	1,403	370	26.4
2000	2,174	799	36.8	1,439	442	30.7
65 years and older:						
1994	6,299	637	10.1	5,259	345	6.6
1995	6,108	727	11.9	5,252	326	6.2
1996	6,206	726	11.7	5,025	281	5.6
1997	6,316	724	11.5	4,933	277	5.6
1998	6,317	648	10.3	5,114	404	7.9
1999	6,457	706	10.9	5,186	426	8.2
2000	6,358	739	11.6	5,513	401	7.3

NOTE: Retirement plans may include a traditional pension, a retirement savings plan, or both.

SOURCE: Author analysis of the annual income supplement to the Current Population Survey.

Table 6. Social Security retired-worker benefits awards by age and sex, 1989–98

Age in year benefits began	Men: Number of awards	Men: Percent of awards	Women: Number of awards	Women: Percent of total awards
62 to 64 years:				
1989	616,200	73.2	490,700	80.6
1990	618,900	73.8	487,800	79.6
1991	639,800	73.3	489,100	79.0
1992	641,800	74.2	510,600	80.1
1993	646,100	75.3	502,800	79.5
1994	607,600	76.1	504,600	81.5
1995	596,500	75.6	486,200	79.5
1996	581,900	76.0	488,100	80.4
1997	586,300	75.4	486,500	66.7
1998	586,800	75.7	497,500	75.9
65 years:				
1989	173,700	20.6	87,500	14.4
1990	160,300	19.1	86,900	14.2
1991	172,200	19.7	95,400	15.4
1992	166,100	19.2	89,900	14.1
1993	159,400	18.6	97,100	15.4
1994	145,500	18.2	82,600	13.3
1995	145,900	18.5	88,900	14.5
1996	135,200	17.7	86,500	14.3
1997	137,300	17.7	86,500	11.9
1998	136,300	17.6	92,500	14.1
66 years and older:				
1989	52,100	6.2	30,700	5.0
1990	58,900	7.0	38,200	6.2
1991	61,300	7.0	34,400	5.6
1992	57,600	6.7	36,600	5.7
1993	52,100	6.1	32,200	5.1
1994	45,600	5.7	31,600	5.1
1995	47,000	6.0	36,300	5.9
1996	48,300	6.3	32,200	5.3
1997	53,800	6.9	156,600	21.5
1998	52,100	6.7	65,800	10.0

NOTE: Special outreach programs by the Social Security Administration resulted in an above-average number of conversions of nondisabled widows to retired worker benefits in 1997 and 1998. Initial awards exclude conversions from disabled worker benefits to retired worker benefits.

SOURCE: *Annual Statistical Supplement to the Social Security Bulletin*, (Social Security Administration, various years).

economic conditions. More time will be needed before firm conclusions can be drawn. Among women aged 62 to 64, the proportion who were receiving Social Security benefits fluctuated between 34 percent and 36 percent from 1989 to 1998, with no clearly discernible trend.

Older workers and phased retirement

In the traditional view of retirement, a worker moves from full-time employment to complete withdrawal from the labor force in a single step. In fact, however, some workers choose to continue working after they have retired from their "career" jobs. The data in table 5, for example, show that 37 percent of men and 31 percent of women aged 55 to 64 who received income from private pension plans in 1999 were employed in March 2000. The process of retiring often occurs gradually over a number of years, with many workers retiring from year-round, full-time employment and moving to part-time or part-year work at another firm, often in a different occupation.

As members of the baby-boom generation begin retiring in the coming decades, millions of skilled and experienced workers will exit the labor force. As this occurs, employers may find it necessary to alter their employment practices and pension plans to induce some of those who would otherwise retire completely to remain on the job, perhaps on a part-time or part-year schedule. This process is sometimes referred to as *phased retirement*. No statutory definition of phased retirement exists, but one analyst has described it as "the situation in which an older individual is actively working for an employer part time or [on] an otherwise reduced schedule as a transition into full retirement. [It] may also include situations in which older employees receive some or all of their retirement benefits while still employed."[12]

Advocates of phased retirement contend that more pension-eligible individuals would choose to continue working if employers could offer them the opportunity to collect pension benefits while remaining on the employer's payroll. Under current law, this option may be offered only to employees who have reached a pension plan's *normal retirement age*. Some employers have suggested that phased retirement would be embraced by more firms if this option could be offered to employees at the plan's *early retirement age*. Employers generally would prefer the freedom to offer these "in-service" pension distributions only to selected categories or classifications of plan participants.[13] In order for either of these actions to occur, however, the Internal Revenue Code and the Employee Retirement Income Security Act (ERISA) would need to be amended.[14]

Current approaches to phased retirement A study conducted by the benefits consulting firm Watson Wyatt Worldwide found that 16 percent of the 586 firms participating in the survey offered some form of phased retirement to their employees.[15] The firms surveyed by Watson Wyatt described a number of strategies that employers can use to retain the services of valued employees who are eligible for retirement, and who might be lost to the firm if the only options available are full-time employment or full-time retirement. Although the firms participating in the survey may not be representative of all employers, their practices with respect to phased retirement offer some insights into the strategies that firms have been able to employ under current law and regulations to promote phased retirement among their employees.[16]

According to the data collected by Watson Wyatt, many firms rehire retired employees on a part-time or temporary basis: 75 percent of the firms having a phased retirement arrangement said that they rehire employees after they retire, usually as part-time or temporary workers. In addition, 42 percent said they contracted with retired employees to be consultants. (Some firms had both kinds of arrangements with retired employees.) Of the firms with phased retirement, 60 percent said that their approach included allowing retirement-eligible employees to work fewer days per week or fewer hours per day. Other policies include allowing employees who are

Table 7. Social Security retired-worker beneficiaries by age and sex, 1989–98

[Numbers in thousands]

Age in year benefits began	Men		Women	
	Number of beneficiaries	Percent of age group	Number of beneficiaries	Percent of age group
62 to 64 years:				
1989	1,330	44.0	1,180	34.8
1990	1,336	43.6	1,167	34.2
1991	1,345	43.7	1,150	33.7
1992	1,351	43.9	1,137	33.7
1993	1,350	44.3	1,126	33.9
1994	1,353	44.8	1,139	34.5
1995	1,320	44.8	1,128	35.0
1996	1,293	44.6	1,126	35.7
1997	1,278	43.0	1,131	35.1
1998	1,286	42.5	1,156	35.3
65 to 69 years:				
1989	3,841	82.5	3,019	54.7
1990	3,898	84.0	3,067	55.8
1991	3,896	83.6	3,062	55.7
1992	3,937	84.3	3,098	56.6
1993	3,946	84.5	3,104	57.2
1994	3,906	83.6	3,065	56.9
1995	3,900	83.8	3,058	57.3
1996	3,871	84.3	3,046	58.0
1997	3,836	84.8	3,053	59.2
1998	3,783	84.2	3,036	59.4
70 years and older:				
1989	7,546	89.3	7,399	54.4
1990	7,751	89.2	7,607	54.7
1991	7,985	89.7	7,836	55.3
1992	8,186	89.9	8,037	55.8
1993	8,354	89.4	8,218	56.1
1994	8,536	89.5	8,404	56.6
1995	8,694	89.7	8,570	57.1
1996	8,848	89.4	8,715	57.4
1997	9,012	89.6	8,972	58.5
1998	9,138	89.5	9,112	59.0

SOURCE: Annual Statistical Supplement to the Social Security Bulletin, various years.

not ready to fully retire to transfer to other jobs within the firm (32 percent had such policies), extended leaves of absence (23 percent), and job sharing (19 percent).

As the variety of these arrangements indicates, several approaches to phased retirement can be accommodated under current law. It is important to note, however, that two of the most popular arrangements—hiring retired former employees on a part-time or temporary basis and hiring retirees as contractors—require the individual to *separate* from the firm before returning under an alternative work arrangement. This introduces considerable uncertainty into the process for both the retiree and the employer, because once the employment relationship is severed, neither party is legally bound to renew it.

Another popular approach to phased retirement is to allow employees to reduce the number of days per week or hours per day that they work for a period of months or years before they cease employment altogether. Unless the employee has reached the pension plan's normal retirement age, however, the plan cannot pay retirement benefits to the individual while he or she remains employed by the firm, even if only on a part-time basis. A plan that pays benefits to an employee that has not yet reached the plan's normal retirement age could lose its tax-qualified status.[17] In order to qualify for the favorable tax status granted to tax-qualified pension plans, the plan must pay benefits *only* on condition of death, disability, termination of employment, plan termination, or at the normal retirement age.[18]

An employee who has reached the pension plan's normal retirement age can begin to receive distributions from the plan, even if he or she continues to be employed by the firm.[19] Likewise, an employee who has reached the plan's early retirement age can begin to receive distributions from the plan upon separation from the firm, provided that he or she has met the required number of years of service stipulated by the plan. If a participant has separated from the employer and has begun to receive distributions from the plan at the early retirement age, he or she can continue to receive these distributions, even if at some future date the participant becomes re-employed by the plan sponsor.

Policy issues. Some employers see the statutory prohibition on making in-service pension distributions to employees who have not yet reached normal retirement age as an obstacle to establishing phased retirement plans because some older workers would find it financially impractical to cut back to a part-time or part-year work schedule if they were unable to supplement their earnings with pension income. One way for a firm to offer phased retirement to these workers under current law, without jeopardizing the tax-qualified status of its pension plan, would be to lower the normal retirement age. For example, if the normal retirement age under the plan is 62 years and the early retirement age is 55 years, the firm could reduce the normal retirement age to some age between 55 and 61. From the employer's point of view, there would be at least two potential drawbacks to such an approach: It could result in an unintended exodus of workers into retirement—because all eligible plan participants would be able to receive full pension benefits at an earlier age than previously—and it could result in a dramatic increase in the cost of funding the plan—because full benefits would be payable at a younger age.

Rather than reduce the normal retirement age in their pension plans, some employers would prefer that Congress amend the Internal Revenue Code to allow in-service pension distributions to employees who have reached the plan's early retirement age (or some age between the early and normal retirement ages).[20] Some observers believe, however, that such a policy would be contrary to the main purpose of pension plans, which is to replace wage income during retirement. These critics say that if employers were permitted to pay pension benefits to individuals still engaged in gainful employment, the benefits would become a tax-subsidized *supplement* to wages, paid to individuals who are still able to work; they argue that the benefits were intended to be a *substitute* for wages, paid to retired workers. Permitting in-service distributions to current employees who have not reached the plan's normal retirement age might allow employers to compensate current employees with pension funds, effectively reducing their operating expenses by shifting some of the cost of wages to the pension fund.

In 1999, about 2.4 million workers in the United States were receiving pension payments from a former employer—more than a million were under the age of 65. (See table 5.) Current law allows for an individual who has separated from a firm and is receiving pension distributions under an early retirement provision of the plan to become *re-employed* by that firm, while continuing to receive those benefits. Some employers have argued that it should be permissible to allow eligible employees to receive partial distributions under an early retirement provision without first having to separate from the employer and then be rehired. Such an option would require an amendment to the tax code. However, plan sponsors currently have the option of setting the normal retirement age at any age not greater than 65, and the early retirement age at any age under the normal retirement age, provided that the plan complies with the statutory requirements with respect to benefit accrual, vesting of benefits, nondiscrimination on the basis of age, and other plan characteristics.

An amendment to the tax code permitting in-service distributions at the early retirement age would alter incentives to work or retire, as well as how much to work and for whom to work. Consequently, it would affect both labor force participation and hours worked among affected employees. The *net* effect of these changes in labor force participation and hours worked would be almost impossible to predict. Some workers who would otherwise have fully retired before the plan's normal retirement age would choose instead to continue working for their current employer on a reduced schedule, because they would be able to take partial pension distributions while still employed. This would tend to increase labor force participation. Other workers who would have taken early retirement and then sought other employment might choose instead to remain with their current employer on a reduced schedule. The effect of this change in behavior on hours worked might be close to neutral, depending on the wages available from alternative employment and the income received from pension distributions. Finally, some employees who otherwise would have chosen to continue working until reaching the plan's normal retirement age might instead reduce their work schedule and supplement their earnings with partial distributions from the retirement plan. This would tend to reduce total hours worked.

Distributions from 401(k) plans. Coverage under defined contribution plans, such as those authorized under section 401(k) of the Internal Revenue Code, grew rapidly during the 1990s. Between 1991 and 1997, the proportion of workers in medium and large private-sector establishments (those with 100 or more employees) who participated in defined contribution retirement plans increased from 49 percent to 57 percent.[21] The trend among small establishments (those with fewer than 100 employees) was similar. In 1996, 38 percent of employees in small private establishments participated in defined contribution retirement plans, compared with 28 percent in 1990.[22]

In-service distributions from defined contribution plans that occur before the participant reaches age 59½ are subject to a 10 percent excise tax in addition to ordinary income taxes. Distributions may begin as early as age 55, however, if the employee separates from his employer under an early retirement plan. Distributions in the form of a lifelong annuity are permissible at any age. Some advocates of phased retirement arrangements have suggested that the minimum age for in-service distributions from defined contribution plans should be lowered to age 55.[23] The effect on labor force participation of such a change in tax policy would likely be very similar to the effect of allowing in-service distributions from a defined benefit plan at the plan's early retirement age. Some workers who might have fully retired from the labor force earlier than age 59½, so that they could begin taking distributions from the plan, would be induced to work longer. Others who would have taken early retirement and then sought work elsewhere would remain with their current employers, because they would be able to combine wages from part-time work with distributions from the retirement plan. Finally, some employees who otherwise would have chosen to continue working until age 59½ or later would reduce their work schedules and supplement their earnings with distributions from the retirement plan.

Flexibility versus nondiscrimination. Pension plans that provide benefits mainly to the owners of a firm or to highly paid employees do not qualify for favorable tax treatment under the Internal Revenue Code.[24] The tax code defines specific tests that must be applied to a pension plan to determine whether or not it meets these requirements for *nondiscrimination* in favor of highly compensated employees.[25] These tests consist mainly of mathematical computations of the percentage of plan participants who are highly compensated employees and the percentage of contributions to the plan or benefits paid by the plan that are made on behalf of highly compensated employees.

It is a relatively common practice for firms to establish separate *nonqualified* retirement plans for the company owners or senior executives. However, if a plan that was originally established as a tax-qualified plan is subsequently found to discriminate in terms of coverage or benefits in favor of highly compensated employees, it could lose its tax-qualified status. In most of these cases, the only viable options available to the plan sponsor would be to remove the discriminatory provisions of the plan or terminate the plan. Covering rank-and-file employees under a nonqualified plan usually would not be practical because of the substantial tax liability that would result for both the plan sponsor and plan participants.

In general, employers would prefer the flexibility to offer phased retirement to some—but not all—pension plan participants. Some analysts have suggested that, even if Congress were to amend the Internal Revenue Code to allow in-service distributions from pension plans before the normal retirement age, it would do little to spur the growth of phased retirement unless employers also were permitted to limit eligibility for this benefit to employees with particular skills or abilities. However, a phased retirement option that offered in-service distributions only to managerial or professional employees could result in the plan failing to meet the nondiscrimination requirements of the Internal Revenue Code by altering the distribution of benefits among plan participants in a way that favored the highly compensated group.[26] In contrast, a phased retirement option that offered in-service distributions to *all* participants meeting specified age and length-of-service requirements would not conflict with the IRC antidiscrimination requirements.

Section 410(b) of the Internal Revenue Code prescribes specific tests for determining if a pension plan's coverage or benefits discriminate in favor of highly compensated employees. These tests are mathematical calculations that reveal the proportion of plan participants who are highly compensated employees and the proportion of contributions or benefits that are made on behalf of highly compensated employees. Some plan sponsors who would like to implement phased retirement programs would prefer to have these tests for nondiscrimination replaced by the more subjective method of testing that was in effect until 1994, which was based on the "facts and circumstances" surrounding the operation of the plan. In some cases, a phased retirement option that fails the mathematical tests for nondiscrimination that are required under current law might not fail if it could be tested under the earlier (pre-1994) approach.

Legislation in the 106th Congress. Only July 19, 2000, the U.S. House of Representatives passed the Comprehensive Retirement Security and Pension Reform Act. Among many other pension reforms, this act would authorize the Secretary of the Treasury to, in some cases, employ a test based on facts and circumstances.[27] Earlier in July, the Phased Retirement Liberalization Act (H.R. 4837; S. 2853) was introduced, which would amend the Internal Revenue Code to permit in-service (preretirement) distributions from a defined benefit or defined contribution plan when the participant has either reached the plan's normal retirement age, reached age 59½, or has completed 30 years of service, whichever comes first. Currently, such distributions cannot be made from a defined benefit plan before the participant has reached the plan's normal retirement age or from a defined contribution plan before age 59½.

Policy responses to an aging population

In a free market economy, individual employers decide how much compensation to offer and whether that compensation will include benefits like pensions and health insurance. Employees decide whether they will work, where they will work, and how much they will work at least in part on the basis of the compensation offered by prospective employers. The terms of these labor market transactions can be influenced through direct regulation—such as ERISA, the Age Discrimination in Employment Act, and minimum wage legislation—through social insurance programs—such as Social Security and Medicare—and through the financial incentives created for both employers and employees by the Internal Revenue Code.

Social insurance programs and the tax code differ from direct regulation in that their primary objectives are, respectively, to provide benefits to individuals and to collect revenue for government operations. Nevertheless, both Social Security and the tax code affect the labor market behavior of employers and workers by establishing financial rewards or sanctions for certain actions. Given that the aging of the population and the impending retirement of the baby-boom generation are likely to affect the supply of labor and the productive capacity of the economy, both the Social Security Act and the tax code may be amended to provide incentives for people to work longer.

The rules that govern eligibility for Social Security benefits can have a substantial influence on workers' decisions about when to retire. Empirical evidence indicates that more retirements occur at age 62—the earliest age at which reduced retired worker benefits are available—and at age 65—the earliest age at which full retired worker benefits are available—than at other ages. The "earnings test," which reduces benefits for some Social Security beneficiaries who work, and the "delayed retirement credit," which increases benefits for workers who defer their benefits until after age 65, also may influence one's decision to work (and how much to work) after becoming eligible for Social Security. At times each of these provisions has been amended to provide greater incentives for individuals who are eligible for Social Security to continue working.

The Social Security Amendments of 1983 mandated a gradual increase in the age at which individuals are eligible for full retirement benefits from its current level of 65 years to 67 years in 2022. As a result, the actuarial reduction in Social Security benefits for those who retire at 62 will increase from 20 percent to 30 percent, creating a financial incentive to delay receipt of Social Security and continue working. The 1983 amendments also provided for an increase in the delayed retirement credit (DRC) for workers who defer their application for Social Security benefits until after age 65. In 1977, Congress set the DRC at 3 percent, meaning that benefits were permanently increased by 3 percent for each year that a worker delayed receipt of Social Security beyond age 65. The 1983 amendments provided for a gradual increase in the DRC beginning in 1990. When fully phased-in, the DRC will be 8 percent per year for people who turn age 65 in 2008 or later, which will result in a DRC that is close to being "actuarially fair" for the average worker.

The Social Security Act was recently amended to repeal the earnings test for beneficiaries who are 65 or older. As a result of Public Law 106–182 (April 7, 2000), the earnings test has been eliminated for people at the full retirement age (currently 65 years) or older, effective January 1, 2000. The earnings test remains in effect, however, for beneficiaries who are under the full retirement age. In 2000, Social Security recipients under age 65 will have their benefits reduced by $1 for each $2 of earnings in excess of $10,080.

Some employers are calling on Congress to amend the tax code to allow employers greater flexibility in designing phased retirement programs for their employees. One proposed amendment would permit pension in-service distributions to employees who have not reached the pension plan's normal retirement age. This, employers say, would allow them to offer older employees the chance to cut back their work schedules to part time, while supplementing their reduced salaries with pension income. Under current law, such an arrangement would be permissible only for plan participants who have reached the plan's normal retirement age.

The Phased Retirement Liberalization Act would allow in-service pension distributions to begin when a participant has reached the earliest of the plan's normal retirement age (59½ years), or the completion of 30 years of service. This might promote continued employment among older workers who—if given the choice between working full time and taking early retirement—would otherwise have chosen to retire. A more complicated issue, not addressed by this legislation but likely to arise in the future, is whether an employer may offer such an option only to specific categories of workers. □

Notes

[1] *Current Population Reports*, series P–25, no. 1130, reproduced in *Statistical Abstract of the United States: 1999* (Bureau of the Census, 1999), table 17, p. 17.

[2] For more on this trend, see Joseph F. Quinn, *Retirement Patterns and Bridge Jobs in the 1990s*, Issue Brief 206 (Washington, DC, Employee Benefit Research Institute, February 1999).

[3] Labor force participation rates are annual averages from the monthly CPS data. The CPS, a scientifically designed survey of about 50,000 households, is conducted monthly by the Bureau of the Census on behalf of BLS. Using data derived from the CPS, BLS publishes numerous labor force statistics by a variety of economic, social, and demographic characteristics. For more information on the CPS, see *BLS Handbook of Methods*, Bulletin 2490 (Bureau of Labor Statistics, April 1997), ch. 1, pp. 4–14.

[4] Approximately one-quarter of the employees of State and local governments—about 5 million people—work for governments that have elected not to participate in Social Security. This is the only remaining large group of workers not covered by Social Security.

[5] See *Employee Benefits in Medium and Large Private Establishments, 1997,* Bulletin 2517 (Bureau of Labor Statistics, September 1999), tables 136–37, pp. 108–09.

[6] Although the labor force participation rates discussed in the previous section were based on annual averages of monthly data, the employment data analyzed in this section are from the March supplement to the CPS. They show employment in the week prior to the March CPS interview. The March CPS files were used for this analysis because they include detailed data about sources of income in the previous year. We used information about *current* labor force status rather than information about labor force status in the previous year, because an individual who reported that he or she both worked and received pension income during the previous year might have worked and received pension income *consecutively* rather than *concurrently*.

[7] *Economic Report of the President* (Council of Economic Advisers, February 2000), table B–40, p. 354; and table B–2, p. 308.

[8] See *Employee Benefits in Medium and Large Private Establishments, 1993,* Bulletin 2456 (Bureau of Labor Statistics, November 1994) table 1, p. 8; and *Employee Benefits in Medium and Large Private Establishments, 1997,* Bulletin 2517, table 1, p. 5.

[9] The percentage of awards to women aged 65 and older increased temporarily in 1997 and 1998 as a result of an outreach effort by the Social Security Administration to convert nondisabled widow beneficiaries to a higher status, so they could receive benefits as retired workers.

[10] The *normal retirement age* also is 62 in about a quarter of private pension plans.

[11] On April 7, 2000, the President signed H.R. 5, the Senior Citizens' Freedom to Work Act (P.L. 106–182), which eliminated the earnings test for people at the *full retirement age* (currently age 65) or older, effective January 1, 2000. The earnings test remains in effect for Social Security recipients under the full retirement age.

[12] Testimony of Wilma K. Schopp on behalf of the Association of Private Pension and Welfare Plans before the U.S. Senate Special Committee on Aging, April 3, 2000.

[13] This discussion refers to in-service distributions under *defined benefit* pension plans. In-service distributions under *defined contribution* plans are discussed later in the article.

[14] See, for example, *New Opportunities for Older Workers,* (Washington, DC, Committee for Economic Development, 1999).

[15] Laurene A. Graig and Valerie Paganelli, "Phased Retirement: Reshaping the End of Work," *Compensation and Benefits Management*, vol. 16 no. 2 (spring 2000).

[16] The 586 firms that participated in the survey represent only about 6 percent of the 9,500 employers to whom the survey materials were sent. Thus, caution should be used when interpreting the results of this survey.

[17] In a "tax-qualified" plan, employer contributions to the plan are deductible business expenses for the firm and neither the employer contributions nor investment earnings on those contributions are counted as income to the employee in the years that they occur; instead, pensions are taxed as income when the benefits are paid to plan participants in retirement. Usually, retirees are taxed at a lower marginal tax rate than when they worked.

[18] *Code of Federal Regulations*, § 1.401-1(b)(1)(i).

[19] If a plan participant continues to work for an employer beyond the plan's normal retirement age, the plan must meet the statutory requirements for continued benefit accruals; see 26 U.S.C. § 411(b)(1)(H).

[20] Requirements for qualification of pension plans are defined at 26 U.S.C. § 401(a).

[21] *Employee Benefits in Medium and Large Private Establishments*, Bulletin 2422 (Bureau of Labor Statistics, May 1993) and *Employee Benefits in Medium and Large Private Establishments*, Bulletin 2517 (Bureau of Labor Statistics, September 1999).

[22] *Employee Benefits in Small Private Establishments*, Bulletin 2388 (Bureau of Labor Statistics, September 1991) table 1, page 5; and *Employee Benefits in Small Private Establishments*, Bulletin 2507 (Bureau of Labor Statistics, April 1999), table 1, page 5.

[23] It might also seem reasonable that if legislation were passed to allow in-service distributions from an employer's defined benefit plan at the plan's early retirement age, then distributions from the employer's defined contribution plan should be permitted at the same age (perhaps with a lower limit of 55). However, such a policy would suffer from at least two drawbacks. First, the minimum age for in-service distributions from defined contribution plans, which is now the same for all such plans, would differ from firm to firm, thus making the retirement planning process even more confusing for workers and their families. Second, it would be administratively difficult—and in some cases, perhaps, impossible—to tie the minimum age for in-service distributions in the defined contribution plan to the early retirement age specified in the employer's defined benefit plan.

[24] 26 U.S.C. § 401(a)(4) states that a qualified pension trust is one in which "the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of section 414(q))." The term "highly-compensated employee" is defined at 26 U.S.C. § 414(q) as a person who is at least a 5-percent owner of the firm or is paid compensation of at least $85,000 and is among the top 20 percent of employees in the firm with respect to compensation.

[25] 26 U.S.C. § 410(b).

[26] Employers whose approach to phased retirement does not affect eligibility for pension distributions are less likely to violate the IRC nondiscrimination provisions. Examples would be phased retirement plans that involve *only* reductions in hours of work, job sharing, transfers to other duties, or that are based on rehiring retired former employees. These are *conditions of employment* rather than *characteristics of the pension plan*.

[27] H.R. 1102 was ordered reported with amendments by the Senate Finance Committee on September 7, 2000.