PAYING PEOPLE NOT TO WORK:
THE ECONOMIC COST OF THE SOCIAL SECURITY RETIREMENT EARNINGS LIMIT

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INTRODUCTION

BY

CONGRESSMAN DICK ARMEY

America is known throughout the world as the land of opportunity – a place where people can work hard and freely use their talents and abilities to make a better life for themselves and their children. Yet many elderly workers aged 62-69 are dismayed to find that the promise of America is conditional. For if elderly workers choose to work to improve their standard of living, they find that government takes the vast bulk of their additional wages through special taxes that apply only to them.

Of all the special taxes the federal government imposes on senior citizens, the most insidious and counter-productive is the Social Security retirement earnings test. The retirement earnings test reduces an elderly worker's Social Security benefits by $1 dollar for every $2 dollars earned above $8,880.

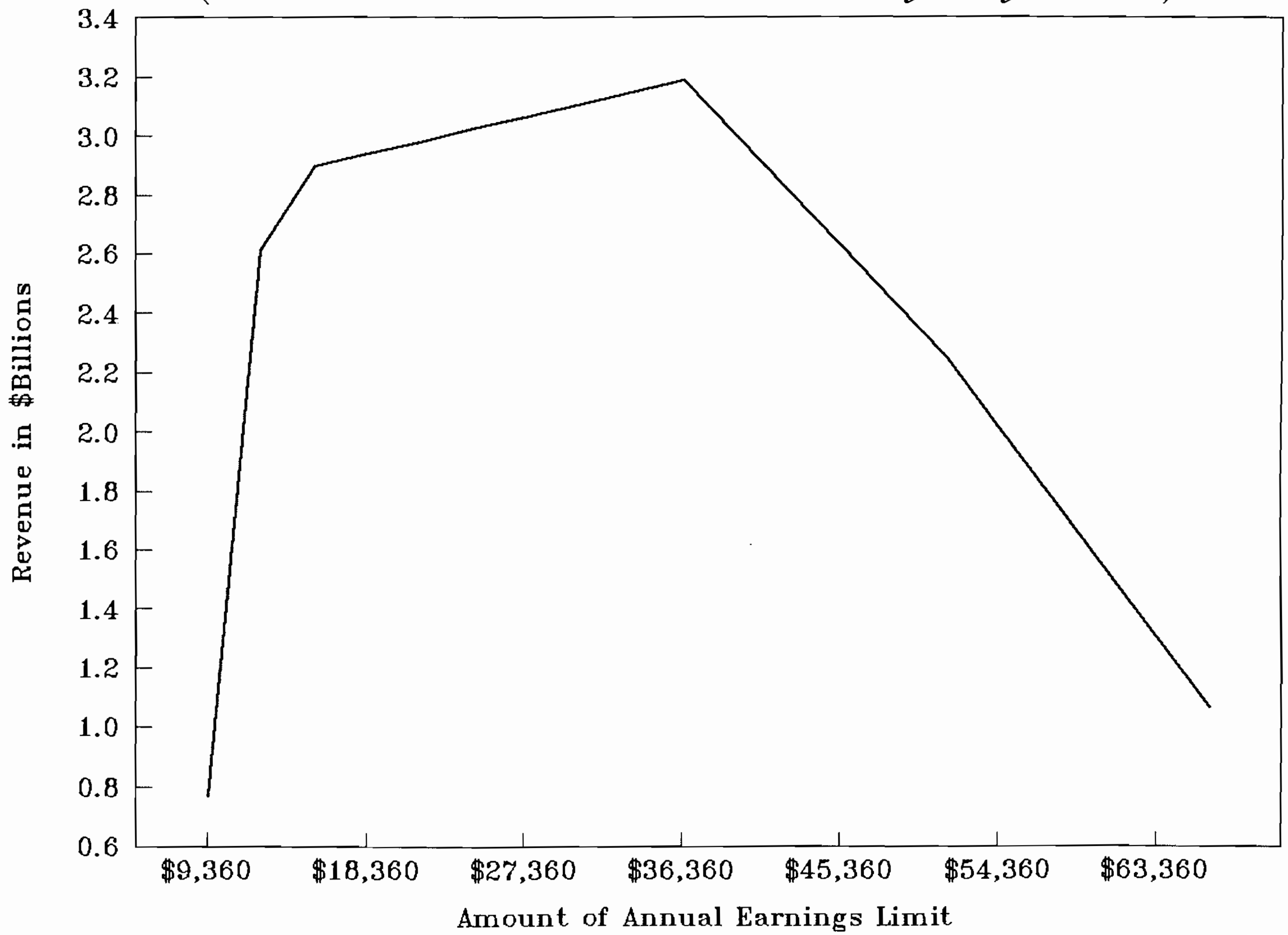
This penalty amounts to a 50 percent marginal tax rate and does not include other federal and state income and unemployment taxes, or the surtax for catastrophic health coverage. Because the penalties for working are so high, many elderly workers are simply dropping out of the system and becoming more dependent on government instead. And that hurts all of us, for elderly workers have millions of years of collective work experience and skills – attributes that are lost to American employers as they engage in a fierce international competitive struggle.

While more and more Americans are feeling the pinch caused by the retirement earnings test, many in Washington have been reluctant to suggest changes for fear that it would cost the Treasury billions in lost federal revenues. That fear is unfounded. As this study by Gary and Aldona Robbins clearly demonstrates, this punitive tax actually costs the government money.

If the retirement earnings limit were raised significantly or abolished altogether – unleashing the productive capabilities of elderly workers – the federal government would receive more in new, work-related taxes than it would lose because of increased Social Security benefit payments. In short, our federal deficit would go down, not up, and it would be because we were able to harness the rich wealth of human capital that America's senior work force represents.

I hope the public and my colleagues in Congress will read this report carefully, and act swiftly to reduce the harmful effects of this discriminatory and fruitless tax.

INCREASE IN NET FEDERAL REVENUE
FROM RAISING THE RETIREMENT EARNINGS LIMIT
(Net Taxes Minus Social Security Payments)



EXECUTIVE SUMMARY

Our nation's senior citizens represent a rich pool of talent and ability that is largely untapped. This vast resource of valuable human capital has the potential to add billions of dollars to our annual output of goods and services; provide new, earnings-related tax revenues for federal, state, and local governments; and strengthen the competitive position of the U.S. economy in the international marketplace.

One reason why so many of the elderly have abandoned the workplace is that the federal government has imposed extraordinarily high marginal tax rates on wages they earn.

- For middle-income elderly workers, federal taxes take at least 75 cents out of each additional dollar of wage income.

- In some cases, the marginal tax rate reaches 102 percent, and elderly workers lose $1.02 for each $1 of earnings.

Of the various taxes on the wage income of the elderly, the most draconian is the Social Security retirement earnings penalty. Because of this tax, elderly workers currently lose 50 cents in Social Security benefits for each $1 of earnings -- a marginal tax rate of 50 percent. Yet this tax is self-defeating. It raises no additional net revenue for the federal government and imposes a large cost on the U.S. economy. Based on a conservative estimate,

- If the retirement earnings penalty were eliminated, at least 700,000 elderly retirees would enter the labor market.

- As a result, our annual output of goods and services would increase by at least $15.4 billion.

- Government revenue would increase by $4.9 billion, more than offsetting the additional Social Security benefits that would be paid.

One argument against the complete elimination of the retirement earnings penalty is that it would obligate the federal government to pay Social Security benefits to high-income elderly individuals who are willing to continue working whether or not they receive the benefits. For these workers, elimination of the earnings penalty would cause the federal government to lose funds (in the form of Social Security benefit payments) and get nothing in return. Yet if the only objective were to reduce the federal deficit, Congress is passing up the opportunity for a free lunch.

- In 1990, elderly workers will be allowed to earn as much as $9,360 (the earnings limit) without loss of Social Security benefits.

- If this earnings limit were doubled, tripled, or even quadrupled, the federal government would receive considerably more in new work-related tax revenues than it would lose in increased Social Security benefit payments.

- If the earnings limit were increased to $39,360 the federal deficit could be reduced by $3.2 billion.

PAYING PEOPLE NOT TO WORK:
THE ECONOMIC COST OF THE SOCIAL SECURITY
RETIREMENT EARNINGS LIMIT

The retirement earnings limit has been part of Social Security since its inception. This provision allows elderly retirees to earn only a small amount of wage and salary income and still receive full Social Security benefits. At the same time, the earnings limit imposes a very high tax on retirees who choose to work and earn additional income.

- Elderly workers are currently losing 50 cents in Social Security benefits for every dollar in wages above the earnings limit -- reflecting a marginal tax rate of 50 percent.
- In 1990, this marginal tax rate will decrease from 50 percent to 33 percent, and elderly workers will lose 33 cents in benefits for each extra dollar of wages.

The original reason given for the retirement earnings limit 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 work force, making more jobs available for younger workers.

Times have changed, however. Current fears are that the United States is facing 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, will be increasingly important to the health of the U.S. economy in future years.

In response to these economic realities, Congress is considering proposals to liberalize the Social Security retirement earnings limit:

- Senator William Armstrong (R-CO) has proposed an amendment that would begin to phase out the earnings limit for retirees between the ages of 65 and 69 by raising the limit an additional $3,000 per year in 1990, 1991, and 1992.
- The House Ways and Means Committee has voted to increase the 1990 earnings limit for retired workers between the ages of 65 and 69 from $9,360 to $9,720 and to increase the 1991 limit from $9,840 to $10,440.

Reducing or eliminating the earnings limit raises budgetary concerns. The Social Security Administration estimates that in 1990 approximately $4.8 billion will be withheld from beneficiaries between the ages of 65 and 69 because of the earnings limit. From a static view of the world, it would seem that there would be a corresponding increase in federal budget deficit of $4.8 billion.

Because the earnings limit imposes extremely high marginal tax rates on income from work, however, elimination of the limit will induce retired workers to enter the labor force and to increase their earnings. This increased work effort will lead to higher federal income and payroll tax revenues that will more than offset the increased payout of Social Security benefits.

TABLE I

PENALTIES FOR ELDERLY WORKERS[1]

Year	Social Security Earnings Limit: Ages 65 to 69	Social Security Earnings Limit: Ages 62 to 64	Loss of Benefits for Excess Earnings
1989	$8,880	$6,480	$1 for every $2 of wages
1990	$9,360[2]	$6,840[2]	$1 for every $3 of wages

[1]Social Security beneficiaries age 70 and over are not subject to the earnings limit.

[2]These are estimates for 1990. The earnings limit is indexed and rises with the growth of average wages.

THE RETIREMENT EARNINGS LIMIT AND MARGINAL TAX RATES

Elderly workers between the ages of 65 and 69 face higher marginal tax rates on labor income than any other group of American workers.[1] In addition to the federal income tax, the federal payroll tax (FICA), and the retirement earnings limit, two new taxes adopted during the last six years have dramatically increased marginal tax rates for the elderly. The first is the Social Security benefit tax, enacted as part of the 1983 Social Security reform legislation. The second is the Medicare surtax, enacted as part of the Catastrophic Coverage Act of 1988.

The Social Security Benefit Tax. Under current law, one-half of Social Security benefits potentially are subject to the income tax. In 1986, for example, at least 20 percent of the elderly had to pay taxes on an average of $3,373 of Social Security benefits, and the percentage of the elderly paying the tax will rise continuously in future years.[2] As the law is structured, however, one-half of Social Security benefits are not automatically included in the ordinary income of the taxpayer. Instead, the tax applies only if one-half of Social Security income plus all non-Social Security income (including income from tax-exempt bonds) exceeds $25,000 for an individual or $32,000 for a couple. For taxpayers who exceed these amounts, 50 cents of Social Security benefits is taxed for each dollar of additional income.

One way to think about the Social Security benefit tax is to see it as a tax on income, rather than as a tax on Social Security benefits -- since the tax increases only as income increases. For individuals who exceed the income limits described above,

- Taxpayers who earn an additional $1 of income are forced to pay taxes on $1.50.[3]
- This means that taxpayers in the 15 percent income tax bracket automatically face an income tax rate of 22.5 percent.
- Individuals in the 28 percent income tax bracket automatically face an income tax rate of 42 percent.

The Medicare Surtax. As pointed out in a previous NCPA report, genuine catastrophic insurance for the elderly is rather inexpensive, provided it does not include nursing home care. For example, genuine catastrophic coverage could be provided for as little as $60 per year per Medicare beneficiary, or through small increases in the Medicare deductibles and copayments.[4] In

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[1]For a discussion of the special taxes on the elderly, see John C. Goodman and A. James Meigs, "The Elderly: People the Supply-Side Revolution Forgot," NCPA Policy Report No. 135, February 1989. See also Stephen Entin, The Social Security Retirement Earnings Test (Washington, DC: Institute for Research on the Economics of Taxation, 1989).

[2]The percentage of elderly paying the tax will continue to rise because the income thresholds, beyond which Social Security benefits become taxable, are not indexed. See Aldona Robbins, *The ABC's of Social Security* (Washington, DC: Institute for Research on the Economics of Taxation, 1988), p. 16.

[3]Assumes that additional income does not result in a loss of Social Security benefits. If taxpayers are at or above the earnings limit, they pay taxes on $1.38 for each $1 of earnings.

[4]John C. Goodman and Gerald Musgrave, "Health Care for the Elderly: The Nightmare in our Future," NCPA Policy Report No.130, October 1987, pp. 29-30. See also Peter J. Ferrara and Edmund F. Haislmaier, "The Catastrophic Health Tax on America's Elderly," *Issue Bulletin*, No. 132, Heritage Foundation, July 21, 1987.

the hands of politicians, however, catastrophic health insurance quickly developed into a Christmas package of costly benefits, even without including coverage for nursing home care.[5] Because Congress needed additional tax revenues to fund this program, the elderly now pay a Medicare surtax equal to 15 percent of income taxes. This surtax will increase in future years, reaching 28 percent of income taxes in 1993.

For taxpayers in the 15 percent income tax bracket, the surtax equals 2.25 percent (15% X 15%) of income. For taxpayers in the 28 percent income tax bracket, the surtax equals 4.20 percent (15% X 28%) of income. Remember, however, that taxpayers who are subject to the Social Security benefit tax face income tax rates as much as 50 percent higher than the rates faced by other taxpayers. As a result:

- For elderly taxpayers earning little more than the minimum wage, the Medicare surtax can be as high as 6.3 percent of each additional dollar of income.
- In 1993, when the surtax reaches 28 percent of income taxes, elderly taxpayers will face a Medicare surtax as high as 11.76 percent of each additional dollar of income.[6]

Total Marginal Tax Rates for the Elderly. Retired people receiving Social Security benefits face higher marginal tax rates on income from labor today than have ever been imposed on middle-income American workers. As Table II shows,

- Elderly workers earning only $8,880 are facing a marginal tax rate this year of at least 58 percent -- even if they earn too little to pay income taxes.
- For those elderly workers who barely have enough income to pay federal income taxes, the marginal tax rate is at least 75 percent.

Elderly workers with incomes just high enough to be subject to the Social Security benefit tax face the highest tax rates of all. The income of these workers will be reduced by at least 80 cents for each additional dollar of wages. Moreover,

- For those elderly workers who earn $8,880 in wages and are also in the 28 percent income tax bracket, marginal tax rates are 102 percent.
- Federal policy forces these elderly workers to pay to work -- each additional dollar they earn will decrease their total income.

It is important to note that marginal tax rates in excess of 100 percent are not imposed on the wealthiest of elderly taxpayers. Indeed, for very high-income earners, the marginal tax rate is 28 percent. The highest marginal tax rates are imposed on middle-income elderly. For those with non-Social Security incomes of $25,000 to $40,000, tax rates are higher than they have ever been for any group of U.S. taxpayers.

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[5]For a critique of catastrophic health care legislation, see Aldona Robbins and Gary Robbins, "Facts About Catastrophic Coverage," *Economic Report*, No. 41, Institute for Research on the Economics of Taxation, May 23, 1988.

[6]Assumes the 1993 cap on the Medicare surtax will be increased sufficiently to apply to couples in the 28 percent income tax bracket.

Elderly workers will get some relief in 1990, when the retirement earnings penalty is reduced from a 50 percent to a 33 percent tax on earnings. Yet this gain will be partially offset by a rising Medicare surtax. Elderly workers who pay income taxes in 1990 will face a marginal tax rate of at least 60 percent, and the highest marginal tax rate imposed on middle-income elderly workers will be 90 percent.

TABLE II

MARGINAL TAX RATES OF ELDERLY WORKERS EARNING $8,880[1] ($9,360 In 1990)

Income Too Low to Pay Federal Income Taxes[2]

	1989	1990
FICA Tax	7.51%	7.65%
Earnings Penalty	50.00%	33.00%
Total	57.50%	40.64%

Income High Enough to Pay Income Taxes, But Too Low to Pay the Social Security Benefit Tax[3]

15 Percent Bracket	1989	1990
Federal Income Tax	15.00%	15.00%
FICA Tax	7.51%	7.65%
Medicare Surtax	2.25%	3.75%
Earnings Penalty	50.00%	33.00%
Total	74.76%	59.40%

28 Percent Bracket	1989	1990
Federal Income Tax	28.00%	28.00%
FICA Tax	7.51%	7.65%
Medicare Surtax	4.20%	7.00%
Earnings Penalty	50.00%	33.00%
Total	89.71%	75.65%

Income High Enough to Pay the Social Security Benefit Tax[4]

15 Percent Bracket	1989	1990
Federal Income Tax	15.00%	15.00%
FICA Tax	7.51%	7.65%
Social Security Benefit Tax	5.63%	6.26%
Medicare Surtax	3.09%	5.32%
Earnings Penalty	50.00%	33.00%
Total	81.23%	67.23%

28 Percent Bracket	1989	1990
Federal Income Tax	28.00%	28.00%
FICA Tax	7.51%	7.65%
Social Security Benefit Tax	10.50%	11.69%
Medicare Surtax	5.78%	9.92%
Earnings Penalty	50.00%	33.00%
Total	101.79%	90.26%

[1]Refers to workers age 65 to 69.

[2]In 1989, taxable earnings are less than $10,800 for a couple. Most single individuals earning the earnings limit are subject to the income tax.

[3]Total income from all sources (including Social Security benefits) less than $25,000 for an individual and $32,000 for a couple.

[4]Assumes taxpayers pay tax on some of their Social Security benefits but remain under the maximum of one-half of benefits taxed. Taxpayers also pay less than the maximum Medicare surtax of $800 in 1989 and $900 in 1990.

Delayed Retirement Credit. Workers who delay receiving Social Security benefits past normal retirement age are rewarded with an increase in their future benefits. A retired worker reaching age 65 in 1990 will receive an additional 3.5 percent in benefits per year for delaying Social Security benefits past age 65. For each month that benefits are withheld due to the earnings test, the retired worker receives a pro-rated share of the delayed retirement credit.[7] At age 70, the worker receives full benefits plus the delayed retirement credit, regardless of earnings.

This increase in lifetime Social Security benefits, however, falls far short of offsetting the tax imposed by the earnings penalty. For example, a retired worker reaching age 65 in 1990 can expect to collect benefits until age 81. Table III shows the present value of increased Social Security benefits due to the delayed retirement credit and the additional taxes on earnings (federal income taxes + payroll taxes + withheld benefits) for a worker who earns enough to have Social Security benefits withheld. As the table shows,[8]

- Elderly workers who earn enough to have 20 percent of their benefits withheld can expect to pay six times more in additional taxes than the additional benefits they will receive because of the delayed retirement credit.

- For elderly workers who have 100 percent of their benefits withheld, the additional taxes paid are twice the additional benefit they will receive because of the delayed retirement credit.

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[7] A retired worker may receive credit for Social Security benefits delayed for up to five years. The maximum credit for someone reaching age 65 in 1990 is 17.5 percent. The delayed credit is also prorated. In the case of a 3.5 percent annual credit, the retired worker would receive 0.29 percent for each month that benefits were withheld.

[8] In order to equalize the streams of benefits and taxes, there would have to be a negative internal rate of return. Specifically, the internal rates of return are as follows:

Internal Rate of Return to Equalize Present Values:

	20% Withheld	100% Withheld
Without FICA tax	-7.5 %	-7.7 %
7.65% FICA tax	-10.6 %	-12.7 %
15.3% FICA tax	-12.9 %	-15.8 %

TABLE III

EFFECTS OF THE DELAYED RETIREMENT CREDIT[1]

Present Value	20% of Benefits Withheld Because of Earnings	100% of Benefits Withheld Because of Earnings
Additional Social Security Benefits at Age 70	$ 3,038	$15,191
Additional Taxes Paid While Working	$18,692	$31,060

[1]Elderly workers age 65 to 69.

EFFECTS OF THE EARNINGS LIMIT ON THE LABOR SUPPLY

America's most underutilized resource is the productive capacity of our elderly population. The 40 million men and women age 60 and over represent a vast store of human capital, rich in talent and ability. They have more than one billion years of cumulative experience in business, accounting, engineering, finance; and virtually every other productive endeavor. 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.[9]
- Today the labor force participation rate of men age 65 and over is about 16 percent.[10]

The withdrawal of the elderly from the labor force is predicted to get worse.[11] It is occurring as the Department of Labor is warning us about future labor shortages.[12] It is also

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[9]Aldona Robbins, *The ABC's of Social Security* (Washington, DC: Institute for Research on the Economics of Taxation, 1988), p. 4.

[10]U.S. Bureau of the Census, *Statistical Abstract of the United States*: 1989 (109th edition) Washington, DC, 1989, p 376.

[11]*Older Worker Task Force: Key Policy Issues*, U.S. Department of Labor, 1989, p. 2.

[12]*Labor Market Shortages*, U.S. Department of Labor, 1989.

occurring as entry into the labor market is becoming increasingly easy for senior citizens, and may involve little more than establishing a telephone link between a computer in the home to one at the office.[13]

Some retirees do continue to work after age 65. About 26 percent of retired workers between the ages of 65 and 69 who are eligible for Social Security benefits report some earnings.[14] Of those working, 65 percent earn less than the retirement earnings limit.

Graph 1 illustrates the earnings distribution in 1990 for the 1.9 million retired workers between the ages of 65 and 69 who will be eligible for Social Security benefits and who will have earnings.[15] As the graph illustrates, there are an extraordinarily large number of elderly retirees who 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.
- These workers are apparently attempting to earn all they can without being subject to the retirement earnings penalty.

There are undoubtedly many others who pass up the opportunity for full-time or part-time work because a substantial part of their earnings would be subject to the earnings penalty.

In 1990, the maximum Social Security benefit for a worker retiring at age 65 will be $11,712.[16] This individual will have to earn $43,041 before all Social Security benefits are withheld.[17] Beyond that point, the earnings limit has no effect since there are no Social Security benefits left to tax. For a retiree receiving the average Social Security benefit of about $8,000, Social Security benefits will be completely withheld at an income level of $33,360.[18] As Graph 1 illustrates, within the range of $31,908 to $43,041 the number of wage earners begins to rise -- reflecting the fact that the retirement earnings penalty at this point no longer influences the decision about how much to earn.

In the absence of the earnings limit, there would not be the sharp drop in the number of retired workers earning between $9,360 and $43,041. Rather, the market would exhibit a

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[13]Joanne H. Pratt, "Legal Barriers to Home-Based Work," NCPA Policy Report No. 129, September 1987.

[14]Based upon Social Security Administration data from the 1983 Continuous Work History Survey (CWHS) of Social Security beneficiaries.

[15]Figures are derived from the 1983 CWHS by adjusting the class intervals for the growth in average wages. Number of retired workers are from projections made by the Social Security Administration, Office of the Actuary.

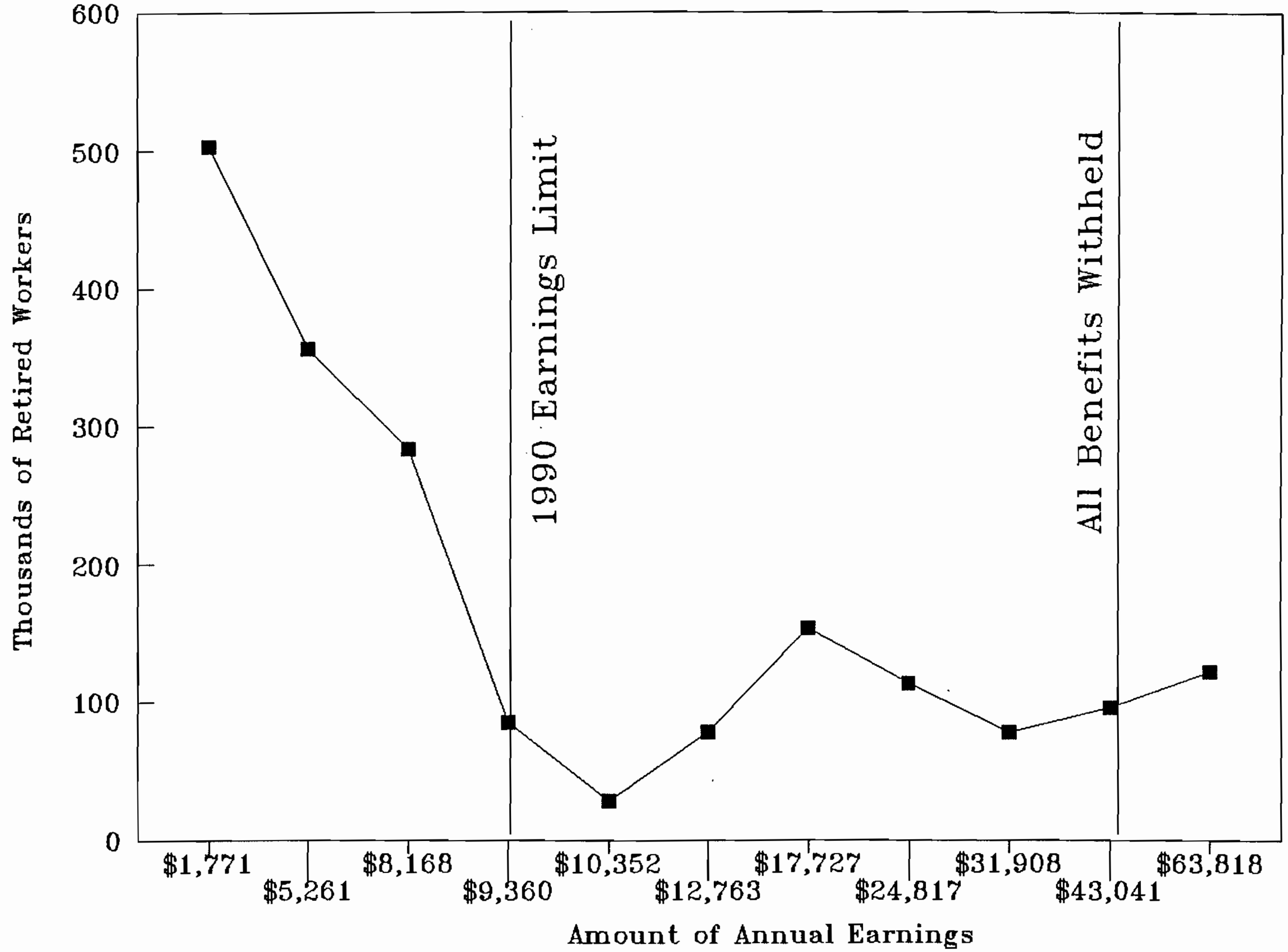
[16]Board of Trustees of the Federal Old-Age Survivors Insurance and Disability Insurance Trust Funds, *1989 Annual Report of the Board of Trustees of the Federal Old-Age Survivors Insurance and Disability Insurance Trust Funds*, Washington, DC, April 24, 1989, Table F6, p. 138.

[17]Calculated as ($11,712 X 3) + $9,360.

[18]Calculated as ($8,000 x 3) + $9,360.

Graph 1

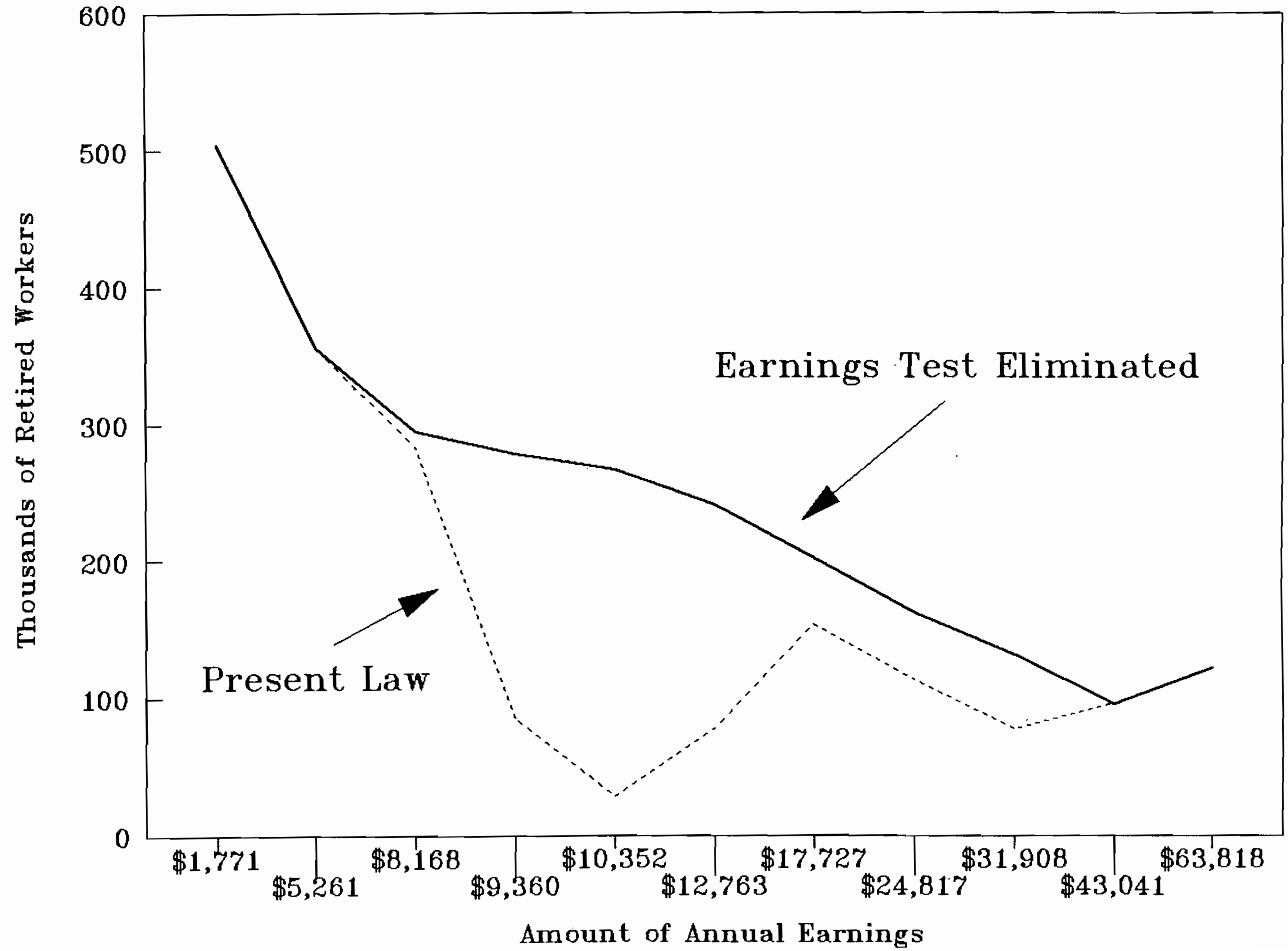
DISTRIBUTION OF RETIRED WORKERS AGES 65 TO 69 WITH EARNINGS *



* About 26% of retired workers have earnings

Graph 2

EARNINGS DISTRIBUTION FOR RETIRED WORKERS AGES 65 TO 69
UNDER PRESENT LAW AND IF EARNINGS TEST WERE ELIMINATED



smoother decline (as illustrated in Graph 2) with more elderly workers earning higher annual earnings.[19] Specifically:

- Without a Social Security earnings limit, 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.[20]

THE EFFECT OF ELIMINATING THE EARNINGS LIMIT ON THE FEDERAL DEFICIT

Eliminating the earnings limit 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. If the increase in taxes paid exactly offsets the higher Social Security benefits, there will be no net effect on the federal budget deficit. If the increase in revenues is greater than the increase in benefit payments, the deficit will decrease, and if it is less than the benefit increase, the deficit will increase.

Taxes on the increased earnings include both federal income taxes and the Social Security payroll tax, which will be 15.3 percent in 1990.[21] In Appendix B we estimate the increase in taxes on earnings using two different marginal tax rates. The first provides a lower-bound estimate because it assumes a 15 percent federal income tax rate for all the earnings classes. The second provides the more likely impact because it uses the average marginal federal income tax rate for each income class.[22]

Raising the Earnings Limit by $1,000. In 1990, there will be approximately 750,000 elderly workers whose Social Security benefits are partially withheld because their wage income exceeds the 1990 earnings limit of $9,360. If each of them were allowed to earn an additional $1,000 without penalty, the Social Security Administration would have to increase Social Security benefit payments by about $37 million.[23] Yet as Table IV shows, this increase in government spending would be more than offset by an increase in federal revenue. According to the best estimate,

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[19]We estimated a logarithmic function based upon the change in earnings between $1,771 and every other earnings class.

[20]Aftertax earnings would increase by 122 percent. This would imply a labor supply elasticity of 0.31 (0.38/1.22) for workers between the ages of 65 to 69, which is quite plausible. Labor supply elasticities for the U.S. labor force as a whole range from 0.1 to 0.45, and it is generally believed that the labor supply elasticity for elderly workers is much higher than for younger workers. It is important to note that income from capital would also increase. Historically, for every $1 increase in labor income, capital income goes up by 50 cents.

[21]The employer and employee each pay 7.65 percent.

[22]The Appendix lists the average marginal tax rate by adjusted gross income and average wage. The marginal rates used in the calculations do not include the new Medicare surtax.

[23]At this point 640,000 would still have benefits partially or wholly withheld.

- If the retirement earnings limit were increased by $1,000, the federal government would receive an additional $563 million in taxes on the increased earnings of elderly workers.

- The government would receive an additional $134 million in taxes because of an increase in capital income.[24]

- 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.

Raising the Earnings Limit by $3,000. Table IV also shows the effects of raising the earnings limit by $3,000 in 1990. As noted above, this proposal has been made in the Senate by Senator William Armstrong (R-CO). The Armstrong Amendment would cost the federal government $110 million in additional Social Security benefit payments in 1990. However, this Amendment would also generate $1.5 billion in additional federal revenue, thus producing a net decrease in the federal deficit of $1.4 billion.

Maximizing Net Federal Revenue. As the earnings limit is increased, net federal revenue also increases, reaches a maximum, then declines. Thus, if the only goal were to reduce the federal deficit, Congress could achieve significant deficit reduction by simply increasing the earnings limit to the point at which net federal revenue is at a maximum. According to the best estimate, a net federal revenue of $3.2 billion would be available if the 1990 earnings limit were increased to $39,360.

Abolishing the Earnings Limit. If the earnings limit were completely abolished, the federal government would still receive more in new tax revenues than it would pay out in increased Social Security benefits, according to our best estimate. Tables V-A and V-B show the increase in net federal revenue by the earnings class of wage earners, and Table VI shows the net results.

- If the earnings limit were abolished, the federal government would be obligated to pay an additional $4.8 billion in Social Security benefits.[25]

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[24]In general, we cannot experience an increase in income from labor without also experiencing an increase in income from capital. For example, if new elderly workers begin working in a previously empty office building, the building owners will receive a new rental income. If the workers use computers, there will be new income to the owners of computers. For the economy as a whole, about 50 cents in capital income is associated with each $1 of labor income. The average marginal tax rate on corporate capital is 47 percent (including dividend taxes) and the average marginal rate on noncorporate capital is 25 percent. Corporate capital constitutes roughly two-thirds of the U.S. capital stock. We have assumed a 15 percent marginal tax rate on capital, however, because tax depreciation offsets about 62 cents out of every dollar of gross capital income.

[25]The Office of the Actuary estimates that eliminating the earnings limit would increase OASDI benefit payments by $3.5 billion in fiscal year 1990 and by $5.3 billion in fiscal year 1991. This translates into $4.8 billion on a calendar-year basis. Included are 80,000 new claimants that the Office estimates would file for benefits solely as a result of eliminating the earnings test.

- The government would collect $4.1 billion in additional taxes on a $10.3 billion increase in income from wages.
- The government would collect $0.8 billion in additional taxes on a $5.1 billion increase in capital income.
- The result would be a $140 million net increase in federal revenue.

TABLE IV

EFFECT ON THE FEDERAL DEFICIT OF RAISING THE EARNINGS LIMIT[1]

(In $ Millions)

Best Estimate

Raising the Earnings Limit From:	To:	Increase in Social Security Benefits	Increase in Revenue from Taxes on Wages	Increase in Revenue from Taxes on Capital	Deficit Reduction
$9,360 →	$10,360	$37	$563	$134	$660
$9,360 →	$12,360	$110	$1,184	$284	$1,358

Lower-Bound Estimate

Raising the Earnings Limit From:	To:	Increase in Social Security Benefits	Increase in Revenue from Taxes on Wages	Increase in Revenue from Taxes on Capital	Deficit Reduction
$9,360 →	$10,360	$37	$449	$134	$539
$9,360 →	$12,360	$110	$927	$284	$1,101

[1]For elderly workers ages 65 to 69.

TABLE V-A

INCREASE IN NET FEDERAL REVENUE FROM ABOLISHING THE RETIREMENT EARNINGS LIMIT: BEST ESTIMATE

Income Intervals	Increase in Net Federal Revenue[1] ($ Millions)	Cumulative Total ($ Millions)
$9,360 → $12,360	$771[2]	$771[2]
$12,360 → $15,360	1,845	2,616
$15,360 → $18,360	284	2,900
$18,360 → $21,360	42	2,942
$21,360 → $24,360	42	2,984
$24,360 → $27,360	42	3,026
$27,360 → $30,360	42	3,067
$30,360 → $33,360	42	3,109
$33,360 → $36,360	42	3,151
$36,360 → $39,360	42	3,192
$39,360 → $42,360	-188	3,005
$42,360 → $45,360	-188	2,817
$45,360 → $48,360	-188	2,629
$48,360 → $51,360	-188	2,441
$51,360 → $54,360	-188	2,253
$54,360 → $57,360	-237	2,016
$57,360 → $60,360	-237	1,779
$60,360 → $63,360	-237	1,543
$63,360 → $66,360	-237	1,306
$66,360 → $69,360	-201	1,069
$69,360 +	-929	140

[1]Additional work-related taxes minus additional Social Security benefit payments.

[2]Note this number is somewhat higher than number shown in Table IV for an increase in the earnings limit of $3,000. That is because completely abolishing the earnings limit will have an even greater effect on this income class.

Source: Appendix B

TABLE V-B

INCREASE IN NET FEDERAL REVENUE FROM ABOLISHING THE RETIREMENT EARNINGS LIMIT: LOWER-BOUND ESTIMATE

Income Intervals	Increase in Net Federal Revenue[1] ($ Millions)	Cumulative Total ($ Millions)
$9,360 → $12,360	$628[2]	$628[2]
$12,360 → $15,360	1,492	2,120
$15,360 → $18,360	182	2,303
$18,360 → $21,360	-21	2,282
$21,360 → $24,360	-21	2,261
$24,360 → $27,360	-21	2,240
$27,360 → $30,360	-21	2,220
$30,360 → $33,360	-21	2,199
$33,360 → $36,360	-21	2,178
$36,360 → $39,360	-21	2,157
$39,360 → $42,360	-188	1,969
$42,360 → $45,360	-188	1,781
$45,360 → $48,360	-188	1,593
$48,360 → $51,360	-188	1,406
$51,360 → $54,360	-188	1,218
$54,360 → $57,360	-237	981
$57,360 → $60,360	-237	744
$60,360 → $63,360	-237	507
$63,360 → $66,360	-237	271
$66,360 → $69,360	-201	34
$69,360 +	-930	-896

[1]Additional work-related taxes minus additional Social Security benefit payments.

[2]Note this number is somewhat higher than number shown in Table IV for an increase in the earnings limit of $3,000. That is because completely abolishing the earnings limit will have an even greater effect on this income class.

Source: Appendix B

TABLE VI

SUMMARY OF ECONOMIC AND REVENUE EFFECTS FROM ELIMINATING THE EARNINGS LIMIT IN 1990
(Amounts in $ Millions)

Addition to:	Lower-Bound Estimate[1]	Best Estimate[2]
Earnings	$10,256	$10,256
Taxes on Earnings	3,107	4,143
Capital Income	5,128	5,128
Taxes on Capital[3]	769	769
Social Security Benefits Paid	4,773	4,773
Net Effect On		
Social Security Trust Fund	-$3,203	-$3,203
Rest of Federal Budget	+ 2,308	+ 3,343
Total Budget Effect	- $896	+ $140

[1]Assumes 15 percent marginal income tax rate.

[2]Assumes average marginal tax rate calculated in Appendix A.

[3]Assumes 15 percent tax rate.

CONCLUSION

Eliminating the earnings limit for retired workers between ages 65 and 69 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. Short of abolishing the earnings test, virtually any increase in the earnings limit would lead to an increase in federal revenue that would more than offset the increase in Social Security benefit payments.

- In 1990, elderly workers will be allowed to earn as much as $9,360 without loss of Social Security benefits.
- If this earnings limit were doubled, tripled, or even quadrupled, the federal government would receive considerably more in new work-related tax revenues than it would lose in increased Social Security benefit payments.
- If the earnings limit were increased to $39,360 the federal deficit could be reduced by $3.2 billion.

Several proposals before Congress also would increase revenue for the federal government. Specifically,

- The Armstrong amendment to increase the earnings limit by $3,000 in 1990 would raise about $1.4 billion in revenue.
- The House Ways and Means proposal to raise the earnings limit to $10,440 by 1991 would raise about $0.7 billion in net federal revenue.

APPENDIX A

COMPUTATION OF AVERAGE MARGINAL TAX RATES FOR ELDERLY TAXPAYERS

Our tax model is based upon 1985 Internal Revenue Service tax return data for taxpayers age 65 and over.[1] This model computes the average marginal tax rates that elderly taxpayers will pay under present law or any other tax regime. Elderly taxpayers are classified as (1) married couples, filing jointly, both age 65 or over; (2) married couples, filing jointly, one age 65 or over; (3) married couples, filing separately; (4) head of households; and (5) single individuals.

Assumptions regarding the growth in the number of taxpayers and income sources are needed to project future income and tax liability. We use the following assumptions:

1. The number of returns grow at roughly 4 percent a year from 1985 to 1989, based on recent experience, and at 3 percent thereafter.

2. Income sources, other than Social Security benefits, grow at the actual rate of per capita income growth from 1985 to 1988; at the per capita income rate assumed in the 1990 Budget from 1989 to 1993; and at 4.35 percent a year, the 1993 rate, thereafter.

3. Social Security benefits are assumed to grow at the actual rate of average retired worker benefits from 1985 to 1988; at the rate of average retired worker benefits in the 1989 Trustees Report from 1989 to 1993; and at 4.56 percent a year, the 1993 rate, thereafter.

4. The tax parameters, such as the brackets, personal exemption, and standard deductions, are actual law from 1985 to 1989; grow at the Consumer Price Index assumed in the 1990 budget from 1990 to 1993; and at 3 percent a year, the 1993 rate, thereafter.

Table A-1 shows the federal marginal tax rate on wages and salaries of elderly taxpayers in 1990 by adjusted growth income (AGI). This tax rate is a weighted average of the marginal tax rates of all taxpayers by AGI class with wage income. The weights are income amounts, and the marginal rate represents the federal income tax consequences if the taxpayer earned an additional dollar of wage income. In 1990, elderly taxpayers who earn an additional dollar of wages will, on average, owe 25 cents in federal income taxes (26 cents if the Medicare surtax is included). These marginal rates *do not* include the Social Security payroll tax rate or the Social Security earnings limit.

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[1] Internal Revenue Service, *Statistics of Income--1985, Individual Income Tax Returns*, U.S. Government Printing Office, Washington, DC, 1988.

TABLE A-1

FEDERAL MARGINAL INCOME TAX RATES ON WAGES & SALARIES OF ELDERLY TAXPAYERS IN 1990

Adjusted Gross Income			Wages	Marginal Tax Rate on Wages: Without Surtax	With Surtax
$0	to	$6,611	$3,799	0.12%	0.12%
$6,611	to	$10,578	4,646	8.70%	9.07%
$10,578	to	$19,834	6,613	14.79%	17.94%
$19,834	to	$23,801	8,930	17.33%	21.16%
$23,801	to	$26,446	9,976	23.47%	28.54%
$26,446	to	$33,057	12,121	23.52%	27.76%
$33,057	to	$39,668	16,701	23.56%	26.51%
$39,668	to	$52,891	18,941	28.03%	29.32%
$52,891	to	$66,114	22,837	29.44%	29.44%
$66,114	to	$99,171	27,028	30.00%	30.00%
$99,171	to	$264,456	43,982	32.41%	32.41%
$264,456	and	over	153,147	28.00%	28.00%
All taxpayers			$4,688	24.74%	26.22%

APPENDIX B

THE IMPACT OF RAISING THE EARNINGS LIMIT ON NET FEDERAL REVENUE

Our estimate of the distribution of earnings for elderly workers between the ages of 65 and 69 is based on Social Security Administration data from the 1983 Continuous Work History Survey (CWHS) of Social Security beneficiaries. The estimate was derived from the 1983 CWHS by adjusting the class intervals for the growth in average wages. The number of retired workers in 1990 is based on projections made by the Social Security Administration, Office of the Actuary.

To obtain a distribution of earnings for the elderly in the absence of a retirement earnings limit, we estimated a logarithmic function based on the change in earnings between $1,771 and every other earnings class. Based on this estimate, we project an overall increase in aftertax earnings of 122 percent and an increase in the number of elderly workers of 38 percent. This implies a labor supply elasticity of 0.31 (0.38/1.22) for elderly workers. Note that this estimate is conservative. Labor supply elasticities for the U.S. labor force as a whole range from 0.1 to 0.45, and it is generally believed that the labor supply elasticity is much higher for elderly than for younger workers.[1]

When elderly workers increase their earnings, the federal government receives additional revenue because of taxes on those earnings. Our estimates of this increase are depicted in Table B-1. The first estimate assumes that all elderly workers pay a 15 percent income tax rate and a 15.3 percent FICA tax rate, for a combined marginal tax rate of 30.3 percent. Since these rates are well below the actual marginal tax rate faced by most elderly workers, this estimating technique establishes a lower boundary on the likely outcomes of increasing the earnings limit.

The second estimate uses the marginal tax rates in Table A-I (excluding the new Medicare surtax) combined with a FICA tax rate of 15.3 percent. This produces the "best estimate" of the increase in federal revenues that would occur if the earnings limit is increased. But since this estimate ignores the Medicare surtax, it is still conservative.

To obtain the net impact on federal revenues from increasing the earnings limit, it is necessary to make two adjustments to the numbers in Table B-1. First, in addition to the increase in income from labor there will also be an increase in capital income as a result of the increased work effort of elderly workers. On the average, the U.S. economy produces 50 cents in capital income for every $1 in labor income.[2] Second, as a result of increasing the earnings limit, the

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[1]For example, in his analysis of the effects of the Reagan tax cuts, Robert Haveman (University of Wisconsin) estimates that the elderly are 2-1/2 times as sensitive to tax rates as male, adult workers under age 62. See Robert Haveman, "How Much Have the Reagan Administration's Tax and Spending Policies Increased Work Efforts?" in Charles R. Hulten and Isabel V. Sawhill, eds., *The Legacy of Reaganomics: Prospects for Long-Term Growth*, (Washington, D.C.: The Urban Institute Press, 1984), p. 114. See also, David R. Henderson, "Analyzing the Reagan Record," NCPA Policy Report No. 114, October, 1984, pp. 9-12.

[2]The average marginal tax rate on corporate capital is 47 percent (including dividend taxes) and the average marginal rate on noncorporate capital is 25 percent. Corporate capital constitutes roughly two-thirds of the U.S. capital stock.

federal government will have to pay more in Social Security benefits. If the earnings limit were completely abolished, we estimate that the federal government would have to pay about $4.8 billion in additional Social Security benefit payments.[3]

Tables B-II and B-III show the net impact of raising the earnings limit, using the two different estimating techniques described above. The net impact on federal revenue is the additional revenue due to taxes on increased wage income plus the additional revenue due to taxes on increased capital income minus the increase in Social Security benefit payments.

Tables V-A and V-B in the text represent interpolations based on Tables B-II and B-III.

We have assumed a 15 percent marginal tax rate on capital; however, because tax depreciation offsets about 62 cents out of every dollar of gross capital income.

[3]The Office of the Actuary estimates that eliminating the earnings test would increase OASDI benefit payments by $3.5 billion in fiscal year 1990 and by $5.3 billion in fiscal year 1991. This translates into $4.8 billion on a calendar year basis. Included are 80,000 new claimants that the Office estimates would file for benefits solely as a result of eliminating the earnings test.

Table B-I

RAISING THE EARNINGS LIMIT:

TAXES ON THE INCREASED EARNINGS OF RETIRED WORKERS, 1990

(Revenues in $ Millions)

	Lower-Bound Estimate		Best Estimate	
Earnings in $1990	Marginal Tax Rate[1]	Added Revenues	Marginal Tax Rate[2]	Added Revenues
$ 8,880	30.30%	$ 28.5	32.63%	$ 30.7
$ 9,360	30.30%	549.2	38.77%	702.7
$10,352	30.30%	747.8	38.77%	956.8
$12,763	30.30%	635.3	38.82%	813.9
$17,727	30.30%	262.1	43.30%	374.6
$24,817	30.30%	368.6	43.30%	526.7
$31,908	30.30%	515.9	43.30%	737.3
$43,041	30.30%	0.0	43.30%	0.0
$63,818	30.30%	0.0	43.30%	0.0
TOTAL		$3,107.4		$4,142.8

[1]Assumes 15 percent income tax bracket and 15.3 percent total payroll tax.

[2]Based on calculations in Table A-1.

Table B-II

TOTAL EFFECTS OF RAISING THE EARNINGS LIMIT:

BEST ESTIMATE[1]

Earnings Limit in 1990	Additional Social Security Benefits Paid	Additional Tax Revenue ($ Millions)[3]	Net Impact On Federal Revenue ($ Millions)
$ 9,360	0	$ 38	$ 38
$10,352	0	877	877
$12,763	$ 37	2,013	1,981
$17,727	125	2,984	2,864
$24,817	553	3,423	2,875
$31,908	1,133	4,041	2,913
$43,041	1,719	4,906	3,192
$63,818	2,658	4,906	2,253
Unlimited[2]	4,773	4,906	140

[1]Entries are cumulative totals.

[2]Includes $693 million in Social Security benefits paid to new claimants.

[3]Includes taxes on labor income (shown in Table B-I) plus taxes on income from capital.

TABLE B-III

TOTAL EFFECTS OF RAISING THE EARNINGS LIMIT: LOWER-BOUND ESTIMATE[1]

($ Millions)

Earnings Limit in 1990	Additional Social Security Benefits Paid ($ Millions)	Additional Tax Revenues ($ Millions)[3]	Net Impact On Federal Revenue ($ Millions)
$ 9,360	0	$ 36	$ 36
$10,352	0	721	721
$12,763	$ 37	1,653	1,616
$17,727	125	2,466	2,321
$24,817	553	2,773	2,220
$31,908	1,133	3,232	2,099
$43,041	1,719	3,876	2,157
$63,818	2,658	3,876	1,218
Unlimited[2]	4,773	3,876	-896

[1]Entries are cumulative totals.

[2]Includes $693 million in Social Security benefits paid to new claimants.

[3]Includes taxes on labor income (shown in Table B-I) plus taxes on income from capital.

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Aldona Robbins, Vice President of Fiscal Associates and Senior Fellow of the NCPA, has extensive experience with public and private retirement programs. As senior economist in the Office of Economic Policy, U. S. Department of the Treasury from 1979 to 1985, Dr. Robbins performed staff work for the Secretary in his capacity as Managing Trustee of the Social Security trust fund. Her research efforts have resulted in a model to project Social Security benefits and tax revenue. Recent publications include *The ABCs of Social Security; Institute for Research on the Economics of Taxation (IRET) Economic Reports* entitled "Effects of the 1988 and 1990 Social Security Tax Increases" and "Facts about Catastrophic Coverage" (both with Gary Robbins); *IRET Economic Policy Bulletins* entitled "Social Security Build-Up or Shake-Down?" and "Catastrophic Health Insurance is Bad Medicine" (with Dr. William Hurwitz); "The Economic Status of the Aged: Implications for Energy Policy" (with Paul Craig Roberts) in *Proceedings of A Symposium on Energy Costs and the Elderly: The Next Twenty Years* sponsored by the U.S. Department of Health and Human Services; and articles on "End IRA Deductions, but Make Withdrawals Tax-Free" (with Gary Robbins) and "At the Heart of Medicare's Woes" (with Paul Craig Roberts) in the *Wall Street Journal*. Her master's degree and doctorate in economics are from the University of Pittsburgh.

Gary Robbins is President of Fiscal Associates and Senior Fellow of the NCPA. Mr. Robbins has developed a general equilibrium model of the U. S. economy that specifically incorporates the effects of taxes and government spending. Before joining the private sector, he was Chief of the Applied Econometrics Staff at the U. S. Treasury Department from 1982 to 1985, Assistant to the Under Secretary for Tax and Economic Affairs from 1981 to 1982, and Assistant to the Director of the Office of Tax Analysis from 1976 to 1981. Recent publications include an article entitled "Encouraging Private Provision for Long-Term Care" (with Aldona Robbins) in *Compensation and Benefits Management;* an *IRET Economic Policy Bulletin* entitled "Mandating Health Insurance" (with Aldona Robbins and John Goodman); an *IRET Op-Ed* entitled "Tax Catastrophes of Medicare Legislation" (with Aldona Robbins and Norman Ture); and two papers prepared for the Congressional Task Force on Long-Term Health Care Policies entitled "Promoting Long-Term Care Insurance through Existing Retirement Programs" and "Tax Policies to Promote Long-Term Care" (both with Aldona Robbins). Articles entitled, "Why the Tax-Reform Numbers Don't Add Up" (with David Brazell); "End IRA Deduction, but Make Withdrawals Tax-Free" (with Aldona Robbins); and "Tax Reform Aims at Very Industries Up for Protection" (with Paul Craig Roberts) have appeared in the *Wall Street Journal*. He earned his master's degree in economics from Southern Methodist University.