# Chapter 6

## RETIREMENT EARNINGS TEST

In keeping with their function of partially replacing lost earnings, Social Security benefits are generally not paid to workers who, while over the retirement age, continue to have relatively high earnings.

like all other forms of insurance, Social Security indemnifies people for a specific loss. The loss is an individual's earnings. Accordingly, it is appropriate for the Social Security law to measure when earnings have been lost and benefits are payable. The earnings test in current law does this in a generally satisfactory way. The Commission therefore recommends that the retirement earnings test be retained.

For older people, the earnings test is a practical way of defining retirement . The current test allows them a great deal of flexibility. A worker with relatively modest earnings is still considered fully retired and receives full benefits; at higher earnings, he or she is considered partially retired and receives partial benefits during the year; at still higher earnings, benefits are not paid because the worker is judged to be not yet retired. When workers reach age 72, they can receive full benefits regardless of their earnings.

The number of people who lose benefits under the earnings test is actually quite small. Of the 24.4 million people 65 and older who were eligible for Social Security benefits at the end of 1979, only 1.1 million--less than five percent--had any benefits withheld under the earnings test.[1] Only 400,000 of those affected by the earnings test received no benefits whatever in 1979.

## Development of the Earnings Test

There has always been an earnings test in the law, but there has always been a problem of what it should be. The difficulty of designing a test satisfactory to all became obvious with the drafting of the original Social Security Act. The bill that passed the House of Representatives in 1935 had no test because:

> The entire matter (of how to define retirement) was referred to the subcommittee . . . which, after something like an hour's consideration, in which every suggestion made by anyone to define retirement was rejected . . . as not being sufficiently definite, finally adopted a motion to strike out the provision entirely.[2]

The financial savings from the test was not a consideration in the original House bill, ". . . in fact there was no discussion of the financial effects whatsoever."[3] But later, when the bill went to the Senate, the provision that benefits be conditioned on retirement was restored:

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1/ Office of the Actuary, Social Security Administration.
2/ Witte, Edwin E., The Development of the Social Security Act, University of Wisconsin Press, 1966 p. 149. Professor Witte served as Executive Director of the Committee on Economic Security. This was the Committee appointed by President Franklin D. Roosevelt to create a Social Security program.
3/ Ibid, page 149.

> This amendment was adopted without any dissent. Later on it was quite readily agreed upon by the House conferees, who explained that the House committee had never understood that the amendment eliminating the requirement of retirement completely upset the actuarial calculations.4/

The original Social Security Act of 1935 barred payment of benefits for any month in which a beneficiary received wages from "regular employment". This provision never went into effect. The Social Security Board thought that it would be too difficult to determine what was "regular" employment in different industries and occupations. The Board recommended a specific monetary amount to avoid administrative difficulties and make the test objective. The law was changed before the first benefits were paid in 1940 so that benefits would be withheld only for months in which covered earnings were $15 or more.

The test has evolved in stages from a monthly test to an annual one. Until the Social Security Amendments of 1950 provided an exemption for people age 75 and over, the earnings test applied to all beneficiaries. When Social Security coverage was extended to the self-employed, it was thought that many of them might never retire and as a consequence would pay Social Security taxes but receive few or no cash benefits in return. The 1950 Amendments, therefore, provided that the test would not apply after age 75. Subsequent amendments lowered the age to 72 and, effective in 1982, to age 70.

## How the Earnings Test Works

The present earnings test consists of four parts.

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4/ Ibid., p. 160.

<u>An Annual Exempt Amount</u> Annual earnings up to a specified amount are exempt from the test; a beneficiary whose earnings do not exceed this exempt amount gets full benefits throughout the year. There are two different exempt amounts, depending on a person's age:

(1) For people aged 65-71 (age 69 beginning in 1982), the annual exempt amount is $5,000 in 1980, $5,500 in 1981, and $6,000 in 1982. Beginning in 1983, the annual exempt amount will be automatically raised to reflect increases in average wage levels.

(2) For people under 65, the annual exempt amount is $3,720 in 1980 and $4,080 in 1981. Beyond 1981 it will continue to increase automatically to reflect rises in average wage levels. It is estimated that, in 1982, the exempt amount for those under age 65 will be $4,440 compared to $6,000 for those aged 65-69.

<u>A Reduction in Benefits if Earnings Exceed the Annual Exempt Amount</u>

One dollar in benefits is withheld for each $2 of annual earnings above the exempt amount. Earnings above this amount reduce the worker's benefits and any benefits for a spouse or child who is entitled to them because of the worker's earnings record. When spouses or children who are entitled to benefits work, their earnings reduce only their own benefits.

Under the $1 for $2 reduction, beneficiaries can have relatively high earnings and still receive some benefits. They can earn an . amount equal to the applicable exempt amount for their age group plus twice their annual benefits before all of their benefits are withheld. Table 6-l illustrates this. A man age 65 in 1980 who always earned the national average wage could earn as much as $16,725 before all his benewould be withheld. If he had a wife age 65 eligible for benefits on his record, he could earn as much as $22,588 before all the couple's benefits would be withheld.

A Monthly Test In the first year of entitlement to benefits, under most circumstances a special provision allows benefits to be paid for months in which wages are not more than one-twelfth of the annual exempt amount and the beneficiary does not render substantial self-employment services. This allows workers who retire mid-year to receive benefits after retirement, regardless of earnings earlier in the year.

An Exemption On Account of Aqe Beginning with the month in which a person reaches age 72, benefits are payable regardless of earnings. This age is scheduled to drop from 72 to 70 in January 1982.

## Recommended Changes

The Commission believes the earnings test serves a useful role in defining the purpose of the Social Security program and in limiting its costs. The scheduled change from 72 to 70 in the age at which the earnings test no longer applies was a part of the 1977 Amendments to the Social Security Act. The Commission believes that this change would erode the usefulness of the test as a measure of retirement. It, therefore, recommends that the scheduled reduction in the exempt age from 72 to 70 be repealed before it goes into effect in 1982. A/

While the Commission believes that people who are not retired should generally not be paid Social Security retirement benefits, it recognizes that those whose benefits are withheld because of the test forego not only this benefit income, but also the tax-exempt treatment which it is accorded. Social Security benefits are not subject to the Federal income tax, while earnings are. To treat older workers more equitably, the Commission is recommending a partial refundable Federal income tax credit for people 65 and older who have benefits withheld under the earnings test. B/

Why Other Chanqes Are Not Recommended

There are several reasons why the National Commission supports retention of the retirement earnings test. The cost of eliminating the test is high, with benefits going to only a small proportion of Social Security beneficiaries who are likely to be among those with higher income and earnings. Elimination of the earnings test would therefore help those ‘who need it least. The Commission does not believe that the cost will be offset by revenues from additional income or payroll taxes.

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A/ See supplementary statement on the retirement earnings test by Mr. Cohen.

B/ See the discussion and dissenting statement on this issue in Chapter 5.

It does not believe that the earnings test is as influential in the retirement decision as is often claimed. Elimination of the test before age 65 would not be good pension planning. Nor, in the opinion of the Comm ssion, is the test unfair in considering only earnings and not other income. However, the Social Security program would appear unfair to younger workers who pay the tax if some of their taxes went to older workers who were earning as much or more than they.

cost

Cost is an important factor in the Commission's recommendation to retain the earnings test. It is estimated that repeal of the earnings test would increase program costs by $6-7 billion in the first year and more in future years. Even if the test were repealed only for those age 65 or older, the first-year cost would be about $2 billion. The Commission believes that this is not a desirable or prudent use of Social Security revenues.[5/]

It is sometimes suggested that the cost of repealing the test could be made up by the additional Federal income and payroll taxes that would be generated. This is very unlikely. People who can earn high wages already have a strong incentive to work; they are likely to be working now if there are jobs available. Therefore, this group is already paying most of the taxes they would pay if the test *were* eliminated. Older workers whose earnings are at or near the exempt

5/ The long-range costs are .18 percent of taxable payroll for complete elimination of the test and .14 percent of payroll for eliminating it only after 65.

amount might work more if there were no earnings test, and if the work were available. But they are not likely to pay large amounts of income taxes because income below certain levels is also exempt from the income tax and those over 65 are treated very favorably under this tax.

## Who Gains From Elimination of the Test?

The Commission considered the kinds of objections that are raised to the earnings test. It is sometimes said that the test discourages older people from working. While this may be true in some cases, it is not likely to affect most workers.

Those with high earning capacity have far more to gain by working than by retiring on Social Security. Their potential gains from earnings far exceed their potential Social Security benefits. They are also usually covered by private pension plans, and the provisions of these plans are often more important to them than Social Security when they are deciding when to retire.

Those who have had low-paying jobs throughout their lifetime often lack pension rights or significant savings in old age. The exempt amount of the present test permits them to make significant supplements to their retirement benefits. The annual exempt amount for those 65 or older is more than the typicai private pension that covered workers receive, and it is almost as much as the full-time wages of lower-paid workers. A worker who always earned the Federal minimum wage could continue working full time and still receive at least 80 percent of his or her retirement benefits. Very low-paid workers are not significantly affected by the earnings test.

A study made for the Social Security Administration shows that to repeal the earnings test (in 1982) would not affect the benefits paid to 90 percent of those age 65-69. They either do not work or they earn less than the exempt amount. Most of the added benefits (67 percent) would go to people who would be earning more than $17,500 in 1982, while only about 6 percent would go to people who would be earning less than about $10,500.[6/] Thus, repeal of the test, instead of helping low- and middle-income workers, would serve primarily to pay more benefits to high-earning workers who have not retired.

Work Incentives

People with low earnings capacity are clearly not discouraged from earning up to the exempt amount. They can earn up to this amount with no loss of benefits. The large majority of older people do not earn that much.

Those who do work but earn at or near the exempt amount might work more if the exempt amount were raised. A move in this direction was made in the 1977 Amendments to the Social Security Act for people 65 and over.

Most people between 65 and 72 do not work at all. Many are retired because of poor health, limited job prospects, or a preference for full retirement. The survey conducted for the Commission found that:

6/ Esposito, Louis, Lucy B. Mallan, and David Podoff. "Distribution of Increased Benefits Under Alternative Earnings Tests," Social Security Bulletin, September 1980, p. 6. Earnings levels shown in Table 2 are increased by 75 percent to take account of economy-wide wage changes between 1975 and 1982.

> "....what is most striking is that the decision to retire is not often seen as a voluntary one. Retirement is something that happens to people, usually at a particular age or because of a particular health situation. Most retirees see themselves as having had relatively little choice .7/

If this is true, it is unlikely that repeal of the earnings test would cause a large number of people to return to work.

The Commission believes that further efforts to encourage older people to work should focus on the delayed retirement credit and the tax treatment of earnings after 65, as recommended in Chapter 5. Increasing this credit is a better way to assure adequate retirement income than liberalizing or eliminating the earnings test. The delayed retirement credit raises benefits after retirement. Liberalizing the earnings test pays higher retirement benefits on top of pre-retirement earnings.

The Relationship to Good Pension Planning

For people who are 62 to 64 and do not retire, elimination of the earnings test would present a significant long-run disadvantage. Most would be likely to claim benefits when they reach 62 since the benefits would no longer be affected by earnings if there were no earnings test. Benefits are substantially reduced, however, if they are claimed before age 65. Benefits might be perceived as a "windfall" while full earnings

7/ A Nationwide Survey of Attitudes Toward Social Security, a report prepared for the National Commission on Social Security by Peter D. Hart Research Associates, Inc., 1979, p. 10.

continued, but after retirement the reduction in early benefits accepted may be regretted. Good pension planning suggests that people should not be encouraged to accept lower benefits at an earlier age that may be inadequate for their needs when other income is no longer available.

Fairness Between Workers

It is sometimes argued that the earnings test discriminates against low-income older people because it is a test on earned income only. Income from employer pension plans and private savings is not offset against Social Security benefits, nor should it be. Doing so would discourage both workers and their employers from providing these important supplemental sources of retirement income.

Fairness between younger and older workers is another concern. To repeal the earnings test could create a feeling of inequity among younger workers and thereby undermine acceptance of the Social Security program. If high-earning workers remain in their career jobs and receive full benefits, their younger, and perhaps lower-paid, coworkers would soon question the basic fairness of the program for which they are paying Social Security taxes. There could be mounting pressure on older workers to relinquish either their high wages or their retirement benefits because younger workers would find it unfair for older workers to receive both. It could also contribute to resistance by the young to pay Social Security taxes.

## Comparing Social Security with Private Plans

Finally, the Social Security earnings test differs from the type of retirement test used in private pension systems. Private plans usually stipulate that the worker must retire completely from his job, trade, or industry as a condition for receiving a pension. Social Security is different. Because it is a national program, it must use a test of retirement that can be applied nationwide to all occupations and all jobs. The earnings test is such a measure. In one respect, the Social Security earnings test is more strict because it is a test against all earnings, including those received outside the worker's usual job. This is an essential ingredient of a national test. In another respect, it is more generous because it provides for partial retirement within the worker's career job, occupation, or industry. The Commission recognizes that both the private and public program concepts for determining retirement serve a useful role in determining eligibility for retirement benefits for the particular program of which it is a part.

TABLE 6-1
EFFECT OF SOCIAL SECURITY EARNINGS TEST
IN ILLUSTRATIVE CASES IN 1980*
PAST EARNINGS HISTORY

| Marital Status | Sufficient to Qualify For Minimum Benefit | | Federal Minimum Wage Worker | | Career Earnings Equal To National Average Earnings | | Maximum Earnings | |
|---|---|---|---|---|---|---|---|---|
| | Worker alone | With spouse | Worker alone | With spouse | Worker alone | With spouse | Worker alone | With spouse |
| **Worker and Spouse Both Age 65** | | | | | | | | |
| Annual Benefit | $1,741.20 | 2,612.40 | 3,859.10 | 5,789.00 | 5,862.30 | 8,793.70 | 7,436.60 | 11,154.90 |
| Total Earnings and Benefits before any benefits are withheld | $6,743.19 | 7,614.39 | 8,861.09 | 10,790.99 | 10,864.29 | 13,795.69 | 12,438.59 | 16,156.89 |
| Earnings at which all Benefits are withheld | $8,484.00 | 10,226.00 | 12,720.00 | 16,57[illegible] 00 | 16,726.00 | 22,589.00 | 19,875.00 | 27,311.00 |
| **Worker and Spouse Both Age 62** | | | | | | | | |
| Annual Benefit | $1,269.20 | 1,865.00 | 2,759.20 | 4,052.60 | 4,112.70 | 6,040.70 | 5,236.80 | 7,691.40 |
| Total Earnings and Benefits before any Benefits are Withheld | $4,991.19 | 5,586.99 | 6,481.19 | 7,774.59 | 7,834.69 | 9,762.69 | 8,958.79 | 11,413.39 |
| Earnings at which all Benefits are Withheld | $6,260.00 | 7,451.00 | 9,240.00 | 11,827.00 | 11,947.00 | 15,803.00 | 14,195.00 | 19,104.00 |

Assuming no earnings by the spouse, and also assuming that worker and spouse reached the specified age at the beginning of the year.