Social Sec

Pres: elim earnings test + improve benefit for poor elderly widows

mty decided House Ways + Means wld intro Pres. proposal -

$ improvement needed - wH Hse working on

~~the~~ when SOTU → ext. solvency to 2055 - need longer but on bipartisan basis to get to 2075

Bill won't have $ or benefit changes -

Do more equity? Widows improvement will be small

~~what does t~~

Soc. sec earnings test - affects 65-69

second/diff rules affects 62-64

not a tax on earnings that reduces benefits -

at 70, ~~or~~ or when you stop working, get a higher benefit to compensate for lower benefit earlier -

Most bills elim 65-69, some 62

Rep. bill HR5 elim 65 not 62

McCain bill " "

Archer Shaw 62

Shd focus for 62 or 65

By impact on poverty on older widows sys. increases poverty among elderly widows

Age 62-64 - if earnings test elim may more

Social Sec

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Shd Dems go for 62 or 65
Big impact on poverty on older widows sys. increases
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Age 62-64 - If earnings test elim many more

will draw benefits at 62 — additional
people who start drawing at 62 will
get a lower benefit for more yrs.
∴ when old w/ no other source of
income, larger prop of income soc sec
provides — by widows issues

Peter Orszag + John Gruber at MIT worked for
to do research on earnings test —
Their research found that if we elim earnings test before 62 —
sign. increase in poverty
different benefits of widows 80+
— those w/ reduced b/c drew before 65
ave 8,500/below poverty
— those w/o .. did not .. .. ..
above ~~poverty~~ line
Other factors explained ½ diff

Research circulated w/in WH —
~~Jack~~ Jack, Apfel etc concluded 65

Issue reopened b/c W+M Dem staff — want to
follow ~~[illegible]~~ at 62

Person feels most strongly — Ken Apfel
Bill coming from W+M —→ concern about 62

CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510
Washington, DC 20002
Telephone: 202/408-1080
Fax: 202/408-0848 or 408-1056

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To:	Shirley Sagawa
FAX NUMBER:	456-6244
FROM:	Bob Greenstein
REGARDING:	
DATE:	June 22, 1999
NUMBER OF PAGES: (including cover sheet)	11

Comments:

Shirley please find enclosed the one page memo to Hillary, as well as a short memo I've written and a memo that Peter Orszag and Jon Gruber wrote to several senior Administration officials on the Social Security earnings test issue. The copy I have and am sending you of the Orszag/Gruber memo has the names of the addressees removed. I think Peter sent it to Gene, Larry Summers, Ken Apfel, Jack Lew, and maybe a couple of other people.

Revised June 21, 1999

SHOULD THE SOCIAL SECURITY EARNINGS TEST BE ELIMINATED FOR THOSE UNDER AGE 65?

President Clinton and many Members of Congress have called for eliminating the Social Security "earnings test." 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 Social Security benefits are reduced when earnings exceed the threshold. A question facing the Administration and Congress is whether to propose eliminating both earnings tests or only the test for those aged 65 and over, which is the earnings test that has drawn most of the criticism.

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. H.R. 5, the principal House Republican bill to eliminate the earnings test — which has been introduced by Rep. Sam Johnson and has 83 Republican cosponsors (including several Ways and Means Committee members) and 16 Democratic cosponsors — eliminates the earnings test for those at or above the full benefit age. It retains the earnings test for individuals below the full benefit age. The same is true of both the Stenholm-Kolbe bill and S. 279, a bill to repeal the earnings test that Senator John McCain has introduced with 10 Republican senators and one Democratic senator. On the other hand, the Archer-Shaw proposal, also said to eliminate the earnings test, drops it for beneficiaries age 62 and over.

This memo recommends that the Administration and Congress follow the path of H.R. 5 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 several reasons.

- Eliminating the earnings test for those under age 65 is very likely to worsen the extent and depth of poverty among elderly widows. President Clinton 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.

- There is no evidence that eliminating the earnings test for those below the full benefit age will result in more employment among this group. Evidence of positive effects of eliminating the earnings test on employment is limited and applies only to those at or above the full benefit age.

Two economists with expertise in Social Security issues, Jon Gruber of M.I.T. and Peter Orszag, now with the University of California at Berkeley and formerly with the Council of Economic Advisers and the National Economic Council, have recently conducted an exhaustive review of research on the earnings test. They also have undertaken new research in this area. Their findings indicate that eliminating the earnings test below the full benefit age could have significant adverse effects on poverty among elderly widows and that there is no evidence to suggest it would boost employment. A memo they wrote last week to Administration officials last week recommends, as this memo does, that the earnings test be eliminated for those at or

The 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 likely opt to begin receiving benefits early even if they continue to work. 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 age at which full benefits are paid rises from 65 to 67, those starting to draw benefits at 62 will face a *30 percent* benefit reduction. Because women tend to live longer than men, the negative impact of these benefit reductions are sharpest among widows. This means that if the earnings test is eliminated for those who draw benefits early and, as a consequence, more individuals begin to draw benefits at 62 while still working, a substantial number of women who outlive their husbands will be faced with reduced benefits for many years while they are very old. Eliminating the earnings test for individuals below the full benefit age thus would likely lead to a significant increase in the number of elderly widows who are poor.

New research by Gruber and Orszag heightens this concern. They examined Social Security benefits among widows and widowers aged 80 and over in 1996. They found that the average annual benefit was significantly *below* the poverty line among those whose benefits were reduced because they or their deceased spouses had begun to draw benefits before 65. By contrast, among widows and widowers whose benefits had *not* been reduced because of early receipt of benefits, the average annual benefit was substantially higher and was well *above* the poverty line. Gruber and Orszag's work suggests that reductions in monthly benefits caused by decisions to begin receiving benefits before the full benefit age accounted for about half of this difference.

above the full benefit age but *not* for those below it. (A copy of their memo is enclosed.)

One other set of issues also should be noted — those relating to cost. Elimination of the earnings test has no cost over the next 75 years but does have a sizable short-term cost. Eliminating the test for those at or above the full benefit age would cost about $15 billion over the first five years. Eliminating it for those 62 and over would cost about $30 billion over the first five years. (In addition, eliminating the earnings test for early retirees might lead to other measures that would increase Social Security costs over the full 75-year actuarial balance period. Eliminating the earnings test for early retirees could pave the way for easing the earnings test for survivors, a test currently tied to the earnings test for early retirees, and for Social Security disability beneficiaries aged 62 to 64. The estimates which show that eliminating the earnings test has no significant cost over the 75-year period as a whole do not include the costs that would be incurred if the earnings tests for survivors and some disabled beneficiaries also were liberalized.)

In short, there are significant drawbacks to eliminating the earnings test for early retirees, while there do not appear to be countervailing benefits. Eliminating the earnings test for workers under age 65 would be likely to result in a reduction in the incomes of a significant number of elderly widows and a rise in the number of such widows living in poverty, contrary to the President's expressed intention to increase Social Security benefits and reduce poverty for elderly widows. In addition, there is neither evidence of positive employment effects from eliminating the earnings test for early retirees nor a political need to follow such a course. As noted, a number of bills — including the principal House Republican bill to eliminate the earnings test — drop it only for those at or above the full benefit age.

Sponsors of virtually all bills that end the earnings test for those at or above the full benefit age but retain it for early retirees describe their bills as "eliminating the earnings test." A Democratic Ways and Means Committee bill can and should follow the same course.

To:

From: Jon Gruber
Peter Orszag

Subject: Earnings Test

Date: May 17, 1999

We understand from news reports that following your meeting with Ways and Means Democrats today, a bill will be drafted implementing the President's Social Security reform proposals. Since that proposal includes elimination of the earnings test in some form, we wanted to highlight the conclusions that we have reached after studying the issue.

Our main conclusion is that the earnings test should be eliminated at and above the full benefit age. But eliminating the earnings test for those below the full benefit age would be unwise because (1) it could increase widow poverty, (2) it is not obviously politically necessary, (3) it involves additional short-run budgetary costs, and (4) there is no evidence that it will produce a significant increase in labor supply.

Increased widow poverty

- Eliminating the earnings test below the full benefit age could result in *increased* widow poverty. It would thus pose additional challenges for ensuring that the overall Social Security reform package reduces such poverty.

- The earnings test results in higher Social Security benefits for survivors and thus provides some protection against poverty among widows. The earnings test results in such widow protection in two ways:

  -- Directly, through the subsequent benefit increase for working beneficiaries who have their benefits reduced under the earnings test; and

  -- Indirectly, through the effect of the earnings test on delaying when beneficiaries claim initial benefits.

- The indirect effect is likely to be more important. Many analysts believe that the earnings test is an important reason why 40 percent of beneficiaries delay initial receipt beyond age 62. Elimination of the earnings test below the full benefit age could therefore induce increased early election of benefits. And increased early benefit election would reduce subsequent survivor benefits (in addition to annual retiree and spousal benefits), thus exacerbating widow poverty.[1]

- The effect of additional early claiming on widow poverty could be substantial: *average benefits for widows who have had their benefits reduced for early retirement are significantly below the poverty line, whereas average benefits for widows whose benefits are not reduced for early retirement are significantly above the poverty line*. More specifically:

  -- Among non-disabled widows and widowers aged 80 and over in 1996 with benefits reduced for early retirement, the mean annual benefit was $7,009, or $516 *below* the poverty line of $7,525 for a single elderly person.

  -- Among other beneficiaries (those whose deceased spouses did not claim early retired worker benefits, and who did not claim early survivor benefits themselves), the average benefit was $9,174,or $1,649 *above* the poverty line.

  Differences in Primary Insurance Amounts explain only about half of the mean difference across these groups. These figures are suggestive rather than conclusive, but we find them troubling nonetheless.

- In 1996, a significant portion of those who delayed receiving benefits until the full benefit age or thereafter had relatively low Primary Insurance Amounts.[2] If the removal of the earnings test below the full benefit age induced even a modest share of such retirees to elect benefits earlier, the adverse consequences in very old age (either for the workers, or their spouses, or both) could be significant. Again, further research is required on this important topic, but the potential magnitude of the effect is sufficiently large to warrant concern.

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[1] Beneficiaries could save enough of their early benefits to ensure that income in very old age remained constant. But we doubt that such saving is likely to occur; recent research strongly suggests that higher Social Security benefits will simply lead to higher consumption levels.

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

Politically unnecessary

- Complete elimination of the earnings test (above and below the full benefit age) may appear to have political advantages. But numerous proposals with substantial Republican bipartisan support on the Hill only eliminate the earnings test at the full benefit age, not below it. They thus provide a basis for bipartisan support for retaining the earnings test below the full benefit age, while removing it at and above the full benefit age.

  Such proposals include H.R. 5, the Republican leadership bill to eliminate the earnings test, which was introduced by Rep. Sam Johnson, 83 Republican co-sponsors (including several members of the Ways and Means Committee), and 16 Democratic co-sponsors. Proposals to "eliminate the earnings test" that retain the test below the full benefit age also include S. 279, introduced by Senator John McCain and 10 other Republican senators,[3] and the National Commission on Retirement Policy plan introduced in varying forms by Reps. Stenholm and Kolbe and Senators Breaux and Gregg.

Additional short-term costs

- While eliminating the earnings test has roughly zero long-term actuarial cost, it does have short-term costs. Eliminating the earnings test only at or above the full benefit age costs about half as much in the short run -- about $15 billion less over 5 years -- as eliminating it both above and below the full benefit age.

Unclear labor supply effect below the full benefit age

- The traditional view of the labor supply effect of the earnings test was that it had little impact.

- A recent study for those above the full benefit age, has reached a somewhat different conclusion, suggesting that eliminating the earnings test at age 65 would produce a 5.3 percent increase in work activity among elderly beneficiaries aged 65 and over.[4]

- There is no similar evidence regarding the labor supply effect below the full benefit age. In other words, unlike the questions the recent study raises about the traditional view of the labor supply effect above the full benefit age, we are not aware of any credible evidence suggesting that the labor supply effect for those below the full benefit age is significant.

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[3] The bill also has one Democratic co-sponsor.

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

Eliminating the earnings test at and above the full benefit age

Despite our arguments against removing the earnings test below the full benefit age, there is a much stronger case to be made for removing it at that age. (A brief appendix discusses whether it should be removed at the full benefit age, at age 65, or at age 67, which differ because of the scheduled increase in the full benefit age.)

- First, we have less concern about poverty among widows whose spouses waited until the full benefit age before claiming benefits, so there is less need for protection in this regard.
- Second, the actuarial adjustment that compensates individuals for the delayed benefits receipt embodied in the earnings test is less equitable after age 65 than before.[5]
- Third, the new evidence on the labor supply disincentives of the earnings test does apply to those in this age range.

Other policy suggestions

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

- **Education:** Concerns about keeping the earnings test in place for those age 62-64 could be alleviated by a campaign by the Social Security Administration to make older persons aware that the earnings test is not a tax. Even popular tax guides do not mention the subsequent benefit increase under the earnings test. A clear and concise mailing to all 61-year olds about how the earnings test really works, with simple examples, could substantially improve understanding of the system. Similarly, beneficiaries whose benefits are reduced because of the earnings test should be told how much their subsequent benefits will be increased as a result.
- **Spousal benefits:** Benefit reductions under the earnings test are pro-rated between the worker and the spouse. But spouses above the full benefit age do not have their subsequent benefits increased as a result. For a couple with a spouse past the full benefit age, this provision partially converts the earnings test from a forced savings program to a true lifetime tax.[6]

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[5] Even after the delayed retirement credit reaches 8 percent in 2005, it will still not fully compensate those who are 68 or 69.

[6] It should be noted, however, that widow benefits *are* increased by the delayed retirement credit. Therefore, the spouse may receive a higher benefit as a survivor (but not as a spouse) because of the benefit reductions under the earnings test. In other words, she only receives the higher benefit after her spouse (the worker) dies.

One possibility is therefore to apply the benefit reduction under the earnings test exclusively to the worker's benefits, rather than pro-rating it between the worker's benefits and the spouse's benefits. That approach would obviate the need to adjust the spousal benefit subsequently, thus removing the quirk.

- **Medicare coverage and election of Social Security benefits:** When workers register for Medicare benefits at age 65, they are encouraged (but not required) to elect Social Security benefits as well – even if they plan to continue working, in which case their benefits would be reduced through the earnings test until they reach age 70 – to ensure that they do not later forget to elect Social Security benefits. This practice should be ended. Indeed, if anything, 65-year olds should be presented with a table showing how much higher their Social Security benefits would be if they waited to elect initial benefits. Encouraging those 65-year olds working full-time to elect Social Security benefits – only to have those benefits eliminated through the earnings test – only increases frustration with the perceived tax and exacerbates the administrative burden of operating the system. Changing the current practice will become even more important as the full benefit age increases above 65.

Appendix: Elimination at the full benefit age versus elimination at age 65 or age 67

We concluded that the earnings test should be eliminated at and above the full benefit age, but not below it. Some analysts have expressed concerns about linking the age at which the earnings test no longer applies to the full benefit age:

- First, it would cause the earnings test to apply to older workers as the full benefit age increases from 65 to 67 under current law;

- Second, it could create a political disincentive to increasing the full benefit age further or faster, since it would impose a "tax" on those then falling below the full benefit age.

One twist on our proposed reform is therefore to eliminate the earnings test at age 65 so that the age at which the earnings test no longer applies is not linked to increases (currently scheduled or otherwise) in the full benefit age. While this proposal merits scrutiny, our initial reaction is that it is inferior to elimination at the full benefit age itself. Since one of our primary concerns is the impact of the earnings test removal on early claiming and therefore on widow poverty, and since the actuarial reductions for early claiming are tied to the full benefit age, we believe that tying the earnings test removal to the full benefit age is more appropriate than simply eliminating it at age 65. Elimination at age 65, in other words, could encourage early claiming as the full benefit age rises above 65. We believe that eliminating the earnings test at the full benefit age is the most auspicious approach.