

Removing the Disincentives in Social Security for Long Careers

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Since Social Security was instituted in 1935, life expectancy at age 20 has increased from 66 to 76 for men; and from 69 to 80 for women. Health at older ages has also improved. Such dramatic advances in health and longevity mean that people have the physical and mental capability to work until older ages. Yet people are retiring younger, even as they live longer and healthier lives. Indeed the duration of retirement has grown by even more than the increase in life expectancy at retirement.

This study considers the role of Social Security policy in influencing – or more precisely distorting – the work and retirement decisions of older workers. It highlights the features of Social Security that discourage long careers, discourage work at older ages, and increase the number of years in retirement. The main finding of the paper is that Social Security imposes high implicit tax rates on workers late in their careers. As a result of this distortion, the duration of retirement is suboptimally long, compounding the financial stress on public and private retirement support systems.

One example of the distortion in Social Security is how benefits are calculated based on the highest 35 years of earnings. This means that the 33rd, 34th, and 35th years of work noticeably improve retirement benefits by replacing a “zero” in the benefit calculation formula. The 36th year of work, on the other hand, may or may not count, and if it does, it will replace a lower year of earnings and not a zero in the calculation. Thus the benefit formula encourages careers of 35 years or less. Another distortionary aspect of the benefit formula offers disproportionately higher benefits to workers with short careers, treating them with the same redistributive advantages as if they were lower earners. Both characteristics lead to large discontinuities and high implicit tax rates at older ages and for longer careers.

The authors suggest three reforms that would reduce the distortionary impact of Social Security at older ages. First, they propose using 40 years, rather than 35, in the benefit computation. Second, they propose disentangling career length and progressivity in the benefit formula. And third, they propose establish a “paid-up” category of workers who have more than 40 years of contributions, who would no longer be subject to the payroll tax. The study finds that these proposed changes would eliminate most of the large positive tax rates for older workers. They would also reduce the association between age and tax rate, and move tax rates closer to zero for most workers in most years of their lives. With these changes, the implicit tax rates associated with Social Security remain roughly constant over a worker’s life, resulting in less distortion of career length choices. The authors find, in addition, that the proposed reforms would not affect the overall progressivity of the Social Security system.

The study concludes that by eliminating the disincentives against working longer careers, we can capitalize on the good fortunes of increasing life expectancy and favorable health status by paving the way for those in good health to stay in the labor force longer.

The full working paper is available on our website, www.nber.org/programs/ag/rrc/books&papers.html as paper NB06-06.

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