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# Retirement Policies, Employment, and Unemployment

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## Abstract

[Excerpt] There is a growing consensus among economists that reliance on aggregate demand policies alone will not be sufficient to move the economy to full employment with a nonaccelerating inflation rate, and that policies which alter the structure of labor markets will be required. While obvious structural policies such as public sector employment programs and training programs are the focus of current debate, many other public policies affect labor markets in subtle ways which may well adversely affect the level and distribution of employment and unemployment. To help improve the inflation-unemployment tradeoff, policymakers should seek to marginally modify these policies, preserving their benefits while reducing their adverse labor market effects.

To illustrate these points, this paper discusses the influence of public and private retirement policies on the level and distribution of employment and unemployment. I focus on the Social Security system *(OASDHI),* the Employee Retirement Income Security Act *(ERISA),* the amendment to the Age Discrimination in Employment Act that raised the permissible mandatory retirement age to 70, the Supreme Court decision in the Manhart case prohibiting sex differentials in employee pension contributions, and early retirement provisions negotiated in private collective bargaining agreements. Certainly, it would be difficult to criticize the *intent* of these policies. However, each of the *public* policies adversely affects the level or distribution of employment and unemployment. I conclude by noting several reforms of the method of financing the Social Security system which would reduce the system's adverse labor market effects.

## Keywords

retirement policies, employment, unemployment, Social Security, labor market

## Disciplines

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## Comments

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# Retirement Policies, Employment, and Unemployment

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There is a growing consensus among economists that reliance on aggregate demand policies alone will not be sufficient to move the economy to full employment with a nonaccelerating inflation rate, and that policies which alter the structure of labor markets will be required. While obvious structural policies such as public sector employment programs and training programs are the focus of current debate, many other public policies affect labor markets in subtle ways which may well adversely affect the level and distribution of employment and unemployment. To help improve the inflation-unemployment tradeoff, policymakers should seek to marginally modify these policies, preserving their benefits while reducing their adverse labor market effects.

To illustrate these points, this paper discusses the influence of public and private retirement policies on the level and distribution of employment and unemployment. I focus on the Social Security system (*OASDHI*), the Employee Retirement Income Security Act (*ERISA*), the amendment to the Age Discrimination in Employment Act that raised the permissible mandatory retirement age to 70, the Supreme Court decision in the Manhart case prohibiting sex differentials in employee pension contributions, and early retirement provisions negotiated in private collective bargaining agreements. Certainly, it would be difficult to criticize the *intent* of these policies. However, each of the *public* policies adversely affects the level or distribution of employment and unemployment. I conclude by noting several reforms of the method of financing the Social Security system which would reduce the system's adverse labor market effects.

## I. The Social Security System

The Social Security system influences labor markets in a variety of ways. First, the *retirement earnings test* for receipt of benefits and the 50 percent *marginal tax rate* on earnings above the $4,000 *earnings exemption* discourage labor force participation and employment of the aged (see Michael Boskin). These parameters, by reducing the net return to work effort after age 65, also induce a life cycle reallocation of work effort from the retirement years to earlier years (see James Smith). Empirical evidence suggests that the work week of prime age males may have *increased* by over two hours above the level it otherwise would have been because of this effect (see Richard Burkhauser and John Turner).

Second, if employers cannot shift 100 percent of the share of the payroll tax paid by them onto employees in the form of lower wages (or smaller wage increases), then firms' employment decisions will be affected. Although evidence on the extent of shifting is mixed, two recent studies concluded that less than 50 percent of employers' share of the tax is shifted onto labor (see Daniel Hamermesh, 1977a; the author, Robert Hutchens, and Robert Smith), which should induce employers to hire fewer employees than they would in the tax's absence.

Furthermore, the existence of a maximum taxable earnings level causes payroll tax rate increases to increase the cost of low-wage employees relative to the costs of high-wage employees. If relative wages do not fully adjust, increases in the tax rate should lead firms to substitute high-wage for low-wage workers. In contrast, increases in the taxable earnings level reduce the incentives for such substitution (see John Pencavel). Between 1960 and 1978, the *OASDHI* tax rate more than doubled, while the maximum taxable

earnings level rose from $4,800 to $17,700. The latter change has likely dominated the former, causing a reduction in employers' incentives to substitute high-wage for low-wage employees and a shift in the distribution of employment (unemployment) towards (away from) low-skilled individuals.

The share of the payroll tax either nominally paid by employees or implicitly paid by them in the form of lower wages has a differential impact on different classes of individuals. For individuals outside the labor force it has a pure substitution effect, discouraging labor force participation. For employed individuals earning more than the taxable earnings level, it has a pure income effect, stimulating increased work effort. For employed individuals earning less than the taxable wage base, both effects are present, and the net impact is ambiguous.

The large increases in both the tax rate and maximum taxable earnings levels during the past decade may have reduced the work effort of individuals who earned more than the maximum taxable level prior to the increase, but less after. Although the impact of these changes on the unemployment rate is ambiguous, their net effect was probably to reduce the growth rate of employment. This effect may have been partially offset by the accompanying liberalization of promised future benefits. Since eligibility for *OASI* benefits depends upon career work effort, promised higher future benefit levels may stimulate greater work effort on the part of nonaged workers. However, this *entitlement effect* is likely to be greatest for low-wage workers as the benefit-earnings ratio declines as earnings rise. Moreover, since married females have the option of receiving either their own benefits or 50 percent of their husband's benefits (100 percent after he dies), their lifetime work effort entitles them to only small net additional *OASI* benefits and the entitlement effect is likely to be unimportant for them.

Finally, recent evidence suggests that the Social Security system may substantially reduce private savings (see Martin Feldstein, 1974a,b 1976; Alicia Munnell, 1974; and for contrasting evidence, Robert Barro). This net

reduction is *not* offset by an increase in public savings because of the pay-as-you-go nature of the system. As a result, total savings and capital accumulation in the economy are reduced, leading to reduced growth in productivity and output, and ultimately to reduced rates of growth of employment and/or real wages. Recent increases in Social Security taxes and promised future benefits levels have likely exacerbated this effect.

In sum, the parameters of the system interact to produce numerous effects on labor markets. The reduction in labor force participation and employment of the aged is a planned effect and should not be judged a negative feature. In contrast, the *OASDHI* payroll tax on employers *and* employees and the unfunded nature of the retirement trust fund probably serve to reduce both the labor force participation rates and employment levels of the nonaged. The parameters of the system also differentially influence the distribution of employment and unemployment across sex classes and earnings classes of employees. Recent changes in the system's parameters probably have marginally slowed the growth rate of employment and reduced employers' incentives to substitute high- for low-skilled labor.

## II. Employee Retirement Income Security Act of 1974 *(ERISA)*

The *ERISA* was designed to increase the probability that private sector employees receive promised retirement benefits. It includes provisions requiring liberalized vesting rules, more stringent funding requirements, and increased fiduciary responsibility. These provisions increase employers' costs of providing pensions and should lead employers to shift at least part of the increased costs to employees in the form of lower wages, smaller wage increases, or pension plan terminations. Although it is too early to assess *ERISA*'s impact on wages, recent studies show that a tradeoff exists between wages and retirement system characteristics in both the private and public sectors (see the author; Alan Gustman and Martin Segal; Randall Weiss and Bradley Schiller). If employers cannot fully shift

*ERISA*'s costs, unit labor costs will increase, resulting in a reduction in the level (or rate of growth) of private employment. This reduction would be concentrated in those firms with pension plans whose pre-*ERISA* provisions did not meet the *ERISA* standards. Adoption of *ERISA*-type controls over public employees' retirement systems would have a similar negative impact on employment in the public sector.

The *ERISA*-type controls also affect the level of pension plan funding and composition of pension funds' portfolios. By requiring pension plans to be fully funded, they increase the stock of curent pension fund assets which, if not offset by a decline in individuals' saving, will increase the level of capital accumulation and ultimately the level of employment. On the other hand, by restricting the type of investments which pension funds may make, the controls prevent pension fund assets from being invested in projects with the highest expected rate of return (but also highest risk) and hence reduce the rate of productivity growth. Without empirical evidence, one can not ascertain which of these effects dominates.

### III. Mandatory Retirement

The amendment to the Age Discrimination in Employment Act passed by Congress earlier this year, subject to a few exceptions, raises from 65 to 70 the age at which employers may compel their employees to retire. This will influence the level and distribution of employment in a number of ways. Mandatory retirement provisions tend to be found in large establishments which are unionized and in which employees usually have long actual or expected job tenure (see Edward Lazear). The typical life cycle relationship between an individual's earnings and productivity in firms, where an implicit long-term contract exists between the firm and its employees, is one in which earnings first exceed productivity, then productivity exceeds earnings, and finally earnings again exceed productivity. These stages correspond to a period of formal or informal training, a period of peak productivity, and a final period

in which productivity is declining, but informal rules or union contracts prevent wages from being cut. The age at which this latter period starts, if at all, varies widely across individuals and depends upon factors such as the employee's health and the demands of his or her specific job. The establishment of a mandatory retirement age at an age such that, *on average*, the present value of employees' earnings just equals the present value of their productivity allows a firm to maximize its expected presented value of its profits. Such rules also allow increases in the present value of employees' earnings over their life cycles (see Lazear).

If the legislation induces some individuals to postpone their retirement, then on average the present value of wages will exceed the present value of marginal productivities over employees' careers. Employers may respond by negotiating flatter or everywhere lower real wage profiles. The overall *level* of employment would be unchanged, however new hires would be reduced, because the average employee would have a longer work-life. Hence, some jobs would be redistributed from new hires, primarily youths, to the aged. Further if employers face any difficulty in making wage adjustments, then they will tend to reduce their *stock* of employees, causing still *larger* reductions in new hires.

The change may also discourage employers from hiring middle-aged employees. Prior to the legislation, a firm would be willing to hire a middle-aged worker provided that his expected present value of marginal productivities less wages was nonnegative. If expected wages at the old retirement age exceeded expected marginal productivities, the legislative-induced increase in the expected retirement age reduces the firm's incentive to hire middle-aged workers and the maximum age at which it will hire new employees. Indeed, this provides employers an added incentive to prefer young rather than middle-aged new hires, and partially offsets the legislation's negative impact on youth employment (see Barry Chiswick and Carmel Chiswick). However, to the extent that the legislation reduces the number of retirees per year, employers may be forced to increase layoffs to

achieve desired lower employment levels in periods of declining aggregate demand, causing a further redistribution of employment away from those with the least seniority and increasing the measured unemployment rate.

The magnitudes of all of these effects depend upon the number of retirements postponed in response to the legislation; one recent study concluded some 200,000 aged employees would be added to the work force in the first year (see U.S. Department of Labor). However, growth in real incomes, private pensions, and Social Security benefits have reduced males' average age at retirement and as long as the Social Security retirement earnings test rules are maintained, workers aged 65 face a substantial incentive to retire. Thus, although the legislated change may marginally alter the distribution of employment and unemployment across age groups, its overall effect on the level of employment is likely to be small. It may, however, also substantially slow the progress of nonwhites into professional positions (see George Johnson and Juli Malveaux).

## IV. The Manhart Case

On April 25, 1978, the U.S. Supreme Court declared that employers who require females to contribute a greater proportion of their salaries than males to contributory pension plans are committing illegal sex discrimination (see City of Los Angeles vs. Manhart). However, because female life expectancies are longer than males', to maintain the actuarial soundness of a defined benefit pension plan females must either (a) receive lower annual retirement benefits than otherwise identical males, or (b) receive equal annual retirement benefits, with larger annual contributions being made for females. The Supreme Court decision prohibits (b) unless the larger contribution is nominally paid by employers. This increases the relative costs of female employees, providing employers with an incentive to substitute males for females.

One proposal to eliminate this incentive is to use a "unisex" mortality table, calculated by weighting the relevant male and female mortality tables by the proportion of employees of each sex employed by a firm. Equal net contribution rates for *all* employees of a given age necessary to fully fund equal retirement benefits per year for retirees of each sex could then be determined. However, employers should realize that by reducing the proportion of females in their work force, they would reduce their required average net contributions (see Burt Barnow and the author). The likely magnitude of this substitution depends upon the true pension cost differential between males and female employees, and the extent to which males and females are substitutes in production. The former is likely to be quite small in plans which provide survivors benefits for spouses of beneficiaries, while precise estimates of the latter have yet to be obtained (see Hamermesh and James Grant).

## V. Early Retirement

Early retirement provisions contained in many privately negotiated contracts typically allow early retirement at reduced benefit levels. While early retirement provisions are of value to employees, they also have the effect of redistributing employment losses across age groups of employees during periods of low or declining demand which may well *reduce* employers' costs.

Union contracts typically require that layoffs be inversely related to seniority; however utilizing such a policy to reduce employment may not be optimal from an employer's prospective. Due to the experience-rated nature of the unemployment insurance (*UI*) payroll tax, after some point layoffs raise the employer's payroll tax. Moreover, if the firm's most senior workers are in the stage of their life cycles in which wages exceed marginal productivities, the firm would best be served by reducing their employment rather than younger workers. Furthermore, if these senior workers voluntarily leave their jobs, an employer's *UI* tax rate would not increase as voluntary separations are not eligible for *UI* benefits in most states. Early retirement provisions thus allow employers to

redistribute employment losses in periods of low or declining demand from younger to older workers and to reduce their *UI* payroll tax contributions (see James Medoff). Since retirees tend to be out of the labor force, these policies probably do reduce the measured unemployment rate.

### VI. Conclusion

All of the retirement policies discussed in this paper, except for privately negotiated early retirement provisions, were shown to have adverse effects on the level and distribution of employment and unemployment. These examples support the contention that more explicit attention should be given to the employment effects of social programs prior to their adoption *and* that consideration should be given to restructuring existing programs to reduce their adverse labor market effects. While each of the effects is probably quite small, their sum may be sizable.

Three examples of possible changes in the financing of the Social Security system illustrate the types of restructuring one might consider. First, the use of general revenue financing from personal and corporate income tax revenues, for all or some fraction of future system revenue needs, would reduce employer's incentives to substitute capital for labor. Second, increasing system revenues by more than is necessary to fund benefits in the short-run to build up a larger Social Security trust fund, and using this fund to buy outstanding government debt, would increase the social rate of savings and capital accumulation which ultimately would result in increased rates of growth of employment (see Feldstein, 1977). Third, raising the maximum taxable earnings level, rather than the payroll tax rate, to meet future system revenue needs would reduce employers' incentives to substitute high-wage for low-wage workers. To the extent that the overall rate of wage inflation is influenced more by the level of excess demand for labor in high-wage labor markets than that in low-wage labor markets, this change will also reduce the unemployment rate associated with each level of inflation (see Martin

Baily and James Tobin; George Johnson and Arthur Blakemore).

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