

## OASDI EARNINGS TEST

WARREN R. LUCKNER

### ABSTRACT

The earnings test provision of the old-age, survivors, and disability insurance system (OASDI) has been, and continues to be, controversial. Both the 1979 Advisory Council on Social Security and the National Commission on Social Security in its *Final Report*, March 1981, favored retention of the earnings test, although with some modifications. However, the Reagan administration recommended phasing out the earnings test for persons aged 65 and over during a three-year period beginning in 1983. This, of course, seems contrary to the cost-reduction objectives of the other major aspects of the administration's proposed changes. Thus it is assumed that the motivation was a combination of philosophical opposition to the test and a desire to encourage older workers to remain in the work force. Because of the attention paid to other aspects of the proposals—for example, the significant reduction in benefits for early retirement—apparently not much attention was given to the subtle but fundamental change represented by the recommendation to eliminate the earnings test. The following discussion analyzes the arguments for and against an earnings test and concludes with a recommendation the author believes is consistent with the proper purpose and nature of the OASDI system.

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### I. THE EARNINGS TEST

The current provisions of the OASDI earnings test are complicated, as the following summary indicates ([5], p. 10):

A beneficiary (other than a disabled beneficiary) can, for 1981, earn up to \$4,080 a year (\$5,500 for a person aged 65 or over) in any employment, covered or noncovered, without loss of benefits. For each \$2 of covered or noncovered earnings in excess of such amount, \$1 of benefits is withheld. During the initial year of retirement (or other receipt of benefits), in no case are benefits withheld for any month in which the beneficiary's remuneration as an employee is  $\frac{1}{12}$  of annual exempt amount (or less) and in which he rendered no substantial services in self-employment. For a retired worker with dependents who are beneficiaries, the reduction for "excess earnings" is applicable to the total family benefit. For

beneficiaries aged 72 or over (aged 70 and over, beginning in 1983), there is no limitation on earnings. The annual and monthly exempt amounts are automatically adjusted in the same manner as the earnings base, in units of \$120 per year and \$10 per month; this is done for the calendar year after an automatic adjustment of the benefit amounts has occurred (amount for persons under age 65 will \$4,440 in 1982, and for persons aged 65 or over will be \$6,000 in 1982; thereafter, both amounts will be automatically adjusted). For disabled beneficiaries, earnings of more than an amount prescribed by regulations (\$300 per month for 1981 and also, probably, for 1982) earned over a period of time ordinarily prove that individual is no longer disabled.

An important point to note is that income from sources other than employment (e.g., savings, rental property, and private pension plans) is not subject to the earnings test.

## II. ARGUMENTS

Arguments for or against an earnings test can be classified into four general categories: philosophical, financial, political, and practical.

### *Philosophical Arguments*

Those who support the earnings test consider it to be consistent with the principle that the benefits are based on a presumed need. All OASDI benefits are to be paid upon loss of earnings. The need for retirement benefits does not occur until the worker has retired. For survivors' benefits, the rationale is a bit less clear. The loss occurs if the worker dies, but if the beneficiary works, the loss is offset and benefits are subject to an earnings test because the presumed need is less. Payment of the benefit is contingent upon the occurrence of a specific event: loss of earnings due to death, disability, or retirement. This characteristic is not significantly different from a private pension plan. Private plans usually require that the worker retire completely from his job, trade, or industry as a condition for receiving a pension. The chief difference is that, since OASDI is a national program, it must use a test of retirement that can be applied nationwide to all occupations and all jobs. The earnings test is an objective measure that can be applied in such a manner. On the one hand, it is more restrictive than the test for private plans, since it includes earnings received outside the worker's usual job. On the other hand, it is more generous because it provides for partial retirement within the worker's career job, occupation, or industry ([9], p. 151).

Supporters contend that the OASDI benefit is not an annuity benefit payable purely upon attainment of a specific age (although it actually is payable at age 72—or, after 1982, at age 70) and that to change the benefit to an annuity payable at a specific age would fundamentally change the nature of the program and be contrary to its original and proper purpose.

In addition, the supporters argue that the elimination of an earnings test may appear unfair to younger workers whose taxes would help provide benefits for older workers earning as much or more than themselves.

Those who argue against an earnings test on philosophical grounds generally do so on the basis of fairness. Several aspects of the test are considered unfair. Some contend that the earned right to receive benefits is taken away by the earning test because benefits are not awarded automatically at age 65. Supporters argue that, although there is a statutory right to benefits, this right is contingent upon fulfillment of certain conditions set down in law, and does not imply automatic payment of benefits at a specified age.

Opponents also contend that the test makes the OASDI program a welfare program and that the exemption of unearned income from the test is unfair. However, supporters contend that to include unearned income would provide a disincentive to private savings and thus would be contrary to the principle that OASDI is a base upon which workers should build through private savings and supplemental pensions. Including unearned income would transform the earnings test into a needs test, and the OASDI program would become a welfare program. The current earnings test does not make OASDI a welfare program, particularly since the benefit determination is related to earnings.

Some opponents contend that taxes paid plus accumulated interest belong to each person individually, and thus it is unfair to prevent workers from receiving benefits because of earnings. The supporters argue that the taxes collected and benefits paid represent an intergenerational transfer of funds. Taxes paid do not belong to each person individually. The earnings levels upon which taxes are paid determine the ultimate benefit, but there are no individual accounts that accumulate taxes paid.

Opponents also argue that the earnings test makes it possible for an individual to receive no benefits despite all the taxes paid. Further, an individual may be doubly penalized if he has retired from his career job but is working in another job. Not only will the individual's benefit be reduced or eliminated, but a portion of the benefit may be deducted from his pension plan benefit if the plan is integrated with OASDI on an offset basis.

Opponents also argue that it is unfair to have an earnings test for beneficiaries under 72 but not to have one for those 72 or over, and to have different exempt amounts for those under 65 and those at least 65 but under age 72.

Finally, opponents argue that the test is unfair because the individual not only loses benefits but also loses the income-tax-exempt status of those benefits.

*Financial Arguments*

The financial arguments concerning the earnings test are of two types: those involving the cost to the OASDI program and those involving its impact on the financial well-being of the beneficiaries.

Those who support the earnings test argue that having the test saves a lot of money, which allows a more adequate benefit for those who really need it, or a lower tax rate than would otherwise be possible, or a combination of the two. Those who oppose the earnings test argue that the cost of eliminating the test would be offset by increased social security tax receipts from additional earnings. Moreover, the additional earnings would contribute to national income and thus increase the base for corporate and personal income tax. Supporters, however, can point to the findings of the National Commission ([9], pp. 146-47):

It is estimated that repeal of the earnings test would increase program costs by \$6-\$7 billion in the first year and more in future years. Even if the test were repealed only for those age 65 or older, the first-year cost would be about \$2 billion. . . .

It is sometimes suggested that the cost of repealing the test would be made up by the additional Federal income and payroll taxes that would be generated. This is very unlikely. People who can earn high wages already have a strong incentive to work; they are likely to be working now if there are jobs available. Therefore, this group is already paying most of the taxes they would pay if the test were eliminated. Older workers whose earnings are at or near the exempt amount might work more if there were no earnings test, and if the work were available. But they are not likely to pay large amounts of income taxes because income below certain levels is also exempt from the income tax and those over 65 are treated very favorably under this tax.

Appendix 5 of Appendix B, "Report of the Panel of Consultants to the 1979 Advisory Council on Social Security," gives a more detailed summary of studies that attempted to quantify the impact of removing the earnings test. The report concludes that the removal of the test is likely to have a significant net monetary cost ([8], p. 356).

The opponents of the earnings test contend that the aged should be allowed to work to supplement their inadequate benefits. Also, they contend that the test actually causes the event the OASDI program insures against—the loss of earned income—because some workers who otherwise would work (and earn more money) withdraw from the labor force rather than have their benefits reduced or eliminated. The supporters contend that the exempt amounts allow the truly needy to earn enough to maintain their standard of living. Also, if the benefits are inadequate in the context of their original purpose, the solution is to increase the

benefit level rather than eliminate the earnings test. Further, the supporters argue that those who would benefit from elimination of the test are relatively few and, more important, are likely to be those with higher earnings. OASDI benefits were withheld for less than 5 percent (about 1.1 million) of the 24.4 million people aged 65 and older who were eligible for OASDI benefits at the end of 1979. Of those, only 400,000 received no benefits in 1979 ([9], pp. 140–41). Supporters can also point to a study made for the Social Security Administration that showed that repeal of the earnings test in 1982 would not affect the benefits paid to 90 percent of those at ages 65–69. Moreover, 67 percent of the added benefits would go to people earning more than \$17,500 in 1982, while only about 6 percent would go to people earning less than about \$10,500 ([9], p. 148). Thus, elimination of the test would help those who need it least.

Finally, supporters argue that elimination of the test for ages 62–64 might encourage poor pension planning by providing incentive for individuals not retired to accept OASDI benefits at the earliest age (62), not realizing that this lower benefit may be inadequate for their needs when income from earnings is no longer available. (Many who would eliminate the test, however, propose doing so only at ages 65 and over.) On the other hand, opponents can point out that although benefits are reduced, they are approximately actuarially equivalent and thus there is no difference in the value of the benefits.

### *Political Arguments*

The political arguments concerning the earnings test relate primarily to the impact that the OASDI program has, or should have, on determining or implementing governmental policy, especially as it relates to work opportunities for various segments of the population.

Those who support the test on this basis contend that it encourages retirement and thus creates more job opportunities for younger workers. This argument is particularly relevant now because of the influx of workers from the post–World War II baby boom. Also, supporters argue that the test can be used to facilitate changes in the size of the work force as the nation's work opportunities change because of changing demographics (e.g., relative number of aged and young, dependency ratios) and changing production needs. ([7], p. 143). Finally, supporters contend that without the test, wage levels might be depressed because beneficiaries might work for lower wages than those with no other source of income. On the other hand, opponents can argue that the test holds down wage levels, since beneficiaries may work for less in order to retain benefits.

Those who oppose the test argue that it lessens the incentive to work,

with a loss of gross national product as a result. Further, this disincentive to work is inconsistent with the work ethic that pervades the OASDI program. Supporters counter that this disincentive is not a factor in the retirement decision for a great majority of those who retire. Their position is supported to a certain extent by the findings of a survey conducted for the National Commission on Social Security. The researchers who conducted the survey observed: "What is most striking is that the decision to retire is not often seen as a voluntary one. Retirement is something that happens to people, usually at a particular age or because of a particular health situation. Most retirees see themselves as having had relatively little choice" ([2], p. 10).

### *Practical Arguments*

The practical arguments regarding the earnings test relate to the number of people affected and the administrative complexities. The supporters contend that since the earnings test reduces benefits for only a relatively small number of people, and completely eliminates benefits for an even smaller number, the problems it may create cannot be too widespread. Thus, since the fundamental principle is sound, it should be retained. On the other hand, opponents argue that since it affects so few people, it can be eliminated without causing too many problems.

The opponents also contend that the complexities of the provision can cause anomalies in its administration. Supporters counter with the fact that recent changes have been made to eliminate such anomalies ([4], pp. 96-97).

### *Attitudes of the General Population*

It is also important to consider the attitude of the general population toward the earnings test. Surprisingly, the nationwide survey of attitudes toward social security commissioned by the National Commission on Social Security did not address the issue of the earnings test.

Although somewhat dated, the following statement reflects the attitude of the general public that seems to have prevailed in the past: "Virtually all informed and influential groups are strongly in favor of it. These groups include the administration, the congressional committees that deal with the OASDI program, labor unions, and business. On the other hand, a significant proportion of the general public seems to oppose the earnings test, and more bills in this direction have been introduced in Congress than on any other subject relating to the OASDI program" ([3], p. 89).

The report of the panel of consultants to the 1979 Advisory Council seems to indicate that this statement continues to represent the attitude

of the general public ([8], p. 349). In an attempt to learn more about public attitudes toward the earnings test, the following two questions have been prepared for possible inclusion in the 1982 Nebraska Annual Social Indicators Survey (NASIS):

- A. The Reagan administration has proposed that the earnings test be eliminated.<sup>1</sup> Do you strongly favor, mildly favor, mildly oppose, or strongly oppose that proposal?
- B. The earnings test is designed to reduce or eliminate social security benefits when a beneficiary has more than nominal earnings. Which of the following statements about the earnings test comes closest to your view?
1. The earnings test should be eliminated because social security benefits have been "bought and paid for" and it is inconsistent and unfair to withhold benefits just because the beneficiary continued to work.
  2. The earnings test should be maintained because social security benefits are to replace income lost when a worker becomes disabled, dies, or retires in old age, and the earnings test provides a measure of whether a loss of income has occurred.
  3. The earnings test should be maintained because to eliminate it would add to the financial woes of the social security system.

A preliminary test of the question was completed (by telephone) for a sample of ten persons to determine costs and potential problems with the questions as stated. The questions were in two different groups of questions asked of two different samples. Although the sample is too small for the results to have any statistical significance, they may be of interest:

*Results for question A:*

Strongly favor	0
Mildly favor	1
Mildly oppose	0
Strongly oppose	2
Don't know/Not sure	7

Perhaps the most significant observation about these results is that the question needs to be reworded, or grouped with the other question, to provide some awareness of what is meant by the earnings test.

*Results for question B:*

Alternative 1	2
Alternative 2	6
Alternative 3	2

<sup>1</sup> Actually the proposal is that the test be eliminated for persons aged 65 or over; this will be reflected in the 1982 NASIS but was not reflected in the trial runs that are discussed here.

Although the sample is too small to be significant, the results are surprising, especially since this sample indicated responses very similar to those of a nationwide sample on other questions regarding social security. It will be interesting to analyze the responses from the 1982 NASIS.

### III. CONCLUSION AND RECOMMENDATIONS

The fundamental principle of benefits based on a presumed need has been a part of the OASDI program since its inception. It is a valid principle for a social insurance program intended to insure individuals against loss of earnings due to death, disability, or retirement. The test is a condition of eligibility for benefits and not a prohibition of benefit payment (or a prohibition against working) ([4], p. 341). Paying benefits to fully employed persons is not socially necessary, but paying partial benefits to part-timers and low-paid workers seems desirable ([4], p. 341). Most of the philosophical arguments against the test reflect a misunderstanding about the fundamental nature and purpose of the OASDI program; it is a social insurance program intended to provide a base of protection against loss of earnings due to death, disability, or retirement. It is not intended to be a retirement annuity payable at age 65, nor is it intended to provide enough money to meet the basic needs and obligations of retired people. It is intended to provide enough so that, by combining it with other sources of income, retired people may meet their basic needs and obligations. Unless the fundamental nature and purpose of the OASDI program is to be changed from a social insurance program to an annuity payable at a certain age, the earnings test is an important provision of the program.

Thus, the retention of the earnings test is favored primarily on philosophical grounds; however, other arguments are also persuasive:

1. The financial impact of eliminating the test is significant. The long-range costs are 0.18 percent of taxable payroll for complete elimination of the test and 0.14 percent of payroll for eliminating it only after age 65 ([9], p. 146). Moreover, as indicated above, these costs most likely would not be made up by additional federal income taxes. Further, the benefits of elimination would go only to a small portion of OASDI beneficiaries, who are likely to be those with higher income and earnings.
2. As indicated above, the number of individuals adversely affected has been relatively minor, especially if only the low-to-middle income workers are considered. Also, as Table I indicates, the current exempt amounts allow for fairly significant continued earnings and benefit levels. Currently, these combined levels increase in two ways. First, the exempt amounts are adjusted automatically in the same manner as the taxable earnings base, after an automatic adjustment of the benefits has occurred. Second, automatic adjustment of benefits themselves affects the combined earnings and benefit levels.

TABLE 1\*

## EFFECT OF SOCIAL SECURITY EARNINGS TEST IN ILLUSTRATIVE CASES IN 1980†

	PAST EARNINGS HISTORY							
	Sufficient to Qualify for Minimum Benefit		Federal Minimum Wage Worker		Career Earnings Equal to National Average Earnings		Maximum Earnings	
	Worker Alone	With Spouse	Worker Alone	With Spouse	Worker Alone	With Spouse	Worker Alone	With Spouse
	Worker and Spouse Both Aged 65							
Annual benefit .....	\$1,741.20	\$ 2,612.40	\$ 3,859.10	\$ 5,789.00	\$ 5,862.30	\$ 8,793.70	\$ 7,436.60	\$11,154.90
Total earnings and benefits before any benefits are withheld .....	6,743.19	7,614.39	8,861.09	10,790.99	10,864.29	13,795.69	12,438.59	16,156.89
Earnings at which all benefits are withheld .....	8,484.00	10,226.00	12,720.00	16,579.00	16,726.00	22,589.00	19,875.00	27,311.00
	Worker and Spouse Both Aged 62							
Annual benefit .....	\$1,269.20	\$ 1,865.00	\$ 2,759.20	\$ 4,052.60	\$ 4,112.70	\$ 6,040.70	\$ 5,236.80	\$ 7,691.40
Total earnings and benefits before any benefits are withheld .....	4,991.19	5,586.99	6,481.19	7,774.59	7,834.69	9,762.69	8,958.79	11,413.39
Earnings at which all benefits are withheld .....	6,260.00	7,451.00	9,240.00	11,827.00	11,947.00	15,803.00	14,195.00	19,104.00

\* Reprinted from *Social Security in America's Future: Final Report of the National Commission on Social Security*, March, 1981, p. 152.

† Assuming no earnings by the spouse, and also assuming that worker and spouse reached the specified age at the beginning of the year.

3. Although some feel uneasy about using the OASDI program as a tool to implement government policy, consideration of the demographics of the current work force suggests that this is not the time to encourage employment of OASDI beneficiaries. Also, it is debatable whether the earnings test is a significant disincentive to work for those who really have a need or desire to work.
4. While the attitude of the general public is an important consideration, in an issue as complex as OASDI it should not be considered the primary determinant of change. Thus, although in the past the attitude has been very negative about the earnings test, that alone should not justify elimination of the test.

The current earnings test can be improved. Various recommendations have been set forth to rectify certain perceived defects and inconsistencies. A majority of the 1979 Advisory Council of Social Security recommended that the earnings test for those under age 65 be made the same as for those aged 65 and older, but that the test not be otherwise liberalized ([8], p. 173). In a supplementary statement to the Advisory Council's report, several council members indicated support for liberalizing the earnings test according to a method first proposed by Peter Diamond of the Massachusetts Institute of Technology. This approach grades the percentage of the OASDI benefit subject to the earnings test from 85 percent at age 65 down to 25 percent at age 69 (using equal increments of 15 percent) and then eliminates the earnings test at ages 70 and over ([8], pp. 357-58). This would encourage people to work without incurring the cost of eliminating the earnings test entirely at age 65 and over. However, this approach maintains the somewhat illogical pattern of encouraging people to work more as they get older.

The National Commission on Social Security recommended only that the scheduled reduction in the exempt age from 72 to 70 be repealed before it goes into effect in 1982 (legislation enacted on August 13, 1981, the Omnibus Budget Reconciliation Act of 1981, maintained the age at 72 for 1982 and reduced the age to 70 for 1983), and that a refundable credit be provided under the federal income tax to offset part of the effect of the earnings test ([9], pp. 144-45).

A. Haeworth Robertson, a former chief actuary of the Social Security Administration, has suggested that the trend toward elimination of the earnings test be reversed and that the original concept of a strict earnings test be restored ([7], p. 143). His suggestion is due, in part, to the seemingly illogical work pattern encouraged by the current law: individuals are encouraged to retire at age 62 (since, according to Mr. Robertson, the worker receives greater total value by retiring at age 62), to engage in limited paid

employment until age 65, to increase the level of paid employment from age 65 to age 72, and then to work in full-time paid employment ([7], pp. 285-86).

The primary defects and inconsistencies in the current law are (1) the different exempt amounts at different ages, (2) the elimination of the test after a certain age, and (3) the loss of both benefits and the tax-exempt status of benefits. Thus, it is recommended that the earnings test have the same exempt amount for all ages at the level currently in effect for beneficiaries aged 65 or over, and that the test apply uniformly at all ages.

To address the more fundamental issue of what OASDI payroll taxes (contributions) represent, it is further recommended that employee (and self-employed) OASDI payroll taxes be deductible from gross income for income tax purposes and that OASDI benefits be fully taxable. Since the payroll taxes represent contribution from current workers for the benefit of those not currently working, and their dependents, this deduction can be justified either on the same basis as a charitable deduction, or on the basis used to justify the tax-deferred status of some other vehicles for providing retirement income. It is recognized that the great majority of individuals have no choice in the matter of paying OASDI taxes and, thus, that using a tax incentive to encourage contributions may not be meaningful; however, it may make the fact that there is no choice more acceptable. Income taxation of social security benefits is justified on the basis that the benefits are a form of income, the level of which is determined by prior earnings levels, and that the OASDI contributions that generated the benefits are to be tax-deductible. Two members of the National Commission on Social Security indicated support for the deductibility of payroll taxes in conjunction with full taxability of benefit payments and elimination of the earnings test ([9], p. 336). The elimination of the earnings test is not recommended by this author for the reasons indicated above.

The tax deductibility of OASDI contributions can be started immediately, in conjunction with other changes resulting from the administration's overall review of the country's federal tax structure. It can be argued that benefits should be taxed immediately if the OASDI contributions being used to pay those benefits are tax-deductible immediately. However, it may be somewhat unfair to tax the benefits of individuals who did not have the benefit of tax deductibility of their OASDI contributions. As a compromise between these two points of view, the taxation of OASDI benefits could be phased in over a period of time and implemented in conjunction with a review of what are the appropriate benefit levels, accounting for the taxation of benefits.

If adopted, these recommendations would accomplish the following:

1. Retain the earnings test in a form consistent with its purpose—determination of when loss of earnings has occurred—and in a form that would allow a reasonable amount of earnings without reduction of benefits.
2. Eliminate inconsistencies in the application of the test.
3. Provide a tax advantage for social security contributions, thus offsetting, in part, the seeming unfairness of a situation in which an individual could pay taxes and not receive any benefits (e.g., because of the earnings test, or because of death without dependents), except for the very minor lump-sum death benefit.
4. Eliminate the double loss—benefits and tax-exempt status of benefits—produced by the earnings test.
5. Emphasize the nature of the payroll tax as a transfer from workers to non-workers rather than a payment for an individual advance-funded deferred annuity.

Of course, many will find some of the recommendations difficult to accept; for example:

1. The deliberalization of the earnings test by elimination of age beyond which the earnings test does not apply.
2. The effective reduction of social security benefits through taxation of such benefits (although it is recommended that the overall benefit level be reviewed in light of this taxation).
3. The effective deliberalization of the earnings test through taxation of social security benefits (e.g., in Table I, the net income—total earnings plus benefits less taxes—before any benefits are withheld would be somewhat less because of the taxation of benefits).
4. The potential loss of tax revenue because of deductibility of payroll taxes (ultimately offset, in part, by the taxation of benefits).

These recommendations may be more acceptable in view of the double income tax exemption for the elderly, which significantly reduces the impact of taxation of social security retirement benefits, especially for those for whom such benefits are the only source of income. Further, given the current mood of the country and the administration, now may be the best time to consider such changes and incorporate them in the overall review of the federal tax structure of the United States.

#### IV. ACKNOWLEDGMENTS

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## DISCUSSION OF PRECEDING PAPER

RALPH E. EDWARDS:

In his philosophical arguments, Professor Luckner adopts the premise that social security is based upon a perceived need. From this need arises a system that gives larger benefits to the rich than to the poor. Once this difference is accepted, I do not see how perceived need can be applied, particularly for the earnings test.

Consider a 66-year-old individual with an annual social security benefit of \$3,000 who wants to work enough to increase his income to \$10,000, or \$7,000 more. With a \$6,000 earnings test limit, he has to earn \$8,000 while the social security benefit reduces to \$2,000. If he is subject to income tax, he must earn even more than \$8,000. Has not perceived need been totally disregarded?

The needs test originated when it was seriously believed that the supply of jobs was very limited. Married women were not hired and marrying females were terminated so that jobs would be opened up for male heads of households. The philosophical basis of the earnings test was enforced retirement, and the social security reduction was not 50 percent but 100 percent.

I also question Professor Luckner's basis for the popular attitude toward the earnings test. How much did the respondents know about the test and its ramifications? Assume an individual becomes self-employed upon retiring at age 65. He has a good pension (with a social security offset) and substantial investment earnings. He earns \$6,100, or \$100 over the earnings test limit of \$6,000. Assume that the \$100 excess is reduced by \$50 for social security, \$43 federal income tax, and \$7.50 state income tax. On top of that, a self-employed social security tax of about \$9.50 adds insult to injury. That \$100 of income is offset by \$110 of outgo. I doubt that Professor Luckner's population knew this, or would approve of it if they did.

This is not the place to argue at length whether encouraging productivity by all segments of the population (as exemplified in recent years by increased female employment) results in a higher standard of living for that population. But the earnings test should not be judged in the artificially restricted area of social security philosophy or financing. In real-life situations, the earnings test represents a confiscatory income tax on older persons of modest earning power, as well as a repressor of productivity.

THOMAS J. HUMMEL:

Mr. Luckner's recommendation with respect to the earnings test is sound and logical. In what appears to be an afterthought, he proposes deductibility of payroll taxes and taxability of benefits. This proposal, which is hardly incidental, would appear to have but one direct connection with the earnings test—it softens the blow because taxable rather than tax-exempt benefits are lost, a kind of liberalization of the earnings test through the back door. But the deductibility-taxability proposal does have other profound effects, which are identified in the paper.

The proper purpose and nature of the OASDI system fully support the taxability of social security benefits. There is no justification for deductibility; the notion that OASDI is like a pension plan is mistaken. The concept that payroll deductions are like charitable contributions is also mistaken; they are more like taxes used for welfare.

If deductibility is the price of taxability, then there is a question of what kind of deductibility. If social security contributions are to be considered charitable contributions, then only those who itemize will get the benefit of the deduction. This is somewhat defensible on the basis that those with high prior earnings are likely to itemize and then are likely to be in higher tax brackets when they receive benefits. These same people are likely to be those who are most critical of the OASDI system; deductibility may make them feel more sanguine about the system. However, "deductible from gross income" is presumed to mean a Schedule A deduction for those who itemize and an additional standard deduction for those who do not.

Deductibility of any kind is tantamount to supporting OASDI through general revenues, unless offset by tax revenues realized from the taxability of benefits. To effect implementation, it would be necessary to "establish appropriate benefit levels, taking into account the taxation of benefits." Does this mean that benefit levels would be set higher, so that net after-tax benefits would be roughly equal to previously tax-exempt benefits? Or does it mean a reduction in net (after-tax) benefits for all except the truly needy?

There was a time when it seemed possible to recommend that payroll taxes be made deductible and that benefits be made taxable in proportion to the deductions taken for payroll taxes. In other words, an account would be kept for each individual, showing total payroll taxes and deducted payroll taxes; the portion of benefits to be taxed would be determined by the ratio of deducted payroll taxes to total payroll taxes. The addition of this record-keeping to an already complex tax and OASDI system should not prove too onerous. The balance of revenue gains and

losses might be acceptable on a present value basis but the deficits in the early years of such a program are not.

Perhaps the current mood of the country would support the implementation of deductibility-taxability in lieu of a change such as a cap on indexing except for the use of the smaller of the wage increase or the price increase. Whatever changes are made, the OASDI system should be treated as an entity outside of the general budget so that it neither is supported by nor contributes to general revenues.

JAMES L. COWEN:

I would like to commend Mr. Luckner on his thorough, clear, and concise presentation of the arguments for and against the OASDI earnings test. It is regrettable that the paper will not receive as wide a distribution as it deserves because of the limited readership of the *Transactions*. This is a paper that would be understood by the general public and those politicians who make policy for the OASDI programs.

As a supporter of the earnings test and one who feels that it has been liberalized too much, I would like to emphasize some of the points made by Mr. Luckner. Many of these apply to social security in general and are not limited to the earnings test.

In my estimation, philosophical arguments for and against the earnings test are the most important part of the paper since the major problems of the social security program will not be solved until there is a clear understanding of the goals and philosophy of the system.

The following quotes from the paper (which are generally from the arguments supporting the earnings test) express my views as to the nature of the OASDI program.

Payment of the benefit is contingent upon the occurrence of a specific event: loss of earnings due to death, disability, or retirement. This characteristic is not significantly different from a private pension plan. . . . The chief difference is that, since OASDI is a national program, it must use a test of retirement that can be applied nationwide to all occupations and all jobs.

The taxes collected and benefits paid represent an intergenerational transfer of funds. . . . The earnings levels upon which taxes are paid determine the ultimate benefit, but there are no individual accounts that accumulate taxes paid.

Most of the philosophical arguments against the test reflect a misunderstanding about the fundamental nature and purpose of the OASDI program; it is a social insurance program intended to provide a base of protection against loss of earnings due to death, disability, or retirement. It is not intended to be a retirement annuity payable at age 65, nor is it intended to provide enough money to meet the basic needs and obligations of retired people.

There are a few additional points that also should be mentioned. Most opponents of the earnings test equate the social security program with retirement income or endowment policies, which are a combination of savings and insurance. In reality, social security is more like casualty insurance, where benefits are paid only if the event insured against occurs. In casualty insurance, there are no separate accounts, since most people never receive any monetary return for their premiums. Under social security, however, most people do receive a return, but it is likely to be quite different from the amounts paid in taxes.

The paper brings out the principle that social security benefits are based on presumed need and that the earnings test is one way of measuring this need. This principle (unlike those expressed earlier, which determine *when* benefits should be paid) dictates the size and type of benefits to be paid. Because our social and economic system is dynamic, these areas should be reviewed periodically even though the risks insured against do not change. In this area, I disagree with the recent change in the law eliminating student benefits, because I do not feel that the need for education has declined. On the other hand, wives' and widows' benefits should be reviewed, because more married women are in the labor force and their earnings are a significant part of the family income.

Finally, I would like to comment on Mr. Luckner's proposals for revising the earnings test.

1. It should be made uniform for all types of beneficiaries—including the disabled, who currently are subject to an all-or-nothing qualification. This seriously hampers attempts to rehabilitate the disabled.
2. I do not agree that social security taxes should be made tax deductible and the benefits taxed. Many other types of federal taxes that also fund transfer payments are not deductible. Taxing the benefits would discriminate against those individuals who had saved for their retirement and would, in effect, apply a stricter earnings test to those with interest and investment income than to others. While no one presently can receive less by working than under full retirement, that result could be possible under this proposal for someone with significant investment income who continues to work. They would receive less than at present, but probably would not lose all their earnings through the earnings test and income taxes. Even those with only a social security benefit as income might have to pay taxes; these beneficiaries could not afford that.

Would it be possible to retain an earnings test and also tax the benefits? Most proponents of taxing benefits tie this to the elimination of the earnings test. Furthermore, unless special provisions were made, taxing benefits would not help the financial condition of the system since it would bring additional income to the general funds and not to the social security trust funds.

3. While it may be hard to put into effect politically, the earnings test should apply at all ages. At the worst, every effort should be made to prevent any further liberalizations.

As stated earlier, I feel that this paper should have wide distribution, especially to members of the Committee on Ways and Means of the House of Representatives, the Senate Finance Committee, and White House staff members who are responsible for setting policy for the social security program.

ROBERT J. MYERS:

Mr. Luckner has presented a very complete explanation and analysis of the earnings test under the OASDI program, along with recommendations for changing it. This test always has been a subject of great controversy, and Mr. Luckner well presents the arguments for and against it, although he comes down strongly for its retention and even recommends extending the limiting age beyond the present 72 (scheduled to be reduced to 70 in 1983).

He also recommends that social security taxes should be deductible from gross income for income tax purposes and that, in some phased-in manner, social security benefits should be includable in income for income tax purposes. Irrespective of the merits of the proposal, it may be noted that Congress has expressed its opinion several times by unanimous or nearly unanimous votes against the latter course.

In discussing the effect of the earnings test as a disincentive to work, Mr. Luckner does not point out a situation under present law that is most inequitable. Consider individuals who have been relatively highly paid and who, after retirement, have income from private pensions and/or investments such that, for example, they are in the 50 percent federal income tax bracket. If such persons earn more than the annual exempt amount (\$6,000 in 1982 for persons aged 65 or over), they actually *lose* money on such "excess" earnings—at least until their earnings are very large. The reason is that the "\$1 for \$2" offset under the earnings test, the 50 percent federal income tax, the social security tax, work expenses, and state income tax will be larger than the additional earnings. Certainly, that situation is a disincentive to work!

The foregoing anomaly would be corrected if Mr. Luckner's recommendation to include social security benefits in taxable income were adopted, although there would be little monetary incentive to work. If only 50 percent of social security benefits were subject to tax—as some, such as the 1979 Advisory Council on Social Security, have proposed—there would remain some financial loss for working.

Mr. Luckner quotes the findings of a survey conducted for the National Commission on Social Security (of which I was a member) that retirement almost always occurs because of health conditions. It is true that this is what people *reported*, but I am not convinced that it is really so. I have considerable reservations about survey results, because respondents often will give answers which are not true. This can occur because of belief that they will lose financially if they report correctly (under the earnings test) or that their answer is not "socially acceptable" (ceasing work because they dislike it and prefer leisure).

Mr. Luckner quotes A. Haeworth Robertson as saying that the reduction factors for claiming OASDI benefits before age 65 are such that individuals receive greater total value by retiring at age 62 than if they wait until age 65 for unreduced benefits. I believe that this is not so, but rather that the factors are actuarially based and equitable. My paper "Appraisal of Early-Retirement and Deferred-Retirement Adjustment Factors under Social Security" (*PCAPP*, XXX [1980-81], 422) demonstrates that the present early-retirement reduction factors are appropriate in the case of a person who leaves the work force at age 62 and has the choice of a reduced benefit immediately or a full benefit deferred until age 65. It is not proper to compare the value of the benefit obtained at age 62 to that obtained by continuing to work and paying social security taxes until age 65, because in the latter case the value of the additional earnings or the possibly increased benefit amount due to such earnings is not taken into account.

A solution to the problem of the earnings test being a significant disincentive to work after age 65 was proposed by the National Commission on Social Security. A refundable income tax credit for persons aged 65 and over would be given with respect to benefits withheld under the test. Such credit would be the lowest federal income tax rate (currently, 14 percent), multiplied by a factor based on age in the year under question (ranging from 0.6 at age 65 to 1.3 at age 72 or over), multiplied by the amount of benefits withheld.

(AUTHOR'S REVIEW OF DISCUSSION)

WARREN R. LUCKNER:

I would like to thank Messrs. Cowen, Edwards, Hummel, and Myers for their written discussions. I also would like to thank Mr. Dwight Bartlett and others who discussed the paper with me at the Colorado Springs meeting. I appreciate the interest shown in the issues discussed in the paper.

Mr. Edwards does not agree that the earnings test is tied to the fundamental principle of benefits based on a presumed need. Although the balance of the principles of individual equity and social adequacy produces a weighted benefit formula that gives lower wage earners a relatively greater benefit, he believes that the OASDI system “gives larger benefits to the rich than to the poor,” and that “perceived” need is irrelevant, particularly for the earnings test. Perhaps the disagreement comes over the concept of need. By implication a “presumed” need is related to a certain event. For OASDI, the event is loss of earnings due to death, disability, or retirement. The earnings test is the vehicle that determines if there has been a loss of earnings. Presumed need does *not* imply a means test, whereby an individual receives more (up to a point) because he has a greater financial need. The earnings test does not distinguish between those living in poverty and those living a life of wealth; it distinguishes among those retired, semiretired, and not at all retired, as defined by earnings levels. The social adequacy orientation of the OASDI weighted benefit formula addresses the issue of relative degrees of financial need.

In Mr. Edwards’s first example, perceived need has *not* been disregarded. The need occurs when retirement occurs. In effect, the earnings test currently implies that one can earn up to \$6000 and still be considered retired; if one earns more than \$6000, one is considered increasingly nonretired and OASDI benefits are reduced accordingly.

I also believe that Mr. Edwards’s assessment of the historic philosophical basis for the earnings test is mistaken. It is true that in specific situations individuals may have felt forced to retire because the disincentive to work was too strong. However, the primary philosophical basis of the test has never been to encourage a particular retirement pattern.

The recommendation for deductibility of OASDI contributions and taxability of OASDI benefits received attention in all the written discussions, as well as in comments made at the Colorado Springs meeting. Mr. Hummel is correct that the deductibility-taxability issue is not related *directly* to the earnings test issue (except to eliminate an inequity, as indicated below). However, the more fundamental issue of what OASDI payroll taxes represent may be causing some of the difficulty with accepting the earnings test as a proper provision of the OASDI program. My motivation for the tax deductibility of OASDI contributions was a combination of several rather unscientific factors. First, OASDI contributions might be considered similar to a tax-deferred TIAA-CREF plan, not because OASDI is a pension plan, but because it serves a similar purpose—providing retirement income. Second, I supported the taxing of OASDI benefits and

did not feel it quite "fair" to tax benefits arising from contributions made from fully taxable income. Third, with the provision of tax deductibility, everyone gets some benefit from his OASDI contributions. Finally, the intergenerational transfer to provide a base of financial security for the elderly, the disabled, or survivors of the deceased can be considered a charitable endeavor as much as some of those items currently qualifying for tax deductibility. I do believe deductibility should be available to all persons who make OASDI contributions, not just those who itemize deductions.

Taxation of benefits is a deliberalization of the earnings test in the sense that, all else being equal, the *net* income implied by the figures in Table 1—total earnings plus OASDI benefits less taxes—will be less because of the taxation of benefits.

Mr. Myers and Mr. Edwards (in his second example) point out an inequity for more highly paid workers under the current earnings test. As Mr. Myers indicates, full taxation of benefits corrects that problem. In Mr. Edwards's example,

$$[\$6,100 + (\text{OASDI benefit} - \$50)][1 - (0.43 + 0.095)] \\ > (\$6,000 + \text{OASDI benefit}) [1 - (0.43 + 0.095)] .$$

Note that the social security payroll tax is not included, since it would be deductible. There still may be little incentive for some individuals (those who are in a high tax bracket) to earn more money, although they never will lose money by working. It may be that some will decide that it is more rewarding and worthwhile to do volunteer work rather than work for money. In my opinion, this would be a positive result, although not a primary objective of the earnings test.

As Mr. Myers indicated, the 1979 Advisory Council on Social Security proposed that 50 percent of the OASDI benefit be taxed (primarily on the premise that roughly 50 percent of the benefit is attributable to the employer contributions, which are tax deductible). Based on 1978 data, it was estimated that such taxation would increase annual federal tax collections by \$3.7 billion. I am not aware of any studies of the impact of the combination of full deductibility and taxability. Ultimately, it would seem there should be a roughly equal trade-off, although differing tax rates and changing demographics could have a significant impact. This financial impact requires further study and should be addressed before any change is implemented. Although deductibility can be considered use of general revenues, I do not believe this should cause concern, especially

in light of the taxability of benefits. Some of the existing tax features for the elderly are a result of the structure of OASDI benefits and thus could also be thought of as use of general revenues to support OASDI. I also recognize that, as Mr. Myers points out, taxation of benefits is not popular in Congress. However, the combined deductibility-taxability proposal should be somewhat appealing, especially with a phase-in period. This is a good time to raise the issue of deductibility-taxability, since the tax structure of the federal government currently is receiving much discussion.

I share Mr. Myers's and Mr. Edwards's concern about the use of survey results. As indicated in the paper, the responses to the preliminary test of NASIS questions should not be interpreted as representative, especially since the sample size was small. Moreover, as Mr. Myers points out, the results of any survey of the general population may be biased due to misinformation and intentionally misleading statements. However, I still believe it is important to analyze results of population surveys, with those qualifications in mind.

The issue raised by Mr. Cowen regarding the possibility of retaining the earnings test *and* taxing the benefits can be considered a question of consistency of philosophy. Some consider taxation of benefits to be related to individual equity, while the earnings test is related to social adequacy. Thus if one emphasizes individual equity, taxation of benefits and elimination of the earnings test is favored; while if one emphasizes social adequacy, retention of the earnings test and nontaxation of benefits is favored. Since writing the paper, I have discovered that the President's Commission on Pension Policy had recommended deductibility-taxability in conjunction with elimination of the earnings test. However, I believe one can favor retention of the earnings test *and* taxation of benefits as a balance of the individual equity and social adequacy aspects of OASDI. Moreover, as indicated above, the earnings test is not exclusively a result of a social adequacy orientation. As Table 1 shows, the earnings test allows for some individual equity, since, even with the earnings test, those having higher past earnings (and thus having paid higher payroll taxes) receive more.

Mr. Cowen also suggests that deductibility-taxability would discriminate against those individuals who had saved for their retirement. By saving, an individual may be in a higher tax bracket after retirement. If OASDI benefits were taxed, an individual who had saved would receive less of the benefit than a comparable individual who had not saved. This is an important question, which needs to be studied. This discrimination may or may not be acceptable as a part of the social adequacy orientation

of the OASDI program, but it also is a result of the progressive nature of the income tax system.

As indicated in the paper, taxation of benefits should be preceded by review of the OASDI benefit levels. This review should establish reasonable net replacement rates. Mr. Myers's 1981 edition of his text, *Social Security*, presents an analysis of net replacement rates leading to the conclusion that for retirement cases, OASDI benefits take care of the full economic needs of very low earners reasonably well, provide substantially for average earners, and yield a floor of protection for upper-middle and high earners. The disability benefits when eligible dependents are present and the young-survivor benefits are at a relatively high level for all income, leaving little need for supplementation, except for high earners. In my opinion, the net replacement rates for OASDI are generally a bit too high and could be reduced without undermining the initial benefit adequacy principle. Overall, taxation of benefits generally would require some increase in benefit levels, even if some of the current replacement rates were reduced.

I strongly agree with Mr. Cowen's assertion that to determine the appropriate solutions to the problems confronting the OASDI system, it is important to have a clear definition and understanding of its goals and philosophy. That was a large part of the motivation for writing the paper; I am thankful for the healthy exchange of ideas that it generated. We need to continue to work to determine the appropriate form of social insurance system in the United States, and then work to implement it.