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Executive Summary

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PERSISTENCE IN LABOR SUPPLY AND THE RESPONSE TO THE SOCIAL SECURITY EARNINGS TEST

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This paper investigates the impact on labor supply of changes in the Social Security earnings test in 1996 and 2000. Social Security beneficiaries who earn too much may suffer a reduction in their Social Security benefits. Beneficiaries between ages 62 and about 64 in 2005 lost \$1 in benefits for every \$2 in earnings above an annual threshold of \$12,000. Until the mid 1990s, beneficiaries between ages 65 and 69 faced an annual threshold that was higher by about 1/3, and a benefit reduction rate that was lower. Two pieces of subsequent legislation drastically altered the earnings test for this older group. 1996 legislation raised the threshold in stages from \$11,280 in 1995 to \$15,500 in 1999, with additional scheduled increases to \$17,000 in 2000, \$25,000 in 2001, and \$30,000 in 2002. A new law in 2000 eliminated the earnings test entirely above the Full Retirement Age (FRA), which is increasing gradually from 65 to 67.

We investigate how constraints on labor supply responses influenced the response to these recent changes. Various constraints may cause labor supply choices to be persistent over time. It is likely that there are fixed costs of changing jobs and even changing work hours within a job, as search, hiring, and training are costly to workers and employers. Such fixed costs will introduce inertia into labor supply decisions, with amplified effects for older workers who have shortened time horizons due to impending retirement.

For these reasons, we expect a much smaller immediate response to earnings test changes from people who are not working, given the difficulty of returning to the labor force. Even among those in jobs, we expect a muted impact early on. We expect to see a greater response as younger workers with time to adjust their plans age into the new rules. The persistence of labor supply choices can also cause changes in labor supply at other ages not directly affected by a change in the earnings test. Knowing that the earnings test now disappears at the FRA instead of at 70, people in their early 60s might postpone retirement in order to take advantage of the higher return from working in their late 60s. Similarly, people who are now induced to continue working in their late 60s may stay in the labor force into their 70s, while before they would not return to the labor force upon reaching 70.

The recent changes in earnings test rules offer an opportunity to investigate these issues. While other recent studies have found significant effects of the elimination of the earnings test in 2000, we argue that some effects are missed by ignoring 1996, and we focus on the importance of recognizing inertia in labor supply. We use data on labor supply transitions from the Current Population Survey to show that

conditioning on last year's labor force status is important in identifying responses to earnings test changes in the current year. We find major differences in how workers and non-workers responded to the recent changes, and that flows into full-time versus part-time work were altered as well. We also find suggestive evidence of increases in earnings in the range of the earnings distribution where the earnings test threshold lies. Manchester and Song (2006) found such results following 2000, and we find them after 1996 as well.

We then use regression methods to identify shifts in labor supply that coincide with and follow changes in earnings test parameters, as distinguished from aggregate labor supply patterns. We exploit variation in earnings test parameters experienced by cohorts at different ages and in different years. To do so, we include variables that reflect current and future earnings test thresholds at the current age and at age 62 (or age 65 in another set of estimates), with four parallel variables for earnings test dummies.

This approach identifies the presence of dynamic effects resulting from changes in earnings test parameters by comparing estimated effects on labor supply of only current earnings test parameters, compared with past and anticipated future parameters. We find that current values of earnings test parameters become less important when we include measures of future and past parameters. For example, one specification shows that a 10% increase in the present value of the future threshold values results in almost a half-percentage-point increase in employment at the current age, implying that the 1996 legislation raised employment by 1.8 percentage points when comparing the cohort reaching age 62 in 1995 versus 1996. We also use the estimates to simulate the elimination of the earnings test in 2000. In one set of results, employment is predicted to rise by around two percentage points at ages 66-69 and by 3.5 points at age 65 in 2000 due to the elimination of the earnings test, with further increases for the same cohorts of a percentage point in 2001 and over half a percentage point in 2002.

Future research should consider developing a rigorous model that incorporates the types of constraints that generate the persistence in labor supply choices that we have highlighted. Research in this vein has growing relevance in light of recent trends in retirement. Following decades of decline, the average retirement age stabilized in the 1980s at around 62 and has started to rise more recently. The delays in retirement mean that growing numbers of workers are confronting the earnings test, so interactions between the earnings test and constraints on labor supply are taking on importance.

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