Incentives for Older Workers to Remain in the Workforce

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Older workers could be induced to work longer, as improved health has accompanied longer longevity and as jobs that require hard physical labor have declined in relative importance. Many older workers have suggested that more flexible work arrangements, such as shorter hours and longer vacations, would enhance the attractiveness of working longer.

Unfortunately, there are a large number of economic, legal, and institutional barriers to providing more flexible employment arrangements to older workers. These were not considered a problem when there was a positive desire to move people out of the labor force early to make room for the horde of baby boomers working its way up the career ladder. While it was usually not appropriate to erect these barriers then, the prospect of losing important skills and experience as baby boomers retire in large numbers has greatly increased the urgency of reform.

Inducing older workers to work longer would be more feasible if phased retirement programs were a routine employee benefit. Such programs would permit workers to make a gradual—rather than an abrupt—transition from work to retirement, and provide them with an opportunity to work longer while working less.

Phased retirement programs are frequently available to state and local government workers and tenured faculty in higher education. But they are rare today in the private sector. Many employers express interest in phased retirement, but only a small minority try to implement it. There is no uniform model. Many employers prefer to make individual arrangements to retain employees with specialized skills and expertise. Others offer reduced hours or work schedules to a larger group. But most private employers do not have any phased retirement option for current employees. Instead, if they have any program at all, they prefer to rehire previously retired workers for part-time and temporary work whether or not they once worked for the same firm.

To expand the reach of phased retirement programs will require a 180-degree shift in traditional benefits thinking. For decades, employers have looked for benefits packages to ease older workers out of the workforce. Phased retirement programs, however, have very different design needs. In order to facilitate a gradual transition to full retirement through adjusted work hours and responsibilities, they should permit flexible compensation and benefits structures while providing employers with reasonable and predictable costs. They should also impose minimal administrative responsibilities and provide legal protection from age discrimination claims. Sufficient information on the details of a plan should be provided to enable workers to make informed decisions about participation, and the plan must maintain current law protections for older workers, especially for those who work out of financial necessity.

These objectives are difficult to achieve today. Employers who offer benefit programs must comply with the rules of three complex statutes—the tax code, the Employee Retirement Income Security Act of 1974 (ERISA) and the Age Discrimination in Employment Act (ADEA). Each has features that create a design nightmare and make phased retirement programs unappealing. Both ERISA and the tax code are complex and inflexible statutes. They set rules on who can and must participate in a plan, on the amount and types of benefits that can be paid, on when benefits can be paid, and on how those benefits will be taxed.

For example, hiring retirees for part-time and temporary work seems like an obvious option because it avoids many benefit complications, but it is straightforward only if the retirees are from other companies. In addition, employers cannot pay pensions from defined benefit plans to their workers before they terminate employment or attain normal retirement age. But many workers would count on these payments to supplement pay from part-time work in a phased retirement arrangement. So many employers use a strategy of rehiring workers shortly after they "retire" in an attempt to satisfy this rule. This is a risky strategy because tax regulations have never specified how long an employee must separate to make his or her "retirement" legitimate. But severe penalties are imposed for violating the law. Hiring retirees as consultants is another risky strategy. Many of these retirees do not fit the tax code definition for an independent contractor, and

misclassification of employees as independent contractors has recently become a high-profile legal issue. Companies that do misclassify employees risk not only regulatory action by the Internal Revenue Service but law suits by their own employees.

The ADEA, which forbids employers from discriminating against workers age 40 and older, is even more problematic. The courts are just beginning to flesh out its impact on employee benefit plans. Until there is more guidance on how much benefit plans that satisfy the tax code and ERISA must be changed to comply with ADEA, employers will be reluctant to adopt phased retirement plans, largely because of their legal exposure.

Phased retirement programs today may pose dilemmas for workers too. Because a phased retirement option is usually an ad hoc arrangement, many will find that working part-time has significant drawbacks. They may find that part-time work significantly reduces their pension benefits. They may also lose all or part of other employee benefits, such as health insurance, life insurance, and disability insurance. Age-based restrictions on their ability to receive pension payments plus extra tax penalties make a phased retirement program with their current employer an unattractive option. Many who might otherwise prefer to remain at the same job find it easier to negotiate flexible work arrangements with a new employer.

Several regulatory changes and statutory amendments would make phased retirement programs more appealing to both employers and workers. For example, the IRS could issue rules about when a bona fide termination of employment occurs so employers would know when pension payments could safely continue to returning workers.

Such changes would eliminate some of the current barriers to phased retirement programs, but it is difficult to argue that they would have more than a marginal effect. Most of the legal complexities and ambiguities that plague such programs today would still exist. The reality is that a special statute amending the tax code, ERISA, and the ADEA to authorize phased retirement programs will probably be required before they can become a routine employee benefit program.

Such a statute could be structured in many ways, and no single design or feature is pivotal. The most important consideration is that this is an opportunity to import flexibility and creativity into the rigid and overly complex world of benefits law. Any statute should be capable of stimulating the creation of innovative plan designs for private sector employers. The deferred retirement option plans (DROPs) now common among state and local government employers might serve as a model, as could the rules applied to academics as a result of earlier amendments to the relevant laws. The new statute should also establish parameters for safe harbor plans that employers could adopt without assuming the burden of expensive administrative requirements. In addition, such a statute might allow late retirement benefits to be added to defined benefit plans to provide incentives for continued work. Another important contribution would be to authorize special benefits packages just for phased retirees that would not be subject to the current cumbersome rules for nondiscrimination and coverage testing.

In many respects, the legal and regulatory problems facing workers in phased retirement programs reflect more their status as part-time workers than as older workers. Phased retirement programs raise benefits issues that are common to all types of flexible work arrangements. By working through these issues for phased retirees, the development of phased retirement programs—whether by enacting a special statute or adding flexibility to existing law—could serve as a model for adapting various laws to meet the needs of the 21st century workforce.

Other Publications by the Authors

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