



# Signals matter? Large retirement responses to limited financial incentives

Jonathan Cribb<sup>a,b,\*</sup>, Carl Emmerson<sup>a</sup>, Gemma Tetlow<sup>a</sup>

<sup>a</sup> Institute for Fiscal Studies, 7 Ridgmount Street, London WC1E 7AE, UK

<sup>b</sup> University College London, UK

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## ABSTRACT

Do early retirement ages (ERA) provide a signal about the appropriate age to retire? We examine the impact of increasing the ERA for women in a context (the UK) where the financial incentive to retire at the ERA is very limited. Despite limited financial incentives, we find that women's employment rates at the old ERA increased by 6.3 percentage points. Our results suggest that wealth effects, credit constraints and changes to marginal financial incentives to work do not drive this effect but instead that most of the excess retirements observed at the ERA are driven by a signal to retire.

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## 1. Introduction

Governments across the developed world have, over recent decades, legislated for increases in the early and normal claiming ages that apply to public pension schemes. Such policies have often been adopted with the explicit intention of strengthening the public finances in the face of rapidly aging populations – not only by reducing payments to pensioners but also by increasing average retirement ages and thus generating additional tax revenues. In this paper we exploit a recent reform of the early retirement age (ERA) for women in the UK to estimate the effect on their labor force participation. This provides an important addition to the small existing empirical literature on this topic by examining such a reform in the context of a public pension system that provides minimal financial incentives to exit work at the ERA.

In 1995, the UK government legislated to increase the ERA (known in the UK as the state pension age) for women from 60 to 65 between 2010 and 2020.<sup>1</sup> This paper uses evidence on labor market behavior in the UK between 2010 and 2014 to examine what impact increasing the ERA from 60 to 62 has had on the economic activity of the affected cohorts of women.

Gruber and Wise (2004) surveyed evidence on eleven developed countries and highlighted the fact that labor force exits are concentrated around legislated early and normal retirement ages and tend to be larger than can be explained by the pure financial incentives associated with retiring at these ages. Most of the early papers that attempted to

simulate the impact of moving these early and normal retirement ages on labor force participation relied on using out-of-sample predictions. Papers simulating changes in early and normal retirement ages in the US suggested quite large effects on retirement ages (Fields and Mitchell, 1984; Gustman and Steinmeier, 1985; Rust and Phelan, 1997; Coile and Gruber, 2000; French, 2005). For the UK, Blundell and Emmerson (2007) estimate that a three-year increase in the ERA for both men and women (and assuming that defined benefit occupational pension schemes respond with a three-year increase in their normal pension ages as well) would increase retirement ages by between 0.4 and 1.8 years, depending on the specification used.

However, while the effects estimated in these ex ante simulations were quite large, if anything the results of ex post evaluations suggests even larger effects. One of the first papers to examine ex post the impact of a change in ERAs was Börsch-Supan and Schnabel (1999), who looked at evidence from the reduction in the earliest age of pension receipt in Germany from 65 to 63 in 1972. Prior to this reform, the vast majority of men in Germany retired at age 65, whereas after the reform there was a significant shift towards retiring at age 63. More recently, there have been a growing number of reforms around the world, which have increased pension ages. Therefore, ex post evaluations have become more common in the literature, although almost all of these have focused on changes to normal, rather than early, retirement ages (including, among others: Mastrobuoni, 2009; Hanel and Riphahn, 2012; Behagel and Blau, 2012; and Lalive and Staubli, 2014).

\* Corresponding author at: Institute for Fiscal Studies, 7 Ridgmount Street, London WC1E 7AE, UK

E-mail addresses: [jonathan\\_c@ifs.org.uk](mailto:jonathan_c@ifs.org.uk) (J. Cribb), [carl\\_e@ifs.org.uk](mailto:carl_e@ifs.org.uk) (C. Emmerson), [gemma\\_t@ifs.org.uk](mailto:gemma_t@ifs.org.uk) (G. Tetlow).

<sup>1</sup> This is the only focal age in the UK state pension system – that is, there is no separate normal retirement age. In keeping with the rest of the literature, we refer to the state pension age as the *early retirement age*. However, as is explained in more detail below, there is no requirement in the UK for people to retire at the point they claim their pension, and they experience no financial penalty for remaining in paid work.

The two major exceptions are Staubli and Zweimüller (2013) and Atalay and Barrett (2015), who examine the effect of changes in ERAs. The former use administrative data and employ a similar estimation strategy to that used in this paper to examine an increase in the ERA in Austria. They find that a one year increase in the ERA led to an increase in employment rates of 9.75 percentage points for affected men and by 11 percentage points for affected women, with increases in unemployment rates of a similar size. Manoli and Weber (2016) study the same Austrian reforms and find large delays in job exits and pension claiming caused by the increase in the ERA. However, the Austrian state pension system is different from the UK (and a number of other countries' systems) in several important ways. First, in the Austrian system, individuals' pension benefits are completely withdrawn if their earnings exceed around \$500 a month. Second, although the Austrian system provides some increase in pension income for delayed drawing, this is done at a less than actuarially fair rate. Third, the Austrian state pension provides a very high level of earnings replacement (according to Staubli and Zweimüller (2013), the average net replacement rate of pre-retirement earnings is 75%); public pensions, therefore, provide the main source of income for most pensioners in Austria.

Atalay and Barrett (2015) examine the effect of an increase in the earliest age at which women can access the Australian Age Pension. They find, using cross-sectional survey data, that a one year increase in the eligibility age induced a 12–19 percentage point increase in female labor supply. In Australia (unlike in the UK and many other countries) receipt of the state pension is means-tested against income, which provides a strong incentive for many Australians to retire at the point at which they can become eligible for the pension.<sup>2</sup>

Importantly, our paper adds to the evidence provided by Staubli and Zweimüller (2013) and Atalay and Barrett (2015) by providing the first evidence from a change in ERA in the context of a system (the UK system) in which there are not strong financial disincentives to working beyond the ERA, and where private pension saving provides a significant fraction of retirement income for many people. In these respects, the UK pension system is more similar to that in the US than either the Austrian or the Australian system.

Women's economic activity could be affected by an increase in the ERA through four main mechanisms. First, increasing the ERA will have some effect on individuals' marginal financial incentives to work, through changing marginal tax rates and eligibility for out-of-work benefits. This channel will be significantly less important in the UK than it is in some other countries because there is no earnings test for state pension receipt in the UK.

Second, the increase in the ERA reduces the length of time that individuals receive state pension income for and thus reduces their lifetime wealth; this will tend to increase labor supply. However, if those affected were forward looking and well informed, this response might have manifested as soon as the legislation was passed. Since this policy reform was announced 15 years in advance, we might expect adjustments in employment rates around the ERA to be quite small, as individuals have had a considerable period of time over which to adjust their behavior. However, evidence suggests that – even many years after the legislation was passed – many of the women affected were unaware of it. Crawford and Tetlow (2010) – using data collected in 2006–07 – find that, at that time, six-in-ten of those women who face an ERA somewhere between 60 and 65 were unaware of their true ERA. This suggests that some women may face a significant shock as they approach their ERA and thus may have to adjust their behavior sharply

<sup>2</sup> There have also been some studies of “early retirement” programs. Vestad (2013) studies the reduction in the age that individuals can take early retirement in Norway and find that 2/3 of pensioners would have been in work at age 63 had the age for early retirement been 64 rather than 62. However, this “early retirement” program was not open to all workers (it excluded half of private sector workers), it involved very high replacement rates (70% of after-tax earnings) and the pension benefits were earnings-tested, meaning the institutional structure is, once again, very different to that seen in the UK.

over a short period of time. Previous evidence suggests that individuals respond most strongly to what they believe the rules of the system are, even if their beliefs are incorrect (Bottazzi et al., 2006; Coppola and Wilke, 2014).<sup>3</sup>

Third, individuals who are credit constrained may have to continue working during the period when they are no longer able to receive their state pension in order to finance their consumption.

Fourth, the ERA may provide a signal about the ‘appropriate’ age at which to retire. The UK Department for Work and Pensions writes to each person who is entitled to a state pension four months before they become eligible to tell them how to claim. Therefore, even if the person is entirely unaware of their eligibility date before this, this communication may provide a strong signal. If the ERA does provide such signals, moving this age could have a greater impact on employment rates than the pure financial incentives would suggest.

There is mixed evidence from previous work about the importance of such signals around retirement ages. Lumsdaine et al. (1996) found that there are excess peaks in retirement in the United States at age 65 (the Social Security normal retirement age at the time), over and above those explained by the financial incentives generated by Social Security and Medicare, implying that there is an important signal to retire at 65. Kopczuk and Song (2008) find a significant pattern of individuals claiming Social Security in January or on their birthday, either of which might be considered a simple focal point or signal. Behagel and Blau (2012) conclude that non-standard preferences can explain why older Americans responded so strongly to the increase in the normal retirement age in Social Security that occurred in the early 2000s. Conversely, others have found evidence to the contrary – for example, Asch et al. (2005), who examined the retirement behavior of civil service employees in the US, who face different financial incentives to retire from the majority of the population who are covered by Social Security.

We identify the impact of increasing the ERA by comparing cohorts who face different ERAs, while allowing for a flexible specification of cohort, age and time effects. However, the specification we have chosen limits us to identifying only those effects that manifest between the old and new ERAs; other differences in employment rates between treated and control cohorts that occur before or after these points will be subsumed into the cohort effects that are included in our specification.<sup>4</sup>

We find that employment rates of women at ages 60 and 61 increased by 6.3 percentage points when the ERA was increased from 60 to 62; this result is statistically significant at the 1% level. This is equivalent to about a two month increase in the average retirement age and implies that around three-quarters of excess retirements that used to occur at age 60 are explained by that being the ERA. The result is robust to a number of specification tests, including using a linear probability model rather than probit, and variations in the sample chosen to exclude repeat observations on the same individuals, and allowing for serial correlation in employment shocks.

Subgroup analysis provides some evidence on which mechanisms may be important in explaining the changes in behavior that we observe. There is no significant difference in the response among owner-occupiers and renters, which we interpret as suggestive evidence that credit constraints may not be the primary driver. In addition, the cohort fixed effects included in our model control for differences in state pension wealth across cohorts that are a direct result of the increase in

<sup>3</sup> Moreover, there is evidence that individuals change their behavior upon receiving correct information about state pension rules. Liebman and Luttmer (2015) run an experiment providing individuals with information on life expectancy and Social Security rules in the US and find labor force participation is 4 percentage points higher than the control group one year later.

<sup>4</sup> The working paper version of this paper explores employment responses prior to the ERA using a method similar to that employed by Mastrobuoni (2009): that is, essentially specifying a functional form for the cohort effects and attributing any deviations from this pattern between cohorts who were affected by the 1995 legislation and those who were not as being the result of the policy change. We find no significant evidence of women having responded at earlier ages (Cribb et al., 2013).

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