

# **THE SOCIAL SECURITY EARNINGS TEST:**

## **An Overview and Examination of Reform Options**

Jonathan Gruber  
Peter Orszag<sup>1</sup>

May 1999

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<sup>1</sup> Jonathan Gruber is Professor of Economics at M.I.T., and Director of the Children's Program at the National Bureau of Economic Research (gruberj@mit.edu). Peter Orszag is the President of Sebago Associates, Inc., an economics consulting firm, and a lecturer in economics at the University of California, Berkeley (orszagp@sbgo.com). The authors thank Henry Aaron, Debra Bailey, Bob Cumby, Peter Diamond, Steve Goss, Leora Friedberg, Bob Greenstein, Alicia Munnell, Tim Kelley, Virginia Reno, Gene Steuerle, and Diane Whitmore for helpful conversations and/or comments. We also thank Debra Bailey, Sal Gallicchio, Tim Kelley, and others at the Social Security Administration for their help in obtaining data about the earnings test.

## EXECUTIVE SUMMARY

The Social Security earnings test is one of the least popular features of Social Security. It also is one of the most widely misunderstood. Our paper discusses how the earnings test functions and examines options for reform.

### *Operation of the Earnings Test*

Most Social Security beneficiaries are aware that benefits are reduced if their earnings exceed certain limits. For those aged 62-64, benefits are reduced by \$1 for every \$2 of earnings over an earnings threshold of \$9,600 in 1999; for those aged 65-69, benefits are reduced by \$1 for every \$3 of earnings over an earnings threshold of \$15,500. But many appear unaware that *this reduction triggers an increase in subsequent benefits*. The increase is based on an actuarial adjustment and is intended to ensure that, on average, the subsequent benefit increase roughly offsets the benefit reduction.

### *Benefits of Eliminating the Earnings Test*

The benefits of eliminating the earnings test include:

1. Reduced complexity. The earnings test is complicated. Beneficiaries often do not understand the system, and it imposes administrative burdens of roughly \$100 to \$150 million a year on the Social Security Administration.
2. No long-run actuarial cost. Eliminating the earnings test would have almost no effect on the long-run solvency of the program. Since the system is roughly actuarially fair, eliminating it for retirees would have almost no effect on the long-run actuarial balance.
3. Modest increased work incentives. Eliminating the earnings test may have a positive, albeit modest, influence on work activity. To the extent that workers perceive the current system as a tax on earnings, eliminating it may induce some additional work effort. Most of the literature has suggested that the labor supply impact is modest, but one recent study that focused exclusively on those over age 65 has suggested a somewhat larger effect.

### *Costs of Eliminating the Earnings Test*

The costs of eliminating the earnings test include:

1. Increased poverty among the very old. The higher benefits provided in later years from the earnings test result in larger Social Security benefits to survivors and thus provide some protection against poverty among widows, a group with a much higher poverty rate than the

elderly population in general. Indeed, among older widow and widower beneficiaries of Social Security, the average annual benefit for those who had claimed early Social Security benefits is significantly below the poverty line, while the average annual benefit for those who had not claimed early Social Security benefits is significantly above the poverty line. Eliminating the earnings test may induce more beneficiaries to elect early and therefore reduced benefits. As a result, the poverty rate among the very old — and especially among widows — may increase.

2. Increased budgetary costs in the short run and potentially lower national saving. Removing the earnings test for those at the full benefit age and above would raise Social Security expenditures by about \$15 billion over the first 5 years. The higher benefit payments may reduce national saving, if beneficiaries consume their additional benefits and if taxes are not increased or other government spending is not reduced.

### ***Weighing Costs and Benefits Below the Full Benefit Age***

*Our opinion is that there is a reasonably strong case for retaining the earnings test for those below the full benefit age, with a much more ambiguous case at or above the full benefit age.* Below the full benefit age, the costs of the earnings test seem to be outweighed by its benefits. The labor supply distortion for these ages appears to be modest. More importantly, in our view, removing the earnings test for this population would likely lead to higher rates of early benefit claiming, with reduced benefit levels later in life. Given that poverty among the elderly is most concentrated in the oldest old, such a redistribution strikes us as inappropriate.

### ***Weighing the Costs and Benefits At and Above the Full Benefit Age***

The costs of retaining the earnings test may begin to outweigh the benefits at the full benefit age for three reasons. First, recent evidence suggests a more significant labor supply distortion from the earnings test for the population aged 65 and over. Second, the rate of return to forced savings provided to those age 65 and over, and in particular those close to age 70, is lower relative to alternative options. Third, beneficiaries beyond the full benefit age already receive increased Social Security benefits relative to their Primary Insurance Amounts. Old age poverty is therefore less likely to be a problem, so there is less concern about their consuming more now.

### ***Conclusion***

A substantial amount of both genuine disagreement and misunderstanding exists about the benefits and costs of the earnings test. Our view, which is shared by the architects of some recent proposals to reform the earnings test, is that there is a much stronger argument for removing the test above the full benefit age than below it. The modest and uncertain implications for labor supply are outweighed by the potential large and inefficient transfer of Social Security income from the poorest (older) elderly to the most well off (younger). By the same token, the argument for retaining the test

after the full benefit age is weaker, and removing it after that age could even stimulate increased work among 62-64 year olds.

## **THE SOCIAL SECURITY EARNINGS TEST: An Overview and Examination of Reform Options**

Jonathan Gruber (MIT and NBER)

Peter Orszag (Sebago Associates, Inc., and University of California, Berkeley)

### **Introduction**

The Social Security retirement earnings test is one of the least popular -- and least understood -- aspects of the Social Security system. Under the retirement earnings test, Social Security benefits of recipients aged 62 to 70 are reduced by between 33 cents and 50 cents for each dollar earned above a floor amount, and benefits are subsequently increased after work ceases. The earnings test has been criticized as a significant deterrent to labor supply among older workers, and politicians from across the political spectrum support its repeal.<sup>2</sup>

This policy brief has three sections. The first section describes how the earnings test works, exploring the myriad misunderstandings about the system. The second reviews the literature on the labor supply effects of the earnings test for older workers. The third section reviews policy options. Our conclusion is that there is a reasonably strong argument that the earnings test for those above the full benefit age should be eliminated, but that the earnings test for those below the full benefit age should be retained.

Throughout the paper, we examine the impact of the earnings test on two different sets of beneficiaries:

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<sup>2</sup> In his State of the Union address this year, President Clinton proposed that "we should eliminate the limits on what seniors on Social Security can earn." (available on-line at <http://www.whitehouse.gov>.) The Speaker of the House has also endorsed repeal, and Senator McCain has complained that, "It is quite evident that the earnings test is outdated, unjust and discriminatory." (See McCain's comments upon introducing S. 279, the Senior Citizen's Freedom to Work Act of 1999, available through <http://thomas.loc.gov>. S. 279 would eliminate the earnings test for those at or above the full benefit age. Cosponsors include Senators Kyl, Helms, Ashcroft, Spencer Abraham, DeWine, Bunning, Cochran, Coverdell, and Gordon Smith. In the House, similar legislation has been introduced as H.R. 5 and has 79 bipartisan cosponsors.) Several other Social Security reform proposals, from the Moynihan-Kerrey bill to the National Commission on Retirement Policy proposal, suggest eliminating or loosening the earnings test. The Moynihan-Kerrey proposal eliminates the earnings test for beneficiaries aged 62 and older effective January 1, 2003. The National Commission on Retirement Policy plan eliminates the retirement earnings test for individuals at or above the full benefit age (currently age 65) effective January 1, 2000.

- ? Those who do not change the age at which they claim benefits but do change their work patterns because of the earnings test
- ? Those who delay claiming benefits because of the earnings test.

## I. History, design, and operation of the earnings test

When the Social Security system was created in 1935, one of the motivations was to encourage older workers to retire in order to boost demand for younger workers.<sup>3</sup> The 1935 Social Security Act therefore stipulated that *no* benefits would be paid to a beneficiary who had received “wages with respect to regular employment.”<sup>4</sup>

Subsequent statutes have relaxed the rules significantly, allowing higher earnings and reducing benefits only partially for earnings above the limit (rather than fully eliminating benefits once the earnings test is surpassed, as the original Social Security Act required).<sup>5</sup> Following the 1977 Amendments, the earnings test effectively became two separate tests: one for those under the full benefit age of 65 and another one for those above that age.

The earnings test as it currently operates has three components: the earnings thresholds above which benefits are reduced, the percentages by which benefits are reduced for earnings exceeding those thresholds, and the increase in future benefits that is designed to compensate (on a lifetime basis) for the benefit reduction while working.

### *Threshold amounts*

Under current rules, Social Security beneficiaries can earn up to a threshold amount without any reduction in retirement benefits.<sup>6</sup> The threshold level depends on whether the beneficiary is above or below the age at which full benefits are paid, currently age 65. For beneficiaries aged 70 and above, there is no earnings test. In effect, there are therefore two earnings tests for those under 70:

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<sup>3</sup> Leora Friedberg, “The Social Security Earnings Test and Labor Supply of Older Men,” in James Poterba, ed., *Tax Policy and the Economy* (MIT Press: Cambridge, 1998), page 122.

<sup>4</sup> Committee on Ways and Means, *1998 Green Book* (Government Printing Office: Washington, DC, 1998), page 31.

<sup>5</sup> For example, the 1939 Amendments allowed beneficiaries to earn up to \$14.99 in monthly wages while still receiving benefits. The 1950 Amendments then raised the exempt amount to \$50 and excluded beneficiaries aged 75 and over from the earnings test. Later statutes allowed partial rather than full reduction of benefits (the 1954 and 1972 Amendments), exempted those aged 70 and over (the 1954 and 1981 Amendments), shifted the system from monthly to annual earnings except for the first year of benefit receipt (the 1977 Amendments), and created separate limits for those under and over age 65 (the 1977 Amendments). The 1983 Amendments promulgated further changes in these rules.

<sup>6</sup> Earnings are defined as wages and earnings from self-employment; pension, interest, dividend, and other unearned income is not counted for purposes of this test.

- ? For beneficiaries aged 62-64, the 1999 threshold is \$9,600. This limit is raised each year by the percentage that average wages have risen, as computed by the Social Security actuaries.
- ? For beneficiaries aged 65-69, the 1999 threshold is \$15,500. Under current law, it is scheduled to increase each year until it reaches \$30,000 in 2002, after which it, too, will be indexed to changes in average wages. (See Table 1).

Thus, a 63 year-old beneficiary could earn \$9,500 in 1999 and still receive the entire amount of the Social Security benefits to which he or she is entitled. Similarly, a beneficiary aged 67 could earn \$15,400 and receive the entire benefit to which he or she is entitled.<sup>7</sup>

**Table 1**

| <b>Earnings Thresholds Under the Retirement Earnings Test</b> |                    |                     |
|---|--------------------|---------------------|
|   | <b>Ages 62-64*</b> | <b>Ages 65-69**</b> |
| 1998  | \$9,120            | \$14,500            |
| 1999  | \$9,600            | \$15,500            |
| 2000  | \$10,080           | \$17,000            |
| 2001  | \$10,440           | \$25,000            |
| 2002  | \$10,680           | \$30,000            |

\*The figures for 1998 and 1999 are the actual levels. The estimated figures for 2000 and beyond are based on the intermediate assumptions of the 1999 Trustees Report for the percentage increase in the average wage level, applied with a rolling two-year lag (as the law requires) to the actual 1999 level of \$9,600. The precise computation methodology used by the Social Security Administration to compute the limit for each year is described in the *1999 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds*, page 200. The categories “ages 62-64” and ages “65-69” should properly be “below the full benefit age” and “above the full benefit age.” The full benefit age is scheduled to increase gradually under current law, starting in 2000, ultimately reaching 67 for those turning 62 in 2022

\*\*These amounts are specified in PL 104-121, the Contract with America Advancement Act.

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<sup>7</sup> Special rules apply during the first year of benefit receipt. In the first year, the earnings test is applied on a monthly basis rather than an annual basis. Consequently, a worker with very high earnings for only, say, five months but then low earnings for the other seven months would receive full benefits for those other seven months during the first year of benefit receipt. Following that first year, the earnings test is applied on an annual basis.

### *Benefit reduction for earnings above the threshold*

If beneficiaries earn more than the threshold amount, their current-year Social Security benefits are reduced. The reduction rates depend on whether the beneficiary is above or below the current full benefit age of 65:

- ? For beneficiaries aged 62-64, benefits are reduced by \$1 for every \$2 of earnings over the earnings threshold. For example, a beneficiary aged 63 who earns \$12,000 would be earning \$2,400 more than the limit of \$9,600, and his benefit would be reduced by \$1 for every \$2 of earnings above the limit. He benefit would therefore be reduced by \$1,200.
- ? For beneficiaries aged 65-69, benefits are reduced by \$1 for every \$3 of earnings over the earnings threshold. A beneficiary aged 67 who earns \$17,900 would be earning \$2,400 more than the limit of \$15,500, and her benefits would be reduced by \$1 for every \$3 of excess earnings.<sup>8</sup> Her benefit would therefore be reduced by \$800.

Table 2 shows the percentage of beneficiaries, by age, whose benefits were reduced in 1989 because of earnings above the relevant threshold. As the table indicates, roughly 10 percent of worker beneficiaries had their benefits reduced because of earnings above the relevant threshold. The higher share of those with benefits reduced because of the earnings test among those aged 65-69 than those aged 62-64 may reflect the common practice of encouraging workers to elect benefits at age 65 -- even if they plan to continue working until age 70 -- when they register for Medicare benefits.<sup>9</sup>

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<sup>8</sup> It is worth noting that earnings must be relatively high for the benefit reduction to eliminate *all* Social Security benefits, especially for those above the full benefit age. For example, consider a worker with steady average earnings throughout her career. If the worker elects to receive initial Social Security benefits at the earliest eligibility age of 62, she would have to earn roughly \$30,000 at age 62 to have her Social Security benefits exhausted through the benefit reduction under the earnings test. If the worker elects to receive initial benefits at age 67, she would have to earn more than \$53,000 to have her benefits eliminated by the benefit reduction under the earnings test.

<sup>9</sup> We thank Henry Aaron for pointing this important phenomenon out to us, and Tim Kelley of the Social Security Administration for a helpful discussion regarding the prevalence of the practice. When workers register for Medicare benefits at age 65, they are encouraged (but not required) to elect Social Security benefits as well -- even if they plan to continue working, in which case their benefits would be reduced through the earnings test until they reach age 70 -- to ensure that they do not later forget to elect Social Security benefits.

**Table 2**  
**Retired worker beneficiaries with benefits reduced due to earnings test, 1989**

|              | Total retired worker beneficiaries | With benefits withheld because of earnings test | Percent of total beneficiaries with benefits withheld because of earnings test |
|--------------|------------------------------------|---|--|
| Ages 62-64   | 2,549,084                          | 168,782   | 6.6  |
| Ages 65-69   | 7,229,512                          | 757,560   | 10.5   |
| Total, 62-69 | 9,778,596                          | 926,342   | 9.5  |

Source: Leora Friedberg, "The Social Security Earnings Test and Labor Supply of Older Men," Table 5, page 136

*Increase in subsequent benefits*

Perhaps the least understood aspect of the earnings test is that *reductions in current benefits are offset by an increase in future benefits*. In theory, the increases are intended to be actuarially fair, so that the expected *lifetime* tax from the system is zero.<sup>10</sup> For specific individuals, the rate at which subsequent benefits are restored may be less or more than actuarially fair – implying either a lifetime tax or lifetime subsidy. In either case, however, the initial benefit reduction is a misleading indicator of the lifetime impact, which should be what affects workers' decisions.

The actuarial adjustments under the earnings test are the same as those used to adjust benefits up or down depending on the age of initial benefit receipt:<sup>11</sup>

? If an individual elects to begin receiving benefits before the full benefit age (currently 65), and if those benefits are reduced as a result of the earnings test, the subsequent benefit restoration occurs by adjusting the discount for claiming early benefits.<sup>12</sup> The subsequent benefit increase

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<sup>10</sup> It is worth noting that in addition to the initial benefit reduction, workers are also subject to the payroll tax on their earnings up to the maximum taxable earnings level (\$72,600 in 1999), including any earnings *below* the earnings test threshold. Subsequent benefits are increased as a result of these earnings (through the benefit recomputation mechanism) only if annual earnings exceed one of the years included in their average indexed monthly earnings.

<sup>11</sup> The actuarial adjustments under the earnings test are expressed in terms of the recipient's monthly benefits. For beneficiaries aged 65 to 69, the benefit reduction in a given year must amount to at least one month's worth of benefits or subsequent benefits are *not* adjusted upwards. For beneficiaries aged 62 to 64, on the other hand, a subsequent actuarial adjustment is granted for a full month's worth of benefits even if the benefit reduction only amounts to a fraction of a month's benefit.

<sup>12</sup> The subsequent benefit adjustment occurs when the beneficiary reaches the full benefit age or upon death of the beneficiary.

is thus equal to 6 2/3 percent of the worker's Primary Insurance Amount for each year's worth of benefits reduced under the earnings test.

- ? If an individual elects to begin receiving benefits at or after the full benefit age, and if those benefits are reduced as a result of the earnings test, the subsequent increase in benefits occurs through the delayed retirement credit. Under current law, the delayed retirement credit is scheduled to increase to 8 percent -- roughly its actuarially fair level -- by 2005.

The key point is that *any reduction in benefits under the earnings test triggers a subsequent increase in benefits*. The amount of the increase is intended to ensure that, on average, lifetime benefits are not affected by the application of the earnings test. As a result, it is misleading to look at the benefit reduction imposed by the earnings test while a beneficiary is working as a simple tax on earnings, since the benefit reduction will effectively be paid back later. In other words, losing benefits through the earnings test is effectively the same as not receiving benefits through delaying initial benefit receipt: those dollars will be paid back, with an actuarial adjustment, in the future.

Several caveats to this general conclusion, however, should be noted:

- ? Even if the actuarial adjustments are fair on average for the population as a whole, they are not necessarily accurate for specific population groups. For groups with longer-than-average life expectancies, for example, the subsequent benefit increases more than offset the initial benefit reductions -- implying a lifetime *subsidy* from the earnings test. For groups with shorter-than-average life expectancies, the opposite is true.

Because of differences in life expectancies, the earnings test subsidizes work for female beneficiaries while taxing work for male beneficiaries; subsidizes work for Hispanic American beneficiaries while taxing work for African American beneficiaries; and subsidizes work for higher-income beneficiaries and taxes work for middle-income beneficiaries who are subject to benefit reductions under the earnings test.<sup>13</sup> This final implication is worth highlighting, because it suggests that *on a lifetime basis, the earnings test may be regressive -- contrary to its perceived progressivity*.

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<sup>13</sup> These statements apply only to retiree benefits and ignore the effects of spousal and survivor benefits. For further discussion, see text. For evidence on differential mortality rates by socioeconomic status, see, for example, Jonathan Feinstein, "The Relationship between Socioeconomic Status and Health: A Review of the Literature," *Milbank Quarterly*, Volume 71, Number 2, 1993.

? The actuarial adjustments do not apply to spousal benefits for spouses above the age at which full benefits are paid.<sup>14</sup> For example, consider a worker aged 67 with \$20,000 in earnings who has a spouse, also aged 67, who receives benefits based on the worker's earnings history. The worker's earnings are \$4,500 above the earnings threshold of \$15,500, so the couple's benefits are reduced by \$1,500 (one-third of \$4,500). Benefit reductions due to the earnings test are pro-rated between the benefit that the retiree receives and any benefits paid to the retiree's spouse. The \$1,500 total reduction in benefits for the couple is therefore allocated by reducing the worker's benefit by \$1,000 and the spouse's benefit by \$500.

How the reduction in the couple's benefits is allocated between the worker and the spouse would not matter if the subsequent actuarial adjustment applied to both of their benefits. But for spouses above the full benefit age (now 65) when the earnings test is applied, the actuarial increase in subsequent benefits applies *only to the worker's benefits*. In other words, the subsequent upward actuarial adjustment in benefits in this example above would apply *only* to the \$1,000 reduction in the worker's benefit. The \$500 reduction in the spouse's benefit would not be offset by a subsequent increase. In this sense, the system operates to the disadvantage of couples with spouses above the full benefit age.<sup>15</sup> (For spouses below the full benefit age, the subsequent actuarial increase applies to the spousal benefit in addition to the worker's benefit.)

The absence of a subsequent benefit adjustment for spouses above the full benefit age is consistent with the general feature of Social Security that spousal benefits are not increased for the delayed retirement credit. It should be noted, however, that widow benefits *are* increased by the delayed retirement credit. Therefore, the spouse in our example may receive a higher benefit as a survivor because of the benefit reductions under the earnings test.

### *The earnings test and elderly poverty*

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<sup>14</sup> The subsequent benefit increase also does not apply to beneficiaries who qualify as a parent or child. For example, consider a young mother whose husband dies. She becomes entitled to benefits because her child is under 16, but she is also subject to the earnings test (the earnings limit for those under the full benefit age applies). If her benefits are reduced because of the earnings test, there is no subsequent increase. Proposals to eliminate the retirement earnings test do not normally include elimination of the retirement test for such survivors. The legislative record does not make clear why the delayed retirement credit was not applied to spousal benefits, although the natural suspicion is cost (conversation with Tim Kelley of the Social Security Administration).

<sup>15</sup> See discussion in footnote 31, page 232, in Eugene Steuerle and Jon Bakija, *Retooling Social Security for the 21st Century* (Urban Institute Press: Washington, 1994), and Alan Gustman and Thomas Steinmeier, "Changing the Social Security Rules for Work After 65," *Industrial and Labor Relations Review*, Vol. 44, No. 4, July 1991, page 734.

An important implication of this discussion is that the actuarial adjustment system can be thought of as a program of *forced saving*. If beneficiaries have difficulty in borrowing, the initial benefit reduction reduces consumption today in exchange for higher income tomorrow. Such an inter-temporal shift has both costs and benefits. Its main benefit is that it provides additional protection against poverty and asset depletion in very old age (which would impose burdens both on the individuals themselves and on the rest of society). In particular, the higher benefits provided in later years as a result of the earnings test result in larger Social Security benefits to survivors and thus provide some protection against poverty among widows, a group with a much higher poverty rate than the elderly population in general.<sup>16</sup> Receiving benefits earlier rather than later could thus be associated with higher poverty rates among the very old.

The potential importance of actuarial adjustments in affecting elderly poverty is illustrated by Table 3 below. In 1996, 1.8 million elderly aged 80 and over were receiving Social Security benefits as nondisabled widows or widowers. Among these beneficiaries, more than a third (647,040) had their benefits reduced for early retirement (i.e., either they or their since-deceased spouses had initially claimed benefits before the full benefit age), and the rest (1,144,180) had not claimed early benefits. Among those with benefits reduced for early retirement, the mean annual benefit was \$7,009 – or \$516 *below* the poverty line of \$7,525 for a single elderly person.<sup>17</sup> Among the other beneficiaries – those who claimed benefits at or after the full benefit age – the average benefit was \$9,174, or \$1,649 *above* the poverty line.

**Table 3**  
**Widow/widower benefit levels and early reduction of Social Security benefits, 1996**

|   | With reduction for<br>early retirement | Without reduction for<br>early retirement | Total     |
|---|--|---|-----------|
| Number of nondisabled widows and widowers, ages 80 and over | 647,040                                | 1,144,180                                 | 1,791,220 |
| Average annual benefit                                      | \$7,009                                | \$9,174                                   | \$8,392   |
| Average annual benefit - poverty line                       | -\$516                                 | \$1,649                                   | \$866     |

<sup>16</sup> The widow poverty rate is approximately 20 percent, well above the national poverty rate of 13 percent. For further discussion on poverty rates and the Social Security program, see Kathryn H. Porter, Kathy Larin, and Wendell Primus, "Social Security and Poverty Among the Elderly: A National and State Perspective," Center on Budget and Policy Priorities, April 1999, available at <http://www.cbpp.org>.

<sup>17</sup> The poverty line for a single person aged 65 or over was \$7,525 in 1996, or \$627 per month. See Bureau of the Census, *Poverty in the United States: 1996*, Table A-2, page A-4.

Source: Social Security Bulletin, *Annual Statistical Supplement 1997*, Table 5.A1, page 192; Table 5.A3, page 196; and authors' calculations.

It is important to note that these figures should only be taken as suggestive. In particular, the characteristics of couples with early and late claiming could differ in important ways. For example, unpublished data suggest that about half of the difference across the groups in Table 3 results from differences in Primary Insurance Amounts rather than from the actuarial adjustments to those amounts (i.e, those who claim early benefits, on average, have lower Primary Insurance Amounts than those who delay, and that difference in Primary Insurance Amounts accounts for roughly half of the mean benefit difference between the two groups).<sup>18</sup> Nonetheless, about half of the dramatic difference in average benefit levels in Table 3 does result from the choice of early retirement. Similarly, the poverty rate based on Social Security benefits alone exaggerates the degree of poverty, since the elderly often have some other sources of income in addition to Social Security. On the other hand, since Social Security benefits tend to account for a higher share of income for those with lower benefits, this effect may tend to *accentuate* the differences between these groups. In any case, the figures in Table 3 are striking and suggest that a further investigation of the role of early claiming in determining poverty among widows and widowers is warranted.

Shifting income from the early years of retirement to later years may reduce poverty among the oldest old, but it also has costs. It forces beneficiaries to reduce consumption while they are working, even if they do not expect to live long enough to recoup the benefits of higher benefits later. In addition, some beneficiaries may prefer other forms of saving to forced savings through the Social Security system. Some individuals may feel that the actuarial return (obtained through the benefit reduction and subsequent increase) is lower than they could obtain elsewhere. On the other hand, saving through the Social Security system automatically provides an inflation-indexed annuity, which provides valuable insurance against outliving one's saving or seeing it eroded by inflation. Such an annuity is expensive, if not impossible, to obtain in the private market.<sup>19</sup>

Of course, if potential beneficiaries wish to have more savings in the form of an inflation-indexed annuity, they could always simply delay claiming their Social Security benefits. But the problem with this approach is that it is discrete: the individual must decide whether to receive either all or none of

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<sup>18</sup> Unpublished data for 1998 indicate that the average Primary Insurance Amount among non-disabled widows and widowers aged 80 and over was \$852 for those with benefits not reduced for early retirement, and \$751 for those with benefits reduced for early retirement. That difference in average Primary Insurance Amounts – \$101 – accounts for about half of the mean difference in average monthly benefits (\$203) across the two groups in 1998.

<sup>19</sup> Private-sector providers have begun to offer inflation-indexed annuities following the introduction of the Treasury's inflation-indexed bond. But volumes remain quite low, and adverse selection raises their price above the actuarially fair value for the typical individual. For further discussion of the inflation-indexed market in the United States and the United Kingdom, see Jeffrey R. Brown, Olivia S. Mitchell, and James M. Poterba, "The Role of Real Annuities and Indexed Bonds in an Individual Accounts Retirement Program," NBER Working Paper 7005, March 1999.

their benefits at age 62. The earnings test, on the other hand, allows individuals to receive some of their benefits, while saving the rest for later in life. In other words, one could think of an actuarially fair earnings test as a way of smoothing out the decision between claiming and not claiming benefits at ages 62-69.

## II. The earnings test and labor supply

Regardless of the underlying actuarial reality, many elderly workers *perceive* the earnings test to be an impediment to work. For example, a study by Cordelia Reimers and Marjorie Honig concludes that the pattern of re-entry of older men into the labor market following initial retirement is inconsistent with assuming that workers are aware of the actuarial adjustments. They write, “These results indicate that behavior is ‘myopic’ with respect to Social Security; that is, older men consider current income only and do not take into account that lost benefits will be replaced later, with interest.”<sup>20</sup> Leora Friedberg, in another recent study, also concludes that workers ignore the actuarial adjustments. She adds that popular descriptions of the system, such as those published in *Money* magazine and the *Los Angeles Times*, do “not mention that higher future benefits compensate for current benefits lost to the earnings test.”<sup>21</sup> *J.K. Lasser’s Your Income Tax 1998* guide, furthermore, warned readers that if “you are under age 70, Social Security benefits are reduced by earned income,” but did not note the subsequent benefit adjustment.<sup>22</sup> Even a popular undergraduate public finance textbook notes the initial reduction in benefits but not the later increase.<sup>23</sup>

As this section discusses, even if the earnings test is perceived as a tax, its labor supply effects may still be somewhat modest. In particular, it is worth keeping in mind that only about 10 percent of beneficiaries have their benefits reduced through the earnings test (see Table 2 above), and that perhaps another 2 percent or so are bunched immediately under the earnings threshold (see Table 4 below). These figures suggest that the earnings test may simply not affect the vast majority of beneficiaries.

### *The “clustering effect”*

Analyses of the distribution of earnings for those 62-69 also suggest that some workers perceive the earnings test to be a tax. Many analysts have noted that a number of workers in their 60s have earnings at or slightly below the earnings tests. Such bunching could indicate that many individuals in their 60s believe that earnings above the limits are taxed. On the other hand, the number of individuals “clustered” at or just below the earnings tests is relatively small. In addition, any such clustering may reflect *reported* rather than actual labor supply, if workers misreport earnings in an

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<sup>20</sup> Cordelia Reimers and Marjorie Honig, “The Perceived Budget Constraint under Social Security: Evidence from Re-entry Behavior,” *Journal of Labor Economics*, vol. 11, no. 1, 1993, 184-204, page 201.

<sup>21</sup> Leora Friedberg, “The Social Security Earnings Test and Labor Supply of Older Men,” in James Poterba, ed., *Tax Policy and the Economy* (MIT Press: Cambridge, 1998), page 128.

<sup>22</sup> J.K. Lasser, Institute, *J.K. Lasser’s Your Income Tax 1998* (MacMillan: New York, 1997), page 519.

<sup>23</sup> Harvey S. Rosen, *Public Finance* 4<sup>th</sup> edition (Irwin: Chicago, 1995), page 201.

attempt to avoid the benefit reduction under the earnings test. The Social Security Administration, however, now relies primarily on W-2 forms to enforce compliance with the earnings test system, limiting the opportunity for cheating.<sup>24</sup>

The “clustering” effect is illustrated in Table 4 below, tabulated for us by Leora Friedberg from Current Population Survey (CPS) earnings data for 1996. These data do not include information on those age 62 or 65, since the CPS does not permit us to know exactly respondents’ age precisely in the time period that they were earning.

The evidence of “clustering” within \$1,000 of the earnings test is apparent here, relative either to the \$1,000 interval below the earnings threshold or to the \$1,000 interval above it. In the third-to-final row of the table, we calculate the implied earnings test bunching relative to two benchmarks: the earnings interval between \$1,000 and \$2,000 below the earnings test, and the interval between \$1,000 and \$2,000 above the earnings test. Since the extent of “natural bunching” at each interval is declining over this range, the former is probably a bit too high a benchmark, and the latter too low. In either case, the impacts are small in terms of number of persons. At most, under 150,000 persons are bunching due to the earnings test, which is 1.3 percent of the total population at these ages and 4.1 percent of the working population at these ages. As the final two rows of the table show, the implied clustering represents a higher percentage of those 63-64 than those 66-69. Interestingly, the implied clustering represents a higher percentage of females than males for those aged 63-64, but a higher percentage of males than females for those aged 66-69.

**Table 4: The earnings test and “clustering” of workers**

| Group                                       | 63-64 years old (thousands) |       |       | 66-69 years old (thousands) |       |       |
|---|-----------------------------|-------|-------|-----------------------------|-------|-------|
|   | All                         | Men   | Women | All                         | Men   | Women |
| All   | 3,826                       | 1,809 | 2,016 | 7,674                       | 3,493 | 4,182 |
| No Work                                     | 2,115                       | 869   | 1,246 | 5,706                       | 2,400 | 3,306 |
| Earnings \$2,000 or more below threshold    | 370                         | 158   | 211   | 1,024                       | 470   | 554   |
| Earnings \$1,000 to \$2,000 below threshold | 56                          | 32    | 24    | 48                          | 21    | 27    |

<sup>24</sup> Telephone discussion with Tim Kelley of the Social Security Administration (April 23, 1999), and Social Security Administration, *Social Security Handbook 1997*, Chapters 18 and 19. It is not clear, furthermore, why workers would misreport earnings in household surveys not linked to Social Security or the Internal Revenue Service.

|  |                |                |                |                           |                |                |
|--|----------------|----------------|----------------|---------------------------|----------------|----------------|
| Earnings \$1000 or less below threshold            | 114            | 52             | 62             | 79                        | 60             | 19             |
| Earnings up to \$1,000 above threshold             | 14             | 6.6            | 7.6            | 23                        | 16             | 7.1            |
| Earnings \$1,000 to \$2,000 above threshold        | 25             | 20             | 5.2            | 22                        | 14             | 7.6            |
| Earnings more than \$2,000 above threshold         | 1,132          | 672            | 459            | 827                       | 511            | 316            |
| <b>Implied Earnings Test Clustering (see text)</b> | <b>58-89</b>   | <b>20-32</b>   | <b>38-57</b>   | <b>31-57<sup>25</sup></b> | <b>39-46</b>   | <b>8-11</b>    |
| <i>Clustering as percent of people</i>             | <i>1.5-2.3</i> | <i>1.1-1.8</i> | <i>1.9-2.8</i> | <i>0.4-0.7</i>            | <i>1.1-1.3</i> | <i>0.2-0.3</i> |
| <i>Clustering as percent of workers</i>            | <i>3.4-5.2</i> | <i>2.1-3.4</i> | <i>4.9-7.4</i> | <i>1.6-2.9</i>            | <i>3.6-4.2</i> | <i>0.9-1.3</i> |

*Overall labor supply effect from the earnings test*

Limited clustering does not necessarily prove a small effect of the earnings test; it is possible that many older persons who cannot find jobs that pay just below the earnings test amount decide to leave the labor force rather than pay this (perceived) high tax rate. But most of the academic literature that has attempted richer evaluations of the impact of the earnings test on work decisions suggests that, contrary to popular impression, the test has little effect. The established view is summarized in Leonesio (1990), who writes that “numerous scholarly studies have examined the effect of the Social Security retirement test on the labor supply of older workers [i.e., the extent to which older workers participate in the labor force]. Virtually all of this research indicates that the effect is probably small and that eliminating the test would have a minor impact on the work activity of older Americans.”<sup>26</sup> The overall labor supply impact could be small for several reasons:

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<sup>25</sup> We are aware that the 31 thousand figure for the lower bound may appear incorrect to some readers, given the male and female figures. It is not: the apparent mistake is the result of a composition effect between males and females.

<sup>26</sup> Michael Leonesio, “The Effects of the Social Security Earnings Test on Labor-Market Activity of Older Americans: A Review of the Evidence,” *Social Security Bulletin*, May 1990, page 2.

- ? Work decisions are affected by many factors, including pension rules, family needs, job opportunities, and health. Relative to these other factors, the Social Security earnings test may not be particularly influential.
- ? Some workers may recognize the subsequent benefit increases under the earnings test, and therefore not perceive the system as a tax in a lifetime sense. There is some recent evidence to suggest that decisions such as the date of initial benefits claiming do respond to actuarial features such as length of life and spousal age differentials.<sup>27</sup>
- ? Even if the initial benefit reduction is viewed as a tax on working, the income effect (which reduces lifetime income and therefore boosts labor supply, assuming that leisure is a normal good) may dominate the substitution effect (which reduces the net return to working relative to leisure, and therefore reduces labor supply) for many workers. In evaluating the income and substitution effects, it is necessary to distinguish among three types of workers: Those at or immediately below the earnings threshold above which benefits are reduced; those within the range in which some benefits have already been reduced, and for whom each additional dollar of earnings reduces benefits further; and those for whom earnings are so high that the benefit reduction has already exhausted their benefits. Workers in the first category face a substitution effect but no income effect; workers in the second category face both a substitution and income effect; and workers in the final category face only an income effect. Depending on the relative strengths of the substitution and income effects, and the distribution of workers within these three categories, the labor-reducing substitution effect may be balanced by the labor-enhancing income effect. Some of the academic research suggests these two effects roughly offset each other in the aggregate.<sup>28</sup>
- ? Finally, even if the earnings test discourages work for retirees overall because it is perceived as a tax, it may encourage work among younger workers, who anticipate that working at older ages will be taxed more heavily.<sup>29</sup>

An important recent study, however, has reached a somewhat different conclusion. Friedberg (1998) suggests that eliminating the earnings test at age 65 would produce a 5.3 percent increase in

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<sup>27</sup> Courtney Coile, Peter Diamond, Jonathan Gruber, and Alain Jousten, “Delays in Claiming Social Security Benefits,” Working Paper, MIT, 1997.

<sup>28</sup> Majorie Honig and Cordelia Reimers, “Is It Worth Eliminating the Retirement Test?” *AEA Papers and Proceedings*, May 1989, page 106.

<sup>29</sup> Michael Packard, “The Earnings Test and the Short-Run Work Response to its Elimination,” *Social Security Bulletin*, September 1990, page 11.

work activity among elderly beneficiaries aged 65 and over.<sup>30</sup> She argues that previous studies are out-of-date and difficult to interpret because they relied on data from the 1970s, a period in which there were few changes to the earnings test system -- making it difficult to identify the impact of the earnings test *per se*. Using more recent data, she concludes that elderly workers are relatively sensitive to the earnings test. (Friedberg's study, however, ignores the subsequent benefit increases and treats the earnings test as though it were simply a reduction in benefits.<sup>31</sup>)

Until additional evidence is available, our conclusion from the body of earlier studies and the current data on the distribution of retirees' earnings is that the earnings test has some, but relatively modest, effect on overall work activity. It may have more significant effects on particular types of workers, with Friedberg's recent findings suggesting some impact on workers over age 65. An important question for further inquiry is whether her findings extend to workers in the ages 62-64 range.

### **III. Implications for reforming the earnings test**

A number of Social Security reform proposals have suggested eliminating or loosening the earnings test. Such proposals are certain to be considered as part of any bipartisan Social Security reform package. This section explores the pros and cons of eliminating the earnings test.

#### *Benefits of eliminating the earnings test*

The benefits of eliminating the earnings tests include:

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<sup>30</sup> Leora Friedberg, "The Social Security Earnings Test and Labor Supply of Older Men," in James Poterba, ed., *Tax Policy and the Economy* (MIT Press: Cambridge, 1998).

<sup>31</sup> Friedberg notes that she "tried estimating a model of the earnings test capturing the effect of the delayed retirement credit, but no such effect emerged." Leora Friedberg, "The Social Security Earnings Test and Labor Supply of Older Men," in James Poterba, ed., *Tax Policy and the Economy* (MIT Press: Cambridge, 1998), page 129. Another study (Aldona Robbins and Gary Robbins, "Paying People Not to Work: The Economic Costs of the Social Security Retirement Earnings test," National Center for Policy Analysis Policy Report no. 142, 1989) also estimated very large retirement effects. But the study has been criticized sharply, raising substantial questions about its results. For a trenchant analysis of the errors in the Robbins and Robbins analysis, see David Pattison, "A Review of the Net Revenue Estimates in Robbins and Robbins, 'Paying People Not to Work'," Office of Research and Statistics, Working Paper Number 41, Social Security Administration, January 1990. Pattison notes "Evaluating the estimates is difficult because Robbins and Robbins provide few details on how they arrive at their results. I have been able, however, to replicate their earnings and revenue estimates very closely. The replication indicates that these estimates incorporate a serious flaw and are of no value. I have not been able to replicate the benefit estimates, but there are strong indications that these estimates, to, are seriously flawed." Pattison, page 3.

1. The earnings test is complicated and unpopular. Beneficiaries often fail to understand how the system works. Eliminating it would remove one of the more unpopular and confusing aspects of the Social Security system.
2. The earnings test is administratively complicated.<sup>32</sup> Tracking the various benefit adjustments necessitated by the earnings test imposes administrative burdens on the Social Security Administration (SSA). According to SSA, administering the earnings system costs between \$100 and \$150 million a year.<sup>33</sup> As Gene Steuerle and Jon Bakija write, “Eliminating the earnings test at all ages would...greatly simplify the administration of the system, since the earnings test is the largest source of errors in benefit calculations.”<sup>34</sup>
3. Eliminating the earnings test would have almost no effect on the long-run actuarial soundness of the program. Since the system is close to being actuarially fair on average, eliminating it for retirees would have almost no effect on the long-run actuarial balance.
4. Eliminating the earnings test may have a modest positive influence on work activity. To the extent that workers perceive the current system as a tax on earnings, eliminating it may induce some additional work effort.
5. Eliminating the earnings test would remove workers from potentially inefficient forced savings. One issue is whether workers who want to save are likely to obtain a better rate of return than they do through the actuarial adjustment and delayed retirement credit. Both (after the new DRC is fully phased in) are designed to provide, for the typical life expectancy, a real rate of return equal to that on Treasury bonds (currently in the 2.5-3% range). A riskless real rate of this level, particularly as a real annuity that is largely unavailable in the private market, may be a reasonably attractive savings opportunity, even if forced. Of course, another issue is whether a given worker should be saving at all. For some workers with short life expectancies, it may not make sense to save. It is inefficient to force these short-lived consumers to reduce consumption today for higher benefits that they won’t actually obtain in the future.

### *Costs of eliminating the earnings test*

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<sup>32</sup> For a description of SSA’s administrative procedures with regard to the earnings test, see Virginia P. Reno, “Administering Partial Benefit Offsets for Social Security or SSI,” unpublished background paper for the Disability Policy Panel, National Academy of Social Insurance, Washington, DC, October 1994.

<sup>33</sup> Telephone conversation with Timothy Kelley of the Social Security Administration, April 16, 1999.

<sup>34</sup> Eugene Steuerle and Jon Bakija, *Retooling Social Security for the 21st Century*, pages 228-229.

The costs of eliminating the earnings test include:

1. Eliminating the earnings test would have short-run budgetary costs. Removing the earnings test for those at the full benefit age and above would raise Social Security expenditures by about \$15 billion over the first 5 years. Since the elimination of the earnings test reduces the subsequent benefit increases that would have occurred through the actuarial adjustments, the additional expenditures required decline as the years pass, and there is (as noted above) essentially no actuarial impact in the long run.
2. Eliminating the earnings test may induce even more beneficiaries to elect early benefits. The Social Security system provides reduced benefits to those electing to receive benefits before the full benefit age. The majority of beneficiaries already elect to receive such reduced benefits. A potential concern regarding eliminating the earnings test for beneficiaries -- especially for those aged 62 to 64 -- is that it may encourage more beneficiaries to elect benefits earlier than they otherwise would.<sup>35</sup> If so, the worker's annual benefit will be lower for the remainder of his or her life than if the worker had waited before beginning to draw benefits. If those electing earlier benefits consume them rather than saving enough to offset the reduction in their Social Security benefits, they will have lower income in later years. As a result, the poverty rate among the very old — and especially among widows — may increase in the long run.<sup>36</sup>

The notion that any increase in benefits will be consumed, rather than saved, is supported by recent research which suggests a strong connection between the consumption of retirees and their post-retirement income replacement rate; the evidence is suggestive that higher income replacement is not saved, but rather consumed.<sup>37</sup> It has also been documented at length that

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<sup>35</sup> These concerns may be heightened as the full benefit age increases. The increase in the full benefit age under current law means that the benefit reduction for those claiming at age 62 will be even larger than today (benefits for those claiming at age 62 will amount to 70 percent of the Primary Insurance Amount rather than 80 percent). It should be noted, however, that survivor benefits will remain at least 82.5 percent of the worker's Primary Insurance Amount for surviving spouses at or above the full benefit age, if the worker had elected early benefits. The reduction in initial benefits from 80 to 70 percent of the Primary Insurance Amount will thus not necessarily affect surviving spouses in old age.

<sup>36</sup> Any such increase could also result in increased costs for certain means-tested government programs, including Supplemental Security Income (SSI). Any increased costs for the SSI program would have to be met out of the general budget; SSI costs are not included in the 75-year actuarial projections for Social Security.

<sup>37</sup> B. Douglas Bernheim, Jonathan Skinner, and Steven Weinberg, "What Accounts for the Variation in Retirement Wealth Among U.S. Households?," NBER Working Paper #6227, October 1997.

the remaining poverty problems among the elderly are concentrated among the oldest old, and not among new retirees.<sup>38</sup>

Note that while the concerns over labor supply distortions apply to only a very small number of retirees, the concerns over undersaving apply to a much larger number: all those now working past their 62nd birthday and not claiming benefits, who might start claiming if there were no earnings test. In 1996, 40 percent of new retired worker benefit awards were made to those aged 63 or older, and 22 percent were made to those aged 65 or older. Among those who delayed receiving benefits beyond the full benefit age, furthermore, a non-trivial portion had relatively low Primary Insurance Amounts.<sup>39</sup> If the removal of the earnings test below the full benefit age induced even a modest share of such retirees to elect benefits at an earlier age, the adverse consequences in very old age (either for the workers or their spouses or both) could be substantial. Clearly, further research is required on this important topic, but the sheer magnitudes are sufficiently large to warrant concern.

3. Eliminating the earnings test could remove a potentially useful saving device for some workers. As noted earlier, in the absence of the earnings test, the only decision available to the worker is to claim or not claim his or her benefits. Some workers, however, may want to claim part of their benefits, and save the rest in the form of a real indexed annuity. This is exactly the type of savings mechanism that the Social Security earnings test provides. In the absence of the earnings test, this savings mechanism is unlikely to be available.
4. Removing the earnings test might also lower national savings slightly, although the effect is not likely to be large. With a purely pay-as-you-go Social Security system (in which taxes are always equal to benefits), removing the earnings test would not reduce national savings (since it is implausible that private saving would fall, and public saving would be unaffected -- the higher benefits would be matched by higher taxes, as required under a pure pay-as-you-go system). Indeed, national saving may even increase, to the extent that some of the additional benefits by working beneficiaries were saved. But with our current partially funded system, higher benefit payments may reduce public saving (since benefits would be higher without any corresponding change in taxes). If the potential increase in private saving is smaller than the decline in public

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<sup>38</sup> Eugene Steuerle and Jon Bakija, *Retooling Social Security for the 21st Century*.

<sup>39</sup> For example, one-third of new retirees electing benefits at or after age 65 in 1996 had Primary Insurance Amounts below \$650 per month, and a similar proportion had benefits below that level. Social Security Bulletin, *Annual Statistical Supplement 1997*, Table 6.B3, page 263, and Table 6.B4, page 264. Some of these beneficiaries are officials formerly employed by state and local governments or the Federal government who were not covered by Social Security for at least part of their careers and have other pension income for those years.

saving (i.e., if taxes and other spending are not affected, and if beneficiaries do not save all of their additional benefits), removing the earnings test would reduce national savings.

### *Recommendations for reform*

In evaluating the pros and cons of eliminating the earnings test, it is important to remember that Social Security embodies *two* earnings tests — one for beneficiaries above the full benefit age, and one for beneficiaries below the full benefit age. The relative weight of the pros and cons for eliminating the earnings test may differ for the two earnings tests. Furthermore, the full benefit age is scheduled to increase from 65 to 67 under current law. Therefore, the options before policymakers properly include:

1. Retaining both existing earnings tests
2. Eliminating both earnings tests (above *and* below the full benefit age)
3. Eliminating the earnings test at the full benefit age (currently age 65), but retaining the earnings test below the full benefit age
4. Eliminating the earnings test at age 65 (the current full benefit age) and retaining the earnings test below age 65 even as the full benefit age increases above 65, or simply eliminating the earnings test immediately at age 67.

There are clearly important and influential arguments on either side of this debate. In considering whether to eliminate the earnings test, policymakers should remember that there are two such tests and that the judgment regarding one need not be the judgment regarding the other. Our opinion is that there is a reasonably strong case to be made for leaving the earnings test in place for those below the full benefit age, with a much more ambiguous case at or above the full benefit age.

#### Costs and benefits of retaining the earnings test below the full benefit age

The major costs of leaving the earnings test in place for early retirees are the continued distortion to labor supply that arises, and the potential inefficiency of forcing 62-64 year olds to save in this form.

- ? In terms of labor market distortions, existing evidence seems to suggest a small effect of the earnings test. The bunching at the earnings test kink at those ages is relatively small as a percent of the population. The new results of Friedberg (1998) are suggestive of a larger impact, but they are much larger than what has been found in most other studies, they only apply directly to workers over age 65, and they do not take account of the subsequent increase in benefits.

- ? In terms of the inefficiency of forcing beneficiaries to save, our view is that the inefficiency of this forced savings is not large, and that any such inefficiency is offset by the distributional implications among the elderly. Moreover, increased benefits from removing the earnings test are likely to be consumed, not saved.

The benefit of retaining the earnings test below the full benefit age is that it would avoid a redistribution of income from the relatively poorly off oldest years of life to the relatively well off age of early retirement. It is obviously difficult to assess how large this intertemporal redistribution would be. But given the modest benefits from removing the earnings test for this age group, and the potential for substantial increases in elderly poverty, the benefits of retaining the earnings test for those below the normal retirement age appear to us to outweigh the costs.

#### Costs and benefits of removing the earnings test at or above the full benefit age

At the full benefit age (currently 65), the costs of retaining the earnings test may begin to outweigh the benefits for three reasons.

- ? First, the Friedberg (1998) evidence is directly relevant to this age group, and does imply some labor supply distortion from the current system.
- ? Second, even when the delayed retirement credit increase is fully phased in, the actuarial adjustment will be fair only around age 65, but unfair by age 69, so that the system will impose a lifetime tax for workers at that age.
- ? Third, beneficiaries in this age category will already receive increased Social Security benefits relative to their Primary Insurance Amounts. For these beneficiaries, old age poverty is less likely to be a problem, so there is less concern about their consuming more now.

As a result, a stronger case can be made for removing the earnings test after the full benefit age than below it. Moreover, another advantage of removing the earnings test after the full benefit age only is that it might provide an additional stimulus to labor supply among those age 62-64. Consider a 62 year-old who today wants to claim benefits but who doesn't want to be subject to the earnings test (either because she doesn't understand how the system works or because she doesn't like the forced savings aspects). That person may retire today in the face of eight years of high perceived tax rates on continued earnings. But, if told that the earnings test will be removed after the full benefit age, she may decide instead to continue working until she reaches the full benefit age, at which point she would claim benefits and could continue to work without worrying about the earnings test. That is, if labor market

reentry once retired is difficult, removing the earnings test at the full benefit age may provide a “light at the end of the tunnel” that will promote work among the young old.

#### Elimination at the full benefit age versus elimination at age 65 or age 67

Some analysts have expressed concerns about linking the age at which the earnings test no longer applies to the full benefit age:

- ? First, it would cause the earnings test to apply to older and older workers as the full benefit age increases from 65 to 67 under current law;
- ? Second, it could create a political disincentive to increasing the full benefit age further or faster, since it would impose a “tax” on those then falling below the full benefit age.

One twist on our proposed reform is therefore to eliminate the earnings test at either age 65 or age 67, so that the age at which the earnings test no longer applies is not linked to increases (currently scheduled or otherwise) in the full benefit age. While these proposals deserve careful scrutiny, our initial reaction is that either is inferior to elimination at the full benefit age itself:

- ? Since one of our primary concerns is the impact of the earnings test removal on early claiming and therefore widow poverty, and since the actuarial reductions for early claiming are tied to the full benefit age, we believe that tying the earnings test removal to the full benefit age is more appropriate than simply eliminating it at age 65. Elimination at age 65, in other words, could encourage early claiming as the full benefit age rises above 65.
- ? We do not believe that it is politically feasible to remove the earnings test only at age 67 effective immediately. That view is shared by many sophisticated observers of Social Security reform, and is consistent with the fact that several legislative proposals eliminate the earnings test above the full benefit age – but none simply eliminate it at age 67.

Therefore, while we are open to alternative formulations, we believe that eliminating the earnings test at the full benefit age is the most auspicious approach.<sup>40</sup>

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<sup>40</sup> We believe that any disincentive created against further increases in the full benefit age could be addressed in drafting any such legislation. For example, the earnings test removal could remain at the full benefit age as scheduled under current law even if that schedule is subsequently changed. Such an approach, however, would once again raise concerns about early claiming and widow poverty – the very concerns that led us to favor our approach over simply eliminating the earnings test at age 65.

## IV. Other policy suggestions

We have three further suggestions for reform that could complement our major policy suggestion of removing the earnings test for those at or above the full benefit age, but not below it:

- ? First, concerns about keeping the earnings test in place for those age 62-64 could be alleviated by a campaign by the Social Security Administration to make older persons aware that the earnings test is not a tax. A clear and concise mailing to all 61 year olds in America about how the earnings test really works, with simple examples, would remove a substantial amount of the misinformation about the functioning of the system. Similarly, beneficiaries whose benefits are reduced because of the earnings test should be told how much their subsequent benefits will be increased as a result.
- ? Second, the lack of adjustment of spousal benefits for older spouses is an anomaly that complicates the system. For a couple with a spouse past the full benefit age, this provision partially converts the earnings test from a forced savings program to a true lifetime tax. There is no clear argument for this quirk in the law.

On the other hand, providing a subsequent adjustment to spousal benefits would have short-run and long-run costs. (The long-run actuarial cost, however, is likely to be quite small, perhaps 0.05 percent of payroll or less.) Furthermore, it is not clear whether this anomaly can be removed without addressing the broader issue of delayed retirement credits for spousal benefits. Adding a delayed retirement credit for all spousal benefits would have a more significant cost. Such an expansion of the delayed retirement credit system would improve the work incentives among older married workers, but would do so for a group already benefitting from the redistributive aspects of dependent benefits.

One possibility is therefore to apply the benefit reduction under the earnings test exclusively to the worker's benefits, rather than pro-rating it between the worker's benefits and the spouse's benefits. That approach would obviate the need to adjust the spousal benefit subsequently, thus removing the quirk involving the non-adjustment of spousal benefits for older spouses. (If the worker's annual benefit were exhausted by the benefit reduction under the earnings test, additional reductions could be applied to the spouse's benefit and then subsequently adjusted at the same rate as the worker's benefit. That would imply that some spouses effectively obtain a higher benefit through the delayed retirement credit, but the number of such spouses may be small enough that it would not pose a substantial threat to the overall policy of not adjusting

spousal benefits for the delayed retirement credit. Alternatively, any excess reduction beyond a full year's benefit for the worker alone could be applied to the worker's benefit during the subsequent year, without affecting spousal benefits.)

- ? Third, when 65-year olds sign up for Medicare coverage, they should *not* be encouraged (as they are today) to elect Social Security benefits simultaneously. Indeed, if anything, they should be presented with a table showing how much higher their Social Security benefits would be if they waited to elect initial benefits. Encouraging those 65-year olds working full-time to elect Social Security benefits – only to have those benefits eliminated through the earnings test – only increases frustration with the perceived tax and exacerbates the administrative burden of operating the system. Changing the current practice will become even more important as the full benefit age increases above 65.

Finally, it may be worth noting that Henry Aaron and Peter Diamond have separately put forward other policy suggestions that would affect the earnings test system:

- ? Henry Aaron has proposed that the earnings test be retained, but that the delayed retirement credit be replaced with a lump-sum payment to the worker at a specific age. In other words, rather than receiving a higher *monthly* benefit in later years to compensate for a reduced benefit from the earnings test, the worker would receive a single *lump-sum* payment at a specific age (e.g., 70) or upon death. There is some evidence that such delayed lump-sum payments may be more attractive to workers – and thus make the earnings test appear less burdensome – than a series of continuing payments.<sup>41</sup> On the other hand, one of the principal benefits of the Social Security system is that it provides an inflation-indexed annuity; this proposal would effectively replace part of that annuity with a lump-sum payment.
- ? Peter Diamond has proposed applying the earnings test to a smoothly decreasing fraction of benefits as the worker ages.<sup>42</sup> For example, 15 percent of benefits could be paid independently of earnings to 65 year olds. The remaining 85 percent would be subject to the earnings test. Workers aged 66 would receive 30 percent of benefits, with 70 percent subject to the earnings test. The fraction paid independently of earnings would continue increasing until it reaches 100 percent for 70 year-olds. In principle, this approach is intriguing and may

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<sup>41</sup> See Dennis Fetherstonhaugh and Lee Ross, "Framing Effects and Income Flow Preferences in Decisions about Social Security," draft, April 1, 1999.

<sup>42</sup> Peter Diamond, "Social Security: A Case for Changing the Earnings Test but not the Normal Retirement Age," mimeo, June 1980.

provide improved work incentives relative to the existing system. In practice, however, it may cause seem more confusing than the current system and may lack the political appeal of simply eliminating the earnings test at a common reference age.

## **Conclusion**

There is a substantial amount of both genuine disagreement and, perhaps more importantly, misunderstanding about the benefits and costs of the earnings test. Our view, which is shared by the architects of some recent proposals to reform the earnings test, is that there is a much stronger argument for removing the test above the full benefit age than below it. The modest and uncertain implications for labor supply are outweighed by the potential danger of earlier election of benefits, with a concomitant threat to subsequent income among the very old. By the same token, the argument for retaining the test after the full benefit age is weaker.

If this type of policy were adopted, we suggest three auxiliary reforms as well. First, a public relations campaign should be carried out by the Social Security Administration to educate older workers as to the savings aspects of the earnings test. Second, steps should be taken to remedy the feature of the current system that converts the earnings test from a savings mechanism to a tax for those with spouses above the full benefit age. Third, 65-year olds signing up for Medicare should not be encouraged to elect Social Security benefits as they are today.