

# CRS Report for Congress

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## Social Security: Proposed Changes to the Earnings Test

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### Summary

On April 7, 2000, President Clinton signed H.R. 5, the Senior Citizens' Freedom to Work Act. The new law (P.L. 106-182) eliminated the Social Security earnings test — which reduces the benefits of recipients who work and earn more than a specified amount — for recipients between the “full retirement age” (currently age 65 and two months) and age 70, effective January 1, 2000. In the 108<sup>th</sup> Congress, Representative Shaw has introduced a bill (H.R. 75) that would gradually eliminate the earnings test for recipients age 62 and older. This report will be updated periodically.

### Background

With variations, the earnings test has been part of the Social Security program since its beginning. It reduces the benefits of recipients under a certain age who earn income from work in excess of a certain sum (the “exempt amount”). It does not apply to disabled recipients.<sup>1</sup> The original rationale for the test was that, as a “social insurance” system, Social Security protects workers from certain risks, among them the loss of income due to their retirement, and therefore benefits should be withheld from workers who show by their substantial earnings that they have not in fact “retired.”

**Old Law.** Before passage of P.L. 106-182, the law provided different tests for recipients under and over the full retirement age. Recipients who would not attain the full retirement age (currently age 65 and two months) in the current calendar year and had

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<sup>1</sup> However, in the disability program earnings above a certain amount indicate ability to engage in “substantial gainful activity” (SGA) and therefore disqualify a person from receiving benefits. For non-blind recipients, that amount is set by regulation at \$800 a month. Before enactment of P.L. 104-121, SGA for the blind was tied to the monthly earnings test (the annual exempt amount divided by 12) for those who have attained the full retirement age. P.L. 104-121 removed this linkage. Instead, the SGA level for the blind continues as before (i.e., adjusted annually to reflect growth in average wages — it is \$1,330 a month in 2003). For more information, see CRS Report RS20479, *Social Security: Substantial Gainful Activity for the Blind*, updated periodically.

earnings in excess of their annual exempt amount (\$11,520 in 2003) lost \$1 of benefits for each \$2 of excess earnings. Recipients who had attained the full retirement age in the current or previous calendar year, and who had earnings in excess of their annual exempt amount (\$30,720 a year in 2003), lost \$1 of benefits for each \$3 of excess earnings (see following examples). The exempt amounts rise each year at the same rate as average wages in the economy. The test did not apply to recipients over age 69.

Under Age 65 in 2003:	
Earnings . . . . .	\$35,000
Exempt Amount . . . . .	11,520
Difference . . . . .	23,480
Reduction in benefit . . . . .	11,740
(1/2 of difference)	

Age 65 in 2003	
Earnings . . . . .	\$35,000
Exempt Amount . . . . .	30,720
Difference . . . . .	4,280
Reduction in benefit . . . . .	1,427
(1/3 of difference)	

**New Law.** Effective January 1, 2000, the earnings test does not apply to recipients beginning in the month that they attain the full retirement age. In that year, for months before attainment of the full retirement age the old law continues to apply, e.g., in 2003, these individuals can earn up to \$30,720 in the months before attainment, and for earnings above this amount, they lose \$1 in benefits for each \$3 of earnings. The old law also continues to apply to years in which recipients have not attained the full retirement age, i.e., in 2003 they lose \$1 of benefits for each \$2 of earnings in excess of \$11,520. Beginning in 2003, the full retirement age is gradually rising, reaching 66 in 2009 and 67 in 2027, and the age for which the earnings test ceases to apply is rising accordingly.

## Recent Legislation

The test has always been one of the most unpopular features of the program, and proposals to liberalize or eliminate the earnings test are perennial. In 1996, P.L. 104-121 increased the annual earnings test limit, for those attaining the full retirement age, over a period of 7 years, reaching \$30,000 in 2002. In the 106<sup>th</sup> Congress, 20 bills were introduced that would have eliminated or liberalized the earnings test.

**H.R. 5.** On February 16, 2000, the Social Security Subcommittee of the House Committee on Ways and Means approved H.R. 5, the Senior Citizens' Freedom to Work Act, which eliminated the Social Security earnings test for recipients who have reached the full retirement age, effective in 2000. According to the Social Security Administration, the bill will increase Social Security's outlays by \$17 billion over 5 years and \$26 billion over 10 years. The Congressional Budget Office estimates that the bill will cost \$ 19.7 over 5 years and \$22.7 billion over 10 years. These costs would reduce projected unified budget surpluses over this period by the same amount, but, because Social Security is scored as an off-budget item, there would be a negligible effect on projected on-budget surpluses. In the long range, the cost would be negligible because of offsetting effects. (Retirees will no longer receive delayed retirement credits, which under current law compensate for the benefits lost to the earnings test applied to workers above the full retirement age, and the savings from this would offset the cost of eliminating the earnings test.) It was estimated that initially about 600,000 recipients would be affected by the elimination of the test. H.R. 5 continued the severance between the earnings test and the SGA level of the blind enacted in P.L. 104-121 (see footnote 1).

A concern with the bill was that one of its effects would be to reduce benefits for workers turning age 65 in 2000. (Workers receive the higher exempt amount and the 1 for 3 reduction not in the month they actually attain the full retirement age, but at the beginning of that year. Simply eliminating the test for those above the full retirement age would mean that in the year of attainment, for months before attainment of age 65 the lower exempt amounts and the 1 for 2 reduction would apply.) A provision added in the Chairman's mark would, for 2000 only, allow workers turning age 65 to continue to receive the current-law higher exempt amount and the 1 for 3 reduction rate for months before they turn age 65. The House of Representatives approved H.R. 5 on March 1, 2000 by a vote of 422-0.

On March 22, 2000, the Senate approved H.R. 5 by a vote of 100-0. A manager's amendment changed the House provision affecting workers turning age 65 in 2000 to make it applicable to all future workers for the year they reach the full retirement age (i.e., after 2000 workers would continue to receive the current-law higher exempt amount and the 1 for 3 reduction rate for months before they turn the full retirement age). On March 28, 2000, the House of Representatives approved the Senate version of H.R. 5 by a vote of 419-0. President Clinton signed the measure into law on April 7, 2000.

**Legislation in the 107<sup>th</sup> Congress.** H.R. 1731, introduced by Representative Sessions, would have repealed the earning test for recipients who have attained the age of 62, effective in 2002. H.R. 3497, introduced by Representative Shaw, would have gradually raised the exempt amount for recipients under the full retirement age over the period 2002 through 2006, and would have repealed the test entirely in 2007.

**Legislation in the 108<sup>th</sup> Congress.** H.R. 75, introduced by Representative Shaw, would gradually raise the exempt amount for recipients under the full retirement age over the period 2004 through 2008, and would repeal the test entirely in 2009.

**Arguments for liberalizing or eliminating the earnings test.** A common complaint among affected recipients is that they are being denied a benefit that they have "bought and paid for." Social Security has always been described as a program in which benefits are paid as an "earned right" rather than as a welfare program. The concept that workers earn rights to benefits through a lifetime of "contributions" to the program, avoiding any perceived stigma of collecting "handouts" or submitting to a demeaning "needs test" is often cited as one of the reasons for broad public acceptance of the program. Thus, to some critics it seems inappropriate to impose what appears to them to be a form of needs test, which deprives workers of benefits that they have "earned." As this thinking goes, many workers have been led to regard Social Security as a government-run savings plan. Their acceptance of the payroll tax is facilitated by the idea that they will get the money back some day, and they do not readily accept the rationale that access to "their" money should be withheld just because they continue to work.

The test is criticized as a severe disincentive for the "young retired" to work. Critics say that not only do they suffer a reduction in their standard of living because of the test, the country loses valuable experience and skills as well. They see the test as a relic of the Great Depression, when concern over massive joblessness led to a perception that retired workers should be discouraged from rejoining the workforce. Moreover, they see the test as inconsistent with other federal policies, and contrary to the recommendations of gerontologists and others concerned with the health of the elderly, that strive to increase

hiring and retention of older workers. Even if on a purely economic basis the penalty the test imposes is not high enough to support a rational decision to not work, opponents argue that the test creates a psychological barrier that dampens the desire to work.

The disincentive effect is magnified when viewed on an after-tax basis. The beneficiary who works loses not only 50% or 33% of his or her benefit above the exempt amount due to the earnings test; he or she must pay Social Security taxes and probably Federal and State income taxes as well. The result can be a high effective marginal tax rate, exceeding 100% in extreme cases. One result of this disincentive is that some seek lower paying or part-time work to limit their earnings, and thus do not employ the full value of their skills that could enhance the nation's productivity and economic output. Another can be to encourage being paid "under the table."

Critics of the test maintain that it discriminates against younger retirees who must work to supplement their benefits. Others who have alternative forms of income such as private pensions can still receive full benefits. If an individual receives a fairly small Social Security benefit that he must supplement through work, some consider it unfair to reduce that benefit once he earns more than what critics see as modest amounts – only \$11,520 a year for those under the full retirement age. They sometimes state the question another way: why should income from investment be treated more favorably than that from earnings, especially since most investment income is received by upper-income persons who also usually have higher Social Security benefits? Thus, it is claimed that the earnings test is inequitable to persons who need additional income in retirement.

Furthermore, critics say that in addition to being complicated and difficult for the individual to understand, the test is complex and costly to administer. For example, before enactment of P.L. 106-182, it was responsible for more than one-half of retirement and survivor program overpayments. Elimination of the test would thus hold down administrative expenses, and recipients would be less confused and less tempted to cheat on reporting their earnings.

Finally, critics of the test maintain that repealing it not only would have no long-range costs, it would have positive budgetary and economic effects. They argue that people would work more and pay more Social Security and other taxes, offsetting the increase in benefit payments. They contend that many people deliberately keep their earnings below the limit, or that because of the existence of the test, have chosen to do part-time, lower paying work rather than work in skilled professional jobs that typically require full-time employment. The effect, they argue, is to lower the output and earnings of productive young retirees significantly, which is particularly short-sighted in these times when a booming economy has produced labor shortages. They maintain that if the potential output of these workers were realized, the benefit to the economy would substantially increase government revenues – not only directly in the form of taxes but also in the form of rippling "multiplier" effects. Furthermore they claim that the overall costs to the government would be relatively modest. Similarly, because of offsetting effects, the long-range costs of repealing or reducing the earnings test are said to be negligible. For example, one reason the earnings test was repealed for workers who have attained the full retirement age was that in the long range it had negligible cost. Under current law workers who do not receive benefits after their full retirement age receive a "delayed retirement credit" (DRC), which increases their benefits by a certain percentage for each month they do not receive benefits. When the DRC increases to two-thirds of one

percent per month in 2008, its value will be approximately actuarial; that is, the additional benefits a person would receive over his or her lifetime due to the DRC would be approximately equal to the value of the benefits lost due to the earnings test. Thus, the long-range cost of eliminating the earnings test for those above the full retirement age was offset by the savings produced by fewer payments of DRCs. Similarly, if the test were repealed for retirees under the full retirement age, there would be only a very small long-range cost to the program (0.01 % of taxable payroll), again because of offsetting effects. Workers and their spouses who retire before the full retirement age have their benefits “actuarially reduced,” meaning that a person will receive approximately the same value of benefits over a normal lifetime regardless of whether he or she began to receive benefits before or at the full retirement age. Workers who retire today exactly at age 62 receive 76.67% of the benefit they would receive at the full retirement age. However, if benefits are withheld because of the earnings test, under the law their benefits are recomputed at the full retirement age to remove the actuarial reduction for those periods in which they did not receive benefits. Thus, similarly to the case with the DRCs, the long-range cost of eliminating the earnings test for those below the full retirement age would be almost entirely offset by the savings produced by eliminating the recomputation of benefits at the full retirement age.

**Arguments against liberalizing or eliminating the earnings test.** Those who defend the earnings test take the position that benefits should be paid only when the risks insured against by the Social Security program actually occur, e.g., the loss of earned income when one retires. As the program does not pay disability benefits to those who are not disabled, nor Medicare benefits to those who are not ill, similarly it should not pay full benefits for those who are not truly “retired.” They point out that the program is not intended to be a savings plan that provides an annuity upon retirement but rather is intended to be a form of insurance that provides benefits upon the occurrence of the contingency insured against (loss of income due to the retirement of the worker).

Even so, proponents say, the provision already has been liberalized to the point where most working recipients are better off in retirement than younger workers. Take the example of someone who files for retirement at age 65 and two months in 2003 but continues to work. He or she would receive all of his or her Social Security benefit which, in combination with his or her earnings, would provide more income than before he or she “retired” (and this does not count the value of Medicare coverage and the tax breaks from receiving tax-advantaged Social Security benefits and extra deductions for the elderly).

Thus, defenders of the test maintain that, contrary to allegations that the test causes hardship, on the whole it actually is fairly generous, and to liberalize or abolish it would further erode the concept that Social Security is designed to replace lost earnings. They assert that repeal or further liberalization of the test would benefit mainly the well-off, particularly people who want to continue to work full time at their regular jobs. Rather, it would pay a premium to people who are fortunate enough to be able to work after becoming eligible for retirement, as opposed to those who are forced to retire because of health or other compelling reasons.

There are some who, while they supported repeal of the earnings test for those who have reached the full retirement age, oppose total repeal of the test. Their main concern is that many people will end up poor in old age because of the permanent reduction in

their benefit that occurs when one files for early retirement. Because the incentive to file for benefits at age 62 would be so high, they believe virtually everybody would choose to do so, and find when they do cease work that their permanently reduced benefit is now inadequate. They are particularly concerned that this would have a detrimental effect on elderly widows, already the poorest of Social Security recipients, because if their spouses retired early they will receive a survivor benefit that also is permanently reduced.

Another argument is that, although eliminating the earnings test has no appreciable cost over 75 years, the offsetting savings that cause this effect will lag behind the expanded cost of the program for many years. Thus, to some extent the extra outgo will exacerbate the potential strain Social Security may cause on the rest of the budget in 2017 when its tax revenues are projected to fall below its outlays, and it also would have some effect at the time when Social Security is projected to become insolvent in 2041. Much before then, the “baby boom” generation will begin to retire. Some believe that one way to ease the burden this would impose on society is to reduce the debt the government owes to the public by running budget surpluses over the next decade or two. It is argued that this will increase national savings and economic growth so that the nation could more easily afford to support the large numbers of retirees, and also would have room to borrow again from the public if necessary. However, increases in Social Security expenditures would mean that less of the publicly held debt would be retired during this period. If one views retirement of the publicly held debt as a means for the country to afford the retirement of the baby boom, then such action would weaken this goal. It also could open the door to other program liberalizations if they were cost-neutral to the program in the long-range due to offsetting measures that would not take effect for many years.

In regard specifically to P.L. 106-182, some analysts express regret that, with the need for reform of the program so paramount, Congress’ first step was to liberalize benefits. Even some proponents of repealing the test say that it would be better to include a package that addresses the program’s long-range solvency. They point out that enacting a single popular measure like repealing the test would take away an item that would “sweeten the pot” in order to face more difficult choices in shoring up Social Security.

Finally, proponents of the test fear that its repeal would serve as a vehicle for altering the philosophical basis of the program. Today, Social Security has a mixture of social and insurance goals that are considered incomparable to a private annuity or insurance system. Paying benefits regardless of earnings clearly would appear to make the program seem more like an annuity, and could reinforce questions about the other redistributive aspects of Social Security. Thus, advocates of the program’s current structure sometimes regard elimination of the earnings test as a “Trojan Horse.”