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Misperceptions of the Social Security Earnings Test and the Actuarial Adjustment: Implications for Labor Force Participation and Earnings

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Key Findings and Policy Implications

This paper analyzes the earnings distribution of workers affected by the Social Security Earnings Test, and why there is disproportionate "bunching" of earnings just below the level of the earnings exemption. The study uses IRS earnings data for 53 million people between ages 60 and 64, born between 1939 and 1953. The paper finds that:

- Confirming results from other studies, the earning distribution of workers affected by the Social Security Earnings Test exhibits substantial left bunch just below the exempt amount. Left bunching is particularly pronounced among those whose earnings just prior to retirement age were substantially above the exempt amount.

- One explanation for left bunching is that the underlying distribution of earnings is downward sloping, thus creating more mass to the left than to the right of any point on the earnings distribution. While relevant to the Earnings Test, this explanation is unlikely to explain the magnitude of left bunching that is observed.

- Left bunching may also be explained by workers misperceiving the incentives of the Earnings Test. For example, they may misperceive the Earnings Test as applying to infra-marginal earnings below the exempt amount, as well as above it, thereby creating a "notch" as opposed to a "kink" in the incentive structure. They may also be unaware, or otherwise misperceive, the readjustment in Social Security benefits that happens later, when they reach normal retirement age. The study finds that misperceptions of incentives explain the disproportionate left bunching well.

Social Security policy increases the benefit rate of early claimants at the normal retirement age by five-ninths of one percent for every month in which the Earnings Test was applied. Since this adjustment is roughly actuarially fair, on average, it significantly dulls the incentive to bunch or reduce earnings more generally. Thus, the impact of worker misperceptions about Social Security incentives may be costly.

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