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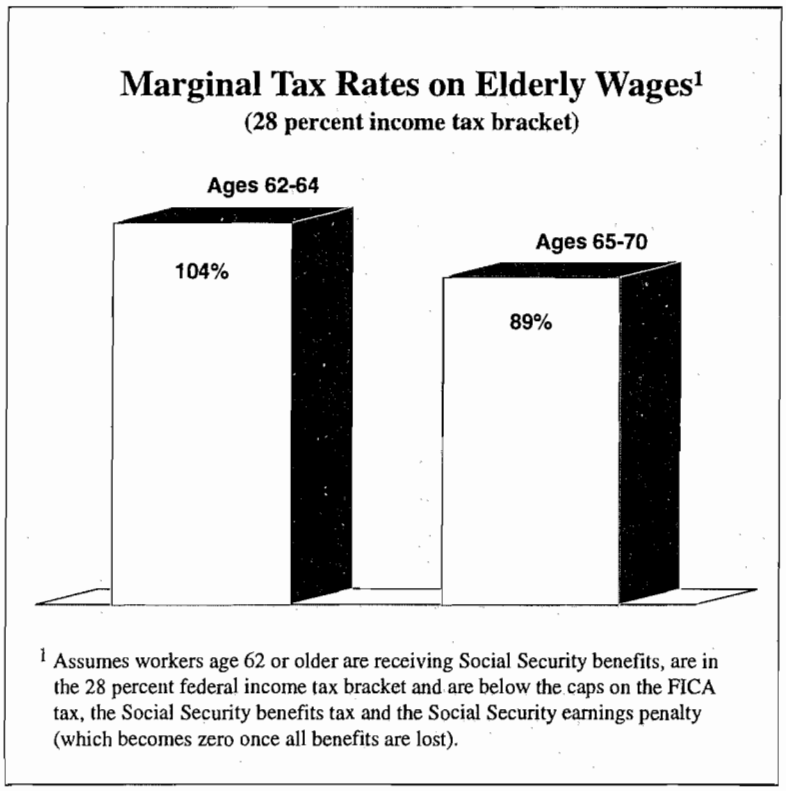
Raising the Earnings Limit

The 42 million-plus Americans age 60 and over represent a vast store of human capital, rich in talent and ability. Yet this valuable resource is increasingly wasted.

- In 1930, before Social Security, 54 percent of men age 65 and over were in the labor force.
- Today the labor force participation rate of men age 65 and over is about 16 percent.

One reason for that change is government policy. If elderly workers under the age of 70 want to improve their standard of living or continue using their work experience and skills, the government takes the bulk of their additional wages through special taxes. The most onerous and counter-productive of the taxes is the Social Security retirement earnings test. This penalty reduces Social Security benefits for those ages 62 to 64 by $1 for every $2 earned above $8,160 — a 50 percent marginal tax rate — and for those ages 65 to 69 by $1 for every $3 earned above $11,280 — a 33 percent marginal tax rate. Faced with the earnings penalty in addition to other taxes, many elderly workers simply drop out of the system.

Calculating the Total Marginal Tax Rate for Elderly Workers. The earnings penalty is not the only problem. When the Social Security (FICA) tax (7.65 percent) is added to the income tax rates of 15 and 28 percent, marginal tax rates for younger workers are 23 and 36 percent. For elderly workers, there is also a tax on Social Security benefits. As much as 85 percent of any benefits remaining after the earnings penalty is subject to taxation as regular income if other income (including tax-exempt income) plus half of the beneficiary's Social Security benefits total more than $34,000 for an individual or $44,000 for a couple. As the figure shows, this results in far higher marginal tax rates for elderly workers than for younger ones:



- Workers ages 65 to 69 face a marginal tax rate as high as 88.81 percent.
- For workers ages 62 to 64, the marginal rate is as high as 103.5 percent.
- This means elderly workers could pay as much as $1.04 in federal taxes when they earn an additional dollar of income.

The marginal rate can go even higher for workers who are self-employed and paying a 15.3 percent FICA and for those living where there are state or local income taxes.

Effects on Elderly Workers. These high marginal tax rates affect the behavior of elderly workers. About 1.9 million retired workers ages 65 to 69 who are eligible for Social Security benefits have earnings. An extraordinarily large number of them earn up to (or near) the earnings limit and then quit working. Specifically:

- About 400,000 elderly workers earn annual wages within 10 percent of the earnings limit.

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- These workers apparently earn all they can without being subject to the retirement earnings penalty.

No doubt many others pass up full-time or part-time work because of the earnings penalty. And no doubt still others work in the underground economy, receiving unreported cash or some other form of payment.

Why Have an Earnings Limit? The retirement earnings limit has been part of Social Security since its inception. The original reason given for it was that Social Security should replace lost earnings. Benefits, it was believed, should not go to people who continued to work. This policy was consistent with the Depression-era view that Social Security should encourage older workers to leave the workforce, making more jobs available for the young.

Times have changed. The United States now faces a shortage of workers, not a glut. The continuing labor force participation of older Americans, who possess valuable skills acquired over 30 or 40 years, is increasingly important to the health of the U. S. economy.

Washington has been reluctant to change the Social Security earnings penalty, partly because of a fear that the change would cost the Treasury billions in lost federal revenues. An econometric analysis by NCPA Senior Fellows Aldona Robbins and Gary Robbins showed that fear to be unfounded. The analysis found that increasing the earnings limit, or eliminating it altogether, would result in the federal government's receiving more in new work-related tax revenues than it would lose in increased Social Security benefit payments.

Effects of Increasing the Earnings Limit. The Social Security benefits of some 750,000 elderly workers are partially withheld because their wage income exceeds the earnings limit. If each of these workers were allowed to earn an additional $1,000 without penalty, benefit payments would rise by about $37 million. However:

- The workforce would increase by the equivalent of 60,000 to 70,000 full-time jobs.
- The federal government would receive an additional $563 million in taxes on increased earnings and another $134 million in taxes because of an increase in capital income.
- On balance, the total increase in new revenue ($697 million) would exceed the total increase in new Social Security spending ($37 million) by $660 million.

Raising the earnings limit by $1,000, then, would result in a *net increase* in federal revenues and a *reduction* in the federal deficit.

Effects of Abolishing the Earnings Limit. Eliminating the earnings limit altogether for retired workers between the ages of 65 and 69 would increase labor and capital income, thereby increasing federal tax revenues. It would also increase the amount of Social Security benefits paid, thereby increasing federal spending.

- The number of elderly workers with some wage income would rise from 1.9 million to 2.6 million — an increase of 38 percent.
- The additional work effort would increase the wage income of all elderly workers by $10.3 billion.
- The federal government would be obligated to pay an additional $4.8 billion in Social Security benefits, but would collect $4.94 billion in additional taxes, for a net increase in federal revenue of $140 million.

Public Policy Implications. The Republicans' Contract With America proposes to increase the amount that older workers can earn without penalty to $30,000 by the year 2000, with an increase to $15,000 next January. Lifting or eliminating the earnings limit for retired workers makes good economic sense. The substantial reduction in marginal tax rates on wages will lead to an increase in labor effort that yields additional income and payroll tax revenues to offset the increase in Social Security benefit payments.

This Brief Analysis is based on testimony by NCPA President John C. Goodman before the Subcommittee on Social Security of the U. S. House Ways and Means Committee.