

IN BRIEF: Impact of the Social Security Retirement Earnings Test on 62-64-Year-Olds

Introduction. The Social Security Retirement Earnings Test (RET) reduces the Social Security benefits of beneficiaries who have labor earnings above a threshold amount (\$11,520 in 2003). For workers between 62 and the Normal Retirement Age (NRA, currently 65 and 2 months for someone born in 1938), the earnings test reduces benefits by \$1 for every \$2 of wage or salary earnings above the threshold. Many workers do not realize that they will recover these benefits after they retire, in the form of higher benefit payments. In 2000, Congress eliminated the RET for workers over the NRA.

This paper explores how eliminating the RET might affect total income. An individual's total income could change because the RET affects two types of incentives: (1) how many hours to work; and (2) the age at which an individual starts to receive Social Security benefits.

Some have argued that the RET discourages older citizens from working, and this is likely to be true for those with wages just below the RET threshold who also receive Social Security, and also for those with wages between the RET threshold and the point at which the RET taxes away the worker's entire Social Security benefit. Higher earners may be affected in the opposite direction: removing the RET would allow them to receive Social Security benefits for the first time, and this might lead some high earners to cut back on their work hours. Analysts have found that the RET does affect labor supply within specific income ranges, but in the aggregate they have found that the offsetting effects nearly or completely cancel each other out. On balance, there may be a minor increase in total work hours across the whole elderly population.

The RET may also discourage workers from taking up Social Security benefits at ages below the NRA. This is because workers aged 62 to 64 who receive Social Security might temporarily lose some benefits to the RET, if their labor earnings were over the RET threshold. Such workers might postpone claiming Social Security. If the RET were eliminated, more workers might claim Social Security at an earlier age. Taking up Social Security before the NRA leads to a permanent, actuarially-based reduction in benefits (5/9 of one percent for every month below the NRA, up to 36 months; if benefits are received more than three years before the NRA, then they are reduced a further 5/12 of one percent for every month).

The authors supply two kinds of analyses. The first analysis provides a description of the income sources of 62-64-year-olds, including the role of Social Security benefits in total income. The second analysis simulates the impact of eliminating the RET on these decisions.

Findings. The analyses use data from both the Census Bureau's Survey of Income and Program Participation (SIPP) and the Health and Retirement Study (HRS). The SIPP data are used to provide a descriptive analysis of earnings and incomes of 62-64-year-olds in the early 1980s and 1990s. The HRS data, linked to Social Security data, are used to simulate the effect of eliminating the RET for individuals below the normal retirement age.

The descriptive analysis, using SIPP data, shows that in both 1984 and 1992-93, about 60 percent (i.e. the majority) of 62-64-year-olds received Social Security retirement benefits. Women were more likely to be beneficiaries than men and the less educated were more likely to receive benefits than

those with more than high school educations. Consistent with the patterns of benefit receipt, about 60 percent of 62-64-year-olds had no labor earnings in the early 1990s. The vast majority of these individuals with no labor earnings were Social Security beneficiaries—80 percent of beneficiaries had no labor earnings, while 25 percent of eligible nonbeneficiaries had no labor earnings.

The analysis also shows that average real incomes of 62-64-year-olds increased between 1984 and 1992-93. On average, labor earnings were the largest source of income for 62-64-year-olds. However, for those with earnings below the RET threshold, Social Security benefits were the largest income source.

Using HRS data linked to Social Security data, the authors simulated the effect of eliminating the RET on the incomes of 62-64-year-olds. They conducted nine different simulations, using varying assumptions about labor supply changes and Social Security take-up. There are three labor supply response scenarios combined with three Social Security take-up scenarios. The first labor supply scenario is based on recent literature and assumes a modest increase in work hours across the entire population aged 62 to 64; the second two scenarios assume greater aggregate increases in work hours. The three Social Security take-up scenarios assume that workers with incomes at above the RET threshold take up Social Security benefits at the rates of 25 percent, 50 percent or 100 percent (workers below the RET who have not already claimed Social Security benefits would have little additional incentive to do so if the RET were eliminated).

The authors find that eliminating the RET would raise current total income across all

simulations. In large part, these results are due to earlier receipt of Social Security benefits. Because lower-income workers are more likely to be receiving Social Security already, much of the income gains occur among the new beneficiaries at higher income levels.

The effect on current total income of a decision to increase work hours is smaller. Incentives to work more are generally limited to Social Security beneficiaries with wage or salary income that is just below the RET, or between the RET and the point at which benefits would be completely eliminated by the RET.

Although the paper does not simulate future income levels, the authors note that future poverty levels might rise because taking up Social Security at ages below the NRA causes a permanent reduction in benefits.

Conclusions. Eliminating the RET for ages 62 to 64 would increase current total income for many people, primarily because more workers in this age range would claim Social Security. There might be minor increases in total income due to increased work hours for workers with wage earnings at the RET threshold or between the threshold and the point at which the RET would entirely tax away the Social Security benefit. In the long-run, however, some workers would face a reduction in future retirement income, because claiming Social Security at ages below the NRA leads to a permanent reduction in Social Security benefits.

Source: Caroline Ratcliffe, Jillian Berk, Kevin Perese and Eric Toder, *Impact of the Social Security Retirement Earnings Test on 62-64-Year-Olds*. For a copy of the 48-page Issue Paper, write for PPI Issue Paper #2003-15, Public Policy Institute, AARP, 601 E Street, NW, Washington, DC 20049. © 2003 AARP, www.aarp.org/ppi.