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The Social Security Retirement Earnings Test, Retirement and Benefit Claiming

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Abolisihing the earnings test results in the earlier flow of benefits from social security worsening the cash flow problems of the system. On the other hand, increasing the early entitlment age delays the flow of benefit payments, improving the system's finances.

There is a great deal of concern that the looming retirement of the baby boom generation and other demographic changes will adversely affect the solvency of the Social Security system. In response to this concern, Congress has taken a number of steps to encourage older Americans to postpone their retirement. Most recently, the Senior Citizens Freedom to Work Act of 2000 (PL 106-182) abolished the Social Security earnings test for those between the full retirement age and 70 years of age.

A major focus of the literature on the retirement earning test has been on the decline in economic activity observed once the earnings test limit is reached – that is, once a person's earnings reach the amount of the earnings disregard after which further earnings reduce current benefits. The finding that economic activity tails off after the earnings test amount is reached has puzzled some analysts. The reason is that those who lose benefits to the earnings test are compensated with higher benefits later on. Because for many between the ages of 62 and normal retirement age the increase in future benefits is actuarially fair, or even better than fair, one might expect the earnings test to have little influence on real economic activity. Yet it clearly does influence economic activity.

Our analysis of Health and Retirement Study data confirms earlier findings in that it also shows a decline in activity after the earnings test amount is reached. Our findings also suggest that abolition in 2000 of the earnings test for those between the full retirement age and age 70 increased full time work. Specifically, among those who were 65 to 67 years-old, and thus benefited from abolition of the earnings test, the ratio of full time workers in 2002 compared to 1998 increased by about 22 percent. In contrast, the ratio of full time workers in 2002 to 1998 who were 62 to 64 years-old, and thus did not experience a change in the earnings test, increased by about 11 percent.

The Model

In our analysis, we specify a structural econometric model which explains retirement, saving and, for the first time in this modification of our previous work, the timing of benefit claiming. The model allows three retirement states: full time work, partial retirement, and full retirement. It also includes a myriad of factors that influence retirement behavior: wages paid for additional work, the increase in the value of Social Security benefits from additional work, estimated from earnings histories obtained from the respondent's Social Security earnings records, and changes in the value of the pension with additional work, estimated from details of the respondent's pension plan, which was obtained from employers.

We also model the individual's time preference, which is estimated based on asset accumulation. Those who tend to value time save less for their retirement, view future payments of Social Security benefits less favorably than current benefits, and thus are more likely to apply for benefits early even if there is an apparent actuarial advantage to delaying application. We use data for married men from the first six waves of the Health and Retirement Study (HRS). The model does a very good, but not perfect job of simulating retirement outcomes and benefit claiming behavior observed in the population.

Effects of Abolishing the Earning Test

In our earlier work, we examined the effects of increasing the early entitlement age for Social Security benefits from 62 to 64. This is a policy that we expect to have similar effects on retirement as eliminating the earning test between early and full retirement age. But we also expect raising the early entitlement age to have a more favorable effect on the liquidity of the Social Security system.

Once it is estimated, the model is used to simulate the effects of abolishing the retirement earnings test between ages 62 and the age of eligibility for full retirement benefits. Effects on retirement, the timing of benefit claiming, and the value and timing of benefit payments from Social Security are all examined Abolishing the earnings test is simulated by allowing immediate benefit claiming between the early and full retirement age without reducing benefits in accordance with a person's earnings.

Because benefits can be claimed immediately, the opportunity cost of continued work is reduced. Before the abolition of the earnings test, when earnings exceed the test amount, the current benefits are lost, and the increase in future benefits is inadequate to compensate. Consequently, an individual who values present benefits may choose to retire rather than continuing at work. After the earnings test is abolished, the same individual will be able to continue to work without having to forego the benefit payment, and so may choose to stay at work. The resulting changes in full-time and part-time work, among other things, depend on the distributions of time and leisure preference, as well as the opportunity set, all of which are estimated by the model.

We find that from age 62 through full retirement age, the earnings test reduces the proportion of individuals working full time by about four percent of the married male population. This represents a reduction of about ten percent in the number of married men of that age at full time work. However, abolishing the earnings test would adversely affect the cash-flow of the system. If the earnings test were abolished between early and full retirement age, the share of married men claiming Social Security benefits would increase by about 10 percentage points, and average benefit payments would increase by about $1,800 per recipient. This would be offset eventually by actuarially fair or better than fair reductions in benefit payouts throughout their 70s, 80s and 90s.

Conclusion

For persons between the early entitlement and full entitlement age, the earnings test is or is better than actuarially fair in that later earnings are increased so as to more than compensate for lost benefits from earnings over the annual exempt amount. Hypothetically, the earnings test should not affect retirement behavior. However, we find significant effects. A number of people have a high time preference which means they are reluctant to trade off current consumption (spending) against future consumption. One can increase the employment of older persons either by abolishing the earnings test or by increasing the early entitlement age under Social Security. A major difference on the funding side is that abolishing the earning test results in an earlier flow of benefit payments from Social Security, worsening the cash-flow problems of the system. On the other hand, increasing the early entitlement age delays the flow of benefit payments from the system, improving its liquidity.

About the Researcher

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