The Heritage Foundation Backgrounder

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THE TAX SYSTEM SHOULD STOP PENALIZING THE WORKING ELDERLY

INTRODUCTION

The American work force is aging rapidly. In 1950 the ratio of workers to retirees was 4 to 1; this has dipped to 3 to 1, and by the year 2020 – when the baby boom generation starts retiring – there will be less than two workers for every potential retiree.

This "graying of America" has profound implications for the future of the United States labor force. Already there is a shortage of skilled workers in many industries.[1] And while the American economy is projected to generate some 20 million new jobs by the year 2000, by that time, the Census Bureau projects, there will be 1.5 million fewer 16- to 24-year-olds than today to replace the 5 million more elderly workers reaching retirement age.

Too Expensive to Work. This problem may become a crisis because federal tax policies are keeping from the labor pool a group of workers that is growing in number and that generally possesses needed skills – Americans over age 65. The federal government now slaps the working elderly with so many tax penalties that hundreds of thousands literally find it too expensive to work. Among these penalties:

◆◆ The "earnings test," which reduces Social Security benefits for the working elderly;

◆◆ The Delayed Retirement Credit, which is insufficient to restore lifetime Social Security benefits for the working elderly;

◆◆ The taxation of Social Security benefits; and

◆◆ The Medicare tax surcharge introduced this year.

1 United States Department of Labor, *Labor Market Shortages*, January 1989, pp. 1-9.

Each of these taxes applies uniquely to the working elderly. These tax liabilities are in addition to the regular federal and state taxes that other Americans with similar incomes must pay.

Thanks to these taxes and benefit reductions, it is not uncommon for elderly families to confront effective marginal tax rates of 65 percent to 85 percent. Indeed, according to an analysis by former Social Security Administration chief actuary Robert Myers, some working senior citizens could face tax rates exceeding 100 percent.[2]

Forcing Premature Retirement. The effect of these punitive federal taxes is predictable. They force many healthy and productive elderly citizens into premature retirement. Today, more than 80 percent of all men and 90 percent of all women over age 65 are fully retired.[3] Despite longer life expectancies and such modern labor practices as making it easier for the elderly to work flexible hours or at home, Americans are withdrawing from the work force at an ever earlier age. The retirement rate of 55 to 64 year olds has doubled in just three decades.[4] The average retirement age is now just 61 – the lowest it has been since records have been kept in this century.[5] Opinion polls find that many retired senior citizens would like to be working.

Congress finally is beginning to reassess the taxes it imposes on the elderly. Earlier this year, Senator William Armstrong, the Colorado Republican, sponsored an amendment to the minimum wage bill to raise the Social Security earnings test threshold level by $1,000. The earnings test threshold level now is $8,400. Any working senior citizen loses $1 of Social Security benefits for every $2 of earnings above this level. Armstrong's amendment passed by a wide margin, but was rejected by the House. Now, in a victory for the working elderly, Senate Finance Committee Chairman Lloyd Bentsen, the Texas Democrat, has won unanimous approval for an amendment to the child care bill to reform the earnings test work restrictions. The House has not acted on the Bentsen proposal, but some 15 bills to repeal or raise the earnings test limit have been introduced in that chamber.

In addition to granting this modest relief, Congress should address three other measures to assist the working elderly:

1) Raising the Delayed Retirement Credit (DRC) immediately to its actuarial correct level of 8 percent. The DRC raises the future monthly Social Security level of senior citizens who opt to defer collecting benefits and continue working. At a rate of 8 percent, a person over age 65 would receive the same lifetime benefits by continuing to work as he or she would by immediately retiring.

2 Robert Myers, "Income of Social Security Beneficiaries as Affected by Earnings Test and Income Taxes on Benefits," *The Journal of Risk and Insurance*, June 1985, pp. 289-300.

3 John C. Goodman and A. James Meigs, "The Elderly: People the Supply-Side Revolution Forgot," National Center for Policy Analysis, February 1989.

4 Michael D. Packard and Virginia Reno, "A Look at Very Early Retirees," in Rita Ricardo-Campbell and Edward P. Lazear, *Issues in Contemporary Retirement* (Stanford, California: Hoover Institution, 1989).

5 U.S. Department of Labor, *Older Worker Task Force: Key Policy Issues*, 1989.

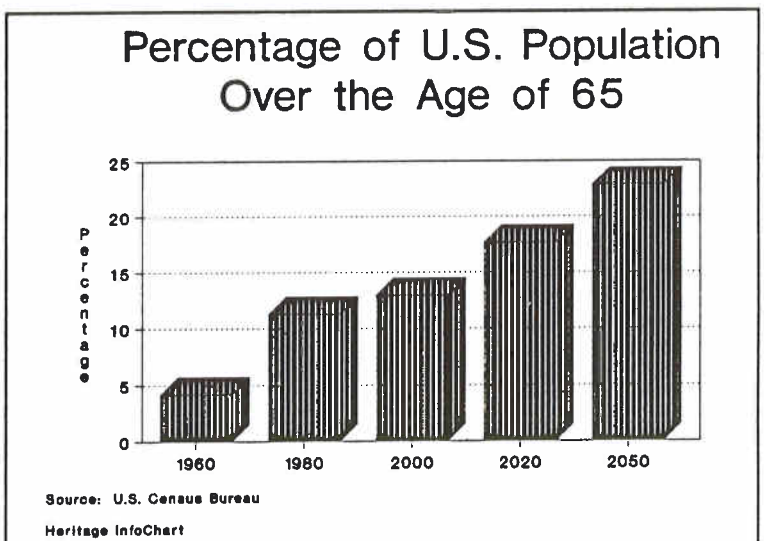
2) Indexing the income threshold level for the Social Security benefits tax. This would guarantee the working elderly that inflation will not allow the tax code to erode their benefits more each year.

3) Repealing the new Medicare surtax.

No other age group in America faces the draconian tax rates now imposed on the working elderly. Senator Armstrong has labelled the tax barriers to work now confronted by Americans over the age of 65 as "the most unfair case of age discrimination in the country."[6] He is right. But these taxes are much more than unfair. They rob the national economy of the productive contributions of hundreds of thousands of skilled and talented senior citizens. In short, these taxes make America poorer.

HOW FEDERAL TAX POLICIES HURT SENIORS WHO WANT TO WORK

About 30 million Americans are over age 65. By the year 2000 this number will grow to 35 million, and by the year 2020 it is expected to climb to 52 million. At the same time, the Census Bureau estimates that there will be about 1.5 million fewer 16- to 24-year-olds than today to replace elderly workers retiring from the work force. The figure below shows the steady rise in the "over 65" age group as a share of U.S. population with projections through the year 2050.



The general work force shortages threatened by an aging labor pool are exacerbated by the increased percentage of Americans in retirement at various age groups. As the table below shows, the retirement rate of men between ages 55 and 60 roughly has doubled since 1970 and has risen by about twenty percentage points for 65-year-olds.

Contrary to conventional wisdom, these rising rates of retirement are not attributable to mandatory retirement policies. According to the 1985 report of President Reagan's Council of Economic Advisers, only between 2 percent and 5 percent of workers retire because of manadatory retirement laws. The report concludes: "There is increasing evidence that the retirement decision

6 Press release, May 4, 1989.

Percentage of Men Aged 55-70 Out of the Labor Force in 1963, 1970, and 1985

Age	1963	1970	1985
55	7	8	16
56	7	9	18
57	9	11	20
58	9	12	23
59	11	12	25
60	12	16	29
61	16	19	34
62	20	26	49
63	24	31	55
64	28	36	58
65	46	50	70
66	57	55	74
67	61	61	76
68	67	62	80
69	67	66	80
70	73	70	84

Source: Rita Ricardo-Campbell and Edward P. Lazear, eds., *Issues in Contemporary Retirement* (Stanford: Hoover Institution, 1989), based on unpublished Bureau of Labor Statistics data.

is a matter of choice, a choice that is strongly influenced by the economic incentives inherent in both Social Security and private pensions."[7]

Forfeiting Benefits. The availability of Social Security benefits clearly is a major factor motivating retirement decisions, evidenced by the large leap in the number of workers who now retire at age 62 and 65 (see data in table). At age 62 Americans first become eligible to receive partial Social Security benefits. Full benefits are available at age 65.

One of the harmful effects of the Social Security program is that Americans who wish to work beyond age 65 must forfeit a large share of the Social Security benefits they would receive if they retired immediately. For senior citizens with moderate earnings potential, several federal tax policies combine to discourage the elderly from continuing in the work force. Among them:

1) The Social Security "earnings test."

This withholds one dollar of Social Security benefits from those between the ages of 65 an 69 for every two dollars of earnings over $8,400.

2) The reduction in lifetime Social Security benefits for those continuing to work.

7 "Economic Status of the Elderly," *Economic Report of the President, 1985*, p. 121.

Americans reaching age 65 who continue to work do receive a 3 percent per year Delayed Retirement Credit (DRC), which is added to their monthly Social Security benefits when they eventually retire. But this does not fully compensate working senior citizens for the loss of immediate benefits. The credit would have to be about three times higher than the current amount to completely reimburse the elderly for deferring retirement. Although the current DRC rate discourages late retirement, there is no such penalty for early retirement. The Social Security program does not reduce lifetime benefits for Americans choosing retirement at age 62.[8]

3) The taxation of Social Security benefits.

The Social Security benefits collected by those elderly with gross income over $25,000 is subject to the income tax at a rate of 50 cents for every additional dollar earned. This discourages the earning of outside income because each added dollar of earnings raises taxable income by $1.50. Today, more than 300,000 working senior citizens are hit with both the earnings test and the benefit tax. The income threshold for the benefits tax, unlike other tax thresholds, is not indexed. The result: the benefits tax will cut the real income each year for increasing numbers of elderly.

4) The new Medicare surtax.

Last year's Medicare catastrophic legislation requires the elderly to pay a $22.50 surcharge on each $150 of federal income tax they owe this year. This raises the marginal tax rate on Americans age 65 and over 15 percent above rates paid by all other age groups. This surtax, moreover, will rise to 28 percent by 1993.

These federal policies effectively have converted Social Security into a *de facto* mandatory retirement program. The incentive for work after age 65 has been taxed away. Several studies document the confiscatory tax rates now imposed on the elderly. Examples:

♦ ♦ A study by the Dallas-based National Center for Policy Analysis finds that the typical working senior citizen, with earnings of about $9,000, loses one dollar of Social Security benefits for every $2 of income under the earnings test.[9] This places the senior citizen in an effective 80 percent tax bracket. If that same worker had a total income of just over $25,000, the individual also would have to pay taxes on his or her Social Security benefits. This could push the marginal tax rate above 100 percent.[10] In other words, the senior citizen would be worse off by working than by not working.

8 For a more detailed discussion of the DRC, see Robert J. Myers, Statement before the Committee on Ways and Means, Subcommittee on Social Security, U.S. House of Representatives, September 29, 1988.

9 Goodman and Meigs, *op. cit.*

10 In computing the marginal tax rate, this study and others ignore the 3 percent Delayed Retirement Credit, which increases future Social Security benefit income by working. Taking this into account would lower the tax rate slightly. See Myers, "Income of Social Security Beneficiaries," *op. cit.*

◆ ◆ According to a study by Stephen Entin of the Washington, D.C.-based Institute for Research on the Economics of Taxation, moderate income working elderly typically face effective marginal tax rates of between 65 to 85 percent.[11]

SHOULD SOCIAL SECURITY ONLY BE FOR THE COMPLETELY RETIRED?

When the Social Security system was launched in 1935, the objective in part was to create jobs for young Americans during the Depression by removing elderly workers from the labor force. Indeed, Senator Robert Wagner, the original chief sponsor of the Social Security Act, claimed that "the incentive to the retirement of elderly workers will improve efficiency standards, [and] make new places for the strong and the eager."[12] The earnings test was a conscious attempt by Congress to discourage the elderly from working – the original income limit was set at $15 per year.

Without passing judgment on the merit of that strategy in the 1930s, the situation today is very different. Unemployment in the 1930s was as high as 25 percent; today it is just over 5 percent. Jobs were scarce in the 1930s; today, skilled workers are scarce and in the future will be scarcer.[13]

Insensitive to Economic Reality. The Social Security system today should give the elderly the option of retiring, not push them out of the labor market. But by imposing marginal tax rates of 65 to 85 percent on the middle class elderly, Congress essentially has removed the work option for many of them.

Nevertheless, the conventional wisdom in Congress is that Social Security should be granted only to those Americans who are completely retired. This "all or nothing" view of Social Security is insensitive to the economic reality confronting many low and moderate income elderly. The average Social Security monthly benefit today is between $500 and $600. This is a helpful supplement to the incomes of elderly Americans, but it is not – and was not intended to be – an elderly person's only source of income. Those who depend only on Social Security live at or near the poverty level. Many moderate income elderly choose to work to maintain the living standard they achieved when they were younger.

HOW TO REMOVE THE ELDERLY'S DISINCENTIVE TO WORK

The punitive tax rates imposed on the working elderly are inequitable and economic folly for a nation facing a shortage of skilled workers. To correct this, reforms are needed. These include:

11 Stephen Entin, "Social Security Retirement Earnings Test," Institute for Research on the Economics of Taxation *Economic Report* No. 46, February 9, 1989.

12 *Congressional Record*, June 14, 1935, p. S-9286.

13 U.S. Department of Labor, *Labor Market Shortages, op. cit.*

1) Revising and eventually eliminating the Social Security earnings test.

The earnings test is the most perverse feature of Social Security because it is a direct tax on working. The earnings test penalizes only income from work; it does not apply to "unearned" income from investments. Workers between the ages of 65 and 69 who earn over $8,800 lose $1 in benefits for every $2 in earnings; starting in 1990 this will be reduced to a loss of $1 in benefits for every $3 in earnings – equivalent to a 33 percent marginal tax rate. In addition, the worker pays federal, state, and perhaps local taxes on the income, and the earnings are subject to payroll taxes, making the marginal rate even higher.

Under the proposal by Senator Bentsen, who chairs the Senate Finance Committee, the loss in benefits would be cut to $1 for each $4 in income, starting next year. This would be a significant step to ending the work disincentive for senior citizens.

A longstanding proposal by Senator Armstrong – recently supported in an about-face by Bentsen – would increase the income threshold level by about $1,000 next year. This would exempt nearly 100,000 moderate income elderly from a loss in Social Security benefits by working. But even with this improvement, the earnings test still would affect some 200,000 moderate income families.

The threshold income level should be raised in stages and eventually eliminated. If the limit were raised to $25,000 next year, for example, virtually all low- and moderate-income families families would be exempt from the earnings test.

2) Increasing the Delayed Retirement Credit (DRC) to compensate working elderly Americans fully for Social Security benefits they forego.

Americans who continue to work after age 65, and who do not apply for any Social Security benefits, receive a 3 percent increase in their monthly Social Security benefits when they do retire. This is known as the Delayed Retirement Credit.

This credit is far below the amount needed to compensate workers fully for the loss of immediate benefits. For lifetime Social Security benefits to be the same for a worker who retired immediately at age 62 or 65, and one who deferred benefits and continued to work, actuarial calculations indicate that the credit would have to be 8 percent.[14] The current 3 percent rate is simply an incentive for the elderly to leave the work force as soon as they become eligible for Social Security benefits.

Congress recognized this inequity when it passed the 1983 Social Security Amendments. That legislation will raise the credit to 8 percent in the year

14 Even at an 8 percent rate, the impact on the federal budget of a person continuing to work is positive, not neutral. This is because the DRC actuarial equivalent rate takes into account only the amount of Social Security benefits an individual will receive over his or her lifetime. It does not take into account the federal income taxes the person pays while continuing to work. The economy thus might benefit from raising the DRC to above 8 percent.

2010. But there is no compelling reason for waiting two decades. It should be raised immediately. Former Chief Actuary of the Social Security Administration Robert Myers, who was Executive Director of the 1983 Social Security Commission, endorses this, pointing out that: "Increasing the DRC at once would reduce costs in the short run because individuals would be more likely to defer retirement and thus receipt of benefits."[15] The long-term cost to the Social Security trust fund – attributable to slightly higher benefit payments to those who already defer retirement at the lower rate – would be offset by Social Security payroll and income taxes paid by those elderly who would choose to work longer.

One further reform of the DRC is necessary. Under current law, the credit does not apply to working senior citizens over age 70. Many Americans over that age, however, wish to continue to work and defer Social Security benefits into the future. They should be granted this option. Extending the DRC to these Americans would cost the taxpayer nothing.

3) Indexing the income level that triggers the Social Security benefits tax.

Another inequity of the tax treatment of Social Security is that the income threshold level, at which Social Security benefits are counted as income and subject to federal income taxes, is not indexed. The current income level is $25,000 for individuals and $32,000 for married couples. At these income levels each additional dollar of income subjects an additional 50 cents of Social Security benefits to the income tax. This raises the effective tax rate on the elderly by 50 percent. For instance, an elderly worker in the 28 percent bracket is lifted into an effective 42 percent bracket.[16]

Because this income threshold level is not indexed for inflation, over time an increasing number of middle and lower income elderly families will become subject to the tax. Hence even if the congressional supporters of raising the earnings test are successful, the beneficial impact of their actions will be nullified partially by the increased number of working elderly families subject to the benefits tax.

The positive work incentive intended by repealing or raising the earnings test level will only be realized if that step is coupled with an indexing of the income level for taxing Social Security benefits. Since virtually all other features of the Social Security program protect the elderly from the harmful effects of inflation through indexing, there is no reason why the benefits tax should not be indexed as well.

4) Repealing the new Medicare surtax.

More than 11 million senior citizens are paying the new Medicare surtax this year, and 14 million will pay the tax in 1993. For an elderly worker in the 28 percent income tax bracket, the surtax raises his or her marginal federal

15 Myers, Statement, *op. cit.*

16 28 percent plus 0.5 x 28 percent.

income tax rate alone to 36 percent. This anti-work surtax should be repealed. To compensate the Treasury for the lost revenues, Congress should eliminate the non-catastrophic provisions of last year's Medicare catastrophic legislation, most notably, the new drug benefits.[17]

ARGUMENTS AGAINST REFORM

Those who oppose reforms to grant tax relief to the elderly generally base their case on three myths:

Myth #1: Reducing the Social Security earnings test would benefit only the rich.

The Social Security earnings test affects nearly 500,000 moderate income senior citizens, those earning between $9,000 and $35,000. Elderly workers with wages as low as $4.65 an hour lose Social Security benefits under the test. And while some elderly workers with high incomes would gain from raising or eliminating the earnings test, these workers would pay taxes on any additional Social Security benefits they received – even if the benefits tax were indexed.

Myth #2: Reducing the tax burden on the elderly would not increase their incentive to work.

Some critics of reform argue that easing taxes on the elderly would have little or no impact on their decisions to retire. This claim is refuted by a large body of empirical research demonstrating that marginal tax rates of the magnitude now faced by many middle income elderly workers constitute a serious disincentive to work.[18] The elderly are just as responsive to tax incentives as any group – indeed, work effort by senior citizens may be even more sensitive to work incentives. A study by Robert Haveman, for the Urban Institute, finds that "Persons 62 and Over" had "high responsiveness

17 Edmund F. Haislmaier, "The Medicare Tax Revolt of 1989," Heritage Foundation *Executive Memorandum* No. 223, February 9, 1989.

18 There is substantial empirical evidence that tax rates over 50 percent reduce work. After John Kennedy cut federal tax rates in 1963 and Ronald Reagan cut them in 1981, hours worked and tax collections rose. See Lawrence B. Lindsey, "Supply Side Lessons for Reducing the Deficit," *Business Economics*, October 1988, pp. 13-18; "The Classical Case for Cutting Marginal Tax Income Rates," working paper prepared for Representatives Robert Michel, Trent Lott, and Jack Kemp, February 1981.

to changes in work incentives" enacted between 1981 and 1985 by the Reagan Administration.[19] This supports the work of earlier studies.[20] There also is evidence that when the earnings test threshold level has been raised in the past (most recently in 1977), there was a rise in the hours worked by those elderly near the exempt amount.[21]

Myth #3: Reducing the elderly's tax rates would cost too much.

Many in Congress oppose raising the earnings test and indexing the income level for taxing Social Security benefits on the grounds that these changes would increase the federal deficit. This argument implies, of course, that inequities are permissible if they bring in money to the Treasury. In any case, the budget impact of these tax relief measures is trivial compared with the overall benefit to the economy of unlocking the productive contributions of the elderly.

The Congressional Budget Office estimates that eliminating the earnings test would raise Social Security outlays by almost $5 billion per year, while raising the threshold level by $1,000 would cost about $250 million per year.[22] Yet these estimates ignore the higher income taxes and Social Security payroll taxes the elderly would pay as they increased their hours worked. These revenues could cut the budgetary cost of earnings test changes by up to 50 percent, according to a recent study by Stephen Entin of the Institute for Research on the Economics of Taxation.[23]

Compensating Social Security. Furthermore, Congress could fully "pay" for the proposed tax changes by introducing policies that would encourage the elderly to defer retirement. For example, raising the retirement age by two months per year for twelve years until the normal retirement age reaches 67, would compensate the Social Security trust fund completely for the extra cost of eliminating the earnings test and raising the Delayed Retirement Credit.

A second option would be to impose a benefit penalty for early retirement. Under current law, Americans retiring at age 62 receive an annual benefit equal to 80 percent of the amount they would have received if they had worked three more years and retired at age 65. At this 80 percent rate, it is as attractive to retire at age 62 as at age 65, in terms of the lifetime benefit

19 Robert H. Haveman, "How Much Have the Reagan Administration's Tax and Spending Policies Increased Work Effort?" in Charles R. Hulten and Isabel V. Sawhill, eds., *The Legacy of Reaganomics* (Washington, D.C.: Urban Institute, 1984), pp. 91-125.

20 Stanley Masters and Irwin Garfinkel, *Estimating the Labor Supply of Income Maintenance Alternatives* (New York: Academic Press, 1977).

21 One study examining retirement and earnings data between 1969 and 1979 concludes: "The elimination of the [earnings] test is estimated to raise the work effort of average retirees over age 62 by 30 percent to 40 percent." Gary Burtless and Robert A. Moffitt, "The Effect of Social Security Benefits on the Labor Supply of the Aged," in Henry J. Aaron and Gary Burtless, eds., *Retirement and Economic Behavior* (Washington, D.C.: Brookings Institution, 1984), pp. 135-174.

22 Congressional Budget Office, "The Social Security Earnings Test and Options for Change," Staff Working Paper, September 1988.

23 *Op. cit.*

package that the individual receives from Social Security. But the economy (and the federal Treasury) gains far more when the individual chooses to work the three additional years. Thus it would be sound economic and budget policy to reduce the early retirement compensation rate by 2 percent per year for five years until it reaches 70 percent, to pay for the tax and benefit reforms.

CONCLUSION

America's most valuable asset is its people. And perhaps the single greatest untapped part of that asset is the productive talent of the 35 million elderly Americans. They are experienced. They have acquired work discipline. They are reliable. And they are skilled.

Giving the Elderly a Choice. For most elderly Americans retirement is – as it should be – a matter of free choice. But for at least hundreds of thousands of others, retirement is virtually required by a perverse set of taxes that punishes them for working. Beginning in 1981, federal policy makers have been reforming the federal tax system to reduce marginal tax rates to increase the incentive for most Americans to work. But for the elderly – and particularly the middle class elderly – effective marginal tax rates are far higher than for younger Americans. Congress should end this inequity to restore fairness and to boost the economy.

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