The Cost of Retirement Age Uncertainty

By Kerry Pechter *Thu, Sep 15, 2016*

At age 23, Americans would give up as much as $1 out of every $25 of future personal spending to know exactly what year they would retire, a new research paper suggests. Is there a market for retirement age uncertainty insurance?

As if we didn't have enough retirement-related risks to hedge against, a group of economists now point to a new one—uncertainty about one's retirement date—and their findings point out a structural weakness of the Social Security system.

In a new paper, "The Welfare Cost of Retirement Uncertainty," Frank N. Caliendo and Aspen Gorry of Utah State University, Maria Casanova of Cal State-Fullerton, and Sita Slavov of George Mason suggest that many Americans spend less and save more during their lifetimes in the belief that a layoff or illness might force them to retire a few years earlier than they expected.

Despite the advisability of thrift in general, the authors don't believe such behavior is necessarily efficient. In other words, retirement timing uncertainty is a large enough risk to consider insuring, and the authors go so far as to put a rough price on it.

"Our conservative estimates of the standard deviation of the difference between retirement expectations and actual retirement dates range from 4.28 to 6.92 years," the paper said. "This uncertainty implies large fluctuations in total wage income. We find that individuals would give up 2.6%-5.7% of total lifetime consumption to fully insure this risk and 1.9%-4.0% of lifetime consumption simply to know their actual retirement date at age 23." I'm not sure how to translate that into dollars, but it sounds like equivalent of $1 out of every $25 to $50 of personal spending.

Precise knowledge of one's retirement date, of course, is a luxury that vanished with defined benefit pensions, gold watches and retirement parties. You might suppose that Social Security buffers the risk of unexpected early retirement, because it offers enrollment across an eight-year age band (62 to 70). But the economists argue that the Social Security not only fails to take the sting out of this risk, it can make it worse.

That's because Social Security exacts a price for early retirement, regardless of whether it's voluntary or involuntary, according to the paper. If someone retires involuntarily at age 62 instead of age 65, for instance, they lose three years of earned income and the opportunity to make what might have been their biggest-ever payroll tax contributions. Whether they claim Social Security at 62 or wait until later, they are likely to have lower benefits than they otherwise would have.

"While current programs in the U.S. (Old Age and Survivors Insurance and Social Security Disability Insurance) may appear to offer protection against this risk, in fact they do not," the paper said. "Social Security does just the opposite because of the positive relationship between benefits and earnings, making it ineffective at providing timing insurance: individuals who suffer early retirement shocks have low average earnings and benefits while individuals who retire late have high average earnings and benefits."

The paper, which was published this month by the National Bureau of Economic Research, was based on data about 3,251 men who participated in the Health and Retirement Study, a biennial study of 7,700 U.S. households. The authors reviewed data from 11 waves of the study, between 1992 and 2012, and included men who were ages 51 to 61 during the first wave, 14 years ago.

There is a possible solution, the paper said. Adding a benefit to Social Security that isn't earnings-dependent would make involuntary early retirement less of a lose-lose, the authors suggest. It seems to work in other countries.

"In some public pension systems such as Japan, the UK, Spain and other European countries, part of retirement benefits is independent of the individual's earnings history. In other words, a component of retirement benefits is fixed regardless of when retirement occurs. This feature can mitigate up to one-third of the welfare costs of retirement timing uncertainty."

The hazard of such a benefit is that it might encourage people to leave the workforce early by choice, the authors warned, and that would be counter-productive at a time when working longer may be more advisable. So it looks like Americans have another retirement risk that they need to hedge: the risk of starting retirement earlier than they thought because of a late-life layoff.