



Work Impediments at Older Ages

Richard W. Johnson, Gordon Mermin, and C. Eugene Steuerle

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The Retirement Project

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A crosscutting team of Urban Institute experts in Social Security, Medicare, Medicaid, tax and budget policy, and micro-simulation modeling ponder the aging of American society.

The aging of America raises many questions about what's in store for future and current retirees and whether society can sustain current systems that support the retired population. Who will prosper? Who won't? Many good things are happening too, like longer life and better health. Although much of the baby boom generation will be better off than those retiring today, many face uncertain prospects. Especially vulnerable are divorced women, single mothers, never-married men, high school dropouts, and Hispanics. Even Social Security—which tends to equalize the distribution of retirement income by paying low-income people more than they put in and wealthier contributors less—may not make them financially secure.

Uncertainty about whether workers today are saving enough for retirement further complicates the outlook. New trends in employment, employer-sponsored pensions, and health insurance influence retirement decisions and financial security at older ages. And, the sheer number of reform proposals, such as personal retirement accounts to augment traditional Social Security or changes in the Medicare eligibility age, makes solid analyses imperative.

Urban Institute researchers assess how current retirement policies, demographic trends, and private sector practices influence older Americans' security and decision-making. Numerous studies and reports provide objective, nonpartisan guidance for policymakers.

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Executive Summary

Private and public retirement systems discourage work at older ages. People now retire earlier than they did 50 years ago, even though they are now healthier and work in less physical jobs. Unless older adults work more, the aging of the population will reduce the share of adults that is employed, slow the rate of growth in national output, and strain government's ability to pay for retirement programs and other public services. Changes to private pensions, Social Security, Medicare, and tax and discrimination law can promote work at older ages.

Traditional defined benefit plans penalize workers who remain on the job after they become eligible to receive pension benefits. Plans pay monthly lifetime benefits beginning at retirement. Benefit formulas typically pay more for more years of service, so participants can generally increase future monthly benefits by working longer. But for every year that workers remain on the job past the plan's retirement age, they forego a year of retirement benefits. The increase in annual benefits from an additional year on the job does not offset the loss from the reduction in the number of pension payments, lowering lifetime benefits. In a typical plan, older workers can lose as much as \$10,000 in lifetime benefits every year they remain on the job past the plan's normal retirement age.

Cash balance plans generally do not create incentives to retire early, but their legal status remains uncertain. Employers offering cash balance plans regularly set aside a given percentage of salary for each employee and credit interest on these contributions. Retirement benefits are set by the balance in the worker's account. Another year of work increases the account balance and future benefits. However, Internal Revenue Service (IRS) regulations governing cash balance plans have not been in effect since 1999, and Congress has been slow to

act. One federal court has ruled that cash balance plans violate age discrimination prohibitions, but other federal courts have found no violations.

Social Security discourages work at older ages by not rewarding additional employment much for workers who have spent more than 35 years in the labor market.

Like everyone else, older workers must pay Social Security payroll taxes equal to 12.4 percent of earnings (up to \$94,200 in 2006) split between employers and employees. These taxes discourage employment at older ages, because older people with many years of work experience do not gain much more in Social Security benefits by remaining on the job.

The availability of relatively generous Social Security benefits at age 62 creates early retirement incentives. Most people can begin to collect Social Security benefits at 62, and some can also receive benefits from their employer pension plans as early as age 55. It is generally difficult to convince people to remain on the job if they could stop work without having to reduce their standards of living. Some people in their early 60s could receive nearly as much after-tax income by retiring as by remaining at work, even after accounting for the loss of employer-provided health benefits. And some people in their mid- to late 60s could actually receive more after-tax income by retiring than by working.

Medicare rules forcing employer health benefit plans to pay for older workers discourage employers from retaining and hiring them. Federal law establishes employer-sponsored health insurance as the primary payer of health care costs for active workers age 65 and older. Medicare becomes secondary coverage, paying only for services not covered by the employer plan that are included in the Medicare benefits package. Medicare secondary payer

rules add thousands of dollars per year to the cost of employing each older worker at firms that offer health insurance.

Tax, pension, and age discrimination laws discourage employers from establishing phased retirement programs. Phased retirement programs would encourage workers to gradually transition into full retirement, reducing their hours and job responsibilities but remaining on the payroll. Although many older workers express interest in phased retirement, tax and pension rules discourage it. These rules forbid employers from making payments from defined benefit pension plans to participants who still work for them. Many workers cannot afford to reduce their hours without receiving at least part of their pensions. Some participants retire, begin collecting their pensions, and then return to work with the original employer, but these arrangements often violate at least the letter of the law. Phased retirement programs could also run afoul of existing age discrimination laws by providing preferential treatment to a select group of older workers.

As the baby boom cohort nears retirement, policymakers are beginning to focus on employment at older ages. The IRS recently proposed new regulations governing phased retirement, and legislation is pending in Congress that would promote phased retirement and address the controversy surrounding cash balance plans. Recent Social Security reforms have also reduced some work disincentives in the system.

- Proposed IRS regulations would allow workers to draw partial pensions from their defined benefit plans if they reduced their hours by at least 20 percent, but employer groups complain that these proposals do not go far enough;

- Legislation passed by both houses of Congress in late 2005, but not yet law, would allow defined benefit plan participants age 62 and older to receive plan benefits while still at work;
- The same congressional bill specifies that cash balance plans do not ordinarily discriminate against older workers under federal law;
- Pending congressional legislation would provide tax credits to employers that offer flexible or phased work to older adults and would improve access at older ages to federally funded employment and training services;
- Social Security recently raised the rate at which it increases payments for those who wait to claim their benefits, better compensating them for the reduced number of payments they will receive; and
- Social Security no longer reduces payments to working beneficiaries age 66 and older with substantial earnings.

Introduction

Reducing incentives for productive older Americans to retire and shorten their work lives would ease the economic pressures created by an aging population. If current employment patterns persist, the aging of the population will reduce the share of adults that is employed, in turn slowing the rate of growth in national output and government revenues and further straining the government's ability to cover the rising cost of retirement programs and other public services. Raising the employment rate of older adults, however, would ease economic pressures and improve individual well-being later in retirement. Delayed retirement gives people more time to earn, save, accumulate Social Security credits, and build more wealth in employer-sponsored pension plans. Working longer also increases the amount that can be spent in old age by reducing the number of years over which people spread their Social Security, pensions, and other wealth.

Despite improvements over time in health at older ages and reductions in the physical demands of work, people now retire at younger ages and for many more years than they did 50 years ago, in part because of the work disincentives created by private and public retirement systems and certain federal statutes. This report describes how traditional defined benefit plans, Social Security, and Medicare impede work at older ages. Traditional defined benefit plans typically penalize workers who remain on the job after they become eligible to receive pension benefits. Social Security leads many workers to retire early by providing relatively generous benefits at age 62 and by generally failing to reward additional employment much for workers who have spent more than 35 years in the labor market. Medicare rules forcing employer health benefit plans to pay for older workers discourages employers from retaining and hiring them. And tax, pension, and age discrimination laws discourage employers from establishing phased

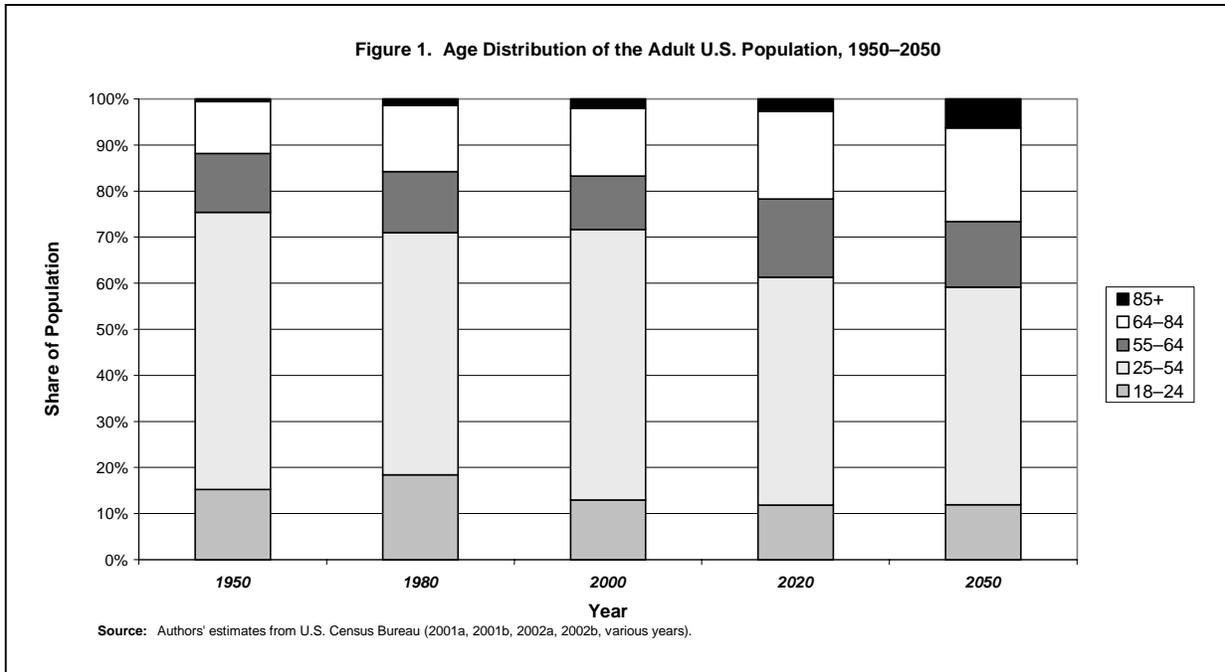
retirement programs, which could increase part-time employment among older adults. The report concludes with a summary of recent policy initiatives designed to address these work impediments and promote employment at older ages.

Confronting An Aging Population

The economic challenges created by an aging society depend on both the relative size of the older population and the adult employment rate. Understanding how individuals and employers make work and employment decisions is crucial to assessing the economic impact of an aging population.

The Population Is Growing Older

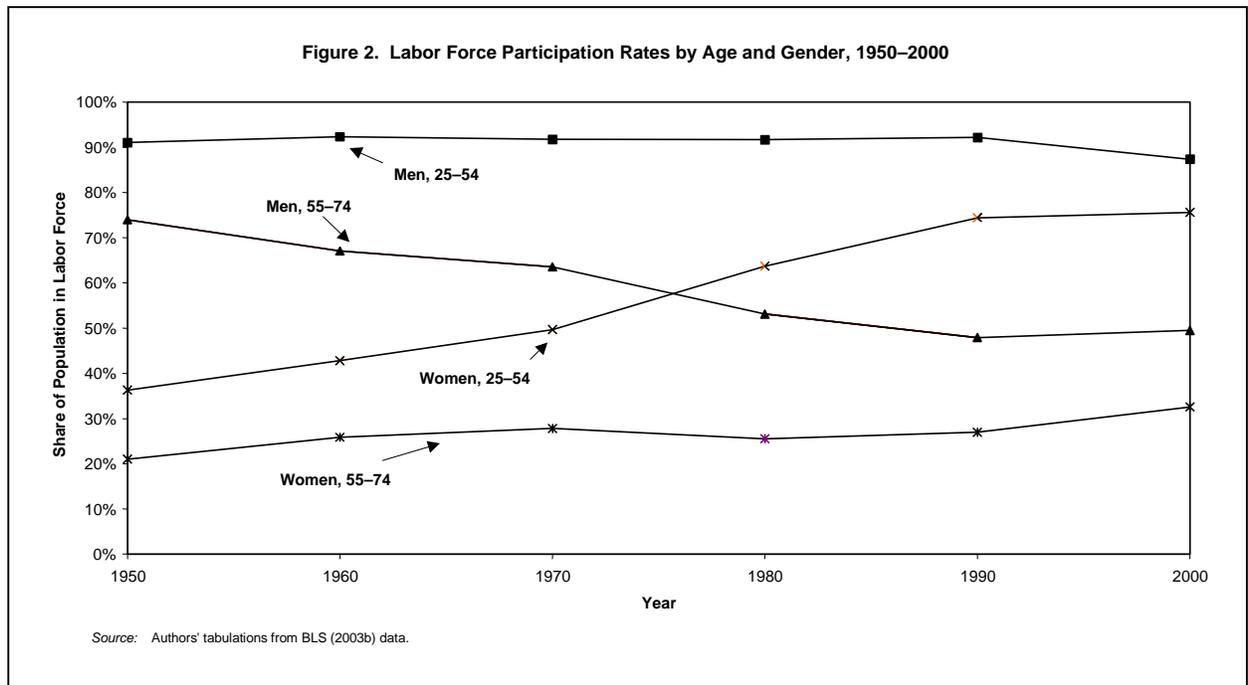
The population is growing older as people now live longer and have fewer children than in the past. Between 1950 and 2000, the share of the adult population age 65 and older increased from 12 percent to 17 percent (figure 1). This long-term trend will accelerate over the next 50 years with the aging of the baby boom cohort, the unusually large generation of Americans born between 1946 and 1964. With baby boomers reaching old age in the coming decades, the total number of adults under the age of 55, who have traditionally dominated the nation's workforce, will remain virtually unchanged between now and 2020, even though the overall population will grow by 44 million (U.S. Census Bureau 2002a, 2002b). The U.S. Census Bureau projects that 27 percent of the adult population will be at least 65 years old in 2050.



Labor Force Participation Rates Have Fallen at Older Ages

But changes in population tell only part of the story. What really matters for total economic output, and the burden of supporting the older population, is the number of workers in the economy relative to those who will be supported, which in turn depends on individual decisions about work.

Until recently, labor force participation rates for men have been declining steadily, particularly at older ages (figure 2). Almost three-quarters of men age 55 to 74 worked in 1950, compared with just under half in 2000. Nonetheless, there are encouraging signs that the decline in participation rates has ended and may have even reversed. For example, between 1995 and 2003, employment rates among men age 62 to 64 increased from 45 percent to 50 percent, although employment rates among men age 55 to 61 did not increase (Federal Interagency Forum on Aging Related Statistics 2004).



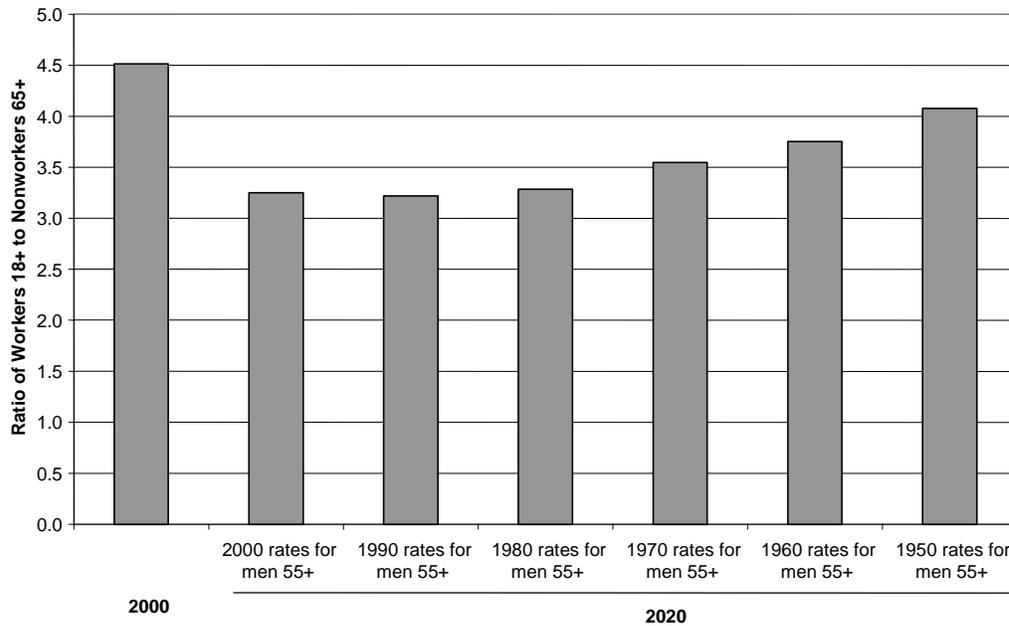
Labor supply patterns differ for women, who entered the labor force in large numbers over the past 50 years. Female participation rates at age 25 to 54 more than doubled between 1950 and 2000, to 76 percent, and women in this age group are now almost as likely to work as men. The movement of women into the labor force has offset the decline in male participation and maintained the overall size of the labor pool. Labor force participation rates among all adults increased in almost every non-recession year since 1950 (Steuerle and Carasso 2001; BLS 2003a). But it is unlikely that participation rates among young and middle-aged women will rise much higher in coming years, since women generally shoulder more child care responsibilities than men. Participation rates among older women will probably increase in the near term, however, as later generations of women accustomed to paid employment grow older and replace earlier generations who worked less outside the home. In fact, between 1995 and 2003, employment among women age 55 to 61 rose from 56 percent to 63 percent (Federal Interagency Forum on Aging Related Statistics 2004).

Work decisions will influence how the aging of the population affects the size of the future labor force. If current rates of labor force participation by age and sex continue into the future, the number of workers per nonworking adult age 65 and older will fall from 4.5 to 3.3 between 2000 and 2020. However, if men age 55 and older instead participate at the same rate as they did in 1950 (when jobs were more physical and health problems more prevalent), and women and other men participate at their 2000 rates, then the ratio would fall only to 4.1 in 2020 (figure 3). Although this improvement alone would not solve the old age crisis, it would make the problem significantly more manageable. The key policy issue, then, is to remove disincentives to work among older adults.

Employment Outcomes Depend on Both Workers and Employers

Employment rates depend on the willingness of individuals to work and the willingness of employers to hire and retain them. Many people are at least somewhat reluctant to work once they have accumulated enough retirement savings to live comfortably without having to remain employed, especially if they develop health problems. When considering how long to work, people weigh total pay, including nonwage benefits, which often change in value as workers age. Many workers particularly value employer-provided health benefits at older ages, at least until they and their spouses qualify for Medicare. But some employers offer health insurance to retirees before they qualify for Medicare, discouraging work by eliminating the link between employment and health benefits. In addition, lifetime benefits in many traditional pension plans decline in value when workers remain on the job beyond a certain age, encouraging older workers to retire.

Figure 3. Number of Workers Age 18+ per Nonworking Adult Age 65+ in 2000 and 2020, under Alternative Assumptions about Participation Rates for Men Age 55+



Source: Johnson and Steuerle (2004).

The willingness of employers to hire and retain older workers depends on the value of what they produce and how much they need to be compensated. The many years of experience that older workers bring to the job sometimes make them more productive than their younger counterparts, especially if they have worked for the same employer for a long time. However, people sometimes lose physical strength and mental acuity as they age, reducing their productivity. Some employers also believe that older workers are less adaptable to changing technologies than younger ones. Further, compensation costs often increase as workers age. Seniority pay rules tend to increase salaries at older ages, and employers generally must pay more to provide health benefits to older workers than younger workers.

Employers are often more likely to retain older workers than hire them. Experienced older workers generally develop specialized skills after many years of service with a single

employer, making them especially productive employees. Older workers are often expensive to hire, because they sometimes retire before employers are able to recoup recruiting and training costs.¹ Although traditional defined benefit pension plans are becoming less common, those that still exist raise the cost of hiring older workers (at least before age 65), because they tend to accumulate expensive pension benefits more rapidly than younger workers, as explained below.

Retirement Programs Limit Work at Older Ages

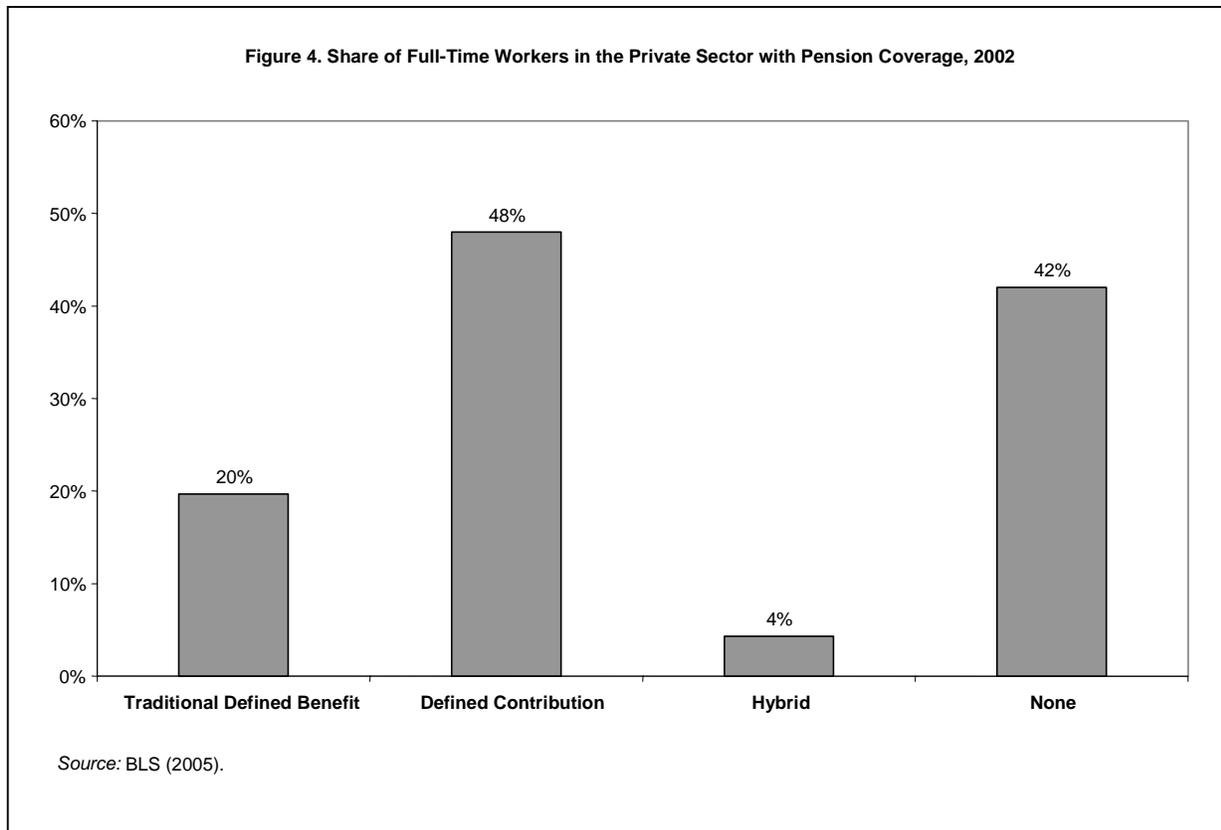
Characteristics of both private and public retirement systems create disincentives to work at older ages. Employer-sponsored pensions, Social Security, and Medicare all influence retirement decisions.

Employer-Sponsored Pensions: Traditional Plans Discourage Work at Older Ages

Nearly 6 in 10 full-time workers in the private sector participate in employer-sponsored pension plans (BLS 2005). There are two broad types of plans—traditional defined benefit plans and defined contribution plans—as well as hybrid plans that combine features of these two prototypes. Traditional defined benefit plans once dominated, but defined contribution plans have now surpassed them in popularity. In 2002, 48 percent of full-time workers in the private sector participated in defined contribution plans, 20 percent participated in traditional defined benefit plans, and 4 percent participated in hybrid plans (almost all of which were cash balance plans) (figure 4).² However, traditional defined benefit plans remain widespread within certain

¹ However, older people switch employers less frequently than younger people, especially those in their 20s, so the barriers to training older workers may not be as significant as some claim.

² Some workers participate in both defined benefit and defined contribution plans.



sectors of the workforce. The federal government continues to offer defined benefit plans to its employees (although it now also offers supplemental defined contribution plans). About 90 percent of state and local government workers and 70 percent of unionized workers in the private sector participate in defined benefit plans (BLS 2000, 2004).

Traditional Defined Benefit Plans

Traditional defined benefit plans provide workers with lifetime annuities that begin at retirement and pay regular benefits until death. Benefits are typically expressed as a multiple of years of service and earnings received near the end of the career (e.g., 1 percent of average salary received during the final three years on the job times the number of years of service). Some plans instead pay benefits equal to a fixed dollar amount per year of service. Participants cannot collect

full benefits until reaching the plan's normal retirement age, but most plans allow workers who retire early to collect reduced benefits if they have completed enough years of service.

Retirement ages vary across plans. The normal retirement age is set at 65 in about two-thirds of plans in the private sector, at 62 in about one-sixth of private plans, and at 60 or 55 in most of the rest (BLS 2005). Most plans set the early retirement age at 55. Participants cannot collect benefits until they leave the employer, unless they have reached the plan's normal retirement age.

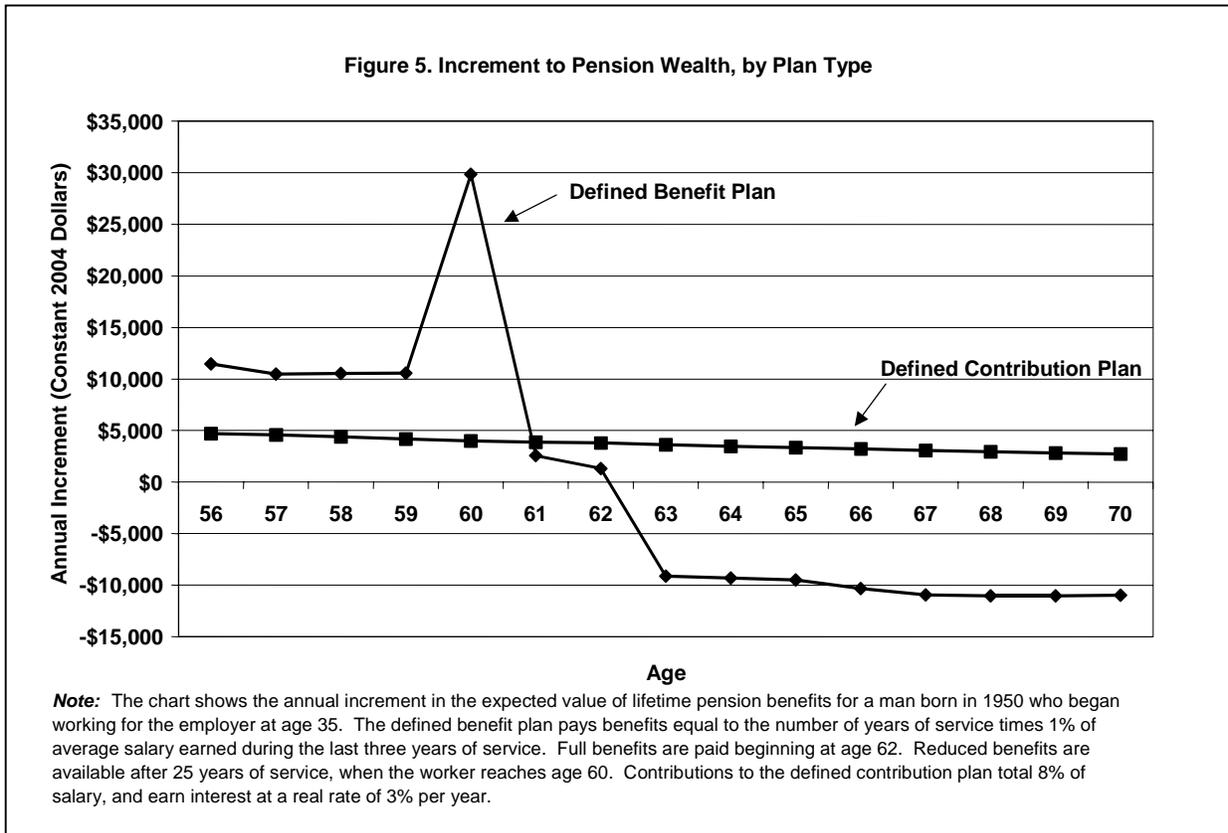
The value of expected lifetime benefits in traditional defined benefit plans grows unevenly over the worker's career, typically spiking sharply at the plan's early retirement age and declining after the normal retirement age. The value of pension benefits rises as workers age and accumulate substantial tenure. An additional year on the job increases traditional pension benefits not only by adding an additional percentage of pay, but also by raising the value of previous accumulated benefits by a combination of real wage growth and inflation. This increment is often substantial for workers with lengthy job tenures. The value of lifetime benefits also increases as workers approach retirement age because the benefits are no longer discounted far into the future.

Workers in traditional defined benefit plans often lose lifetime pension benefits if they stay on the job beyond a certain age or seniority level. For every year that workers remain on the job past the plan's retirement age, they forego a year of retirement benefits. Lifetime benefits decline if the increase in annual benefits from an additional year of work is insufficient to offset the loss from the reduction in the number of pension installments. Lifetime benefits often erode because wage growth generally slows at older ages. In addition, some plans cap the number of

years of service that workers can credit toward their pensions, and others cap the share of pre-retirement earnings that the plan replaces in retirement. As a result, traditional defined benefit plans often introduce strong disincentives to work at older ages.

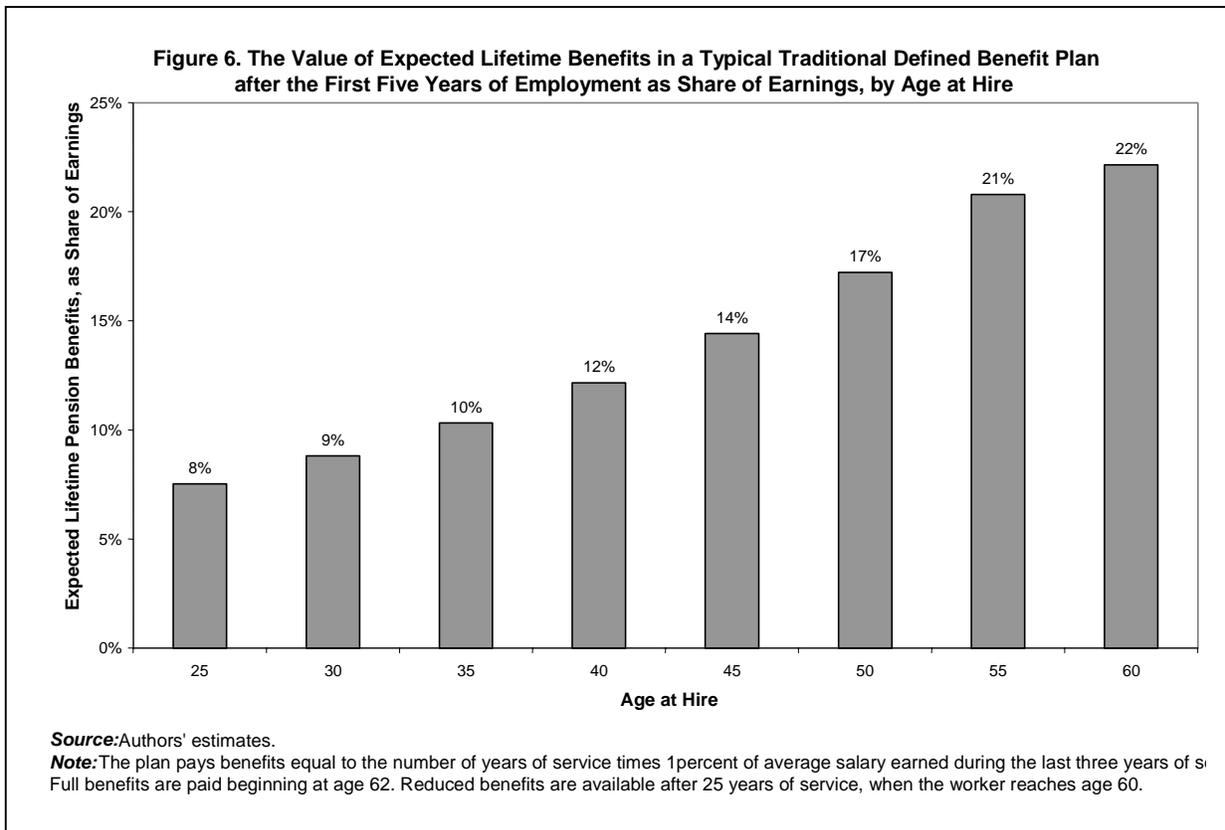
Work incentives and disincentives created by traditional defined benefit plans can be substantial. Consider a hypothetical but typical plan that pays monthly benefits equal to 1 percent of average monthly salary received during the final three years on the job times years of service. Participants qualify for full benefits at age 62, but can collect reduced benefits as young as age 55 if they have completed 25 years of service. Figure 5 shows the annual increment to the value of lifetime benefits from an additional year of work for a man with average earnings who has participated in this plan since age 35. The annual increment to lifetime benefits is about \$10,000 when he is in his late 50s, or slightly more than one-fifth of salary. It then spikes upward to \$30,000 (or about 65 percent of his annual salary) at age 60, when he has completed 25 years of service and qualifies for an early pension. If he remains on the job, the annual wealth increment falls to \$2,500 at age 61, and for every year he remains on the job after age 62 he loses about \$10,000 in lifetime benefits, equivalent to nearly one-quarter of his annual salary. This plan, then, provides employees with strong incentives to remain on the job until they qualify for early retirement benefits and to leave once they have reached the plan's normal retirement age.

Many workers respond to these pension incentives. A study of a random sample of workers near retirement age found that those in traditional defined pension plans retired about two years earlier on average than those in defined contribution plans, which do not create incentives to retire (Friedberg and Webb 2005).



Effects on Hiring Older Workers. Traditional defined benefit plans also increase the cost of hiring older workers. They typically provide more generous benefits to new employees near the plan’s retirement age than to new employees who are much younger.³ Consider again the typical defined benefit plan described earlier that pays benefits beginning at age 62 equal to 1 percent of final average salary times years of service, and provides reduced benefits at age 55 for those with 25 or more years of service. Figure 6 shows how lifetime pension benefits accumulated by a typical worker during the first five years of service steadily increases with age of hire. If hired at age 25, during the first five years of employment the worker would accumulate lifetime benefits worth only 8 percent of the salary he earned over the period.

³ More than four-fifths of defined benefit plans require workers to complete five years of service before qualifying for benefits (BLS 2005). Federal law forbids employers from imposing waiting periods longer than seven years to qualify for full benefits.



However, a 50-year-old hire would accumulate lifetime benefits equal to 17 percent of earnings during his first five years of service, and a 60-year-old would accumulate benefits equal to 22 percent of earnings received during the five-year period. This typical defined benefit plan dramatically raises the cost of hiring older workers, and the differentials by age of hire are too large to be offset by differences in wages.

Defined Contribution Plans

Defined contribution plans, the most common of which are 401(k) plans, generally do not create incentives to retire early. They specify the level of employer contributions, typically as a share of salary or a given dollar amount, and deposit them into individual accounts. At retirement, workers receive the funds that have accumulated in their accounts, generally as lump-sum

payments (Johnson, Burman, and Kobes 2004), although they can use the proceeds to purchase annuities that pay regular benefits until they die. Workers face tax penalties if they withdraw funds before age 59½, unless they elect to receive their benefits as annuities. Many plans require participants to separate from the employer before they can withdraw funds, but federal law gives employers the option of distributing plan benefits to older workers who remain with the employer.

The value of future retirement benefits from defined contribution plans generally grows smoothly over time. Future benefits increase each year by the value of contributions made to the plan and by the investment returns earned on the account balance. As long as market returns are relatively stable and employers contribute consistently over time, the account balance will increase steadily each year until retirement. Consequently, defined contribution plans do not create strong incentives to retire.

An employer with a defined benefit plan could switch to a defined contribution plan and eliminate work disincentives for older employees, but tax and pension law discourage these conversions. If the defined benefit plan is underfunded, lacking sufficient assets to cover projected future pension payments, the employer must make up the shortfall before it can terminate the defined benefit plan and replace it with a defined contribution plan. If the plan is overfunded, with more assets in the tax-advantaged pension fund than necessary to pay expected future benefits, the employer could pay steep taxes on the excess assets by terminating the plan. (If the employer instead maintains the overfunded defined benefit plan, it could use the excess assets to reduce, or even eliminate, its required payments to the plan.)

Cash Balance Plans

Cash balance plans, which do not generally create incentives to retire early, are attractive alternatives to employers with traditional defined benefit plans that are seeking to retain older workers. They are the most common type of hybrid pension plan, combining elements of defined contribution plans and traditional defined benefit plans, but they are classified as defined benefit plans for legal and regulatory purposes. Converting an existing defined benefit plan from the traditional format to the cash balance format does not require employers to terminate the plan. As a result, they do not have to make up any shortfalls in plan assets or pay taxes on any excess assets. Many private employers with defined benefit pension plans have in fact switched in the past 10 years from the traditional format to the cash balance format. About 17 percent of private workers in defined benefit plans in 2002 belonged to cash balance plans (BLS 2005).

Employers offering cash balance plans regularly set aside a given percentage of salary for each employee and credit interest on these contributions. Interest credit rates are usually tied to a specific benchmark, such as the U.S. Treasury bill rate. Benefits are expressed as an account balance, as in defined contribution plans, but these balances are only bookkeeping devices. Plans pay benefits from commingled funds invested in a pension trust on behalf of all participants. Because cash balance plans are special types of defined benefit plans, they must offer to pay benefits in the form of lifetime annuities, although most participants elect to receive benefits in lump-sum payments (Schieber 2003).

Because retirement benefits in cash balance plans are set by the balance that accumulates in the worker's account, the value of lifetime benefits never declines in these pension plans. In most cases, an additional year of work increases the account balance, in turn increasing the

lump-sum retirement payment or the stream of future pension payments. In traditional plans, by contrast, lifetime benefits sometimes decline at older ages because for every year that eligible workers wait to receive their pensions they lose a year of payments. In addition to eliminating work disincentives at older ages, these plans offer important advantages to relatively mobile workers and can improve individual retirement security (Johnson and Uccello 2004).

Despite their many advantages, cash balance plans are controversial and their legal status remains uncertain. The controversy stems from the possibility that workers who spent many years in a traditional plan could lose future pension benefits if their employer converted to a cash balance plan. For example, an older worker in the traditional plan shown in figure 5 would lose the sharp increase in lifetime pension benefits that he would have received at age 60. In a highly publicized 2003 case, the U.S. District Court for the Southern District of Illinois ruled that IBM's cash balance plan violated age discrimination prohibitions. The court found that the plan discriminated against older workers because their plan contributions received interest credits for fewer years than those received by younger workers. Other courts, most recently the U.S. District Court for the Eastern District of Pennsylvania in a case involving PNC Financial Services Group, have ruled that cash balance plans do not necessarily violate federal prohibitions against age discrimination.

Given the legal uncertainties, employers have stopped converting to cash balance plans for the time being. Internal Revenue Service (IRS) regulations governing plan conversions have not been in place since 1999. The IRS withdrew proposed regulations in 2004, leaving the matter to Congress. The U.S. Senate and the House of Representatives passed separate pension reform

bills in late 2005, stipulating that cash balance plans are not inherently discriminatory. However, as of early May 2006 the two bills had not yet been reconciled and thus not enacted into law.

Social Security Payroll Taxes Discourage Work at Older Ages

Social Security payroll taxes create disincentives to work at older ages for people who have spent most of their adult lives in the labor force. Workers and their employers each pay a flat Social Security tax equal to 6.2 percent of earnings, as well as a flat Medicare tax equal to 1.45 percent of earnings.⁴ Although employers nominally pay half of the payroll tax, almost all economists believe that employers completely offset their share of the tax bill by reducing wages below the amount they would have paid in the absence of the tax (Fullerton and Rogers 1993). Workers effectively pay the entire payroll tax themselves, especially over time as employers adjust to the cost of labor.⁵

Older workers with 35 or more years of employment typically gain relatively few additional Social Security benefits by continuing to work and pay taxes. Benefits are based on average indexed monthly earnings, computed over the 35 years with the highest indexed earnings.⁶ For workers with fewer than 35 years of employment, an additional year of work and

⁴ Earnings above a specified level are exempt from Social Security taxes (but not Medicare taxes). The taxable ceiling, which rises each year with average wages, now stands at \$94,200.

⁵ The people who pay the tax collector are often not the same people who bear the burden of the tax, in terms of lost income. Employers set wages so that the total cost of employing a worker equals the value of his or her output. Payroll taxes raise this cost, which also includes wages and nonwage benefits. Employers respond by reducing wages by the exact amount of the employer's portion of the payroll tax. The wage received by the worker equals the wage the employer would have paid in the absence of a payroll tax, less the amount of the payroll tax that the employer pays to the government. Employees then pay their share of the payroll tax out of these wages.

⁶ Married, divorced, and widowed retirees have the option of collecting Social Security benefits based on their spouses' (or former spouses') earnings records. Instead of receiving benefits based on their own earnings, current spouses can elect to receive one-half of their spouses' benefits, and widows and divorcees can receive their spouses' full benefits. (However, people must have been married for at least 10 years to qualify for survivor or ex-spouse benefits.)

contributions eliminates a year of zero earnings from the benefit computation, generally raising future benefits substantially. But for those with longer employment histories, an additional year of work will raise future Social Security benefits only to the extent that current earnings exceed adjusted earnings in the least remunerative of the top 35 years already used in the computation. This relatively small gain in benefits is not typically large enough to compensate for the additional payroll taxes that workers must pay (Butrica et al. 2004). For someone employed continuously since age 25, work beyond age 60 does not generally produce much net gain in future Social Security benefits.

Even for older workers who have not completed 35 years of qualified work, the net increase in Social Security benefits is often small. Under Social Security's benefit formula, the last dollars of lifetime earnings subject to tax generate future benefits at a much lower rate than the first dollars earned, even within a 35-year timeframe. In addition, many spouses earn few or no additional Social Security benefits in return for the payroll taxes they pay. By design, Social Security pays a higher benefit to workers only when and if the workers' benefit exceeds what they are already eligible to receive as spouses or survivors of beneficiaries.

Recent changes in Social Security rules have eliminated the incentive to *claim* benefits at early ages. The program has always increased monthly payments for those who delayed claiming their benefits beyond the full retirement age, to compensate for the fewer number of payments they will receive than those who claim earlier. Similarly, Social Security has always reduced payments for those who chose to collect before reaching the full retirement age (since early retirement became available to women in the late 1950s and men in the early 1960s).⁷ However,

⁷ Social Security's full retirement age was 65 for people born before 1938 and is gradually rising for people born in later years. Those born in 1960 and later face a full retirement age of 67. The early retirement age remains 62.

these adjustments were not large enough to offset completely the advantages of collecting benefits early. The 1983 Social Security amendments increased the delayed retirement credit, as these adjustments are known, to make the expected value of lifetime benefits about the same for a given beneficiary regardless of the age at which she first claims benefits.⁸ These increases, fully implemented for the first time this year, eliminate much of the incentive to claim at early ages, but do not eliminate work disincentives created by the presence of Social Security payroll taxes.

Elimination of Retirement Earnings Test at Older Ages

Congress also eliminated the retirement earnings test for Social Security beneficiaries who have reached the full retirement age, in an effort to promote work at older ages. The retirement earnings test reduces Social Security benefits for those with earnings above certain levels, although the benefit reduction is partly offset by future benefit increases. Early evidence suggests that the elimination of the retirement earnings test, which was abolished in 2000, did not significantly increase employment rates (as opposed to hours of employment) among adults age 65 to 69 in 2000 (Song 2003/2004). The policy change does appear to have increased earnings among higher-earning older workers, but not among older workers with lower earnings. However, its full effect may not be apparent for several years, since eliminating the earnings test may have had little effect on people who had already retired.

The retirement earnings test remains in effect for those who have not yet reached the full retirement age, reducing benefits by \$1 for every \$2 of earnings in excess of a specified

⁸ Men and women receive the same delayed retirement credit, even though women live longer on average than men. As a result, the program still somewhat encourages women to claim benefits early, but encourages men to wait before claiming benefits.

threshold, set at \$12,480 in 2006 (and adjusted each year by the average change in earnings). As with the retirement earnings test after the full retirement age, those whose benefits are taxed away would eventually recover their benefits through higher benefits in the future. Recent evidence suggests that eliminating the earnings test before the full retirement age might only modestly increase labor supply at older ages, because it would affect only the relatively small number of working beneficiaries with earnings between the threshold and the point at which they would lose all of their Social Security benefits to the earnings test (Friedberg 2000; Ratcliffe et al. 2003). However, the retirement earnings test may send a signal to older people that they should not work, discouraging employment more than the financial incentives alone suggest.

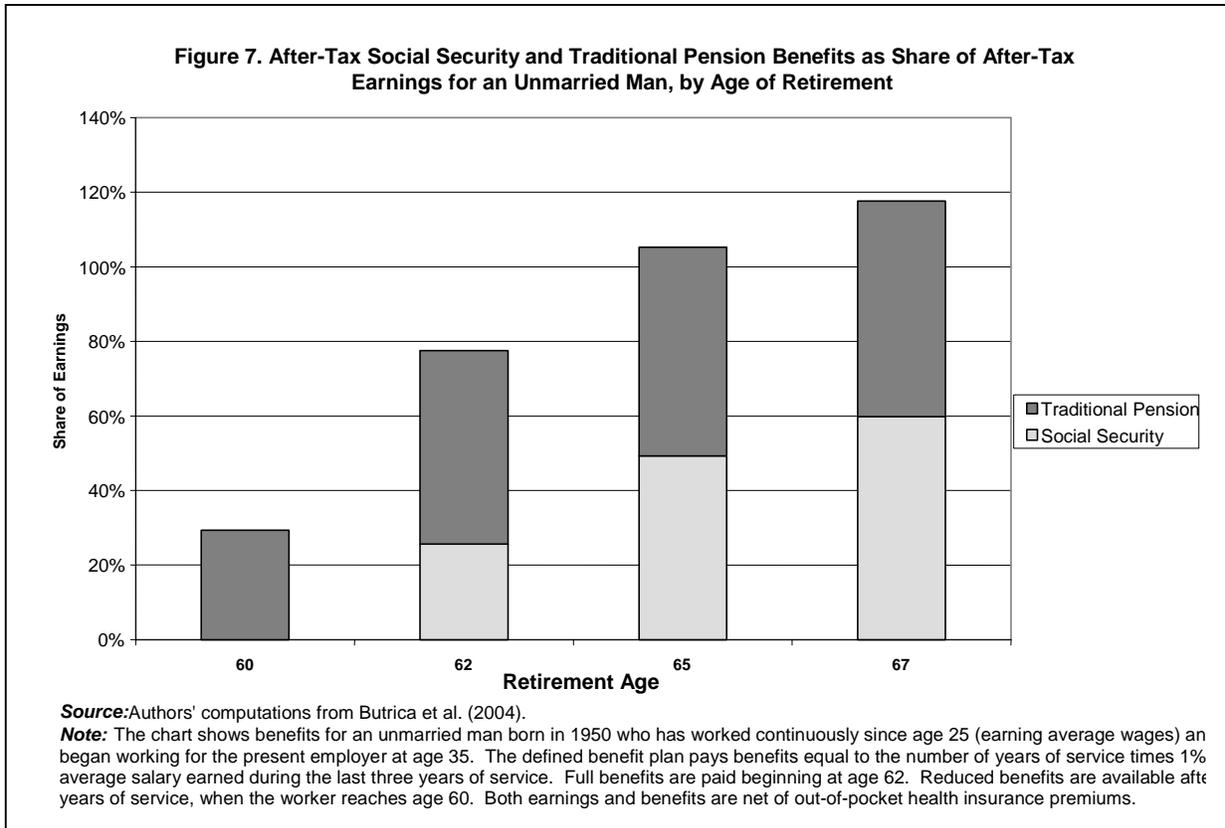
Access to Retirement Benefits Discourages Work at Older Ages

The availability of retirement benefits at relatively young ages encourages some workers to retire early. Most people can begin to collect Social Security benefits at 62, the program's early retirement age, and in fact retirement rates increase sharply at that age (Coile and Gruber 2004). Some people can also receive benefits from their employer pension plans as early as age 55. It is difficult to convince many people to remain on the job if they could stop work without having to reduce their standards of living. But by remaining at work, people could generally increase their future incomes substantially, because delaying retirement would raise their Social Security and pension benefits and give them more time to earn and save. It would also reduce the number of years over which they need to spread their retirement savings, thus raising the annual amount available to spend at older ages even more than the lifetime total. Unfortunately, few people seem to appreciate these longer-term effects. Most people nearing retirement appear to simply

compare the amount of cash available to them at a point in time by working and not working, instead of making more complicated comparisons of lifetime income streams.

Some people in their early 60s could receive nearly as much after-tax income by retiring as by remaining at work, even after accounting for the loss of employer-provided health benefits. By their mid- or late 60s, some people could actually receive more after-tax income by retiring than by working. Figure 7 shows how much an unmarried man could receive from Social Security and traditional pension benefits if he retired at various ages, as a share of what he would receive if he remained on the job. The estimates refer to the same man we considered earlier, who participates in a traditional defined benefit pension plan that pays benefits equal to 1 percent of final average salary for every year of service. He qualifies for reduced benefits at age 60 and full benefits at age 62. If he retired at age 60, before becoming eligible for Social Security, his initial retirement benefits would replace only about 30 percent of his earnings, after taxes and out-of-pocket health insurance premiums.⁹ If he waited until age 62 to retire, he could replace nearly 80 percent of his after-tax earnings net of health premiums. By age 65, he would receive more income after taxes and health insurance premiums from Social Security and pension benefits than he would from remaining at work. This example describes the circumstances for a worker fortunate enough to have a generous defined benefit plan and does not describe the level of retirement income available to most workers. Nonetheless, as noted early, fully one in five workers in the private sector and nearly all workers in the public sector have generous pension coverage.

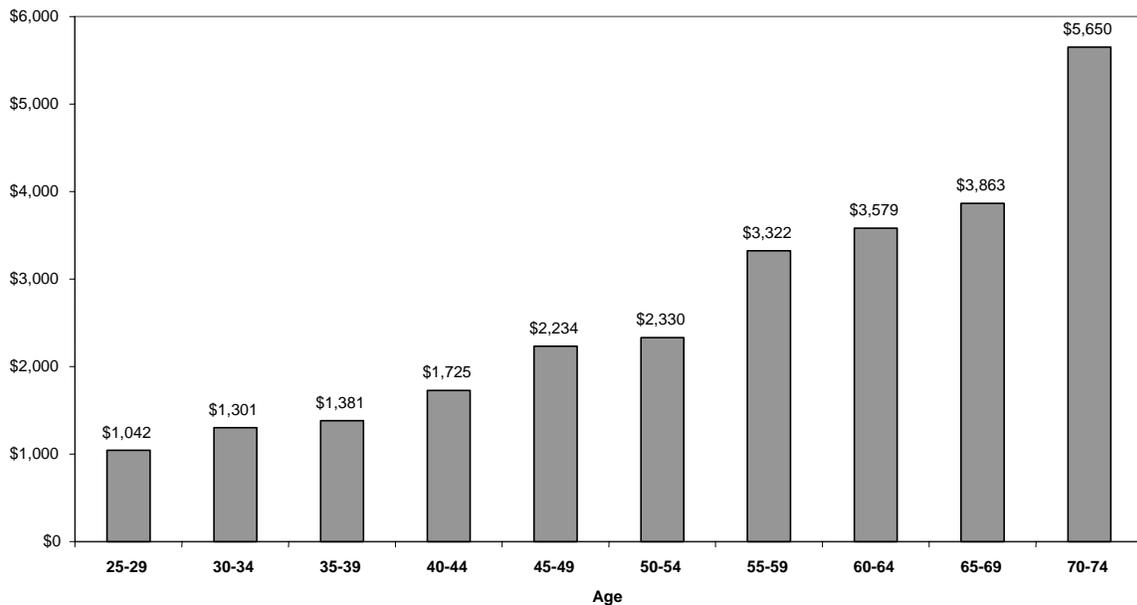
⁹ These estimates understate retirement resources available to most people by ignoring savings outside of Social Security and employer pension plans.



Health Costs, Medicare Secondary Payer Rules Discourage Hiring of Older Workers

Health care expenses increase with age, raising the cost to employers of providing health benefits to older workers. We estimate that workers in their early 60s with employer-sponsored health insurance incurred an average of \$3,579 worth of insured health expenses in 2002, compared with only \$1,301 for covered workers in their early 30s (figure 8). Most employers offering health benefits now require health plan participants to contribute toward the cost of their benefits, so the costs to employers of insuring workers are somewhat less than the estimates reported in figure 8. However, employee contributions do not reduce age differentials in health expenses, because employers are prohibited by law from requiring older workers to make higher contributions to their health plans than younger workers. As a result, health care costs added

Figure 8. Average Annual Health Insurance Costs by Age, 2002



Source: Authors' estimates from the Medical Expenditures Panel Survey.

Notes: Estimates equal 71 percent of average total health care expenditures incurred during the year, the average share of total costs paid by private insurance among adults age 25 to 64.

about \$2,000 per year to the cost of employing older workers in 2002 relative to those in their early 30s. Employers could try to offset these costs by paying lower salaries to older workers with health benefits than they would if they did not offer health benefits, but age discrimination rules limit their ability to reduce wages. Although the age difference in health costs is fairly small relative to average earnings for full-time workers, empirical evidence suggests that employers offering generous health benefits are in fact less likely to hire older workers than employers that do not offer health benefits (Scott, Berger, and Garen 1995).

Medicare secondary payer rules further increase the cost of employing older workers. Federal law establishes employer-sponsored health insurance as the primary payer of health care costs for active workers age 65 and older. Medicare becomes secondary coverage, paying only for services not covered by the employer plan that are included in the Medicare benefits package.

Workers with employer-sponsored health coverage essentially forfeit their Medicare benefits when they remain on the job beyond age 65. Because Medicare benefits are less generous than those offered by most employers, having Medicare as a secondary payer does not generally enhance insurance protection. Medicare secondary payer rules add thousands of dollars per year to the cost of employing each older worker at firms that offer health insurance.

Federal Pension Regulations May Limit Phased Retirement

To better retain older workers, some analysts have suggested that employers offer opportunities for phased retirement, a gradual transition into full retirement that provides flexible work schedules and reduced hours and job responsibilities. In a recent AARP survey, 38 percent of workers expressed interest in phased retirement, and 78 percent of those interested said these programs would encourage them to stay in the labor force longer (Brown 2005). Few private employers, however, currently offer formal phased retirement programs. Only 16 percent of employers in a Watson Wyatt Worldwide survey and 23 percent of employers in a William H. Mercer survey reported offering any kind of flexible employment arrangements to older workers (Graig and Pagnelli 2000; Rappaport 2001). Most of these arrangements are ad hoc and available only to a limited number of employees. The legal hurdles created by federal pension regulations appear to discourage many employers from adopting phased retirement programs (Brown and Schieber 2003; Committee for Economic Development 1999; ERISA Advisory Council 2000; GAO 2002; Penner, Perun, and Steuerle 2002; Purcell 2004).

Federal regulation of pensions through the Internal Revenue Code, the Employee Retirement Income Security Act of 1974 (ERISA), and the Age Discrimination in Employment

Act of 1967 (ADEA) is the most commonly cited impediment to the proliferation of phased retirement programs. The tax code encourages employers to establish and maintain pension plans for their employees by providing preferential tax treatment to these plans, but in return requires employers to meet certain standards. ERISA, which is enforced by the Employee Benefits Security Administration, also sets minimum standards for employer-provided pensions. The ADEA, which is enforced by the Equal Employment Opportunity Commission, prohibits age discrimination in employment at firms with 20 or more employees. These pension regulations pose problems for phased retirement programs that combine a reduction in responsibility with access to pension benefits.

Restrictions on Pension Payments to Active Workers. An important obstacle to phased retirement created by the tax code and ERISA is the restriction on payments by defined benefit pension plans to participants who still work for the plan sponsor. The regulations prevent defined benefit plans from making payments to participants before they separate from their employers, unless they have reached the plan's normal retirement age.¹⁰ Workers may not be able to afford to reduce their hours (and hence earnings) without immediate access to their pension benefits. Also, many defined benefit plans stop accruing additional benefits after a certain number of years of service, which in combination with the restriction on payments to employees can cause workers to lose lifetime pension benefits by staying on the job. In addition, workers can lose future pension benefits by moving to part-time status, through a reduction in the final salary on which benefits are based.

¹⁰ Federal law allows workers to access benefits in defined contribution plans at age 59½ regardless of employment status, although many employers only allow participants who have already separated to withdraw benefits.

Some employers have dealt with the restriction on plan payments to active workers by re-hiring retirees. Workers retire, begin collecting their benefits, and after a certain period of time return to work. Because the legal status of these arrangements is ambiguous, the required employment separation is risky for both employers and employees. This ad hoc approach, then, is not a viable long-term option for retaining large numbers of employees.

Anti-Discrimination Rules. Another way in which the Internal Revenue Code and ERISA may pose a problem for phased retirement is through their requirement that pension plans not discriminate toward highly compensated employees. To ensure that rank-and-file employees share in tax-preferred benefits, the tax code prohibits plans from paying a disproportionate share of benefits to highly compensated employees. However, this requirement may pose problems for phased retirement programs among employers that wish to selectively retain older (and better compensated) workers. In addition, highly compensated workers may end up disproportionately participating in phased retirement programs that are open to all employees.

Protection of Benefits. In an effort to protect employee rights, ERISA forbids employers from revising their pension plans in any way that would reduce benefits that workers have already earned. This restriction may discourage firms from experimenting with phased retirement programs. Once they allow workers to receive benefits through a phased retirement program, they may face legal challenges if they later wish to terminate the program, perhaps in response to higher-than-anticipated employee participation or to changing economic conditions. These rules forbidding reductions in earned pension benefits also make it difficult for employers to remove existing early retirement subsidies from pension plans and encourage older workers to remain on the job.

Age Discrimination Rules. While protecting workers against age discrimination, the ADEA may also complicate efforts by employers to create phased retirement programs and retain older workers. Employers express concern that formal phased retirement programs may expose them to ADEA lawsuits, as claims under this statute continue to be broad. Phased retirement programs might be interpreted as violating the ADEA because they treat one group of older workers differently from another group, solely on the basis of age. Even when employers believe they are operating within the law, the threat of lawsuits may be enough to deter them from adopting phased retirement plans. Lawsuits generate expensive legal fees and make it difficult for firms to plan for the future while the issue is being resolved, which can take many years.

In addition to potentially raising legal issues for phased retirement, the ADEA may hinder efforts to retain older workers by limiting wage and benefit flexibility. For example, the statute may make it more difficult to adjust the compensation of older workers in response to any declines in productivity. As noted earlier, one court has ruled that the age discrimination rules in ERISA and the tax code prohibit employers from converting their defined benefit plans to the cash balance format, by finding that cash balance plans reduce the rate of benefit growth for older workers.

Recent Policy Initiatives

As the baby boom cohort nears retirement, policymakers are beginning to turn their attention to the employment challenges posed by an aging population. The IRS recently proposed some new

regulations governing phased retirement, and legislation is pending in Congress that would tend to promote phased retirement and address the controversy surrounding cash balance plans.

Proposed IRS Regulations

In November 2004, the IRS proposed amendments to the Internal Revenue Code that would allow defined benefit pension plans to pay benefits to active workers under certain phased retirement programs. The regulations would allow partial payments of defined benefit pensions at age 59½ for workers who reduce their hours of employment by at least 20 percent. These phased retirees would receive a partial benefit equal to what their full benefit would be at that age, net of any early retirement reductions, multiplied by the percentage reduction in their hours. Workers would continue to accumulate additional retirement benefits on a pro-rated basis and would not be penalized for working part-time.¹¹ Employers would be required to periodically test whether phased retirees have really reduced their hours (except for workers who agree to retire within two years). Like other pension benefits, phased retirement benefits would be subject to nondiscrimination tests and the ADEA.¹²

Business groups argue that this proposal does not go far enough. At a hearing on the proposed regulations in March 2005, witnesses from the American Society of Pension Professionals and Actuaries, the ERISA Industry Committee (representing large employers that offer pensions), and the American Benefits Council (representing firms that sponsor or administer retirement benefits) advocated several changes to the proposed regulations:

¹¹ When calculating benefits, phased retirees would receive credit for a prorated year of service and their full-time salary. Consequently, part-time work at the full-time wage rate would not reduce benefits under plans that base benefits on the last few years of earnings.

¹² The full-time salary for phased retirees would be used for nondiscrimination tests.

- phased retirees should not have to reduce hours of work;
- testing requirements should be reduced;
- phased retirement should be allowed before age 59½;
- employers should be able to selectively offer phased retirement; and
- employers should be able to terminate or modify phased retirement plans.

These regulations have not yet been finalized.

Legislative Proposals

Plan Payments to Employees. In December 2005, the U.S. House of Representatives passed the *Pension Protection Act* (H.R. 2830), a comprehensive pension reform bill. Although the legislation deals primarily with pension funding issues, it includes a provision modifying ERISA to allow employers to pay benefits to defined benefit plan participants age 62 and older while they are still at work. The U.S. Senate passed a different pension reform bill, the *Pension Security and Transparency Act* (S. 1783) in November 2005, containing the same provision. However, House and Senate negotiators must resolve other differences between the two bills before it can become law. Compromise may not be easy, and President Bush has indicated that he may veto the bill unless Congress changes certain pension funding rules. The House and Senate were still resolving differences between the two bills in May 2006, and it is not certain that the reforms will be enacted.

Cash Balance Conversions. The *Pension Protection Act* (H.R. 2830), passed by the House in December 2005, also provides legal protection to cash balance plan providers. The bill stipulates that cash balance plans would not violate age discrimination rules as long as older participants' accrued benefits were at least as large as the accrued benefits for similarly situated

younger workers. The *Pension Security and Transparency Act* (S. 1783), passed by the Senate in November 2005, would also legally sanction cash balance plans, but only if they met certain vesting and interest-crediting requirements. House and Senate negotiators must resolve these differences, as well as other disparities between the two bills, before these reforms can become law.

Broad Efforts to Expand Employment Opportunities at Older Ages. Senator Kohl (D-WI), ranking member of the Senate Special Committee on Aging, introduced the *Older Worker Opportunity Act* (S. 1826) in October 2005 to encourage work at older ages. The bill would

- provide tax credits to employers who offer flexible or phased work to older adults and protect them from health insurance or pension loss;
- extend Consolidated Omnibus Budget Reconciliation Act (COBRA) coverage to older workers who lose their health insurance after reducing their hours of work;¹³
- provide tax credits for those who pay long-term care expenses for aged spouses or dependents;
- improve access at older ages to employment and training services funded under the Workforce Investment Act (WIA); and
- create a federal task force on older workers.

¹³ COBRA currently requires employers to allow former employees to participate in the employer's group health insurance plan for up to 18 months after the separation (or for up to 36 months if the employee is disabled). Employees are responsible for all premium payments, however.

Conclusions

Policy reforms designed to promote work at older ages could improve employment rates among Americans in their 60s and late 50s. Instituting rules by which employers could convert their traditional defined benefit plans to the cash balance format would help employers eliminate work disincentives from their retirement plans. Reducing Social Security payroll taxes for workers past the full retirement age for Social Security would lower the high marginal tax rate faced by older workers, and could lead to a sizeable increase in labor supply. Increases in income tax revenue resulting from higher rates of employment would at least partially offset the loss in payroll tax revenue. Eliminating Medicare's secondary payer rules for privately insured workers would substantially reduce the cost of employing workers age 65 and older. And establishing clear guidelines for phased retirement programs would enable older workers to more easily move to part-time work, instead of retiring completely. With the oldest members of the baby boom generation now turning 60, these policy reforms are becoming increasingly urgent.

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