

# I

## **Gradual Retirement: An Additional Option in Work and Retirement**

**Yung-Ping Chen<sup>\*</sup> and John C. Scott<sup>†</sup>**

**Presented at Retirement Implications of Demographic and  
Family Change Symposium  
Sponsored by the Society of Actuaries**

**San Francisco**

**June 2002**

---

<sup>\*</sup> Yung-Ping Chen, Ph.D., holds the Frank J. Manning Eminent Scholar's Chair, Gerontology Institute, University of Massachusetts Boston, 100 Morrissey Boulevard, Boston, MA 02125-3393. A founding member of the National Academy of Social Insurance, he served on the panel of actuaries and economists of the 1979 Advisory Council on Social Security. He welcomes comments by phone (617-287-7326), fax (617-287-7080), or e-mail (bing.chen@umb.edu).

<sup>†</sup> John C. Scott, J.D., is Director of Retirement Policy at the American Benefits Council, 1212 New York Avenue, NW, Washington, D.C. 20005. Involved in developing and implementing the Council's retirement, investment, and equity ownership policies, he focuses on regulatory affairs and equity ownership policy issues. He welcomes comments by phone (202-289-6700), fax (202-289-4582), or e-mail (jscott@abcstaff.org).

## **Abstract**

This paper is concerned with the implications of demographic and labor force changes for work and retirement. It discusses the role of gradual retirement in introducing flexibility into the range of choices between work and retirement. Part I explains the rationale for gradual retirement. Part II discusses some of the major barriers and possible solutions to gradual retirement, along with some examples of gradual retirement arrangements in both the public and private sectors. Part III contains some concluding remarks.

## **Part I: Rationale For Gradual Retirement**

We begin by reference to some recent news items from abroad. The *London Telegraph* reported that cities across France were choked with demonstrators on January 25, 2001, as thousands took to the streets to protect their right to retire at age 60. On August 1, 2001, a news outlet (smh.com.au) summarized the Australian prime minister's policy for dealing with a dramatically aging population in four words: don't retire, keep working. These reports reflect the dichotomous nature of work versus retirement. French workers' insistence on retiring at age 60 and the Australian leader's "keep working" policy would be tempered, we submit, if arrangements for gradual retirement were more prevalent.

The either-or choice between work and retirement also is implicit in much of the discussion of living longer and working more in a recent U.S. book on income and the health security of an aging workforce, although bridge jobs and phased retirement are mentioned. Three discussants of the chapter by Burtless and Quinn (2001) reacted to their suggestion of encouraging older workers to delay retirement from different perspectives. Rappaport (2001) centered on the employer perspective; Pransky (2001), on the workability point of view; and Ghilarducci (2001), on the distributional effects of raising the normal retirement age. We argue that much of the concern and debate about postponing the age at which full Social Security benefits are paid could be ameliorated if gradual retirement arrangements were more available and better utilized.

Financing retirement is becoming more difficult as the population ages and longevity lengthens. Many people in many countries may spend half their adult life in retirement, if the current patterns of retirement persist. Consumption during retirement may be financed collectively by society and privately by individuals and families. Although some people may have under their command

multiple means of support for retirement, others do not, and they may therefore desire employment as a source of supplemental income. Then there are those who may wish to continue work for non-pecuniary reasons. In other words, some people *need* to work, others *want* to work.

Whereas some older people doubtless wish to continue in their full-time positions, many more would opt for part-time work. However, when faced with a dichotomous choice of work or retirement, more people will choose retirement. In fact, we hypothesize that there would have been more incidence of gradual retirement if systemic and reasonable ways to enable workers to gradually retire had been more widely available.

Since retirement income security is one of the major policy concerns in the United States as elsewhere, we will first review the role of employment in providing income for people aged 65 or older.

The metaphor widely used to symbolize the sources of income to older people in the United States is the three-legged stool, comprising Social Security, pensions, and individual savings. Social Security is designed to provide an income protection floor, to be supplemented with pensions and savings. In fact, however, employment is another major source of income.

According to the latest available statistics, the proportions of those aged 65 and over who received income from these major sources in 2000 were (see Table 1):

- Social Security, 90%
- Asset income, 59%
- Occupational pensions, 41%  
(private pensions, 29%)
- Employment income, 22%
- Public assistance, 5%.

These sources of income did not contribute equally to the total income of the elderly, however. The relative shares of those sources in the total income in 2000 were (see Table 2):

- Social Security, 38%
- Asset income, 18%
- Occupational pensions, 18%  
(private pensions, 9%)
- Employment income, 23%

- Other sources, 2%.

During the last four decades, important developments have occurred in the relative contributions of the various sources from which older persons derive income. For the purpose at hand, we will point out that employment as a source of income has clearly declined during the past few decades. Whereas 36% of the older population had earnings in 1962, only 22% of them did in 2000 (Table 1). Although earnings represented 28% of total income of all older persons in 1962, they accounted for 23% of their total income in 2000 (Table 2).

Since the mid-1980s, it should be noted, while employment was a source of income to a near constant proportion of older people (20%), employment's contribution to their income rose from 16% or 17% in the mid-1980s to 20% or 21% in the late 1990s. This has been a significant development over the past decade and a half. In 2000, it reached 23%, a level attained in 1976, a quarter-century prior.

Although employment has become a more important source of income, there is considerable variation among people in different income classes. As Table 3 shows, although earnings contributed only 1% of income to the people in the lowest quintile of income distribution, they constituted 31% of income to the people in the highest quintile. In fact, employment as a source of income increases as income levels rise. This bears out the fact that, under current employment patterns, white-collar professionals are the ones who could more easily arrange for gradual retirement or keep on working full time.

Proposals to keep people working longer are a policy prescription that arises from several factors. A major reason is Social Security's long-range funding problem. Raising the normal retirement age is one way to moderate the rise in total benefit payments. However, increasing the normal retirement age is a contentious issue, igniting spirited debate. There are legitimate distributional concerns about increasing the age at which full benefits begin to be available. Gradual retirement may soften the impact of postponing the normal retirement age.

Another factor that leads to the idea of keeping people working longer is the projected slower growth in the working-age population. This way of mitigating labor force shortages does raise legitimate concerns for certain segments of the workforce. Gradual retirement, in our opinion, may provide a solution. If older workers may receive partial pensions as they are paid wages for

the reduced amount of work under arrangements for partial retirement, then people could lengthen their working years without the strain of full-time work throughout their careers.

Before pursuing the possibility of a wider application of gradual retirement, it is necessary first to understand the existing barriers that impede the adoption of gradual retirement, and then suggest ways of removing those impediments. We turn to these tasks in Part II, where we also refer to several examples of gradual retirement arrangements.

## **Part II: Barriers and Solutions to Gradual Retirement**

### **Barriers to Implementing Gradual Retirement Programs**

While a variety of gradual retirement practices exist, there appears to be a large number of barriers to an employer who might desire, either formally or informally, to adopt a gradual retirement arrangement. Many of these barriers are legal in nature, but there are also barriers that are economic, cultural, or practical.

#### **Legal Barriers**

A prime concern for many employees who would like to retire gradually is ensuring adequate retirement income through a combination of wages and retirement benefits. Access to retirement benefits, however, is often legally conditioned on the employee's full retirement, which conflicts with the idea of gradual retirement. Whether a rule or regulation impedes gradual retirement may also depend on the type of retirement plan and may also involve issues outside of the retirement plan context.

*Accessing Retirement Benefits Provided under Defined Benefit Plans.* Under current law, distributions from qualified defined benefit plans are not permitted prior to the earlier of termination of employment or the attainment of normal retirement age.<sup>1</sup> Moreover, there is some question about whether certain defined benefit pension formulas (so-called "final average pay" plans) could result in reduced benefits if an employee participated in a gradual retirement program.

---

<sup>1</sup> Treas. Reg. sec. 1.401-1(b)(1)(i); Rev. Rul. 56-693, 1956-2 C.B. 282, as modified by Rev. Rul. 60-323, 1960-2 C.B. 148.

Each of these requirements presents its own set of issues when a gradual retirement program is considered.

*Termination of Employment.* Reducing the number of working hours does not by itself constitute a termination of employment that would trigger entitlement to a pension distribution.<sup>2</sup> Specifically, the Internal Revenue Service (IRS) stated that:

Though relatively few authorities have considered whether a participant has experienced a separation from service when she changes from full-time to part-time employment with one employer, such a change apparently would not qualify as a separation from service. This is because the employer/employee relationship is not completely severed, but is simply modified when the employee changes her work schedule.<sup>3</sup>

There are ways outside of a formal gradual retirement program to access the pension benefits while continuing to work, but these raise other legal issues. Under one method, an employer and an employee may enter into a “retire and rehire” arrangement in which the employee fully retires, thereby becoming eligible to collect a pension benefit, and then is rehired by the employer to continue work with reduced hours or responsibilities. According to one survey, 59% of employers have a policy of rehiring retirees in some type of relationship (William M. Mercer 2001). The IRS has ruled consistently, however, that the act of retirement must be bona fide. Otherwise, the retirement plan may be disqualified under Internal Revenue Code (hereinafter “Code”) section 401, which would result in immediate disallowance of all tax benefits of the plan benefits. To avoid plan disqualification, some employers may require that the employee-retiree wait a period of time—for example, six months—before he or she can be rehired. Such a long wait may not be satisfactory to workers who would like to continue in their current positions, albeit in a reduced role, and may generate administrative complexity for the employer.

Another arrangement involves the hiring of a retired employee as an independent contractor by the employer. Of surveyed companies that rehire retirees, 61% will engage the services of retirees as independent contractors

---

<sup>2</sup> See, e.g., Edwards v. Commissioner, T.C. Memo, 1989-409, aff'd 906 F.2d 114 (4th Cir. 1990). Interestingly, under Code and IRS rules, working as much as 500 hours in a year will not permit a pension distribution even though one may be required to work at least 1,000 hours to accrue a year of service in a pension plan.

<sup>3</sup> IRS Information Letter 2000-0245, September 6, 2000.

(William M. Mercer 2001). Because an independent contractor arrangement may relieve the employer of certain responsibilities, such as employment taxes, the worker's status as an independent contractor is subject to scrutiny. The contractual/employment relationship is governed by common law principles of agency, and the IRS has provided guidance by which to judge whether such an arrangement is in fact legitimate. A key concept to establishing a legitimate independent contractor relationship is that the employer cannot direct the manner of performance of the independent contractor, and this requirement may be difficult for employers who wish for more control over employees participating in the gradual retirement program.

*Normal Retirement Age.* As noted above, distributions are not permitted prior to termination of employment or attainment of normal retirement age. The employer typically sets the plan's normal retirement age, but it generally cannot be higher than age 65. Some of the problems in accessing a pension while still working could be resolved by lowering the normal retirement age in the plan. However, lowering the normal retirement age presents a separate set of problems.

One problem is the higher cost of providing a benefit that commences at an earlier normal retirement age. For example, the value of a benefit equal to \$1,000 per month commencing at age 50 is more than a benefit of the same amount but commencing at age 60. Another issue is possible violation of the accrual rules under Code section 411(b), which requires that plans pass numerical tests that are designed to prevent excessive backloading of benefit accruals, and a reduction in the normal retirement age may change the results of these strict tests. Reducing the retirement age only for those who would participate in a gradual retirement program may also cause difficulties in the benefits, rights, and features test of Code section 401(a)(4) nondiscrimination rules.<sup>4</sup>

---

<sup>4</sup> The benefits, rights and features test of Code section 401(a)(4) requires that a plan's benefit, right, or feature cannot discriminate in favor of highly compensated employees. Special distribution options under a gradual retirement program and/or different retirement ages (if an employer targets gradual retirement to a subset of its employee population) are likely to be covered under the requirements of this test such that the distribution would have to pass numerical coverage tests (Treas. Reg. 1.401(a)(4)).<sup>4</sup> Although a gradual retirement program would be open to all who meet the age and service requirement, there generally is a higher concentration of highly paid employees in the older age and longer service categories. There may also be a higher concentration of highly compensated employees in the occupational categories for which the employer wishes to retain employees (e.g., professionals) in a gradual retirement program.

A participant working past normal retirement age as part of a gradual retirement arrangement may raise additional complexities under the suspension of benefit rules.<sup>5</sup> The suspension of benefit rules allow a plan to cease payment of retirement benefits to a participant who resumes working for their employer after distributions have started or who continues working past the plan's normal retirement age if certain conditions are satisfied, but these conditions may make a gradual retirement program unattractive to an employer.

*Final Average Pay Plans.* Some defined benefit pension plans have benefit accrual formulas that base benefits on a worker's final average pay (e.g., pay averaged over the last three years of employment). Participation in a gradual retirement program would likely reduce one's pay at the end of a career, thereby reducing a pension benefit under a final average pay plan. Although current law prohibits a pension from being reduced because of increasing age or service, there is no specific rule that prevents the reduction of a pension benefit because of a decrease in final average pay. The IRS stated informally that a pension could not be reduced because of a decrease in pay, but many experts in the private sector disagree.

*Accessing Retirement Benefits Provided under Defined Contribution Plans.* For participants in defined contribution plans, there are fewer restrictions on taking in-service withdrawals than in defined benefit plans, and this flexibility helps employees who wish to participate in a gradual retirement arrangement. Profit-sharing plans and 401(k) plans may distribute all or a portion of the participant's account balance after a specified number of years, after attainment of a certain age, or upon occurrence of an event such as death or disability. There are some restrictions, such as a participant's elective salary deferrals to 401(k) and 403(b) plans<sup>6</sup> and pre-1989 earnings thereon may not be withdrawn prior to age 59½,

---

<sup>5</sup> DOL Reg. sec. 2530.203-3. Benefits are only suspended for each month in which the participant works 40 or more hours, and the plan must provide a specific notice that alerts the participant that benefits are being suspended. When the notice requirement is satisfied, the plan sponsor may give a participant only the benefit accruals for future service. If the plan does not suspend benefits and benefits have not begun, the plan must provide to the participant an accrued benefit that is the greater of the actuarial adjustment for delayed retirement or the benefit actually accrued for each year of service after the participant reaches normal retirement age. If benefits have commenced, the actuarial value of the benefits paid during the year is used to offset the additional accrued benefit.

<sup>6</sup> 401(k) and 403(b) plans are, generally, retirement plans qualified under the Internal Revenue Code that permit employees to make pretax contributions from their salaries. While there have been historical and legal distinctions between these types of salary deferral plans, recent changes in the law have blurred these distinctions. However, it is still the case that 401(k) plans are usually sponsored by private sector employers, and 403(b) plans are sponsored by nonprofit or public sector employers or employees.

except in cases involving hardship.<sup>7</sup> Despite these restrictions, defined contribution plans may permit participants to borrow against their account balances, and a plan may also allow its participants to take distributions in order to avoid a financial hardship. Participants in defined contribution plans, therefore, generally (absent other barriers) will find it easier to supplement wages from reduced work with retirement income.

*Tax on Premature Distributions.* Even when the plan or the tax code permits access to retirement benefits, a financial penalty on withdrawals may apply regardless of the type of retirement plan. Code section 72(t) imposes a 10% additional tax on taxable distributions, unless the participant is over age 59½, has separated from service after attaining age 55, or is receiving the distribution over his or her life expectancy (or joint life expectancy if married), provided employment has terminated. This tax is a clear financial disincentive to participation in a gradual retirement program for those under age 59½.

*Limits on Plan Design.* An employer may wish to design their retirement plan with a provision for gradual retirement. In addition to the restrictions discussed above, the Code places limitations on plan designs, and these limitations affect the degree to which employers can modify their plans to accommodate gradual retirement programs.

The benefits, rights, and features test of Code section 401(a)(4), mentioned above, may require that special features of a gradual retirement program have to pass numerical coverage tests in order to ensure that these features do not unduly benefit highly paid employees.

401(k) plans have their own nondiscrimination rules that test the relative salary deferrals of highly compensated employees versus non-highly compensated employees (the so-called “ADP/ACP tests”). Although 401(k) plans might be more favorable for gradual retirement in terms of their ability to provide in-service withdrawals, as mentioned above, their specific nondiscrimination tests may be difficult to pass if the gradual retirement program helps retain highly compensated employees or forces out non-highly compensated employees.

---

<sup>7</sup> Post-1988 earnings on elective deferrals, employer-matching contributions, and qualified non-elective contributions (including earnings) used to satisfy the 401(k) nondiscrimination tests may not be withdrawn before age 59½ while a participant is still employed.

Distribution forms must be available to participants based on objective criteria.<sup>8</sup> Thus, employer discretion would be somewhat limited in providing distribution options in a gradual retirement program within the retirement plan. Another problem with distribution options for a plan-based gradual retirement program is that a participant may wish to receive a smaller periodic pension benefit while working part time (or in some other reduced capacity) and then to increase the pension benefit when fully retired. Current law and plan designs do not allow flexibility in benefit payments in order to meet changed circumstances. Generally, only a single election is applicable to the entire benefit payable from a qualified retirement plan.

Employers cannot remove a plan benefit that is deemed a “protected benefit” under Code section 411(d)(6). If a gradual retirement benefit or feature is considered a protected benefit such that they cannot be modified or removed at a later date, employers may be reluctant to establish a gradual retirement provision in their plans. Moreover, employers likely cannot offer gradual retirement benefits as an alternative to additional cash compensation under Treasury regulations.<sup>9</sup>

*Application of ERISA.* Gradual retirement programs in the public sector are more developed than in the private sector. One example is the growing use of deferred retirement option plans (DROPs) in the public sector (see below for a fuller description of DROPs), but they are not widely utilized in the private sector. One reason for this difference may be the impact of the Employee Retirement Income Security Act (ERISA). Drawing on both the tax and labor laws, ERISA provides a uniform and comprehensive statutory framework for U.S. pension programs. Many public and nonprofit plans, however, are not subject to ERISA, and private sector employers may not be attracted to gradual retirement until questions over ERISA’s applicability are resolved. In addition, ERISA’s framework is fairly rigid when applied to the growing demand for flexible work arrangements, particularly by older workers.

*Age Discrimination.* Rules outside of the tax code may also raise problems for a gradual retirement program. For example, it is not clear whether and how the age discrimination laws and regulations would permit gradual retirement programs, and this uncertainty may inhibit employers in developing such programs. The various age discrimination laws—the Age Discrimination in

---

<sup>8</sup> Treas. Reg. sec. 1.411(d)-4, Q&A 6.

<sup>9</sup> Treas. Reg. secs. 1.401(k)-1(a)(3) and 1.401(k)-1(a)(5)(iv).

Employment Act and its amendments and related laws—are quite broad in scope, and the federal judiciary is still developing their interpretation.

## **Barriers Related to Plan Objectives**

Apart from legal rules, there are aspects of pension plans that inhibit gradual retirement. Many pension plans were drafted with an eye toward inducing retirement by older participants in order to control labor supply and costs. While some or all of the underlying demographic and economic assumptions might have changed, many pension plan provisions remain unchanged.

*Early Retirement Incentives.* For participants who have not reached the plan's normal retirement age, the plan's design may encourage such participants to retire fully in order to collect benefits. Many defined benefit plans have significant incentives for early retirement benefits, and the early retirement benefit is collectible only if the participant completely severs employment. If the participant delays retirement past the eligibility date for subsidized early retirement benefits, the economic value of the early retirement benefit will decline (even if the dollar amount remains unchanged). In a similar fashion, if a plan provides a lump-sum payment option, low interest rates may encourage retirement because lower interest rates typically result in larger lump-sum values. In both cases, the plan design provides strong inducements to retire fully in order to collect valuable pension benefits.

*Disincentives to Continued Work.* For those participants who have attained normal retirement age, plan designs may encourage participants to retire in order to avoid the reduction in economic value of benefits. Many defined benefit plans commence benefits at normal retirement age. If a participant works past normal retirement age, the value of the benefit may decrease because it is calculated for commencement at a normal retirement age such as age 65. In addition, some plan designs make it difficult to accrue meaningful benefits if a participant works past normal retirement age. A participant considering gradual retirement may be deterred by the lack of financial reward for continued service in the pension plan.

In addition, reduced benefits may occur in defined benefit plans that base benefits on a participant's final average pay, or at the very least, benefits could fail to grow appreciably in spite of an employee's additional service. This reduction in pay often occurs when a person goes from full-time employment to

part-time work. Under final average pay plans, the participant's benefit is a function of his or her salary averaged over a period immediately prior to retirement, and the reduction in pay due to part-time work would necessarily reduce the benefit payable upon full retirement. Although current law prohibits a pension from being decreased because of increasing age or service, there is no clear guidance that prohibits reductions in benefits due to reductions in final average pay.<sup>10</sup>

### **Other Barriers**

There are issues and complexities outside of the legal and retirement plan context that may be barriers to gradual retirement. These barriers involve norms and the interaction with other programs and institutions.

*Company Paternalism.* Company paternalism may hinder the establishment of a gradual retirement program. Employers may be concerned that early distribution of benefits through a gradual retirement program may weaken retirement income security for its workers. This would be particularly true with defined contribution plan benefits, which may not be sufficient in amount for long-lived participants.

*Employer Flexibility.* The fostering of employee expectations could also inhibit gradual retirement. Employers may view gradual retirement as a program to deal with changing labor supply such that they wish to retain as much flexibility as possible in its design and operation. However, the offering of gradual retirement may be viewed by employees as a beneficial plan feature that should not be modified. If employers sense that they have little ability to modify gradual retirement programs in order to respond to changed business circumstances in the future, they may be reluctant to offer such programs in the first place.

*Health Care.* Access to health care for part-time workers and for employees who sever employment is a major concern, and this concern could be true for those participating in a gradual retirement program depending on how the program is structured. Many employers do not provide health care coverage to part-time employees (according to the definition of "part-time" under the health

---

<sup>10</sup> There is some uncertainty on this point. In testimony delivered to the ERISA Advisory Council, IRS officials asserted that pensions may not be reduced if final average pay decreases, but there is no specific regulatory guidance that supports this assertion. Moreover, witnesses before the same panel testified that pensions, in fact, have been reduced and that court cases supported such reductions. See the Working Group Report on Gradual Retirement, ERISA Advisory Council, November 14, 2000, at <http://www.dol.gov/dol/pwba/public/adcoun/gradualr1.htm>.

plan's eligibility rules). For terminating employees, the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) allows an insured worker to obtain continued health care coverage for up to 18 months following the loss of health care insurance coverage. There could be a large gap, however, between the end of COBRA coverage and eligibility for Medicare. Moreover, the cost of health care insurance coverage on an individual policy basis is often very expensive or simply not available because of health conditions for older workers. Finally, an employer may extend health insurance coverage to gradual retirees in much the

same way it extends coverage to regular retirees. The value and cost to the retiree of retiree health insurance can vary widely, and a recent federal appeals court decision has cast some uncertainty on the future of retiree health programs.<sup>11</sup>

### Possible Solutions for Implementing Gradual Retirement

A number of things might be done, particularly on the legal front, that would facilitate gradual retirement. These actions may include the following:

*Pension Reductions.* Pension law and regulations should clarify whether a defined benefit pension based on final average pay could be reduced if a participant's salary is reduced because of participation in a gradual retirement program. If pension law is clarified to permit such reductions, participants should be notified if a change in pension benefits will be affected by a change in their employment status.

*In-Service Payments.* Defined benefit plans, 401(k), 403(b), and 457<sup>12</sup> plans maintained by an employer, should be permitted to make payments to any current employee who qualifies for in-service payments under a gradual retirement program. Under such a program, employers could set a "floor" age and/or service requirement, such as attainment of age 50 or 25 years of service, according to their particular workforce demographics. Legislation that has been introduced in the prior 106th Congress, the Phased Retirement Liberalization Act,<sup>13</sup> would have allowed pension payments to be made to an active employee

---

<sup>11</sup> Erie County Retirees Ass'n v. County of Erie, 2000 WL 1053833 (3d Cir. 2000). The provision of health benefits to Medicare-eligible retirees through an HMO, while providing benefits to younger, pre-Medicare retirees through a point-of-service plan, can violate the Age Discrimination in Employment Act.

<sup>12</sup> For 457 plans, the constructive receipt rule should also be repealed.

<sup>13</sup> H.R. 4837/S. 2853 in the 106th Congress. Senator Charles Grassley and Representative Earl Pomeroy introduced the Phased Retirement Liberalization Act.

after the earlier of (a) normal retirement age, (b) age 59½, and (c) 30 years of service.

In order to effectuate such payments, an exception from the 10% additional tax on early pension payments should be made for benefits paid after the attainment of a specified age or amount of service. For example, if an employee has attained age 50 or 30 years of service, the 10% additional tax would not apply to periodic payments of all or a part of the employee's benefit that are made for the life (of life expectancy) of the employee or for the joint lives (or joint life expectancies) of the employee and his or her beneficiary.

*Relief from Nondiscrimination Rules.* Conceptually, it is not a violation of the nondiscrimination rules under Code section 401(a)(4) for a defined benefit plan to facilitate older employees' shift to part-time status in a bona fide gradual retirement program as long as the applicable plan provisions are available to a broad group of employees. Nonetheless, such a program could still fail the quantitative tests under the nondiscrimination rules. Because bona fide gradual retirement programs are not promoting discrimination in any real sense, a "facts and circumstances" test should be permitted under the general nondiscrimination rules of Code section 401(a)(4) for gradual retirement provisions within a pension plan. More generally, safe harbors and/or special rules addressed to gradual retirement programs should be developed.

*Age Discrimination Relief.* Congress should direct the Department of Labor and the Equal Employment Opportunity Commission to collaborate on a review of the application of the age discrimination laws on gradual retirement programs. The agencies should also be directed to use their regulatory authority to facilitate the implementation of gradual retirement programs while ensuring that the protections for older workers are not diminished.

*Unknown Regulatory Barriers.* Congress should direct the Treasury Department, the Internal Revenue Service, and the Department of Labor to review the application of the Internal Revenue Code and ERISA to gradual retirement programs in order to identify potential barriers to gradual retirement programs. The agencies should have broad authority to provide appropriate relief from the various statutory and regulatory provisions that impede the development of gradual retirement programs. If the agencies identify barriers that cannot be changed by regulatory action, Congress should develop and pass the necessary legislation.

It is important that any regulatory guidance provide flexibility for employers who sponsor bona fide gradual retirement programs. For business reasons, employers will need to retain reasonable discretion to determine who is eligible for a gradual retirement program and to modify the eligibility rules as reasonably necessary.

*Health Care.* To alleviate the barriers to health care for participants in gradual retirement programs, some or all of the following might be considered:

- Allow the purchase of Medicare coverage between the ages of 55 and 65 at a rate that is commensurate with group insurance policies that provide similar benefits but without consideration of insurability and preexisting condition requirements.
- Extend the total COBRA period for employees losing coverage after age 55 to the lesser of (a) the period of time to Medicare eligibility, or (b) the period of coverage with the employer prior to the COBRA period.
- Allow more flexibility for the use of surplus pension assets in funding retiree health benefits. One possible use would be to increase pension benefits by the amount of individual health insurance coverage.

*Alternative Work Arrangements.* The expansion of alternative work arrangements in general, regardless of an employee's age, may in effect foster the development of gradual retirement. Currently, more than half of all employers currently offer employees flextime, and nearly one-quarter of employers offer telecommuting, compressed work weeks, and job sharing (Society for Human Resource Management 1999). Although not targeted specifically to older workers, these programs may serve as vehicles for gradual retirement, and their continued development will serve to promote the expansion of gradual retirement.

### **Selected Examples of Gradual Retirement Programs**

Despite the litany of barriers to gradual retirement recited above, gradual retirement arrangements exist today. Although such practices are not common, there are indications that the use of gradual retirement is growing. But gradual retirement programs vary from employer to employer, and this variation reflects the particular circumstances of demography, culture, and economics that face an employer. Gradual retirement can consist of reduced hours or schedules, special or temporary assignments, consulting work, job sharing, leaves of absences, job

transfer, and/or telecommuting (Watson Wyatt 1999; William M. Mercer 2001). Below are selected summaries of some current gradual retirement practices. These examples are not meant to be comprehensive in scope, but they do illustrate the variety of arrangements in effect today.

*"DROP" Arrangements.* A deferred retirement option plan (DROP) is a program under which an employee who would otherwise be eligible to retire and receive benefits under an employer's defined benefit plan instead continues working. DROPs are usually offered by state and local government plans. Instead of continuing to accrue pension benefits under the plan's accrual formula, the employee has a sum of money credited during each year of continued employment to a separate account under the employer's retirement plan. The account earns interest according to a specified rate or based on the plan's underlying investment return. The account is paid to the employee when he or she fully retires as a supplement to the benefit earned under the plan's traditional defined benefit formula. DROPs are effective in retaining employees who have earned the maximum benefit under the plan as well as for those employees who either value a lump-sum benefit or may receive a higher rate of return under the DROP than under the traditional defined benefit plan's continued benefit accrual.

*Example:* Employee Smith is covered by a local government plan that provides that she will receive an annual benefit beginning at retirement of 2% of average final compensation multiplied by her years of service. If Smith retires at age 60 with 35 years of service and final average compensation of \$20,000, she would have an annual benefit of \$14,000. The plan also permits early retirement without actuarial reduction at age 55. If Smith chose early retirement (with no change in average compensation), her benefit would \$12,000. The local government's DROP permits Smith at age 55 to continue working for five more years but to have her compensation and years of service frozen at the level they were when she was 55. Her employer contributes \$12,000 per year of continued employment into a separate account, which earns a competitive return. When she retires at age 60, Smith would receive (a) \$12,000 per year, plus (b) \$60,000 plus earnings (Calhoun 2000).

*Retiree Pools.* A problem to implementing gradual retirement is that generally employees must separate from service in order to begin receiving retirement benefits. Retiree pools are ongoing and formal programs that can be used to provide continued work to retirees on a temporary basis.

*Example:* A large pharmaceutical and food sciences company offers all retirees the opportunity to participate in a retiree pool. The company uses the retiree pool to employ retirees to fill in for active employees with prolonged absences due to illness, vacation, or when there is a temporary need for additional work such as a special project. While not performing the jobs they held prior to retirement, the retirees are using the skills earned in their former positions. The retiree pool is open to all levels of skill, from clerical to research chemists. Compensation is not based on the former position of the retiree but rather is based on skill level and the needs of the job assignment. No benefits are accrued while on temporary assignment, and health care is provided by the company's existing retiree health program. Only when there are no available people in the retiree pool for a particular assignment does the employer go outside of the company to hire temporary help (Shopp 2000).

*Job Sharing.* A clothing manufacturer provides a job-sharing program for its older workers. The 10-year-old program allows eligible employees to work 40 hours over two weeks and retain full health insurance benefits, prorated vacation leave, and the corporate match to their own salary deferrals to the company 401(k) plan. Eligible employees are factory production and day care workers. The program was started in order to retain the skills of older workers when the employer was not in a position to offer higher wages. The company has found that older workers' productivity remains high because of the program and that workers are conscientious about arranging schedules so that machines are rarely idle (Perkins 2000).

*Flexible Work Arrangements.* A food and merchandise retailer operating 210 stores in seven Midwestern states targets older workers for recruitment and retention because of labor shortages. Despite the physical nature of the store work, approximately 5% of employees are over the age of 60. The company actively recruits older individuals by working through job service agencies and senior organizations. The employer also seeks to keep older workers through the use of liberal work scheduling policies and accommodating special needs. Flexible scheduling is permitted on a daily, weekly, and seasonal basis. For example, an employee may work in the spring, summer, and fall and still spend the winter in Florida. All employees regardless of age have access to training, profit sharing, 401(k) plans, and health care insurance, including a continuation of medical benefits program for part-time workers over the age of 50 (Meyer 2000).

*Gradual Retirement Benefits in a Defined Benefit Plan.* The National Rural Electric Cooperative Association (NRECA) is comprised of nearly 1,000 consumer-owned not-for-profit electric cooperatives. NRECA provides health and retirement benefits to over 130,000 rural electric employees in 46 states. The NRECA defined benefit plan has provided a gradual retirement option since 1983 because of the tight labor market in rural America. The plan covers 850 cooperative employers, who select the benefit level, eligibility requirements, and other plan features, such as the plan's normal retirement age for its own cooperative employees. Normal retirement age in the NRECA defined benefit plan can be 60, 62, 65, or the earlier of 30 years of service or age 62. About 50% of the cooperatives select age 62 as the normal retirement age, while another 35% choose the 30 year/age 62 standard. Participants in the plan may elect to receive retirement benefits in the month in which the employee reaches normal retirement age, while continuing to work. Participants in the gradual retirement program continue to accrue a benefit even as the employee draws down on the benefit previously earned. In addition, employees retain access to health insurance, life insurance, disability insurance, and paid vacation because the employee is still active even if he or she is on a reduced work schedule (Dau 2000).

*Gradual Retirement at a Large University.* Universities have led the way in developing gradual retirement programs. Although 27% of universities offer a formal gradual retirement program, this is above a recent estimate of 16% for private sector employers (Ehrenberg 2001; Watson Wyatt 1999). In one example that is not atypical, a large, privately supported university allows tenured faculty members to reduce their teaching, research, and administrative duties prior to full retirement. Generally, the program is available to all full-time faculty members after reaching age 55 and holding a full-time appointment at the university for at least 10 years. Prior to 1998, the age eligibility requirement was 60 years of age. Service must be at least half time for one term in an academic year but cannot exceed half time over the entire academic year. The university continues to provide health and dental benefits. If the faculty member's appointment is for one-half time, the university will make retirement contributions in an amount equivalent to the faculty member's full-time pay, but if the appointment is for less than half time, retirement contributions by the university are based on 20% of the actual gradual retirement base pay. The faculty member may elect to receive retirement distributions during the gradual

retirement period. Other benefits, such as life insurance, will be adjusted according the ongoing status of the faculty member's appointment.<sup>14</sup>

*"Retire-and-Rehire."* The state of Washington passed a law in 2001 that permits public school teachers and administrators to return to their jobs up to full-time status while retaining pension and health care benefits. If an educator has fully retired, he or she may return either part time or full time on a year-by-year basis once they have been retired at least 30 days. As of November 2001, over 500 individuals are participating in the program, which was implemented to help relieve a shortage of teachers, clerical staff, and administrators. State lawmakers were concerned that retired teachers were simply taking up new positions at private schools or accepting teaching jobs out of state (Pohlig 2001).

### **Part III: Concluding Remarks**

To promote gradual retirement whereby older workers may receive a partial pension together with current wages (from working less) would require a major change in Social Security and occupational pension programs. It would also require changing attitudes on the part of employers and workers themselves. However, gradual retirement arrangements can have many salubrious effects, including easing the concern over the extension of the normal retirement age. Gradual retirement via part-time jobs potentially is compatible with health promotion, caregiving, and volunteering, self-actualization activities, not to mention the benefits to society through continued work by those older without necessarily competing against younger people for full-time employment. Moreover, we argue that opportunities for gradual retirement should be made available to as large a spectrum of workers as possible. In other words, this policy change should aim to popularize, universalize, and democratize a practice that is heretofore only available to higher-paid white-collar professionals.

In order to bring about a major shift in employment practices and retirement income arrangements such as what we are advocating here, combined efforts by employers, unions, government, as well as workers themselves will be required. It is not an easy task, but the payoff for individuals and society can be quite substantial.

---

<sup>14</sup> The example is based on an informational document that was supplied to the author and is entitled "Cornell University Phased Retirement Program for Endowed Faculty," dated May 2, 2000.

## References

- Burtless, G., and J. F. Quinn. 2001. "Retirement Trends and Policies to Encourage Work among Older Americans." In *Ensuring Health and Income Security for an Aging Workforce*, ed. Peter P. Budetti et al., 375–415. Kalamazoo, MI: W. E. Upjohn Institute for Employment Research.
- Calhoun, C. V. 2000. "DROP/Phased Retirement Arrangements, 457 Matches, and Other Current Trends in Governmental Plans." Presentation Materials Prepared for the ALI/ABA Program for Retirement, Deferred Compensation, and Welfare Plans of Tax-Exempt and Governmental Employers, September 15, Washington, D.C.
- Dau, S. L. 2000. Testimony on behalf of the National Rural Electric Cooperative Association before the Senate Special Committee on Aging on Employment of Older Workers, April 3, Washington, D.C.
- Ehrenberg, R. G. 2001. "The Survey of Changes in Faculty Retirement Policies." American Association of University Professors,  
<http://www.aaup.org/newweb/Issues/retirement/retrpt.htm>.
- Ghilarducci, T. 2001. "Commentary." In *Ensuring Health and Income Security for an Aging Workforce*, ed. Peter P. Budetti et al., 439–47. Kalamazoo, MI: W. E. Upjohn Institute for Employment Research.
- William M. Mercer. 2001. *Gradual Retirement and the Changing Face of Retirement*, New York: William M. Mercer.
- Meyer, S. 2000. Testimony on behalf of Hy-Vee, Inc., before the Senate Special Committee on Aging on Employment of Older Workers, April 3, Washington, D.C.
- Perkins, J. 2000. Testimony on behalf of AARP before the Senate Special Committee on Aging on Employment of Older Workers, April 3, Washington, D.C.

- Pohlig, C. 2001. "Law Helps Teachers Shift from Retired to Rehired." *Seattle Times*, November 26, [http://seattletimes.nwsource.com/html/localnews/134370965\\_retire-rehire26m.html](http://seattletimes.nwsource.com/html/localnews/134370965_retire-rehire26m.html).
- Pransky, G. 2001. "Living Longer, but Able to Work?" In *Ensuring Health and Income Security for an Aging Workforce*, ed. Peter P. Budetti et al., 431–38. Kalamazoo, MI: W. E. Upjohn Institute for Employment Research.
- Rappaport, A. M. 2001. "Employer Perspective on Retirement Trends and Policies to Encourage Work among Older Americans." In *Ensuring Health and Income Security for an Aging Workforce*, ed. Peter P. Budetti et al., 417–29. Kalamazoo, MI: W. E. Upjohn Institute for Employment Research.
- Shopp, W. 2000. Testimony on behalf of the Association of Private Pension and Welfare Plans before the Senate Special Committee on Aging on Employment of Older Workers, April 3, Washington, D.C.
- Social Security Administration 2002 Income of the Population 55 or Older. Office of Policy, Office of Research, Evaluation, and Statistics, SSA Publication No. 13-11871. March.
- Society for Human Resources Management. 1999. *1999 Benefits Survey*. Washington, D.C.: Society for Human Resources Management.
- Watson Wyatt Worldwide. 1999. *Phased Retirement: Reshaping the End of Work*. Washington, D.C.: Watson Wyatt Worldwide.

**Table 1**  
**Sources of Income, 1962–2000, Selected Years**

Year	Social Security	Asset Income	Occupational Pensions*	Employment Income	Public Assistance
1962	69%	54%	18%	36%	14%
1967	86	50	22	27	12
1971	87	49	23	31	10
1976	89	56	31	25	11
1978	90	62	32	25	9
1980	90	66	34	23	10
1982	90	68	35	22	8
1984	91	68	38	21	9
1986	91	67	40	20	7
1988	92	68	42	22	7
1990	92	69	44	22	7
1992	92	67	45	20	7
1994	91	67	42	21	6
1996	91	63	41	21	6
1998	90	63	43	21	5
2000	90	59	41	22	5

\*Includes private pensions or annuities, government employee pensions, Railroad Retirement, and Individual Retirement Accounts, Keogh plans, and 401(k) accounts.

*Source:* Social Security Administration, 2002, Table 1.1.

**Table 2**

**Shares of Income from Various Sources, 1962–2000, Selected Years**

Year	Social Security	Asset Income	Occupational Pensions*	Employment Income	Public Assistance
1962	31%	16%	9%	28%	16%
1967	34	15	12	29	10
1976	39	18	16	23	4
1978	38	19	16	23	4
1980	39	22	16	19	4
1982	39	25	15	18	3
1984	38	28	15	16	3
1986	38	26	16	17	3
1988	38	25	17	17	3
1990	36	24	18	18	3
1992	40	21	20	17	3
1994	42	18	19	18	3
1996	40	18	19	20	3
1998	38	20	19	21	2
2000	38	18	18	23	1

\* Includes private pensions or annuities, government employee pensions, Railroad Retirement, and Individual Retirement Accounts, Keogh plans, and 401(k) accounts.

*Source:* Social Security Administration 2002, Table 7.1.

**Table 3**  
**Shares of Income, by Quintiles of Total Income**

Source	Lowest	Second	Third	Fourth	Highest
Total Percentage	100	100	100	100	100
Social Security	82	80	64	45	18
Pensions*	3	7	15	24	20
Asset income	2	6	10	14	28
Earnings	1	3	7	13	31
Public Assistance	10	2	1	**	**
Other	2	2	3	3	2

\* Includes private pensions and annuities, government employee pensions, Railroad Retirement, and IRA, Keogh, and 401(k) payments.

\*\* Less than 0.5%.

*Note:* Percentages may not sum to 100 because of rounding.

*Source:* Social Security Administration, 2002. Table 7.5.