POLICY BACKGROUNDER No. 126
For people with limited time and a need to know.

For Immediate Release
June 10, 1993

Federal Budget Issue:

Should 85 Percent of Social Security Benefits Be Taxed?

"Although it's called a tax on benefits, it's really a tax on elderly wages and income from savings."

President Clinton proposes to increase the tax on Social Security benefits. Although the administration calls this an "entitlement spending reduction," what it proposes is a tax that will fall primarily on elderly investment income. The remainder of the burden will fall on the wages of elderly workers. If passed into law, the proposal would cause marginal tax rates faced by the middle-income elderly to reach a record high, resulting in less capital and labor, a slower rate of economic growth and a lower income for all Americans.

Current Law. The elderly pay income taxes on up to one-half of their Social Security benefits if their total income (including one-half of their benefits) 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. President Clinton proposes to tax up to 85 percent of Social Security benefits. Above the income thresholds, the elderly would pay taxes on 85 cents of benefits for each additional $1 of income. The administration says this change would increase federal revenue by $23 billion over five years.[1] Proposals to increase taxation of Social Security benefits have long been favored by Budget Director Leon Panetta and by the Brookings Institution and are routinely listed as a budget option by the Congressional Budget Office (CBO).

"Under a complex formula, the Social Security benefit tax reaches even tax-exempt income."

Calculating Taxable Social Security Benefits for a Couple

Combine:	**WAGES**
	+
	INVESTMENT INCOME
	+
	TAX EXEMPT INCOME
	=
	NON-SOCIAL SECURITY INCOME
Add:	**1/2 SOCIAL SECURITY BENEFITS**
	-
Subtract:[1]	**$32,000**
	x
Multiply difference by:	**0.50 (current law)**
	0.85 (Clinton plan)
Taxable Benefits:[2]	**TOTAL**

[1] No tax is payable unless the total exceeds $32,000.

[2] Treated as taxable income subject to ordinary income tax rates. Maximum taxable benefits are equal to one-half of Social Security benefits (current law) or 85 percent (Clinton plan).

How the Social Security Benefit Tax Works. The federal government uses a complex formula to determine how much of Social Security benefits is taxable. [See the sidebar on calculating taxable benefits.] Here is an example of how the formula works: Suppose an elderly couple receives $12,000 in Social Security benefits and $26,000 in other income. Since the total amount of income as measured by the formula — $26,000 plus one-half of the benefits ($6,000) — is $32,000, the income tax applies only to the $26,000 in non-Social Security 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, an additional $6,000 (one-half of their Social Security benefits) is taxed.

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. 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.

Current 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).[2] For most 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.[3] [See Table I.]

- 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).

"When the elderly earn an extra $1 they would pay taxes on $1.85."

TABLE I

How the Social Security Benefit Tax Affects Marginal Tax Rates on Income from Savings

(Current Law)

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

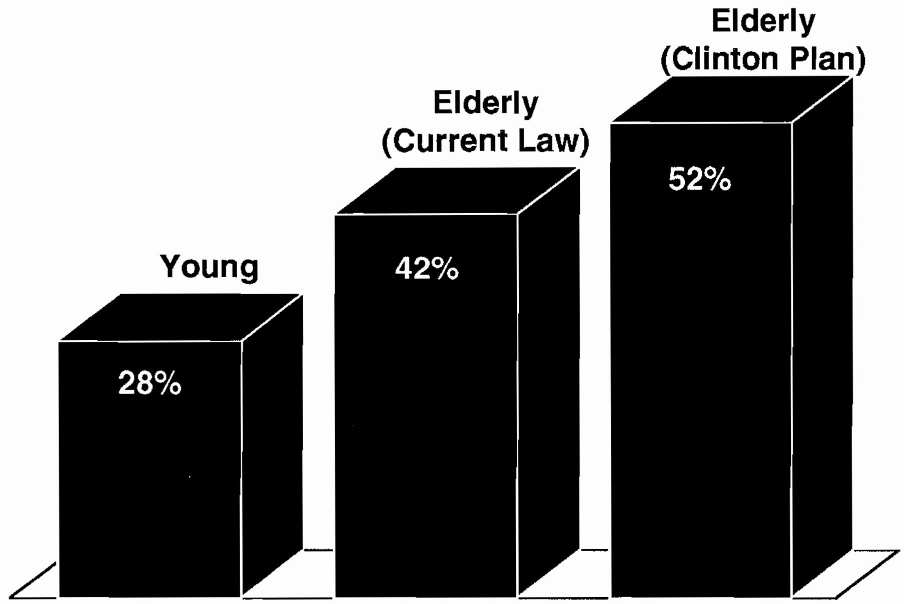
(Clinton Proposal)

Income Tax Bracket	Social Security Benefit Tax	Total Tax
15%	12.8%	27.8%
28%	23.8%	51.8%

"Tax rates for elderly savers would be up to 85 percent higher than those for most younger people."

FIGURE I

Marginal Tax Rates for Savers[1]
(28 percent income tax bracket)



[1] Assumes that adjusted gross income for elderly families is more than $32,000 but that they include less than the maximum amount of Social Security benefits subject to tax.

The President's Proposal: Raise the Rates on Savings to 27.8 and 51.8 Percent. Under President Clinton's proposal, the elderly would pay taxes on up to 85 percent of their Social Security benefits. Thus, to the extent that they exceed the income threshold, they would pay taxes on $1.85 for each additional $1.00 of income. As a result, the tax rates for the elderly on income from savings would be up to 85 percent higher than those for most younger people. [See Figure I.]

- Elderly taxpayers in the 15 percent income tax bracket would pay an effective rate of 27.8 percent (15% x 1.85).
- Elderly taxpayers in the 28 percent tax bracket would pay an effective rate of 51.8 percent (28% x 1.85).

Current Tax Rates on Elderly Wages: As High as 96 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.[4] For the elderly between 65 and 70 who earn more than $10,560 there is an additional penalty. They lose $1 of Social Security benefits for each additional $3 of wages. For those under age 65, the penalty is even more severe: if they earn more than $7,680 in wages, they lose $1 of benefits for each additional $2 of earnings. Add these penalties to the FICA tax, the income tax and the Social Security benefit tax, and the results are as shown in Table II:

- Under current law, the marginal tax rate on wage income for someone between the ages of 65 and 70 can reach 80.65 percent.
- For a worker between the ages of 62 and 65, the marginal rate is as high as 96 percent.
- Thus elderly workers can face a tax rate almost three times as high as the rate faced by a younger worker earning identical income. [See Figure II.]

The President's Proposal: Raise the Tax Rates on Wages as High as 104 Percent. The president's proposal would make the tax rates on wage income for elderly workers even higher. As Table III shows:

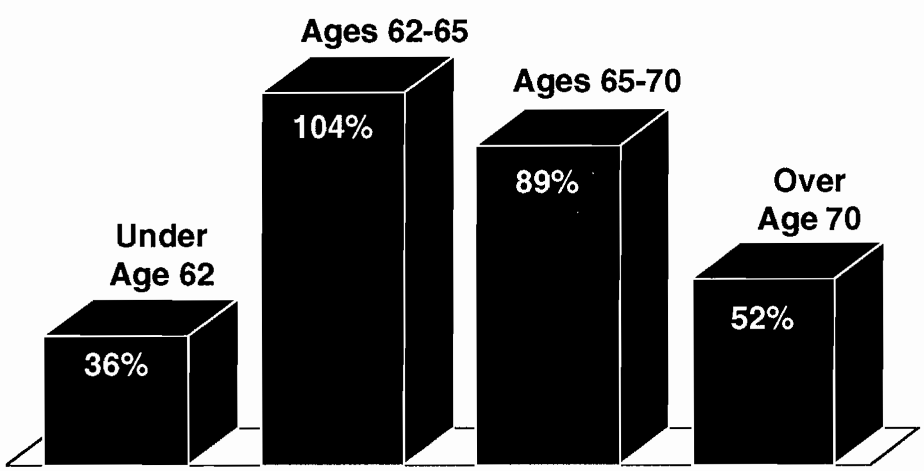
- Workers between 65 and 70 years of age would face a marginal tax rate as high as 88.81 percent.
- For workers between the ages of 62 and 65, the marginal rate could be as high as 103.5 percent.
- This means that workers could pay as much as $1.04 in taxes when they earn an additional $1.00 of income.

"Elderly workers would have to pay as much as $1.04 in taxes when they earn an additional $1.00 of income."

FIGURE II

Marginal Tax Rates on Wages under the Clinton Plan[1]

(28 percent income tax bracket)



[1] Assumes workers age 62 or older are receiving Social Security benefits, are in the 28 percent federal income tax bracket and are 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).

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

TABLE II

Current Marginal Tax Rates on the Wages of Elderly Workers[1]

Ages 65-70

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]	6.25%	11.67%
Total Federal Tax	62.23%	80.65%

Ages 62-64

Tax	15% Bracket	28% Bracket
Income Tax	15.00%	28.00%
FICA Tax	7.65%	7.65%
Social Security Earnings Penalty	50.00%	50.00%
Social Security Benefit Tax[2]	5.63%	10.50%
Total Federal Tax	78.28%	96.15%

[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 than the rate shown in Table I because of the loss of benefits due to the earnings penalty.

"Under the Clinton plan, the elderly would face the highest tax rates ever imposed on the American people."

TABLE III

Marginal Tax Rates on the Wages of Elderly Workers under the Clinton Plan[1]

Ages 65-70

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]	10.63%	19.83%
Total Federal Tax	66.61%	88.81%

Ages 62-64

Tax	15% Bracket	28% Bracket
Income Tax	15.00%	28.00%
FICA Tax	7.65%	7.65%
Social Security Earnings Penalty	50.00%	50.00%
Social Security Benefit Tax[2]	9.56%	17.85%
Total Federal Tax	82.21%	103.50%

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 than the rate shown in Table I because of the loss of benefits due to the earnings penalty.

"A self-employed worker in North Dakota could face a 130 percent tax rate."

Rates for Some Elderly Workers Could Go Still Higher. The tax rates shown in Table III and Figure II are by no means the worst cases. For some workers the rates will be even higher. For example:

- If workers face a state and local income tax rate of 5 percent, the highest marginal tax rate on wages could climb to 112.75 percent.

- For workers who are self-employed — and thus are paying a 15.3 percent FICA (Social Security payroll) tax — the marginal rate could climb to 120.4 percent.

- Elderly workers who are self-employed and living in Montana [see Table IV] could face a 130 percent marginal tax rate.[5]

The Long Reach of the Social Security Benefit Tax. Because of the way income tax returns are organized, 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 Table V]. And because many states accept the federal definition of taxable income, it increases some state and local income tax rates by 50 percent.[6] Under the Clinton plan:

- Capital gains income would be subject to the 52 percent top rate for persons receiving Social Security benefits versus 28 percent for others.
- Tax-exempt income could be taxed at a rate of 24 percent versus a zero rate for younger taxpayers.
- Social Security cost-of-living adjustments (COLA) increases would be taxed at a rate as high as 12 percent.
- And state and local income taxes could be increased as much as 9 percentage points.

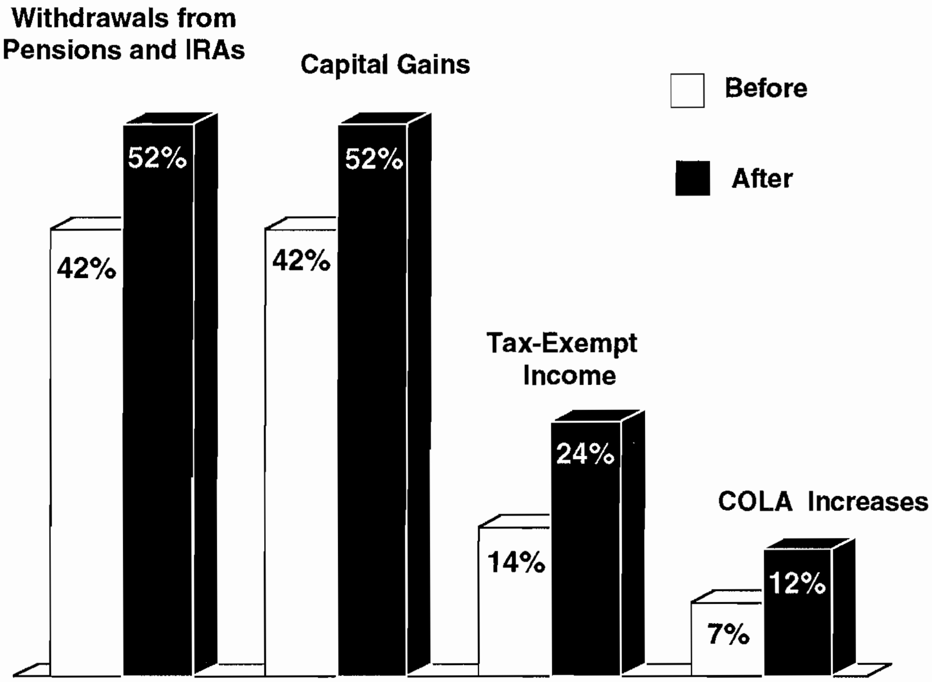
Moreover, the tax rates on these other sources of income would be considerably higher than under current law. [See Figure III.] For example:

- Under the Clinton plan, there would be a 24 percent increase in the top marginal tax rate applied to capital gains, withdrawals from pensions and IRAs and other investment income.
- There would be a 71 percent increase in the top marginal tax rate imposed on tax-exempt income and entitlement COLA increases.

The Highest Rates Are Paid by the Middle-Income Elderly. A cornerstone of Bill Clinton's election campaign was tax fairness, and the concept of a fair tax burden is being used to promote the Clinton economic

FIGURE III

What the Clinton Plan Does to Other Marginal Tax Rates of the Middle-Income Elderly[1]



[1] Taxpayer is assumed to be in the 28 percent income tax bracket, receiving Social Security benefits and below the cap on the Social Security benefit tax.

"Tax-exempt income is taxed at a marginal rate of 14 percent now, and that would increase to 24 percent under the Clinton proposal."

package as well. But the Social Security benefit tax increase is anything but fair. If this proposal becomes law, elderly families with incomes between $40,000 and $60,000 could be required to pay several thousand dollars in additional taxes. Since the purpose of the proposal is to reduce the deficit (see the analysis below), why single out the middle-income elderly to shoulder more than their fair share of the load?

Moreover, the higher marginal tax rates would affect the incentives of middle-income families, not of the wealthy elderly. Once a taxpayer reaches an income level at which fully 85 percent of Social Security benefits are taxed (about $30,000 of other income for an individual and about $42,000 for a couple), additional income is taxed at ordinary tax rates.[7] The wealthy elderly, who face a marginal tax rate of 31 percent, 36 percent or even 39.2 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, invest in or sell assets and realize other types of income.

"In addition to the heavy federal tax, 15 states tax Social Security benefits."

TABLE IV

State Taxes on Social Security Benefits

State	Top Marginal Rate	Income Level[1]
Colorado	5.00%	All income levels
Connecticut	4.50%	All income levels
Iowa	9.98%	Over $47,700
Kansas	7.75%	Over $30,000 (s)
	6.45%	Over $60,000 (m)
Minnesota	8.50%	Over $47,110 (s)
		Over $83,300 (m)
Missouri	6.00%	Over $9,000
Montana	11.25%	Over $59,400
Nebraska	6.92%	Over $27,000 (s)
		Over $45,000 (m)
New Mexico	8.50%	Over $41,600 (s)
		Over $64,000(m)
North Dakota	14.00%[2]	All income levels with the short form.
	12.00%	Over $50,000 with the long form.
Rhode Island[3]	—	
Utah	7.20%	Over $3,750 (s)
		Over $7,500 (m)
Vermont[4]	—	
West Virginia	6.50%	Over $60,000
Wisconsin	6.93%	Over $15,000 (s)
		Over $20,000 (m)

[1] S is single and m is married, filing jointly.

[2] As an option any taxpayer may pay 14 percent of federal income tax liability.

[3] Tax is based on federal income tax liability. For taxpayers with federal income tax liability greater than $15,000, the tax equals 32 percent times the amount of federal income tax liability greater than $15,000.

[4] Tax is based on federal income tax liability. The tax equals 34 percent of federal income tax liability exceeding $13,100.

Source: David Baer, American Association of Retired Persons, Public Policy Institute.

TABLE V

Highest Marginal Tax Rates on Income under the Clinton Plan[1]

Type of Income	Elderly[2]	Nonelderly[3]
Wages and Salaries	104%	46%
Withdrawals from Pensions, IRAs, etc.	52%	45%
Capital Gains	52%	28%
Other Investment Income	52%	45%
Tax-Exempt Income	24%	0
Entitlement COLA Increases	12%	0

[1] Ignores state and local taxes and higher FICA taxes for the self-employed.

[2] Includes people age 62 and over who receive Social Security benefits. Assumes 28 percent federal income tax bracket.

[3] Not receiving Social Security benefits. Assumes a new top income tax rate of 36 percent, a 10 percent surtax on incomes over $250,000, phaseouts of personal exemptions and itemized deductions and elimination of the Medicare wage ceiling.

"The capital gains tax faced by the elderly would be almost twice that faced by younger taxpayers."

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 (Simplified Employee Pension) 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 may no longer be true for many young workers.[8]

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

- 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 see their retirement income taxed at a rate above 50 percent under the Clinton plan.

The proposal to tax 85 percent of Social Security benefits is not merely a proposal to tax the elderly. If enacted, it will immediately decrease the aftertax value of most American workers' pension plans.[9]

"Ultimately, the tax will lose more revenue than it will gain."

Effects of the Proposal on the Budget: Short-Term Revenue Gains, Long-Term Revenue Losses. The Social Security benefit tax currently adds about $6 billion to federal revenue.[10] 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. Even without the adoption of the Clinton plan:[11]

- 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.

Eroding the Philosophical Underpinnings of Social Security. To ensure popular support, the designers of Social Security wanted benefits to be something that people earned and not a handout. They also wanted government to be obliged to pay promised benefits. They accomplished these objectives by linking payroll taxes paid with benefits received.[12] Payroll taxes exclusively funded Social Security for the first four decades. Then, in 1983, the link was broken. Social Security benefits were taxed for the first time to help fund the continued payment of benefits. Because the resulting tax revenues were explicitly earmarked for Social Security, the benefits taken from better-off beneficiaries were kept within the system.

In yet another break with the past, the Clinton administration proposes to use the revenues from higher Social Security benefit taxes for general deficit reduction. Taking this money breaks the link between contributions going in and benefits coming out. Blurring the distinction between Social Security and other programs will make it easier to renege on promised benefits in the face of the significant tax increases that will be needed sometime after the turn of the century.[13]

"In another break with the past, Clinton proposes to use the revenue from higher Social Security benefit taxes for general deficit reduction."

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] Even if the argument is accepted, beneficiaries should be taxed at the same marginal tax rate as all other taxpayers. For example, a portion of Social Security benefits could be included in the ordinary income of elderly beneficiaries — taxable at ordinary income tax rates. 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.*

Encouraging the elderly to work and to save is important to the economic well-being of the nation. The withdrawal of elderly workers from the labor market is costly for the nation as a whole. In addition to their talents, they contribute to the nation's output of goods and services and to both tax revenue and Social Security revenue. The Labor Department warns that in the long run we face labor shortages, and elderly workers will be needed to help fill the gap.[15]

"The elderly supply 40 percent of the nation's capital and critical work skills to an economy that may soon face severe labor shortages."

Although the elderly constitute only 12 percent of the population, they hold about 40 percent of all capital assets in the United States.[16] The driving force behind the American economy is its ability to combine labor with larger and larger amounts of capital. More capital per worker leads to more output per worker. These productivity gains result in higher wages and a higher standard of living for all Americans. To the degree that government discourages saving for the retirement years, everyone is worse off — old and young.

Aldona Robbins

Gary Robbins

John C. Goodman

NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

Notes

[1] The original proposal released in February put the tax increase at $29 billion over five years. However, the formal budget document released on April 8 lowered that estimate by $6 billion. *Employee Benefit Research Institute Notes,* Vol. 14, No. 4, April 1993, p. 7.

[2] 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.

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

[4] We have counted only the employee's share of the FICA tax because that is directly deducted from the paychecks of workers. Most economists, however, would agree that workers pay the employer's share (also 7.65 percent) as well in the form of reduced wages. Our calculations of marginal tax rates, therefore, are conservative.

[5] Based on a 10 percent state income tax rate that applies to Social Security benefits.

[6] Currently, 15 states tax Social Security benefits: Colorado, Connecticut, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont, West Virginia and Wisconsin. See David Baer, "State Taxation of Social Security and Pensions," American Association of Retired Persons (AARP), Public Policy Institute, Issue Brief No. 13, June 1992. See also Table IV in this report.

[7] Assumes the individual receives a benefit of $10,000 and the couple receives a $20,000 benefit. Someone who always earned the average wage retiring at age 65 in 1993 would be entitled to a benefit of $9,853. *1993 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds,* Washington, DC, April 1993, Table II.F.12, p. 112.

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

[9] 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.

[10] *1993 OASDI Trustees' Report*, Table II.F.12, p. 112.

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

[12] As President Franklin Roosevelt put it, "With those [payroll] taxes in there, no damn politician can ever scrap my Social Security program." Aldona Robbins, *The ABCs of Social Security* (Washington, DC: Institute for Research on the Economics of Taxation, 1988), pp. 1-5.

[13] Although Social Security is currently running a surplus, deficits will appear as the Baby Boomers approach retirement. For a discussion of long-run problems, see John C. Goodman and Aldona Robbins, "The Immigration Solution," National Center for Policy Analysis, NCPA Policy Report No. 172, August 1992.

[14] Note that the argument can easily be reversed for young workers. Many of today's young people will pay more in Social Security taxes than they will ever receive in benefits. So if the goal is to make taxes equal benefits, we should lower the payroll tax for the current generation.

[15] *Labor Market Shortages,* U.S. Department of Labor, 1989.

[16] Aldona Robbins and Gary Robbins, "Taxing the Savings of Elderly Americans," Appendix B.

MEDIA CONTACTS

Economic Experts

1.	John Goodman (President) National Center for Policy Analysis	214-386-6272
2.	Gary Robbins (NCPA Senior Fellow) (President) Fiscal Associates	214-386-6272
3.	Aldona Robbins (NCPA Senior Fellow) (Vice President) Fiscal Associates	214-386-6272
4.	Norman Ture (President) Institute for Research on the Economics of Taxation	202-347-9570
5.	Stephen Entin (Economist) Institute for Research on the Economics of Taxation	202-347-9570

Representatives of Senior Organizations

1.	William Lessarde (Director of Policy and Research) National Committee of Preserve Social Security and Medicare	202-822-9459
2.	Judy Park (Legislative Director) National Association of Retired Federal Employees	202-234-0832
3.	John Rother (Director of Legislation and Public Policy) American Association of Retired Persons (AARP)	202-434-2277
4.	Daniel Hawley (Past President) Senior Coalition Against Catastrophic Coverage Act	702-646-1775
5.	Peggy Hinchey Senior Citizen Guild	313-663-3394

The National Center for Policy Analysis

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 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, that a capital gains tax cut would increase federal revenue and that 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, written by 40 representatives of think tanks and research institutes, and a first-of-its-kind, pro-free enterprise environmental task force report, written by 76 representatives of think tanks and research institutes.

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

- 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.

What Others Say About the NCPA

"...influencing the national debate with studies, reports and seminars."

— TIME

"...steadily thrusting such ideas as 'privatization' of social services into the intellectual marketplace."

— CHRISTIAN SCIENCE MONITOR

"Increasingly influential."

— EVANS AND NOVAK