

**The Elderly:
People the Supply-Side Revolution Forgot**

by

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EXECUTIVE SUMMARY

Elderly taxpayers now face the highest marginal tax rates ever imposed on middle-income Americans. In some cases, elderly workers who earn a dollar will lose *more than* a dollar in taxes and lost Social Security benefits.

- Some elderly employees are facing 1989 marginal tax rates as high as 102 percent -- they will lose \$1.02 for each \$1.00 they earn.
- For the elderly self-employed who also pay state and local income taxes, marginal tax rates are as high as 118 percent.

Like other workers, elderly workers are forced to pay income taxes and payroll taxes. Unlike younger workers, however, elderly workers also must pay these special taxes:

- The tax on Social Security benefits raises marginal tax rates for the elderly by as much as 27 percentage points.
- The new Medicare surtax raises marginal tax rates for the elderly by as much as 6.3 percentage points.
- The Social Security retirement earnings limit causes elderly workers to lose \$1 in benefits for each \$2 of earnings, imposing an effective tax rate of 50 percent.

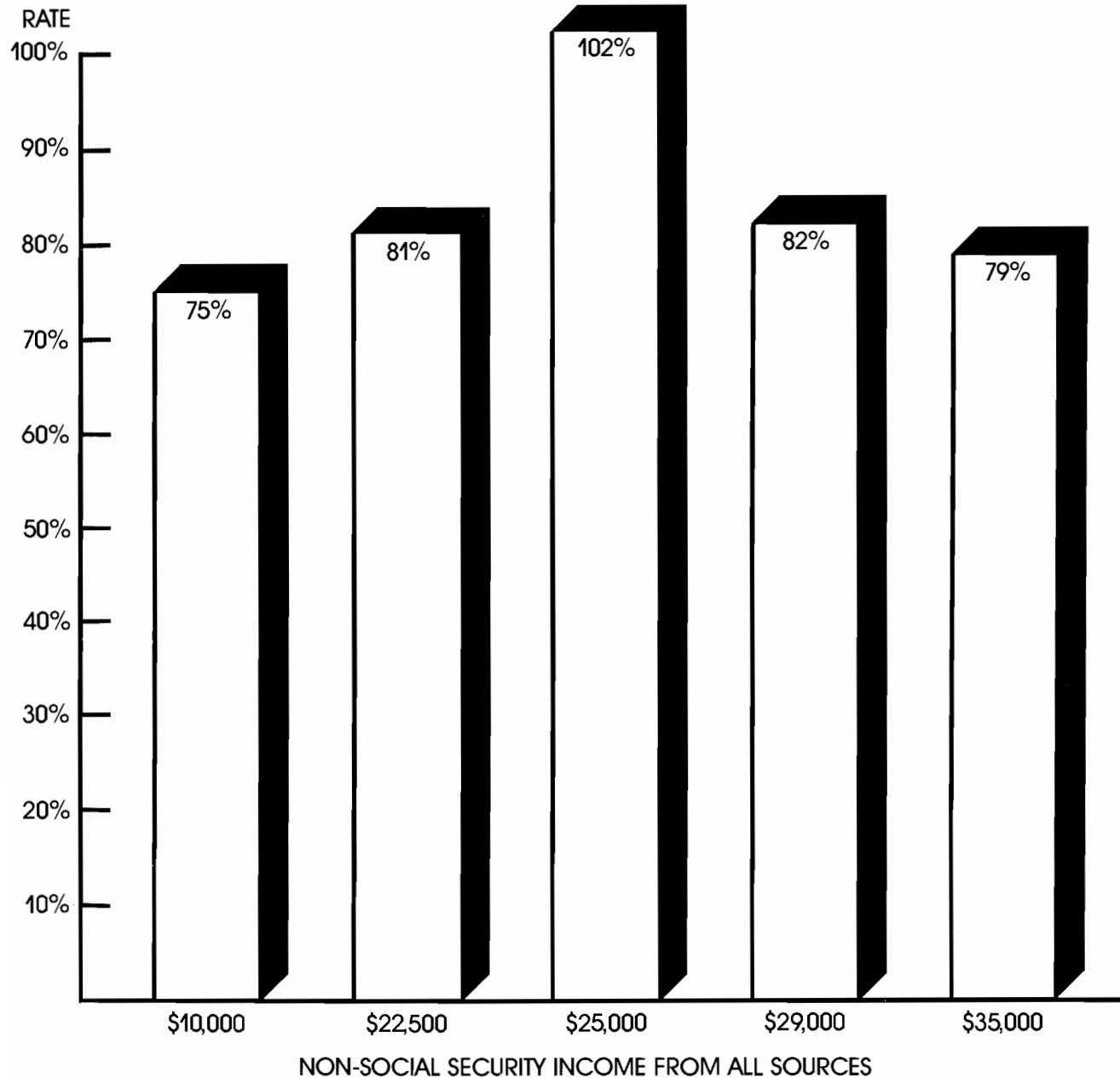
Because the tax rates on wage income for elderly workers are so high, many of the elderly will be unable to earn enough additional money to pay the new Medicare surtax and maintain their 1988 standard of living in 1989.

- In the worst possible case, elderly workers will have to earn an additional \$19,599 in order to pay a Medicare surtax of only \$432.
- Of the \$19,599 in additional wages, \$432 will pay the initial surtax, \$10,167 will go for additional taxes, and \$9,000 will be needed to replace the Social Security benefits lost because of the additional earnings.

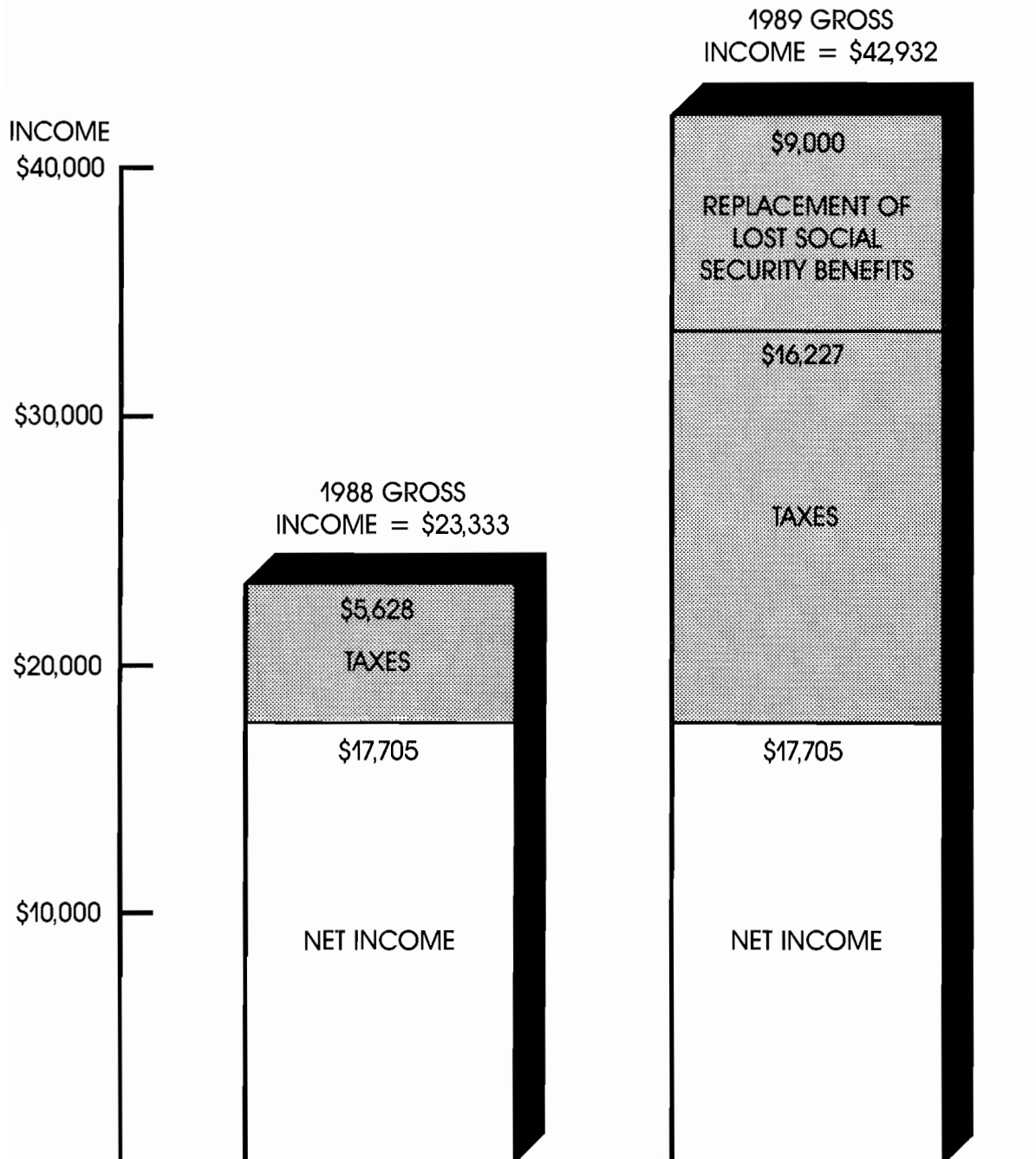
Even before the imposition of the Medicare surtax and the Social Security benefits tax, federal policies were causing a massive withdrawal of the elderly from the labor market. The percent of males age 60 and over in the labor market steadily declined from 65 percent in 1930 to 32 percent in 1980. The new taxes imposed during the Reagan Administration are pushing marginal tax rates to draconian levels, encouraging a further exodus of the elderly from the labor market and ensuring that only the most highly paid elderly workers will remain productive members of our society. Special taxes on the elderly also have effects that many elderly taxpayers may be unaware of.

- Elderly taxpayers now pay a tax rate as high as 48 percent on investment income.
- They pay a tax rate as high as 16 percent on "tax-exempt" income.
- Social Security cost-of-living adjustments are taxed at a rate as high as 8.0 percent.
- A "marriage tax" penalizes elderly married couples as much as \$3,000 per year.
- The elderly pay effective state and local income tax rates that are as much as 50 percent higher than the rates paid by younger taxpayers.

**EFFECTIVE MARGINAL TAX RATE ON WAGES FOR ELDERLY INDIVIDUALS
EARNING \$8,880**



HOW TAXES ON THE ELDERLY AFFECT TAKE-HOME PAY



NOTE: ELDERLY WORKER IS SELF-EMPLOYED AND PAYS
LOCAL INCOME TAXES IN DISTRICT OF COLUMBIA. WAGE
INCOME IS \$8,880 IN 1988 AND \$28,479 IN 1989. PENSION
INCOME IS \$14,453. GROSS INCOME IS NON-SOCIAL
SECURITY INCOME.

AMERICA'S MOST UNDERUTILIZED RESOURCE¹

America's most underutilized resource is the productive capacity of our elderly population. The 40 million men and women age 60 and over represent a vast store of human capital, rich in talent and ability. Among their numbers are people who have more than one billion years of cumulative experience in business, accounting, engineering, finance and virtually every other productive endeavor. Yet, increasingly, this valuable resource is wasted.

- Since the passage of the Social Security Act in 1935, there has been a continuous, almost unbroken decline in the percent of elderly male workers who remain in the labor market.²
- Today, 83 percent of all men and 92 percent of all women age 65 and over are completely retired and are making no contribution to the nation's annual output of goods and services.³

This withdrawal from the labor market has affected every age group among the elderly:⁴

- Among those 65 years old, the retirement rate has increased by 40 percent between 1970 and 1985.
- Over the same period, the retirement rate increased by 20 percent for 70-year-olds.

Particularly striking is that the most pronounced movement toward retirement is occurring among the "young" elderly -- those less than 65 years of age.⁵

- Among those age 60 to 64, the retirement rate has doubled in the past twenty years.
- Among those age 55 to 59, the retirement rate has doubled in the last 15 years.

The withdrawal of the elderly from the labor force is predicted to get worse.⁶ It is occurring at a time when the Department of Labor is warning us about future labor market shortages.⁷ It is also occurring at a time when entry into the labor market is becoming increasingly

¹The authors would like to thank Gary Robbins and Aldona Robbins, of Fiscal Associates, for help in preparing the tables and case studies for this report. The authors also would like to acknowledge the assistance of Cathy Thomas.

²Roger L. Ransom and Richard Sutch, "The Decline of Retirement in the Years Before Social Security: U.S. Retirement Patterns, 1870-1940," in Rita Ricardo-Campbell and Edward P. Lazear, eds., *Issues in Contemporary Retirement*, (Stanford: Hoover Institution, 1988), pp. 3-37.

³U. S. Department of Labor, *Employment and Earnings*, November, 1988, Government Printing Office, Washington, D.C.

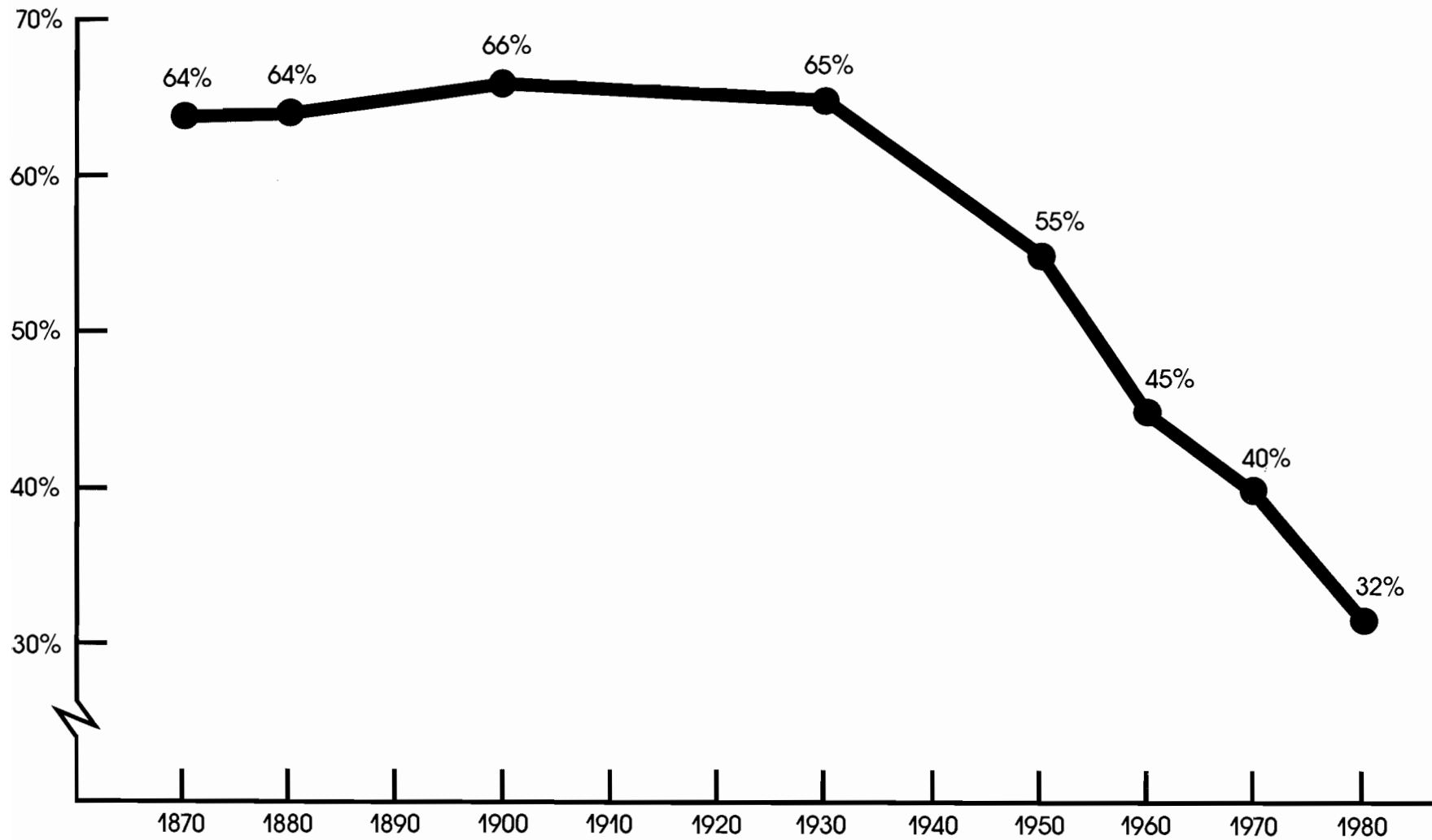
⁴Michael D. Packard and Virginia P. Reno, "A Look at Very Early Retirees," in Rita Ricardo-Campbell and Edward P. Lazear, eds., *Issues in Contemporary Retirement*, (Stanford: Hoover Institution, 1988), Table 9.1, p. 245.

⁵*Ibid.*

⁶*Older Worker Task Force: Key Policy Issues*, U.S. Department of Labor, 1989, p. 2.

⁷*Labor Market Shortages*, U.S. Department of Labor, 1989.

PERCENT OF MEN AGE 60 AND OVER IN THE LABOR MARKET



SOURCE: ROGER L. RANSOM AND RICHARD SUTCH, "THE DECLINE OF RETIREMENT IN THE YEARS BEFORE SOCIAL SECURITY: U.S. RETIREMENT PATTERNS, 1870-1940," IN RITA RICARDO-CAMPBELL AND EDWARD P. LAZEAR, EDS., *ISSUES IN CONTEMPORARY RETIREMENT*, (STANFORD: HOOVER INSTITUTION, 1988, TABLE 1.2, P. 12.

easy for senior citizens, and may involve little more than connecting a computer in the home to one at the office by telephone.⁸

Why are so many elderly citizens failing to make a productive contribution to the U.S. economy? In this report we argue that the major reason is government policy. During the eight years of the Reagan Administration, the United States developed the policies of supply-side economics -- an approach that is being copied in virtually every other country in the world.⁹ In tax policy, supply-side economics means lowering marginal tax rates to give people economic incentives to produce more and earn higher incomes. In spending policy, supply-side economics means redesigning government transfer programs in ways that discourage dependency and increase the rewards of working.

Yet the elderly are one significant population group that the supply-side revolution forgot. Despite a planned decrease in the penalties for working beginning in 1990 and the creation of incentives to delay retirement in the future,¹⁰ other "reforms" adopted during the Reagan Administration increased the marginal tax rates on the elderly to draconian levels and insured that all but the most determined of elderly citizens will choose dependency over productiveness in the coming years.

Indeed, in view of the lavish benefits the federal government confers on the elderly (about one-fifth of all federal spending and 68 percent of all transfer payments¹¹), and in view of the high marginal tax rates imposed on elderly workers earning modest incomes, it is probably no exaggeration to say that we have created a welfare state for the elderly of dimensions never imagined in the most socialist of European countries.

⁸Joanne H. Pratt, "Legal Barriers to Home-Based Work," NCPA Policy Report No. 129, September, 1987.

⁹For a survey of recent reductions in marginal income tax rates in other countries, see Vito Tanzi, "The Response of Other Countries to the U. S. Tax Reform Act," *National Tax Journal*, Vol. 40, No. 3, September, 1987, pp. 339-355.

¹⁰The age at which Social Security beneficiaries can work without any reduction in benefits was lowered from age 72 to age 70; and, beginning in 1990, the penalty imposed on elderly workers less than age 70 will be a reduction of \$1 in benefits for each \$3 of earnings above a minimum income rather than the current penalty of \$1 of reduced benefits for each \$2 of earnings. Legislation also was passed to phase in a reduction in the financial incentives for early retirement (before age 65) and an increase in the financial incentives to delay retirement beyond age 65. Finally, in the next century, the normal retirement age will be gradually increased to age 67.

¹¹U.S. Bureau of the Census, *Current Population Reports*, Series P-60, No. 164-RD-1, "Measuring the Effects of Benefits and Taxes on Income and Poverty," 1989.

MYTHS ABOUT RETIREMENT

A number of myths surround contemporary thinking about retirement. Among the many mistaken notions are: (1) that retirement is a completely modern convention; (2) that modern retirement is the result of greater life expectancy; (3) that retirement is mainly the result of poor health; and (4) that current retirement patterns are inevitable and Social Security merely provides a minimum income for people who would have retired anyway. A brief discussion of these myths follows.

Retirement Before 1935. Far from being a modern convention, retirement appears to have been just as common in the 19th century as it was at the time our Social Security system was adopted. In 1870 (the earliest date for which we have reliable data) about one-third of all men age 60 and over were retired. This is the same percent of elderly males who were retired in the 1930s at the time the Social Security Act was passed.¹²

Retirement and Life Expectancy. Although life expectancy at birth has increased significantly during the 20th century, life expectancy among the elderly has not changed that much. In 1900, a 65-year-old white male had a life expectancy of 11.5 years and a 75-year-old white male had a life expectancy of 6.8 years. These are virtually identical to the life expectancies of elderly males in the 1930s and not much different from the life expectancies of elderly males today.¹³

Retirement and Health. Prior to the passage of the Social Security Act, poor health appears to have been the most frequent reason for the decision to retire. Yet that is no longer the case. Among newly retired male Social Security beneficiaries, only 25 percent give "poor health" as a reason for retiring.¹⁴ Moreover, although the vast majority of men and women 65 years of age and over are retired, fully 60 percent of them have no limitation on their activities because of ill health.¹⁵

Retirement and Social Security. The mass withdrawal of elderly workers from the labor market since the passage of the Social Security Act cannot be explained as the result of normal labor market patterns, increased life expectancy among the elderly, or poor health. Instead, it appears largely due to the introduction and expansion of Social Security and private pensions¹⁶ since the 1930s.

The trend toward retirement among the elderly is not a natural and inevitable development. Although retirement levels remained fairly constant during the 60 years prior to the passage of the

¹²Packard and Reno, "A Look at Very Early Retirees," p. 245.

¹³Ransom and Sutch, "The Decline of Retirement in the Years Before Social Security," p. 8.

¹⁴Michael D. Packard and Virginia Reno, "A Look At Very Early Retirees," in Campbell and Lazear, *Issues in Contemporary Retirement*, p. 260.

¹⁵Kingsley Davis, "Retirement As A Dubious Paradise," in Campbell and Lazear, *Issues in Contemporary Retirement*, p. 193.

¹⁶Although a private sector phenomenon, the private pension system has been shaped and molded by federal policy. See Edward J. Harpham, "Private Pensions in Crisis: The Case for Radical Reform," NCPA Policy Report No. 115, January, 1984; and Dennis G. Logue, "Pension Plans at Risk: A Potential Hazard of Deficit Reduction and Tax Reform," NCPA Policy Report No. 119, October, 1985.

Social Security Act, the patterns within particular industries were very different. Retirement in agriculture was quite high, probably because of the physical demands. By contrast, retirement in non-agricultural sectors actually was declining prior to the 1930s. As the population became less agricultural, it seems likely that the national retirement rate would have decreased over the last 50 years but for the existence of Social Security and private pensions.

THE SOCIAL COST OF RETIREMENT

If current trends continue, young people entering the labor market today can expect to spend more than one-third of their adult life in retirement. Moreover, with the increasing average age of the population, in 40 years (by the year 2030) there will be one retired adult for every two non-retired adults.¹⁷ These developments are the result of an elderly population reacting to economic incentives created by government policies. Unfortunately, these policies carry a very heavy price tag for the nation as a whole.

When people retire they are no longer contributing to the nation's output of goods and services. All too often, they receive pension and health care benefits paid for by working taxpayers -- thus becoming a drain on the economy rather than a productive participant in it. Collectively, retirement has enormous consequences for our nation's economy.

To appreciate these consequences, consider what would happen if elderly men today participated in the labor force at the same rate as before the passage of the Social Security Act. This would mean that one-third of elderly men would reenter the labor market. The effect would be staggering:

- If one-third of the men age 60 and over reentered the labor market and earned as little as \$5 per hour, more than \$55 billion would be added to our national income.
- As producers, these men would generate as much as \$12 billion in Social Security taxes and income taxes.
- If these elderly workers were not paid Social Security benefits, Social Security spending would be reduced as much as \$46 billion.
- The net reduction in the federal deficit would be as much as \$58 billion.

If one third of elderly women also were induced to reenter the labor market, the effects would be even more dramatic:

- If one-third of all men and women age 60 and over reentered the labor market, and earned as little as \$5 per hour, national income would be increased by \$132 billion.
- The net reduction in the federal deficit would probably be in excess of \$100 billion.

The withdrawal of elderly workers from the labor market since the 1930s, then, has been extremely costly for the nation as a whole. In the future, the costs will rise as the non-productive, dependent elderly become an ever-increasing burden for the nation's younger workers. According

¹⁷Peter Uhlenberg, "Population Aging and the Timing of Old Age Benefits," in Campbell and Lazear, *Issues in Contemporary Retirement*, pp. 366-368.

the forecasts of the Social Security Administration, by the middle of the next century, Social Security and Medicare benefits alone will equal as much as 39 percent of the nation's total taxable payroll.¹⁸

HOW GOVERNMENT POLICIES DISCOURAGE WORK AND ENCOURAGE RETIREMENT

Table I lists some of the major changes in government policy that have given the elderly economic incentives to drop out of the labor force and retire. What follows is a brief summary of these policies.

Benefit Policies

By design, the Social Security system lowers the cost of retirement by increasing the income of retirees. This economic incentive alone would account for a considerable amount of retirement among the elderly. In addition, the following policies further encourage retirement and dependency as an alternative to productive work.

Rewards For Early Retirement. Beginning in 1956, women were allowed to choose early retirement (with reduced Social Security benefits) at age 62.¹⁹ That option was extended to men in 1961. The response to these options has been overwhelming:²⁰

- In 1961, only 16 percent of all Social Security beneficiaries were receiving reduced benefits because of early retirement.
- By 1985, 66 percent of all Social Security beneficiaries were early retirees.

Penalties For Delayed Retirement. Just as workers receive reduced benefits if they retire early, they also receive increased benefits if they delay retirement beyond age 65.²¹ From a purely financial point of view, the option to elect early retirement is actuarially fair. That is, an individual who elects early retirement cannot expect an increase or decrease in the total benefits from Social Security. The same is not true of the decision to delay retirement past age 65, however. Although delaying retirement does increase the monthly Social Security benefit, the net

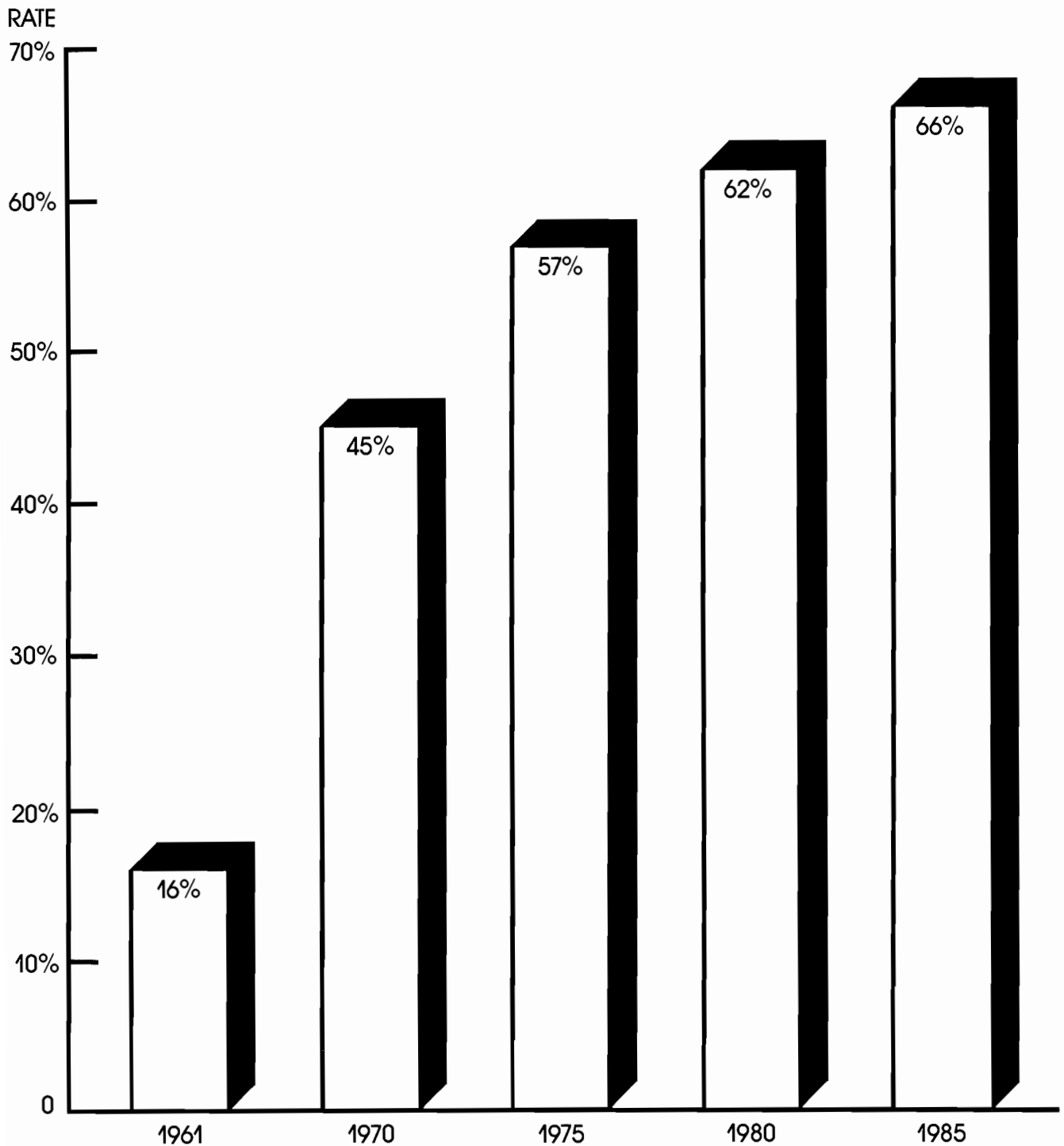
¹⁸*The 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors' Insurance and the Federal Disability Insurance Trust Funds*, May 9, 1988, Appendix E, Table E3, pp. 129-130. These projections do not include the effects of the recently-passed catastrophic health insurance legislation for Medicare beneficiaries.

¹⁹The amount of reduction in benefits is equal to 5/9 of 1% for each month of early retirement. Thus, workers who elect to retire at age 62 receive 80 percent of full benefits, workers who elect to retire at age 63 receive 90 percent of full benefits. Under current law, the penalty for early retirement will increase -- rising from a 20 percent reduction in benefits for retirement at age 62 to a 30 percent reduction by the year 2000.

²⁰*Social Security Bulletin*, Vol. 49, No. 9, September, 1986, Table Q-2, p. 54.

²¹For workers age 65 to 70, the retirement benefit increases by 3 percent for each year retirement is delayed. For those reaching the retirement age after 1989, however, the percent by which benefits increase will rise, reaching nine percent by the year 2009.

PERCENT OF SOCIAL SECURITY BENEFICIARIES WHO CHOSE EARLY RETIREMENT



SOURCE: SOCIAL SECURITY BULLETIN, VOL. 49, NO. 9, SEPTEMBER, 1986,
TABLE 6-2, P. 54.

effect is to reduce total expected Social Security benefits for the remainder of the individual's life.²²

Rewards For Disability. Far from being an objective medical fact, "disability" often is a subjective condition.²³ Moreover, persons classified as disabled receive payments that are higher than normal retirement benefits, and these higher payments are converted to higher retirement benefits at age 65. For example:

- In 1988, the maximum retirement benefit for a family was \$15,144.
- By contrast, the maximum disability benefit for a family was \$18,924.

Penalties For Earning Wages While "Retired." In order to qualify for full Social Security benefits, a retiree must satisfy the retirement earnings test. For example, in 1988 individuals were counted as "retired" if they earned \$6,480 or less and were age 62 to 64, and if they earned \$8,880 or less and were age 65 to 70. Individuals who have wage income in excess of these amounts lose \$1 of Social Security benefits for each \$2 of earnings above the limits. This benefit loss amounts to an effective tax on wage income, with a marginal tax rate of 50 percent. Beginning in 1990, the penalty will decrease to \$1 of lost Social Security benefits for each \$3 of earnings -- an effective marginal tax rate of 33 percent.

Tax Policies

Two major tax policy changes adopted during the Reagan Administration, have dramatically increased the marginal tax rates faced by the elderly. The first is the Social Security benefit tax, enacted as part of the 1983 Social Security reform legislation. The second is the Medicare surtax, enacted as part of the Catastrophic Care Act of 1988.

The Social Security Benefit Tax. Under current law, one-half of Social Security benefits potentially are subject to the income tax. In 1986, for example, at least 20 percent of the elderly had to pay taxes on an average of \$3,373 of Social Security benefits and the percentage of the elderly paying the tax will rise continuously in future years.²⁴ As the law is structured, however, one-half of Social Security benefits are not automatically included in the ordinary income of the taxpayer. Instead, the tax applies only if one-half of Social Security income plus all non-Social Security income (including income from tax exempt bonds) exceeds \$25,000 for an individual or \$32,000 for a couple. For taxpayers who exceed these amounts, 50 cents of Social Security benefits is taxed for each dollar of additional income.

²²Gary S. Fields and Olivia S. Mitchell, "Restructuring Social Security: How Will Retirement Ages Respond?" in Stephen H. Sandell, ed., *The Problem Isn't Age*, (New York: Praeger, 1987), pp. 192-205.

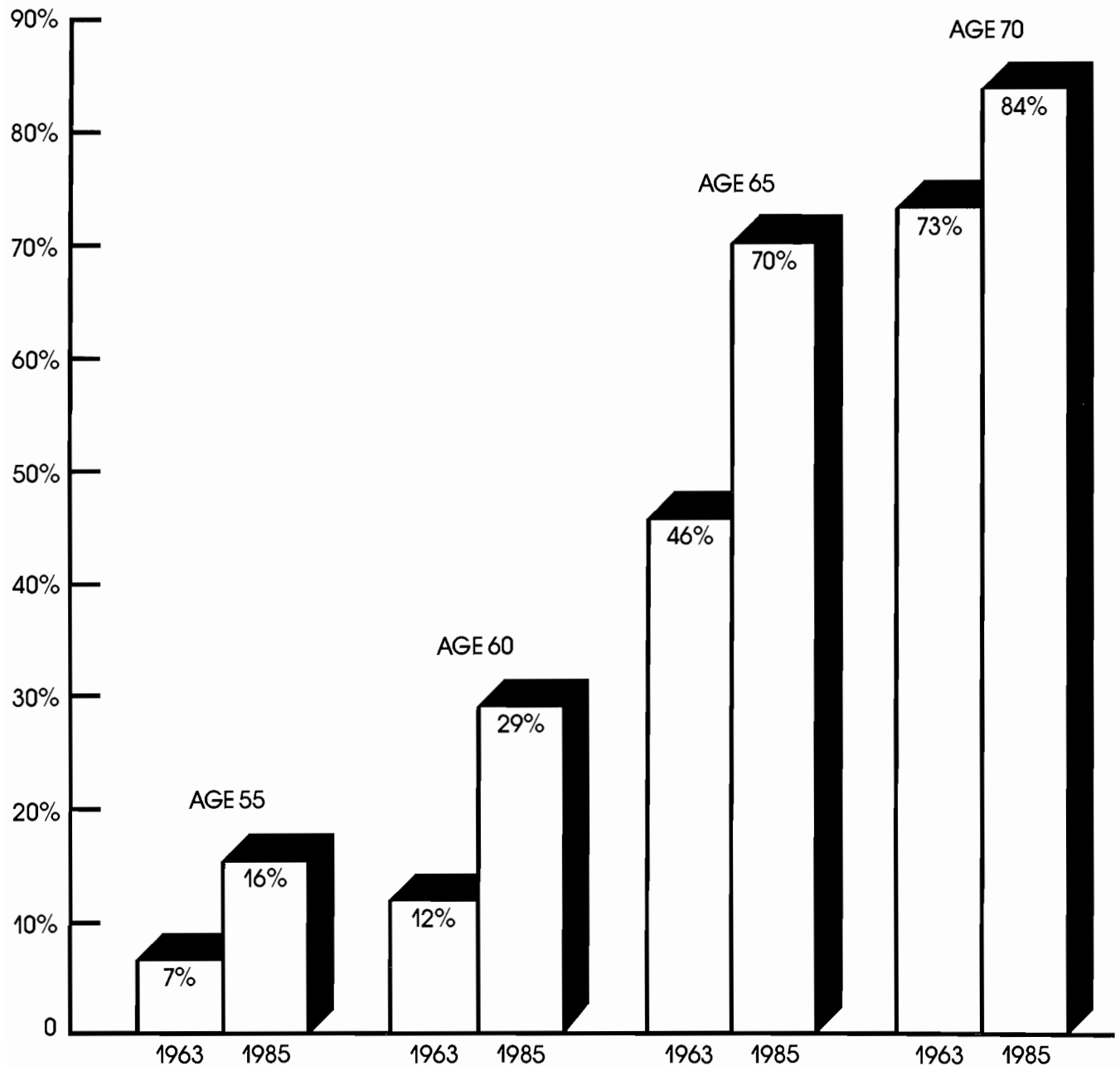
²³See Philip R. Alper, "A Doctor's View of Disability Claims," *The Wall Street Journal*, September 17, 1987.

²⁴The percentage of elderly taxpayers paying the tax will continue to rise because the income thresholds, beyond which Social Security benefits become taxable, are not indexed. See Aldona E. Robbins, *The ABC's of Social Security*, (Washington, D.C.: Institute for Research on the Economics of Taxation, 1988), p. 16.

TABLE I
INCENTIVES TO RETIRE:
FEDERAL LEGISLATION

<u>Date</u>	<u>Legislation</u>
1935	The Social Security Act is passed.
1940 - 1980	Legislation broadens coverage to include more workers. Percent of workers covered grows from 56 percent in 1940 to 74 percent in 1960 to 87 percent in 1980.
1950 - 1980	Social Security benefits are liberalized. Average benefit for a retired male (as a percent of median male earnings) grows from 14 percent in 1950 to 28.5 percent in 1960 to 37.5 percent in 1980.
1956	Women can elect early retirement at age 62.
1956	Social Security benefits are available for the permanently disabled, age 50 to 64.
1958	Benefits are extended to the dependents of the permanently disabled.
1961	Men can elect early retirement at age 62.
1965	Medicare, Medicaid and Supplemental Security Income (SSI) programs are established.
1972	Elderly who do not qualify for Social Security may "buy" into Medicare.
1975	Automatic cost-of-living indexing for Social Security benefits.
1983	Social Security benefits are subject to income taxes. The tax increases if wage income increases.
1989	The Medicare surtax increases taxes on wage income.

PERCENT OF MEN RETIRED 1963 AND 1985



SOURCE: MICHAEL D. PACKARD AND VIRGINIA P. RENO, "A LOOK AT VERY EARLY RETIREES," IN RITA RICARDO-CAMPBELL AND EDWARD P. LAZEAR, EDS., *ISSUES IN CONTEMPORARY RETIREMENT*, (STANFORD: HOOVER INSTITUTION, 1988), TABLE 9.1, P. 245.

One way to think about the Social Security benefit tax is to see it as a tax on income, rather than as a tax on Social Security benefits -- since the tax increases only as income increases. For individuals who exceed the income limits described above,²⁵

- Taxpayers who earn an additional \$1 of income are forced to pay taxes on \$1.50.
- This means that taxpayers in the 15 percent income tax bracket automatically face an income tax rate of 22.5 percent.
- Individuals in the 28 percent income tax bracket automatically face an income tax rate of 42 percent.

Once taxpayers reach the point at which one-half of their Social Security benefits are fully taxed, however, a bizarre twist occurs. At this point, an additional dollar in wages causes taxable Social Security benefits to be reduced by 25 cents.²⁶

- Once elderly taxpayers reach the cap on the Social Security benefit tax, when they earn an additional \$1 of income they pay taxes on only 75 cents.
- This means that the Social Security benefit marginal tax rate is negative -- it reduces overall income tax rates by 7.0 percentage points.

The Social Security benefit tax has anomalies that many elderly taxpayers may be unaware of. For example, because tax exempt income is included in the calculation of the Social Security benefit tax, tax exempt income is actually taxed. That is, when tax exempt income rises, so does the Social Security benefit tax.²⁷ Similarly, because Social Security cost-of-living adjustments (COLAs) increase the Social Security benefit tax, cost-of-living increases also are taxed. In general,

- The tax rate on tax exempt income for elderly taxpayers is as high as 16.1 percent.
- The tax rate on Social Security cost-of-living adjustments is as high as 8.0 percent.

The Medicare Surtax. As pointed out in a previous NCPA report, genuine catastrophic insurance for the elderly is rather inexpensive, provided it does not include nursing home care. For example, genuine catastrophic coverage could be provided for as little as \$60 per year per Medicare beneficiary, or through small increases in the Medicare deductibles and copayments.²⁸ In the hands of politicians, however, catastrophic health insurance quickly developed into a Christmas package of costly benefits, even without including coverage for nursing home care.²⁹

²⁵Assumes that additional income does not result in a loss of Social Security benefits. If taxpayers are at or above the earnings limit, they pay taxes on \$1.38 for each \$1.00 of earnings.

²⁶Since Social Security benefits are reduced by 50 cents, taxable benefits are reduced by one-half that amount.

²⁷This issue is considered more fully below.

²⁸John C. Goodman and Gerald Musgrave, "Health Care for the Elderly: The Nightmare in our Future," NCPA Policy Report No.130, October, 1987, pp. 29-30. See also, Peter J. Ferrara and Edmund F. Haislmaier, "The Catastrophic Health Tax on America's Elderly," *Issue Bulletin*, No. 132, Heritage Foundation, July 21, 1987.

²⁹For a penetrating critique of catastrophic health care legislation, see Aldona Robbins and Gary Robbins, "Facts About Catastrophic Coverage," *Economic Report*, No. 41, Institute for Research on the Economics of Taxation, May 23, 1988.

TABLE II

**STEPS FOR CALCULATING THE
SOCIAL SECURITY BENEFIT TAX
FOR AN INDIVIDUAL**

Combine:	WAGES
	+
	INVESTMENT INCOME
	+
	TAX EXEMPT INCOME
	=
	NON-SOCIAL SECURITY INCOME
	+
Add:¹	1/2 SOCIAL SECURITY BENEFITS
	-
Subtract:	\$25,000
	÷
Divide:	<u>2</u>
Taxable Benefits:²	TOTAL

¹No tax is payable unless total exceeds \$25,000.

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

Because Congress needed additional tax revenues to fund this program, the elderly now pay a Medicare surtax equal to 15 percent of income taxes. This surtax will increase in future years, reaching 28 percent of income taxes in 1993.

For taxpayers in the 15 percent income tax bracket, the surtax equals 3.38 percent (15% X 15%) of income. For taxpayers in the 28 percent income tax bracket, the surtax equals 4.20 percent (15% X 28%) of income. Remember, however, that taxpayers who are subject to the Social Security benefit tax face income tax rates as much as 50 percent higher than the rates faced by other taxpayers. As a result:

- For elderly taxpayers earning the minimum wage, the Medicare surtax can be as high as 6.3 percent of each additional dollar of income.
- In 1993, when the surtax reaches 28 percent of income taxes, elderly taxpayers earning the minimum wage will face a Medicare surtax as high as 11.76 percent of each additional dollar of income.³⁰

At the time the Catastrophic Care Act was passed, very few legislators were familiar with its details. In an election year, members of Congress did not want to be seen as voting against benefits for the elderly. At the time, the tax rates appeared modest, and a reassuring, but false, report by the Congressional Budget Office (CBO) predicted that the maximum Medicare tax (\$800 per person) would only be paid by individuals earning at least \$42,000 and by couples earning at least \$94,000.³¹ Once the dust had settled and elderly taxpayers had time to analyze the damage, they were justifiably outraged. Among their discoveries:³²

- The 1989, Medicare surtax applies to the first \$150 of taxable income, and the maximum tax (\$800 per person) in 1989 will be paid by elderly individuals earning as little as \$29,710 and by couples earning \$57,151.
- In 1993, the maximum tax (\$1,050 per person) will be paid by individuals earning \$26,735 and by couples earning \$48,075.
- More than one-half of all elderly families will be paying the Medicare surtax.³³

The Effect of Bracket Shift. Because of the Social Security benefit tax, some elderly taxpayers are pushed from the 15 percent tax bracket to the 28 percent tax bracket. Thus elderly workers who otherwise would pay 15¢ on an additional \$1 of earnings must now pay 28¢.

³⁰Assumes the 1993 cap on the Medicare surtax will be increased sufficiently to apply to couples in the 28 percent income tax bracket.

³¹These inaccurate numbers are still being widely reported by the national media.

³²Assumes Social Security benefits equal to \$7,600 -- the benefit paid to a male worker earning the male median wage and retiring in 1987. Assumes a couple receives an additional 50 percent dependent's benefit, or a total benefit of \$11,400. Income amounts shown refer to non-Social Security income.

³³Robbins and Robbins, "Facts about Catastrophic Coverage," p. 12.

Conceptually, and as a matter of tax law,³⁴ the resultant increase in taxes is fully attributable to the Social Security benefits tax. As a result:

- For those elderly workers who earn less than \$8,880 and who are pushed into the 28 percent tax bracket because of the tax on Social Security benefits, the Social Security benefit tax increases the marginal tax rate by 27 percentage points.
- For those workers earning \$8,880 or more, the Social Security benefit tax increases the marginal tax rate by 23.5 percentage points.

Effects on State and Local Income Taxes. In many places, the Social Security benefit tax affects state and local income taxes in the same way that it affects the federal income tax.³⁵ That is, elderly workers who earn \$1.00 of income pay state and local taxes on \$1.50 because of the Social Security benefit tax.

- Under the conditions described above, elderly taxpayers who face a state and local income tax rate of 4.0 percent must pay an effective rate of 6.0 percent because of the Social Security benefit tax.
- Similarly, elderly taxpayers who face a state and local income tax rate of 8.0 percent must pay an effective rate of 12 percent.

The Social Security benefit tax was passed as part of the 1983 Social Security reforms, ostensibly to insure the financial health of Social Security system. Whatever the merits of the tax, there is no relationship between Social Security benefits and services provided by state and local governments. Yet because of the way in which federal tax law defines adjusted gross income, state and local governments are taxing Social Security benefits, Social Security cost-of-living adjustments (COLAs) and even tax-exempt income.

Although many state and local officials may be unaware of it, elderly taxpayers now pay state and local income tax rates that are as much as 50 percent higher than the rates paid by younger taxpayers on ordinary income. Although many state and local officials complained when Congress included tax-exempt income in the calculation of the Social Security benefit tax, because of this tax state and local governments are currently taxing income from their own securities. For example, if the state and local income tax rate is 8.0 percent, tax-exempt income is subject to an effective state and local tax of 4.0 percent. The result is windfall revenues from elderly taxpayers, although no new state and local services are being provided for the elderly.

³⁴The allocation of the additional tax is important because proceeds from the Social Security benefit tax are deposited in the Social Security trust fund for accounting purposes.

³⁵Currently, 12 states tax Social Security benefits. The states are Colorado, Iowa, Kansas, Minnesota, Missouri, Nebraska, Montana, West Virginia, Wisconsin, North Dakota, Rhode Island and Vermont. 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.

THE COMBINED EFFECT OF THE SOCIAL SECURITY BENEFIT TAX AND THE MEDICARE SURTAX

Ronald Reagan's most important economic legacy was the lowering of marginal tax rates on wage income. In 1980, taxpayers faced a marginal tax rate as high as 70 percent. Today all non-elderly taxpayers face a top marginal tax rate of 33 percent -- a reduction of 37 percentage points. However, the picture is very different for elderly taxpayers.

Reversing the Effects of Tax Reform. As Table III shows, the gains from tax reform have been more than reversed for many elderly taxpayers. As a result of the Social Security benefit tax and the Medicare surtax,

- Some elderly taxpayers will see their 1989 marginal tax rates increased by 33.3 percentage points.
- By 1993, marginal tax rates will be increased by 38.76 percentage points for some elderly taxpayers.

Regressive Taxes on Wages. Another fact revealed in Table III is that the Social Security benefit and Medicare surtax rates are higher for a low-wage individual than for a high-wage individual, even though total income for the two individuals may be identical. Thus, in 1989, an elderly individual earning only a minimum-wage income faces a tax rate that is 4.02 percentage points higher than the rate faced by an individual earning more than \$8,880 -- even though both workers may have the same total income from all sources.³⁶

Regressive Taxes on Total Income. Because there is a cap on the Medicare surtax (\$800 per person) and on the Social Security benefit tax (applies to only one-half of benefits), both of these taxes are regressive with respect to total income. Once taxpayers reach these tax caps, the taxes become an increasingly smaller proportion of income, as income rises. Table IV shows the effects of this regressiveness in terms of marginal tax rates for taxpayers at different income levels. As the table indicates:

- The Medicare surtax and the Social Security benefit tax raise the marginal tax rates of an individual with a \$25,000 income by 16.28 percentage points, while lowering the tax rates of a \$30,000-a-year taxpayer by 7.0 percentage points.
- This means that a taxpayer with a \$30,000 income gets to keep 23 cents more out of each additional dollar earned than a taxpayer with \$5,000 less income.

The Social Security benefit tax and the Medicare surtax, then, are primarily taxes on the elderly middle class. As Table V shows, the range of income to which these taxes apply is the income range of the middle class. High-income taxpayers also pay these taxes, but the taxes do not restrict the earnings opportunities of the high-income elderly. With respect to penalties on work, the greatest burden of these taxes falls on middle-income wage earners.

³⁶In general, the marginal tax rates are lower for individuals earning more than \$8,880, because their Social Security benefits are reduced. As a result, their Social Security benefit tax is reduced. Thus, while an individual earning less than \$8,880 pays taxes on \$1.50 for each additional dollar of income, an individual earning more than \$8,880 pays taxes on \$1.38 for each additional dollar of income. In 1993, an individual earning more than \$8,880 will pay taxes on \$1.41 for each dollar of additional income.

TABLE III

**ADDITION TO MARGINAL TAX RATES
DUE TO THE SOCIAL SECURITY BENEFIT TAX
AND THE MEDICARE SURTAX**

(For Taxpayers Below the Caps on These Taxes)

Addition to Marginal Rates in 1989

<u>Income Tax Bracket</u>	<u>Wages Less Than \$8,880</u>	<u>Wages More Than \$8,880</u>
15 Percent Bracket	10.88 %	8.72 %
28 Percent Bracket	20.30 %	16.28 %
Bracket Shift: From 15 Percent to 28 Percent¹	33.30 %	29.28 %

Addition to Marginal Rates in 1993

<u>Income Tax Bracket</u>	<u>Wages Less Than \$10,730</u>	<u>Wages More Than \$10,730</u>
15 Percent Bracket	13.80 %	12.21 %
28 Percent Bracket	25.76 %	21.80 %
Bracket Shift: From 15 Percent to 28 Percent¹	38.76 %	35.47 %

¹ Assumed to be caused by the tax on Social Security benefits.

TABLE IV
TAX BURDENS FOR THE ELDERLY MIDDLE CLASS:
ADDITIONS TO MARGINAL TAX RATES

(Wage Income Equals \$8,880)¹

	<u>Elderly Individuals</u>			
Non-Social Security Income	\$22,500	\$25,000	\$29,000	\$30,000
Social Security Benefit Tax	5.63%	10.50%	- 7.00%	- 7.00%
Medicare Surtax	<u>3.09%</u>	<u>5.78%</u>	<u>3.15%</u>	<u>0.00%</u>
Combined Marginal Rate	8.72%	16.28%	- 3.85%	- 7.00%
	<u>Elderly Couples</u>			
Non-Social Security Income	\$35,000	\$37,500	\$40,000	\$57,500
Social Security Benefit Tax	5.62%	10.50%	- 7.00%	- 7.00%
Medicare Surtax	<u>3.09%</u>	<u>5.78%</u>	<u>3.15%</u>	<u>0.00%</u>
Combined Marginal Rate	8.72%	16.28%	- 3.85%	- 7.00%

¹ Assumes Social Security benefits equal \$7,600 for an individual and \$11,400 for a couple. Income levels shown are based on current tax brackets. The income levels for these tax brackets may be increased in 1990 due to inflation indexing.

TABLE V
TAX BURDENS FOR THE ELDERLY MIDDLE CLASS:
INCOME RANGE FOR TAXES

	<u>Taxpayer Starts Paying the Tax When Income Equals:</u>	<u>Taxpayers Pay No More Tax When Income Equals:</u>
<u>Individuals</u>		
Social Security Benefit Loss; Wage Income Equals:	\$8,881	\$24,080
Medicare Surtax; Non-Social Security Income Equals: ¹	\$6,851	\$29,710
Social Security Benefit Tax; Non-Social Security Income Equals: ¹	\$21,201	\$28,801
<u>Couples</u>		
Social Security Benefit Loss; Wage Income Equals:	\$8,881	\$31,680
Medicare Surtax; Non-Social Security Income Equals: ²	\$11,401	\$57,151
Social Security Benefit Tax; Non-Social Security Income Equals: ²	\$26,300	\$37,700

¹ Assumes wage income equals \$8,880 or less and the individual is entitled to \$7,600 in Social Security benefits.

² Assumes wage income equals \$8,880 or less and the couple is entitled to \$11,400 in Social Security benefits.

EFFECTIVE MARGINAL TAX RATES FOR ELDERLY WORKERS

An "effective marginal tax rate" measures the income reduction workers experience when they earn one more dollar of wages. The reduction in income includes the payment of all taxes on income. For the elderly, as we have seen, this includes the Social Security benefit tax and the Medicare surtax, in addition to regular income taxes and payroll taxes. The reduction in income also includes any reduction in Social Security benefits that occurs as a result of earning one more dollar in wages. What follows is a brief discussion of the new effective marginal tax rates faced by the elderly.

New Marginal Tax Rates For the Elderly

Beginning in 1989, with the introduction of the Medicare surtax, almost all elderly taxpayers face higher effective marginal tax rates than any U.S. taxpayers have faced since the early 1960s, when the highest tax bracket was 90 percent for very high-income persons. For many elderly workers, the effective marginal tax rate will exceed 100 percent -- if they earn an additional dollar of wages, their total income will go down by more than a dollar. For these elderly workers, tax rates are higher than they have ever been for any other group of U.S. taxpayers.³⁷

Moreover, effective marginal tax rates in excess of 100 percent are not imposed on the very wealthiest of elderly taxpayers. Indeed, for very high-income earners, marginal tax rates are a modest 28 percent. As the graphs at the beginning of this report indicate, the very highest marginal tax rates for the elderly are imposed on middle-income families -- those with non-Social Security incomes of \$25,000 to \$40,000. Table VI summarizes the effective marginal tax rates the elderly face in 1989 and 1993.

- All elderly workers who earn more than \$8,880 -- slightly more than the full-time minimum wage -- will face marginal tax rates in excess of 80 percent.³⁸
- The total income of these workers will be decreased by more than 80 cents for each additional dollar of earnings.
- For those elderly workers who earn more than \$8,880 in wages and are also in the 28 percent income tax bracket (about \$25,000 of total income for individuals and \$35,000 for couples), marginal tax rates are higher than 100 percent.
- Federal policy forces these elderly workers to pay to work -- each additional dollar they earn will decrease their total income.

In 1993, marginal tax rates will increase for all elderly workers earning less than \$8,880 in wages because of the scheduled increase in the Medicare surtax. For some workers, the increase in the surtax between now and 1993 will add more than 5.6 percentage points to their marginal tax rates.

³⁷Note: Prior to the tax reforms of the 1980s, very wealthy elderly taxpayers could have faced marginal tax rates in excess of 100 percent if they had very high non-wage income and only modest wage income. It is not known how many taxpayers actually faced these rates.

³⁸Assumes the worker is within the range where an additional dollar of income reduces Social Security benefits by 50 cents.

EFFECTIVE MARGINAL TAX RATES ON WAGES FOR SOME ELDERLY WORKERS IN 1989

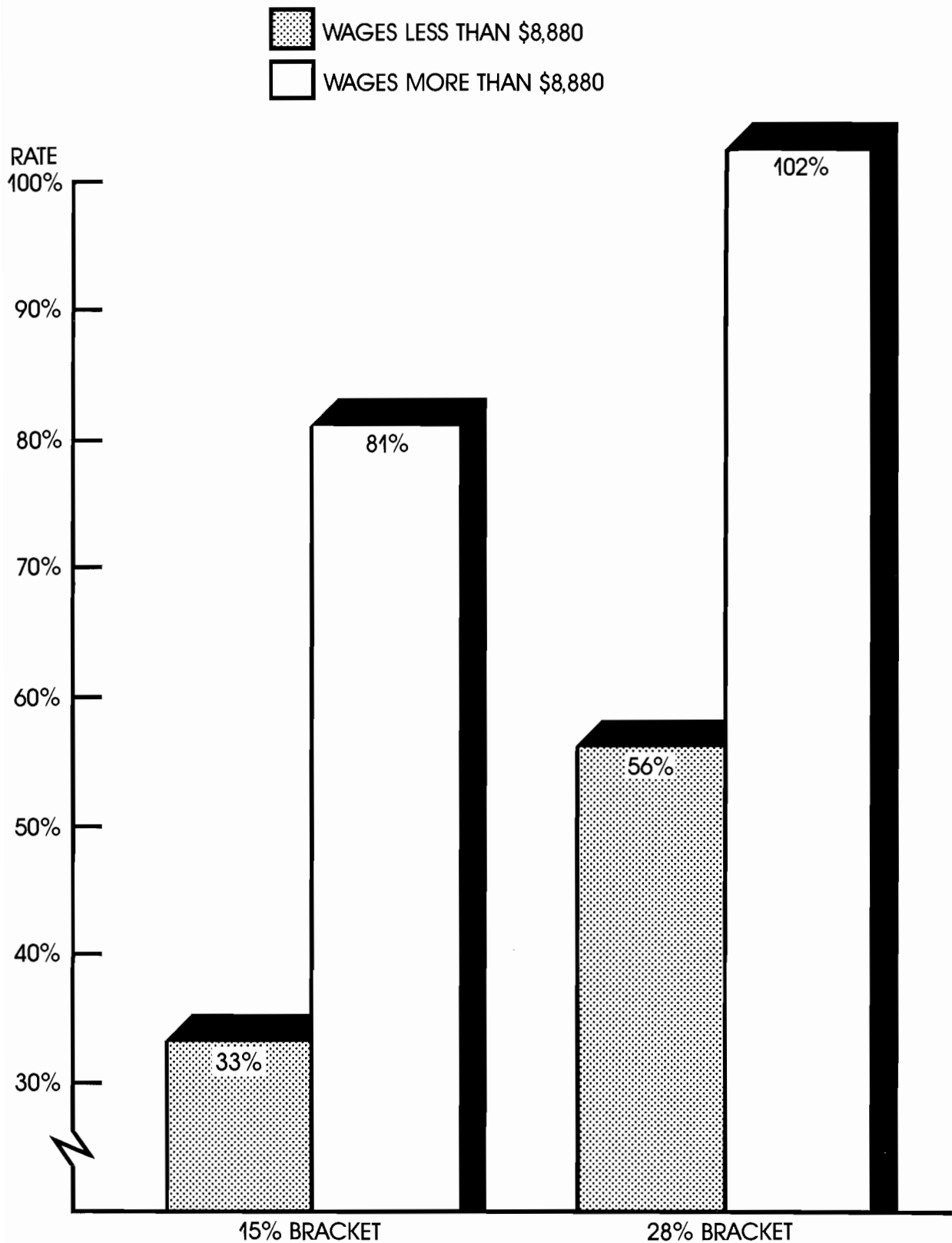


TABLE VI

**SUMMARY OF EFFECTIVE MARGINAL
TAX RATES FOR ELDERLY WORKERS¹**

Marginal Rates in 1989

<u>Income Tax Bracket</u>	<u>Wages Less Than \$8,880</u>	<u>Wages More Than \$8,880</u>
15 Percent Bracket	33.39 %	81.23 %
28 Percent Bracket	55.81 %	101.79 %

Marginal Rates in 1993

<u>Income Tax Bracket</u>	<u>Wages Less Than \$10,730</u>	<u>Wages More Than \$10,730</u>
15 Percent Bracket	36.45 %	67.38 %
28 Percent Bracket	61.41 %	90.26 %

¹ Assumes that the Social Security benefit tax applies and that the taxpayer is below the caps on the Social Security benefit tax and the Medicare surtax.

Beginning in 1990, those elderly workers who earn more than \$8,880 will get some relief. In that year the penalty for working will be reduced to \$1 of lost Social Security benefits for each \$3 of earnings, rather than the current reduction of \$1 in benefits for each \$2 of earnings. This relief on the benefit side, however, will be partly offset by increases in the Medicare surtax for many workers. After both changes are put into effect, individuals in the 28 percent income tax bracket may still face effective marginal tax rates in excess of 90 percent.

Two Case Studies

To illustrate the impact of these tax rates, we offer examples of elderly workers earning relatively low wages and receiving only modest total income.

Case Study: A Salary Increase For An Elderly Widow Earning Twice the Minimum Wage. Table VII shows the income and taxes for an elderly widow who is earning twice the minimum wage and who has the opportunity to take a new job paying a \$1,500 higher salary. Even before the job switch this woman is already losing \$2,528 in Social Security benefits because her wages exceed \$8,880. After the job switch she will lose an additional \$750 in Social Security benefits and will be forced to pay an additional \$777 in taxes. Net result: Although the woman's salary will be \$1,500 higher, her gross income from all sources will be \$27 lower.

Case Study: A Salary Increase For An Elderly Couple, Each Earning \$8,880. Table VIII shows the income and taxes for an elderly couple. Since neither earns more than \$8,880 in wages, initially they are receiving full Social Security benefits. But suppose one of the two has the opportunity to take a new job paying \$1,000 more. As a result of the job change, the couple will lose \$500 in Social Security benefits and be forced to pay \$518 in additional taxes. Net result: Although the couple's wage income will be \$1,000 higher, their total income will be \$18 lower.

A Comparison Of Effective Marginal Tax Rates For Elderly and Non-Elderly Workers

In 1981, the president and the Congress reached an agreement on marginal tax rates -- no one should pay more than 50 cents in income taxes for each additional dollar of earnings. In 1986 a new agreement was reached -- no one should pay more than 33 cents in income taxes for each additional dollar of earnings.³⁹ These sentiments have been echoed around the world. In response to the lowering of marginal tax rates in the U.S., virtually every developed country has either lowered its highest marginal tax rates or announced its intention to do so.⁴⁰

Yet while marginal tax rates were reduced dramatically for the non-elderly, the increase in marginal rates for middle-class elderly workers has been equally dramatic. As a result, elderly workers today are a disadvantaged minority in the American labor market. Table IX shows effective marginal rates for elderly and non-elderly workers.

³⁹Does not include the FICA (Social Security) tax.

⁴⁰See Tanzi, "The Response of the Industrial Countries to the U. S. Tax Reform Act."

TABLE VII

**CASE STUDY: A SALARY INCREASE FOR
AN ELDERLY WIDOW EARNING TWICE THE MINIMUM WAGE¹**

	<u>Before Salary Increase</u>	<u>After Salary Increase</u>	<u>Change</u>
Wage Income	\$13,936	\$15,436	+ \$1,500
Pension Income	11,064	11,064	0
Social Security Benefit	5,072	4,322	- 750
Income Tax	2,950	3,371	- 420
FICA Tax	1,047	1,159	- 113
Social Security Benefit Tax	355	512	- 157
Medicare Surtax	496	583	<u>- 87</u>
Change In After-Tax Income:			- \$27

¹Wage earner is assumed to be entitled to \$7,600 in Social Security Benefits and to take the standard income tax deduction.

TABLE VIII**CASE STUDY: A SALARY INCREASE FOR
AN ELDERLY COUPLE, EACH EARNING \$8,880¹**

	<u>Before Salary Increase</u>	<u>After Salary Increase</u>	<u>Change</u>
Wage Income	\$17,760	\$18,760	+ \$1,000
Pension Income	18,640	18,640	0
Social Security Benefit	11,400	10,900	- 500
Income Tax	3,900	4,050	- 150
FICA Tax	1,334	1,409	- 75
Social Security Benefit Tax	771	1,006	- 235
Medicare Surtax	700	758	<u>- 58</u>
Change In After-Tax Income:			- \$18

¹Couple is assumed to be entitled to \$11,400 in Social Security benefits and to take the standard income tax deduction.

TABLE IX

**A COMPARISON OF EFFECTIVE MARGINAL TAX RATES
FOR ELDERLY AND NON-ELDERLY WORKERS¹**

**(Includes the FICA tax and the Social Security Benefit
Loss for Elderly Workers)**

Workers Earning Less than \$8,880

<u>Income Tax Bracket</u>	<u>Marginal Rates for the Elderly</u>	<u>Marginal Rates for the Non-Elderly</u>	<u>Extra Tax on the Elderly</u>
15 Percent Bracket	33.39 %	22.51 %	+ 10.88 %
28 Percent Bracket	55.81 %	35.51 %	+ 20.30 %

Workers Earning \$8,880 or More

<u>Income Tax Bracket</u>	<u>Marginal Rates for the Elderly</u>	<u>Marginal Rates for the Non-Elderly</u>	<u>Extra Tax on the Elderly</u>
15 Percent Bracket	81.23 %	22.51 %	+ 58.72 %
28 Percent Bracket	101.33 %	35.51 %	+ 65.82 %

¹Assumes that the Social Security benefit tax applies and that the taxpayer is below the caps on the Social Security benefit tax and the Medicare surtax.

- Among workers earning more than \$8,880, young workers are able to keep at least 64 cents of each additional dollar earned, whereas no elderly worker is able to keep more than 19 cents.⁴¹
- Overall, elderly workers face marginal tax rates that are at least 10 percentage points higher, and in some cases 65 percentage points higher, than those faced by their younger counterparts.

PAYING THE MEDICARE SURTAX

On the surface, a Medicare surtax of \$800 or less does not seem that burdensome. However, because marginal tax rates for the elderly are so high, many elderly workers get to keep only a few cents out of each dollar they earn. As a result many of the elderly may find it difficult or impossible to earn enough additional income in order to pay the surtax and maintain their 1988 standard of living. For example, a taxpayer facing a marginal tax rate of 90 percent must earn \$1,000 in order to have \$100 of take-home pay. This means that:

- A taxpayer with a 90 percent marginal tax rate must earn \$1,000 in order to be able to pay a \$100 surtax.
- The taxpayer must earn \$4,000 in order to be able to pay a \$400 surtax.
- Additional income of \$8,000 is necessary in order to be able to pay an \$800 surtax.

For those taxpayers who face marginal tax rates in excess of 100 percent, the picture is even worse. These taxpayers will experience decreases in total income as they earn additional dollars. In order to pay the Medicare surtax, then, these individuals must continue working until they reach a point where their marginal tax rate is less than 100 percent. From that point on, they must earn enough take-home pay to be able to pay the surtax plus make up for the decrease in income that occurred when their marginal tax rate was above 100 percent. For these unfortunate taxpayers, being able to pay a Medicare surtax of only a few hundred dollars may require earning tens of thousands of dollars of additional wages.

Note that the problem discussed here is not confined to the problem of paying the Medicare surtax. The problem arises if the elderly experience a need for additional income for *any* reason -- to pay the cost of a short nursing home stay, to pay the cost of an accident or casualty loss, to pay the cost of maintenance and repairs on a house, etc.

The sad truth is that the elderly are increasingly becoming wards of the government -- a government that not only controls and regulates their Social Security income and takes an increasing share of their income from savings,⁴² but a government that also effectively prevents them from obtaining additional income through productive work.

⁴¹Assumes the worker is within the range where an additional dollar of income reduces Social Security benefits by 50 cents.

⁴²The way in which the new taxes on the elderly affect non-wage income is discussed below.

Case Study: An Elderly Widow Earning Enough Additional Wages to Pay the Medicare Surtax and Maintain Her 1988 Standard of Living. As noted in the first case study, an elderly widow earning twice the minimum wage will face a new Medicare surtax of \$496. Yet if this woman wants to earn additional wages so she can pay the surtax and maintain her after-tax standard of living, she will have to earn almost ten times the amount of the surtax. As Table X shows,

- In order to pay a \$496 Medicare surtax, this woman will have to earn \$4,930 in additional wages.
- Of the \$4,930, \$496 will pay the initial surtax owed, \$1,969 will go for additional taxes, and \$2,465 will be needed to replace the half of her Social Security benefits which she loses because she is earning additional income.
- In order to earn \$4,930 at a wage of \$6.70 an hour, this woman will have to work an additional 14 hours each week in addition to the 40-hour-week she is already working.
- For each additional hour worked, she will get to keep about 67 cents to apply to the payment of the Medicare surtax.

Case Study: Worst Possible Case. A self-employed elderly man with a modest pension and \$8,880 in wage income, and living in the nation's capital, is the worst possible case. Because he is self-employed, his FICA tax rate is 13.02 percent of wages rather than 7.51 percent. Because he lives in the District of Columbia, he must pay 11 percent in local income taxes. As a result, his effective marginal tax rate is 118.37 percent, at his current level of income. In 1989, this man will be faced with an initial Medicare surtax of \$432. Yet, as Table XI shows,

- In order to pay the \$432 Medicare surtax and enjoy the same after-tax income he had in 1988, this man will have to earn \$19,599 in additional wages.
- Of the \$19,599, \$432 will pay the initial surtax, \$10,167 will go for additional taxes and \$9,000 will be needed to replace Social Security benefits which are lost because of the additional earnings.

Of course, it is inconceivable that anyone could (or would) work enough to earn \$19,599 in wages in order to prevent a \$432 decrease in his after-tax income. However, this case study illustrates an important point about incentives under the tax law. *Beginning at \$8,880, each additional dollar of income this worker earns lowers his after-tax income until he reaches a salary of \$16,260* For example,

- At a salary of \$12,000, this worker will be \$1,003 worse off than he would have been if he had continued earning \$8,880.
- At a salary of \$15,000, this worker will be \$1,313 worse off than he would have been if he had continued earning \$8,880.

TABLE X

**CASE STUDY: AN ELDERLY WIDOW
EARNING ENOUGH ADDITIONAL WAGES
TO PAY THE MEDICARE SURTAX
AND MAINTAIN HER 1988 STANDARD OF LIVING**

	<u>Without Medicare Surtax</u>	<u>With Surtax And Additional Earnings</u>	<u>Change</u>
Wage Income	\$13,936	\$18,866	+4,930
Pension Income	11,064	11,064	0
Social Security Benefits	5,072	2,607	- 2,465
Income Tax	2,950	4,330	- 1,380
FICA Tax	1,047	1,417	- 370
Social Security Benefits Tax	355	365	- 10
Medicare Surtax	<u>0</u>	<u>704</u>	<u>- 704</u>
After-Tax Income	\$25,720	\$25,720	0

Initial Medicare Surtax Owed: \$496

**Amount of Additional Earnings
Needed to Pay the Surtax: \$4,930**

TABLE XI

**WORST POSSIBLE CASE:
A SELF-EMPLOYED ELDERLY MAN PAYING STATE
AND LOCAL INCOME TAXES**

	<u>Without Medicare Surtax</u>	<u>With Surtax And Additional Earnings</u>	<u>Change</u>
Wage Income	\$8,880	\$28,479	+\$19,599
Pension Income	14,453	14,453	0
Social Security Benefits	9,000	0	- 9,000
Income Tax	2,622	7,972	- 5,350
FICA Tax	1,156	3,708	- 2,552
Social Security Benefits Tax	258	0	+ 258
State and Local Income Tax	1,592	3,748	- 2,156
Medicare Surtax	<u>0</u>	<u>800</u>	<u>- 800</u>
After-Tax Income	\$26,705	\$26,705	0

Initial Medicare Surtax Owed: \$432

**Amount of Additional Earnings
Needed to Pay the Surtax: \$19,599**

ARE THE SPECIAL TAXES ON THE ELDERLY SELF DEFEATING?

One of the most interesting components of supply-side economic theory is the finding that when very high income tax rates are imposed, higher tax rates mean less total revenue for the federal government and lower tax rates mean more total revenue. Although the finding is relatively new, the history of the U.S. income tax provides considerable supporting evidence.

- In the 1920s, when the highest income tax rate fell from 73 percent to 25 percent, the share of total taxes paid by the wealthiest taxpayers more than doubled -- rising from 28 percent to 51 percent of total revenues.⁴³
- After 1931, when the highest tax bracket was increased from 25 percent to 63 percent, the share of taxes paid by the wealthiest taxpayers fell from 47 percent to 36 percent.⁴⁴
- In the 1960s, when the highest tax bracket was reduced from 91 percent to 70 percent, the share of income taxes paid by the top five percent of taxpayers rose from 35.6 percent of all taxes in 1963 to 38.5 percent of all taxes in 1965.⁴⁵
- After the highest marginal rate was lowered from 70 percent to 50 percent as part of the 1981 tax reform, the amount of taxes paid by people earning \$200,000 or more rose from \$21.7 billion in 1981 to \$49.5 billion in 1985.⁴⁶
- Further increases in tax revenue from high-income taxpayers are expected as a result of the Tax Reform Act of 1986.

When tax rates are high, people go to great lengths to avoid earning taxable income. They take advantage of more tax shelters and arrange their affairs in order to have more tax deductions;⁴⁷ they withdraw their services from the labor market; and they turn to the underground economy. For these reasons the rate at which the federal government can collect the most possible tax revenue is fairly low. Lawrence Lindsey, the nation's leading expert on tax rates and revenues, has estimated that:

⁴³James Gwartney and Richard Stroup, "Tax Reductions, Incentive Effects, and the Distribution of the Tax Burden," (unpublished manuscript, 1982).

⁴⁴*Ibid.*

⁴⁵*Ibid.*

⁴⁶Lawrence B. Lindsey, "Individual Taxpayer Response To Tax Cuts: 1982-1984, With Implications for the Maximizing Tax Rate," *Journal of Public Economics*, Vol. 33, No. 2, July, 1987, pp. 173-206.

⁴⁷James E. Long and James D. Gwartney, "Income Tax Avoidance: Evidence From Individual Tax Returns," *National Tax Journal*, Vol. 40, No. 4, December, 1987, pp. 517-532.

- For the country as a whole, a maximum federal tax rate of 35 percent will generate the highest possible tax revenues.
- At tax rates above 35 percent, the federal government receives less total revenue than it does with a 35 percent tax rate.

Are these estimates applicable to the elderly? To our knowledge, there have been no special studies of the supply-side response of the elderly to marginal tax rates. But most labor economists believe that tax rates have considerably more effect on the labor market activities of the elderly than on the non-elderly. For example, in his analysis of the effects of the Reagan tax cuts, Robert Haveman (University of Wisconsin) estimates that elderly workers and potential workers are 2 1/2 times as sensitive to tax rates as male, adult workers under age 62.⁴⁸ Thus it seems likely that the imposition of the Social Security benefit tax and the Medicare surtax will lead to lower, not higher, tax revenues from the elderly.

THE ELDERLY MARRIAGE TAX

Are elderly couples living together better off being married or unmarried? That depends. On the one hand, marriage raises the income threshold beyond which Social Security benefits are taxed -- from \$25,000 to \$32,000. So if only one member of a couple has income, the couple gains by marriage. On the other hand, since two unmarried individuals with independent incomes both enjoy a \$25,000 threshold, their combined threshold is \$50,000. If these two individuals are married, their combined threshold is lowered from \$50,000 to \$32,000 -- an \$18,000 reduction. In this case, the Social Security benefit tax and the Medicare surtax can impose severe penalties for being married. Table XII contrasts the alternative taxes for two elderly workers, depending on their marital status. In this example:

- Being married costs the couple \$2,921 in additional income taxes.
- Of this amount, 99 percent of the marriage tax is attributable to the Social Security benefit tax and the Medicare surtax.

It is important to note that the "marriage tax" described here is almost solely the result of special taxes imposed on the elderly. For the rest of the population, Congress has either eliminated or greatly reduced the tax impact of marriage. The new "marriage tax" is almost exclusively a tax on the elderly.

What about the possibility for an elderly married couple of filing separate returns? Congress and the IRS thought about that option too. While any elderly married couple can file separate returns, the penalties for doing so are even more severe than the marriage tax. If a married couple lives together at any time during the year and files separate tax returns, their *entire Social Security benefits will be subject to the income tax*.

⁴⁸Robert Haveman, "How Much Have the Reagan Administration's Tax and Spending Policies Increased Work Efforts?" in Charles R. Hulten and Isabel V. Sawhill, eds., *The Legacy of Reaganomics: Prospects for Long-Term Growth*, (Washington, D.C.: The Urban Institute Press, 1984), p. 114. See also, David R. Henderson, "Analyzing the Reagan Record," NCPA Policy Report No. 114, October, 1984, pp. 9-12.

TABLE XII

**HOW THE SOCIAL SECURITY BENEFIT TAX
AND THE MEDICARE SURTAX
CONTRIBUTE TO THE MARRIAGE TAX**

	<u>Single Man</u>	<u>Single Woman</u>	<u>Married Couple</u>
Wage Income	\$ 8,000	\$ 8,000	\$16,000
Pension Income	12,000	12,000	24,000
Social Security Benefit	<u>10,000</u>	<u>10,000</u>	<u>20,000</u>
Total	\$30,000	\$30,000	\$60,000
 Income Tax	 \$2,123	 \$2,123	 \$4,265
Social Security Benefit Tax	- 0 -	- 0 -	2,520
Medicare Surtax	<u>318</u>	<u>318</u>	<u>1,018</u>
 Total Taxes	 \$2,441	 \$2,441	 \$7,803
Tax for Married Couple		\$7,803	
Combined Tax for Two Singles		<u>4,882</u>	
Marriage Tax		\$2,921	
Percent of Marriage Tax			
Attributable to the Social Security Benefit Tax and the Medicare Surtax		99%	

TAXES ON NON-WAGE INCOME

Congress has created a number of tax-deferred savings vehicles in order to encourage retirement savings. Among these are employer-provided pension plans, IRAs, SEPs, Keogh plans, 401(K) plans, etc. A common feature of all is the assumption that workers will face higher tax rates during their working years than during the years of their retirement. Thus, funds placed in a tax-deferred savings plan will avoid high marginal tax rates today, and will be taxed at lower marginal rates when they are withdrawn in the future.

Table XIII shows that this assumption may no longer be true. As a result of the special taxes imposed on the elderly:

- Funds withdrawn from an IRA account will be taxed at rates as high as 48.30 percent for some elderly individuals in 1989.
- By 1993, the tax on IRA withdrawals and pension income will be as high as 53.90 percent.

Table XIII also illustrates a little-noticed feature of the taxes imposed on the elderly -- the tax on "tax-exempt" income. Because tax-exempt income is included in the calculation of Social Security benefits, an additional dollar of tax-exempt income is subject to the Social Security benefits tax and, therefore, the Medicare surtax. As the table shows:

- Tax-exempt income for elderly taxpayers will be taxed at a rate as high as 16.10 percent tax in 1989.
- By 1993, the rate on tax-exempt income for elderly taxpayers will be as high as 17.92 percent.

In general, tax-exempt securities pay a lower interest rate -- reflecting the fact that taxpayers do not have to pay a 28 percent income tax. For elderly investors, however, the after-tax return on tax-exempt securities is much lower than for the non-elderly, who avoid paying the 16.10 percent tax paid by the elderly. Tax-exempt securities may still be a good buy for elderly investors, however -- especially if the alternative is fully taxable securities which will be taxed at a 48.3 percent rate. In general:

- Elderly taxpayers who are below the cap on the Social Security benefit tax avoid a tax of 48.3 percent and pay a tax of 16.10 percent (a 32.2 percent difference) by buying tax-exempt securities. For these taxpayers, tax-exempt securities are more attractive.
- Elderly taxpayers who are at or above the cap on the Social Security benefit tax, however, get the same advantage from tax-exempt securities as younger taxpayers.

Unfortunately, for middle-income elderly taxpayers uncertain about how their investment income will be taxed, making wise investment decisions may require a complicated computer program.

TABLE XIII

**TAX RATES ON NON-WAGE INCOME¹
FOR ELDERLY TAX PAYERS**

**Tax Rates on Income from Pensions,
Personal Savings and the Sale of Assets²**

<u>Income Tax Bracket</u>	<u>Rates in 1989</u>	<u>Rates in 1993</u>
15 Percent Bracket	25.88 %	28.80 %
28 Percent Bracket	48.30 %	53.76 %

Tax Rates on Tax Exempt Income³

<u>Income Tax Bracket</u>	<u>Rates in 1989</u>	<u>Rates in 1993</u>
15 Percent Bracket	8.63 %	9.60 %
28 Percent Bracket	16.10 %	17.92 %

¹ Assumes the taxpayer is below the cap on the Social Security benefit tax and the Medicare surtax.

² Refers to that portion of pension income and IRA withdrawals which is taxable.

³ Refers to income from tax exempt securities, the tax exempt portion of pension income and tax free IRA withdrawals.

CONCLUSION AND POLICY RECOMMENDATIONS

Supply-side policies are being adopted in this country and around the world because of the belief that people respond to economic incentives, that people will produce more and earn more if they are allowed to keep a greater share of what they earn.

As we have seen, the elderly are one population group that the supply-side revolution forgot. While young workers saw their tax rates lowered, middle-income older workers saw their tax rates increased. With the imposition of the Medicare surtax in 1989, many elderly workers face the highest marginal tax rates ever imposed on any significant group of U.S. taxpayers. These tax increases not only create an unfair burden for elderly workers, they impose a huge cost on the nation as a whole -- in terms of reduced output and reduced tax revenues for the federal government.

To reverse the effects of these misguided policies and allow the elderly to share the benefits of the supply-side revolution, we recommend the following:

1. **Repeal the Catastrophic Care Act.** Needed changes in Medicare coverage can be accomplished with modest premium increases or with small increases in Medicare deductibles and copayments and do not require an additional tax on income.
2. **Change the Current Method of Taxing Social Security Benefits.** The current Social Security benefit tax is not really a tax on benefits -- it is a tax on income that requires some elderly workers to pay income taxes on \$1.50 when they earn \$1.00. A better alternative would be to include one-half of Social Security benefits in the ordinary income of all Social Security beneficiaries. Along with the abolition of the Medicare surtax, this would allow the elderly to face the same income tax rates (e.g. 15 percent and 28 percent) faced by younger taxpayers. Taxing one-half of Social Security benefits as ordinary income would potentially increase government revenues, but it would also impose a hardship on the low-income elderly. The change can be made fair and revenue-neutral by offsetting the potential revenue gains with higher personal exemptions and/or standard deductions for elderly taxpayers.
3. **Adopt an Alternative Maximum Tax for Federal Income Taxes.** Elderly taxpayers currently face an effective federal income tax rate as high as 48.3 percent. By 1993, the federal income tax rate will be as high as 53.76 percent. Elderly taxpayers should have the opportunity of paying an alternative maximum tax, designed to insure that marginal tax rates are no higher than 33 percent. Lowering marginal tax rates to 33 percent would result in very little revenue loss, even if there was no change in the labor market activities of elderly workers. In view of the likely supply-side response, however, this change in the tax code would probably increase federal revenues.
4. **Eliminate the Special Taxes on the Elderly by State and Local Governments.** Although many state and local officials may be unaware of it, the federal government (through the Social Security benefit tax) has increased effective state and local income tax rates by as much as 50 percent for the elderly. The social Security benefit tax was adopted at the federal level for the ostensible purpose of protecting the financial health of the Social Security system. Yet this tax is inadvertently causing elderly taxpayers to pay unfair, discriminatory tax rates to state and local governments. This inequity can be eliminated by confining state and local income taxes to non-Social Security income.

5. **Repeal the Retirement Earnings Test.** As with private pensions and other government pensions, the elderly should be able to continue working without losing Social Security benefits. By one estimate, this change alone would induce between 300,000 and 600,000 elderly people to reenter the workforce.⁴⁹ Repeal of the retirement test would cause the government to pay out more in Social Security benefits. But from one-third to two-thirds of these higher benefit payments would be offset by increases in income taxes and payroll taxes as a result of the higher earnings of elderly workers.⁵⁰

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.

⁴⁹Aldona Robbins, "Some Effects of the Social Security Retirement Earnings Test"; testimony before the House Republican Research Committee Task Force on Regulatory Reform, December 9, 1987, p. 5.

⁵⁰*Ibid.*

APPENDIX A

TABLE I-A

MARGINAL TAX RATES FOR ELDERLY WORKERS EARNING \$8,880 OR LESS IN WAGES¹

15 Percent Income Tax Bracket

<u>Tax</u>	<u>1989 Marginal Rates</u>	<u>1993 Marginal Rates</u>
Income Tax Bracket	15.00 %	15.00 %
FICA Tax	7.51 %	7.65 %
Medicare Surtax	3.38 %	6.30 %
Social Security Benefit Tax ²	<u>7.50 %</u>	<u>7.50 %</u>
Total	33.39 %	36.45 %

28 Percent Income Tax Bracket

<u>Tax</u>	<u>1989 Marginal Rates</u>	<u>1993 Marginal Rates</u>
Income Tax Bracket	28.00 %	28.00 %
FICA Tax	7.51 %	7.65 %
Medicare Surtax	6.30 %	11.76 %
Social Security Benefit Tax	<u>14.00 %</u>	<u>14.00 %</u>
Total	55.81 %	61.41 %

¹ Assumes taxpayers are below the caps on the Social Security benefit tax and the Medicare surtax.

² Total income from wages, pensions and assets, Social Security and tax exempt income must exceed \$25,000 for an individual and \$32,000 for a couple.

TABLE II-A
EFFECTIVE MARGINAL TAX RATES
FOR ELDERLY INDIVIDUALS EARNING \$8,880 IN WAGES

Income Range: \$21,200 - \$23,332¹

<u>Tax</u>	<u>1989 Rate</u>	<u>1993 Rate</u>	<u>Comment</u>
Income Tax	15.00%	15.00%	Applicable to taxable income up to \$18,550. ²
FICA Tax	7.51%	7.65%	Employer pays an equal amount.
Social Security Benefit Loss	50.00%	33.33%	In 1989, Social Security benefits are reduced by \$1 for each \$2 of earnings above \$8,880 for individuals age 65 to 69. Beginning in 1990, benefits will be reduced by \$1 for each \$3 of earnings.
Medicare Surtax	3.09%	5.78%	Equal to \$22.50 for each \$150 of income taxes in 1989 and \$42 for each \$150 of income taxes in 1993.

¹Refers to income from all sources other than Social Security. The individual is assumed to be entitled to \$7,600 in Social Security benefits. Income tax brackets and all other dollar amounts are based on the 1989 rates recently announced by the Secretary of the Treasury. These numbers may be slightly higher in 1990 because of inflation indexing.

²The 15 percent tax bracket applies to taxable income up to \$18,550. Taxable income is total income plus taxable Social Security benefits minus the standard deduction plus personal exemption (\$5,850).

<u>Tax</u>	<u>1989 Rate</u>	<u>1993 Rate</u>	<u>Comment</u>
Social Security Benefit Tax	5.63%	5.62%	Taxable Social Security benefits are defined as 1/2 (non Social Security Income + 1/2 Social Security benefits - \$25,000) up to the point where one-half of Social Security benefits are fully taxed. Below the cap, each \$1 of wage income (after adjusting for the Social Security benefit loss) subjects 37.5 cents of Social Security benefits to the income tax in 1989 and subjects 41.75 cents of benefits to the income tax in 1993. For taxpayers who have reached the cap on the tax, each \$1 of wage income reduces the Social Security benefits tax by 25 cents in 1989 and by 16.5 cents in 1993.
Total	81.23%	67.38%	

TABLE III-A
EFFECTIVE MARGINAL TAX RATES
FOR ELDERLY INDIVIDUALS EARNING \$8,880 IN WAGES

Income Range: \$23,333 - \$28,800¹

<u>Tax</u>	<u>1989 Rate</u>	<u>1993 Rate</u>	<u>Comment</u>
Income Tax	28.00%	28.00%	Applicable to taxable income above \$18,850. ²
FICA Tax	7.51%	7.65%	Employer pays an equal amount.
Social Security Benefit Loss	50.00%	33.33%	In 1989, Social Security benefits are reduced by \$1 for each \$2 of earnings above \$8,880 for individuals age 65 to 69. Beginning in 1990, benefits will be reduced by \$1 for each \$3 of earnings.
Medicare Surtax	5.78%	10.78%	Equal to \$22.50 for each \$150 of income taxes in 1989 and \$42 for each \$150 of income taxes in 1993.

¹Refers to income from all sources other than Social Security. The individual is assumed to be entitled to \$7,600 in Social Security benefits. Income tax brackets and all other dollar amounts are based on the 1989 rates recently announced by the Secretary of the Treasury. These numbers may be slightly higher in 1990 because of inflation indexing.

²Taxable income is total income plus taxable Social Security benefits minus the standard deduction and personal exemption (\$5,850).

<u>Tax</u>	<u>1989 Rate</u>	<u>1993 Rate</u>	<u>Comment</u>
Social Security Benefit Tax	10.50%	10.50%	Taxable Social Security benefits are defined as 1/2 (non Social Security Income + 1/2 Social Security benefits - \$25,000) up to the point where one-half of Social Security benefits are fully taxed. Below the cap, each \$1 of wage income (after adjusting for the Social Security benefit loss) subjects 37.5 cents of Social Security benefits to the income tax in 1989 and subjects 41.75 cents of benefits to the income tax in 1993. For taxpayers who have reached the cap on the tax, each \$1 of wage income reduces the Social Security benefits tax by 25 cents in 1989 and by 16.5 cents in 1993.
Total	101.79 %	90.26 %	

TABLE IV-A
EFFECTIVE MARGINAL TAX RATES
FOR ELDERLY COUPLES EARNING \$8,880 OR MORE IN WAGES

Income Range: \$26,300 - \$36,335¹

<u>Tax</u>	<u>1989 Rate</u>	<u>1993 Rate</u>	<u>Comment</u>
Income Tax	15.00%	15.00%	Applicable to taxable income up to \$30,950. ²
FICA Tax	7.51%	7.65%	Employer pays an equal amount.
Social Security Benefit Loss	50.00%	33.33%	In 1989, Social Security benefits are reduced by \$1 for each \$2 of earnings above \$8,880 for individuals age 65 to 69. Beginning in 1990, benefits will be reduced by \$1 for each \$3 of earnings.
Medicare Surtax	6.19%	0.00%	Equal to \$22.50 for each \$150 of income taxes in 1989 and \$42 for each \$150 of income taxes in 1993.

¹Refers to income from all sources other than Social Security. The table assumes that Social Security benefits are \$11,400. Income tax brackets and all other dollar amounts are based on the 1989 rates recently announced by the Secretary of the Treasury. These numbers may be slightly higher in 1990 because of inflation indexing.

²The 15 percent tax bracket applies to taxable income up to \$30,950. Taxable income is total income plus taxable Social Security benefits minus the standard deduction plus personal exemptions (\$10,800).

<u>Tax</u>	<u>1989 Rate</u>	<u>1993 Rate</u>	<u>Comment</u>
Social Security Benefit Tax	3.09%	5.78%	Taxable Social Security benefits are defined as 1/2 (non Social Security Income + 1/2 Social Security benefits - \$32,000) up to the point where one-half of Social Security benefits are fully taxed. Below the cap, each \$1 of wage income (after adjusting for the Social Security benefit loss) subjects 37.5 cents of Social Security benefits to the income tax in 1989 and subjects 41.75 cents of benefits to the income tax in 1993. For taxpayers who have reached the cap on the tax, each \$1 of wage income reduces the Social Security benefits tax by 25 cents in 1989 and by 16.5 cents in 1993.
Total	81.23%	67.38%	

TABLE V-A
EFFECTIVE MARGINAL TAX RATES FOR ELDERLY COUPLES
EARNING \$8,4880 OR MORE IN WAGES

Income Range: \$36,335 - \$37,700¹

<u>Tax</u>	<u>1989 Rate</u>	<u>1993 Rate</u>	<u>Comment</u>
Income Tax	28.00%	15.00%	Applicable to taxable income above \$30,950 in 1989 and above \$35,050 in 1993. ²
FICA Tax	7.51%	7.65%	Employer pays an equal amount.
Social Security Benefit Loss	50.00%	33.33%	In 1989, Social Security benefits are reduced by \$1 for each \$2 of earnings above \$8,880 for individuals age 65 to 69. Beginning in 1990, benefits will be reduced by \$1 for each \$3 of earnings.
Medicare Surtax	5.78%	3.15%	Equal to \$22.50 for each \$150 of income taxes in 1989 and \$42 for each \$150 of income taxes in 1993.

¹Refers to income from all sources other than Social Security. The couple is assumed to be entitled to \$11,400 in Social Security benefits. Income tax brackets and all other dollar amounts are based on the 1989 rates recently announced by the Secretary of the Treasury. These numbers may be slightly higher in 1990 because of inflation indexing.

²Taxable income is total income plus taxable Social Security benefits minus the standard deduction and personal exemptions (\$10,800).

<u>Tax</u>	<u>1989 Rate</u>	<u>1993 Rate</u>	<u>Comment</u>
Social Security Benefit Tax	10.50%	- 3.75%	Taxable Social Security benefits are defined as 1/2 (non Social Security Income + 1/2 Social Security benefits - \$32,000) up to the point where one-half of Social Security benefits are fully taxed. Below the cap, each \$1 of wage income (after adjusting for the Social Security benefit loss) subjects 37.5 cents of Social Security benefits to the income tax in 1989 and subjects 41.75 cents of benefits to the income tax in 1993. For taxpayers who have reached the cap on the tax, each \$1 of wage income reduces the Social Security benefits tax by 25 cents in 1989 and by 16.5 cents in 1993.
Total	101.78%	55.38%	

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