The Earnings Test and the Short-Run Work Response to Its Elimination

by Michael D. Packard*

Eliminating the earnings test will have different effects on the work effort of persons aged 65–69, depending on whether or not they are currently working or currently receiving Social Security benefits. This article reviews the development of the earnings test and examines the theoretical implications on work effort of removing the test for members of this age group. It looks at the Current Population Survey (CPS) data to determine how many persons aged 65–69 have characteristics that can be identified with groups that would theoretically increase, decrease, or not change their work effort should they no longer be subject to the earnings test.

This analysis suggests that at least 80 percent, and perhaps more than 90 percent, of the 9.7 million persons aged 65–69 will not change their level of work effort if the earnings test is eliminated. Individuals who would modify their hours worked and earnings are fairly evenly split among those who would increase, decrease, or have an undetermined direction of change in their work effort.

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The Social Security program was initially designed to provide social insurance against the loss of income following withdrawal from the labor force. Loss of earnings was necessary to qualify for benefits and, therefore, provisions for an earnings test were included in the original Social Security Act. The 1935 Act specified that any earnings whatever from covered employment [1] by a beneficiary were sufficient to cause the loss of all Social Security benefits for that month. This severe restriction on earnings has gradually changed. Currently, beneficiaries aged 70 or older are not subject to the earnings test; those under age 70 who are covered may now have a fairly substantial level of annual earnings before they become ineligible for any benefits.

There has recently been a resurgence of interest in eliminating the earnings test (also referred to as the retirement test) for persons aged 65–69. Most of those supporting elimination of the earnings test for this age group believe the test imposes a work disincentive and that its removal will result in an increased supply of labor. This article reviews the development of the earnings test and looks at the likely labor-supply effects of removing the test for different categories of persons aged 65–69. Data from the March 1987 Supplement to the Current Population Survey (CPS) are used to determine how many persons aged 65–69 were in these categories in 1986, and the net labor supply effect of removing the earnings test for them is estimated.

[1] Earnings from covered employment, or covered earnings, are earnings that are subject to the Social Security payroll tax.

Background

The earnings test has been modified a number of times by Congress since the enactment of the 1935 legislation. [2] The original test, which applied to beneficiaries of all ages, required that monthly benefits not be paid for any month in which the beneficiary received covered wages from regular employment. Because the program was set up to insure against the loss of earnings, the receipt of any earnings was considered sufficient to demonstrate that the insured event had not occurred.

Exempting Certain Groups

Modifications to the earnings test have taken two paths. The most important in the current debate, but the second to be implemented, was exempting beneficiaries above a certain age from the earnings restrictions. The 1950 amendments began this process by eliminating the restrictions for beneficiaries aged 75 or older. The rationale for this exemption was based on a moneysworth principle, not a labor supply one (Myers 1964, page 5). The argument was forcefully made that some groups, notably farmers and the professional self-employed, never retired and would, therefore, never benefit from the contributions they had been making to the Social Security system. On equity grounds, it was perceived necessary to provide benefits at some specified age, no matter what the level of earnings.

[2] These changes are summarized in table 1.

This change severely weakened the original social insurance rationale for the Social Security program and formalized the view that the receipt of Social Security retired-worker benefits was an "earned right" based on years of contributing to the program. The worker had to wait 10 years past the "normal retirement age" of 65 to be eligible for an annuity, but the benefit was available, regardless of earnings, when the individual attained age 75.

The age at which the beneficiary was exempt from the earnings test was reduced twice more—to age 72 by the 1954 amendments and to age 70 (effective in 1983) by the 1977 and 1981 amendments. Thus, proposals to further reduce the exempt age to 65 are calls for a continuation of the trend begun in 1950.

Changing Allowable Earnings and Rate of Benefits Withheld

The second path by which the earnings test has been modified has been through changes in the level of allowable earnings and changes in the amount of benefits lost once earnings exceed the allowable limit, known as the "threshold." These changes began even before any benefits were paid when the 1939 amendments allowed beneficiaries up to $14.99 per month in covered earnings with no loss in benefits. When covered earnings reached $15 in a month, all benefits for that month, including those for an eligible spouse, were forfeited. The earnings test threshold remained at $14.99 until 1950, and then was increased on an ad hoc basis from 1950 to 1974 (table 1). It has been indexed to the growth in average covered earnings since 1975.

A number of modifications were made to the earnings test along this second path over the years. The 1950 amendments brought many self-employed persons into the Social Security system. Because these individuals generally determined their earnings on a taxable year basis, the monthly earnings test had to be modified for them to create a test with an annual threshold. [3] As long as taxable year earnings were below this threshold, no benefits were lost. If taxable year earnings exceeded the threshold, an amount equal to 1 month's benefit would be withheld for each increment of excessive earnings equal to all or part of the monthly threshold. However, the number of monthly benefits withheld could not exceed the number of months during the year that the beneficiary was substantially self-employed.

The 1954 amendments extended the annual threshold to all working beneficiaries, not just to the self-employed. The procedure for withholding benefits was the same as for the self-employed, but no benefits were withheld for any month in which earnings were below the monthly threshold. The 1954 amendments also made noncovered earnings subject to the test. No longer would some beneficiaries be able to work and be exempt from the test because they were working in noncovered employment.

The 1960 amendments made an important modification to the test. The annual and monthly earnings test thresholds remained, but a worker no longer lost benefits in full month increments once yearly earnings exceeded the annual threshold. Instead, benefits were reduced by $1 for each $2 of the first $300 of earnings in excess of the annual threshold. If earnings exceeded the annual threshold plus $300, benefits were further reduced by $1 for each $1 of earnings above this level. [4]

The importance of this modification is that beneficiaries would no longer incur a net loss in total income because of earnings in excess of the annual threshold. Before this change, if a beneficiary had a monthly benefit entitlement of $75 (roughly the average monthly retired-worker benefit in 1960) and had earnings $50 in excess of the annual threshold, he or she would lose all $75 in benefits. The individual would be $25 better off by limiting earnings to the annual threshold and losing no benefits. Under the 1960 change, the $50 in excess earnings would cause only a $25 benefit reduction—leaving total income $25 higher than it would have been if the beneficiary had stopped working at the annual threshold.

From an administrative standpoint, the Social Security Administration (SSA) found it easier to withhold excess benefits in monthly lump sums rather than to reduce all benefit payments equally throughout the year. Withholding $1 in benefits for each $2 in earnings above the annual threshold reduced the amount of benefits that were withheld, but beneficiaries with excessive earnings still experienced a month, or often several consecutive months, when they received no benefits. [5]

The 1972 amendments made two modifications to the earnings test. First, the $1 reduction in benefits for each $1 of earnings provision was eliminated. Henceforth, all reductions caused by earnings in excess of the annual threshold would be at the $1 for $2 of earnings rate. Second, provisions were made for automatic adjustments to the monthly and yearly earnings test thresholds. Beginning in 1975, the annual and monthly thresholds were automatically increased in proportion to increases in average covered earnings.

In addition to lowering the earnings test exempt age (described above), the 1977 amendments made two major changes to the test. First, a separate earnings test with a higher annual threshold for those aged 65–71 was legislated. The threshold level for the group aged 65–71 was increased on an ad hoc basis until 1982, when it exceeded the threshold of the group under age 65 by approximately 35 percent. Threshold levels for both groups are now indexed to increases in average earnings. Second, except in a grace year (generally the first year of benefit entitlement [6]), monthly earnings of less than one-twelfth the annual threshold no longer exempted benefits for that month from the

[3] Aside from the period January 1955 through August 1958, the annual earnings test threshold has always equaled 12 times the monthly threshold. It was 15 times the monthly threshold during the aforementioned 3½ year period.

[4] Very high earnings did not necessarily ensure the loss of all benefits. By concentrating their earnings into a few months during the year, beneficiary workers could retain benefits for those months in which their earnings were below the monthly threshold.

[5] The number of months of benefits withheld was computed by dividing the beneficiary's monthly benefit into the amount to be withheld. Any remainder was subtracted from one of the payments that were made.

[6] A person becomes entitled to benefits when he or she applies for and is awarded benefits. Eligibility is based on insured status and age requirements.

Table 1.—Earnings test history

			Amount permitted without reduction in benefits		Reduction in monthly benefits [2]	
Act	Beneficiary exempt	Earnings subject to test	Annual earnings	Monthly wages [1]	Amount	Effective for taxable years
1935	...	Covered	...	$0	Full monthly benefit	...
1939	...	...	...	14.99	...	Beginning Jan. 1, 1940.
1950	Aged 75 or older	...	[3] $600	50.00	...	Beginning Sept. 1, 1950.
1952	...	...	[3] 900	75.00	...	Ending after Aug. 31, 1952.
1954	Aged 72 or older	Covered and non-covered [4]	[5] 1,200	80.00	One month's benefit for each $80 or fraction of $80 in excess of $1,200.	Beginning after Dec. 31, 1954.
1956	Disabled worker, disabled child [6]	...	...	...	...	...
1958	...	...	...	100.00	...	Beginning after Aug. 31, 1958.
1960	...	...	...	...	$1 for each $2 of earnings from $1,201-$1,500 plus $1 for each $1 of earnings above $1,500.	Beginning after Dec. 31, 1960.
1961	...	...	...	...	$1 for each $2 of earnings from $1,201-$1,700 plus $1 for each $1 of earnings above $1,700.	Ending after June 30, 1961.
1965	...	...	[5] 1,500	125.00	$1 for each $2 of earnings from $1,501-$2,700 plus $1 for each $1 of earnings above $2,700.	Ending after Dec. 31, 1965.
1967	Disabled widow(er), disabled surviving divorced wife	...	[5] 1,680	140.00	$1 for each $2 of earnings from $1,681-$2,880 plus $1 for each $1 of earnings above $2,880.	Ending after Dec. 31, 1967.
1972b	...	...	[7] 2,100	175.00	$1 for each $2 of earnings above $2,100.	Ending after Dec. 31, 1972.
1973ab [8]	...	...	[7] 2,400	200.00	$1 for each $2 of earnings above $2,400.	Beginning after Dec. 31, 1973.
	...	...	[7] 2,520	210.00	$1 for each $2 of earnings above $2,520.	Beginning after Dec. 31, 1974.
	...	...	[7] 2,760	230.00	$1 for each $2 of earnings above $2,760.	Beginning after Dec. 31, 1975.
	...	...	[7] 3,000	250.00	$1 for each $2 of earnings above $3,000.	Beginning after Dec. 31, 1976.
1977	...	For beneficiaries under age 65	[7] 3,240	270.00	$1 for each $2 of earnings above $3,240.	Beginning after Dec. 31, 1977.
	...	...	[7] 3,480	290.00	$1 for each $2 of earnings above $3,480.	Beginning after Dec. 31, 1978.
	...	...	[7] 3,720	310.00	$1 for each $2 of earnings above $3,720.	Beginning after Dec. 31, 1979.
	...	...	[7] 4,080	340.00	$1 for each $2 of earnings above $4,080.	Beginning after Dec. 31, 1980.
	...	...	[7] 4,440	370.00	$1 for each $2 of earnings above $4,440	Beginning after Dec. 31, 1981.
	...	...	[7] 4,920	410.00	$1 for each $2 of earnings above $4,920.	Beginning after Dec. 31, 1982.
	...	...	[7] 5,160	430.00	$1 for each $2 of earnings above $5,160.	Beginning after Dec. 31, 1983.
	...	...	[7] 5,400	450.00	$1 for each $2 of earnings above $5,400.	Beginning after Dec. 31, 1984.
	...	...	[7] 5,760	480.00	$1 for each $2 of earnings above $5,760.	Beginning after Dec. 31, 1985.
	...	...	[7] 6,000	500.00	$1 for each $2 of earnings above $6,000.	Beginning after Dec. 31, 1986.
	...	...	[7] 6,120	510.00	$1 for each $2 of earnings above $6,120.	Beginning after Dec. 31, 1987.
	...	...	[7] 6,480	540.00	$1 for each $2 of earnings above $6,480.	Beginning after Dec. 31, 1988.
1977	...	For beneficiaries aged 65-72	[7 9] $4,000	[9] $333.33	$1 for each $2 of earnings above $4,000.	Beginning after Dec. 31, 1977.
	...	...	[7 9] 4,500	[9] 375.00	$1 for each $2 of earnings above $4,500.	Beginning after Dec. 31, 1978.
	...	...	[7 9] 5,000	[9] 416.66	$1 for each $2 of earnings above $5,000.	Beginning after Dec. 31, 1979
	...	...	[7 9] 5,500	[9] 458.33	$1 for each $2 of earnings above $5,500.	Beginning after Dec. 31, 1980.
	Aged 70 or older [10]	...	[7 9] 6,000	[9] 500.00	$1 for each $2 of earnings above $6,000.	Beginning after Dec. 31, 1981.

See footnotes at end of table.

Table 1.—Earnings test history—**continued**

Act	Beneficiary exempt	Earnings subject to test	Amount permitted without reduction in benefits: Annual earnings	Monthly wages [1]	Reduction in monthly benefits [2]: Amount	Effective for taxable years
1980	Disabled surviving divorced husband [11]	...	(12)	...	...	...
1981a	Aged 70 or older	For beneficiaries aged 65–70	[7] 6,600	550.00	$1 for each $2 of earnings above $6,600.	Beginning after Dec. 31, 1982.
	...	...	[7] 6,960	580.00	$1 for each $2 of earnings above $6,960.	Beginning after Dec. 31, 1983.
	...	...	[7] 7,320	610.00	$1 for each $2 of earnings above $7,320.	Beginning after Dec. 31, 1984.
	...	...	[7] 7,800	650.00	$1 for each $2 of earnings above $7,800.	Beginning after Dec. 31, 1985.
	...	...	[7] 8,160	680.00	$1 for each $2 of earnings above $8,160.	Beginning after Dec. 31, 1986.
	...	...	[7] 8,400	700.00	$1 for each $2 of earnings above $8,400.	Beginning after Dec. 31, 1987.
	...	...	[7] 8,880	740.00	$1 for each $2 of earnings above $8,880.	Beginning after Dec. 31, 1988.
1983	...	For beneficiaries aged 65–70	...	...	$1 for each $3 of earnings above annual exempt amount.	Beginning after Dec. 31, 1989.

[1] Monthly test for self-employment income is defined in terms of substantial services. For taxable years beginning after Dec. 31, 1977, monthly test eliminated for both wage and self-employment income except that each individual may use monthly test for 1 grace year, usually the year of retirement.
[2] Earnings of retired-worker beneficiary affect total monthly family benefit; earnings of dependent or survivor beneficiary affect only his or her benefit. However, effective January 1985, earnings of retired-worker beneficiary do not affect benefit to divorced spouse who has been divorced at least 2 years.
[3] Applied to self-employment income only.
[4] Special provisions for earnings in noncovered employment outside the United States.
[5] Includes earnings during first year of eligibility for benefits and during year of attainment of exempt age.
[6] No earnings test applied to disabled child's earnings, but earnings of retired-worker beneficiary affect disabled child's benefit.
[7] Includes earnings during first year of eligibility to benefits, but excludes earnings in and after month of attainment of exempt age.
[8] Beginning in 1975, annual and monthly amounts subject to annual automatic adjustments in proportion to increases in average earnings level. (Superseded 1972a legislation of adjustments.)
[9] Discretionary increase included in 1977 legislation.
[10] 1981a legislation postponed effective date of new exempt age by 1 year.
[11] Beneficiary category established by District Court Decision, July 17, 1980. Statutory change enacted in 1983.
[12] Excludes self-employment income received in a year after entitlement but derived from pre-entitlement services.

earnings test. [7] This provision countered the tactic some beneficiaries had been using of concentrating earnings in a few months during the year to minimize the effects of the test.

The most recent amendments affecting the earnings test were passed in 1983. These amendments lowered the benefit reduction rate beginning in 1990 from 50 percent to 33⅓ percent [8] for beneficiaries aged 65–69. The 50-percent rate remains for beneficiaries under age 65.

[7] It was necessary to retain the monthly threshold during the grace year to ensure that persons who became entitled to benefits during the year did not lose benefits to the earnings test because of earnings received before entitlement.

[8] That is, from $1 in benefits withheld for each $2 of earnings in excess of the earnings test threshold to $1 withheld for each $3 of earnings above the threshold.

Effect of the Changes

The restrictiveness of the earnings test has been significantly relaxed since the inception of the Social Security program. It has progressed from disallowing benefits to any beneficiary with any covered earnings, through allowing earnings up to a specified threshold before all benefits were lost, to gradually reducing benefits for beneficiaries whose earnings exceed a specified threshold. It has also changed from covering all beneficiaries to exempting beneficiaries above a specified age.

As a demonstration of the extent to which the earnings test has been relaxed, the first modification to the test allowed only a modest level of earnings before all monthly benefits were forfeited. Earnings from covered employment of less than $15 per month in 1940 did not result in the loss of benefits. This level of earnings was about 25 percent of median monthly covered earnings of workers and 66 percent of average monthly benefits in that year. A beneficiary who earned $15 in each month in 1940—$180 during the year—would lose all benefits for the year. In contrast, the 1986 threshold for those aged 65–69, was $650 on a monthly basis—67 percent of median monthly covered earnings for workers and 133 percent of average monthly retired-worker benefits. These are significant increases over the 1940 levels. In addition, by 1986, benefits were gradually reduced as earnings rose above the annual threshold. In 1986, a beneficiary aged 65–69 entitled to the average benefit amount ($488.50 per month) would have to earn more than 100 times as much as his or her 1940 counterpart, more than $19,500, before all benefits were lost.

Current Issues

Further liberalization of the earnings test will increase the overall net cost of the Social Security program. [9] The SSA's Office of the Actuary has estimated that current proposals to eliminate the test for those aged 65–69 will lead to additional costs of some $5–$6 billion annually. In the past, when the earnings test has been liberalized, contribution rates have been raised (or legislated to be raised at some point in the future) to cover the increased costs. However, most of the current proposals to eliminate the earnings test tend to assume that a significant fraction of the increased costs can be recouped from two other sources: (1) increased payroll and income taxes generated by the increased work effort of those no longer subject to the test and (2) elimination of upward benefit recomputations that take into account earnings obtained while Social Security benefits are received.

If, as has been argued, the earnings test is a work disincentive for those aged 65–69, then it may pose an even greater work disincentive for those under age 65 because it is even more severe: The earnings threshold is 27 percent lower for the younger age group than for those aged 65–69 and, beginning in 1990, their benefits (already actuarially reduced) are withheld at a higher rate if they have earnings above the earnings test threshold. If the test is a work disincentive and it is eliminated for those aged 65–69, the test remaining for 62-64-year-old beneficiaries could encourage workers in this age range to leave the labor force for 2–3 years and then to try to reenter the labor market at age 65. When they tried to reenter the labor force, they would probably have difficulty finding a job that paid a wage comparable to their "preretirement" wage. Despite this disincentive most proposals limit the elimination of the test to the group aged 65–69. Costs may be one reason. The SSA Actuary's cost estimates of eliminating the test for everyone are $12–$13 billion per year (compared with $5–$6 billion per year for removing the test for those aged 65–69 only), but these estimates assume only modest labor-supply changes.

Will the elimination of the earnings test for those aged 65–69 cause a significant increase in their work effort? History indicates that exemption of selected age groups from the earnings test did not result in an increase in their overall work effort. In chart 1, the labor-force participation rates of men and women aged 70 or older are plotted for 1947–88. The age at which the test no longer applies was set at age 75 by the 1950 amendments and lowered to age 72 by the 1954 amendments and to age 70 (effective after 1982) by the 1977 and 1981 amendments. If exempting individuals from the test results in increased work effort, then increased labor-force participation rates should be observed in the years immediately following this action. No indication of any such increase is found in the data in chart 1. The pauses in the downward trend in the labor-force participation rates for men in 1954–55 and 1985–88 may be partially the result of lowering the exempt age, but they are more likely due to the economic recovery from the recessions of 1953–54 and 1979–84.

Although the repeal of the earnings test may cause some persons to increase their work effort and earnings, the evidence indicates that previous exemptions of selected age groups from the earnings test has not had much effect in the aggregate. Why didn't the elimination of the test lead to an increase in aggregate labor supply among the exempted age group? This topic is the subject of the next section.

Economic Theory

It is often assumed that elimination of the earnings test will increase the work effort and earnings of those affected, but this result is by no means certain. The test is considered a work disincentive because, for a range of earnings above the earnings test threshold ($9,360 until all benefits are lost), Social Security benefits are reduced $1 for each $3 earned. [10] Eliminating the test, it is argued, will effectively raise the wage rate by one-half over this earnings range, resulting in increased work effort. However, while the earnings and work effort of those within this earnings range **may** increase if the test is eliminated, more than 90 percent of those aged 65–69 do not have earnings in this range. Their labor-supply response to the elimination of the test will not always match that of workers with earnings in the affected range. [11]

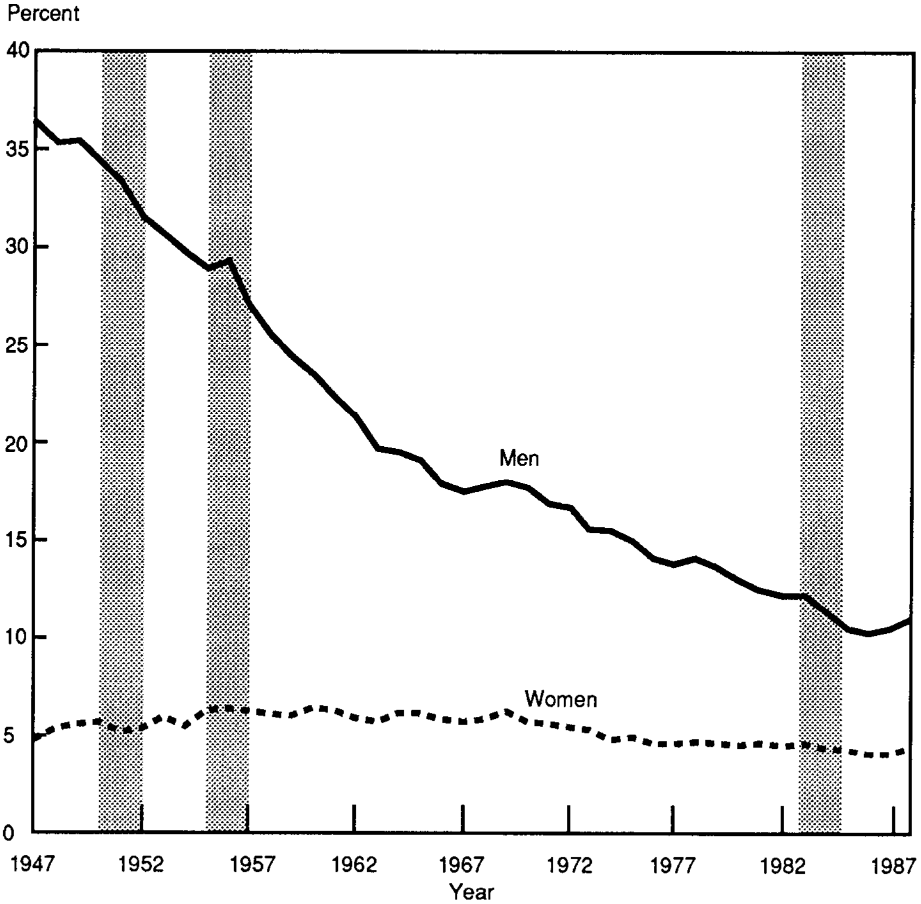
Two provisions in the current Social Security Act may lead one to conclude that the earnings test may not pose much of a work disincentive. One provision is the recomputation of benefits that credits the worker for annual earnings from covered employment after entitlement to Social

[9] These costs primarily reflect additional benefits to be paid as a result of eliminating the earnings test. Most of these additional benefits would go to persons earning $20,000 or more. Pattison et al. (1989) estimate that, if the earnings test were eliminated for 1990, the majority of the net benefits (benefits less any change in payroll or income taxes) would go to those families in the upper end of the income distribution within the group aged 65–69.

[10] Benefits are reduced $1 for each $2 of earnings in excess of the threshold for beneficiaries under age 65.

[11] Another, secondary, effect often overlooked is that workers younger than age 65 may alter their hours of work or their retirement plans in response to the elimination of the test for those aged 65–69, and these potential responses must be included in any analysis that tries to determine the total effect on labor supply of eliminating the earnings test.

Chart 1.—Labor-force participation rates of persons aged 70 or older, 1947-88[1]



[1]The earnings test no longer applied to those aged 75 or older beginning in 1950, those aged 72 or older beginning in 1955, and those aged 70 or older beginning in 1983. The bars indicate 2-year periods from the effective dates of these changes.

Security benefits. [12] If annual postentitlement earnings are larger than the lowest annual earnings used in computing the individual's benefit amount, they will replace those lowest earnings, and benefits for future years will be recomputed. [13] The second provision is the benefit adjustment that takes into consideration the individual's age at retirement. For each month of benefits lost because of the earnings test, the beneficiary will be deemed to have retired 1 month later than his or her previous retirement month and benefits will be adjusted upwards accordingly. The adjustment factor used is that applicable for the age at which benefits are lost because of the earnings test, not the age at which the beneficiary first received benefits.

For persons under age 65 with average life expectancies, the age-based benefit adjustment is approximately actuarially fair—that is, the total lifetime value of Social Security benefits will be approximately the same no matter when before age 65 retired-worker benefits are first received. [14] For those aged 65–69, the situation is different. The adjustment is only about one-third the actuarially fair level—that is, delaying retirement will reduce lifetime benefits. [15] The adjustment for those aged 65–69 is being gradually increased to a more actuarially fair 8 percent over the next 18 years.

Persons aged 70 or older are not subject to the earnings test, nor do they receive an age-based benefit adjustment for delaying benefit receipt. For each month persons aged 70 or older decline to take benefits, they lose 1 month's benefit.

These two provisions—the benefit recomputation and the age-based benefit adjustments—can each increase future benefits when benefits are lost because of the earnings test. Thus, they offset a large portion of the work disincentive for workers subject to the test. If the benefit adjustment for delaying the receipt of benefits or for losing benefits because of the test were actuarially fair for those aged 65–69, these provisions would offset the entire work disincentive effect. Unfortunately, the effects of these provisions would be behaviorally significant only if they were fully understood by the beneficiary population. Little indication exits that the beneficiary population is aware of the potential effects of either provision.

How are persons aged 65–69 likely to change their work behavior if the

[12] The recomputation provision applies to retired-worker beneficiaries of all ages, not just to those subject to the earnings test.

[13] Several proposals to eliminate the earnings test also propose that recomputation of benefits cease once a person becomes entitled to benefits.

[14] For those expecting to live longer than average, the increase is more than actuarially fair—that is, it is an incentive not to take early retirement benefits. For these "long lifers," the expected lifetime benefits will increase each month benefit acceptance is delayed until age 65.

[15] Proposals to eliminate the earnings test generally also propose concurrently raising the adjustment, also called the delayed retirement credit, to 8 percent upon elimination of the earnings test. At present, the delayed retirement credit is scheduled to increase gradually, beginning in 1990, from 3 percent to 8 percent per year for those above the normal retirement age (currently age 65).

earnings test is removed? The answer depends on whether one is looking at the short-run or long-run response.

Short-Run Responses

In the short run, the primary impact will be on those currently aged 65–69, but not all persons in this age group will be affected. Table 2 shows the expected impact of removing the test on work effort and earnings for persons in each of five earnings categories.

Table 2.—Expected effects of earnings test elimination for persons aged 65–69, by earnings level

Earnings level	Expected effect of on—	
	Benefits	Earnings
Zero Earners	None	Marginal increase
Below-Threshold Earners	None	Marginal increase
Threshold Earners	None	Increase
Benefit-Reduction Earners	Increase	Ambiguous
Benefit-Loss Earners	Increase	Decrease

Zero Earners.—These individuals have no earnings. Most Zero Earners aged 65–69 receive Social Security benefits as retired workers, survivors, or spouses. Some will not be eligible for benefits, and a few will have elected to forego benefits even though they are eligible. Most Zero Earners will be retirees, but some may have never worked. For the retirees, the decision to retire will have been based on a number of factors that include health status; relative availability and size of retirement income versus preretirement income; the number, ages, and health of dependents; job satisfaction; and the available opportunities for work. Once the decision to retire has been made, it is often difficult to return to the labor market at the same wage one had when one left. A lower wage may discourage retirees from reentering the labor market. Also, certain fixed costs may be associated with work (uniforms and transportation, for example). Such costs would reduce disposable earnings and the desire to return to work.

Removing the earnings test will not increase Social Security benefits for Zero Earners because they are receiving, or are eligible to receive, all the benefits to which they are entitled. Neither will it increase the marginal (take home) wage rate for this group because they do not have at least threshold level earnings. Thus, in the absence of hours-constrained job offers,[16] removing the earnings test is not expected to have much of an impact on this group's work behavior because it does not change any observable factors relevant to their decision to work.

In the presence of hours-constrained job offers, removing the earnings test could lead some retirees to return to work. These retirees may have had to work a minimum number of hours on their highest paying job before retirement in order to remain employed on that job. If they wanted to receive Social Security benefits and limit their earnings, they had to move to a job paying a lower wage. They were faced with the choice of working in their primary occupation and foregoing some or all their Social Security benefits or of taking full benefits and either not working or working at a lower paying job. The existence of this "all or something less" type constraint suggests the possibility that some individuals who are not working will return to work if the earnings test is removed.

Economic theory suggests that the number of Zero Earners who would reenter the labor market if the earnings test is eliminated is negligible. Nevertheless, some debate has focused on the probable size of this group. For example, Cagan (1974) assumed that the reentry group could be as large as 10 percent of the nonworking beneficiary population. However, the 10-percent rate he used in his study was for illustrative purposes only and was not based on empirical evidence. Gordon and Schoeplein (1979), following Cagan, assumed 10 percent as the upper bound on the size of the nonworking beneficiary population that might reenter the labor force if the earnings test were eliminated.

Vroman (1985) looked at the actual reentry rates of beneficiaries over the 1970–80 period and concluded that eliminating the earnings test would probably not raise the reentry rate for beneficiaries aged 65–71 by as much as 2 percentage points. Packard (1988) looked at actual reentry rates for those aged 70–71 and found no significant change in the reentry rate after 1983, the year in which this age group was exempted from the earnings test. However, some evidence was found that suggests a small, 2-percentage-point increase in the labor-force participation rate for men in this age group. This increase, which may have been caused by the increase in economic activity after 1983 and not by the elimination of the test, seems to have been caused by workers delaying retirement, not by retirees returning to the workplace. No change

[16] An hours-constrained job offer is one where the employer sets a minimum number of hours the employee must work in order to be employed.

was found in the labor-force participation rates of women aged 65–69.

Although many of those calling for the elimination of the earnings test give substantial weight to the potential return to work by retirees, empirical studies on the subject indicate that it will not be a sizable group. The most solid empirical work done to date suggests that fewer than 2 percent of nonworking beneficiaries will return to work if the earnings test is removed.

Below-Threshold Earners.—These individuals have earnings below the earnings test threshold. They are receiving or are eligible to receive the entire amount of Social Security benefits to which they are entitled. Removing the test will not increase their benefits. Neither will it increase their marginal wage rate because they are not losing benefits due to excessive earnings. If workers are free to vary the hours they work at the prevailing wage rate, theory predicts that Below-Threshold Earners will not change their hours of work or earnings if the test is removed. These beneficiaries are already assumed to have the opportunity to increase their hours of work and earnings without affecting their Social Security benefits even though they are subject to the earnings test. That they have not increased their earnings to at least the earnings test threshold is an indication that the test is not a binding constraint on their labor-supply behavior.

However, like the Zero Earners, these Below-Threshold Earners may face minimum hours or other labor-market constraints on the highest-wage job for which they qualify. They may have decided to forego this higher paying job for a lower paying job to qualify for Social Security benefits. Removing the earnings test might cause some of the Below-Threshold Earners to choose a higher paying job. No previous studies have tried to assess the impact of eliminating the earnings test on Below-Threshold Earners. Some workers are likely to try to find higher paying jobs because of the test's elimination, but not all of them will be successful in finding such jobs.

Threshold Earners.—Theoretically, these individuals all earn exactly the threshold level of earnings because, in theory, workers can vary the number of hours they work precisely as they wish. At the threshold level of earnings, a change or kink occurs in the worker's take-home wage rate. An individual who works 1 hour less will lose 1 hour of wages. However, if the individual works 1 hour more, wages for only 40 minutes will be earned because the person's Social Security benefit will be reduced by $1 for every $3 earned—effectively a 33-percent tax rate on earnings above the earnings test threshold that applies until the worker's entire yearly Social Security benefit is taxed away.

If the earnings test is removed, Threshold Earners will not receive increased benefits. As long as they do not earn more than the threshold level, they can receive all the Social Security benefits they are entitled to when the earnings test is in effect. The wage they can receive for working an extra hour will increase, however, because their benefits will no longer be lost due to excessive earnings. The greater net take-home wage rate should cause some, perhaps even most, of the Threshold Earners to increase their hours of work and earnings if the earnings test is eliminated. [17]

Benefit-Reduction Earners.—These individuals have earnings above the earnings test threshold but below the level of earnings that would cause them to lose all benefits. Some may be receiving benefits that have been lowered by the earnings test; others may not yet have applied for benefits. Removing the test will have two effects on this group. First, it will increase the take-home wage rate as it did for the Threshold Earners. This effect should result in an increase in hours of work. Second, it will restore benefits to the full entitlement level. If their earnings remain constant, their incomes will increase by the amount of the Social Security benefits formerly withheld. This increase in income means they can reduce their hours of work and still maintain the same level of disposable income they had while the earnings test was in effect. This second effect will tend to reduce hours of work. Theoretically, these two effects work in opposition. The effect that dominates will vary from individual to individual. For some Benefit-Reduction Earners hours of work and earnings will increase; for others it will decrease. The overall effect on this group's hours of work and earnings is indeterminate.

Benefit-Loss Earners.—These individuals have earnings so large that all their benefits are or would be forfeited to the earnings test. Eliminating the test will allow them to receive the benefits they had been losing because of the test. They will be able to decrease their earnings without decreasing their total incomes. Unlike the effect on Benefit-Reduction Earners, eliminating the earnings test will not change the take-home wage rate of Benefit-Loss Earners (because, at their level of earnings, extra earnings no longer cause a loss in benefits). Thus, with no incentive for them to increase their hours of work and earnings, Benefit-Loss Earners

[17] It should be noted that a reporting responsibility accompanies having earnings that exceed the earnings test threshold. Each year, working beneficiaries who expect their earnings for the next year to exceed the threshold must advise SSA of how much they expect to earn. Benefits for the next year will then be reduced based on these estimates. If the estimates are incorrect, repayments are made or adjustments are made to future benefits. Some workers may hold their earnings at or below the threshold to avoid having to make a report. If the earnings test is removed, the need for reporting will disappear, and these workers may increase their work effort and earnings.

can be expected to reduce both if the test is eliminated.[18]

In sum, economic theory suggests that, in the short run, elimination of the earnings test should:

- have little effect on those with no earnings or earnings below the test threshold;
- lead to increased earnings for those whose earnings are at the threshold;
- lead to decreased earnings for those whose earnings are so large that they lose all benefits because of the test; and
- have an ambiguous effect on the earnings of those who lose only some benefits as a result of the test (table 2).

Depending on the relative sizes of these groups and on the average change in hours worked, the total earnings (and hence payroll and income taxes) of the group aged 65–69 could increase, decrease, or remain approximately the same if the earnings test is eliminated.

Long-Run Responses

In the longer run, elimination of the earnings test may cause a reallocation of lifetime labor supply. One theory by Burkhauser and Turner (1978) suggests that if the earnings test is truly a work disincentive, then, under current law, forward-looking workers may decide to work more when they are young and not subject to the earnings test and to work less when they are subject to the test. Removing the earnings test may cause them to work less when young and more at ages previously covered by the test. This potential increase in labor supply at ages 65–69 may take the form of either delayed retirement, increased earnings without delayed retirement, or both increased earnings and delayed retirement. If a longer-run reallocation of work effort from younger ages to older ages occurs, increases in the earnings and taxes paid by workers aged 65–69 can be expected to be at least partially offset by lower earnings and taxes paid by younger workers.

An alternative long-run theory by Burtless and Moffitt (1985), suggests that the reallocation of work effort will occur primarily within the age 65–69 range. If the earnings test causes worker beneficiaries to restrict their earnings to a level below the test threshold, elimination of the earnings test will allow these workers to increase their earnings. They will be able to amass the savings they need to carry them through the remainder of their lives in a shorter time period, and they will retire earlier if the earnings test is eliminated than if it is kept in place. Under this theory, the total labor supply of those aged 65–69 could increase or decrease somewhat, but the age of labor-force withdrawal would not be extended.

An Empirical Estimation

Data from the March 1987 Supplement to the Current Population Survey (CPS)[19] were analyzed to help estimate how many persons aged 65–69 might change the number of hours they worked if their earnings were no longer subject to the earnings test. The nature of this data is such that only the short-run effects of eliminating the test can be estimated.

The distribution of the noninstitutionalized population aged 65–69, categorized by Social Security beneficiary status, level of earnings, and sex, is given in table 3. This population is divided into two major subgroups—those currently receiving benefits and those not receiving benefits. Additional subdivisions are made within these two groups—those with earnings and those without. Finally, among the earners, distinctions are made by the level of earnings, compared with the earnings test threshold—that is, earnings may be great enough that no benefits could be awarded; above the earnings test threshold but not so large that all benefits would be lost; near the threshold; or below the threshold. The size of each of these groups is estimated from the CPS data. When combined with the direction of anticipated change in work effort resulting from eliminating the earnings test, the sizes of these groups will provide an estimate of how eliminating the test would affect the aggregate labor supply of persons aged 65–69.

Beneficiaries

Persons reporting receipt of Social Security benefits on the March 1987 CPS Supplement are defined as beneficiaries in this article. Some beneficiaries in the CPS sample reported earnings that appear to be high enough that all benefits should have been withheld under the 1986 earnings test. There are two reasons why this reporting of high earnings might occur. First, in the year the beneficiary starts to receive benefits, only earnings received after benefit entitlement are counted toward the

[18] An actuarially fair benefit adjustment may encourage some Benefit-Loss Earners to continue to delay retirement, especially if the recomputation provision, discussed earlier, is eliminated upon the receipt of benefits. Others may forego benefits because they feel they do not need them.

[19] The CPS gathers data for the previous calendar year on sources and amounts of income for a random sample of the noninstitutionalized population. The CPS sample, when weighted, accounts for nearly all Social Security beneficiaries aged 65–69. It should be noted that the CPS population and the Social Security population are not exactly the same. The Social Security population includes persons from two groups that are not included in the CPS sample: The institutionalized and U.S. citizens and foreign nationals living abroad who are receiving, or are eligible to receive, Social Security benefits. The CPS population contains the small percentage of the resident population who are ineligible for Social Security benefits.

Table 3.—Expected effect of earnings test elimination for persons aged 65–69, by beneficiary status and earnings level, 1986

Beneficiary status and earnings level	Total	Men	Women	Estimated effect on earnings: No change	Increase	Decrease	Ambiguous
Total number (in millions)	9.7	4.4	5.3	8.1–9.1	0.1–0.6	0.0–0.6	0.5
Total percent	100	100	100	84–95	1–6	0–6	5
Beneficiaires	87	85	89	77–82	1–6	0	5
Zero Earners	69	63	74	66–69	0–3	0	0
With earnings	18	22	15	11–13	1–3	0	5
Benefit-Reduction Earners	5	7	3	0	0	0	5
Threshold Earners	2	2	1	0	1–2	0	0
Below-Threshold Earners	12	13	11	11–12	0–1	0	0
Nonbeneficiaries	13	15	11	7–13	0	0–6	0
Zero Earners	6	4	7	6	0	0	0
With earnings	7	11	4	1–7	0	0–6	0
Benefit-Loss Earners [1]	3	5	(2)	0–3	0	0–3	0
Benefit-Reduction Earners	3	4	2	0–3	0	0–3	0
Threshold and Below-Threshold Earners	1	1	1	1	0	0	0

[1] Earnings of at least $27,250, the level at which a person aged 65–69 with maximum benefits would lose all benefits because of the earnings test.
[2] Less that 0.5 percent.
Source: March Supplement to the 1987 Current Population Survey.

earnings test threshold. Generally, earnings before entitlement, no matter how large, do not preclude receipt of benefits after entitlement.[20] Second, the worker may have underestimated the level of earnings he or she would receive in 1986, and a benefit overpayment occurred. When an overpayment is discovered, SSA moves to recover the overpayment either by having the beneficiary make immediate restitution or by adjusting the level of future Social Security benefit payments. In this article, beneficiaries with apparently excessive earnings are classified as Benefit-Reduction Earners.

Zero Earners

Almost 70 percent of the population aged 65–69 were beneficiaries who did not report any earnings in 1986 (table 3). They were by far the largest group of beneficiaries, accounting for almost 80 percent of all persons receiving benefits. Economic theory suggests that the number of retired workers who would reenter the labor market if the earnings test is eliminated is negligible. Nevertheless, some debate exists about the size of this group, as discussed above.

If the earnings test is eliminated for those aged 65–69, the percentage of Zero-Earner beneficiaries who reenter the labor force is likely to be small, probably no larger than 2 percent. However, the figures for the size of this group assume that up to 5 percent of Zero-Earner beneficiaries will return to the labor force.[21] Given this assumption, 0–3 percent of the population aged 65–69 could increase their hours of work. Obviously, eliminating the earnings test will not affect the amount of benefits received by this group, but it will lead to an increase in hours worked and in earnings for those returning to the labor force.

It needs to be added that any increase in the rate of reentry into the labor force caused by the removal of the earnings test is likely to be a one-time phenomenon, occurring shortly after the test is removed, and not a continuing occurrence. In the longer run, any increase in the labor-force participation rate of this group will result primarily from workers who delay retirement, not from workers

[20] According to tables 44 and 80 in the **1987 Annual Statistical Supplement** to the **Social Security Bulletin,** 7–8 percent of the total number of retired-worker beneficiaries with benefits in current pay at the end of 1986 were awarded benefits during 1986.

[21] This assumed maximum reentry rate is much larger than the increase in the labor-force participation rate for men aged 70–71 found by Packard (1988) (and his evidence suggests this increase was caused primarily by workers delaying retirement rather than by beneficiaries reentering the labor force) or the maximum reentry rate cited by Vroman (1985) for beneficiaries aged 65–71. The higher rate was used on the assumption that those aged 65–69 have a more recent attachment to the labor force and can more easily return to work than those aged 70–71. This rate is only half the often-cited, but unsubstantiated, figure of 10 percent used by Cagan (1974) and by Gordon and Schoeplein (1979).

temporarily retiring in their late fifties and early sixties and then returning to work at age 65.

The vast majority of Zero-Earner beneficiaries aged 65–69 will not return to the labor force if the earnings test is removed. Many persons in this group have health problems and many others simply do not want to work. Evidence from new retired-worker beneficiaries in 1982 (aged 63 or older at that time) indicated that about one-third were limited in the kind or amount of work they could do. Almost 20 percent reported they could not work at all (Packard 1985). Among retirees who had not been self-employed on their last job, 40 percent of the men and 26 percent of the women said they left their last job because they "wanted to retire or were tired of working" (Sherman 1986).

Earners

Beneficiaries with earnings are divided into three groups—those with earnings above the earnings test threshold, near the threshold, and below the threshold (table 3). Because workers are not likely to control their earnings to precisely match the threshold amount ($7,800 in 1986), for purposes of the discussion that follows "Thresholds Earners" are defined as individuals whose earnings range from about 10 percent below to 5 percent above the actual threshold level ($7,000–$8,200). [22] The "Benefit-Reduction Earners" and "Below-Threshold Earners" have earnings exceeding $8,200 and less than $7,000, respectively.

Below-Threshold Earners.—This group of beneficiaries has earnings lower than the earnings test threshold. They represent about 12 percent of those aged 65–69, and account for about two-thirds of the beneficiaries with earnings. Their benefits will not increase if the earnings test is eliminated and economic theory suggests their work effort is unlikely to change much either. Because no estimates of what portion would increase their work effort are available, it is assumed that up to 5 percent of the Below-Threshold Earners (a maximum of just over one-half of 1 percent of all persons aged 65–69) will increase their earnings and work effort if the test is removed (table 3).

Threshold Earners.—These beneficiaries have earnings from $7,000 to $8,200 and account for about 2 percent of all men and women aged 65–69. [23] Some of these Threshold Earners may have become entitled to benefits during the year and lowered or ceased having earnings at that time. Eliminating the earnings test could result in a small increase in benefits ($200 per year or less) for those with earnings from $7,800 to $8,200. Because most Threshold Earners already receive the full benefit amount to which they are entitled, the effect of the benefit increase on work effort will be negligible. Removal of the earnings test is expected to cause an increase in the aggregate work effort of this small-sized group because it will raise their net wage rate. Realistically, some, but not all, of the Threshold Earners would increase their earnings if the test is removed. However, the upper-bound assumption is that all Threshold Earners will increase their earnings.

Benefit-Reduction Earners.—In 1986, beneficiaries who earned more than the earnings test threshold (more than $8,200 in this analysis) accounted for about 5 percent of all persons aged 65–69. Men were more than twice as likely as women to have earnings above the threshold (7 percent, compared with 3 percent). As mentioned above, because some of these beneficiaries, especially the younger ones, may have begun receiving Social Security benefits during the year and reduced or stopped their earnings at that time, the 5-percent measure is an upper bound on the size of the group that might experience partial withholdings of benefits.

For this small group, the net effect of eliminating the earnings test is unclear. On the one hand, the resulting increase in benefits might cause some beneficiaries to reduce their work effort. On the other hand, the increase in their net wage rate may lead others to increase their work effort.

Nonbeneficiaries

Thirteen percent of those aged 65–69 were nonbeneficiaries. They can also be classified as earners or nonearners. The earners are further subdivided by earnings levels to see how their benefits might be affected if they currently applied for benefits.

Not all nonbeneficiaries are currently eligible for benefits and some will never be eligible. Program statistics for 1986 indicate that 78 percent of those aged 65–69 were eligible for retired-worker benefits based on their own work record (93 percent of the men and 66 percent of the women). Many of the remaining group (especially women) are or will be eligible for benefits based on another person's work record.

To try to determine what proportion of those aged 65–69 would never be eligible for Social Security benefits, persons aged 70–79 who did not have benefits in 1986 were studied (Grad 1988, table 1). In 1986, the earnings test only applied to those under age 70. Of those aged 70–79, about 6 percent were not receiving Social

[22] The range is asymmetric about the threshold because it is assumed working beneficiaries who want to avoid the earnings test tax will do so, insofar as they are able, by keeping their earnings several hundred dollars below the threshold.

[23] Vroman (1985) and Packard (1988) show that the size of this group has been declining since 1970.

Security benefits. Because some individuals will never apply for benefits even though they are eligible to do so, and because the labor-force participation rates of women have been increasing during the past two decades, it is estimated that a maximum of 4–5 percent of persons aged 65–69—about one-third of the nonbeneficiaries—will never be eligible for Social Security benefits as a retired worker, spouse, or survivor.

Most of the nonbeneficiaries who will never become eligible for Social Security benefits are probably either nonworking nonbeneficiaries (Zero Earners) or working nonbeneficiaries whose earnings are below the earnings test threshold. There is little reason for them not be receiving benefits otherwise. [24] A few individuals with earnings above the earnings test threshold may never become eligible for benefits because they work at noncovered jobs. Eliminating the test will have a negligible effect on the benefits or labor supply of those who are not eligible for benefits.

Zero Earners

Almost one-half of the nonbeneficiaries had no earnings in 1986. Most Zero-Earner nonbeneficiaries are presumably ineligible for Social Security benefits as retired workers. If they were eligible for benefits, few reasons are known why the would not have applied. Some persons may become entitled to a spouse's benefit if elimination of the earnings test results in their working spouses becoming beneficiaries. However, while eliminating the test may result in some of these Zero-Earner nonbeneficiaries receiving Social Security benefits, it is unlikely to affect the work effort of this 6 percent of persons aged 65–69 (4 percent of the men and 7 percent of the women). The assumption in table 3 is that none of these Zero-Earner nonbeneficiaires will return to work.

Earners

Working nonbeneficiaries account for about 7 percent of the population aged 65–69 (11 percent of the men and 4 percent of the women). Most of them (86 percent) had earnings at a level where they would have lost some or all of their benefits had they been beneficiaries. [25] Eliminating the earnings test could cause many of these nonbeneficiaries to apply for benefits. [26] Economic theory suggests that receipt of the new income from Social Security benefits will cause those who draw benefits to reduce their work effort. The upper-bound assumption for nonbeneficiary Earners with earnings above the threshold is that eliminating the test will cause all these workers to reduce their work effort. However, it is likely that some of these high-earning nonbeneficiaries will continue to forego benefits, especially if the recomputation provision is modified, as some have proposed, to disallow recomputation after initial entitlement to retired-worker benefits. Finally, it is assumed that the small group of nonbeneficiaries with earnings at or below the threshold will not change their labor supply or earnings because they could have already drawn benefits with no penalty if they were entitled to benefits.

Summary and Likely Tax Effects

Economic theory suggests that, in the short run, eliminating the earnings test will cause some of those no longer affected by the test to increase their work effort and earnings, some to decrease them, and some to maintain them at the same level. Applying this theory to the 1986 population of persons aged 65–69 suggests that the earnings of at least 8.1 million of the 9.7 million persons in this age group (84 percent) would not be affected by the elimination of the earnings test. The number of persons not affected could be as large as 9.1 million.

Eliminating the earnings test could result in increased earnings for as many as 0.6 million persons in the group aged 65–69. This figure is based on the upper-bound estimates of labor response that assume 5 percent of the beneficiaries with no earnings returned to the labor force and 5 percent with earnings below the threshold and the 2 percent at the threshold increased their earnings. However, as many as 0.6 million persons could also decrease their earnings, if all nonbeneficiaries with earnings above the threshold began receiving benefits as a result of the test's removal (also the upper-bound estimate on labor response). Another one-half million persons (the Benefit-Reduction Earners) could either increase or decrease their earnings as a result of the change in the earnings test.

It is not likely that 5 percent of beneficiaries with no earnings will return to work. Studies to date suggest that not even 2 percent would return to work. At this level, less than 0.4 million beneficiaries would increase their level of earnings if the earnings test is eliminated. Likewise, it is doubtful that all high-earning nonbeneficiaries would become beneficiaries and decrease their earnings. Many would continue to

[24] Some nonworking married persons, not eligible for benefits on their own work records, may be waiting for their working spouses to start receiving benefits. Spousal benefits are not payable until worker benefits are paid.

[25] Benefit-Loss Earners among the nonbeneficiaries are persons with earnings of at least $27,250, the level at which a person aged 65–69 in 1986 with maximum benefits would lose all benefits because of the earnings test. This level uses the 1986 earnings test tax rate of 50 percent.

[26] However, Packard (1988) found that few insured nonbeneficiaries aged 70–71 became beneficiaries immediately after the earnings test was removed for them.

foregо benefits and maintain their level of earnings. In any case, the number of beneficiaries who would increase their earnings may be largely, or perhaps totally, offset by the number who would decrease their earnings.

Theory suggests that high-earning nonbeneficiaries who begin receiving benefits as a result of the earnings test elimination will decrease their earnings, but their net income [27] should increase. Theory does not suggest any limits on how much earnings can increase for those who increase earnings. Aggregate earnings can increase or decrease as a result of the test's elimination.

What of tax revenues? Assume for the moment that aggregate earnings do not change—that the total increase in earnings by those who increase earnings is exactly offset by the decreased earnings of those who reduce their labor supply. In this case, payroll taxes should increase slightly because some of those reducing their hours of work will have earnings above the maximum earnings level subject to payroll taxes and their payroll taxes will not decline even though their earnings do. Those with increased earnings will find that almost the entire increase will be subject to the payroll tax. Revenues from the taxation of benefits will increase because many of those receiving benefits for the first time will have incomes sufficient to subject up to one-half their benefits to income taxation. Revenues from income taxation of earnings will probably fall because those who reduce their earnings will have a higher average marginal tax rate than those who increase their earnings. Thus, total tax revenue (payroll taxes plus taxation of benefits plus income taxation of earnings) could rise or fall even though aggregate earnings remained constant. In any event, because the net changes in work are likely to be small, the corresponding changes in tax revenue, although difficult to predict in advance, are also likely to be quite small.

Conclusions

This article looked at the earnings test and at the likely effects of its elimination on work behavior. Some of those asking for the elimination of the earnings test suggest that the test is a work disincentive for many of the persons it affects and that exempting them from the test will result in their increased work effort. They argue that the increase in work effort will result in increased tax revenues based on the resultant higher earnings. [28]

Historically, relaxation of the earnings test or elimination of specific age groups from its coverage have not been accompanied by a noticeable increase in work effort. This past experience does not mean that substantial labor-supply effects could not occur, but economic theory suggests that any labor-supply effects would be modest.

In this article, Current Population Survey data for the 1986 income year were analyzed to determine the number of persons aged 65–69 who might be expected to modify their work behavior if the test were repealed for them. Most of this group (84–95 percent) have characteristics suggesting the elimination of the test would have no effect on their labor-force behavior. From 1 percent to 6 percent have characteristics that would lead to an increase in work and earnings; 0–6 percent have characteristics that would lead to a decrease. For about 5 percent, the effect on labor supply and earnings is indeterminate.

It is beyond the scope of this article to estimate precisely how hours of work or earnings might change in the aggregate if the earnings test is eliminated. However, the order of magnitude of these changes is clear: They would be modest. Given the relatively small percentage of this age group that would experience any labor-supply change at all (less than 20 percent) and given the approximately equal sizes of the groups that would increase or decrease their labor supply, it is evident that removing the test for persons aged 65–69 is not likely to have substantial impact on the aggregate labor supply of this age group. If the labor-supply effects are smaller than anticipated, so, too, will be the additional payroll and income tax revenues from the taxation of earnings. It is highly unlikely that additional tax revenues will be sufficient to significantly offset the additional benefits to be paid.

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[27] It is expected that most of these new beneficiaries will have sufficient income that their Social Security benefits will be subject to the income tax. However, while only one-half their Social Security benefits will be subject to the income tax, all their earnings will be taxable. Thus, it is possible for after-tax income to increase even though gross earnings decline by more than the increase in benefits.

[28] They generally do not allow for the possibility that the increased labor supply by those aged 65–69 may displace some younger workers or that younger workers may also modify their labor supply in response to elimination of the earnings test. Either of these secondary effects may diminish the increase in tax revenues.

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