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5/99 Memos to GS [Gene Sperling] - (401(k) & USAs [Universal Savings Accounts]

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May 11, 1999

MEMORANDUM TO GENE SPERLING

FROM: NATASHA BILIMORIA
CARL HAACKE

CC: BILL DAUSTER

SUBJECT: TREASURY DOCUMENT REGARDING USA COORDINATION WITH
401(K) PLANS

Attached is a draft paper (created by Treasury) answering various questions about USA coordination with 401(k) plans. It is our understanding that once the paper is finalized, Treasury would like to circulate this to press, Hill staff and other groups interested in coordination with employer-sponsored pensions. The following are some of our concerns regarding the document.

1. Overall, the document is confusing. While Treasury has said that this document is targeted toward interest groups, Hill staff, press, and others that have a particular interest in the employer plan issues, it is likely that it would also be distributed to the general public (individuals and groups who do not have technical expertise in the area). This document could create more confusion than clarity around the subject. (Example: Question 9) *Yes*
2. Much of the paper actually highlights how 401(k) plans are better than USAs, instead of explaining how USAs compliment the existing 401(k) system. This could play down the advantages of USAs.
3. This document does not emphasize the overall progressive nature of USAs, unlike all of the other paper we have put out to date.

Let us know how you would like us to proceed.

CH/NB/BD
I agree with some of your comments -- but not all.
Take time

→ My preference is press review at Treasury to review.

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How Will USAs Help Employer Plans?

<p>* * * Frequently Asked Questions * * * * * * About USAs and Employer Plans * * *</p>

- Q1. **What Are Universal Savings Accounts?**

- Q2. **What Impact Can USAs Be Expected to Have on Employers' 401(k) Plans?**

- Q3. **Will USAs Divert Employees' Contributions to 401(k) Plans?**

- Q4. **Why Will 401(k) Contributions Be More Attractive to Employees Than USA Contributions?**

- Q5. **What Is USAs' So-Called "Trickle Up" Effect?**

- Q6. **Do USAs Impose Requirements on Employers?**

- Q7. **Does the Availability of the Governmental USA Match for 401(k) Contributions Depend on Whether the 401(k) Plan Sponsor Offers Its Own Matching Contributions for Employees' 401(k) Contributions?**

- Q8. **How Does the USA Match of Employees' 401(k) Contributions Work?**

- Q9. **Does the USA Match of 401(k) Contributions Affect the Tax Treatment of the Matched 401(k) Contributions?**

- Q10. **Can an Employee Contribute to Both a 401(k) and a USA?**

- Q11. **Are Section 403(b) Tax-Sheltered Annuity Plans Considered "401(k)-Type Plans" for Purposes of USA Coordination?**

Question 1: What Are Universal Savings Accounts?

Answer: Universal Savings Accounts (USAs) are voluntary individual retirement savings accounts that provide a progressive tax benefit. They are designed to achieve universal pension coverage via the second and third legs of the "three-legged stool" (employer-sponsored pensions and individual savings). USAs give the opportunity to build wealth and save for retirement to 124 million Americans, including the half of the workforce that is left out of the current employer plan system and the more than 80% of Americans who have no IRA.

Automatic government contributions. Moderate- and lower-income workers and their spouses receive an automatic government contribution of \$300 as a refundable tax credit deposited in their USAs.

- * The automatic credit is phased out between \$40,000 and \$80,000 of adjusted gross income (AGI) for joint filers (\$20,000 to \$40,000 for single filers; \$30,000 to \$50,000 for head of household filers).

Individuals' voluntary contributions and government matching contributions.

Individuals also may make voluntary contributions to their USAs. An individual's voluntary contributions to a USA or salary reduction contributions to an employer-sponsored 401(k)-type plan are matched in the form of a refundable tax credit deposited in the individual's USA.

- * Lower- and moderate-income individuals receive a dollar-for-dollar (100%) match. The match rate phases down to 50% over the same income ranges as the phaseout for the automatic contribution, and remains at 50% until the income level at which USA eligibility ends (if any).

Limit on contributions. Total voluntary and government (both automatic and matching) contributions to a USA are capped at \$1,000 per year.

Eligibility. To be eligible for a USA, an individual must have at least \$5,000 of earnings (which can be combined earnings on a joint return), must not be another taxpayer's dependent, and must be between ages 18 and 70. USAs, like traditional IRAs, apply to all individuals who are not covered by an employer-sponsored retirement plan. In addition, USAs extend to individuals covered by an employer plan, if their adjusted gross income (AGI) is not more than \$100,000 for joint filers (\$50,000 for single filers; \$75,000 for head of household filers).

- * **Example:** (i) Bill and Susan file a joint tax return. Susan stays at home to care for their children. Their joint AGI is \$80,000, attributable entirely to Bill's salary. Bill participates in a retirement plan sponsored by his employer. (ii) Bill and Susan are each eligible to have their own separate USA account; she is deemed to satisfy the \$5,000 minimum earnings requirement by reason of their joint earnings. If, instead, their AGI exceeded \$100,000,

↳ 2 people

2
15,000 \$/100, 100
Susan would be eligible to have a USA, but Bill would not because he participates in an employer plan.

Question 2: What Impact Can USAs Be Expected to Have on Employers' 401(k) Plans?

Answer: The USA proposal can be expected to encourage participation in 401(k)-type plans.

This is because USAs are designed to give eligible employees a government matching tax credit in their USA when they contribute either to their USA or to a 401(k)-type plan.

- * An estimated [8 to 10] million workers who are eligible to participate in 401(k) plans fail to participate. This is [about one out of every three] eligible employees. [OTA formulating statement of number and percentage]

The USA match will both encourage workers who now participate in 401(k) plans to continue participating and give a powerful new incentive to contribute to the [8 to 10] million workers who could contribute but fail to do so.

Question 3: Will USAs Divert Employees' 401(k) Contributions?

Answer: No, USAs will not cause workers to shift their contributions from private-sector 401(k)-type plans to USAs. This is because the USA proposal provides for a type of coordination between USAs and 401(k)s -- as described below -- which has been designed to avoid giving employees any incentive to contribute to a USA instead of a 401(k).

Under this coordination, workers who contribute to 401(k)-type plans may elect to receive a USA matching government contribution on their 401(k) contributions (up to their USA voluntary contribution limit). The worker's 401(k) contribution is made in the usual fashion to the 401(k) plan. The government matching contribution is deposited in the worker's USA account, so the plan administrator does not need to deal with it in any way.

Question 4: Why Will 401(k) Contributions Be More Attractive to Employees Than USA Contributions?

Answer: Workers eligible to participate in a 401(k)-type plan can be expected to contribute to that plan instead of contributing to a USA, because 401(k)-type plans will have both a financial and a liquidity advantage over USAs.

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NO

Why will USAs not attract
people to not do 401(k)s

Only out of only day

401(k)s' financial advantage. As designed, employees will always be better off financially by contributing to their 401(k) plan -- ~~as compared to their USA -- and electing to take credit for these contributions for purposes of the USA matching tax credit.~~

- In fact, employees with AGI of \$50,000 or less (joint filers) will get the full regular tax benefits of a 401(k) contribution (i.e., the ability to exclude that contribution from income) as well as the USA matching tax credit.
 - * Both the tax benefit of the full 401(k) exclusion from income and the USA matching tax credit are available also to single filers with AGI of \$25,000 or less and head of household filers with AGI of \$37,500 or less.
- Eligible employees with higher incomes will also get a slight tax edge for 401(k) contributions in addition to the USA matching tax credit.
 - * The higher-income employees will get a reduced tax benefit for their 401(k) contributions that receive the USA matching tax credit. This tax benefit, when added to the USA matching tax credit, will always be more valuable than the tax benefit of contributing to the USA (in other words, more valuable than the USA matching tax credit by itself).
- In addition, the matching tax credit supplements any employer matching contributions provided under the 401(k) plan.
- **401(k)s' liquidity advantage.** Contributions to 401(k)-type plans generally will be more accessible to employees ~~than voluntary contributions to USAs.~~ USA contributions cannot be withdrawn until age 65 (or death). By contrast, 401(k) type contributions can be withdrawn when the individual changes jobs, can often be borrowed, and can sometimes be withdrawn in other special circumstances.
- **401(k)s' other advantages.** Contributing to 401(k) plans may be easier and more convenient than contributing to USAs because payroll deduction, which can be used to contribute to a USA, will almost invariably be used to contribute to a 401(k). In addition, 401(k) plans typically will offer employees more investment options than USAs.

Question 5: What Is USAs' So-Called "Trickle Up" Effect?

Answer: By providing government matches on 401(k) contributions, USAs

strengthen existing incentives for lower- and moderate-income employees to save in 401(k)-type plans.

The USA match will encourage participation in 401(k)-type plans by eligible employees who are not currently participating.

- * **Problem:** Lower- and moderate-income workers participate in 401(k) plans at lower rates. This is because, among other things, the regular 401(k) tax incentive (exclusion of the contribution from income) is less valuable for people who are not higher-bracket taxpayers.
- * **Solution:** Lower- and moderate-income workers receive the highest USA matches and will continue to receive an exclusion from income for their USA-matched 401(k) contributions.

Encouraging 401(k) saving by these workers makes it easier for the 401(k) plan to satisfy nondiscrimination standards (the actual deferral percentage test) and, therefore, to increase the amount higher-paid employees can contribute.

- * This in turn could encourage more small businesses to sponsor 401(k)-type savings plans without compromising the nondiscrimination standards.

Question 6: Do USAs Impose Requirements on Employers?

Answer: No. USAs -- including the government USA match of 401(k)-type contributions -- do not impose any administrative or other requirements on employers or other retirement plan sponsors or administrators. Any employer involvement with USAs will be strictly voluntary on the part of the employer and will be limited to facilitating employees' USA contributions through payroll deduction arrangements.

- * Any employer that chooses to do so can allow its employees (if they so choose) to contribute to their USA via payroll deduction. A portion of the employee's paycheck would be transmitted by direct deposit to their USA.

No additional employer reporting requirements. Employee eligibility for USA matching credits is determined from existing Form W-2 information.

No additional tracking or other administrative costs for plans. To avoid added administrative costs for plans, it is contemplated that USA matching tax credits would be deposited in USAs instead of in 401(k) plans, as noted. This means plan sponsors need not administer or keep track of any special rules applicable to the USA matching contributions (or, for that matter, to an individual's matched salary

reduction 401(k)-type contributions).

The flow of plan funds, 401(k) plan administration, plan rules governing the individual's matched 401(k)-type contributions, and the 401(k) distribution rules, including the tax treatment of distributions from 401(k) plans, are all unaffected -- the same as if there were no USA match with respect to 401(k) contributions.

Question 7: Does the Availability of the Governmental USA Match for 401(k) Contributions Depend on Whether the 401(k) Sponsor Offers its Own Matching Contributions for Employees' 401(k) Contributions?

Answer: No. The government USA match supplements any employer matching contributions, and is provided whether or not the employer offers matching contributions under its 401(k)-type plan.

Question 8: How Does the USA Match of Employees' 401(k) Contributions Work?

Answer: The following example illustrates the mechanics of USA coordination with 401(k)-type plans, i.e., the USA 401(k) match.

Mary is a joint filer with AGI of \$30,000 and has a 401(k) plan at work to which she contributes \$600 for a particular year. Mary meets the eligibility requirements for the USA credit. Because her AGI does not exceed \$40,000, Mary is eligible for an automatic contribution of \$300 and a match rate of 100% on any voluntary contribution she might make up to \$350.

Step 1: *Employee election on tax return.* Mary can elect to take USA credit for her 401(k) contributions up to the maximum amount of voluntary contributions she could have made to a USA (\$350). When filing her tax return for that year, she makes the election to receive a 100% USA match on \$350 of her 401(k) contributions.

- * The 401(k) contributions remain in Mary's 401(k) account, and continue to be excludable from income. They are included in the 401(k) contributions reported to the IRS. That reporting (on Form W-2) is unchanged from current law.

Step 2: *Government deposit of matching tax credit.* Mary's \$350 USA match is deposited in her USA, together with the \$300 automatic USA credit. The \$350 government match (in the form of a tax credit) is equal to the matching contribution (in the form of a tax credit) she would have received had she contributed to the USA instead.

Question 9: Does the USA Match of 401(k) Contributions Affect the Tax Treatment of the Matched Contributions?

Answer: No for some people, yes for others, depending on their income. All employees who choose to receive a USA match on their 401(k) contributions not only will receive the government match but also will be able to exclude from income some or all of the 401(k) plan contributions that qualify for the match.

- * For most taxpayers (i.e., joint filers with AGI of \$50,000 or less, \$25,000 or less for single filers, \$37,500 for head of household filers), 401(k) contributions that receive the USA match will be fully excludable from income. The USA match will not change the tax treatment of the matched 401(k) contributions for these people.
- * Because salary reduction 401(k)-type contributions are excludable from income while voluntary USA contributions are not, 401(k) plan participants whose AGI exceeds those thresholds will exclude 20% of the participant's 401(k) contribution that receives a USA match (i.e., will include in income, when filing their income tax return claiming the USA matching credit, 80% of the USA-matched portion of their 401(k) contribution).

Employees with 401(k)-type plans retain the option of making direct contributions to a USA account rather than using the 401(k) contribution as the basis for a matching tax credit. For example, even an employee who has made the maximum contribution to the employer's 401(k) plan could make an additional contribution to a USA.

Example: Brenda is a joint filer with AGI of \$90,000 and has a 401(k) plan at work to which she contributes \$2,200 for a particular year. Brenda meets the eligibility requirements for the USA credit. Because her AGI exceeds \$80,000, Brenda is not eligible for an automatic contribution, but is eligible for a match rate of 50% on any voluntary contribution she might make up to \$667.

Step 1: *Employee election on tax return.* Brenda can elect to take USA credit for her 401(k) contributions up to the maximum amount of voluntary contributions that she could have made to a USA, which is \$667. When filing her tax return for that year, Brenda elects to receive the \$333 USA match (50% USA match on \$667 of her 401(k) contributions).

- * The 401(k) contributions remain in Brenda's 401(k) account. They are included in the 401(k) contributions reported to the IRS. That reporting (on Form W-2) is

unchanged from current law.

Step 2: *Government deposit of matching tax credit.* The \$333 USA match is deposited in Brenda's USA. This matching contribution (in the form of a tax credit) is equal to the amount of matching contribution (in the form of a tax credit) she would have received had she contributed to the USA instead.

Step 3: *Partial recapture of tax benefit on tax return.* In this case, 80% of the USA-matched part of Brenda's 401(k) contribution (\$667), or \$533, will not be excluded from income for federal income tax purposes. Like the election to claim the USA matching credit, this is done on her tax return, and involves no additional reporting by her employer or plan administrator.

If Brenda's marginal federal income tax rate is 28%, her election to obtain the \$333 USA matching tax credit (deposited to her USA account) means Brenda gives up \$149 (28% of \$533) of the \$187 (28% of \$667) in federal income tax savings attributable to that portion of her 401(k) contribution.

- * By contributing to the 401(k) plan, Brenda obtains a tax benefit that is greater than she would receive if she contributed the same amount directly to a USA or to the 401(k) plan without the USA match.

Question 10: Can a person contribute to both a 401(k) and a USA?

Answer: Yes. Employees can contribute to either or both of their 401(k) and USA. In fact, some employees will choose to contribute the maximum salary reduction amount permissible to their 401(k) plan and also to make the maximum voluntary contribution permissible to a USA (and will earn the government matching credit on their USA contribution).

Question 11: Are Section 403(b) Tax-Sheltered Annuity Plans Considered "401(k)-Type Plans" for Purposes of USA Coordination?

Answer: Yes. Salary reduction contributions to a section 403(b) tax-sheltered annuity or custodial account would be eligible for a USA matching tax credit.

May 27, 1999

MEMORANDUM FOR GENE SPERLING

FROM NANCY KILLEFER
ASSISTANT SECRETARY (MANAGEMENT)

LEN BURMAN
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)

RE DIALOGUE WITH PRIVATE SECTOR FINANCIAL INSTITUTIONS

We would like to invite experts in the management of large pension funds to present their views about how best to administer Universal Savings Accounts (USAs). We anticipate that those meetings would start with Treasury presenting an overview of the USA proposal, followed by a discussion about how best to implement the TSP option. The basic purpose of the meetings would be to allow the private sector experts to express their views and provide advice so we could not be accused of having developed the policy in a bureaucratic vacuum, uninformed by the knowledge and experience of experts in the real world.

As you may recall, State Street Bank volunteered an analysis of issues related to implementation of USAs that turned out to be very useful in the process of developing the USA proposal, so it is possible that these discussions would be helpful in the coming months as we try to move forward. We expect that they would tell us about how the private sector could play a role in both the short and long run. We would like to learn about the best practices that they have developed from their own experience in implementing account-based systems. They could share their experience in handling the challenges of investment management and day to day administration of the accounts. They may provide useful information about the most attractive account options and how people's customer service requirements evolve over time. That information could help us to design the most effective administrative apparatus and estimate its cost more accurately.

We would like to start this dialogue as soon as possible. You can reach either of us at work or at home through the Treasury operator (622-1260) if you would like to discuss.

Cc: Larry Summers
Jon Talisman
David Wilcox
Bill Dauster

Earnings TestMichael
Anzick

March 17, 1999

Note to the Commissioner:

Per your request, attached is a summary and critique of the arguments used in the attached Center on Budget and Policy Priorities memorandum on the earnings test. A case study that supports the most important argument is also included. I am also sending this to Jeff Liebman at NEC and Jack Smalligan at OMB.



Jane Ross

cc: Brian Coyne
Judy Chesser

Center on Budget and Policy Priorities Memorandum, "Should the Social Security Earnings Test be Eliminated for Those under Age 65?"

Summary

Bob Greenstein and Wendell Primus make three arguments in the attached memorandum for retaining the earnings test for retired Social Security beneficiaries under age 65 and eliminating it for beneficiaries aged 65-69.

- Elim.*
- It could reduce the retirement income of many elderly widows and could potentially increase the already high proportion of elderly women in poverty.
 - While there would be no significant effect on the long-term actuarial balance, it could lead to increased costs in the long run by easing the way for eliminating the earnings test for Social Security survivors and/ or some disability beneficiaries.
 - More people would opt for early retirement, making it more difficult politically to raise the early eligibility age above 62 at a time in the future when it would be necessary. (This argument is not discussed in as much detail as the first two.)

Sound Arguments

The arguments made are sound. The first is supported below with a case study demonstrating how the earnings test allows early retirees to earn their way out of permanent benefit reductions. In addition to applying to retired workers and their spouses, these permanent benefit reductions would also apply to widows, whose economic vulnerability would be increased.

The benefits of workers who retire prior to age 65 are reduced for each of the 36 months between age 62 and 65. At 65, an adjustment to the reduction factor (ARF) is made for workers whose benefit was either partially reduced or fully eliminated during any month because of earnings above the annual threshold. Without the earnings test, there would be no adjustment to the reduction factor at age 65, and monthly benefits would be permanently reduced. Currently, this reduction is 20 percent if the worker retires at age 62, and it will increase to 30 percent when the normal retirement age rises to age 67.

The table shows that this 62-year-old retired worker and his spouse¹ would have permanent benefit reductions that increase with annual earnings above the earnings test threshold if the test were eliminated. With annual earnings of \$10,000 for ages 62-64, this couple's combined monthly benefit would be permanently reduced by \$24 (2%), because the retired worker would not receive credit for the 3 months where his benefit was partially reduced due to earnings above the threshold. If this retired worker earned

¹ Retired male worker aged 62 who has a same-age spouse and average lifetime earnings who files for benefits to begin at age 62 and receives a combined worker and spouse monthly benefit of \$1132 (80% of the combined average male PIA of \$943 and a spousal benefit of \$472—\$1,415).

\$35,000 a year between the ages of 62 and 65, the couple's combined monthly benefit would be permanently reduced by \$283 (20%), because no credit would be earned for the 36 months of full and partial benefit reductions because of earnings above the threshold. With the earnings test, this retired worker and his spouse would receive his full PIA beginning at age 65. More importantly, with the earnings test, the widow of this retired worker would receive his full PIA.

**Permanent Benefit Reductions Rise with Increased Earnings Above the Threshold
for Retired Workers and Spouses**

Earnings	With Earnings Test	With Earnings Test	Without Earnings Test	Difference	
	Months added to ARF at 65	Monthly Benefits Received at 65	Monthly Benefits Received at 65	\$	%
\$10,000	3	\$1,156	\$1,132	\$24	2%
\$15,000	9	\$1,203	\$1,132	\$71	6%
\$20,000	15	\$1,249	\$1,132	\$117	9%
\$25,000	21	\$1,296	\$1,132	\$164	13%
\$30,000	30	\$1,368	\$1,132	\$236	17%
\$35,000	36	\$1,415	\$1,132	\$283	20%

Other Points

- The earnings test threshold for early retirees is listed in the memorandum as \$9,120, which was the threshold in 1998. The current threshold is \$9,600.



CENTER ON BUDGET AND POLICY PRIORITIES

To: Gene Sperling
Larry Summers
Ken Apfel
Jack Lew

From: Bob Greenstein and Wendell Primus

Subject: Should the Social Security earnings test be eliminated for those under age 65?

Date: February 24, 1999

President Clinton has called for eliminating the Social Security "earnings test." As you know, there actually are *two* earnings tests related to Social Security retirement benefits — one for those 65 through 69 (i.e., those at or above the age at which full benefits are paid), and another for those under age 65. Each of the two tests has its own earnings threshold and its own rules for how much benefits are reduced when earnings exceed the threshold. A question facing the Administration is whether to propose eliminating both earnings tests or just the test for those aged 65 and over.

When policymakers call for eliminating "the earnings test," they can mean either that they want to eliminate the test for those 65 through 69 or that they want to eliminate both tests. The Breaux-Gregg-Stenholm-Kolbe bill and the Moynihan-Kerrey bill are both said to eliminate the earnings test. The Breaux bill eliminates the test for those 65 and over. The Moynihan bill eliminates the retirement earnings limit for all beneficiaries age 62 and over.

This memo recommends that the Administration follow the path of the Breaux bill and eliminate the test for those at or above the normal retirement age, while retaining the test for those who elect to draw retirement benefits early. This would be the better course for three reasons:

- Eliminating the earnings test for those under age 65 is likely to worsen the extent and depth of poverty among elderly widows. The President has rightly said we should make changes in the Social Security benefit structure to reduce poverty among this group. Eliminating the earnings test for early retirees would do the opposite.
- Eliminating the earnings test for early retirees would likely lead to measures that would increase Social Security costs, since it likely would pave the way for easing the earnings test for survivors (a test that currently is tied to the earnings test for early retirees) and also for Social Security disability beneficiaries who are 62 through 64. The cost estimates showing that eliminating the earnings test has no significant effect on long-term actuarial balance *do not include* the costs that will be incurred if the earnings tests for

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survivors and/or some disabled beneficiaries are liberalized. Needless to say, if earnings test changes do end up worsening the actuarial balance, offsetting benefit cuts will be needed.

- At some point, the Social Security early eligibility age, now 62, will likely need to be raised, both for economic reasons (to encourage more work after age 61) and to avoid overly large actuarial reductions in Social Security benefits for those who draw benefits early. Raising the early eligibility age is already difficult politically. Eliminating the earnings test for early retirees will make it still more difficult, since an even larger fraction of elderly people will begin to draw benefits at 62.

In short, there are significant drawbacks to eliminating the earnings test for early retirees. There do not appear to be strong, countervailing reasons why the test should be dropped for this group. The research does not suggest that doing so would generate a significant increase in labor supply. (The reduced "tax" on earnings may induce some additional work effort, but the fact that people will be able to obtain the same level of current income with less in earnings would have an offsetting effect.¹) Nor should there be a political problem with retaining the earnings test for early retirees while eliminating it for older retirees. As noted, this is what the NCRP bill does. Moreover, the earnings test that has drawn most of the criticism over the years is the test for those above the normal retirement age.

The first two of the three reasons why the test should be retained for early retirees are discussed in more detail below.

Effects on Widows

Currently, about 60 percent of workers begin to collect benefits soon after their 62nd birthday. Some 80 percent start receiving benefits before they turn 65. If Social Security benefits for workers in their early 60s are no longer reduced based on earnings, even more workers will opt to begin receiving benefits early, even if they continue to work and have substantial earnings. These workers will see an increase in their monthly income in the short run (while they are in their 60s and still working) but at the cost of much lower Social Security benefits when they are older.

Workers who begin to draw benefits before age 65, along with their spouses, receive actuarially reduced benefits for the rest of their lives. Currently, those who begin to draw benefits at 62 receive a 20 percent benefit reduction; when the normal retirement age rises to 67, those starting to draw benefits at 62 will face a 30 percent benefit reduction. Because

¹ For example, a 62-year-old worker who might qualify today for \$12,000 in annual benefits before the earnings test is applied may choose to keep working for several more years at \$30,000 or so and forego benefits during this period. If the earnings test is dropped for those under age 65 and this individual thus can receive the \$12,000 in Social Security benefits, he or she may decide to switch from full-time to part-time work. If the individual does move to part-time status, he or she also may lose employer-sponsored health care coverage.

women tend to live longer than men, the negative impact of these benefit reductions are sharpest among widows. If the earnings test is eliminated for those who draw benefits early, widows who live for a long time after the death of their spouses will be faced with reduced benefits for many years if their spouses chose to start collecting Social Security benefits in their early 60s while still working. A very likely consequence of eliminating the earnings test for those below the normal retirement age thus would be an increase in the number of elderly widows who are poor. (To avoid such an outcome, those who begin to receive benefits early as a result of elimination of the earnings test will have to save a substantial share of the added income they receive in their 60s as a result. That is unlikely to occur to a sufficient degree to prevent an increase in poverty among very-old widows.)

Eliminating the Earnings Test for Early Retirees Could Lead to Increased Costs

If the earnings test for retirees is eliminated for those under 65, it may be difficult to sustain the earnings test for survivors. There likely also would be pressure to revisit the level of earnings used to determine eligibility for disability benefits for some disabled beneficiaries.

Survivor Benefits

Under current law, survivors are subject to *the same earnings test that is applied to retirees under 65*. A surviving spouse caring for children under age 16 experiences a benefit reduction of \$1 for every \$2 earned above \$9,120, which is the earnings limit for those who begin to draw retirement benefits before age 65.

The benefits of surviving families with children also are subject to a maximum family benefit, which varies depending on a worker's earnings history. For most families with two or more children, the combined benefit levels of the surviving children equal or exceed the maximum family benefit level allowed. As a result, the overall benefit these families receive does not change if the surviving spouse returns to work and earns more than the earnings limit.

The majority of survivors subject to the earnings limit consequently are young survivors with one child. Maintaining an earnings limit for these families when there is no longer an earnings limit for most other Social Security beneficiaries would be politically difficult and likely would be seen as unfair.

Eliminating the earnings test for young survivors would have a cost. The Social Security Administration estimates that in 1997, there were one million child-only survivor families. Presumably, the surviving parent works in these families. In contrast, there were only 224,000 beneficiary families consisting of children *and* their surviving parents. Because of the family maximum, not all of the one million child-only survivor families would see a benefit increase if the earnings test for survivors were eliminated. Nevertheless, the cost could be significant. Offsetting the cost could require cuts in other parts of the Social Security benefit structure.

Disability Benefits

Disabled workers are eligible for Social Security benefits only if they are unable to engage in "substantial gainful activity," defined as the ability to earn above a certain monthly earnings limit, known as the SGA threshold. A disabled individual able to earn \$500 per month (net of impairment-related work expenses) is ineligible for Social Security disability benefits. (The Administration has recently proposed an increase in the SGA threshold to \$700 that is expected to be implemented after a public comment period.)

Historically, the SGA threshold has been tied to the earnings limit that is applied to workers under age 65, although the SGA threshold is set by regulation rather than law. There have been several proposals to update and index the SGA threshold and to keep it in line with the earnings limit for retirement benefits for those under 65. Eliminating the retirement earnings test for those under 65 could bring new pressures to raise the SGA threshold substantially or eliminate it altogether for some beneficiaries. In particular, if Social Security provides retirement benefits at age 62 regardless of whether beneficiaries are retired, an argument would likely be made that the SGA threshold should be dropped for disabled workers age 62 and older. Eliminating the SGA threshold for such workers would add costs.

Conclusion

Eliminating the earnings test for workers under age 65 could have adverse consequences. It would likely result in a reduction in the incomes of many elderly widows and an increase in the number of such widows living in poverty. As a result, it would run counter to the President's expressed intention to make changes in Social Security that increase benefits and reduce poverty for elderly widows. Furthermore, eliminating the earnings test could lead to significant long-run costs if earnings tests are eliminated or weakened for survivors and disabled Social Security beneficiaries.

Eliminating the earnings test for workers aged 65 to 69 would have few adverse consequences and should be considered in the broader context of comprehensive Social Security reform. The earnings test for workers under age 65, however, should be retained.