Enhancing Work Incentives for Older Workers: Social Security and Medicare Proposals to Reduce Work Disincentives

Robert Clark
John B. Shoven

Demographic Facts and Economic Impacts

- The Population is aging
  - Ratio of retirees to workers is rising
  - Cost of maintaining any level of retirement income and health care is increasing
- People are living longer
  - Greater retirement wealth is needed for any level of annual income in retirement
  - Working longer is an important option
- People are healthier at older ages
  - Most individuals have the ability to remain in the labor force

Observations

- With population aging, ability to finance Social Security and Medicare depends in part on increased labor force participation of older individuals

- Ability of individuals to finance retirement depends on reassessing their retirement age

- Can individuals and governments finance 30 years of retirement with only 40 years of work?

Individuals Aged 62 and Older Face Disincentives to Remaining in the Labor Force

- Workers eligible to immediately collect Social Security and those who are eligible for Medicare face substantial disincentives to continued work due to current policies

- For instance, provisions of SS and Medicare subject older workers to payroll taxes even though additional work does not increase current or future benefits.

- For most people over 65, the payroll taxes are a pure tax on work

Policy Recommendations

- We were asked to present policy recommendations that would encourage older persons to work longer
- We rejected changes that would reduce benefits in order to push individuals to work longer
- We focus on policy changes that remove provisions that discourage older persons from remaining in the labor force
- Our proposals do not penalize individuals who are unable or unwilling to delay retirement

Policy Recommendations

- We propose three policy changes that would remove disincentives for work and provide strong incentives to remain in the labor force
- Policy 1. Complete elimination of the earning test
- Policy 2. Paid-up status for Social Security
- Policy 3. Paid-up status for Medicare plus a return to Medicare being the primary payer of health care for all persons over the age of 65

Outline of Presentation

- Describe each of the three proposals
- Discuss how our proposals remove disincentives to work and instead provide substantial positive work incentives
- Review the costs and benefits associated with each proposal
  - Cost to Social Security and Medicare
  - Value of increased earnings
  - Added tax revenues to the general fund

Proposal 1. Complete Elimination of the Earnings Test

- Since it was established, Social Security has imposed an earnings test on some or all beneficiaries

- Initially, the purpose of the earnings test was to encourage individuals to stop working and start receiving benefits

- The earnings test has been modified many times
  - older beneficiaries have been excluded
  - the threshold earnings limit has been raised
  - the benefits clawback rate has been reduced

Today’s Earnings Test

- In 2019, the earnings test only applies to beneficiaries between age 62 and the FRA (66 and 6 months in 2019)
- Clawback rate is 50% on all earnings above the threshold limit
- Clawback rate falls to 33% in the year individuals reach the FRA and the annual earnings limit is much higher

Today's Earnings Test

- The high clawback rates discourage work
- Eliminating the earnings test should stimulate additional hours of work and increase the participation rate for individuals age 62 to FRA
- Magnitude of the increase in labor supply depends on the labor supply elasticity of covered individuals
- In general, the labor supply elasticity of older persons is relatively high

Is the Earning Test a True Tax?

- Workers who have benefits withheld due to the earnings test actually receive higher benefits in the future
- The present value of the increase in future benefits may actually exceed the benefits lost due to the earnings test
- We believe that many workers do not understand this future return and thus treat the earnings test as a tax and reduce labor supply
- A tax that is not a tax but confuses workers should be eliminated

Proposal 2. Paid-up Status for Social Security

- We propose that a paid-up status for Social Security should immediately be adopted
- The simplest criteria for such a proposal would be that once an individual reaches the FRA, they would no longer pay the OASDI payroll tax
- Individuals age 67 and older (as of 2022) and their employers would not be subject to payroll taxes

Proposal 2. Paid-up Status for Social Security

- Impact depends on who bears the burden of the employer portion of the payroll tax
- If employees bear both the employer and employee tax, our proposal would result in a 13.3% increase in take home pay
- This increase in the value of work would stimulate a substantial increase in labor hours and therefore higher earnings for older workers

Proposal 2. Paid-up Status for Social Security

- One could consider several variants of our proposal
    - Paid-up status after a worker achieves a specified number of years of coverage
    - Paid-up status results only in the worker not paying the payroll tax while the employer is still subject to the tax

Proposal 3. Paid-up Status for Medicare and Return Medicare to Primary Payer Status

- We propose a paid-up status for Medicare and a return to the policy of Medicare being the primary payer for all persons over the age of 65
- For Medicare, paid-up status would begin at age 65
- Workers over 65 would receive a 2.9% increase in earnings assuming that employees bear both components of the payroll tax
- Given labor supply elasticity of older workers, hours of work and earnings would increase

Proposal 3. Paid-up Status for Medicare and Return Medicare to Primary Payer Status

- The second component of our proposal should have a greater impact on the value of work
- Cost to employers of providing health insurance can range between 15% and 20% of payroll; if the higher cost of health insurance for older workers is considered, the employer cost would be even greater
- Most economists believe that workers bear the cost of employee benefits in the form of lower wages; the elimination of health insurance cost for older workers should result in higher pay

Evaluation of Our Proposals

- The benefits of our three proposals are clear:
  - Higher take-home pay to older workers
  - Increase in hours of work and annual income
- In evaluating these changes, one must also consider their cost
- We now provide some estimates of the cost of adopting each of our proposals

The Importance of the Labor Supply Elasticity

- Proposals 2 and 3 involve substantially increasing take home pay

- There is limited evidence on the labor supply elasticity of elderly Americans; what there is indicates labor supply elasticity of those 65+ is much higher than for prime age adults

- We evaluate our proposals with the labor supply elasticity set at 2.0 and 3.0

- Key references – Eric French (2005) and Hudomiet, Hurd, Rohwedder (2018)

Table 2. Labor Supply Elasticity for Ages after Permanent Wage Change

At Age 30	.03045
At Age 40	.24397
At Age 50	.54428
At Age 55	82345
At Age 60	1.4884
At Age 61	1.59665
At Age 62	1.83915
At Age 63	2.08358
At Age 64	2.31745
At Age 65	2.68932

Hudomiet, Hurd and Rohwedder (2018) get similarly high estimates for the labor supply elasticity of 70 year olds.

The results of Eric French's (2005) model suggest that the labor supply elasticity of those 65+ is more than 11X as great as for 40 year olds

Table 4. Cost to Employer vs. Take Home Pay for an Extra $100 of Earnings

Income Tax Rate	12%	12% & Paid Up	22%	22% & Paid Up
Cost to Employer	107.65	107.65	107.65	107.65
Less employer payroll tax	7.65	0	7.65	0
Incremental Earnings	100.00	107.65	100.00	107.65
Less Income Tax	12.00	12.92	22.00	23.68
Net Take Home Pay	80.35	94.73	70.35	83.97
Effective tax rate	25.4%	12%	34.6%	22%

Paid up for both Social Security & Medicare would raise take home pay by 18-19%

Table 5. Cost to Employer vs. Take Home Pay for an Extra $100 of Earnings with MPP and Paid Up

Income Tax Rate	12%	12% & Policies	22%	22% & Policies
Cost to Employer	127.65	127.65	127.65	127.65
Less payroll tax & health ins	27.65	0	27.65	0
Incremental Earnings	100.00	127.65	100.00	127.65
Less Income Tax	12.00	15.32	22.00	28.08
Net Take Home Pay	80.35	112.33	70.35	99.37
Effective tax rate	37.1%	12%	44.9%	22%

Policies 2 & 3 combined would raise take home pay by roughly 40%

Table 6 Net Cost of Paid Up and MPP per $100 of existing payroll of impacted employees

Labor Supply Elasticity	2.0	2.0	3.0	3.0
Income Tax Rate	0.12	0.22	0.12	0.22
Cost of Paid Up & MPP/$100 of existing Earnings	35.30	35.30	35.30	35.30
Extra Income Tax on Existing Hours	3.32	6.08	3.32	6.08
Percentage Increase in Take Home Pay	39.8	41.3	39.8	41.3
Total Increase in IRS Revenue	15.51	29.28	21.61	40.88
Net Cost to the Federal Government	9.79	6.02	13.69	(5.58)

In the case of a 22% tax rate, the increased IRS receipts offset between 83% and 116% of the cost of the proposals

Conclusion

- The pension/retirement crisis is partly due to trying to do the impossible – finance 30 year retirements with 40 year careers

- Only solution is to change the division of adult life between work and retirement

- Our three proposals
  - eliminate the earnings test
  - establish paid up status for Social Security
  - establish paid up status for Medicare and return Medicare to Primary Payer status

- We think these three policies would be a good start