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Eliminating the Social Security Earnings Test

Abolishing the Social Security earnings test will encourage more people to work more but also will increase benefit payments to well-off retirees. These mixed effects reflect the difficulty of balancing Social Security's conflicting goals. One is to protect people from a poverty-ridden old age, the other is to provide a guaranteed annuity based on a person's lifetime earnings.

Since Social Security was created in 1935, there have been limits on how much beneficiaries could earn without having their benefits reduced. The original law prevented the payment of any benefits for any month in which a beneficiary had earnings from work covered by the program. It seemed draconian, however, to stop benefits if a person earned just a dollar or two, and before this provision went into effect, the law was changed so that benefits were withheld for any month in which a beneficiary earned $15 or more. This was the first of many moves by Congress to liberalize the "earnings test."

In 1950, the earnings limit was increased to $50 a month and beneficiaries aged 75 or older were exempted from it. The age provision was modified over the years until by 1983 beneficiaries aged 70 or older were entitled to full benefits regardless of their earnings. Beginning in 1977, a distinction was made between beneficiaries aged 65-69 and those under 65, with the exempt amount of earnings for the older group set somewhat higher.

The limit on earnings was further liberalized over time. After price inflation accelerated in the 1970s it was tied to increases in average wages, and Congress periodically legislated additional increases. In addition, the rate at which benefits were reduced was lowered until by 1978 it was $1 for every $2 of excess earnings. In 1990 it became $1 for each $3 for beneficiaries age 65 to 69.

The Contract With America Advancement Act of 1996 further eased the earnings test by substantially increasing the amount of exempt earnings for beneficiaries age 65 to 69. This year the limit is $17,000 and under current law it is scheduled to increase to $30,000 by 2002. For beneficiaries aged 62 to 64, however, the earnings limit remains much lower—$10,080 this year—and is scheduled to increase only as fast as average U.S. wages in future years.

It appears that the earnings test is about to undergo another major change. This month the House and the Senate voted unanimously to eliminate the earnings test for beneficiaries age 65 to 69. President Clinton has said he will sign the legislation. If he does, the change probably would apply retroactively to earnings since the beginning of this year.

The Original Intent

That it discouraged older people from working might seem to be an unintended consequence of the Social Security earnings test. However, this seems to have been the very purpose of the original clause. Its insertion into the Social Security Act reflected the prevailing attitude toward the economy in 1935, which was that there were too many workers and not enough jobs. At the height of the Depression in the early thirties, one out of every four workers was unemployed. The hope was that withholding benefits from older workers would encourage them to stop working and thus open up jobs for younger people.

The original earnings test also underscored that Social Security was intended to partly make up for the loss of earnings due to retirement or death, rather than provide an annuity to old people regardless of their earnings. When he signed the Social Security Act of 1935, President Roosevelt said the law would provide "some measure of protection to the average citizen and his family against the loss of a job and a poverty-ridden old age."

It must be said that these two goals are somewhat inconsistent. A benefit that is only sufficient to keep people out of poverty will not be high enough to encourage many to accept it as an alternative to earnings. (In 1940, the first year benefits were paid, average annual earnings were $1,299 while the *maximum* Social Security benefit was $494.)

In any event, the labor situation is very different now. The unemployment rate is near 4 percent, not 25 percent. The fear is not for a labor glut but a labor shortage. Rather than discouraging people from working, it is thought that they should be encouraged to continue working as long as possible. Moreover, the proportion of the population that is over 65 will increase substantially over the next 30 years, thus it is in the interests of those under 65 to encourage older people to remain part of the workforce. The larger the workforce, the easier it will be to generate the income needed to pay for Social Security and other commitments, if only because more workers can produce more than fewer workers.

In addition, the Social Security program has come a long way from the original goal of keeping old people out of poverty. Benefits have been made much more generous, so that for many if not most retirees Social Security is a mainstay of support. Over the years Congress has backed away from using need as a criterion for old-age benefits, and the public has come to regard Social Security as purely an age-based entitlement. Many people apparently think their benefits are a return of their "contributions," i.e., their payroll taxes, and feel that they should get them without regard to whether they continue to work or how much they earn. Abolishing the earnings test for people aged 65 or older would be just one more step toward making need irrelevant in determining who qualifies for old-age benefits.

Who Gains, Who Loses?

The earnings test is, in effect, an addition to the worker's marginal tax rate. Ironically, this addition is higher for those with moderate earnings than it is for the highest paid. For people who earn less

than the $17,000 limit, the additional tax is zero. Those who earn above the limit pay an additional marginal tax rate of 33 percent, because each additional $3 of earnings results in a $1 reduction of benefits. This 33 percent added tax rate applies until earnings equal the exempt amount plus three times the individual's Social Security benefit, at which point benefits are reduced to zero. For example, consider a 68-year old entitled to a benefit of $1,200 per month. If he earns more than $17,000, each additional $3 of earnings reduces his benefit by a dollar. At $60,200, his benefits are fully withheld. Each additional dollar he makes above that will have no effect on his benefits.

The proportion of Social Security recipients who have benefits withheld, and thus would collect more benefits under the new law, is surprisingly small. About 28 million retired workers were registered to collect benefits in 1996 on the basis of their own lifetime earnings record (rather than as a spouse or widow). Of these, 18 million were 70 or older and therefore exempt from any earnings test. Among the other 10 million people, 865,000 had some or all of their benefits withheld due to excess earnings. About 171,000 of these were aged 62 to 64, an age group that would not be affected by the proposed rule change. Among people 65 to 69 years old, 694,000 lost benefits due to earnings. This is less than 10 percent of retired beneficiaries that age and less than 3 percent of all retired beneficiaries.

The percentage might even be smaller now, because the earnings limit has increased substantially since 1996 ($17,000 vs. $12,500). These figures do not include people who collect spousal or dependent benefits, which are also subject to reduction if the primary beneficiary's earnings exceed the limit. However, counting them would not alter the overall picture, which shows that relatively few people lose benefits due to the earnings test.

Those who lose some or all of their benefits are *not* the ones whose work decisions are most strongly affected by the earnings test, however. After all, they choose to work despite the penalty. The ones who are most discouraged from working are those who deliberately keep their reported earnings below the $17,000 limit to avoid losing benefits. Unlike those who have benefits withheld, there is no way to count those who avoid withholding. But undoubtedly some people would try to work more or get jobs that pay more if the penalty were eliminated. These individuals, their employers, and the economy at large would all gain. Since these retirees already collect benefits, their decision to work more would not cost taxpayers anything.

In short, eliminating the earnings test for people aged 65 to 69 would have two broad effects. More benefits would be paid to high-earning beneficiaries without strongly changing their incentive to work, at a cost to taxpayers equal to the benefits currently withheld. For the much larger number of people who currently do not have benefits withheld, it would strengthen the incentive to work, at no additional cost to taxpayers.

The hope is that the additional economic activity that will result from eliminating the earnings test will be worth the cost. The gains may not be large. Older people have a weaker incentive to work than most. Many have substantial financial resources, such as savings and pensions. Their financial responsibilities typically are minimal—most own their own homes and no longer have to support families or pay for their children's education. Compared to younger people, who have minimal financial assets and are more concerned with raising families, older people are less likely to need or want to work. Some cannot do so for health reasons. The cost of eliminating the earnings test, however, also is not large. In 1996, retired workers aged 65 to 69 had $4.1 billion of benefits withheld. An unknown number of other individuals have never bothered to file for benefits because their earnings were high enough to lose them, and they will now have little incentive not to file. The combined cost is likely to be tiny compared to the $303 billion spent on Old Age and Survivors benefits that year and the $7.5 trillion Gross Domestic Product.

Cost aside, the main objection to eliminating the earnings test is that the additional Social Security benefits would be paid to people who are relatively well-off. Moreover, these benefits would be paid for by the current work force, which includes many people who earn less than the affected Social Security beneficiaries. There is no way to avoid this, however, without leaving in place some disincentive to work. Paying benefits only to those with limited earnings and eliminating work disincentives are conflicting goals. A compromise would be to raise rather than eliminate the earnings threshold that triggers a loss of benefits, or withdraw benefits more gradually as earnings increase. As noted, the current law does this by increasing the earnings limit to $30,000 by 2002, and Congress could raise it further.

The issue of paying benefits to the well-off is complicated by the fact that under current law, benefits *already* are paid to some people with high incomes. The earnings test counts only earned income, i.e., income from work. It does not take into count unearned income. Thus, a wealthy retiree living on the income from stocks and bonds may receive full Social Security benefits, while a person who has to work to earn the same income may have some or all of his benefits withheld. Presumably, most people would agree that this is "unfair."

There are two ways to level the playing field. One is to eliminate the earnings test, so that retirees entitled to a given benefit would receive it regardless of the source of their income. The other is to broaden the earnings test to take unearned income into account, and to withhold benefits whenever income, regardless of the source, exceeds a given threshold. However, this approach would create its own problems. If people expected to have their Social Security benefits withheld because of income from their savings, they would have less incentive to save for their retirement. The current system discourages older people from working, but a broader "income test" would discourage everybody, including younger people, from saving.

The problem of conflicting incentives also arises with respect to people aged 62 to 64. On the one hand, the current law encourages them to stop working, because it allows them to file for "early retirement" Social Security benefits. In addition, those who do file face an earnings test that is more stringent than the one for people over 65. On the other hand, there is a penalty for early retirement that encourages them to delay filing for benefits until age 65. Namely, early retirement benefits are *permanently* reduced from their full benefit by a percentage that varies with age. For example, a person who files for benefits at age 62 receives 80 percent of what he would otherwise receive.

The vast majority of Social Security beneficiaries choose early retirement benefits. In 1998, 72 percent of the 28 million retired-worker beneficiaries collected permanently reduced benefits. This includes people who are now over 65 who began receiving benefits years ago. But even among those who collected benefits for the first time in 1998, 75 percent filed for early retirement benefits. The present penalties for early retirement clearly are not sufficient to dissuade most people from filing early.

If the earnings test were eliminated for this age group, the relatively few people who now delay filing until they turn 65 would have less incentive to wait. More people would file for early retirement, and one concern is that some of them would end up with permanently reduced benefits that are too small to support them when they eventually do stop working. Some might end up with reduced benefits and

not much else. Reportedly this is one reason that Congress is not planning to eliminate, or even liberalize, the earnings test for this age group. Of course, retaining the test will continue to discourage the majority who do take early retirement from working, including those who make relatively modest earnings.

As this discussion may suggest, it is difficult to strike a balance between two conflicting goals of Social Security. One is to help old people in need and the other is to provide a guaranteed annuity to anyone with an earnings record. Abolishing the earnings test will encourage people to work but pay benefits to more well-off people. Retaining the test for people aged 62 to 65 will discourage them from filing for early retirement but will also discourage those who do file from working for even modest pay. Withholding benefits from wealthy retirees who live off investment income would discourage workers of all ages from saving.

Social Security has "come a long way" from its original goal of providing, in FDR's words, "safeguards against the major misfortunes of life." The tendency over the years has been to make changes that provide more benefits for more people with relatively higher incomes, while benefits for those with very low incomes are barely adequate to live on. Abolishing the earnings test is not a bad idea and the economic gains might well outweigh the cost. But it is not an efficient means of providing financial assistance to those who may genuinely need it.

In larger perspective, the earnings test issue simply illustrates the distortions and inequities that have resulted from the transformation of Social Security from its origins as an income "safety net" into an all-inclusive (but unfunded) retirement annuity program. If the original goal of assuring some minimum standard of living for the elderly still has merit, the most useful approach might simply be to have individual benefits paid as needed to attain some guaranteed income threshold and administered as a negative income tax—as people as diverse as Milton Friedman and George McGovern have suggested. In this circumstance, the sole problem would be determining the level of such a threshold, i.e., high enough to provide an adequate standard of living but not so high as to discourage work or savings. Such a reform could greatly reduce the magnitude of benefit outlays and correspondingly reduce the tax burden on the working population. It also would vastly reduce the influence of Government in the financial affairs of all of us—which presumably is one reason the politicians give it scant notice. ❑

BUSINESS-CYCLE CONDITIONS

Given that five of our twelve leading indicators reached new highs this month and that none is contracting, the outlook for continued expansion remains highly favorable.

Five of our twelve primary leading indicators reached new cyclical highs this month. They are *M2 money supply*, *new orders for consumer goods*, *contracts and orders for plant and equipment*, the *ratio of manufacturing and trade sales to inventories,* and *initial claims for state unemployment insurance* (inverted). M2 and all other dollar-denominated series are reported in constant dollars. All five are appraised as clearly expanding.

New orders for consumer goods surpassed its cyclical high set last August despite a drop in the series' base data. *Contracts and orders for plant and equipment* peaked following marked increases in January's and February's base data of 8.7 and 5.8 percent, respectively. After being downgraded last month to probably expanding, renewed strength in the base data for sales to inventories warranted reappraising the series as clearly expanding. This month's jobless claims totaled 279,800, down 1.2 percent from last month and below last year's average of 296,158.

Ignoring long stale peaks, both the *3-month change in consumer debt* and the *3-month change in sensitive materials prices* also reached new highs this month. The growth in consumer debt accelerated from 2.11 percent to 2.95 percent, while the percentage change in materials prices also jumped markedly, rising from -0.34 percent to 2.89 percent. The recent surge in consumer debt warranted upgrading the series to clearly expanding from indeterminate. Sensitive materials prices remain appraised as clearly expanding.

The base data for *vendor performance*, the percentage of purchasing managers reporting slower deliveries from their suppliers, slipped 0.2 percentage points to 55 percent. Now two months off its latest peak, the series was downgraded from clearly expanding to probably expanding. Likewise, the index of common stock prices was downgraded from clearly expanding to probably expanding after falling 3.2 percent. *M1 money supply*—the narrowest measure of money—fell 0.5 percent but

Statistical Indicators of Business-Cycle Changes

Change in Base Data					Cyclical Status		
Nov.	*Dec.*	*Jan.*	*Feb.*	***Primary Leading Indicators***	*Jan.*	*Feb.*	*Mar.*
+	+	-		M1 money supply	?	+?	+?
+	+	+		M2 money supply	+	+	+
+	-	+		Change in sensitive materials prices	+	+	+
+	+	-		New orders for consumer goods	+	+	+
-	+	+		Contracts and orders for plant and equipment	+	+	+
+	+	+	-	New housing permits	-?	-?	?
+	+			Ratio of manufacturing and trade sales to inventories	+	+?	+
-	+	-	-	Vendor performance	+	+	+?
+	+	-	-	Index of common stock prices (constant purchasing power)	+	+	+?
-	-	+	+	Average workweek in manufacturing	?	?	?
+	+	+		Initial claims for unemployment insurance (inverted)	+	+	+
+	+	+		Change in consumer debt	?	?	+
				Percentage expanding cyclically	*89*	*90*	*100*
				Primary Roughly Coincident Indicators			
+	+	+	+	Nonagricultural employment	+	+	+
+	+	+	+	Index of industrial production	+	+	+
-	-[r]	+		Personal income in manufacturing	+?	+?	?
+	+			Manufacturing and trade sales	+	+	+
+	+	+	+	Civilian employment to population ratio	+?	+	+
+	+			Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	*100*	*100*	*100*
				Primary Lagging Indicators			
+	+	-	+	Average duration of unemployment (inverted)	+	+	+
+	+			Manufacturing and trade inventories	+	+	+
+	+	+		Commercial and industrial loans	+	+	+
+	+	+		Ratio of consumer debt to personal income	+?	+	+
-	nc[r]	-		Change in labor cost per unit of output, manufacturing	?	?	?
nc	+	-	+	Composite of short-term interest rates	+	+	+
				Percentage expanding cyclically	*100*	*100*	*100*

nc No change. [r] Revised.

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

remains appraised as probably expanding.

Two series—*new housing permits* and the *average workweek in manufacturing*—are indeterminate. The estimated 1,631,000 building permits authorized this month is 8 percent below January's count and 6 percent below the figure for the same period last year. Despite the substantial drop in its base data this month, the series is 3 months from a trough and no longer warrants being appraised as probably contracting. The average workweek rose 0.2 hour to 41.9 hours. (Manufacturing overtime also edged up 0.2 hour to 4.8 hours.) The average workweek's moving average is expanding, but it is too weak at this time to identify a clear trend in the series.

Overall, 100 percent (ten out of ten) of the primary leading indicators with apparent cyclical trends are expanding. The cyclical score, AIER's purely mathematical assessment of the twelve leading indicators, rose four points to 87. (A score of 100 would indicate that all twelve leaders reached highs for the cycle.) Both of these diffusion indexes remain well above the threshold of 50, below which recession becomes statistically more probable than continued expansion in business activity.

Five of our six coincident indicators reached highs again this month. *Nonagricultural employment* increased modestly by 43,000. Job gains in the service-producing sector (62,000) were well below last year's average monthly gain (121,000), manufacturing hiring was flat, and the construction industry lost 26,000 jobs. The *civilian employment to population ratio* rose by 0.1 percent to 64.8 percent. *Industrial production* increased 0.3 percent in February, with motor vehicle assemblies at a still-high level of 12.9 million units (annual rate). *Manufacturing and trade sales* rose 0.9 percent. According to preliminary estimates, *gross domestic product* (GDP) increased at an annual rate of 6.9 percent in the fourth quarter of 1999. In the advance estimates released last month (based on less complete data) the increase in GDP was 5.8 percent. The large upward revision primarily reflected additions to personal consumption expenditures. All five series remain appraised as clearly expanding.

Personal income in manufacturing was downgraded from probably expanding to indeterminate. Manufacturing income is now five months from its last peak and the series appears to have leveled off. Overall, 100 percent (five out of five) of the primary roughly coincident indicators with apparent cyclical trends are expanding.

Four of our six lagging indicators are at new cyclical highs, including the *average duration of unemployment* (inverted), *manufacturing and trade inventories*, *commercial and industrial loans*, and the *ratio of consumer debt to personal income*. The average duration of unemployment fell from 13.2 weeks to 12.5 weeks. The number of unemployed persons, 5.8 million, and the unemployment rate, 4.1 percent, were unchanged. The jobless rate has been below 4.2 percent for 5 consecutive months. The base data for inventories and C&I loans each advanced by 0.5 percent. The ratio of consumer debt to personal income continued to climb, reaching 17.5 percent. All four series are appraised as clearly expanding.

Although not at a new high, the *composite of short-term interest rates* rose 22 basis points to 5.86 percent, and remains appraised as clearly expanding. On March 21, the Fed raised its target for the federal funds rate by 25 basis points to 6 percent—the highest in five years—and approved a 25 basis point increase in the discount rate to 5.5 percent. This action was the fifth time the Fed has raised rates since June of last year. The FOMC meets again May 16. Identifying a clear trend for the percent change from a year earlier in *manufacturing labor cost per unit of output* remains elusive. The base data fell slightly this month, but not enough to warrant downgrading the series. As long as productivity increases—which it has thus far in 2000—growth in unit labor costs will remain negative.

Overall, 100 percent (five out of five) of the primary lagging indicators with apparent cyclical trends are expanding. The strength in the lagging indicators raises some concern, as in previous cycles the lagging indicators expanded just prior to a slowdown in the leading indicators. Nonetheless, seven leaders are at new highs and 100 percent with apparent cyclical trends are expanding—and there are few indications of bottlenecks forming in the economy. The business outlook remains favorable.

The FOMC: They Still Don't Get It

In 1994, the Federal Open Market Committee (FOMC) began releasing an immediate public statement when it raised or lowered the target for the federal funds rate, and a brief rationale for the action. For example, the Fed released the following statement after the March 21, 2000 meeting:

> The Federal Open Market Committee voted today to raise its target for the federal funds rate by 25 basis points to 6 percent. Economic conditions and considerations addressed by the Committee are essentially the same as when the Committee met in February. The Committee remains concerned that increases in demand will continue to exceed the growth in potential supply, which could foster inflationary imbalances that would undermine the economy's record economic expansion.

At its December 1998 meeting, the FOMC also announced its intention to issue concurrent statements respecting major shifts in its view about prospective developments. The shifts in view would be conveyed in a statement regarding its bias toward a future increase or decrease in the targeted federal funds rate. The FOMC's intent was to communicate before the fact its thinking on future policy actions. In practice, it spawned frantic second-guessing and further volatility in the financial markets—and was abandoned early this year. It now intends to issue more general statements respecting the Committee's weighting of conditions that might foster either "inflationary pressures" or "economic weakness"—and will leave it to the markets to figure out what that may or may not imply for interest-rate policy.

The problem with all of the above is that the FOMC continues to be wedded to the discredited notion that economic growth and price inflation are trade-offs that require balancing. For as Geoffrey Moore (who died earlier this month) demonstrated decades ago, GDP and inflation rates move independently. Indeed, there would seem to be no natural limits to noninflationary rates of growth. Rather than a useful tool for managing it, monetary manipulation is but one of many *unnatural* limits on economic growth imposed by Government. A fitting memorial to Professor Moore would be if the Fed's policymakers finally awakened to this circumstance. It might also allow the financial markets to turn their attention to the "real economy" rather than the delphic utterances of the seers at the FOMC. ❑

PRICE OF GOLD

	1998	*1999*	*—— 2000 ——*	
	Mar. 19	*Mar. 18*	*Mar. 16*	*Mar. 23*
Final fixing in London	$291.50	$284.20	$287.35	$284.75

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