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Changes in spending and labor supply in response to a Social Security benefit cut: Evidence from stated choice data

Adeline Delavande^{a,b}, Susann Rohwedder^{c,d,*}^aUniversity of Essex, United Kingdom^bNova School of Business and Economics, Portugal^cRAND, United States^dNETSPAR, Netherlands

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ABSTRACT

We investigate how individuals in the U.S. expect to adjust their labor force participation and savings if Social Security benefits were cut by 30 percent. Respondents were asked directly what they would do under this scenario. Using the resulting stated choice data we find that respondents would on average reduce spending by 18.2 percent before retirement and 20.4 percent after retirement. About 34.1% of respondents state they would definitely work longer and they would postpone claiming Social Security by 1.1 years. We investigate how working longer and claiming Social Security later would compensate partially for the loss in benefits among the individuals who are currently working, under the assumption that individuals retire and claim at the same time. Individuals would increase their Social Security benefits from the post-reform level due to additional earnings entering the benefit calculation and a smaller early claiming penalty (or higher delayed claiming credit). As a result, the Social Security benefit people would receive would drop on average by 21 rather than 30 percent. Still, the net financial loss, even after accounting for additional earnings, is sizeable for individuals in the lowest wealth tertile.

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Introduction

The U.S. Social Security trust fund (OASI) is predicted to be depleted by 2035 (Board of Trustees, 2016). Although there are several viable reform proposals to restore the Social Security system's long-term solvency, one important element that is critical to the success of any reform remains unknown: How will individuals respond, for example, to a cut in their Social Security benefits? Will individuals work longer or save more or both, and how much will their response make up for the cut in benefits? How would whatever individuals do to adjust be split across spending less and working longer?

It is important to understand how workers might respond to a benefit cut for at least two reasons. First, to evaluate the impact of such a benefit cut on the well-being of individuals (i.e., whether responses in behavior will be adequate to buffer the shortfalls in benefits and whether this would be the case across all groups of workers). Second, the response in individuals' behavior determines the size of benefit cuts required for ensuring the solvency of the

Social Security program in the long-run. If all workers decided to work longer to make up for the shortfall in benefits, then Social Security revenues would increase more than if workers decided to make up for the shortfalls by reducing spending but otherwise sticking with their retirement (and likely their Social Security claiming) plans in the absence of reform. For some workers, additional Social Security contributions would only result in a minor increase in their annual Social Security benefits, whereas for others the increase in benefits would be larger, depending on the worker's earnings history.

Despite the relevance from a policy perspective of understanding individuals' behavior in such circumstances, relatively little is known about how people would adjust their behavior in case of a reform that would decrease their Social Security benefits. Workers have two main ways to respond: they can work longer and/or save more. In the absence of additional constraints, economic theory predicts that individuals should adjust both their saving behavior and the length of their working life (OECD, 2006; Martin and Whitehouse, 2008; Gruber and Wise, 2009; Sass et al., 2010; French and Jones, 2012). However, it has been difficult to show empirically how important each one of these dimensions is and how these two behaviors interact. Most studies focus on only

* Corresponding author.

E-mail address: susannr@rand.org (S. Rohwedder).

one dimension of adjustment, either on the response to savings or on the response to labor force participation, but rarely on both.

Broadly speaking, there are three types of empirical studies on this topic: *within*-country studies, *cross*-country studies, and those adopting a structural approach. An important challenge for *within*-country studies is that there tends to be limited exogenous variation in Social Security rules that could be exploited. Examples of such studies, all focusing on labor supply, include Krueger and Pischke (1992) who investigate the effect of the 1977 amendment to the Social Security Act that sharply reduced benefits for some cohorts, Friedberg (2000) and Gruber and Orszag (2003) who use changes in Social Security rules to investigate the effect of the Social Security earnings test, or Mastrobuoni (2009) who investigates the impact of the increase in the normal retirement age. While those evaluate the impact of enacted reforms, for obvious reasons, policymakers are interested in empirical studies that would inform the design of a reform *before* enacting it. They therefore have to contend with evidence from other countries that have implemented reforms. Examples of studies that present evidence of this sort are Attanasio and Rohwedder (2003) for the United Kingdom, Attanasio and Brugiavini for Italy (2003), and Aguila (2011) for Mexico. Yet, differences in pre-reform institutional settings and preferences may limit what US policy makers can learn from what has happened in other countries.

Cross-country studies rely on variation in institutions, in particular retirement ages, and in pension formulas as exogenous variation to identify the effects of interest. Gruber and Wise (1999, 2004) adopt this approach to study the impact on labor force participation while Samwick (2000) studies how the characteristics of social security systems influence savings. Hurd et al. (2012) use institutional variation in public pension schemes across countries to study variation in wealth accumulation.

Beyond within-country and cross-country studies, another way to assess individuals' responses to Social Security reform is to estimate a structural model on data of observed choices and conduct policy simulations. Examples of such policies include the change in the normal or early retirement age, benefits reduction, increase in payroll tax or health insurance provision (e.g., Blau and Gilleskie, 2006; Gustman and Steinmeier, 2007; van der Klaauw and Wolpin, 2008; Laitner John and Dan Silverman, 2012). While very powerful to simulate the behavioral impact of policies, the challenges of such structural models include computational complexities, taking into account institutional rules, typically unobserved (while complex) choice sets, and unobserved sources of uncertainty faced by decision-makers (e.g., Aguirregabiria and Mira, 2010). While the latter type of studies only take into consideration partial equilibrium effects, there are also a few studies looking at the impact of Social Security reforms within a general equilibrium framework (e.g., İmrohoroglu and Kitao, 2009, 2012).

In this paper, we complement existing studies by adopting a different approach. We ask respondents directly what they will do in the case of a cut of 30 percent of their Social Security benefits: whether they would work longer, claim Social Security later, reduce spending before retirement, and/or reduce spending after retirement. (Answer categories were "definitely yes," "maybe," and "definitely not.") For each of these options, we follow up with questions to assess the size of the response. The advantage of this approach is that it allows us to investigate, without assumptions on individuals' decision-making process or their knowledge of the Social Security system, the behavioral response to a reform currently considered *before* its enactment. Responses are those reported by individuals who could be affected by this reform. Using respondents' stated choice, rather than actual choice, is becoming common in many fields (Louviere et al., 2000). Comparisons of revealed and stated preference data show that both data sets pro-

duced comparable utility parameters (e.g., Adamowicz et al., 1994, Ben-Akiva and Morikawa, 1990, Hensher and Bradley, 1993). Stated intention also relates strongly to subsequent actual choice (e.g., Haider et al., 2007; Delavande and Manski, 2010). However, stated preferences data are not without caveats and may be susceptible to biases. In particular, the context and format of the hypothetical setting have been found to affect the response, and choice model estimation results may therefore be sensitive to the elicitation format (Ben-Akiva et al., 1994).

The credibility of our results relies on individuals being able to predict how they would react to the hypothetical scenario. Whether stated preferences or stated choice questions will be successful in eliciting responses that are as close as possible to individuals' actual behavior depends critically on how salient the event is for respondents and on whether they have already considered the scenario as a real possibility (McFadden, 1998). Several arguments suggest that the scenario we consider was salient and realistic, especially at the time of the survey in 2007. The need for Social Security reform to restore the solvency of the program has been well advertised in the media and by political leaders for a number of years.¹ Time and time again, the message has been repeated that under current law, full benefits will only be payable until sometime in the 2030s; projections vary somewhat from year-to-year. After that, only about 75 percent of benefits will be payable given the current structure of the system. Importantly, workers' Social Security statements that were mailed out every year until 2011 included this same message in bold face, and there is evidence that individuals consult their Social Security statement (Mastrobuoni, 2011). Moreover, in our sample, respondents believe on average that there is a 61 percent chance that Congress will change Social Security sometime in the next 10 years so that it becomes less generous than it is currently.² We focus on a 30 percent cut because this was a plausible number discussed at the time of our survey. For example, in 2006, the Social Security Board of Trustees (2006) suggested either a payroll tax increase or a cut in Social Security benefits by 26 percent in 2040 (the estimated point of trust fund exhaustion at the time), with reductions reaching 30 percent in 2080. Finally, the credibility of our results also relies on whether individuals can forecast their Social Security benefits. There is evidence that the majority of people have relatively accurate expectations about their future Social Security benefits, and that the accuracy improves closer to retirement (Rohwedder and Kleinjans, 2006).

There has been other recent work using similarly stated choice data to look at retirement-related issues. For example, Luttmer and Samwick (2015) investigate the welfare loss faced by households due to political uncertainty associated with their future Social Security benefits. Like us, they ask survey respondents hypothetical questions about how they would change behavior (savings, labor supply, bequests) if their benefits could be guaranteed. Maurer et al. (2017) use a similar approach asking respondents to report their expected claiming age under various benefits payment options (e.g., lump sum). Michaud and van Soest (2008) investigate the impact of the 2000 repeal of the earnings test above the normal retirement age on retirement expectations (i.e., individual-specific subjective probability to work full-time past ages 62 and 65) of male workers. Van Soest, Kapteyn and Zissimopoulos (2007) investigate preferences for full and partial retirement by asking survey respondents to rate several hypothetical retirement trajectories involving early retirement, late retire-

¹ For example, then President Bush launched his initiative "Strengthening Social Security" in 2005.

² This statistic is computed for our analytical sample of respondents who are not receiving Social Security benefits at the time of the interview but report a positive probability of receiving Social Security benefit in the future (no weights applied).

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