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Iron Threads Amongst The Gold

The Senate Finance Committee has approved an amendment to the Social Security Act that would raise the Social Security earnings limit to $21,000 by 1997 and to $51,000 by 2001 for those age 66 through 69. The Committee proposes to offset the higher projected benefit payout by increasing the taxable wage base — the amount of a worker's annual earnings subject to the 12.4% retirement and disability portions of the payroll tax. By 1997, the wage base would rise to $71,700 instead of the projected $69,300 under current law; by 2001, the base would be $89,700 versus a projected $84,600 under current law. The House has passed a similar earnings limit increase without the tax increase.

Raising the earnings limit would help the elderly and raise GNP between now and 2009. Raising the wage base will reduce GNP and lower employment permanently. The transitory gains from raising the earnings limit will be dwarfed in later years by the ongoing effect of the damaging tax increases on the economy.

How the earnings test operates.

The Social Security earnings test limits how much a beneficiary may continue to earn by working and still receive full Old Age and Survivors Insurance (OASI) retirement benefits. In 1992, the limits are $7,440 for beneficiaries under age 65 and $10,200 for beneficiaries age 65 through 69. Those over age 69 are not subject to the earnings limitation. Beneficiaries ages 62 through 64 lose $1 of Social Security benefits for every $2 of wage and salary income above the limit. Beneficiaries ages 65 through 69 lose $1 of benefits for every $3 of earnings above the limit.

Effect on marginal tax rates.

The $1 for $2 benefit reduction is equivalent to a 50 percent marginal tax rate on a beneficiary's earnings in excess of the exempt amounts, until the excess earnings build to more than twice the social security benefits and all benefits have been lost. The $1 for $3 benefit reduction imposes a 33-1/3 percent add-on tax rate on a range of earnings equal to three times the benefits. On top of this must be added other tax rates facing the working beneficiary (such as marginal federal and state income tax rates, the payroll tax rate, and federal and state unemployment taxes.)

When the various taxes are considered, marginal tax rates can become very high at moderate income levels. A single retiree age 64 with a total income of $15,000 or a married couple age 64 with total income of $19,500 could face an 80 percent to 85 percent marginal tax rate. A single retiree age 65 with income of $18,000 or a couple age 65 with income of $20,000 could face a 65 percent to 70 percent marginal tax rate. These workers get to keep only 15 to 30 cents of an extra dollar of income as a result of the earnings test. At higher incomes (over $25,000 for a single beneficiary, over $32,000 for a married couple) a beneficiary is subject to both the earnings test and the phase-in of income taxation of benefits. For these workers, the marginal tax rates on additional earnings can reach 90 percent for those 65 to 69 years of age, and can exceed 105 percent for those 62 to 64 years of age! These latter workers lose money with every added dollar they earn. The confiscatory tax rates constitute a federal ultimatum not to work!

Delayed retirement credit.

These penalties are more of a burden on those beginning to draw benefits between now and 2009 than on those who will retire at a later time. Workers who delay claiming benefits beyond "normal

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retirement age" receive a delayed retirement credit that slightly augments their benefits. This credit is currently too small to make up, over an average retirement, for the loss of benefits during the years benefits were not claimed. However, the credit is being increased over time under current law. By 2009, the benefits will be sufficiently augmented to allow people to collect as much over their expected lifetimes as if they had filed for benefits earlier. At that time, workers may delay filing for benefits, and thereby avoid the earnings test while they continue to work, and make up for the lost benefits when they cease working and begin to draw benefits at a later date.

Effect on benefits and work effort of increasing the earnings limit for ages 65-69.

Nearly two million beneficiaries age 65 to 69 have earnings (out of nearly 8 million total beneficiaries). Some 750,000 retirees have benefits partially withheld, and are certainly affected by the limit. About 400,000 beneficiaries appear to be restraining their earnings at levels less than ten percent below the ceiling; they are quite obviously feeling the constraint of the limit. For those with even lower earnings, who could earn substantially more without approaching the limit, the limit may not be a problem. Some lower-earning people are affected, however, as they seek to work part time rather than full time to avoid the ceiling. Many part-time jobs pay less per hour than full-time work, and workers may end up with earnings well below the ceiling for lack of a job that would bring them closer. The limit may have caused some potential workers to quit altogether rather than accept part time work, with its full load of daily commuting and other costs.

Clearly, the daunting, even confiscatory marginal tax rates facing beneficiaries who continue to work have a serious effect on work effort by well over one million elderly. Everyone loses. The elderly lose the added income that they would otherwise wish to earn. The economy loses their energy and experience. The government loses the revenue from the income and payroll taxes the elderly would pay if they continued to work.

Effect of the proposal.

Raising the earnings limit is a good thing. It will more than triple the after-tax wage of those currently losing benefits due to the test — from less than 20 cents for every additional dollar earned to between 60 and 70 cents for each additional dollar. The higher reward for working will result in additional work effort and employment among the elderly equal to several hundred thousand additional full-time equivalent workers. This added employment will increase income and payroll tax receipts by substantially more than the increase in benefits. No offsetting funding provisions are needed. Total budget revenues would be larger, not smaller. The payroll tax revenue gains would be credited to the Old Age and Survivors Insurance (OASI) trust fund, and would offset much of the impact of the proposal on that account.

Unfortunately, the Senate Finance Committee proposal includes a provision to raise the Social Security wage base on which the payroll tax is collected. The wage base increase was included in the package to provide "revenue neutrality" and to offset the effect on the balance of the social security trust fund as required by the Omnibus Budget Reconciliation Act of 1990 (OBRA). Raising the wage base is a bad thing. It will increase the marginal tax rate of 580,000 highly productive workers, reduce their work effort, and cost substantial amounts of income and payroll tax revenues. It would hurt people all across the income distribution.

Raising the wage base would increase the <u>amount</u> of taxes on all of the roughly 8 million workers over the current wage base. In particular, it would increase the marginal tax <u>rate</u> of roughly 580,000 highly productive workers earning more than the current wage base but less than the increased wage base. It is the marginal tax rate — the tax owed on an added dollar of income — that affects work effort. The marginal tax rate of the affected workers would jump from between roughly 35 and 40 percent (adding together federal and state income tax rates and the Medicare portion of the payroll tax) to roughly 50 percent. It would reduce the after tax wage from as much as 60 to 65 cents per additional dollar earned to about 50 cents. This would represent a roughly 20 percent reduction in the marginal after-tax wage. Some of the affected workers would quit, and some would work less. If each 1% cut in the after-tax wage induces a 0.3% reduction in work effort, a ratio in line with historical findings, work effort would decline by the equivalent of more than 35,000 full-time high-paying jobs. Thus, the proposal would collect 12.4% in payroll taxes on up to an additional $5,000 in income in 2001 from about 8 million workers who earn more than the projected taxable wage base and who remain in the work force, but would lose the equivalent of all of the income and payroll taxes, averaging over 30 percent of up to $89,700, of 35,000 full-time equivalent workers. The reduced employment would offset more than 20% of the income supposedly raised by the base increase.

Conclusion.

The earnings limit should be increased or eliminated with no strings attached. Raising the wage base is unnecessary. Raising the earnings limit will bring in added tax revenue to more than pay for itself. The apparent revenue loss from raising the earnings limit and the apparent revenue gain from raising the wage base are the unrealistic outcomes of the static revenue estimating process used by the revenue estimators, who give no consideration to the dynamic response of the public. Congress should either switch to dynamic estimates, or drop the 1990 Budget Act's pay-as-you-go restrictions and its requirement that the actuarial balance of the trust funds not be reduced, or both.

Concern over the financial status of the OASI System is irrelevant; the System is in substantial surplus until well after the earnings test will become moot anyway. Congress need not be concerned about the tiny diminution of the make-believe trust fund that the higher outlays would create. If Congress is truly concerned about the System's financial future, it could insert an additional year of increase in the normal retirement age prior to the increase currently planned between 2000 and 2005. The normal retirement age could be increased one month a year in 1993 and 1994, and two months a year from 1995 through 1999.

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