

New evidence on earnings and benefit claims following changes in the retirement earnings test in 2000[☆]

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Abstract

This paper examines the labor force activity and timing of benefit claims of workers aged 65–69 in response to the removal of the retirement earnings test in 2000. We use the 1% sample of longitudinal Social Security administrative data that covers the period from 4 years before to 4 years after the removal of the test. Using a reduced-form quantile regression method, we find that effects on earnings are limited to workers with earnings just around the test threshold and above, as predicted by economic theory. Our estimated effects suggest that labor supply elasticities with respect to the net-of-tax rate are approximately 0.05–0.07 for working primary beneficiaries aged 65–69 whose earnings are between the median and the 80th percentile. Further, results show that applications for Social Security benefits following the earnings test removal accelerated by 2 to 5 percentage points among individuals aged 65–69 and by 3 to 7 percentage points among those reaching age 65.

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1. Introduction

Social Security benefits are designed to protect against the loss of earnings due to retirement, disability, and death. Under the retirement earnings test, Social Security benefits for workers who have claimed benefits (and their dependents and survivors) are withheld or reduced when the beneficiaries earn a substantial amount. The retirement earnings test, which has been part of the Social Security Old-Age and Survivors Insurance (OASI) program since its inception in 1935, has been gradually modified by exempting certain age groups, increasing allowable earnings, and decreasing withholding rates. A rationale for modifications is to encourage older people to work so that their earnings can supplement their Social Security benefits as people live longer and healthier lives. The most recent major modification occurred in April 2000, when Congress enacted the Senior Citizens Freedom to Work Act of 2000, which removed the earnings test for individuals at the full retirement age (FRA), age 65 and over.¹ The removal of the test in 2000 is one of the most substantial changes in recent years because it affects both the most recent cohorts of persons who have reached the FRA and a wider range of ages than have other modifications.

Although the earnings test compensates individuals for postponing benefit entitlement by increasing their future benefit streams through the delayed retirement credit and automatic benefit recomputation, many people view the earnings test as a tax on earnings above the test threshold. Consequently, the earnings test may cause both a reduction in work effort (for example, hours of work, earnings, and work participation) of old-age beneficiaries and a delay in applications for Social Security retirement (old-age) benefits. This tax aspect of the earnings test causes kinks in the budget constraint in a static labor supply model (Burtless and Moffitt, 1985; Friedberg, 1998, 2000).² In the static model, removing the earnings test causes a decline in the marginal tax rate for those who earn above the threshold.

A number of studies have analyzed how incentives generated by Social Security program rules have affected work participation and benefit claims. Those studies relied primarily on cross-sectional variations in benefit amounts as identification information (see Krueger and Meyer, 2002 for an overview and survey). In response to the identification problem caused by the fact that all workers face an identical benefit schedule in the Social Security system, the earnings test has drawn attention from economists who seek to investigate the disincentive effect that Social Security program rules have on labor supply.

Three recent studies—Friedberg (2000), Gruber and Orszag (2003), and Haider and Loughran (2006)—used the quasi-experimental approach by noting that modifications of the earnings test in the United States affected some age groups but not others.³ Using a structural model built on the kinked budget constraint resulting from the imposition of the earnings test, Friedberg found a small but significant effect of the earnings test on the labor supply of older workers. Gruber and

¹ The FRA has been 65 for those who reach 62 in 1999 or earlier, and it gradually increases to 67 for beneficiaries who reach age 62 in 2022 or later. The law was enacted April 7, 2000, but the elimination of the earnings test for beneficiaries was effective for taxable years ending after December 31, 1999. Earnings tests for individuals aged 75 or older, 72–74, and 70–71 were eliminated in 1950, 1954, and 1983, respectively (Social Security Administration, 1997–2003).

² See the Senate debate on the 2000 elimination of the earnings test (<http://www.socialsecurity.gov/history/senateret.html>). The observation that people bunch at the kink and respond to changes in earnings test rules has been considered to be a basis for supporting that view (Friedberg, 2000).

³ Friedberg investigated three changes in earnings test rules in 1978, 1983, and 1990. Effects reported in Gruber and Orszag (2003) for 1973–1998 and in Haider and Loughran (2006) for 1975–2003 are identified by all changes, including gradual increases in the test threshold in each year. See Leonasio (1990) for reviews of and references to early studies on the earnings test. Gruber and Orszag (2003) and Haider and Loughran (2006) provide an overview of recent studies.

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