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REPEALING THE EARNINGS TEST COULD BE GOOD FOR THE BUDGET

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CONGRESS MOVED QUICKLY TO REPEAL THE Social Security earnings test that applies to retirees between ages 65 and 69. By repealing the test, the government will no longer *automatically* withhold any portion of a Social Security benefit because a retiree[1] earns wages. The Congressional Budget Office (CBO) estimates that this reform will reduce the federal budget surplus by $22.8 billion over the next 10 years. However, this projection does not account for the reform's long-term effects. The Social Security Administration estimates that repealing the earnings test will have a negligible effect on Social Security's long-term actuarial balance. But even this estimate likely understates the reform's long-term budgetary effect because it assumes a very modest behavioral response to the reform and does not fully account for the impact of additional work on general revenues. In reality, repealing the earnings test may actually be good for the budget.

Before repeal, the test reduced a benefit by $1 for every $3 earned over a $17,000 threshold and applied only to those of normal retirement age (between 65 and 69), as opposed to the more stringent test that applies to early retirees. Historically, the earnings test was favored, at least by some, as a means of encouraging older workers to make way for younger workers. Today, that argument—which was weak in the first place—holds even less sway because the tight labor market has created a high demand for labor.

Removing the earnings test is a less radical change than it may seem. Even without reform, the number of beneficiaries affected by the normal-retirement-age earnings test would have declined. The earnings threshold was scheduled to increase, leaving fewer retirees who earn enough to be subjected to the test. In addition, the normal retirement age was to be increased so that by the year 2027 the test would have only applied to beneficiaries ages 67 to 69.[2]

Since 1972, delayed retirement credits (DRCs) have partially compensated retirees whose benefits have been reduced by the earnings test. DRCs increase current benefits for each past year in which benefits were withheld.[3] By 2008, when DRCs will be fully implemented, they would have almost completely compensated workers for benefits lost due to the earnings test. Thus, the initial increase in spending caused by repealing the earnings test will be largely offset by the savings from not having to provide credits.[4]

Because of the rules discussed above, repealing the earnings test promises to be, from a long-term

1. The earnings test that has been repealed applies only to retirees of normal retirement age (between ages 65 and 69). Retirees age 70 and older were never subject to an earnings test.

2. Straight Talk No. 9 (October 15, 1999) provides a discussion of the shrinking number of beneficiaries subject to the earnings test.

3. Under the bill just passed, people of normal retirement age but not yet 70 can volunteer to have their benefits withheld and receive DRCs later.

4. Most of the future savings are not evident in CBO's cost estimates because, for the most part, the budget uses cash flow accounting in which only actual money spent in the period is recorded. The savings would show up, however, under accrual budget accounting in which all future assets and liabilities are recorded.

budgetary standpoint, somewhat uneventful. However, not having the test will alter the way retirees act—and this is likely to have a positive long-term effect on the budget.

Without an earnings test, people of normal retirement age may make different decisions about their participation in the labor force. On the one hand, those with high earnings may work less because available Social Security benefits will compensate for reduced earnings.[5] On the other hand, many would-be retirees may decide not to retire and many retirees may want to work more. Even though the earnings test does not, on average, reduce total lifetime benefits because of the offsetting DRCs, many people do not recognize or understand the DRC calculations and still perceive the test to be a significant tax on their earnings. As a result, some beneficiaries choose not to work or, if they do, choose to limit their wages. An unusually high number of working retirees have earnings that hover around the earnings test threshold.

Repealing the earnings test will likely do much more than simply spark a modest increase in work effort, as the Social Security Administration predicts. The symbolism of eliminating the test may provide powerful motivation to work, increasing Social Security tax revenues far more than expected. Moreover, the Social Security actuaries only account for trust fund revenues and therefore do not estimate possible increases in income tax and other revenues.[6] If repealing the earnings test has, more or less, a neutral effect on long-term expenditures, then additional work is likely to have a positive effect on the budget, increasing government receipts with little effect on its liabilities.

5. Only 12.3 percent of people who are of normal retirement age are attached to the labor force.

6. Taxes paid on *additional* earnings often yield little or no change in benefits because of the progressive nature of the benefit formula and because only limited numbers of earning years are counted in the benefit formula.

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