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Budget Summit Issue:

SHOULD 85 PERCENT OF SOCIAL SECURITY BENEFITS BE TAXED?

"The budget package may contain $54 billion in new taxes on Social Security benefits."

Current Law. The elderly pay income taxes on up to one-half of their Social Security benefits if their total income exceeds $25,000 (individual) or $32,000 (couples). They pay taxes on 50 cents of benefits for each $1 of income above these income thresholds.

Proposed Change. House Budget Committee Chairman Leon Panetta (D-CA) is among those considering a proposal to tax up to 85 percent of benefits and lower the income thresholds from $25,000 to $12,000 for individuals and from $32,000 to $18,000 for couples. Panetta says this change would increase federal revenue by $3.1 billion in the first year and by $54 billion over five years.[1] Similar proposals have long been favored by the Brookings Institution and are routinely listed as a budget option by the Congressional Budget Office (CBO).

Importance of the Proposal. In budget negotiations between President Bush and Congressional leaders, reform of entitlements programs will be part of the final package. So will tax increases. Some Democratic leaders appear to favor subjecting more Social Security benefits to the income tax.[2] [See *Wall Street Journal* enclosure.]

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How the Social Security Benefit Tax Works. Suppose an elderly couple receives $12,000 in Social Security benefits and $20,000 in other taxable income.[3] Since the couple's *total* income (including benefits) is $32,000, the income tax applies *only* to the $20,000 of ordinary taxable income. If they earn $1 more, however, the income tax applies to that $1 *plus* 50 cents of Social Security benefits. If they earn $12,000 of additional income, $6,000 (one-half of their Social Security benefits) is taxed.

"The Social Security benefit tax is really a tax on other income."

Why the Tax is Really a Tax on Income. The Social Security benefit tax usually is described as a tax on *benefits*. In fact, it is a tax on other *income*. No tax is paid unless a taxpayer's income reaches a certain level. Beyond that point, the tax rises as income rises. [See sidebar on calculating the tax.] Since 50 cents of benefits is taxed for each additional $1 of income, when elderly taxpayers earn $1 they pay taxes on $1.50. The effective tax rate on income is 50 percent higher than otherwise.

"Tax rates for elderly savers are 50 percent higher than for younger people."

Tax Rates on Elderly Income from Savings: 23 and 42 percent. About 60 percent of the income of elderly taxpayers comes from investments (including pensions).[4] For younger people, the tax rates on investment income are 15 percent and 28 percent. Yet, because of the Social Security benefit tax, the rates for the elderly on income from savings can be 50 percent higher:[5]

- Elderly taxpayers in the 15 percent income tax bracket pay an effective rate of 22.5 percent (15% x 1.5).
- Elderly taxpayers in the 28 percent tax bracket pay an effective rate of 42 percent (28% x 1.5).

HOW THE SOCIAL SECURITY BENEFIT TAX AFFECTS MARGINAL TAX RATES ON INCOME FROM SAVINGS

Income Tax Bracket	Social Security Benefit Tax	Total Tax
15%	7.5%	23%
28%	14.0%	42%

"With all special taxes, an elderly wage earner can face an 80 percent tax rate."

Tax Rates on Elderly Wages: 62 and 80 Percent. When the Social Security FICA tax (7.65 percent) is added to the income tax rates of 15 and 28 percent, marginal tax rates for younger workers are 23 and 36 percent. For the elderly who earn more than $9,360 in wages, there is an additional penalty. They lose $1 of Social Security benefits for each additional $3 of earnings. The Social Security earnings penalty is a 33 percent tax. When this penalty is combined with the Social Security benefit tax, the total tax rate on earnings can reach 80 percent.

MARGINAL TAX RATES ON THE WAGES OF ELDERLY WORKERS[1]

Tax	15% Bracket	28% Bracket
Income Tax	15.00%	28.00%
FICA Tax	7.65%	7.65%
Social Security Earnings Penalty	33.33%	33.33%
Social Security Benefit Tax[2]	5.62%	10.50%
Total	61.76%	79.48%

[1]Workers are assumed to be below the caps on the FICA tax, the Social Security benefit tax and the Social Security earnings penalty (which becomes zero once all benefits are lost).

[2]The Social Security benefit tax rate is lower in this case because of the loss of benefits due to the earnings penalty.

"The Social Security benefit tax applies even to tax-exempt income and COLA increases."

The Long Reach of the Social Security Benefit Tax. Because of the way income tax returns are organized and printed, many elderly taxpayers do not realize that the Social Security benefit tax actually taxes income. Many also are unaware of how far-reaching it is. The Social Security benefit tax reaches capital gains income, tax-exempt income and Social Security COLA increases. [See sidebar on calculating the tax.] And, because many states accept the federal definition of taxable income, the tax also increases some state and local income tax rates by 50 percent.[6]

HIGHEST MARGINAL TAX RATE ON INCOME

Type of Income	Elderly	Nonelderly[1]
Wages and Salaries:		
With Earnings Penalty	**80%**	**36%**
Without Earnings Penalty	**50%**	**36%**
Withdrawals from Pensions, IRAs, etc.	**42%**	**33%**
Capital Gains	**42%**	**28%**
Other Investment Income	**42%**	**33%**
Tax-Exempt Income	**14%**	**0**
Entitlement COLA Increases	**7%**	**0**

[1]Not receiving Social Security benefits.

"The middle-income elderly pay the highest tax rates in the nation."

The Highest Rates are Paid by the Middle-Income Elderly. Once a taxpayer reaches an income level at which fully one-half of Social Security benefits are taxed (about $30,000 of other income for an individual and about $40,000 for a couple), additional income is taxed at ordinary tax rates. The wealthy elderly, who face a marginal tax rate of 28 percent, are made worse off by the Social Security benefit tax. But the tax does not affect their economic decisions. The middle-income elderly, on the other hand, are affected directly. High marginal tax rates affect their decisions to work additional hours, sell assets and realize other types of income.

Why the Social Security Benefit Tax also Taxes the Young. Congress created a special tax status for employer-provided pensions, IRAs, 401(k)s, Keoghs and SEP plans to encourage retirement savings. The law allows people to avoid taxes now and defer them until their retirement years on the theory that tax rates will be lower for most people after they retire. That theory is no longer true.[7]

- The average U.S. worker is in the 15 percent income tax bracket today.

- Yet because of economic growth and because of the Social Security benefit tax, many of these workers will pay a 42 percent tax rate on their retirement income.

"The Social Security benefit tax also is a tax on the pensions and IRAs of young people."

The proposal to tax 85 percent of Social Security benefits is not merely a proposal to tax the elderly. If enacted, it would imme-

CALCULATING THE SOCIAL SECURITY BENEFIT TAX FOR AN INDIVIDUAL

Combine:	**WAGES**
	+
	INVESTMENT INCOME
	+
	TAX EXEMPT INCOME
	=
	NON-SOCIAL SECURITY INCOME
	+
Add:	**1/2 SOCIAL SECURITY BENEFITS (including COLA increase)**
	-
Subtract:[1]	**$25,000**
	÷
Divide:	**2**
Taxable Benefits:[2]	**TOTAL**

[1]No tax is payable unless the total exceeds $25,000.

[2]Treated as taxable income subject to ordinary income tax rates. Maximum taxable benefits are equal to one-half of Social Security benefits.

diately decrease the aftertax value of the pension plans of the vast majority of American workers.[8]

How the Proposal Would Affect Tax Rates for the Middle-Income Elderly. The proposal to tax 85 percent of benefits would (1) expand the number of elderly people who are subject to the Social Security benefit tax and (2) increase the range of income subject to the very high marginal tax rates.

"The proportion of people who pay the tax would jump from 20 percent to more than 50 percent of all elderly taxpayers."

Currently, about 38 percent of elderly families do not pay any income tax.[9] Among those who do, only one in five has enough income to be subject to the Social Security benefit tax.[10] Under the Panetta proposal, however, the *majority* of elderly taxpayers would be subject to the tax. And, because the income thresholds are not indexed, the effects of inflation alone would increase the percentage of people paying the tax over time.

If the current income threshold is retained, the proposal to tax 85 percent of benefits would substantially increase marginal tax rates for the moderate-income elderly. [See first graphic.] If the income threshold is lowered, the effects would be even more regressive. [See second graphic.] Many low-income elderly taxpayers would pay *twice* as much in total taxes as they now pay.

Economic Effects of the Proposal: Short-Term Revenue Gains, Long-Term Revenue Losses. The Social Security benefit tax currently adds about $4.6 billion to federal revenue. Over the long-run, however, the tax actually reduces federal revenue. Because the tax applies to the tax-deferred savings of young people, it reduces their aftertax return and makes them less willing to save. Because it discourages saving and investment it reduces economic growth. In a study last year for the National Center for Policy Analysis, former U.S. Treasury economists Aldona and Gary Robbins found that:[11]

"In the long run, the Social Security benefit tax reduces federal revenue and increases the deficit."

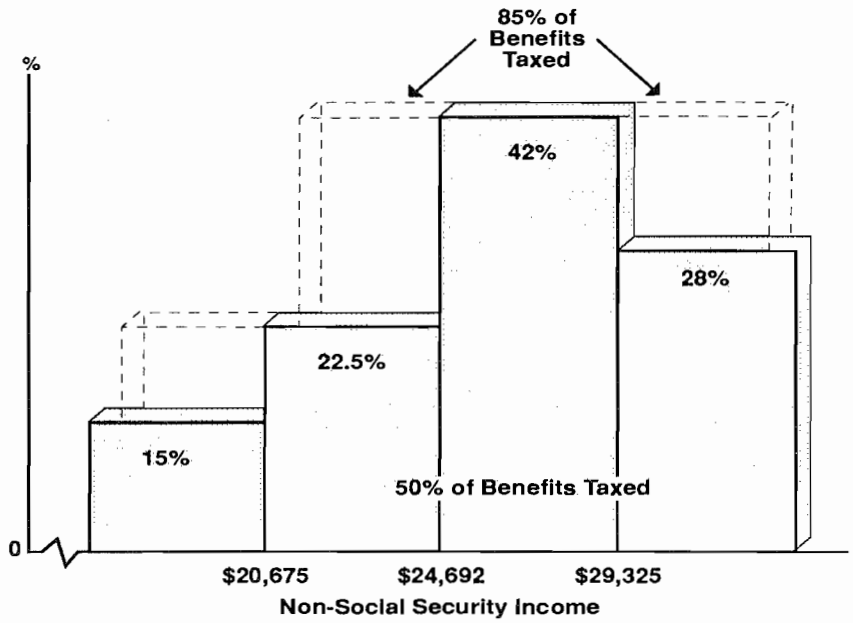
- In the year 2000, the Social Security benefit tax will cause an $84.4 billion reduction in our GNP.
- At that time, annual total federal revenue will be $10 billion lower because of the tax.

The proposal to subject 85 percent of benefits to taxation would have an even greater negative impact. Even if the income thresholds were not lowered, the NCPA study shows that by the year 2000 total federal receipts would drop by $14 billion per year.[12]

MARGINAL TAX RATES ON INCOME FROM SAVINGS FOR AN ELDERLY INDIVIDUAL

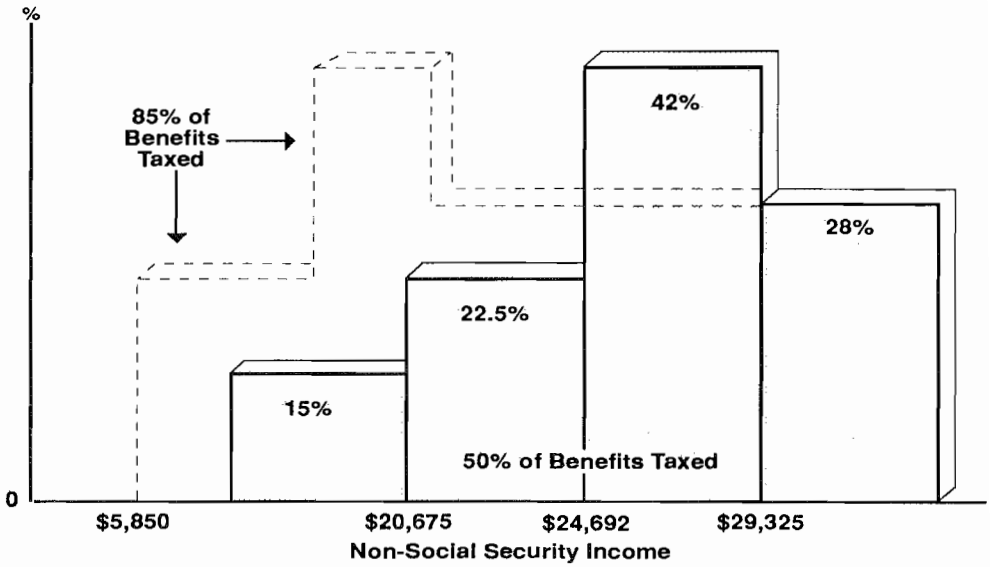
"The proposal would impose higher marginal tax rates on moderate-income elderly families."

Current Income Thresholds[1]



"With a lower income threshold, the total tax payments of the low-income elderly would double."

Lower Income Thresholds[1]



[1]Assumes $8,650 of Social Security benefits. The Social Security benefit tax applies when Social Security benefits plus all other income reach $25,000 (top graph) or $12,000 (bottom graph).

"The value of tax-deferred savings would be greatly reduced for the vast majority of American workers."

Why the Proposal is Inconsistent with President Bush's Goal of Creating Incentives to Save and Invest. The Social Security benefit tax has already greatly diminished incentives for young workers to save. To partially correct the problem, the Bush Administration has proposed Family Savings Accounts (FSAs) in which the timing of taxation would be reversed.[13] Deposits would be made with aftertax funds (at a time in the worker's life when tax rates are relatively lower) and withdrawals (when tax rates are higher) would be tax free. In terms of the amount that could be deposited and restrictions on who could make deposits, however, Bush's proposal would do little to repair the damage that would be caused by taxing 85 percent of benefits.

Is There a Better Way? Yes. The argument for taxing Social Security benefits is that the beneficiaries paid for only a small portion of their benefits through payroll taxes.[14] If the argument is accepted, it is reasonable to include a portion of Social Security benefits in their ordinary income, taxable at rates of 15 and 28 percent. The elderly would face the same marginal tax rates as younger taxpayers. Exemptions could be raised to prevent undue hardship for the low-income elderly without increasing marginal tax *rates*.

John C. Goodman
President
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FOOTNOTES

[1]The Congressional Budget Office predicts that taxing 85 percent of benefits without lowering the income thresholds would produce $1.1 billion in revenue the first year and $20 billion over five years.

[2]A three-month suspension of Social Security cost-of-living-adjustments (COLAs) also is being considered. Panetta predicts this will save $3 billion in the first year and $17 billion over five years.

[3]After adjusting for personal exemptions and deductions.

[4]See Aldona Robbins and Gary Robbins, "Elderly Taxpayers and the Capital Gains Debate," National Center for Policy Analysis, NCPA Policy Report No. 153, July 1990.

[5]Assumes taxpayer is below the maximum Social Security benefit tax.

[6]Currently, twelve states tax Social Security benefits: Colorado, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, North Dakota, Rhode Island, Vermont, West Virginia and Wisconsin. See John R. Gist, "The Effects of State Income Tax Reform," American Association of Retired People (AARP), Public Policy Institute, Issue Paper No. 8801, April 1988.

[7]Aldona Robbins and Gary Robbins, "Taxing the Savings of Elderly Americans," National Center for Policy Analysis, NCPA Policy Report No. 141, September 1989.

[8] In the year 2010, when the *average* Social Security benefit for a couple will be $36,000, these high marginal tax rates would apply to as much as $62,000 of other income. As a result, most of today's workers would pay these high tax rates on most of their income after retirement.

[9]See U.S. Department of the Treasury, *Financing Health and Long-Term Care: Report to the President and Congress*, Washington, DC, March 1990, Table 4.1.

[10]See Aldona Robbins, *The ABCs of Social Security* (Washington, DC: Institute for Research on the Economics of Taxation, 1988), p. 16.

[11]Robbins and Robbins, "Taxing the Savings of Elderly Americans," Table XVI. Amounts are in current dollars.

[12]Ibid. Amounts are in current dollars.

[13]For an analysis of the Bush proposal, see Aldona Robbins and Gary Robbins, "The Bush Savings Plan," National Center for Policy Analysis, NCPA Policy Report No. 152, June 1990.

[14]Note, however, that today's young people will pay more in Social Security taxes than they will ever receive in benefits. No one has suggested that the proposal would be a temporary measure aimed only at the current generation of retirees. The proposal, once adopted, would surely become a permanent feature of the tax code.

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ABOUT THE NCPA

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute, funded exclusively by private contributions. The NCPA originated the concept of the Medical IRA (which has bipartisan support in Congress) and merit pay for school districts (adopted in South Carolina and Texas). Many credit NCPA studies of the Medicare surtax as the main factor leading to the the 1989 repeal of the Medicare Catastrophic Coverage Act.

NCPA forecasts show that repeal of the Social Security earnings test would cause no loss of federal revenue, a capital gains tax cut would increase federal revenue, and the federal government gets virtually all the money back from the current child care tax credit. These forecasts are an alternative to the forecasts of the Congressional Budget Office and the Joint Committee on Taxation and are frequently used by Republicans and Democrats in Congress. The NCPA also has produced a first-of-its-kind, pro-free-enterprise health care task force report, representing the views of 40 representatives of think tanks and research institutes.

The NCPA is the source of numerous discoveries that have been reported in the national news. The NCPA discovered that:

- Blacks and other minorities are severely disadvantaged under Social Security, Medicare and other age-based entitlement programs;
- Special taxes on the elderly have destroyed the value of tax-deferred savings (IRAs, employee pensions, etc.) for a large portion of young workers; and
- Man-made food additives, pesticides and airborne pollutants are much less of a health risk than carcinogens that exist naturally in our environment.

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Industry Week