

# Quarterly Newsletter

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## Director's Corner

Social Security is an important part of income security in retirement. Under current law, Social Security retirement benefits replace about 40 percent of the average worker's earnings. Retirement planners often suggest that people will need to replace 70-80 percent of their earnings in order to maintain their pre-retirement standard of living. Many have traditionally counted on company-sponsored defined benefit pension plans to make up this difference. However, this type of pension plan is on the decline. Plans that emphasize personal savings, such as 401ks, are on the rise. Additional retirement savings may be required beyond these pension sources. Research by Professor Annamaria Lusardi, Dartmouth College, and Professor Olivia S. Mitchell, Wharton, on the topic of personal retirement planning is highlighted in this issue.

We were very pleased to welcome more than 30 MRRC researchers and guests to the MRRC 2005 Researcher Workshop held here in Ann Arbor in April. This has proven itself to be a worthwhile endeavor and, with Associate Commissioner Linda Maxfield and Senior Advisor Howard Iams in attendance, offers a chance for sharing current research with members of the SSA staff in a collegial setting. A write-up of this event is included in this newsletter.

John Laitner, Director

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**Mark Your Calendar for the  
8th Annual Meeting of the Retirement Research Consortium**

**August 10-11, 2006 at the  
National Press Club, Washington, D.C.**

Information about this conference, including registration information, will be provided and updated as needed on the MRRC website: [www.mrrc.isr.umich.edu](http://www.mrrc.isr.umich.edu).

The conference is being organized by the Retirement Research Center of NBER in cooperation with the MRRC, the CRR and the SSA Office of Policy.

## Researcher Q & A

In this issue Annamaria Lusardi and Olivia S. Mitchell discuss their research on the topic of retirement planning.

### How would you describe your MRRC-supported work?

Our objective was to assess whether workers display basic financial literacy. Increasingly, workers are in charge of making decisions about their retirement wealth, but we know little about whether they are well equipped to make these decisions. To address this issue, we have devised questions to measure whether workers understand interest compounding, the effects of inflation, and risk diversification. These are three of the basic concepts necessary to make any saving or investment plans. Our findings paint a rather bleak picture. Most of the respondents surveyed in our module display little or no financial literacy. In fact, only one third of respondents were able to answer correctly our three basic questions and half of our sample could not make simple calculations about interest rates and inflation. Consequently, we also find that the large majority of workers have not made any plans for retirement. Only one third of workers have ever tried to figure out how much they need to save for retirement, but many could not devise a plan. These findings are rather alarming, particularly in view of the pending insolvency of Social Security and the shortcomings of many pension plans.

### Do you find any difference in the behavior of women?

We find that women display lower financial literacy than men. This is true for all of the questions we considered, i.e. interest compounding, inflation, and risk diversification. Most importantly, differences in financial literacy remain significant even after we control for differences in age, race and ethnicity, and education attainment. These findings are important since women live longer than men and are likely to spend some years in their life-time being the single financial

decision-maker in the household. This may be another reason why many women suffer poverty at retirement, particularly following the death of a spouse.



Annamaria Lusardi is Associate Professor of Economics at Dartmouth College. She is also a Research Associate at the National Bureau of Economic Research, a member of the Technical Review Committee for the Bureau of Labor Statistics' National Longitudinal Surveys Program, and a member of the Academic Advisory

Board of the Center for Private Equity and Entrepreneurship at the Tuck School of Business.

Professor Lusardi's main area of research are saving, Social Security and pension, entrepreneurship, and macroeconomics. She has worked with both US and international data. She is the author of numerous articles analyzing the impact of risk on wealth accumulation, the effects of liquidity constraints on occupational choice, the importance of planning costs, the effects of financial literacy and financial education, and the behavior of saving across countries.

Olivia S. Mitchell is the International Foundation of Employee Benefit Plans Professor of Insurance and Risk Management, and the Executive Director of the Pension Research Council, at the Wharton School of the University of Pennsylvania. Her current research analyzes public and private retirement pensions as well as links between wealth, health, and retirement. Her co-authored article on Social Security reform won the 1999 Paul Samuelson Award for Outstanding Writing on Lifelong Financial Security from TIAA-CREF.



She was a member of the President's Commission to Strengthen Social Security; she co-chaired the Technical Panel on Trends in Retirement Income and Saving for the Social Security Advisory Council; she was a panel member for a National Academy of Sciences forecasting/modeling study; and she participated in a Social Security privatization panel for NASI.

## How are your findings relevant for Social Security policy?

As workers take up the responsibility about their retirement, it is critically important to pay attention to the fact that saving decisions are very complex and workers have difficulties grasping basic economic and financial concepts. We believe that the provision of help and financial advice can play a critical role in any policies or reforms aimed to promote household financial security.

## What are your next steps in this line of research?

We are currently examining whether financial literacy has any effects on savings and portfolio choice. This is not an easy question to address. First, it is not clear how the causality goes: does financial literacy affect wealth or does wealth induce people to educate themselves about financial matters? Second, are some people underinformed because they do not need to know? For example, some have little saving and nothing to invest, or believe they will be supported at retirement by Social Security and pensions.

In addition we will assess whether retirement planning affects savings. In previous work, we found that retirement planning had a large impact on both savings and portfolio choice. In this work, we can assess whether the effect of planning is mediated by the effect of financial literacy.

### *Sources:*

Financial Literacy and Planning: Implications for Retirement Wellbeing by Annamaria Lusardi and Olivia S. Mitchell. MRRC Working Paper WP 2005-108.

The Impact of Financial Education on Savings and Financial Asset Allocation by Annamaria Lusardi MRRC Working Paper WP 2003-061.

## *SSA Releases Benefits and Earnings Public-Use File, 2004*

The Social Security Administration (SSA) has released a Benefits and Earnings Public-Use File, 2004. This microdata file consists of two separate but linkable sub-files—one with benefit information and the other with longitudinal earnings information. Sample beneficiary records drawn from the Old-Age, Survivors, and Disability Insurance (OASDI) program can be linked to their corresponding earnings histories.

These microdata—approximately 470,000 records—are highly valuable since this is the first public release of longitudinal earnings records drawn as a representative sample of the beneficiary population. Because of the importance of earnings histories for calculating benefits, this file is expected to have broad appeal to outside researchers studying Social Security-related issues. All identifiers have been removed to protect individual privacy.

The benefit sub-file contains data on demographic characteristics, entitlement, type of benefit, and benefit amounts, and the earnings sub-file contains data on number of credits and earnings. These microdata and their supporting documentation can be accessed directly at [www.socialsecurity.gov/policy/docs/microdata/](http://www.socialsecurity.gov/policy/docs/microdata/).

The release of this public-use file represents continued efforts by the Office of Research, Evaluation, and Statistics to make Social Security administrative data available for research purposes. Comments concerning these files can be sent to [mbr.microdata@ssa.gov](mailto:mbr.microdata@ssa.gov).

# MRRC 2006 Researcher Workshop



*Susann Rohwedder*

With the Michigan winter loosening its icy grip, more than 30 MRRC researchers and guests gathered in Ann Arbor April 7 and 8 to share their research findings and exchange ideas. The workshop was held in the Institute for Social Research with ISR Director James Jackson offering a warm welcome to workshop participants. To begin the first day, Kathleen McGarry chaired a panel on Health and Retirement. Presentations in that panel included Differential Mortality, Uncertain Medical Expenses, and the Savings of the Elderly by Eric French; Modelling the Effect of Health on Retirement by John Bound; Using New Measures of Fatness to Improve Estimates of early Entry onto OASI Rolls by John H. Cawley; The Dynamics of



*Linda Maxfield, Lina Walker, and Purvi Sevak*

Work-related Health and Labor Market Status by Arie Kapteyn.

John Laitner chaired the next panel on Planning and Financial Literacy. Susann Rohwedder presented The Impact of Misperceptions about Social Security and Well-being; Jonathan Zinman presented Fuzzy Math and Mental Accounting: The Importance of Behavioral Decision Rules for Household Wealth Accumulation.

Alan Gustman chaired the last panel of the day on Measuring Well-being Among Retirees. Presentations included Alternative Measures of Replacement Rates by Michael Hurd; New PSID Consumption Data by Bob Schoeni, and Measuring Leisure by Mark Aguiar.

A group dinner was held at Zanzibar in Ann Arbor. Associate Commissioner for Research Evaluation and Statistics, Linda Maxfield provided remarks at dinner concerning research priorities for the Retirement Research Consortium.

On the second day, Charlie Brown, Larry Kotlikoff, and Michael Hurd chaired sessions that addressed the

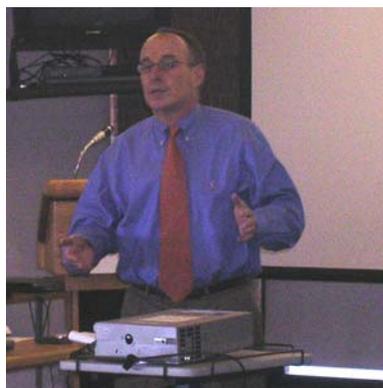


*Alan Gustman and Kent Smetters*



*John Laitner and  
Linda Maxfield*

question: What Can the Life-Cycle Model Tell Us? Papers in these sessions included Projecting Behavioral Responses to the Next Generation of Retirement Policies. by Alan Gustman; Social Security Reform: Changing Incentives for When to Retire by John Laitner; The Effect of Abolishing the Earnings Test on Labor Market Behavior Before Age 65 by Arthur van Soest; Social Security and the Retirement and Savings Behavior of Low Income Households by Wilbert Van Der Klaauw; Pensions and Retirement by David Blau; Local Labor Market Conditions and Retirement Behavior by Dan Black; Update on Our Social Security OLG Model with Idiosyncratic Risk by Kent Smetters and Shinichi Nishiyama; Valuing Lost Home Production of Dual-Earner Households by Dmitriy Stolyarov; Health Stocks and Health Flows in an Empirical Model of Expected Longevity by Hugo Benítez-Silva; Household Savings and Retirement: Expectations and Realizations by Stephen Haider; and The Effect of Children on Retirement Wealth by Ananth Seshadri.



*Larry Kotlikoff*



*Alejandra Cox Edwards*

Kent Smetters chaired a panel on Risk, Private Insurance, and Social Insurance which included: Did the Chilean Pension Reform Postpone Retirement? by Alejandra Cox Edwards; Health Insurance and SSI Participation Among the Aged by Elizabeth Powers and Todd Elder; Planning and Financial Literacy: How Do Women Fare? by Annamaria Lusardi; and Is Conventional Financial Planning Good for Your Financial Health? by Larry Kotlikoff.



*Estelle James and Howard Iams*

A final group of panelists, including Alan Gustman, Larry Kotlikoff, Kent Smetters, and Estelle James discussed the topic: What Have We Learned from Recent Research on Social Security that will be Relevant for Future Research? Alan Gustman's comments from this panel discussion are summarized on the following pages.

## Projecting Behavioral Responses to the Next Generation of Retirement Policies\* by Alan L. Gustman and Thomas L. Steinmeier

The chart below summarizes work we have done using the data in the Health and Retirement Study (HRS) to examine how potential changes in Social Security and pensions may change retirement patterns with concomitant effects on Social Security's finances. A distinguishing feature of our research is the use of a model which allows individuals to have differing degrees of impatience regarding current vs. future consumption. We refer to those with a high degree of impatience as "high discounters," since they discount the value of future spending in favor of spending now. This turns about to be very important in terms of the impact of Social Security policies on retirement behavior.

### Effects of Potential Social Security Policies on Retirements and Social Security's Financial Status.

Policy	Retirements	Social Security Finances
➤ Raise early entitlement age	↓	↑
➤ Abolish earnings test (62-NR)	↓	↓
➤ Establish personal accounts	↑	↓
➤ Account paid as lump sum	↑	↓
➤ Encourage partial retirement	↔	↓
➤ President's Commission proposals	↓	↑

The first bullet indicates that changes in the early retirement age are likely to have a significant impact on retirement. Currently about 15 to 20 percent of each cohort of individuals retires during their 62<sup>nd</sup> year. For high discounters, "actuarially fair" adjustments of future benefits are inadequate to compensate for benefits lost to postponed retirement, inducing retirement at 62. In short, they view the lost benefits more as a tax, which discourages work. Our model indicates that, of those who currently retire at age 62, roughly

three-fifths would delay retirement if the early retirement age were increased to 64. The impact on Social Security solvency would be favorable.

The second bullet shows that eliminating the current earnings test between early and normal retirement age would also reduce retirement, though by a smaller amount than increasing the early retirement age. Fewer individuals would be working part time and more would be working full time if the earnings test were repealed. The reason is that when high discounters can claim benefits at 62, the inadequate adjustment of future benefits for foregone benefit payments mentioned above no longer discourages additional work. However, many more individuals would be collecting benefits at ages 62 through 64, which would be a drain on the finances of the system. Therefore the impact on Social Security finances is unfavorable.

The third bullet shows the impact of a baseline system of personal accounts with the following terms. The system would feature a 4% payroll tax diverted to personal accounts with a 4.31% historical return on a mixed portfolio. For those with a personal account, there would be a reduction of traditional benefit by 37.7%. The minimum required annuity would be equal to the family poverty level. The earnings test applies to the traditional benefit and mandatory annuity, but not to lump sums. Lump sums are available at 62. The overall effect on retirement would be to increase retirement. The net impact on Social Security finances would be negative.

The fourth bullet, suggests that offering lump sum pay-outs on personal account balances will have a net effect of encouraging retirement. If lump sums are

\* This summary is excerpted from a presentation given at the MRRC 2006 Researcher Workshop, Ann Arbor, MI, April 2006.

tied to retirement, individuals may retire earlier in order to gain access to the lump sums, especially if the lump sums are made available at age 62. If the lump sums are not tied to retirement, we nevertheless can expect them to depress the incentive to work for a nontrivial fraction of the population, who will withdraw and spend the lump sums, leaving less income and assets available to support retirement later on. To make matters worse, these are likely to be individuals who have accumulated few other assets for retirement. There is a potential offsetting effect, since the lump sum option encourages high discounters to retire later by reducing the opportunity cost of continued work. But it is not large enough to dominate. The overall impact on Social Security finances would not be favorable.

The fifth bullet indicates that if firms allow their long term workers to partially retire, and regulations are modified to allow firms to pay pensions to partially retired, the number of 62 to 69 year olds completely retired will fall 10 to 15 percentage points, depending on age. Partial retirement increases by roughly 20 percentage points. More than twice as many enter partial retirement as leave full-time work, so total full-time equivalent (FTE) employment increases. But the change in FTE employment is modest, and the effects on Social security are unfavorable.

The last bullet shows that, overall, the President's Commission's proposals reduce retirements from full-time jobs at age 62 in 2075 by 4%. This is due in large part to changes in indexation of benefits (from wage to price indexation) and, in the third proposal, to changes in the actuarial adjustment—both changes that increase incentives to continue working. Because of these provisions, the impact on Social Security finances is positive overall.

The bottom line is that many policies that do not, on

average, affect the marginal reward to continued work, will nevertheless affect retirements and Social Security finances.

*Sources:*

"Retirement Effects of Proposals by the President's Commission to Strengthen Social Security." *National Tax Journal*. Vol. 58 No. 1 (March, 2005), pp. 27-49.

"The Social Security Early Retirement Age In A Structural Model of Retirement and Wealth." *Journal of Public Economics*. Vol. 89, Issues 2-3 (February 2005), Pages 441-463.

"The Social Security Retirement Earnings Test, Retirement and Benefit Claiming" November, 2004. NBER Working Paper 10905.

"Minimum Hours Constraints, Job Requirements and Retirement" . October, 2004. NBER Working Paper 10876.

"Retirement, Saving, Benefit Claiming and Solvency Under A Partial System of Voluntary Personal Accounts". Social Security Administration, Michigan Retirement Research Center. UM05-02. (Aug., 2005).

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## *F Y I*

A great way to get started planning for retirement is to use the retirement planning program available on the Social Security Administration website.

<http://www.socialsecurity.gov/planners/>

This planner provides detailed information about your Social Security retirement benefits **under current law** and points out things you may want to consider as you prepare for the future. There are three calculators that allow you to estimate your potential Social Security benefit amounts using different retirement dates and different levels of potential future earnings.

You can also order your Social Security statement:  
<https://s044a90.ssa.gov/apps6z/iss/main.html>



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