Accounting for Social Security claiming behavior*

Svetlana Pashchenko†
University of Georgia

Ponpoje Porapakkarm‡
National Graduate Institute for Policy Studies

September 24, 2022

Abstract

Why most people claim Social Security benefits early? And why early claimers tend to work less? We investigate the role of preferences and institutions in claiming decisions using a structural framework. A claiming decision represents an annuitization problem, which is linked to labor supply through the Social Security earnings test. We find that this test is distortive and conceals the true size of the early claiming (or annuity) puzzle: without it, even more people would claim early. We show that this unwillingness to annuitize can be explained by combining the impatience and bequest motives in various degrees. We suggest the empirical strategy to disentangle the effects of these preferences and uniquely pin down their relative contribution. In our policy analysis, we find that rewarding claiming delay with lump-sum payments combined with the removal of the earnings test produces large welfare gains.

Keywords: Social Security, Retirement, Annuities, Consumption and Saving, Life-Cycle Model

JEL Classification Codes: D91, G11, G22

*Pashchenko acknowledges the financial support from the Center of Retirement Research at Boston College through the Sandell Grant. Porapakkarm acknowledges the financial support through the Policy Research Grant from GRIPS. We thank all seminar participants at the Household Dynamics at Older Ages Conference (Federal Reserve Bank of Richmond), Annual Meetings of the National Tax Association, Society for the Advancement of Economic Theory, Society of Economic Dynamics, Virtual Australian Macro Seminar, and the University of Kyoto.

†Email: svetlanap.econ@gmail.com

‡Email: p-porapakkarm@grips.ac.jp

1 Introduction

People in the US can start receiving their Social Security benefits several years before or after the full retirement age (FRA), between the ages of 62 and 70. There are two interesting facts about claiming behavior, which are hard to explain by the program incentives. First, around two-thirds of people claim before reaching the FRA, and hardly anyone claims after that. Yet, early claiming is penalized, while late claiming is rewarded, with the rewards and penalties being large and permanent. Second, the fraction of workers among early claimers is much lower than that among late claimers. Yet, there is no rule necessitating working and claiming decisions to be linked.

Our goal in this paper is to understand the observed patterns in claiming behavior. Previous literature examining claiming decisions look at this problem from two perspectives. The first view, mostly taken in empirical literature, emphasizes the parallel between claiming decisions and annuitization problem (e.g., Shepard, 2011; Shoven et al., 2017). The second view, mostly taken in structural work, emphasizes the role of claiming in labor supply/retirement decisions in the end of working life (e.g., Imrohoroglu and Kitao, 2012; Rust and Phelan, 1997). We unite the two perspectives by considering the claiming behavior as a labor supply linked annuitization problem using a structural framework. We argue that this unified perspective is important in order to fully understand claiming decisions.

Claiming decisions represent annuitization problem because choosing the age when to collect pensions is equivalent to deciding how much (if any) annuity income to purchase. Every year of delay results in an increase in pension benefits, i.e., additional lifetime annuity income, while the 'price' of this public annuity is one year of foregone benefits. In this light, early claiming represents low (public) annuity demand. This is consistent with the well-known annuity puzzle, the robust empirical finding that people are unwilling to acquire (private) annuities.

Importantly, the (public) annuitization problem is linked to labor supply. This is because the available annuitization options depend on labor earnings through the Social Security earnings test. As an example, an individual who claims benefits at the earliest possible age of 62 (and thus chooses the minimum possible amount of public annuities) but who continues working may be 'forced' to acquire additional annuities since his current benefits will be withheld and future benefits re-adjusted as if he claimed at a later age.

We develop a rich quantitative framework with the aim of not only understanding the mechanisms behind the observed claiming behavior, but also to gain new insights about the general unwillingness to annuitize. The unwillingness to annuitize is usually attributed to a combination of market frictions, institutions, and preferences. However, the relative

importance of these factors is hard to disentangle given that neither preferences nor the actual "size" of market frictions are observable.[1] In the context of public annuities with compulsory and nearly universal participation, we can abstract from frictions common to private insurance markets. We can thus focus on the role of institutions and preferences, and further investigate the distinct role of different types of preferences.

To estimate the model, we use three datasets: the Health and Retirement Study (HRS), the Medical Expenditure Panel Survey (MEPS), and the Panel Study of Income Dynamics (PSID). Our estimated model is consistent with three sets of important facts. First, it captures the wealth dynamics and labor supply over the life-cycle. Second, it matches the distribution of individuals by claiming age, as well as the fact that early claimers work less compared to late claimers. Finally, it captures the behavioral response of people to the change in the Social Security rules.

Our estimated model delivers three sets of important results. Our first set of results relates to the role of preferences. We show that two forces play an important role in claiming decisions: impatience and desire to leave a bequest. This is because annuity payments are long-term and life-contingent. Thus, their valuation depends on the planning horizon and thus on the subjective discount rate, as well as on how much resources people want to transfer to the state when they are not alive, and thus on bequest motives.

Importantly, we show that it is possible to explain the public annuity puzzle by combining the impatience and bequest motives in various degrees. In order to pin down the contribution of each force, it is important to jointly account for claiming and saving decisions. This is because both low rate of time preferences and strong bequest motives decrease annuity demand but for different reasons. Impatient people want to have low savings in any type of assets, while people with strong bequest motives want to have more savings but less life-contingent assets. Thus, taking into account not only demand for public annuities but also regular savings allows us to assess the contribution of different preferences to the claiming puzzle.

Another way to read this result is that combining claiming and saving decisions can strengthen the identification of important preference parameters. A common approach in structural studies is to estimate both discount factor and bequest motives from wealth moments. However, since regualr savings respond similarly to the change in these parameters, it is difficult to identify them separately (see discussion of this issue in De Nardi et al., 2016; and Lockwood, 2018). We show that claiming decisions are very sensitive to the assumed degree of impatience and thus can be combined with wealth moments to acquire additional

[1] For example, Einav et al. (2010) stress the problem of distinguishing to what extent the observed outcomes in insurance markets are due to adverse selection versus consumers' preferences.

identifying information.

Our second set of results relates to the role of the institutions in public annuity demand. We study the role of two important institutional features: the price of Social Security annuity and the earnings test. We find that claiming decisions are very responsive to the difference between the break-even rate of the Social Security annuity (the interest rate which equates its present value to its price) and the subjective rate of time preferences. The smaller is this difference, the larger is claiming delay. This mechanism is similar to the impatience effect described in Carroll (1997): the gap between subjective and market discount rates is an important driver of people's regular savings. We show that the gap between annuity break-even rate and time preferences is an important driver of annuity demand.

Turning to the Social Security earnings test, we find that it conceals the true size of the public annuity puzzle: without this test, the number of early claimers would be much higher. For example, the percentage of people claiming at the earliest eligibility age of 62 would be 77% without the earnings test while it is 46% in the baseline economy (and in the data). Among workers, many claim later not because they want to acquire more public annuities but because their choices of claiming early are limited: were they to claim early, their benefits would be withheld and returned at the FRA, essentially re-setting their claiming age. Once the earnings test is removed, many choose to claim as early as possible.

Importantly, the earnings test also distorts labor supply: its removal would noticeably increase the fraction of workers between the ages of 62 and 64. The distorting effects of the earnings test on labor supply may seem puzzling since this is not a real tax: the benefits are temporary withheld and are paid back to people at the FRA. While it is oftentimes conjectured that people do not fully understand the earnings test rules and treat it as a regular income tax (see, for example, Benitez-Silva and Heiland, 2006), we find another mechanism at play. Many early claimers reduce their labor supply to avoid being forced to change their annuitization choice. In other words, the distorting effects of the earnings test on labor supply is due to the strong unwillingness to annuitize.

Our third set of results concerns the policy implications. We consider three institutional changes that take the strong unwillingness to annuitize into account: the removal of the earnings test, rewarding claiming delay with lump-sum payments instead of additional annuities, or both policies combined. We implement each policy in an expenditure-neutral way, i.e., we fix the Social Security spending as in the baseline economy. We find that combining the removal of the earnings test with lump-sum payments produces the largest welfare gains across the three considered policies with the average 61-year old person's gains being equivalent to 1.43% of annual consumption.

We contribute to the literate in three important ways. First, we show that a quantitative

life-cycle model can account for the observed claiming behavior, and clearly illustrate though which mechanisms it can do so. Importantly, while our model is rich in terms of representing the risks and institutional environment, it is parsimonious in a sense that we do not introduce preferences heterogeneity, pessimistic beliefs about the future of Social Security or any form of irrational/misinformed behavior.

Second, we provide a detailed investigation of the role preferences and institutions in explaining claiming behavior. Moreover, we show that our approach allows us to disentangle the role of two important preference parameters to the annuity puzzle: impatience versus bequest motives.

Third, we show that analyzing claiming decisions as a joint annuitization/labor supply problem improves our understanding of different aspects of claiming behavior. Specifically, we show that the Social Security earnings test causes distortions in both labor supply and claiming behavior. This happens not because people mistakenly consider the test as a real tax, but because it interferes with their unwillingness to annuitize.

The rest of this paper is organized as follows. Section 2 reviews the related literature. Section 3 introduces the model, while Section 4 explains our estimation. The results and conclusions are presented in Section 5 and 6, respectively.

2 Literature review

We relate to several strands of literature. First is the literature studying the so-called early claiming puzzle. The prevalence of early claiming has been considered as a puzzle since a number of studies conclude that people can gain from delaying claiming (Coile et al., 2002; Meyer and Reichenstein, 2010; Shoven and Slavov, 2014a and 2014b; Sun and Webb, 2009). Both empirical and structural approaches were used in order to examine this puzzle.

Empirical studies investigating what affects claiming decisions find that people who claim early tend to have low subjective survival probability (Hurd et al., 2004), are less educated (Venti and Wise, 2004), and have lower income (Armour and Knapp, 2021). At the same time, there is no strong relationship between early claiming and such factors as gender (Shoven and Slavov, 2014a, 2014b) or financial difficulties (Armour and Knapp, 2021, Goda et al., 2015). Shepard (2011) derives a set of conditions that can be used to empirically test the importance of bequest motives and nursing home shocks in claiming decisions. He argues that these factors cannot explain the early claiming puzzle, while pointing out that he assumes relatively high discount factor. Using a fully specified structural model, we illustrate the interdependence of the effects of bequest motives and discount factor on claiming decisions.

Structural literature studying early claiming puzzle goes back to Gustman and Steinmeier (2005) who were the first to point out that a standard life-cycle model cannot account for the observed claiming behavior. Since then, two approaches were shown to be able to better reconcile the model and the data. The first approach is to introduce uncertainty about the future of Social Security or the misunderstanding of Social Security rules by retirees. Benitz-Silva et al. (2009) construct a full life-cycle model with uncertainty in wages, health and life expectancy and show that in order to account for the large number of early claimers, the model has to also feature a risk that the benefits will be cut in the future. Gustman and Steinmeier (2015) arrive to a similar conclusion. They consider a richer version of Gustman and Steinmeier's (2005) model with stochastic returns on assets and more flexible labor supply, but find it still falls short of capturing a large fraction of individuals claiming as early as possible; however, varying beliefs about the future of Social Security can substantially improve the fit of the model along this dimension. Bairoliya and McKiernan (2021) construct a rich life-cycle model with heterogeneity in education and marital status, and show that an important mechanism helping to explain early claiming is that people underestimate the resulting reduction in benefits.

The second approach taken in the structural literature on early claiming puzzle is to assume people claim at different ages due to difference in preferences. Maurer et al. (2021) construct a partial life-cycle model where individuals differ in their preferences along several dimensions. The authors estimate these preference parameters separately for early and late claimers. Their results imply that early claimers have lower risk aversion, higher preferences for leisure and intertemporal elasticity of substitution, and lower discount rate.

We contribute to this line of research by showing that a rich structural model where claiming is considered as a joint labor supply/annuitization problem can capture the observed claiming pattern, including the prevalence of early claiming and almost no claiming after the FRA. Importantly, we show that it is possible to account for claiming behavior in a relatively standard framework, i.e., without assuming that early and late claimers have different preferences, or that people are uncertain about the future of Social Security, or misinformed about Social Security rules.

The second strand of related literature study the annuity puzzle. A standard life-cycle model predicts that people should annuitize all of their wealth (Yaari, 1965). A large literature emerged trying to explain why only few people buy annuities in reality. The lack of willingness to annuitize has been attributed to market frictions (Brugiavini, 1993, Finkelstein and Poterba, 2004, Mitchell et al., 1999, Pashchenko, 2013), various institutional features, including out-of-pocket medical expenses, (Dushi and Webb, 2004, Reichling and Smetters, 2015, Turra and Mitchell, 2008), and preferences (Lockwood, 2012). We contribute to this

literature by analyzing the public annuity puzzle, which allows us to abstract from market frictions and better examine the role of preferences and institutions.

The third strand of literature we relate to studies the choice individuals make between annuities and lump-sum payouts available in some institutional settings or using survey evidence. Several studies using the data from natural experiments in the US find that people prefer lump-sum payments to annuities (Warner and Pleeter, 2001; Mottola and Utkus, 2007; Fitzpatrick, 2015). More closely related to ours are the studies that compare lump-sum versus annuity options with application to Social Security pensions. Brown et al. (2008) analyze the results of the survey in the experimental module in 2004 HRS. In this module, people were asked whether they would be willing to exchange their pension benefits for actuarially fair lump-sum transfers and three out of five respondents answered they would prefer a lump-sum option. Maurer et al. (2018) and Maurer and Mitchell (2021) consider strategic survey questions using the American Life Panel (ALP) and 2014 HRS datasets, respectively. The questions asked specifically about the willingness to delay claiming in the situation when the delay is rewarded with annuities versus when the reward comes as lump-sum transfers. The first study finds that, on average, people would delay claiming by half a year when offered a lump-sum option, while the second study finds that the fraction of late claimers under the lump-sum scenario would increase by 10 percentage points.

Methodologically, we relate to structural studies with endogenous retirement and claiming decisions. This type of models have been widely used to study various aspects of Social Security reforms, such as how to achieve sustainability (Jones and Li, 2022, Imrohoroglu and Kitao, 2012), or the effects of changing the taxation of Social Security benefits (Jones and Li, 2018). In another two interesting applications, French and Jones (2011) study the relative effects of Medicare versus Social Security eligibility ages, while Keane and Wasi (2016) examine the labor supply elasticities over the life-cycle.

3 Baseline Model

In this section, we develop a life-cycle model with three distinct stages: working period when people are still not eligible to receive pensions, intermediate period when people can continue working or retire, while choosing when to claim benefits, and retirement stage when they no longer work. In our model, people face several sources of uncertainty, that in survival, health, medical spending and labor productivity.

3.1 Demographics and preferences

A model period is one year. Individuals enter the model at age 25 and can live at most until age 99. Until age R^E they make labor supply and consumption/saving decisions, between ages R^E and R^D they also decide when to start collecting Social Security pension benefits, after age R^D individuals cannot work and only make consumption/saving decisions. An individual survives between ages t and $t+1$ with probability ζ_t^h that depends on his age t and health h_t.

Individuals are ex-ante different in their fixed productivity type (ξ) which can take three discrete values: $\xi_1 < \xi_2 < \xi_3$. Fixed productivity type affects one's labor earnings and the evolution of health. This is a parsimonious way to capture heterogeneity in fixed ex-ante characteristics (childhood circumstances, genetics, etc.) that affect both health and labor market outcomes as documented in a number of empirical studies (see De Nardi et al., 2022, for an extensive review).

An individual is endowed with one unit of time that can be used for either leisure $\widetilde{l}_t$ or work l_t, where $0 \leq l_t \leq \bar{l}$. Work brings disutility modeled as a fixed cost of leisure ϕ_w. In addition, people who stopped working and then re-enter employment incur additional age-dependent fixed re-entry costs ϕ_{P_t}, which capture labor market frictions. Since our particular focus is on labor supply in the end of working life, and to reduce computational costs, we assume that $\phi_{P_t} = 0$ for people younger than 60 years old, and $\phi_{P_t} = \overline{\phi}_P$ for all $t \geq 60$.[2] The leisure of an individual can thus be represented as:

$$\widetilde{l}_t = 1 - l_t - \phi_w \mathbf{1}_{\{l_t>0\}} - \phi_{P_t} \mathbf{1}_{\{l_{t-1}=0 \,\cap\, l_t>0\}}.$$

In this formulation, $\mathbf{1}_{\{.\}}$ is an indicator function which is equal to one if its argument is true.

An individual derives utility from consumption c_t and leisure $\widetilde{l}_t$, and the utility flow can be defined as follows:

$$u(c_t, \widetilde{l}_t) = c_t^{\chi} \, \widetilde{l}_t^{1-\chi},$$

where χ is the relative weight of consumption in the consumption-leisure composite.

In our formulation of individual preferences, we do not impose the restriction that risk aversion should be equal to the inverse of the intertemporal elasticity of substitution (IES). Instead, we adopt Epstein-Zin preferences (Epstein and Zin, 1989).[3] This gives us the

[2] Adding re-entry costs is computationally costly since we need to keep track of the labor market status in the previous period as a state variable.

[3] We do this to better capture savings decisions over the life-cycle (we provide more details in Section 4.3). Our key results do not change when we use the expected utility preferences, as we show in Appendix H.

following recursive formulation:

$$U_t = \left[u\left(c_t, \widetilde{l}_t\right)^{1-\gamma} + \beta \left\{ \zeta_t^h E_t U_{t+1}^{1-\psi} + (1-\zeta_t^h)\eta(k_{t+1}+\phi_B)^{\chi(1-\psi)} \right\}^{\frac{1-\gamma}{1-\psi}} \right]^{\frac{1}{1-\gamma}},$$

where ψ is the risk-aversion, $1/\gamma$ is the intertemporal elasticity of substitution (IES), and β is the discount factor. The second term in this equation represents the certainty equivalent which combines future utility when alive and when dead. The latter utility is derived from leaving a bequest in the amount k_{t+1}, and is governed by two parameters: η is the strength of the bequest motive and ϕ_B is the shift parameter which determines to what extent bequests are luxury goods. In this formulation of the bequest function, we follow De Nardi (2004).

3.1.1 Health, medical expenses and labor income

People face health and medical expenses uncertainty. At age t, one's health condition h_t can be either good or bad, $h_t \in \{G, B\}$, where h_t evolves according to a type- and age-dependent Markov process, $\mathcal{H}_t(h_t|h_{t-1}, \xi)$. Health affects productivity, medical expenses, and survival probability.

Each period an agent faces a stochastic out-of-pocket medical expenditure shock x_t^h which depends on his age and health; we denote the probability distribution of medical shocks as $\mathcal{G}_t(x_t^h)$. Individuals after a certain age are also exposed to the risk of needing long-term care; these shocks arrive with age- and health-dependent probability pn_t^h. An agent who needs to move to a nursing home has to pay an out-of-pocket cost of xn_t.

One's labor income y_t is determined as follows:

$$y_t = z_t^h l_t$$

where z_t^h is the idiosyncratic productivity:

$$z_t^h = \lambda_t^h \exp(\varsigma_t) \exp(\xi) \tag{1}$$

Productivity has three componenets: (i) λ_t^h is the deterministic component that depends on age and health; (ii) ς_t is the stochastic shock, (iii) ξ is the fixed productivity type.

We assume that the stochastic part of productivity ς_t is composed of a persistent shock v_t and an iid shock ν_t:

$$\varsigma_t = v_t + \nu_t,$$

where:

$$v_t = \rho v_{t-1} + \varepsilon_t, \quad \varepsilon_t \sim N(0, \sigma_\varepsilon^2) \tag{2}$$
$$\nu_t \sim N(0, \sigma_\nu^2)$$

3.1.2 Taxes, transfers, and Social Security

There are three types of taxes in the model economy. First is the progressive income tax $\mathcal{T}(y^{tax})$, where taxable income y^{tax} includes labor and capital income, and a taxable part of Social Security benefits $y^{ss_{tax}}$. Second are Medicare (τ_{MCR}) and Social Security (τ_{ss}) payroll taxes. The Social Security payroll tax rate for earnings above $\overline{y}_{ss}$ is zero. Third is the Social Security earnings tax, paid by some workers who already claimed benefits. The latter differs from other taxes since the amount taxed away is paid back to an individual once he reaches the FRA, as we explain in more details below.

The government provides two types of transfers: means-tested and pension benefits. Means-tested transfers T_t^{SI} guarantee each individual the minimum consumption level $\underline{c}$, and they target people impoverished by a combination of low earnings and high medical expenses. This safety net is a reduced form representation of the existing public transfer programs such as food stamps, Supplemental Security Income, disability insurance, and uncompensated care.

After reaching the age R^E, people can choose to receive pension benefits $ss(AE, j, j^R, mon)$. These benefits represent a concave function of the average lifetime earnings (AE), with possible additional adjustments depending on the current age (j), the age when the benefits were first claimed $\left(j^R\right)$ and the number of months benefits were withheld due to the Social Security earnings tax (mon). We explain each of the arguments of the benefit function $ss(AE, j, j^R, mon)$ in turn.

The evolution of average earnings AE used to determine pension benefits is approximated as follows:

$$AE_{t+1} = \begin{cases} AE_t + \dfrac{y_{ss_t}}{35} & ;\ \text{if } t < 60 \\ AE_t + \dfrac{1}{35}\max\left\{0, y_{ss_t} - AE_t\right\} & ;\ \text{otherwise,} \end{cases} \tag{3}$$

where $y_{ss_t} = \max\left\{y_t, \overline{y}_{ss}\right\}$. Note that over the 35-year period from age 25 to 60, AE_t is updated every period, while after age 60 it is updated only if the current earnings exceed the average of previous earnings.[4]

The basic level of Social Security benefits ss^b corresponding to the full retirement age

[4] The Social Security benefits are a function of the average earnings of the 35 years with the highest earnings. We use a simplified version of this rule because otherwise we have to keep track of the entire previous earnings history as additional state variables, which makes our computation infeasible.

$\left(j^R = R^F\right)$ is calculated as follows:

$$ss^b = \begin{cases} 0.9AE_t & ; \text{ if } \ AE_t < b_1 \\ 0.9b_1 + 0.32(AE_t - b_1) & ; \text{ if } \ b_1 \leq AE_t < b_2 \\ 0.9b_1 + 0.32(b_2 - b_1) + 0.15(AE_t - b_2) & ; \text{ if } \ AE_t \geq b_2, \end{cases} \tag{4}$$

where b_1 and b_2 are the bend points, i.e., the levels of AE_t when the replacement rate changes first from 0.9 to 0.32, then from 0.32 to 0.15.

The actual benefits can be lower or higher than ss^b depending on the claiming age. We denote the adjustments to the basic level of benefits as $adj(j^R)$, where $adj(R^F) = 1$. The adjustments for our baseline cohort are displayed in the first row of Table 3 in Section 4.5. Thus, a person who has never been subject to the Social Security earnings tax receives benefits $adj(j^R)ss^b$. For a person whose benefits were partially withheld due to the earnings test, rules are more complex, as we explain below.

People who are younger than the FRA and who receive Social Security benefits but continue to work are subject to the Social Security earnings test, i.e., part or all of their benefits can be withheld. We denote the amount withheld (which is also the earnings tax amount) as T^{earn}.[5]

Importantly, the withheld benefits go towards increasing individual's benefits starting from the FRA. The adjustment of benefits due to the earnings tax is done as follows. Consider an individual who claims at age j^R and is entitled to receive benefits $adj(j^R)ss^b$ annually, or $adj(j^R)ss^b/12$ monthly. If he is subject to the earnings tax, part T^{earn} of his benefits is withheld. Social Security continues paying him monthly benefits in the amount $adj(j^R)ss^b/12$ but only for a part of the year, keeping track of the number of months the benefits were not paid. The accumulated number of months the benefits are withheld from age j^R to $R^F - 1$ are computed as follows:

$$mon_{t+1} = mon_t + \frac{T^{earn}}{adj(j^R)ss^b} \times 12. \tag{5}$$

Once an individual reaches the FRA, the penalty for early claiming will be offset at the rate of 5/9% per accumulated month of withheld benefits. For example, if an individual claims at 62 but has all of his benefits withheld every year until he reached the FRA, starting from that age his benefits will be the same as if he first claimed at the FRA.

[5] Starting from 2000, the Social Security earning tax for individuals who reach the FRA was abolished.

We can thus summarize the Social Security benefit function $ss(AE, j, j^R, mon)$ as follows:

$$ss(AE, j, j^R, mon) = \begin{cases} \left(adj(j^R) + \frac{5}{9}\frac{mon}{100}\right) \times ss^b & ; \text{ if } j^R < R^F \text{ and } j \geq R^F \\ adj(j^R) \times ss^b & ; \text{ otherwise.} \end{cases} \tag{6}$$

3.1.3 Timing in the model

The timing in the model is as follows. In the beginning of the period, individuals learn their productivity and health status. Based on this information, an individual decides his labor supply (l_t). An individual who is older than age R^E also decides whether to claim Social Security benefits. We denote the claiming decision as i_t^C; $i_t^C = 1$ if an individual claims benefits and $i_t^C = 0$ otherwise. Afterward, the out-of-pocket medical shock (x_t^h) is realized; for individuals older than age R^D the nursing home shock (xn_t) is realized. At the very end of the period, consumption/saving decisions are made. An individual who reaches age R^D and has yet to claim benefits must claim benefits. Individuals after age R^D only make consumption/saving decisions.

3.1.4 Optimization problem

Individuals younger than the earliest claiming age $\left(t < R^E\right)$. The state variables for an individual younger than age R^E at the beginning of each period are capital (k_t), health ($h_t \in \{G, B\}$), fixed productivity type ($\xi \in \{\xi_1, \xi_2, \xi_3\}$), idiosyncratic labor productivity $\left(z_t^h\right)$, average lifetime earnings (AE_t), and age (t). For those aged 60 or older, there is an additional state variable l_{t-1}, labor supply in the previous period. We denote the vector of state variables of an individual of age t as $\mathbb{S}_t$. The value function of an individual in this age range can be written as follows:

$$V_t(\mathbb{S}_t) = \max_{l_t} \left\{ \sum_{x_t^h} \mathcal{G}_t\left(x_t^h\right) W_t(\mathbb{S}_t; l_t, x_t^h)^{1-\psi} \right\}^{\frac{1}{1-\psi}} \tag{7}$$

where

$$W_t(\mathbb{S}_t; l_t, x_t^h) = \max_{c_t, k_{t+1}} \left\{ \begin{array}{c} u\left(c_t, \widetilde{l}_t\right)^{1-\gamma} + \\ \beta\left[\zeta_t^h E_t\left(V_{t+1}(\mathbb{S}_{t+1})\right)^{1-\psi} + (1-\zeta_t^h)\eta\left(k_{t+1} + \phi_B\right)^{\chi(1-\psi)}\right]^{\frac{1-\gamma}{1-\psi}} \end{array} \right\}^{\frac{1}{1-\gamma}} \tag{8}$$

subject to

$$k_t\left(1 + r\right) + y_t + T_t^{SI} = k_{t+1} + c_t + x_t^h + Tax \tag{9}$$

$$T_t^{SI} = \max\left(0, \underline{c} + x_t^h + Tax - k_t\left(1+r\right) - y_t\right) \tag{10}$$

$$Tax = \mathcal{T}\left(y_t^{tax}\right) + \tau_{ss}\min\left(y_t, \overline{y}_{ss}\right) + y_t\tau_{MCR} \tag{11}$$

$$y_t^{tax} = k_t r + y_t, \tag{12}$$

The conditional expectation on the right-hand side of Eq.(8) is over z_{t+1}^h and h_{t+1}. Eq.(9) is the budget constraint. Eq.(10) describes the means-tested transfers that provide the minimum consumption guarantee $\underline{c}$. In Eq.(11), the first term is the income tax and the last two terms are payroll taxes. Eq.(12) describes the taxable income. The evolution of AE_t is described in Eq.(3).

Individuals older than the earliest claiming age but younger than the latest claiming age $\left(R^E \leq t < R^D\right)$ and who has yet to claim benefits. An individual in this age range has to decide whether to claim Social Security benefits or not. His value function can be written as follows:

$$V_t(\mathbb{S}_t) = \max_{l_t, i_t^C}\left\{\sum_{x_t^h}\mathcal{G}_t\left(x_t^h\right)W_t^E(\mathbb{S}_t; l_t, i_t^C, x_t^h)^{1-\psi}\right\}^{\frac{1}{1-\psi}}$$

$$W_t^E(\mathbb{S}_t; l_t, i_t^C = 0, x_t^h) = \max_{c_t, k_{t+1}}\left\{\begin{array}{c} u\left(c_t, \widetilde{l}_t\right)^{1-\gamma} + \\ \beta\left[\zeta_t^h E_t\left(V_{t+1}(\mathbb{S}_{t+1})\right)^{1-\psi} + (1-\zeta_t^h)\eta\left(k_{t+1}+\phi_B\right)^{\chi(1-\psi)}\right]^{\frac{1-\gamma}{1-\psi}}\end{array}\right\}^{\frac{1}{1-\gamma}}$$

$$W_t^E(\mathbb{S}_t; l_t, i_t^C = 1, x_t^h) = \max_{c_t, k_{t+1}}\left\{\begin{array}{c} u\left(c_t, \widetilde{l}_t\right)^{1-\gamma} + \\ \beta\left[\zeta_t^h E_t\left(V_{t+1}^C(\mathbb{S}_{t+1}, t, mon_{t+1})\right)^{1-\psi} + (1-\zeta_t^h)\eta\left(k_{t+1}+\phi_B\right)^{\chi(1-\psi)}\right]^{\frac{1-\gamma}{1-\psi}}\end{array}\right\}^{\frac{1}{1-\gamma}}$$

subject to

$$k_t\left(1+r\right) + y_t + ss(AE, t, t, 0)\mathbf{1}_{\{i_t^C=1\}} + T_t^{SI} = k_{t+1} + c_t + x_t^h + Tax \tag{13}$$

$$T_t^{SI} = \max\left(0, \underline{c} + x_t^h + Tax - k_t\left(1+r\right) - y_t - ss(AE, t, t, 0)\mathbf{1}_{\{i_t^C=1\}}\right) \tag{14}$$

$$Tax = \mathcal{T}\left(y_t^{tax}\right) + \tau_{ss}\min\left(y_t, \overline{y}_{ss}\right) + y_t\tau_{MCR} + T^{earn}\mathbf{1}_{\{i_t^C=1\}} \tag{15}$$

$$y_t^{tax} = k_t r + y_t + y_t^{ss_{tax}}\mathbf{1}_{\{i_t^C=1\}} \tag{16}$$

$$mon_{t+1} = \frac{T^{earn}}{ss(AE, t, t, 0)} \times 12 \tag{17}$$

Note that the interim value function W_t^E takes different forms depending on whether an individual claims benefits or not; in the former case, there will be another two state variables next period: age at which he begins collecting benefits and number of months benefits were withheld due to the Social Security earnings tax. Eq.(13) includes the Social Security benefits $ss(AE, t, t, 0)$ for individuals who claim (i.e., $i_t^C = 1$). Eq.(15) includes a Social Security earnings tax for individuals who are younger than the FRA and who claimed benefits but continue working. The taxable income in Eq.(16) can include taxable part of the Social Security benefits $y^{ss_{tax}}$. Eq.(17) is the number of months pension benefits were withheld due to the Social Security earnings tax.

Individuals older than the earliest claiming age but younger than the latest claiming age $\left(R^E \leq t < R^D\right)$ and who already claimed benefits. An individual in this category has two additional state variables: j^R, the age at which he started collecting benefits, and mon_t, the number of months benefits were withheld due to the Social Security earnings tax. The value function of an individual in this category can be written as follows:

$$V_t^C(\mathbb{S}_t, j^R, mon_t) = \max_{l_t}\left\{\sum_{x_t^h}\mathcal{G}_t\left(x_t^h\right)W_t^C(\mathbb{S}_t, j^R, mon_t; l_t, x_t^h)^{1-\psi}\right\}^{\frac{1}{1-\psi}}$$

$$W_t^C(\mathbb{S}_t, j^R, mon_t; l_t, x_t^h) = \max_{c_t, k_{t+1}}\left\{\begin{array}{c} u\left(c_t, \widetilde{l}_t\right)^{1-\gamma} + \\ \beta\left[\zeta_t^h E_t\left(V_{t+1}^C(\mathbb{S}_{t+1}, j^R, mon_{t+1})\right)^{1-\psi} + (1-\zeta_t^h)\eta\left(k_{t+1}+\phi_B\right)^{\chi(1-\psi)}\right]^{\frac{1-\gamma}{1-\psi}} \end{array}\right\}^{\frac{1}{1-\gamma}}$$

subject to

$$k_t(1+r) + y_t + ss(AE_t, t, j^R, mon_t) + T_t^{SI} = k_{t+1} + c_t + x_t^h + Tax \tag{18}$$

$$T_t^{SI} = \max\left(0, \underline{c} + x_t^h + Tax - k_t(1+r) - y_t - ss(AE_t, t, j^R, mon_t)\right) \tag{19}$$

$$Tax = \mathcal{T}\left(y_t^{tax}\right) + \tau_{ss}\min\left(y_t, \overline{y}_{ss}\right) + y_t\tau_{MCR} + T^{earn} \tag{20}$$

$$y_t^{tax} = k_t r + y_t + y_t^{ss_{tax}} \tag{21}$$

For an individual subject to the earnings test, the dynamics of the number of months benefits were withheld is described in Eq.(5). For workers in this group, AE_t can still increase as described in Eq.(3).

Individuals after age R^D. An individual older than age R^D only makes consumption/saving decisions and his state variables are capital (k_t), health (h_t), average lifetime earnings (AE), age when he first claimed benefits (j^R), the number of months benefits were withheld due to Social Security earnings tax, $\left(mon^R\right)$, and age (t). Denote the vector of state variables as $\mathbb{S}_t^R$. The value function of an individual in this age range can be written as follows:

$$V_t^R(\mathbb{S}_t^R) = \left\{ \sum_{x_t^h}\sum_{xn_t} \mathcal{G}_t\left(x_t^h\right)\ pn_t^h W_t^R(\mathbb{S}_t^R; x_t^h, xn_t)^{1-\psi} \right\}^{\frac{1}{1-\psi}}$$

where

$$W_t^R(\mathbb{S}_t^R; x_t^h, xn_t) = \max_{c_t, k_{t+1}} \left\{ \begin{array}{c} u\left(c_t, \widetilde{l}_t\right)^{1-\gamma} + \\ \beta\left[\zeta_t^h E_t\left(V_{t+1}^R(\mathbb{S}_{t+1}^R)\right)^{1-\psi} + (1-\zeta_t^h)\eta\left(k_{t+1}+\phi_B\right)^{\chi(1-\psi)}\right]^{\frac{1-\gamma}{1-\psi}} \end{array} \right\}^{\frac{1}{1-\gamma}}$$

subject to:

$$k_t\left(1+r\right) + ss(AE, t, j^R, mon^R) + T_t^{SI} = k_{t+1} + c_t + \mathcal{T}\left(y_t^{tax}\right) + x_t^h + xn_t$$

$$T_t^{SI} = \max\left(\ 0, \underline{c} + \mathcal{T}\left(y_t^{tax}\right) + x_t^h + xn_t - k_t\left(1+r\right) - ss(AE, t, j^R, mon^R)\ \right)$$

$$y_t^{tax} = k_t r + y_t^{ss_{tax}}$$

Note that the interim value function W_t^R is conditional on the realization of the out-of-pocket medical spending shock x_t^h and the nursing home shock xn_t.

4 Model estimation

In this section, we explain our strategy to estimate the model parameters, describe the estimation results, and illustrate the fit of the model to the data. For our estimation, we combine information from the three datasets: the Panel Study of Income Dynamics (PSID), the Medical Expenditure Panel Survey (MEPS), and the Health and Retirement Study (HRS). In all three datasets, we select a sample of male individuals. Our base cohort are people born around 1937. For the external validation, we use cohort born around 1947. We use 2002 as the base year, and all level variables are normalized to the base year using the Consumer Price Index (CPI). We report more detail about these data sets, our samples, and how we use them in Appendix A.

We adopt a two-step estimation strategy. In the first step, we set or estimate directly from the data the parameters related to demographics, taxes, Social Security benefits, survival, health, medical expenses, and labor productivity. We fix the interest rate r at 2%. Given the parameters and the shock processes from the first step, we implement the Method of Simulated Moments to estimate our remaining model parameters.

4.1 First step estimation

4.1.1 Health, survival, medical expense and nursing home shocks

To construct our health measure, we use self-reported health status, which is coded as excellent,very good, good, fair and poor. We classify a person as healthy or in good health ($h_t = G$) if he reports being in the first three categories, and we classify him as unhealthy or in bad health ($h_t = B$) otherwise. This way to convert self-reported health into a binary health measure is common in the literature (see, for example, French, 2005; Capatina, 2015).

We estimate health transitions from the PSID. Since in our model, health transitions depend on productivity type ξ, we start by estimating the fixed productivity. We do this by running a fixed effect regression of log labor income on a set of age dummy variables interacted with health. We define the three productivity types in our sample based on the terciles of the estimated fixed effects distribution. We then model the probability to move to health status h_{t+1} conditional on surviving as a logit model which depends on: (i) age polynomial degree three interacted with the dummy variable for the current health status, (ii) dummy variables for the three productivity types, (iii) cohort dummy variables, where cohort is defined based on a 5-year interval for birth year. Our estimated health transitions corresponding to 1937 cohort are reported in the top panel of Figure 1, which shows that high-productivity types are more likely to be in good health.

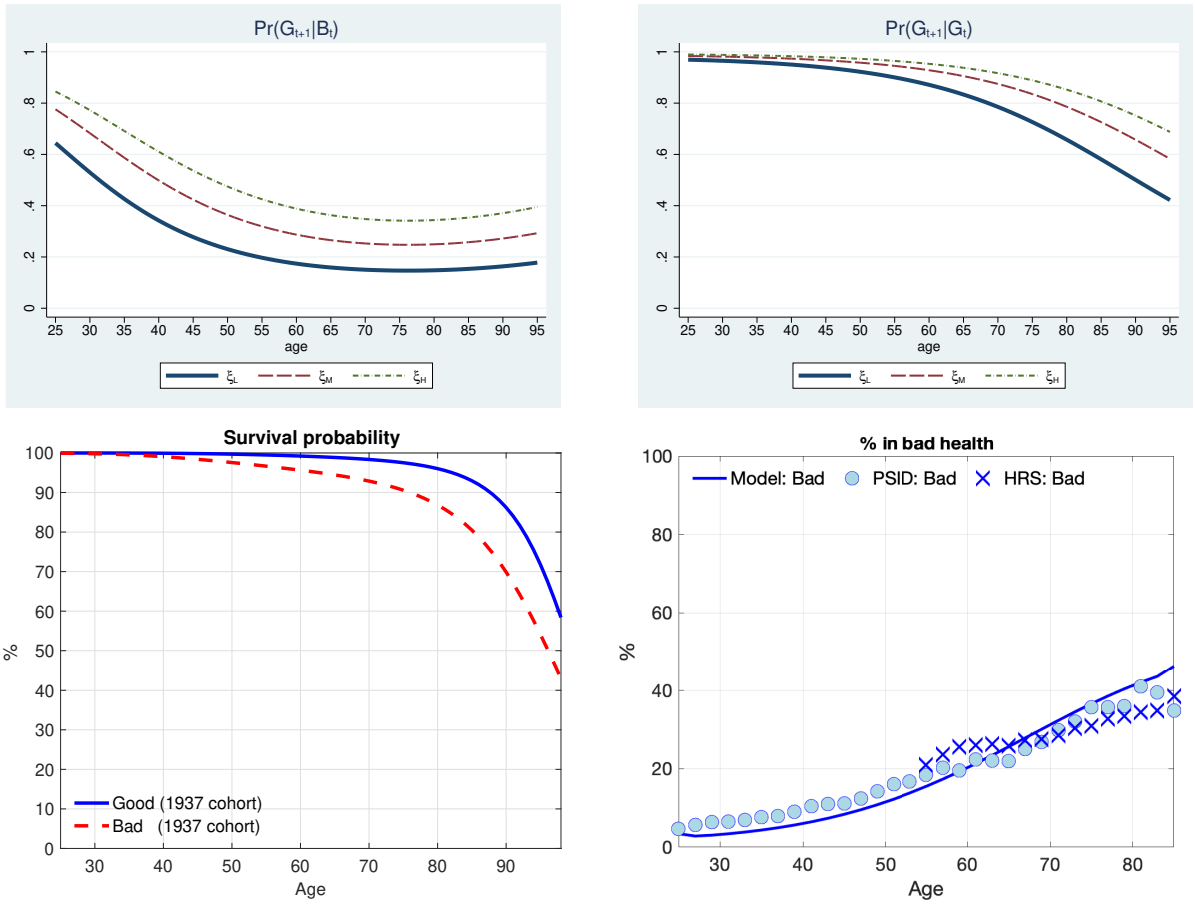


Figure 1: Top panel: probability to be in good health if currently in bad (left) and good health (right), for people with three different productivity types ξ. Bottom left panel: survival probability by health. Bottom right panel: fraction of people in bad health.

We estimate the survival probability from the HRS. We do so by specifying the logit model for the two-year survival probability which depends on (i) the age polynomial degree two interacted with the current health status, (ii) 5-year birth cohort dummy variables. We take a square root of our estimates to convert them into one-year survival probabilities. The estimated survival probabilities for 1937 cohort is reported in the bottom left panel of Figure (1). The bottom right panel of the same figure reports the percentage of people in bad health implied by our estimates of health transitions and survival probabilities, and compares it with the data.

Medical expenses in our model correspond to the out-of-pocket medical expenditures in the MEPS dataset. We assume that medical expense shock is a 3-state discrete health- and age-dependent stochastic process. To estimate this shock, we first regress out-of-pocket medical spending on a set of age dummy variables interacted with health, and cohort dummy variables. Using the estimates, we can reconstruct medical spending for our base cohort. Then, for each age and health status, we divide the resulting medical expenses into three

groups: below the median, between the 50th and 95th percentile of the distribution, and above the 95th percentile. We then compute the average expenses for each group, and smooth it with age polynomial degree two.[6] Appendix B.1 contains more details about the estimation and also includes the plot of the resulting out-of-pocket medical shock in Figure (12).

We estimate the risk of incurring a nursing home shock (pn_t^h) from the HRS by computing the percentage of individuals who report staying in a nursing home in each interview round separately for males in good and bad health. Since the HRS is a biennnial survey, we convert these numbers into annual probabilities by taking a square root. To compute the average nursing home costs, we multiply the number of nights for nursing home stays reported in the HRS by the average daily rate for a semiprivate room in a nursing home. We provide more details on how we estimate the probability to enter a nursing home and the nursing home costs in Appendix B.1. Our resulting estimates are plotted in Figure (13) in the same appendix.

4.1.2 Labor productivity

To estimate the deterministic component λ_t^h of individual idiosyncratic productivity we proceed as follows. In our model, the average labor income of full-time workers is $\lambda_t^h \bar{l}$. We thus use a sample of full-time workers in PSID, defined as people working at least 2000 hours per year, and estimate the following regression:

$$y_{it} = d^y_{age} D^{age}_{it} \times D^h_{it} + d^y_c D^c_i + \epsilon^y_{it}, \tag{22}$$

where y_{it} is labor income; D^{age}, D^h, and D^c is the set of age, health, and 5-year birth cohort dummy variables, and ϵ^y_{it} is the component orthogonal to age, health and cohort. Using our estimates, we compute labor income for our base cohort:

$$\hat{y}_{it} = \hat{d}^y_{age} D^{age}_{it} \times D^h_{it} + \hat{d}^y_{j^c}(D^c_i = 1937) + \hat{\epsilon}^y_{it},$$

After computing the average $\hat{y}_{it}$ for each age and health group, we take log and use age polynomial degree two to smooth our estimates. We plot the estimated $log(\lambda_t^h \bar{l})$ in Figure (14) in Appendix B.2.

For the stochastic productivity, we set the parameters based on the incomplete market literature (Storesletten et al., 2004). For the AR(1) part, we set ρ and σ^2_ε to 0.984 and 0.022, respectively. For the iid part, we set σ^2_ν to 0.057. The fixed productivity ξ has a

[6] The MEPS tends to underestimate aggregate medical expenditures (Pashchenko and Porapakkarm, 2016a). To correct for this, we multiply our estimated medical expenses by 1.60.

normal $N(0, \sigma_\xi^2)$ distribution with σ_ξ^2 equal to 0.242. In our computation, we discretize the AR(1) and iid shock processes using 9 and 2 gridpoints, respectively. We discretize the fixed productivity distribution into three equal mass points.

4.1.3 Parameters related to the tax system and Social Security

For the progressive income taxation, we parameterize the tax function $\mathcal{T}(y)$ following Gouveia and Strauss (1994):

$$\mathcal{T}(y) = a_0 \left[y - (y^{-a_1} + a_2)^{-1/a_1} \right]$$

As in Gouveia and Strauss (1994), we set a_0 and a_1 to 0.258 and 0.768, respectively. We set the parameter a_2 to 0.616 following Pashchenko and Porapakkarm (2016b). We set the Medicare and Social Security taxes to 2.9 percent and 12.4 percent, respectively. The maximum taxable income for Social Security ($\overline{y}_{ss}$) is set to \$76,200.

We use all Social Security rules applied to our baseline 1937 cohort. The full retirement age for this group is 65 years ($R^F = 65$).[7] The earliest age an individual can start receiving benefits (R^E) is 62 and the latest age the benefits can be claimed (R^D) is 70.

We set the bend points, b_1 and b_2, at which the replacement rate for Social Security benefits changes in Eq.(4) to \$6,372 and \$38,424, respectively. To obtain these numbers, we use the bend points corresponding to monthly values, and multiply them by 12 to get annual values.

The benefit adjustments for early/late claiming reported in the first row of Table 3 are based on the following rates. The benefits of early claimers are reduced by 6.7% per year (or 5/9% per month) for ages between 62 and 65. Individuals who claim benefits after the FRA get their basic benefits increased by 6.5% for every year up to age 70.

To determine the taxable part of the Social Security benefits ($y^{ss_{tax}}$), we denote as $\widehat{y}_t$ the sum of labor and capital income, and as $\widehat{ss}^b$ the pension benefits net of the Social Security earnings tax. Then the taxable Social Security income can be written as follows:

$$y^{ss_{tax}} = \begin{cases} 0 & ;\text{ if } \ \widehat{y}_t + 0.5\widehat{ss}^b < b_3 \\ \min\left(0.50 \times \widehat{ss}^b, 0.5\left(\widehat{y}_t + 0.5\widehat{ss}^b - b_3\right)\right) & ;\text{ if } \ b_3 \leq \widehat{y}_t + 0.5\widehat{ss}^b < b_4 \\ \min\left(0.85 \times \widehat{ss}^b, 0.5\,(b_4 - b_3) + 0.85\left(\widehat{y}_t + 0.5\widehat{ss}^b - b_4\right)\right) & ;\text{ if } \ \widehat{y}_t + 0.5\widehat{ss}^b \geq b_4 \end{cases} \quad (23)$$

[7] In our estimation, we target the claiming behavior of those born between 1936 and 1938. The full retirement age of 1936 and 1937 cohorts is 65 years while it is 65 years and 2 months for individuals born in 1938.

The threshold levels b_3 and b_4 are set to \$25,000 and \$34,000, respectively.

The Social Security earning tax T^{earn} that affects working early claimers is determined as follows:

$$T^{earn} = \begin{cases} 0 & ; \quad \text{if } y_t < b_5 \text{ or } t \geq R^F \\ \min\left(ss^b, \ \frac{y_t - b_5}{2}\right) & ; \quad \text{otherwise} \end{cases},$$

Note that for people whose earnings exceed an exempt amount b_5, \$1 of benefits is withheld for every \$2 of earnings in excess of the exempt amount. The exempt amount is set to \$10,080.

4.1.4 Remaining first-step parameters

We set the risk aversion (ψ) to 4. We set the consumption share in the utility function (χ) to 0.5, which is within the range estimated by French (2005). We set the labor supply when working full-time $\bar{l}$ to 0.4. We assume that labor supply of people younger than age 60 is indivisible, $l_t \in \{0, 0.4\}$. For those aged 60 and above, we allow for more flexible working hours to capture possible bridge jobs and gradual retirement, and set $l_t \in \{0, 0.1, 0.2, 0.3, 0.4\}$.

4.2 Second step estimation

At the second step, we estimate the following parameters: disutility from work, fixed re-entry costs, discount factor, IES, bequest parameters and the consumption minimum floor, $\{\phi_w, \overline{\phi}_P, \beta, \gamma, \eta, \phi_B, \underline{c}\}$. In our estimation, we minimize the unweighted sum of squared differences between the simulated and data moments. Our targeted moments are described below.

Labor market outcomes We use three moments related to labor market outcomes. We target the fraction of workers among the unhealthy for two age groups: 35-39 and 60-64. These two moment are marked by thick dots in the left panel of Figure 2. To construct employment profiles for our base cohort, we use the PSID where we define a person as employed if he works at least 520 hours per year, and earns at least the federal minimum wage. We estimate a logit model of employment which depends on a set of age dummy variables interacted with health, and 5-year birth cohort dummy variables. In addition, we target the flow from the state of being non-employed to that of being employed in the age group 62-69 in the PSID. This targeted moment is displayed in Table 2.

Wealth moments We use nine moments related to wealth. The first two are the 25^{th} and 75^{th} percentiles of the wealth distribution for people between the ages of 65 and 69. The other seven moments are the levels of median wealth for people in 5-year age groups between the ages 45-49 and 75-79.

To construct our wealth moments, we use net worth from the PSID (1994, 1999-2017). We first normalize the net worth by using the OECD household equivalent scale. Denoting the resulting normalized variable nw, we run the regression on a set of age and cohort dummy variables:

$$nw_{it} = d^{nw}_{age} D^{age}_{it} + d^{nw}_{c} D^{c}_{i} + \epsilon^{nw}_{it}, \tag{24}$$

where ϵ^{nw}_{it} is the component orthogonal to age and cohort. Using our estimates we compute net worth for our base cohort:

$$\hat{nw}_{it} = \hat{d}^{nw}_{age} D^{age}_{it} + \hat{d}^{nw}_{j^c} (D^{c}_{i} = 1937) + \hat{\epsilon}^{nw}_{it},$$

Our estimated wealth moments are plotted as dots in the right panel of Figure 2.

Claiming behavior We target the fraction of people claiming at the earliest claiming age of 62. This moment is displayed in Figure (3), first bar. To construct the distribution by claiming age, we use a sample of males born between 1936-1938 in the HRS who do not receive disability benefits.

4.3 Second step estimation results

The third column of Table 1 reports our estimated preference parameters and consumption floor. The discount factor plays an important role in decisions to claim benefits as early as possible and we discuss this in more details in Section 5.1. Our estimated discount factor is 0.926, which implies the rate of time preferences of 8%. Structural and macroeconomic studies typically identify the discount factor from aggregate/average wealth holdings (e.g., Guvenen, 2007, Krueger and Perri, 2005, Storesletten et al., 2004) or from the evolution of median wealth or consumption over the life-cycle (e.g., Cagetti, 2003, Gourinchas and Parker, 2002). The resulting rate of time preference is usually estimated to be lower than ours, 5% or less. However, studies that exploit other features of the data oftentimes find that people are less patient. For example, the estimates of the rate of time preferences are 11% in Carroll and Samwick (1997), 19% in Lockwood (2018), and 12% in Laibson et al. (2018). These studies' targeted moments are the wealth response to the degree of uncertainty in permanent income, wealth holdings of the poor, and credit card borrowing data,

respectively.

Parameters		Epstein-Zin preference
Risk aversion	ψ	4.0
Discount factor	β	0.926
1/IES	γ	1.667
Bequest parameter	ϕ_B	\$114,141
"	η	3.85×10^7
Consumption floor	$\underline{c}$	\$3,573

Table 1: Preference parameters and the consumption floor.

Our estimated IES noticeably differs from the inverse of the risk aversion: while risk aversion is fixed at 4, the inverse of the IES is 1.667. IES is identified mainly from the shape of the median wealth profiles. In Appendix H, we estimate a version of our model where we restrict the inverse of IES to be equal to risk aversion and then include risk aversion in the set of parameters estimated at the second step. Two important conclusions from considering the estimated model with regular CRRA preferences are as follows. First, the estimated risk aversion is 3.96, which is close to 4, the number set in our baseline estimation. Second, the CRRA model performs worse in capturing the wealth profiles, and this is the primary reason we have chosen to work with Epstein-Zin preferences.[8]

The estimated bequest parameters η and ϕ_B, which have a strong impact on the wealth accumulated by retirement time, are identified from moments of wealth distribution at ages 65-69. In a one-period consumption-saving model, our estimated values imply that the bequest motive becomes operational at an asset level of \$6,550 and the marginal propensity to bequeath (MPB) is 0.946. In other words, people with assets below \$6,550 would not leave bequests, while people with assets above \$6,550 would leave around 94.6 cents out of every additional dollar for bequests. To put this in perspective, Lockwood (2018) estimated the MPB and the bequest threshold of 0.96 and \$14,665 (in 2002 dollars), respectively, while De Nardi et al. (2016) find values of MPB and the threshold equal to 0.78 and \$3,268, respectively. We explain in more details how we compute the MPB and thresholds and compare them across studies in Appendix C.

The estimated consumption floor, which is identified from targeting the employment of the unhealthy between the ages of 35 to 39, is \$3,573. This estimate is consistent with those from other structural life-cycle models with uncertain medical expenses and endogenous labor supply: Capatina's (2015) estimate of the consumption floor is \$4,114 (in 2006 USD), and De Nardi et al. (2022) estimate is \$3,505 (in 2013 USD).

[8] The extended discussion of why Epstein-Zin preferences can better capture wealth profiles over the life-cycle is provided in Pashchenko and Porapakkarm (2019).

The estimated disutility from work ϕ_w and fixed re-entry costs $\overline{\phi}_P$ are equal to 0.27 and 0.20. These parameters are mainly identified from the employment of the unhealthy in the age group 60-64 and the flow from non-employment to employment in the age group 62-69, respectively.

4.4 Model fit

The left panel of Figure 2 compares the employment rate generated by our model (solid lines) with the profiles from the PSID (dots). Even though we used as targeted moment two points on this graph, employment of the unhealthy in the age groups 35-39 and 60-64 (marked by thick dots on the graph), our model well tracks the data along the entire working period. Table 2 compares the flows from non-employment to employment (NE) and from employment to non-employment (EN) in our model and in the PSID. Our model is able to capture the targeted NE moment.

The right panel of Figure (2) displays the wealth profiles from our model (solid line) and the PSID (dots), and shows that the model well tracks the median as well as the 25th and the 75th percentile of the wealth distribution over the life-cycle. Our model ia also able to capture the fraction of asset-poor people, the non-targeted moment. The percentage of people above the age of 45 who have assets below \$1,000 is 8.6% in the model, and 8.3% in the data.

The left panel of Figure (3) compares the claiming behavior in our model and in the data for 1937 cohort. In our estimation, we target the percentage of individuals in this cohort who start collecting Social Security benefits as early as possible (at age 62) but the model is able to capture the overall pattern of claiming as well.

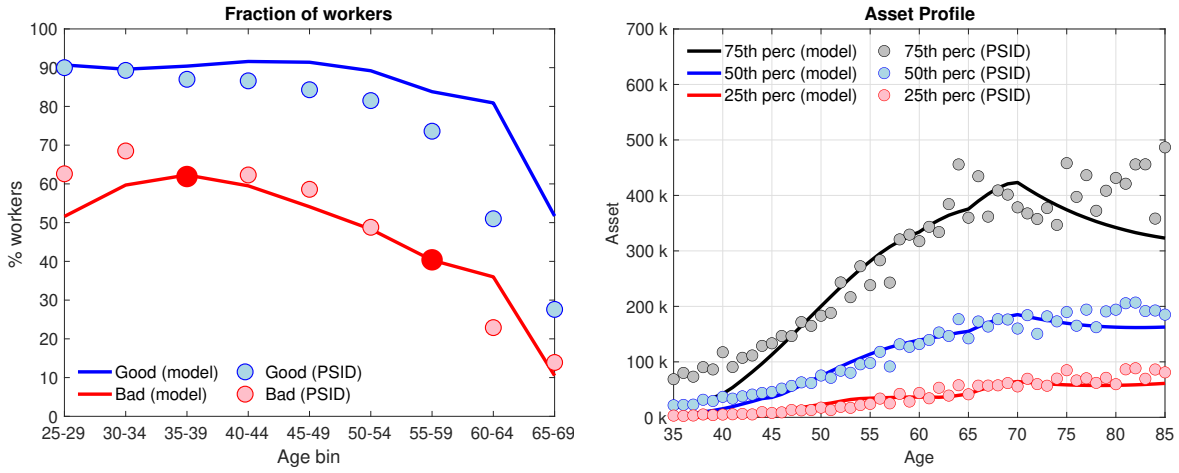


Figure 2: Left panel: employment by age. Right panel: wealth profiles by age.

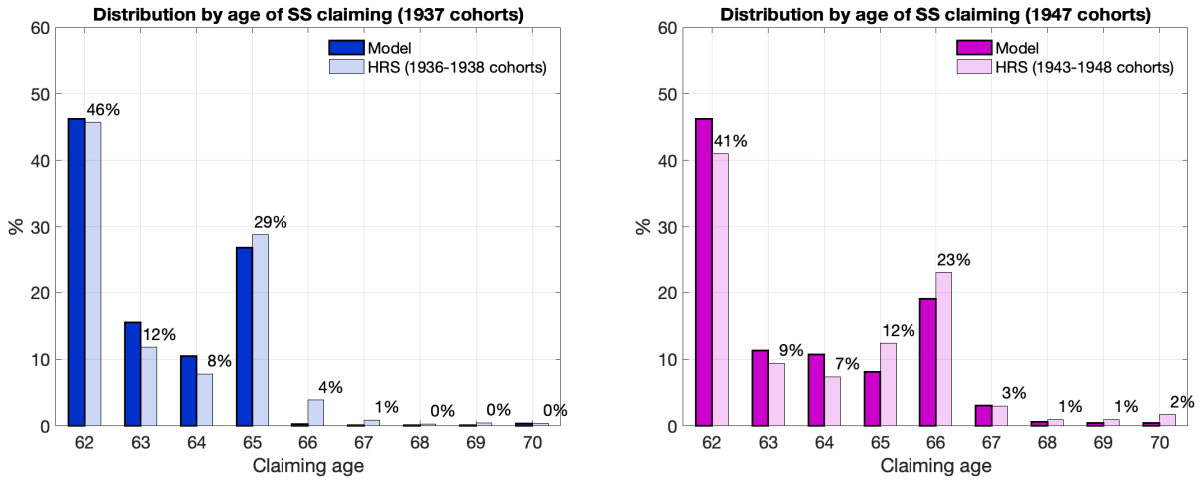


Figure 3: Distribution by claiming age. Left panel: baseline cohort, 1937. Right panel: external validation, 1947 cohort.

Age group	Model		Data (PSID)	
	not work ⇒ work	work ⇒ not work	not work ⇒ work	work ⇒ not work
62-69	4%	17%	4%	29%

Table 2: Employment dynamics

4.5 Additional validation

As an external validation, we consider how our model captures two additional aspects of the data, which were not targeted in our estimation. First, we evaluate the model's predictions about the claiming response to the change in benefit rules. Second, we consider how early and late claimers differ in terms of their income and assets in our model and in the data.

To see how well our model can capture the behavior of people who face different Social Security rules, we replace the baseline benefit schedule with that faced by a younger 1947 cohort. The schedule of penalties/rewards for early/late claiming for this cohort is displayed in the third row of Table 3, while the second row shows the schedule for our baseline cohort.[9]

The right panel of Figure 3 shows the distribution by claiming ages for 1947 cohort in the data and that predicted by our model when we change the Social Security rules to those

[9] The cohort born in 1947 also faces slightly different rules regarding the Social Security earnings test. This difference concerns the adjustments of benefits at the FRA for people whose benefits were partially withheld due to the earnings test. For both 1937 and 1947 cohorts, the adjustment is based on the accumulated number of months benefits were withheld (*mon*). For 1947 cohort the penalty for early claiming is reduced by $\frac{5}{9}\%$ per accumulated month for the first 36 months and $\frac{5}{12}\%$ per accumulated month in excess of 36 months. Note that for 1937 cohort, the accumulated months can never exceed 36 since their FRA is 65 years old.

Age	62	63	64	65	66	67	68	69	70
Cohort 1937 (FRA=65)									
% of full benefits	80%	86.7%	93.3%	100%	106.5%	113%	119.5%	126%	132.5%
Cohort 1947 (FRA=66)									
% of full benefits	75%	80%	86.7%	93.3%	100%	108%	116%	124%	132%

Table 3: Reduction (increase) in benefits for early (late) claiming as a percentage of the benefits received at the full retirement age.

faced by this cohort. Our model closely tracks the data, and the following is worth noting. The FRA for 1947 cohort is 66 years old as opposed to 65 years old for our baseline cohort, and our model can capture the overall shift in claiming to older ages and the marked increase in claiming at age 66.

Our model also captures the important differences between early and late claimers. Figures 4 and 5 report the median wealth and working status by age of claiming benefits. The figures show that people who claim at 62-64 versus those who claim at 65-69 differ in their wealth holdings and in their labor supply. Specifically, late claimers have more assets and are more likely to work, which is true both for 1937 and 1947 cohorts. Our model matches these additional features of the data well. Capturing these aspects of the data is important to understand claiming decisions and to proceed to policy evaluations.

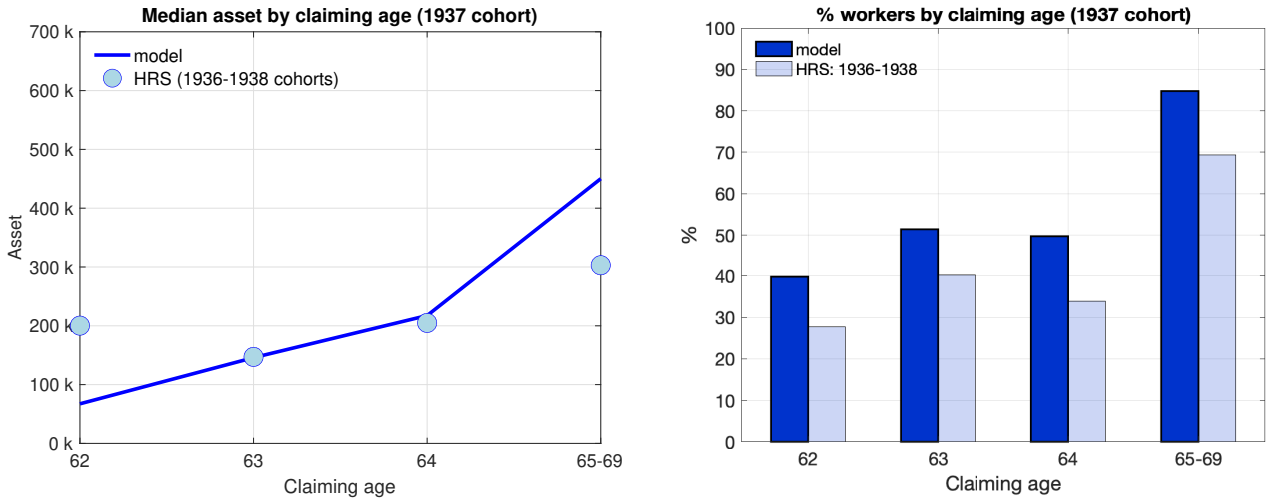


Figure 4: Median wealth and the percentage of working claimers by claiming age (1937 cohort, FRA at 65)

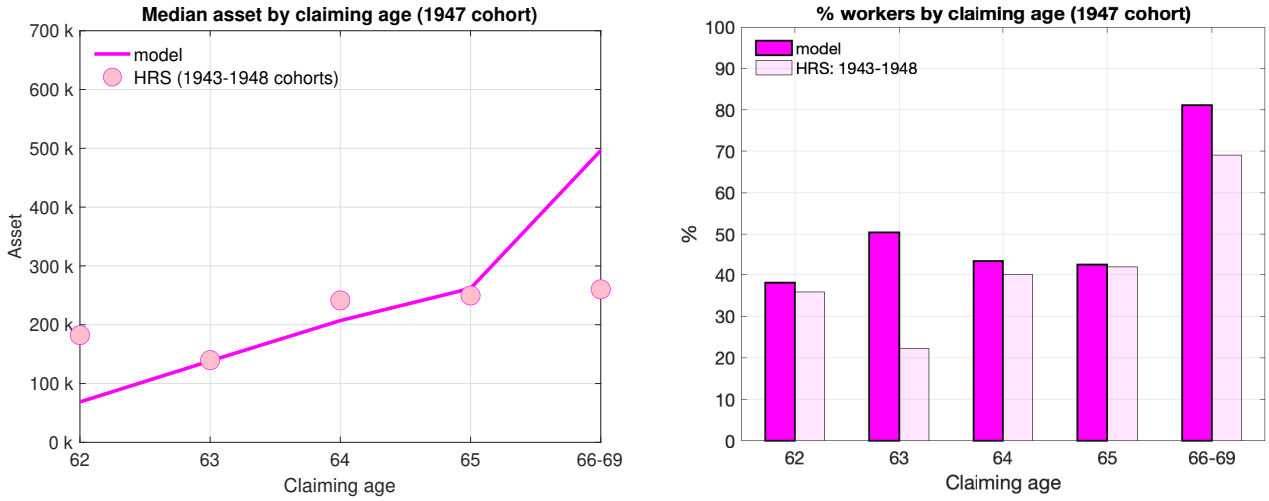


Figure 5: Median wealth and the percentage of working claimers by claiming age (1947 cohort, FRA at 66)

5 Results

In this section, we use our estimated life-cycle model to deliver several interesting results. We start by analyzing the role of preferences in low demand for public annuity, and then evaluate the role of the institutional environment. Finally, we consider policy implications.

5.1 Role of preferences

As we show in the previous section, to simultaneously account for the targeted moments, our estimated model has to feature a relatively low rate of time preferences and relatively strong bequest motives. Our goal in this section is to understand the relative importance of these preferences for the demand for public annuity.

Both impatience and bequest motives are important for annuitization decisions. Annuities represent long-term life-contingent investments, and their valuation depends on the planning horizon, as well as on how much resources people want to transfer to the state when they are not alive. It is thus possible to generate low annuity demand by combining the impatience and bequest motives in various degrees.[10]

To illustrate this, we consider several versions of our quantitative model that vary in the strength of bequest motives, measured as the marginal propensity to bequeath (MPB), while keeping the bequest threshold unchanged. In each version, we fix the MPB at the level that is 1, 2 or 3% higher or lower than our estimated MPB of 0.946. Our goal is to trace the relationship between the MPB and discount factor that can account for both claiming and labor supply decisions. We thus re-estimate the parameters $\{\phi_w, \overline{\phi}_P, \beta, \underline{c}\}$ by targeting moments related to claiming and labor market outcomes (see Section 4.2). We use the bequest parameters η and ϕ_B to obtain the fixed level of the MPB and the baseline value of the threshold. We thus no longer include wealth in our targeted moments, and the IES is fixed at the baseline level. Each estimated model is able to well capture the targeted moments, among them, the fraction of early claimers. The resulting combinations of discount factors and MPB are plotted in the left panel of Figure 6. The estimates of other parameters for each version of the model are reported in Appendix E.

Each point on the line in the left panel of Figure 6 corresponds to the model that fully accounts for the public annuity puzzle. The line has a positive slope because when bequest motives become stronger, annuity demand goes down and more people claim at age 62. To restore the fraction of early claimers as in the data, the discount factor has to increase.

As an example, we compare two points on the graph, A and B. Point A corresponds to the

[10] It is important to point out that even though we use the non-expected utility preferences, we can still interpret the discount factor β as measuring impatience. We illustrate this in Appendix D.

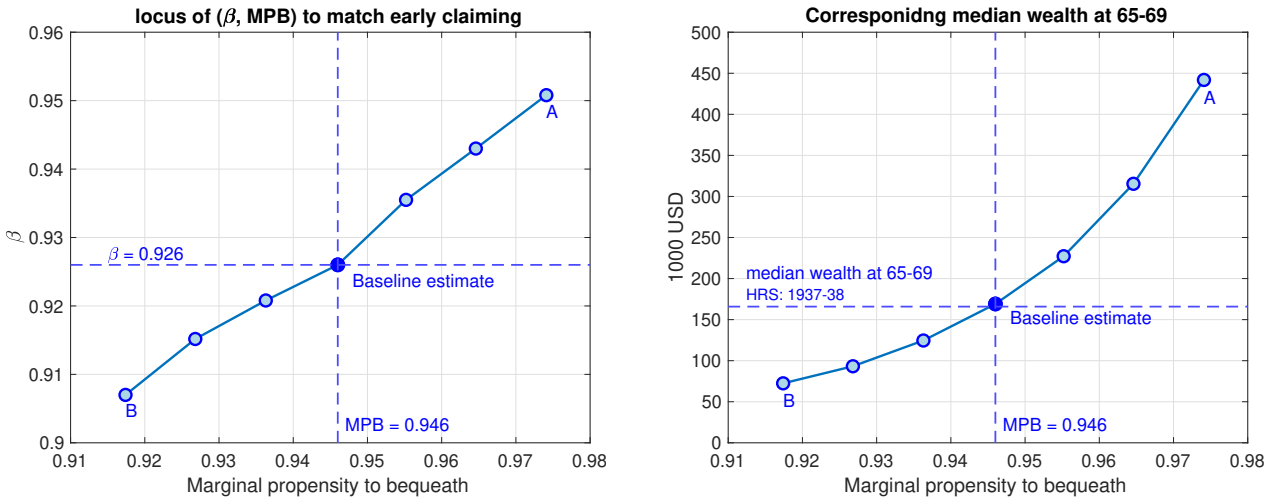


Figure 6: Left panel: combinations of β and MPB that can capture claiming behavior. Right panel: the median wealth at ages 65-69 corresponding to the preference combinations in the left panel.

model where people are more patient and have stronger desire to leave bequests compared to our baseline, while point B corresponds to the model where people are less patient and have weaker bequest motives. Both preferences combinations can well capture the empirical distribution by claiming age (left panels of Figure 7), yet the relative importance of the impatience and bequest motives in shaping these decisions differ.

This exercise illustrates the difficulty of disentangling the role of bequest motives and impatience when accounting for the low annuity demand. In order to pin down the contribution of each force, it is important to use additional features of the data, specifically, wealth moments. The right panel of Figure 6 plots the median wealth for ages 65 to 69 predicted by the estimated models corresponding to each point in the left panel of the same figure, and compares it with the HRS (horizontal dashed line). The median wealth over the entire life-cycle for models at points A and B are plotted in the right panels of Figure 7. An important observation from these figures is that the model with low MPB/low discount factor under-predicts the median wealth, while the model with high MPB/high discount factor over-predicts it, even though both correctly predict claiming and employment decisions.

This result shows that while different combinations of MPB and discount factor can account for claiming decisions, only one combination can *simultaneously* account for claiming and wealth accumulation. This is because lower discount factor makes people desire less saving and less annuities, while stronger bequest motives make them want more savings but less annuities. Our estimation strategy exploits this mechanism to infer the relative importance of these preferences.

Another way to view this result is that using information on both claiming and wealth accumulation can strengthen the identification of important preference parameters. It is

common to use wealth moments to identify both bequest parameters and discount factor. However, it is hard to uniquely pin down the values of these parameters from using wealth moments alone since regular savings respond similarly to changes in both parameters. The issue of separately identifying bequest and discount factor is discussed in De Nardi et al., (2016), while Lockwood (2018, online appendix) discusses the weak identification of the discount factor. Our results suggest that the demand for public annuities complement the information contained in wealth data in an important way and can be used to distinguish between different forces shaping people's decisions.

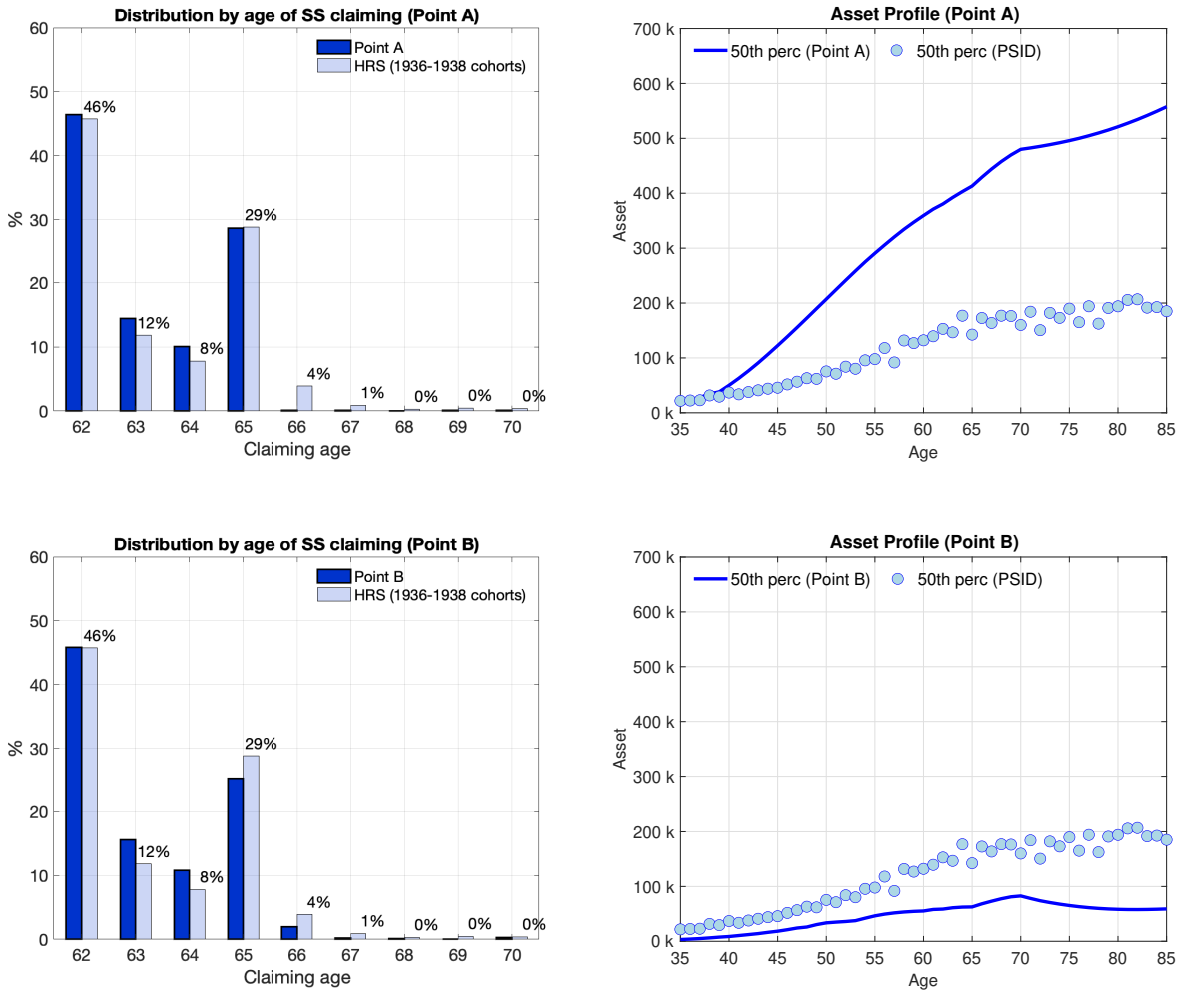


Figure 7: Distribution by claiming ages and median wealth profiles for combinations of β and the MPB at Points A and B in Figure 6.

5.2 Role of the institutional environment

In the previous section, we asked what is the role of preferences in public annuity demand *given* the existing institutional environment. In this section, we ask what is the role of institutions *given* preferences. We focus on the two important features of the Social Security program in order to understand its effects on public annuity demand: the schedule of penalties/rewards for early/late claiming and the earnings test.

5.2.1 Price of the Social Security annuity

We start with the role of benefit adjustments for claiming delay. These adjustments essentially determine the price of the Social Security annuity. To see this, consider a person from 1937 cohort who is entitled to receive annual benefits b at the full retirement age of 65 and is deciding whether to claim at age 62 or 63. If he claims at 63 he will receive additional lifetime annuity income equal to $0.067b$, but this will cost him $0.8b$ in terms of forgone benefits at age 62 (see the schedule of benefit adjustments in Table 3). Thus, the price of an additional dollar of this annuity income is equal to $0.8b/0.067b = \$12$. In the same way, an individual who did not claim by age 63 faces a trade-off between further increasing his annuity income by an additional $0.067b$ versus claiming right away to receive $0.867b$ in benefits. In this case, he can increase his annuity income at a price of $0.867b/0.067b = \$13$ per one dollar of the extra income stream.

We can benchmark the imputed Social Security price against the actuarially fair price based on the average mortality. The actuarially fair annuity purchased at age m is priced as follows:

$$q_m^{AF}(r^b) = \sum_{t=m}^{T-1} \frac{\overline{\zeta}_{t+1|m}}{(1+r^b)^{t+1-m}}, \tag{25}$$

In this equation, r^b represents the break-even rate, the interest rate that determines the present value of the lifelong annuity payments, and $\overline{\zeta}_{t+1|m}$ is the average survival for 1937 cohort based on our estimates in Section 4.1.1.

The left panel of Figure 8 illustrates the difference between the imputed price of the Social Security annuity and the actuarially fair price with the break-even rate of 2% (our baseline interest rate). These two prices, while not very different in the beginning, diverge rapidly for older groups.

To understand whether the discrepancy between the imputed and actuarially fair prices plays an important role in claiming decisions, we consider the following experiment. We change the schedule of penalties/rewards so that the resulting public annuity price is actuarially fair based on the break-even rate of 2%. The resulting adjustments in benefits are

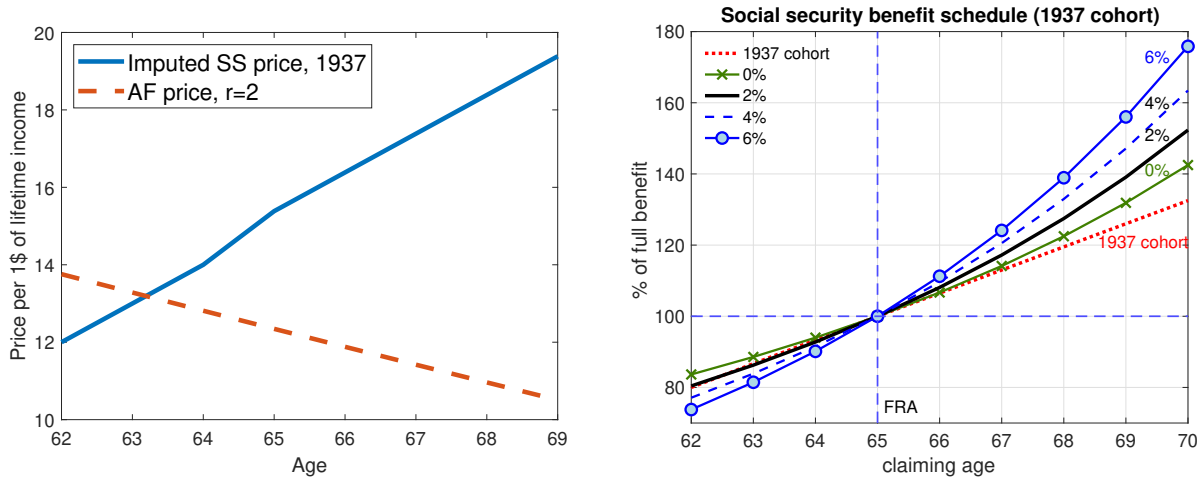


Figure 8: Left panel: the imputed price of the Social Security annuity vs the actuarially fair annuity price with 2% break-even rate. Right panel: adjustments to benefits so that the Social Security annuity is actuarially fair for different break-even rates.

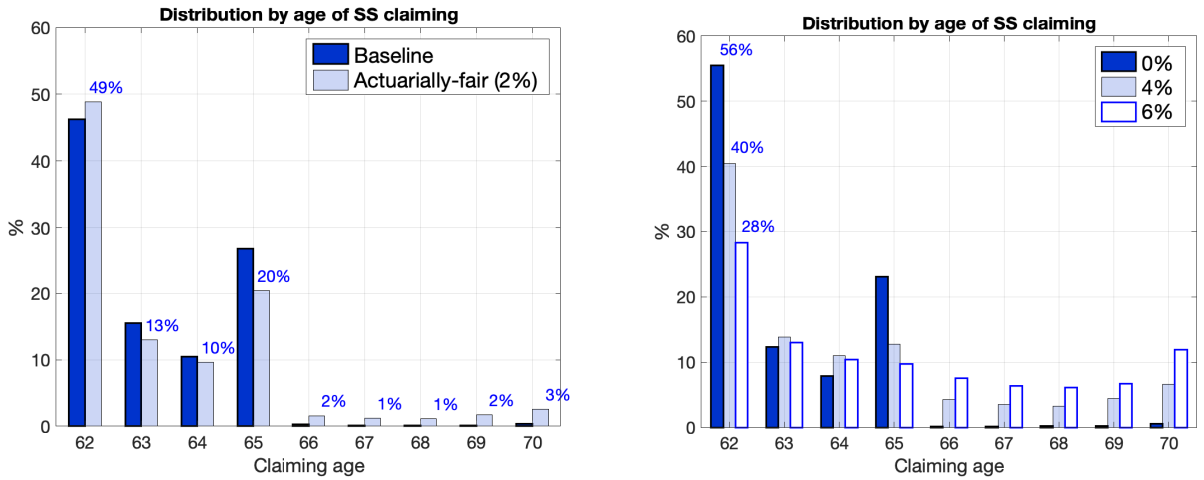


Figure 9: Distribution by claiming ages. Left panel: baseline and the case when the Social Security annuity is priced actuarially fair with the break-even rate of 2%. Right panel: the Social Security annuity is priced actuarially fair with the break-even rate of 0, 4, and 6%.

displayed as a dashed line in the right panel of Figure 8. We provide more details on how we compute these adjustments in Appendix F. The left panel of Figure 9 shows that, faced with this new schedule of benefit adjustments, people do not substantially change their claiming decisions.

To understand this result, it is worth noting that one's valuation of public annuity depends on the difference between ones' subjective rate of time preferences and the break-even rate r^b. Our estimated discount factor implies the rate of time preferences of almost 8%, which is substantially higher than the break-even rate of 2%. In other words, the impatience by far exceeds the implicit return on the public annuity.

To further illustrate this, we re-compute the actuarially fair annuity price based on several alternative break-even rates, below and above the baseline interest rate of 2%. Specifically, we vary the break-even rate from 0% to 6%. The adjustments in benefits for early/late claiming corresponding to each break-even rate are displayed in the right panel of Figure 8. The resulting distribution by claiming age is displayed in the right panel of Figure 9. The overall changes in claiming and employment decisions for each break-even rate are displayed in Tables 4 and 5, respectively.

The results illustrate that claiming decisions are sensitive to the break-even rate of Social Security annuity, and the closer is the break-even rate to the subjective rate of time preferences, the higher is the annuity demand. When the break-even rate is 6%, people claim later by almost two years compared to the baseline, and many choose to claim after the FRA. In addition, people work more in the end of their working life, with the employment for the age group 62-69 increasing by 3.6 percentage points. This suggests that the large discrepancy between the break-even rate of public annuity and subjective rate of time preferences is an important reason why people are unwilling to annuitize.

It is worth noting that in a conventional consumption/saving model, the relationship between the discount factor and the interest rate determines people's savings: when the former is low compared to the latter, people save less (see Carroll, 1997). A similar mechanism operates in case of annuity demand which depends on the difference between the annuity break-even rate and the subjective rate of time preferences.

	Baseline	Social Security break-even rate				No earnings test
		0%	2%	4%	6%	
Early (62-64)	72%	76%	72%	65%	52%	98%
Full retirement (65)	27%	23%	20%	13%	10%	1%
Late (66-70)	1%	1%	8%	22%	39%	1%
average claiming age	63.2	63.0 ↓	63.4↑	64.1 ↑	65.0 ↑	62.4 ↓

Table 4: The effects of the Social Security institutions on claiming decisions.

	Social Security break-even rate				No earnings test
	0%	2%	4%	6%	
62-64	-4.8%	-1.0%	+3.2%	+6.8%	+4.9%
65-69	-0.9%	-0.1%	+0.7%	+1.5%	+0.9%
62-69	-2.4%	-0.4%	+1.7%	+3.6%	+2.5%

Table 5: The effects of the Social Security institutions on employment. The reported number is the percentage point change from the baseline.

5.2.2 Social Security earnings test

We next turn to the role of the Social Security earnings test. This test changes the available annuitization options for some people. Specifically, early claimers who continue to work and earn above a certain threshold, have part or all of their benefits withheld. While this does not represent a tax, and the withheld benefits go towards increasing pensions starting from the FRA, this institutional feature essentially re-sets the age at which one claims benefits. For example, a worker who claims at 62 but due to high earnings have all of his benefits withheld from age 62 to the FRA, will receive pensions benefits as if he claimed at the FRA instead of at 62. In other words, unless this individual stops working or reduces his labor supply, claiming at age 62 is not in his choice set.[11]

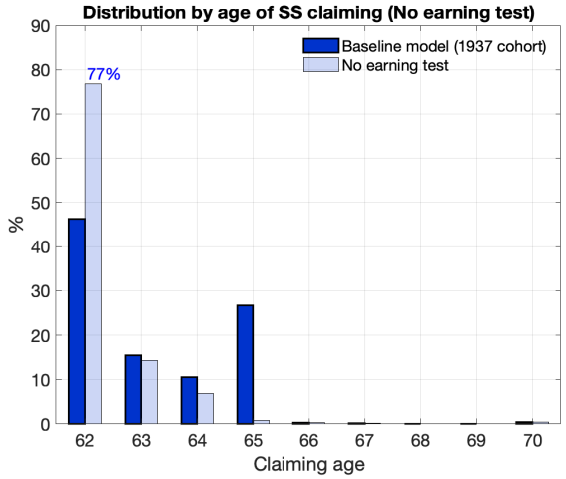


Figure 10: Distribution by claiming age when there is no Social Security earnings test

Because the earnings test changes the annuitization problem by linking it to earnings and labor supply, it can distort both claiming and labor supply decisions. To examine these distortions, we consider the effects of its removal, and the resulting distribution by claiming ages is shown in Figure 10 and Table 4.

The remarkable observation from this figure is that the earnings test conceals the true size of the public annuity puzzle. Without this institutional feature, the percentage of age-62 claimers would be much higher, 77% compared to 46% in the baseline economy (and in the data). This means that many people postpone claiming in the baseline economy not because

[11] It is worth stressing that the earnings test makes claiming delay optimal for some people who exit the labor force after the age of 62 but before the FRA. As an example, consider a person who claims at 62 and receives benefits $0.8b$, where b is his basic pension. Suppose this person works at 62 and has all his benefits withheld ($0.8b = T^{earn}$). This will change his benefits to $0.87b$ but *only* from age 65. If he exits the labor force at age 63, he will still be receiving benefits $0.8b$ at age 63 and 64. In this situation, he is better off claiming at 63 since his benefits will be equal $0.87b$ from age 63 onward.

they want to have more annuities, but because their choices of claiming early are constrained. Once the annuitization choice set is unrestricted, many claim as early as possible. Thus, the true annuity demand is even lower than what we observe due to the confounding effect of the earnings test.

The distorting effect of the earnings test on labor supply decisions is also important. Table 5 shows that when this institutional feature is removed, labor supply in the end of working life noticeably increases. The labor supply distortions may seem puzzling since the earnings test is not a tax but just temporarily withheld benefits. Yet, people react as if they were taxed. This observation is sometimes taken as an evidence that people misunderstand the earnings test and consider it as a regular income tax (e.g., Benitez-Silva and Heiland, 2007). However, when we consider the effects of the earnings test on the joint labor supply/annuitization decisions, the distortions can be explained by the strong unwillingness to get more annuities: some people work less to avoid being forced to change their annuitization choice.

5.3 Policy implications

In the previous section, we show that there is strong unwillingness to annuitize due to the combination of the impatience and bequest motives, and the true annuity demand is much lower than what is currently observed due to the distorting effect of the Social Security earnings test. Based on these results, in this section, we consider three policy changes: removing the earnings test, rewarding late claimers with lump-sum payments, and the combination of the two.

We evaluate the policy effects under two assumptions. First, all policy changes are expenditure-neutral, and we explain how we make the Social Security spending unchanged when describing each experiment. Second, all policy changes are unexpected and announced when people are 61 years old. Thus, the distribution of people at age 61 is the same in the baseline and experimental economies, and we evaluate the welfare from the perspective of a 61-year old person.

To compute welfare effects, we use the following approach. Consider the value function of an age-61 person ($t = 61$). Assume that everyone receives the same cash transfer Δ every period from age 61 onward. The average welfare of people in this age group can be expressed as follows:

$$\overline{V}(\Delta) = \int V_t(k_t + \Delta, h_t, \xi, z_t^h, AE_t) d\Gamma^{BS}(k_t, h_t, \xi, z_t^h, AE_t),$$

where $\Gamma^{BS}(\cdot)$ is the distribution of people at age 61 in the baseline economy. Note that

$\overline{V}(0) = \overline{V}^{BS}$, i.e., without cash transfers we have the baseline economy average welfare.

We next compute the average welfare once we introduce one of the policy changes, denoted as $\overline{V}^{Exp}$:

$$\overline{V}^{Exp} = \int V_t^{Exp}(k_t, h_t, \xi, z_t^h, AE_t) d\Gamma^{BS}(k_t, h_t, \xi, z_t^h, AE_t),$$

Note that since the distribution of people at age 61 in the experimental and baseline economies is the same, we control for the compositional difference when comparing welfare across experiments.

We compute the cash transfers needed to make average welfare in the baseline and experimental economies the same (Δ^*) by solving the following equation:

$$\overline{V}(\Delta^*) = \overline{V}^{Exp}$$

Our welfare measure CEV is expressed as a percentage of average consumption:

$$CEV = \frac{\Delta^*}{\overline{c}},$$

where $\overline{c}$ is the average consumption from age 61 onward in the baseline economy. The positive number implies that the policy change is welfare improving.[12]

5.3.1 Earnings test removal

In Section 5.2.2 we show that the Social Security earnings test creates distortions on labor supply and claiming decisions. In this section, we consider the effects of its removal. To keep the size of the Social Security budget the same as in the baseline economy, we adjust the basic level of Social Security benefits ss^b. The resulting adjustments requires us to scale ss^b up by 2.3%.[13]

The effects of the earnings test removal on the average claiming age and employment by productivity type and age group are reported in the second row of Table 6. On average, people claim 10 months earlier, with the largest shift observed among high productivity types who start claiming earlier by more than a year. This policy change also increases

[12] We use this welfare measure as opposed to the ex-ante consumption equivalent variation of the newborn for the following reason. All the institutional changes we consider directly affect people older than 60, and due to the low estimated discount factor, the change in welfare of the newborns will be too small to compare across experiments.

[13] This is due to the difference between the promised rewards for late claiming and how much it actually costs to the government to provide public annuities. The later is larger in our framework since we sum the government spending over the currently living cohorts abstracting from population growth or government borrowing. Thus, when the average claiming age decreases, the Social Security spending goes down. This effect does not change our key conclusions: in Appendix G we show that even if we do not preserve expenditure neutrality (i.e., throw away the saved Social Security spending), the welfare effects in all three policy experiments are still positive.

	Average claiming age				Change in employment		
	All	ξ_1	ξ_2	ξ_3	62-64	65-69	62-69
Baseline	63.2	62.9	63.1	63.8			
No earnings test	62.4 ↓	62.3 ↓	62.1 ↓	62.6 ↓	+3.4%	-0.5%	+1.1%
Lump-sum benefits	64.4 ↑	64.2 ↑	64.4 ↑	64.6 ↑	+1.8%	-4.3%	-1.9%
Lump-sum benefits + no earnings test	64.4 ↑	64.1 ↑	64.3 ↑	64.7 ↑	+2.6%	-4.2%	-1.5%

Table 6: The effects of the policy changes on claiming ages and employment (fixed Social Security spending)

	All	ξ_1	ξ_2	ξ_3
No earnings test	+0.86%	+1.45%	+1.20%	+0.95%
Lump-sum benefits	+1.33%	+2.70%	+1.38%	+1.13%
Lump-sum benefits + no earnings test	+1.43%	+2.89%	+1.52%	+1.24%

Table 7: The welfare effects of the policy changes (fixed Social Security spending)

employment among people subject to the earnings test, age group 62-64, by more than 3 percentage points.

The first row of Table 7 reports the welfare effects of this experiment, which are equal to 0.86% of average consumption. Part of the gains come from the upwards adjustment in Social Security basic benefits needed to make the policy expenditure-neutral. Table 10 in Appendix G shows welfare effects when we do not preserve expenditure-neutrality. Importantly, the earnings test removal is welfare-improving even when we do not adjust benefits, with the smaller average gains of 0.36%.

Another observation from Table 7 is that the lowest productivity types gain the most from this policy (the CEV is 1.45% for ξ_1-types compared to 0.95% for ξ_3-types). While the earnings test distorts both labor supply and claiming decisions, which margin is distorted more varies by type. As described above, claiming decisions are most distorted among high-productivity types. In contrast, labor supply distortions are the largest among low-productivity types. For the 62-64 age group, in response to removal of the earnings test, labor supply increases by 7.2% among ξ_1-types compared to 2.6% among ξ_3-types.

To understand this effect, consider an individual who, in absence of the earnings test, would like to claim early (to minimize his annuitization level) and continue working. In presence of the earnings test, he can choose between the two adjustment strategies. First, he can claim early to achieve his preferred level of annuitization, but reduce labor supply to avoid getting more annuities through the earnings test. Second, he can continue working but has to claim later. The first strategy results in suboptimal earnings and the second - in suboptimal annuitization level.

Our analysis show that the first strategy is preferred by low-productivity types since they

are especially unwilling to get additional annuities due to their low life expectancy, while high-productivity types prefer the second strategy. Both types of distortions reduce welfare, but more so in case of unproductive types. Thus, welfare-wise, the earnings test penalizes low-productivity types more (by distorting their labor supply) than high-productivity types (by distorting their claiming).

5.3.2 Lump-sum benefits

Given the strong unwillingness to annuitize uncovered in our estimation, the policy of rewarding claiming delay with annuity income can be improved upon by using, instead, the lump-sum payments. In this section, we examine the effects of the following policy change.

Consider an individual whose full retirement benefits are equal to b. In the baseline economy, he receives annuity income $0.8b$ if he claims at age 62, and this income increases with each year of delay. With the new policy, his annuity income is fixed at $0.8b$, and with each additional year of delay he receives a larger lump-sum payment.[14] This payment is the present value of additional annuity income he is entitled to in the baseline case. We can find the lump-sum payment LS_m when claiming at age m as follows:

$$LS_m = \begin{cases} \sum_{t=m}^{T-1} \frac{\zeta_{t+1|m} 0.067b}{(1+\overline{r})^{t+1-m}} & ; \quad \text{if } m = 63, 64 \\ \sum_{t=m}^{T-1} \frac{\zeta_{t+1|m} 0.065b}{(1+\overline{r})^{t+1-m}} & ; \quad \text{if } m = 65, .., 70 \end{cases}$$

Note that the difference in LS_m for people below and above the full retirement age arises because the accrual in extra pension income for each year of delay is higher for the former group than for the latter one ($0.067b$ vs $0.065b$). We adjust the interest rate $\overline{r}$ used to convert annuity income into lump-sum benefits LS_m so that the Social Security spending is the same as in the baseline economy. The resulting interest rate is 0.65%.

The left panel of Figure 11 and the second row of Table 6 show that more people delay claiming once they are rewarded with lump-sum benefits as opposed to additional annuities. On average, people claim by 1.2 years later. In addition, there is an increase in employment for the age group 62-64, as people increase their labor supply while delaying claiming. At the same time, people above the FRA work less after taking the lump-sum benefits due to the wealth effect.

The second row of Table 7 shows that this policy results in welfare gains representing

[14] In this experiment, the annuity income $0.8b$ is still subject to the earnings test.

1.33% of average consumption.[15] People with the lowest fixed productivity benefit the most from this policy with the CEV equal to 2.7%. This is because the conversion of the annuity income into lump-sum payments is based on the average life expectancy, while the low-productivity group has life expectancy below the average.

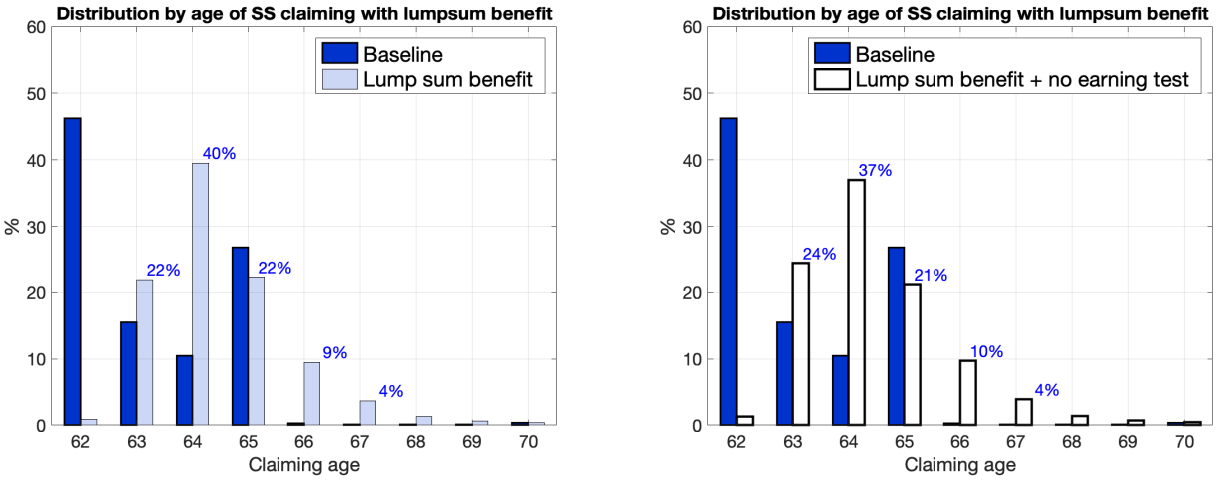


Figure 11: Distribution by claiming age. Left panel: late claiming is rewarded with lump-sum payments. Right panel: the earnings test is removed and late claiming is rewarded with lump-sum payments.

5.3.3 Earnings test removal combined with lump-sum payments

As a final policy exercise, we combine the removal of the earnings test with rewarding late claimers with lump-sum payments as opposed to annuity income. As in the previous policy experiment, we adjust the interest rate used to convert annuity income into lump-sum benefits LS_m to ensure expenditure-neutrality, and the resulting interest rate $\overline{r}$ is 0.49%.

The resulting distribution by claiming age is displayed in the right panel of Figure 11. Note that when the removal of the earnings test is combined with the lump-sum option, we do not observe a sharp shift towards early claiming as in the case when only the earnings test is removed. The third row of Table 6 show that the average claiming age is very similar for the two cases with lump-sum payments, i.e., with and without the earnings test. Overall,

[15] Maurer et al. (2021) consider a similar experiment and find that rewarding late claiming with lump-sum option does not bring welfare gains. In their model, early and late claimers are assumed to have different preferences. Thus, people differ ex-ante in their willingness to annuitize, so when annuities are substituted with lump-sum payments some people lose and some gain depending on their preferences, resulting in zero overall welfare change. In our case, all people have the same preferences and the difference in claiming behavior arise from the difference in economic circumstances and realized shocks. Our estimation procedure uncovers a strong overall unwillingness to annuitize, resulting in welfare gains from introducing the lump-sum option.

this combined policy delivers the highest welfare gains: the average consumption equivalence across all productivity types is equal to 1.43%, as shown in the third row of Table 7.

6 Conclusion

In this paper, we develop a structural framework to study the decisions about when to claim Social Security benefits. Our analysis emphasizes that the claiming behavior is, in fact, a labor-supply linked annuitization problem. Choosing the age when to claim benefits is equivalent to acquiring Social Security annuities, but this choice is affected by earnings due to the current program rules.

Understanding claiming decisions thus allows us to examine the public annuity puzzle, the unwillingness to acquire Social Security annuities. In contrast to studies of the private annuity puzzle, we can abstract from market frictions and thus have a sharper focus on the role of preferences and institutions in annuity demand.

We provide several important findings. We show that the observed claiming behavior can be well accounted for by different combinations of bequest motives and impatience. We can uniquely pin down the contribution of each force by jointly accounting for both claiming and saving decisions. This is because more pronounced impatience and stronger bequest motives both decrease annuity demand, but they have opposite effects on regular savings. We argue that jointly accounting for claiming and saving decisions is thus important for two reasons: (i) it can help us to better understand the public annuity puzzle, (ii) it provides a more transparent strategy to separately identify bequest and time preferences parameters compared to a more common strategy of relying only on wealth moments.

We use our estimated model to evaluate the role of the institutions in public annuity demand. We show that the difference between the Social Security annuity break-even rate and the subjective rate of time preferences plays an important role in annuity demand. For people younger than the FRA, the Social Security annuity is approximately actuarially-fair with the break-even rate of 2%, while our estimated rate of time preferences is around 8%. If, for example, the Social Security annuity break-even rate was 6%, people would claim, on average, two years later.

Importantly, we find that the Social Security earnings test masks the true size of the public annuity puzzle: if the test is removed, the fraction of early claimers would increase from 46% to 77%. Thus, the true demand for public annuities is much lower than what is currently observed since some people delay claiming due to the distorting effect of the earnings test. We also find that the earnings test distorts labor supply. This is because people who are subject to the earnings test are 'forced' to increase their annuity income,

and many try to avoid this. We thus argue that the earnings test distorts labor supply not because people mistake it for a real tax, but due to the strong unwillingness to annuitize.

Based on these results, we show that the institutional changes that take this strong unwillingness to annuitize into account are welfare-improving. Specifically, we consider three expenditure-neutral policies: removal of the earnings test, rewarding late claimers with lump-sum payments as opposed to additional annuity income, or both. We find that combining lump-sum payments with the earnings test removal results in the largest welfare gains.

References

[1] Armour, P., Knapp, D., 2021. The Changing Picture of Who Claims Social Security Early. AARP Report, Rand Corporation

[2] Bairoliya, N., McKiernan, 2021, Revisting Retirement and Social Security Claiming Decisions. Mimeo, Vanderbilt University

[3] Benitez-Silva, H., Dwyer, D., Heiland, F., Sanderson, W., 2009. Retirement and Social Security Reform Expectations: A Solution to the New Early Retirement Puzzle. Mimeo

[4] Benitez-Silva, H., Heiland, F., 2007. The Social Security Earnings Test and Work Incentives. Journal of Policy Analysis and Management. Volume 26, 3, pp 527-555

[5] Brown, J., Casey, M., Mitchell, O., 2008. Who Values the Social Security Annuity? New Evidence on the Annuity Puzzle" NBER working paper 13800

[6] Brugiavini, A., 1993. Uncertainty Resolution and the Timing of Annuity Purchases. Journal of Public Economics, 50, pp 31-62

[7] Cagetti, M., 2003. Wealth accumulation over the life cycle and precautionary savings. Journal of Business and Economic Statistics, 21(3), pp 339– 353.

[8] Capatina, E., 2015. Life-cycle Effects of Health Risk. Journal of Monetary Economics, 74, pp.67-88.

[9] Carroll, C., 1997. Buffer Stock Saving and the Life Cycle/Permanent Income Hypothesis. Quarterly Journal of Economics CXII(1), pp 1–56.

[10] Carroll, C., Samwick, A., 1997. The Nature of Precautionary Wealth. Journal of Monetary Economics, 40, 41–71

[11] Coile, C, Diamond, P., Gruber, J., Jousten, A., 2002. Delays in Claiming Social Security Benefits. Journal of Public Economics, 84(3), pp. 357-385.

[12] Davidoff, T., Brown, J., Diamond, P., 2005. Annuities and Individual Welfare. American Economic Review, 95(5), pp. 1573-1590.

[13] De Nardi, M., 2004. Wealth Inequality and Intergenerational Links. Review of Economic Studies, 71, pp.743-768.

[14] De Nardi, M., French, E., Jones, J., 2016, Medicaid Insurance in Old Age. American Economic Review, 106(11), pp.3480-3520

[15] De Nardi, M., Pashchenko, S., Porapakkarm, P., 2022. The Lifetime Cots of Bad Health. NBER Working Paper No. 23963

[16] Dushi, I., Webb, A., 2004. Household Annuitization Decisions: Simulations and Empirical Analysis. Journal of Pension Economics and Finance 3(2), pp.109-143.

[17] Einav, L., Finkelstein, A., Levin, J., 2010. "Beyond Testing: Empirical Models of Insurance Markets. Annual Review of Economics, 2, pp 311-36

[18] Epstein, L., Zin, S, 1989. Substitution, Risk Aversion, and the Temporal Behavior of Consumption and Asset Returns: A Theoretical Framework, Econometrica, 57(4), pp 937-969

[19] Finkelstein, A., Poterba, J., 2004. Adverse Selection in Insurance Markets: Policyholders Evidence from the UK Annuity Market. Journal of Political Economy, vol 112(1)

[20] Fitzpatrick, M.,2015. How Much Do Public School Teachers Value Their Retirement Benefits? American Economic Journal: Economic Policy, Vol 7(4), 165-88

[21] French, E., 2005. The Effects of Health, Wealth, and Wages on Labor Supply and Retirement Behaviour. *Review of Economic Studies*, 72(2), pages 395-427.

[22] French, E., Jones, J., 2011. The Effects of Health Insurance and Self-Insurance on Retirement Behavior. Econometrica, 79(3), pp. 693-732.

[23] Goda, G.S., Ramnath, S., Shoven, J., Slavov, S., 2015. The Financial Feasibility of Delaying Social Security: Evidence from Administrative Tax Data. NBER Working Paper.

[24] Gourinchas, P-O., Parker, J., 2002. Consumption over the life cycle. Econometrica, 70(1), pp 47–89.

[25] Gouveia, M., Strauss, R., 1994. Effective Federal Individual Income Tax Functions: An Exploratory Empirical Analysis. National Tax Journal, 47(2), pp 317-339

[26] Gustman, A., Steinmeier, T., 2005. The Social Security Early Retirement Age In a Structural Model of Retirement and Wealth. Journal of Public Economics, 89(2-3), pp. 441-463.

[27] Gustman, A., Steinmeier, T., 2015. Effects of Social Security Policies on Benefit Claiming, Retirement and Saving. Journal of Public Economics, 129, pp. 1-62.

[28] Guvenen, F. 2007. Learning Your Earning: Are Labor Income Shocks Really Very Persistent? American Economic Review, Vol. 97 (3), pp 687-712

[29] Hurd, M., Smith , J., Zissimopoulos, J., 2004. The Effects of Subjective Survival on Retirement and Social Security Claiming. Journal of Applied Econometrics, 19(6), pp. 761-775.

[30] Imrohoroglu, S., Kitao, S., 2012. Social Security Reforms: Benefit Claiming, Labor Force Participation and Long-run Sustainability. American Economic Journal: Macroeconomics, 4(3), pp. 96-127.

[31] Jones, J., Li, Y., 2018. The Effects of Collecting Income Taxes on Social Security Benefits. Journal of Public Economics, 159, pp 128-145

[32] Keane, M., Wasi, N., 2016. Labour Supply: The Roles of Human Capital and The Extensive Margin. Economic Journal, 126, pp578-617

[33] Krueger, D., Perri, F., 2005. Does Income Inequality Lead to Consumption Inequality? Evidence and Theory. Review of Economic Studies, Vol 73(1), 163-193

[34] Laibson, D., Maxted, P., Repetto, A., Tobacman, J., 2018. Estimating Discount Functions with Consumption Choices over the Lifecycle. Mimeo, University of Delaware

[35] Lockwood, L., 2012. Bequest Motives and the Annuity Puzzle. Review of Economic Dynamics, 15(2), pp. 226-243.

[36] Lockwood, L., 2018. Incidental Bequests and the Choice to Self-Insure Late Life Risks. American Economic Review, 108(9), 2513-2550

[37] Maurer, R., Mitchell, O., Rogalla, R., Schimetschek, T., 2016. Will They Take the Money and Work? People's Willingness to Delay Claiming Social Security Benefits for a Lump Sum. Journal of Risk and Insurance, 9999, pp. 1-33.

[38] Maurer, R., Mitchell, O., Rogalla, R., Schimetschek T., 2021. Optimal Social Security Claiming Behavior Under Lump Sum Incentives: Theory and Evidence. Journal of Risk and Insurance, 88, pp 5-27

[39] Meyer, W., Reichenstein, W., 2010. Social Security: When to Start Benefits and How to Minimize Longevity Risk. Journal of Financial Planning, 23(3), pp. 49-59.

[40] Metlife, 2003. The MetLife Market Survey of Nursing Home and Home Care Costs, August 2003.

[41] Mitchell, O. S., Poterba, J.M., Warshawsky, M.J., Brown, J.R., 1999. New Evidence on the Money's Worth of Individual Annuities. American Economic Review 89(5), pp. 1299-1318.

[42] Mottola, G., Utkus, S., 2007. Lump Sum or Annuity? An Analysis of Choice inDB Pension Payouts. Vanguard Center for Retirement Research, Volume 30.

[43] Pashchenko, S., 2013. Accounting for Non-Annuitization. Journal of Public Economics, 98, pp. 53-67.

[44] Pashchenko, S., Porapakkarm, P., 2016a. Medical Spending in the U.S.: Facts from the Medical Expenditure Panel Survey Database. Fiscal Studies. 37(3-4), pp. 689-716.

[45] Pashchenko, S., Porapakkarm, P., 2016b. Work Incentives of Medicaid Beneficiaries and the Role of Asset Testing. International Economic Review, 58(4), pp. 1117-1154.

[46] Pashchenko, S., Porapakkarm, P., 2019. Saving Motives Over the Life-Cycle. Mimeo, University of Georgia

[47] Reichling, F., Smetters, K., 2015. Optimal Annuitization with Stochastic Mortality and Correlated Medical Costs. American Economic Review, 105(11), pp 3273-3320

[48] Rust, J., Phelan, C., 1997. How Social Security and Medicare Affect Retirement Behavior In a World of Incomplete Markets. Econometrica, Vol. 65 (4), pp 781-831

[49] Shepard, M., 2011. Social Security Claiming and the Annuity Puzzle. Mimeo, Harvard University

[50] Shoven, J., Slavov, S., 2014a. Does It Pay to Delay Social Security? Journal of Pension Economics and Finance, 13(2), pp. 121-144.

[51] Shoven, J., Slavov, S., 2014b. Recent Changes in the Gains from Delaying Social Security. Journal of Financial Planning, 27(3), pp. 32-41.

[52] Shoven, J., Slavov, S.N., Wise, D., 2017. Social Security Claiming Decisions: Survey Evidence". NBER working paper 23729

[53] Storesletten, K., Telmer, C., Yaron, Y., 2004. Consumption and Risk Sharing Over the Life Cycle. Journal of Monetary Economics 51(3), pp. 609-633.

[54] Sun, W., Webb, A., 2009. How Much Do Households Really Lose by Claiming Social Security at Age 62? Center of Retirement Research at Boston College Working Paper.

[55] Turra, C., Mitchell, O., 2008. The Impact of Health Status and Out-of-Pocket Medical Expenditures on Annuity Valuation. Ameriks, J., and Mitchell, O., editors, Recalibrating Retirement Spending and Saving, pp. 227-250. Oxford University Press.

[56] Venti, S., Wise, D., 2004. The Long Reach of Education: Early Retirement. NBER Working Paper.

[57] Warner, J., Pleeter, S., 2001. The Personal Discount Rate: Evidence from Military Downsizing Programs. American Economic Review, Vol 91(1), pp 33-53

[58] Yaari, M., 1965. Uncertain Lifetime, Life Insurance, and the Theory of the Consumer. Review of Economic Studies, Vol 32(2), pp 137-150

Appendix

A The data

We use three data sets: the Panel Study of Income Dynamics (PSID), the Health and Retirement Study (HRS), and the Medical Expenditure Panel Survey (MEPS). The PSID is a national representative panel survey of individuals and their families. It started in 1968 on an annual basis and from 1997 to 2017 it is administered biennially. We use the PSID to construct data moments related to labor market outcomes, health status, and wealth accumulation.[16] Since health status is not available in earlier waves, our main sample includes males without missing records on health status from 1984 onward.

The HRS is a nationally representative sample of individuals over the age of 50. We use the RAND HRS 2018 (V1) to construct moments related to claiming behavior, and to estimate survival probability and out-of-pocket nursing home costs. For claiming moments used in our baseline estimation (external validation), we use males born in years 1936-1938 (1943-1948) and who were not receiving Disability Insurance (DI) benefits. To estimate out-of-pocket nursing home costs, we use a larger sample by pooling waves 2002-2018 of the HRS. We use a sample of males older than 70 who do not have missing information on nursing home use, health or age.

The MEPS is a nationally representative survey of households with a particular focus on medical usage and health insurance variables. It contains individuals of all ages (top-coded at 85). The MEPS has a short panel dimension: each individual is observed for at most two years. Medical spending reported in the MEPS is cross-checked with insurers and providers which improves its accuracy (Pashchenko and Porapakkarm, 2016a, provide more details on the MEPS dataset.) We use 17 waves of MEPS from 1999 to 2017 to estimate the out-of-pocket medical spending (except for nursing home spending).[17]

[16] The information on net worth is not available in every wave before 1999. We use 1994 wave and every waves after 1999 to construct wealth profile, which results in 36,392 individual-wave observations.

[17] The MEPS dose not contain information on nursing home spending because it only samples the non-institutionalized population and thus excludes nursing home residents.

B Additional details on the first step estimation

B.1 Medical and nursing home shocks

To estimate out-of-pocket medical shocks, we first estimate the following regression:

$$m_{it} = d^m_{age} D^{age}_{it} \times D^h_{it} + d^m_c D^c_i + \epsilon^m_{it}, \tag{26}$$

where m_{it} is out-of-pocket medical spending, D^{age}, D^h, and D^c are the set of age, health, and cohort dummy variables, respectively, and ϵ^m_{it} is the component orthogonal to age, health and cohort. Using our estimates we compute out-of-pocket medical expenses for our base cohort:

$$\hat{m}_{it} = \hat{d}^m_{age} D^{age}_{it} \times D^h_{it} + \hat{d}^m_{j^c}(D^c_i = 1937) + \hat{\epsilon}^m_{it},$$

Then, for each age and health status, we divide adjusted medical expenses $\hat{m}_{it}$ into three groups: below the median, between the 50th and 95th percentile of the distribution, and above the 95th percentile. We then compute the average $\hat{m}_{it}$ for each group, and smooth it with age polynomial degree two.

Figure (12) reports the resulting out-of-pocket medical costs for each of the three medical shocks separately for people in good (left panel) and bad (right panel) health status. People in bad health face higher expenses, especially if they have the worst medical shock realization.

We estimate the risk of incurring a nursing home shock (pn^h_t) from the HRS as follows. First, we compute the probabilities of entering a nursing home for selected ages: 67, 72, 77, 82, 87, and 95. In each case, we use a sample within a 5-year age bracket. That is, we compute the percentage of individuals who report staying in a nursing home in each interview round for the following age groups: 65-69, 70-74, 75-79, 80-84, 85-89, and older than 90. Since the HRS is a biennnial survey, we convert these numbers into annual probabilities under the assumption that the probability to stay in a nursing home over the two-year interval is equal to the product of the annual probabilities. We then extrapolate the probability to stay in a nursing home at other ages using polynomial degree three approximation. We do this separately for males in good and bad health.

To compute the average nursing home costs, for the same age groups, we multiply the number of nights for all nursing home stays reported in the HRS by the average daily rate for a semiprivate room in a nursing home, which was $158.26 in 2003 according to Metlife (2003). We then extrapolate the costs at other ages using polynomial degree two approximation.

The resulting probabilities to enter a nursing home and nursing home costs are plotted in Figure (13) for people in good and bad health. People in bad health face higher probability of experiencing a nursing home shocks, and also have higher expenditures when entering a

nursing home. This is because the unhealthy tend to spend more nights in a nursing home.

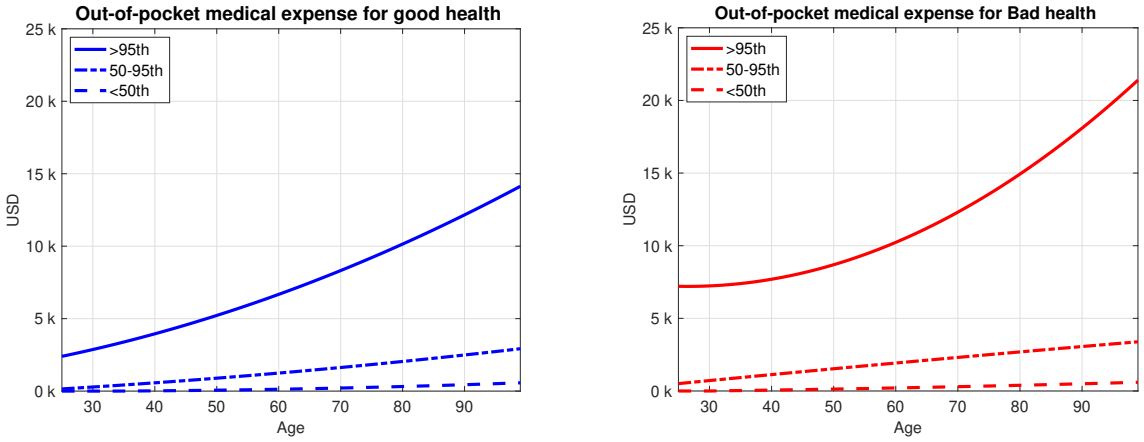


Figure 12: Out-of-pocket medical expense shock for people in good (left) and bad health (right).

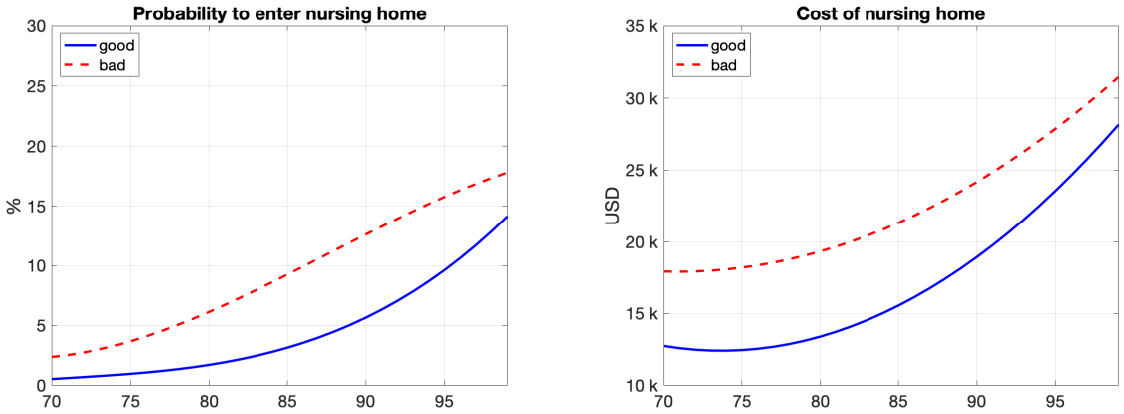


Figure 13: Probability and costs to enter nursing home

B.2 Labor productivity

Figure (14) displays the log of our estimated deterministic labor productivity $\log\left(\lambda_t^h \bar{l}\right)$ as described in Section 4.1.2. Note that people in bad health have noticeably lower labor productivity throughout the entire working stage of life-cycle.

C Comparing bequest parameters with other studies

In this section, we compare our estimated strength of the bequest motive with the results in two other structural studies, De Nardi et al. (2016) and Lockwood (2018). We have

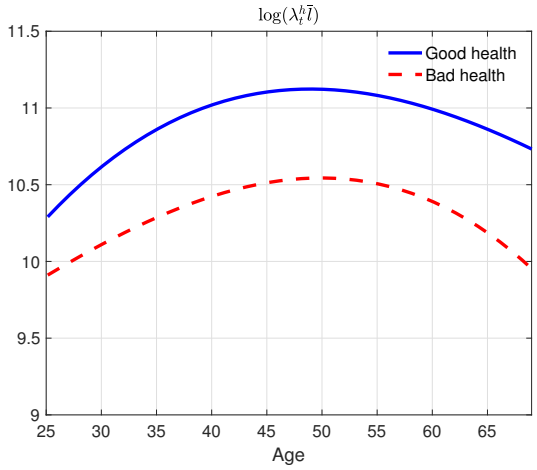


Figure 14: Health-dependent labor productivity: $\log\left(\lambda_t^h \bar{l}\right)$

chosen these studies because they specifically focus on the identification of the bequest motives within a structural framework.

The parameters of the bequest function cannot be directly compared across studies because of some differences in specification. To make the estimates comparable, we convert all the estimates into two parameters: the bequest threshold and the marginal propensity to bequeath (MPB).

Consider a simple model where an agent has one period left to live and he has to allocate his endowment y between consumption c and bequest k. His lifetime utility V is:

$$V = u(c) + \beta U_{beq}(k)$$

where $u(c)$ is utility from consumption, $U_{beq}(k)$ is utility from bequest with $U_{beq}(0) > -\infty$. We can find optimal bequest k^* from the first-order condition (using the fact that $c = y - k$):

$$u'(y - k^*) = \beta U'_{beq}(k^*)$$

Since $U_{beq}(0) > -\infty$ it may be optimal to set $k^* = 0$. We define the bequest threshold $\overline{y}$ as the cutoff level of the endowment such that it is optimal not to leave bequests if $y \leq \overline{y}$. The bequest threshold can be found from the following equation:

$$u'(\overline{y}) = \beta U'_{beq}(0)$$

For positive bequests, the MPB is defined as follows:

$$MPB = \frac{\partial k^*}{\partial y}$$

Note that the values of the MPB and threshold depend on parameters of the utility and bequest functions, as well as on the discount rate. The utility functions used by De Nardi et al. (2016) and Lockwood (2018) are of the standard CRRA type, so that the marginal utility of consumption is $u'(c) = c^{-\gamma}$, where γ is the inverse of the IES. The bequest functions and the resulting MPB and thresholds are described below.

De Nardi, French, Jones (2016) Bequest function:

$$v(k) = \eta \, \frac{(\phi_B + k)^{1-\gamma}}{1-\gamma}$$

The MPB and threshold are:

$$\overline{y} = (\beta\eta)^{-\frac{1}{\gamma}} \phi_B$$

$$MPB = \frac{1}{1 + (\beta\eta)^{-\frac{1}{\gamma}}}$$

Lockwood (2018) Bequest function:

$$v(k) = \left(\frac{\theta}{1-\theta}\right)^{\gamma} \frac{\left(\frac{\theta}{1-\theta} c_b + k\right)^{1-\gamma}}{1-\gamma},$$

where c_b and θ are parameters. The MPB and threshold are:

$$\overline{y} = \beta^{-\frac{1}{\gamma}} c_b$$

$$MPB = \frac{1}{1 + \beta^{-\frac{1}{\gamma}} \frac{1-\theta}{\theta}}$$

Our specification In our case with Epstein-Zin preferences, the lifetime utility of an individual who has one year left to live can be represented as follows:

$$V^{1-\gamma} = c^{\chi(1-\gamma)} + \beta \, \eta^{\frac{1-\gamma}{1-\psi}} (\phi_B + k)^{\chi(1-\gamma)}$$

We can find the MPB and threshold as follows:

$$\overline{y} = \alpha \phi_B \tag{27}$$

$$MPB = \frac{1}{1+\alpha} \tag{28}$$

where

$$\alpha = \left[\beta \eta^{\frac{1-\gamma}{1-\psi}} \right]^{\frac{1}{\chi(1-\gamma)-1}}$$

Comparison Using the parameters estimated in the studies listed above, we compute the MPB and threshold and report them in Table 8 below. The studies use different base year, so to make thresholds comparable, we convert them to dollars of 2002 (our base year).

Study	MPB	Threshold (in $2002)
De Nardi et al., 2016	0.78	3,268
Lockwood, 2018	0.96	14,665
Our specification	0.95	6,550

Table 8: Comparison of the MPB and bequest thresholds across studies

D Comparison of the role of the discount factor with the standard versus non-expected utility preferences

In this section, we compare the interpretation of the rate of time preferences in the standard model and in the model with the non-expected utility preferences. Consider a simple model where agents face stochastic income y_t, and only make consumption/saving decisions every period. The recursive formulation takes the following form:

$$U_t = \left[c_t^{1-\gamma} + \beta z_{t+1}^{1-\gamma} \right]^{\frac{1}{1-\gamma}},$$

where z_{t+1} is the certainty equivalent:

$$z_{t+1} = \left(E_t U_{t+1}^{1-\psi} \right)^{\frac{1}{1-\psi}}$$

Here, γ is the inverse of the IES and ψ is risk aversion. We can write the Euler equation as follows:

$$c_t^{-\gamma} = \beta(1+r)\ z_{t+1}^{\psi-\gamma}\ E_t U_{t+1}^{\gamma-\psi}\ c_{t+1}^{-\gamma}$$

Next, consider the cutoff level of the discount factor that defines an impatient individual in the terminology of Carroll (1997). An individual is impatient if it is not optimal for him to deviate from a plan with zero savings, i.e., if we plug $c_t = y_t$ for all t in the Euler equation above, the left-hand side is going to be weakly greater than the right-hand side. The discount factor at which this condition holds defines the impatience threshold. Consider this cutoff for two versions of the model, corresponding to the standard and Epstein-Zin preferences.

Standard preferences ($\psi = \gamma$) It is optimal for an agent not to save if

$$1 \geq \beta(1+r)E_t g_{t+1}^{-\gamma},$$

where $g_{t+1} = \dfrac{y_{t+1}}{y_t}$ is the income growth. Note that in case with no uncertainty and constant income ($y_t = y_{t+1}$), this transforms into the expression $\beta(1+r) \leq 1$.

Epstein-Zin preferences ($\psi \neq \gamma$) In this case it is optimal for an agent not to save if

$$1 \geq \beta(1+r)E_t \omega_{t+1} g_{t+1}^{-\gamma},$$

where ω_{t+1} is the weighting function:

$$\omega_{t+1} = \left(\frac{U_{t+1}}{z_{t+1}}\right)^{\gamma-\psi}$$

Note that in case with no uncertainty ($U_{t+1} = z_{t+1}$) and constant income ($y_t = y_{t+1}$), we once again have the expression $\beta(1+r) \leq 1$.

This exposition illustrates that even though the impatience threshold in the definition of Carroll (1997) takes a modified form when using the non-expected utility preferences, the parameter β still plays a central role in determining this threshold. By decreasing/increasing this parameter we still decrease/increase the threshold level which defines an impatient household.

E Estimation results when the MPB is fixed

In this section, we report the parameter estimates for several versions of the model with the fixed MPB, as explained in Section 5.1. In all estimations, we fix risk aversion ($\psi = 4.0$), 1/IES ($\gamma = 1.667$), and the implied bequest threshold (\$6,550) at the baseline values, and target moments realted to claiming and labor market outcomes as described in Section 4.2. Table 9 reports the parameters $\{\phi_w, \phi_{P_t}, \beta, \underline{c}\}$.

		Marginal propensity to bequeath (MPB)						
		0.917 *Point A*	0.927	0.936	0.946 *Baseline*	0.955	0.965	0.974 *Point B*
Risk aversion	ψ	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Discount factor	β	0.907	0.915	0.921	0.926	0.936	0.943	0.951
1/IES	γ	1.667	1.667	1.667	1.667	1.667	1.667	1.667
Bequest parameter	ϕ_B	\$72,706	\$82,948	\$96,230	\$114,141	\$139,611	\$178,708	\$246,359
"	η	2.83×10^6	5.99×10^6	1.43×10^7	3.85×10^7	1.23×10^8	5.20×10^8	3.43×10^9
Consumption floor	$\underline{c}$	\$3,123	\$2,874	\$3,110	\$3,573	\$3,340	\$3,352	\$3,145

Table 9: Estimation results when fixing MPB at 1%,2%, and 3% below and above our baseline MPB estimate.

F Actuarially fair Social Security benefits

In this section, we explain how the adjustments to Social Security benefits for early/late claiming reported in the right panel of Figure 8 are computed. Denote the adjustments for age 62 as x_{62}, for age 63 as x_{63}, etc. As in the actual schedule of benefits and rewards, we set x_{65} to 1, i.e., individuals who claim at age 65 get full benefits. In order for the underlying price of the Social Security annuity to be actuarially fair, these adjustments have to satisfy the following:

$$q_t^{AF}(r^b) = \frac{x_t}{x_{t+1} - x_t}, \qquad t = 62, ..., 69$$

where $q_t^{AF}(r^b)$ is the actuarially fair price for the annuity at age t with the break-even rate r^b. This represents a system of 8 equations which can be solved for x_t because $x_{65} = 1$.

G Policy analysis without fixing the budget

In this section, we show the welfare effects from our three policy changes when we do not fix the Social Security expenditures as in the baseline economy. The results are displayed in Table 10. The welfare effects are smaller since all three policies results in smaller Social Security spending. Importantly, even in this case, all policies are welfare-improving.

	All	ξ_1	ξ_2	ξ_3
No earnings test	+0.36%	+0.59%	+0.55%	+0.46%
Lump-sum benefits	+0.83%	+1.92%	+0.80%	+0.65%
Lump-sum benefits + no earnings test	+0.91%	+2.04%	+0.92%	+0.74%

Table 10: The welfare effects of the policy changes. For the policies in the last two rows, we use 2% interest rate to convert annuity benefits into lump-sum payments.

H The model with the CRRA preferences

In our baseline specification, we assume agents have Epstein-Zin preferences. In this section, we re-estimate the model and repeat our policy analysis for the version of the model when agents have regular CRRA preferences.

H.1 Estimation results and model fit

To estimate the CRRA version of our model, we restrict risk aversion to be equal to the inverse of the IES, and estimate the risk aversion (and thus IES) together with other second-step parameters. Our estimates are reported in the third column of Table 11 below, while the second column reproduces our baseline estimates. Overall, while the CRRA specification produces different point estimates, the difference is not large. Our estimate still imply relatively high degree of impatience with β equal to 0.91, and relatively strong bequest motives with the MPB equal to 0.97.

Parameters		Epstein-Zin preferences (*Baseline*)	CRRA preferences
Risk aversion	ψ	4.0	3.96
Discount factor	β	0.926	0.908
1/IES	γ	1.667	ψ
Bequest parameter	ϕ_B	\$114,141	\$187,932
”	η	3.85×10^7	5,400
Consumption floor	$\underline{c}$	\$3,573	\$3,327

Table 11: Preference parameters and the consumption floor. The risk aversion (ψ) is fixed at 4.0 for Epstein-Zin preferences and $\psi = \gamma$ for CRRA preferences. For Epstien-Zin preferences, the implied MPB and bequest threshold are 0.946 and \$6,550. The corresponding values for the CRRA preferences are 0.968 and \$6,112.

To evaluate the performance of the model with CRRA preferences, we report the model fit and external validation similar to those reported in Section 4.4 and 4.5. Overall, the CRRA model well captures many features of the data, but unlike our preferred baseline specification, it under-performs in terms of tracking the shape of wealth profiles, as can be seen in the

right panel of Figure 15. Specifically, the model predicts that wealth monotonically increases over the entire life-cycle.

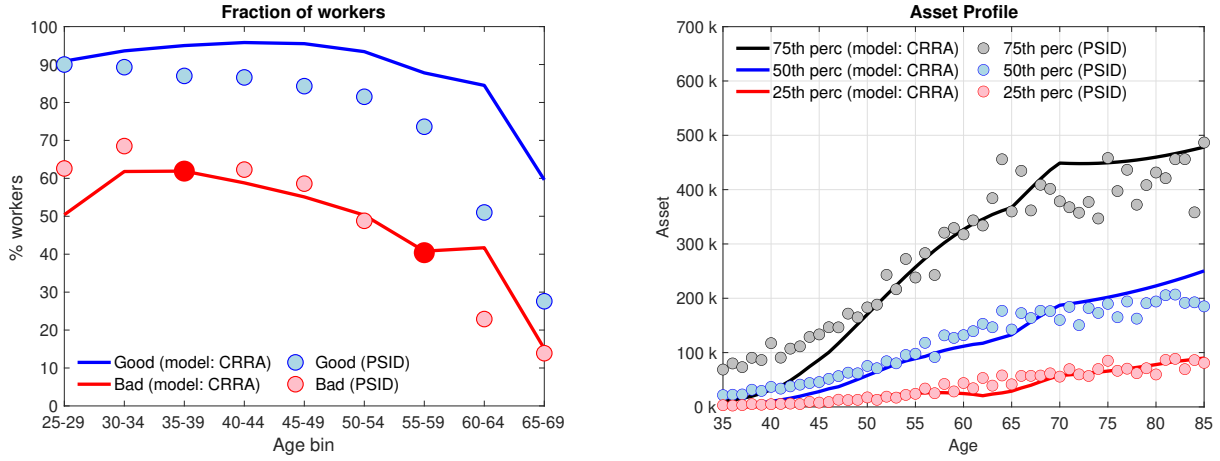


Figure 15: Left panel: employment by age. Right panel: wealth profiles by age.

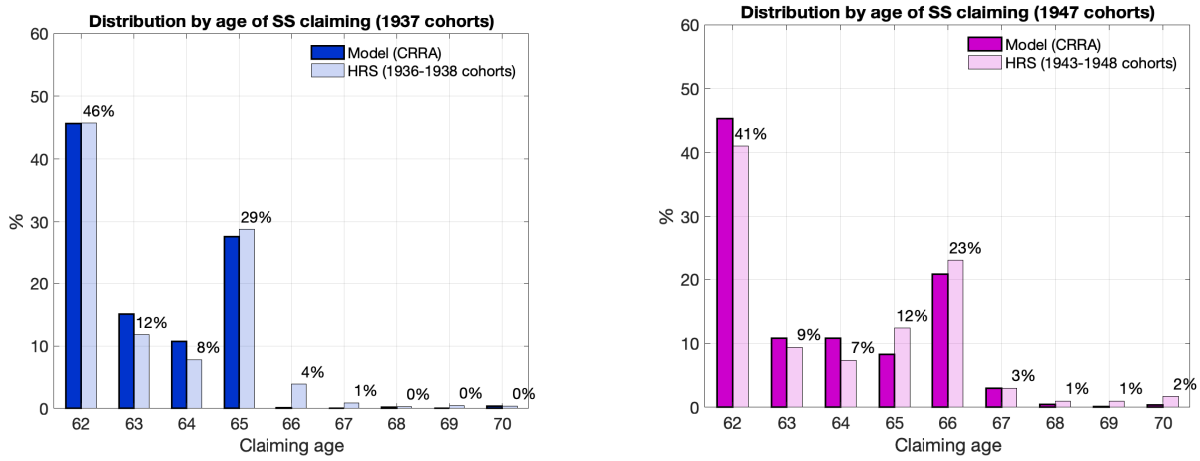


Figure 16: Distribution by claiming age. Left panel: baseline cohort, 1937. Right panel: external validation, 1947 cohort.

Age group	Model (CRRA)		Data (PSID)	
	not work ⇒ work	work ⇒ not work	not work ⇒ work	work ⇒ not work
62-69	4%	14%	4%	29%

Table 12: Employment dynamics

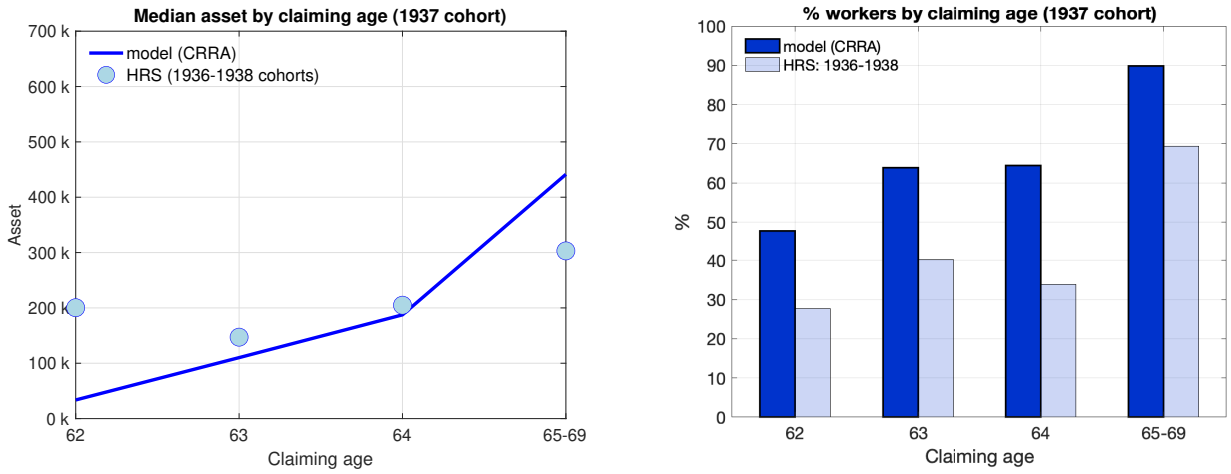


Figure 17: Median wealth and % workers by claiming age (1937 cohort, FRA at 65)

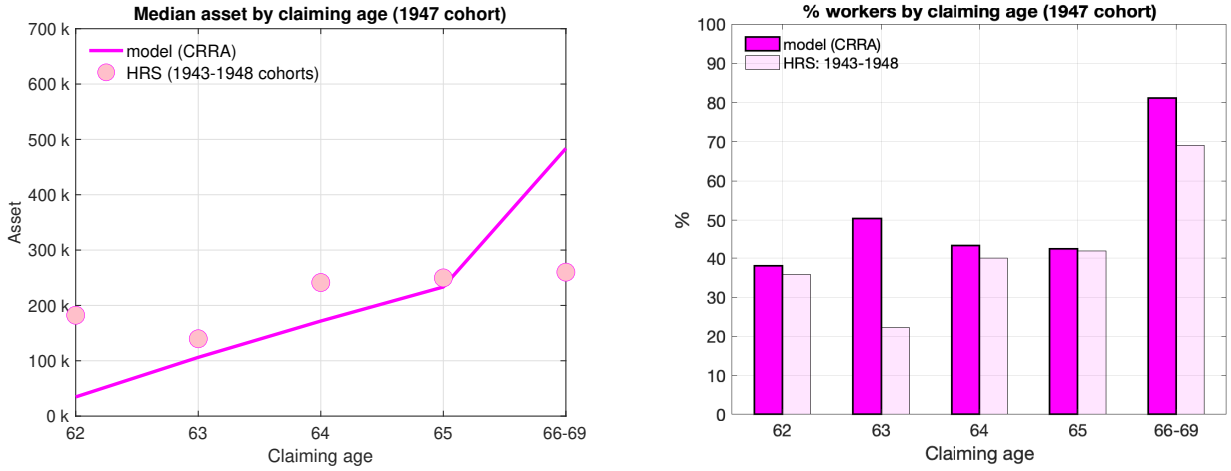


Figure 18: Median wealth and % workers at claiming age (1947 cohort, FRA at 66)

H.2 Policy experiments

Tables 13 and 14 report the change in claiming and employment when changing the Social Security annuity break-even rate and removing the earnings test. The role of the Social Security institutions in the framework with the CRRA preferences is very similar to that in our baseline specification, as can be seen in Tables 4 and 5 in Section 5.2.

Tables 15 and 16 report the behavioral responses and welfare effects of the three expenditure-neutral policy changes: the removal of the earnings test, lump-sum payments, and the combination of both. These results are also similar to our baseline case reported in Table 6 and 7 in Section 5.3.

	Baseline	Social Security break-even rate				No earning test
		0%	2%	4%	6%	
Early (62-64)	71%	74%	71%	63%	47%	99%
Full retirement (65)	28%	25%	21%	11%	9%	0.3%
Late (66-70)	1%	1%	8%	26%	44%	0.7%
Average claiming age	63.3	63.1 ↓	63.5 ↑	64.3 ↑	65.4 ↑	62.4 ↓

Table 13: The effects of the Social Security institutions on claiming decisions (CRRA preferences)

	Social Security break-even rate				No earning test
	0%	2%	4%	6%	
62-64	-4.1%	-0.8%	+2.9%	+5.8%	+3.3%
65-69	-0.9%	-0.1%	+0.8%	+1.8%	+1.1%
62-69	-2.2%	-0.4%	+1.7%	+3.4%	+2.0%

Table 14: The effects of the Social Security institutions on employment (CRRA preferences). The reported number is the percentage point change from the baseline with the CRRA preferences.

	Average claiming age				Change in employment		
	All	ξ_1	ξ_2	ξ_3	62-64	65-69	62-69
Baseline	63.3	62.8	63.1	63.8			
No earnings test	62.4 ↓	62.3 ↓	62.1 ↓	62.7 ↓	+2.3%	-0.1%	+0.9%
Lump-sum benefits	64.2 ↑	63.8 ↑	64.2 ↑	64.6 ↑	+1.3%	-3.0%	-1.3%
Lump-sum benefits + no earnings test	64.2 ↑	63.8 ↑	64.2 ↑	64.7 ↑	+2.1%	-2.9%	-0.9%

Table 15: The effects of the policy changes on claiming ages and employment in the model with the CRRA preferences (fixed Social Security spending)

	All	ξ_1	ξ_2	ξ_3
No earnings test	0.85%	1.40%	1.20%	0.91%
Lump-sum benefits	0.97%	1.72%	1.19%	1.05%
Lump-sum benefits + no earnings test	1.08%	1.90%	1.35%	1.18%

Table 16: The welfare effects of the policy changes in the model with the CRRA preferences (fixed Social Security spending)