



Statement before the Joint Economic Committee

Hearing on “How the Taxation of Labor and Transfer Payments Affect Growth and Employment”

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Vice Chairman Brady and Members of the Committee: Thank you for the opportunity to testify with regard to the effects of taxes and transfer payments on labor supply and the employment.

While taxes are designed to raise revenue for the government, tax policy can also have important effects on individuals' decisions to work. The behavioral impact of tax policy has been studied by economists for decades with an aim to minimizing the economic costs of raising a given level of revenues. However, relatively little attention has been given to how Social Security's taxes and benefits affect labor supply. While the program's effects are not large for individuals in their prime working years, Social Security tax and benefit rules present significant work disincentives for individuals considering delaying retirement. Altering these rules could increase labor supply and improve retirement security at little cost to the federal budget.

Social Security is the largest single domestic spending program of the federal government. Unlike most federal programs, it levies a dedicated tax on earnings and pays retirement, survivors and disability benefits in return. The 12.4 percent Social Security payroll tax on earned income is the largest tax paid by most Americans, and thus it has significant potential to affect their labor supply decisions. In exchange for their payroll taxes, individuals can become entitled to future benefit payments for themselves and eligible family members. The effect of Social Security taxes on labor supply cannot be analyzed in isolation from the benefits those taxes "purchase."

Social Security analysts think of these issues in terms of the "net tax rate," which is equal to the statutory 12.4 percent payroll tax rate net of the present value of any future benefits those taxes purchase. The present value of benefits is a function of the time until benefits will be paid, the expected duration of benefit receipt, the riskless rate of interest at which individuals might invest, and any risk premium individuals apply to Social Security benefits due to solvency or political risk.

If the benefits an individual becomes entitled to are equal to the taxes he pays, his net tax rate is zero. In such cases, the Social Security program should have relatively little effect on an individual's labor supply decisions. If an individual's net tax rate is negative, which can be the case for lower-earning individuals, then Social Security might encourage work. And if his net tax rate is positive, then labor supply is discouraged.

According to Social Security's actuaries, a middle income two-earner couple retiring in 2014 can expect to receive lifetime Social Security benefits equal to around 78 percent of the taxes they pay.¹ This implies that on a lifetime basis, around 78 percent of the Social Security payroll tax (or 9.7 percentage points) can be viewed as a "contribution" which will be repaid at retirement or disability, while the remaining 2.7 percentage points can be viewed as a "pure tax" for which no benefits will be received.

However, labor supply decisions are not generally made on a lifetime basis. Rather, at any given point in time an individual may decide whether and how much to participate in the labor force. Thus, what matters in terms of Social Security's impact on labor supply is what might be called the marginal net tax

¹ This figure is based upon current law scheduled benefits. Reform could alter these figures and, to close the program's financing gap, must necessarily reduce the ratio of total benefits received to taxes paid.

rate, that is, the benefits an individual receives in return for working and paying taxes over a given period of time, such as a year.

In general, the theory of optimal taxation states that taxes should be highest in circumstances in which individuals are least sensitive to the tax and lowest when individuals are most sensitive to tax rates. Following this rule will tend to minimize the harmful effects of taxation on work and the economy.

However, Social Security's treatment of older workers is precisely the opposite of what economic theory recommends. Social Security pays the lowest reward to work to older workers who are near to retirement. These individuals, research indicates, are among the *most* sensitive to tax rates, because they have the easiest option to leave the workforce and retire.

Social Security's benefit formula is roughly actuarially fair for individuals who choose to delay claiming benefits. For instance, imagine a person who leaves the labor force at age 62. He can claim retirement benefits at any age from 62 through 70. For each year he delays claiming benefits, his eventual monthly benefit rises by around 7 percent. Over the course of an average lifetime, total benefits are about the same if you claim at age 62, 70 or any age in between.

However, Social Security is *not* actuarially fair with regard to individuals who delay claiming and remain in the workforce. Most near-retirees who extend their work lives receive little or no additional benefits for any extra taxes they pay. Thus, their net tax rate is very close to the statutory rate of 12.4 percent and therefore discourages labor supply at older ages.

There are three reasons for this. First, Social Security benefits are based upon an individual's highest 35 years of earnings. An additional year of work, particularly if it is part-time, is unlikely to boost benefits. Second, most female retirees receive a spousal benefit based upon their husbands' earnings. Any additional taxes they pay are unlikely to lead to higher benefits. Third, once individuals reach the full retirement age they are ineligible for Social Security disability benefits, but must nevertheless continue to pay the 1.8 percent disability payroll tax.

In a 2009 research paper with David Weaver and Gayle Reznik of the Social Security Administration, I found that for each dollar of additional taxes a near-retiree pays into Social Security, he or she receives only around 2.5 cents in extra lifetime benefits.² Simply put, Social Security provides almost no incentive to keep working.

This would not be of major policy importance if near-retirees were not so sensitive to tax rates. A middle-aged worker with a family to support will likely continue working even in the presence of high implicit tax rates, but once he or she reaches age 62 the option to retire becomes more attractive. Moreover, most retirees receive pension and Social Security benefits, which can increase the marginal income tax rates they pay on earned income. Economic research finds that older Americans are significantly more sensitive to after-tax rewards to work than younger workers.

² Reznik, Gayle, Weaver, David A. and Biggs, Andrew G. "Social Security and Marginal Returns to Work Near Retirement." Social Security Administration. Issue Paper No. 2009-02. April 15, 2009.

In a 2009 study that relied on differences in state income tax rates, Lucie Schmidt of Williams College and Purvi Sevak of Hunter College found that a 10 percent increase in after-tax earnings would increase labor force participation by 7.5 percent among men and 11.4 percent among women.³ These estimated labor supply elasticities are 2 to 5 times higher than the Congressional Budget Office assumes for the working-age population.⁴ In forthcoming research, John Laitner and Dan Silverman of the University of Michigan find that eliminating the payroll tax at age 59 would cause individuals to delay retirement by an average of 1.1 years.⁵ And in a 2005 study, Eric French of the Federal Reserve Bank of Chicago found that a 10 percent increase in wages as of age 62 would dramatically increase work by seniors, sufficient to boost overall labor supply by 1.1 percent.⁶

I have proposed reducing or even eliminating the Social Security payroll tax for older workers as an incentive to remain in the workforce. Doing so would lower Social Security tax revenues, but increased labor supply from older workers would increase other revenues, such as for federal income taxes, Medicare payroll taxes, or state income taxes.

Using the Policy Simulation Group's Social Security models, I estimate that eliminating the payroll tax for workers over age 62 would reduce annual Social Security revenues by roughly 2.2 percent, or about \$16.2 billion in terms of 2012 tax collections. Using French's parameters, eliminating the payroll tax at age 62 would increase overall labor supply by around 1.4 percent.⁷ The offsetting increases in non-Social Security revenues depend upon tax rates paid by older workers. The average 62-year old working full time in 2010 earned around \$58,800⁸, implying a federal income tax rate of about 15 percent. Adding the 2.9 percent Medicare payroll tax and a 4.4 percent average state income tax rate,⁹ total non-Social Security revenues would rise by around \$18.3 billion, of which the federal government would collect about \$14.7 billion.

These figures are approximate, but higher non-Social Security revenues could at a minimum compensate for much of Social Security's revenues lost to a payroll tax cut. As part of a Social Security reform package, transfers of general tax revenue could compensate Social Security for losses in payroll tax revenue, thereby making the payroll tax cut neutral with regard to Social Security's solvency.

While eliminating the payroll tax for older workers would come at little cost to the budget, the gains to individuals and the economy could be substantial. Simply working one additional year would boost

³ Lucie Schmidt and Purvi Sevak. "Taxes, Wages, and the Labor Supply of Older Americans." *Research on Aging*, March 2009; vol. 31, 2: pp. 207-232. <http://roa.sagepub.com/content/31/2/207.abstract>

⁴ Congressional Budget Office. "Labor Supply and Taxes." January 1996.

⁵ *Journal of Public Economics*, forthcoming.

⁶ Eric French. "The Effects of Health, Wealth, and Wages on Labor Supply and Retirement Behavior." *Review of Economic Studies*, April 2005, 72(2), 395-427.

⁷ Eliminating the payroll tax would raise wages by around 13.3 percent (106.2/93.8), times a labor supply elasticity of 0.1067=1.41%.

⁸ Source: American Community Survey.

⁹ See <http://www.nber.org/~taxsim/state-marginal/avrate.html>

average private pension income by almost 5 percent.¹⁰ This would reduce poverty in old age and contribute to overall retirement income security.

Labor force participation among older Americans has ticked upward as near-retirees seek to rebuild their 401(k)s. This demonstrates that, even in a very challenging employment environment, highly motivated individuals can often find positions. But overall, Americans today still retire several years earlier than in prior decades, despite less strenuous jobs and significantly longer life spans. The typical American will spend one-third of his adult life in retirement, financed by entitlement programs that cannot bear the strain. Social Security's poor returns to older workers discourage delayed retirement, which would strengthen the economy and is the single option available to many individuals who reach retirement age with insufficient resources. Policy options such as lowering the payroll tax rate on older workers could increase labor supply, boost the economy and raise retirement incomes.

¹⁰ Author's calculations using Policy Simulation Group models.