WORKING PAPER
Executive Summary

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DOES WORK PAY AT OLDER AGES?

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One way of relieving the economic pressures created by an aging population would be to encourage workers to delay retirement. People who work an extra year produce goods and services that can support their own current consumption and help cover the costs of both retirement programs and other government efforts, while at the same time reducing tax pressures on younger workers to support them in retirement.

Enticing workers to delay retirement depends critically on the individual returns to work at older ages. As work pays more, in terms of current after-tax earnings and increments to future retirement benefits, people become increasingly willing to sacrifice leisure and remain at work to obtain richer consumption opportunities both today and later in retirement. Rising tax rates, however, tend to discourage work, by reducing the share of output that workers take home. Earnings at older ages can be taxed in the traditional way, with payments to the Internal Revenue Service, or they can be "taxed" through reductions in future Social Security and other retirement benefits. Generous Social Security and employer-provided pension benefits can also discourage work, since many people are reluctant to remain in the labor force if they could receive nearly as much by retiring as by working.

To illustrate work incentives at older ages, this report estimates the returns to work for prototypical adults between the ages of 55 and 70. The analysis focuses on a base case, defined as an unmarried man age 55 in 2005 with some post-secondary education. He receives health benefits from his employer and participates in a defined contribution (DC) retirement plan. The report also examines incentives for workers in traditional defined benefit plans, those with access to retiree health benefits, and those who contribute generously to their DC plans.

Key findings include:

- The implicit tax rate on work increases rapidly with age, rising for our representative worker from 14 percent at age 55 to 50 percent at age 70. In addition to income and payroll taxes, the estimated tax rate accounts for changes in the value of future Social Security benefits, gains from access to the group health insurance market, and the loss of Medicare coverage after age 65 for workers with employer-sponsored health benefits. In fact, the loss of Medicare benefits alone causes the tax rate to rise by 15 percentage points at age 65.

· Many people in their mid-60s can receive nearly as much income in retirement as they could by working. By age 66, for example, the replacement rate reaches 90 percent for our base-case worker, 126 percent if he contributes 8 percent of his salary to his DC plan, and 111 percent if he instead participates in a traditional DB plan.

· Older individuals could substantially increase their financial resources in retirement by working longer. For example, our representative worker could nearly double his real annual income at age 75, net of health insurance premiums and federal taxes, by stopping work at age 65 instead of age 55. By waiting until age 68 to retire, he would accumulate enough wealth to finance a consumption stream of $60,000 per year from age 55 onward, nearly three times as much as he could finance if he retired at age 55.

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