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Tax Fairness for the Elderly: Eliminating the Social Security Earnings Penalty

Social Security recipients under age 70 who earn more than a modest amount from wages or salary are America's most heavily taxed citizens. For example, if a married 64-year-old couple with as little as $22,500 in total annual income earns another dollar in wages, as much as 83 cents of it can go to taxes. At higher income levels, the couple can pay even more than a dollar in taxes for each additional dollar they earn —*so their net income decreases if they work for pay.*

"A couple can pay more than a dollar in taxes for each additional dollar they earn."

As part of the Republican Contract With America, the House of Representatives has passed and sent to the Senate legislation that will allow Social Security recipients ages 65 through 69 to earn up to $30,000 a year by the year 2000 without penalty. This is a step in the right direction, but both the elderly and the economy would benefit more if the earnings penalty were abolished completely and immediately.

Because the earnings penalty punishes productive work, our national income is smaller than it otherwise would be. The earnings penalty also is unfair, punishing those who have to rely on wage income. Only those earning wages or salaries face a limit. There is no penalty for those who receive their income from investment.

The Tax Effects of the Earnings Penalty

Social Security beneficiaries face one of two earnings penalties, depending on their age:

- For those ages 62 through 64, the Social Security Administration reduces benefits by $1 for every $2 of wage and salary income above $8,160 per year.
- Those ages 65 through 69 lose $1 in Social Security benefits for every $3 of earnings in excess of $11,280 per year.

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Although these penalties are in the form of the withholding of benefits, they are in effect a type of tax. Specifically:

- A Social Security beneficiary whose benefits are reduced $1 for each $2 of earnings faces the equivalent of a 50 percent marginal tax rate on wage income.[1]
- Beneficiaries who lose $1 for every $3 of wages face a 33 1/3 percent marginal tax rate.[2]

This tax penalty is in addition to federal and state income and payroll taxes. As Figure I and Table I show, when all these taxes are combined, marginal tax rates are very high at moderate income levels, even for those not subject to the additional tax on Social Security benefits discussed below:

- A 64-year-old single retiree with an income of only $17,500 is in the 15 percent federal income tax bracket but may face an 83 percent marginal tax rate.
- A 65-year-old single retiree with an income of $21,000 is also in the 15 percent federal tax bracket but may face a 66 percent marginal tax rate.

"A 64-year-old single retiree with an income of only $17,500 can face an 83 percent marginal tax rate."

Effects of the Social Security Benefits Tax. As high as the marginal tax rates are for these workers, they are even higher when a working beneficiary is also subject to the so-called Social Security benefits tax, which can apply to as much as 85 percent of benefits. Despite its name, the Social Security benefits tax is really a tax on other income — interest, dividends, pensions, wages and even otherwise tax-exempt income — that beneficiaries may receive. No tax is paid unless a taxpayer's Modified Adjusted Gross

FIGURE I

Marginal Tax Rates for Workers

(15% federal income tax bracket)

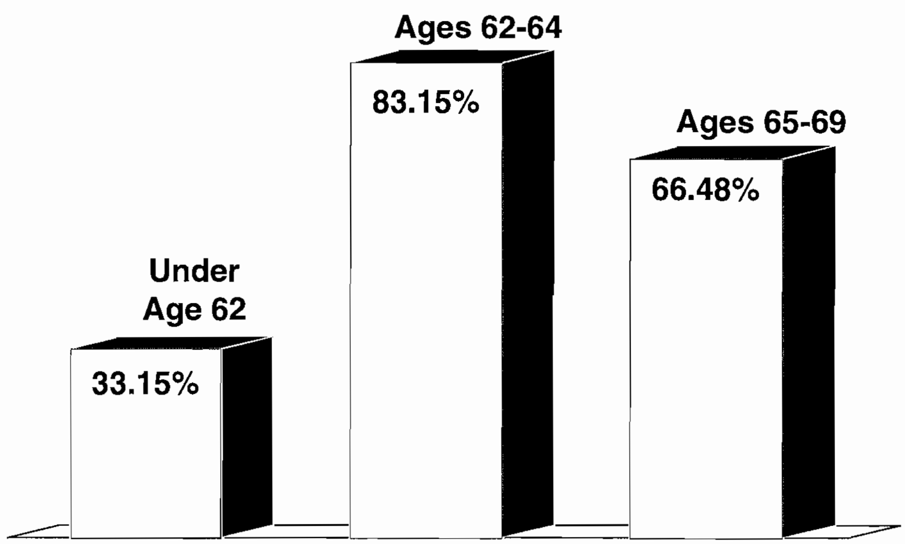

TABLE I

Examples of Marginal Tax Rates With the Earnings Penalty

(Beneficiaries in 15% federal income tax bracket)

Single Retiree	Age 64	Age 65
Savings income	$1,000	$1,000
Wage income	8,500	12,000
Social Security income	8,000	8,000
Total income	$17,500	$21,000
Marginal Tax Rate:		
S.S. benefit reduction	50.00%	33.33%
Federal income tax*	15.00	15.00
Payroll tax**	14.15	14.15
State income tax	4.00	4.00
Total marginal rate	83.15%	66.48%

Married Couple	Age 64	Age 65
Savings income	$2,000	$2,000
Wage income	8,500	12,000
Social Security income	12,000	12,000
Total income	$22,500	$26,000
Marginal Tax Rate:		
S.S. earnings penalty	50.00%	33.33%
Federal income tax*	15.00	15.00
Payroll tax**	14.15	14.15
State income tax	4.00	4.00
Total marginal rate	83.15%	66.48%

* Both individuals and couples with incomes placing them in the 28 percent income tax bracket would also be subject to the Social Security benefits tax. See Table II for examples.

** The examples incorporate the 1995 self-employed payroll tax rate after allowance for the share that is deductible from federal income tax. For those not self-employed, the combined employee/employer rate is the true measure of the tax burden on the gross wage.

Income (MAGI) reaches a certain level. Beyond that point, the tax rises as income rises.

The MAGI is the total of all non-Social Security income, including any tax-exempt interest (such as from municipal bonds), plus 50 percent of any Social Security benefits received. If the total is greater than $25,000 for single persons or $32,000 for couples, one-half of the excess is included in taxable income. Since 50 cents of benefits is taxed for each additional dollar of income, when elderly taxpayers earn $1 they pay taxes on $1.50.

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

- 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 income tax bracket pay an effective rate of 42 percent (28% x 1.5).

"Elderly taxpayers subject to both the earnings penalty and the Social Security benefits tax can face marginal tax rates of more than 100 percent."

Since the Clinton administration's 1993 tax increase, 50 percent of benefits are taxed only up to the point at which the MAGI reaches $34,000 for singles and $44,000 for couples. Beyond that point, 85 percent of benefits become taxable up to the point at which 85 percent of total benefits are included in taxable income. Since 85 cents of benefits is taxed for each additional dollar of income at that level, when elderly taxpayers earn $1 they pay taxes on $1.85.

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

When all taxes are considered [see Figure II]:

- Beneficiaries subject to both the earnings penalty and taxation of up to 50 percent of benefits can face marginal tax rates of 89 percent (those ages 65 through 69) to 105 percent (those ages 62 through 64) on additional wages.
- Beneficiaries subject to both the earnings penalty and taxation of up to 85 percent of benefits can face tax rates on additional wages of 99 percent from ages 65 through 69 and 114 percent from ages 62 through 64.

Table II shows how tax rates on additional earnings rise as Social Security benefits become subject to taxation. This table is based on a 28 percent marginal tax rate, the one to which beneficiaries with these earnings are likely to be subject.

Would Raising the Earnings Limit Increase or Decrease the Deficit?

Current budgeting rules require that added federal spending be matched by cuts in other spending or by increases in revenue. The Congressional Budget Office (CBO) estimates that raising the Social Security earnings limit to $30,000 for workers ages 65 through 69 would cost the government $6.6 billion in additional benefits paid to those workers over the next five years — thus increasing the five-year budget deficit by $6.6 billion. But the CBO's arbitrary and unrealistic accounting methods throw its estimates into question.

"In the static view, the same number of elderly people would work the same amount, whether every dollar they earned left them 50 cents richer or 5 cents poorer."

The CBO and "Static" Forecasting. The three government revenue-estimating agencies — the CBO, the Joint Committee on Taxation and the Treasury Department — all make so-called static estimates. In the case of raising or eliminating the Social Security earnings limit, the static estimate assumes that even though the incentive to earn more would be sharply higher, no more elderly people would be working, earning and paying taxes on their added income. Hence there would be no revenue gains to offset the cost of raising the earnings limit. In this view, the same number of elderly people would work the same amount, whether every dollar they earned left them 50 cents richer or 5 cents poorer.

In reality, increasing or eliminating the earnings limit could easily result in additional tax revenue equal to or greater than the apparent static cost.

The CBO et al. also omit other boosts to the federal budget from increasing or eliminating the Social Security earnings limit, including:

FIGURE II

Marginal Rates for Workers Subject to Tax on Social Security Benefits

(28% federal income tax bracket)

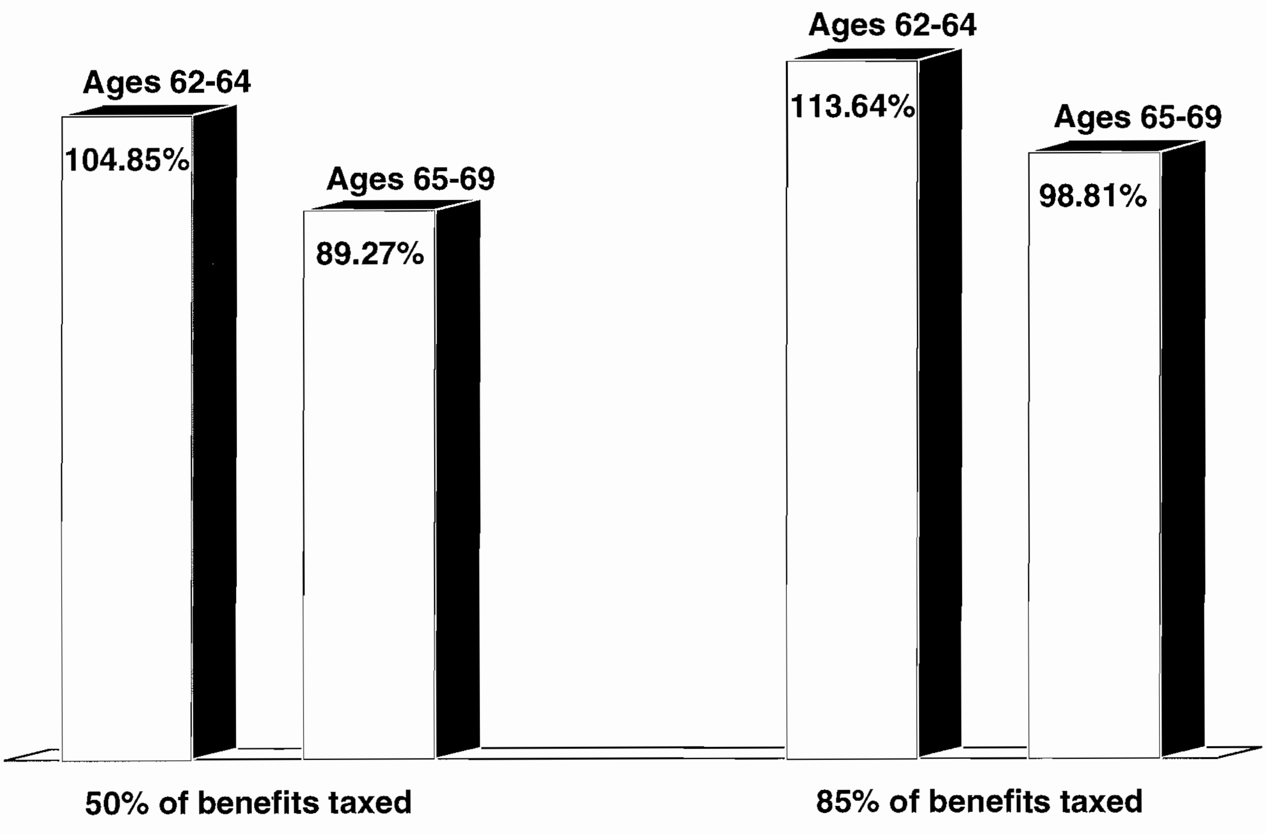

TABLE II

Tax Rates With the Earnings Penalty as Social Security Benefits Become Subject to Taxation

(Beneficiaries in 28% federal income tax bracket)

	Married Couple 50% phase-in range	Married Couple 85% phase-in range
Pension income	$12,000	$18,000
Savings income	7,000	12,000
Wage income	12,000	12,000
Social Security income	12,000	14,000
Total income	$43,000	$56,000

	Age 64	Age 65	Age 64	Age 65
Marginal Tax Rate:				
S.S. benefit reduction	50.00%	33.33%	50.00%	33.33%
Federal income tax*	38.50	39.67	45.85	47.84
Payroll tax**	12.35	12.27	11.79	11.64
State income tax	4.00	4.00	6.00	6.00
Total marginal rate	104.85%	89.27%	113.64%	98.81%

* Effective rate in the 28 percent bracket caused by a complex interaction resulting when the earnings penalty reduces the amount of income considered in calculating the benefits tax. The rate due to the earnings penalty is not strictly additive to the income tax effects of benefits taxation.

** The examples incorporate the self-employed payroll tax rate after allowance for the share that is deductible from federal income tax.

- If greater labor market participation by the elderly caused more of them to be covered by an employer's medical insurance, there would be less spending by Medicare.[3]
- Medicaid and Supplemental Security Income outlays would be less as the elderly ages 65 through 69 saved part of their additional earnings to support themselves later.

"Increasing or eliminating the earnings limit would likely increase tax revenues and decrease federal expenditures."

Increasing or eliminating the earnings limit would likely increase tax revenues and decrease federal expenditures — economic effects the estimators choose to ignore.

Would Changing the Earnings Limit Affect the Social Security "Trust Fund"? Another arbitrary and unnecessary restriction on changing the earnings limit arose from the Omnibus Budget Reconciliation Act of 1990 (OBRA90), which forbade any action to worsen the five-year and 75-year "actuarial balance" of the system. If the payment of benefits increased as forecast by static analysis, it could technically have an unfavorable effect on the Social Security trust fund.

"The trust fund and the actuarial balance are completely irrelevant to changing the earnings limit."

In fact, this restriction has no economic meaning and no impact on the health of the Social Security program. The reason is that the Social Security trust fund does not really fund benefits in the future. It contains Treasury securities — federal IOUs that the government has written to itself. These IOUs are liabilities, not assets, of the government. Thus, the trust fund is nothing more than budget authority for the Social Security Administration — permitting it to continue spending without requiring further permission from the Congress. When the time comes to pay future benefits, the Treasury will have to get the money by taking it out of current tax revenues or borrowing in that year's credit market.

The trust fund and the actuarial balance are completely irrelevant. If the Congress is worried about the trust fund, it can add to it by ordering the Treasury Department to:

- Pay a higher rate of interest on the trust fund balances for five years; or
- Mark up the trust fund balance by $6.6 billion over five years with a simple bookkeeping entry.

Financing Repeal of the Earnings Limit

If Congress nonetheless insists on "paying" for the repeal of the earnings limit under static scoring rules, there are ways to do so within the confines of the Social Security system. Some changes often proposed for the system would enhance work and saving incentives; others would reduce them.

Accelerating the Scheduled Increase in the Normal Retirement Age. The 1983 Social Security Amendments provide for a gradual increase in the normal retirement age (the age at which a retiree may collect full benefits) from 65 to 67, as follows:

- The age will rise from 65 to 66 at a rate of two months per year for those reaching age 62 between 2000 and 2005.
- It will rise from 66 to 67 for those reaching age 62 between 2022 and 2027.
- Retirement will still be allowed beginning at age 62, but an early retiree will receive 5 percent less in benefits for each additional year of early retirement.

If this scheduled increase in the normal retirement age were accelerated by four years so that the phased increases began with those reaching age 62 in 1996, it would save about $4 billion by 2000. This would be enough to cover more than half of the five-year static cost of raising the earnings limit to $30,000 for beneficiaries ages 65 through 69. The rise in the retirement age would be very gradual.

- Someone turning age 62 in 1996, and planning to retire at age 65 in 1999, would have to plan on working an additional eight months to collect current law benefits.
- Someone planning on early retirement at age 62 in 1996 could choose between two additional months of work or an additional early retirement penalty of about 1 percent of the benefit he or she otherwise would receive.

This proposal would encourage work effort and reduce federal spending almost immediately.

"A number of minor adjustments within the Social Security system could provide savings."

Minor Adjustments in the Benefit Computation Process. Several adjustments have been considered at one time or another to provide additional savings. For example, persons retiring later than the month they become 65 receive an increase in benefits for each month they delay. Under current law this credit is going up in stages. Accelerating the process would encourage later retirement and save about $500 million per year in conjunction with ending the retirement earnings limit. It would have no adverse economic impact. Administrative cost savings of nearly $100 million from not having to track down "excess" earners and adjust their benefits should be counted as well. Such savings would be a clear reduction in wasteful costs.

Ending Recomputation of Benefits for Earnings Beyond the Normal Retirement Age. Currently, Social Security benefits are recomputed to take into account additional earnings for those who work past the normal retirement age. Eliminating the recomputation of benefits could save about $800 million per year. This would somewhat reduce the incentive to work, but it would offset only a small portion of the added incentive created by the earnings limit repeal.

Early Retirement Penalty. Eliminating the earnings penalty for those eligible to receive benefits below normal retirement age — currently, people ages 62 through 64 — should be considered. Perhaps the early retirement penalty could be increased slightly to defer part of the cost. However, this should not be done without one or two years' advance notice to give people time to save or to plan to work an additional few months to make up for the change in the benefit computation procedure.

Changing the Method of Taxing Benefits. Ideally, Congress should stop taxing Social Security benefits based on the amount of other income. Lower-income taxpayers could be sheltered from benefits taxation quite simply, and without this tax penalty on other retirement income. Some amount of benefits — say $6,000 for a single retiree, $8,000 for a couple using a 50 percent spousal benefit and up to $12,000 for a couple with independent benefits — could be made tax exempt. Up to one-half of benefits above the exempt amounts could be added to ordinary taxable income. These exempt amounts and/or the percent of benefits subject to tax could be adjusted to produce at least as much revenue as the current method of taxing benefits.

This switch in the method of taxation would reduce marginal tax rates on other retirement income without reducing revenue to government. This, in turn, would sharply enhance saving incentives and economic growth, which would actually increase federal revenue. However, adding more benefits to taxable income would push some taxpayers into higher tax brackets, and to that extent it would be counterproductive. Therefore the new taxation formula should be adjusted to insure it is no more than revenue-neutral, and other means should be found to "pay for" the elimination of the earnings limit.

Reducing Replacement Rates. Finally, a small adjustment in the benefit formula itself could be considered. As shown in Table III, the current formula provides for very large increases in real benefits per retiree in the years ahead. A trade-off could be devised, reducing the projected benefit increases and replacement rates (benefits as a percent of preretirement earnings) in exchange for a phase-out of the earnings limit for the lower age group. Such a reform would have a positive impact on the federal budget and the economy. The rate at which benefits grow must be trimmed anyway to avoid deficits when the baby boom generation retires, and the sooner the better.

"The rate at which benefits grow could be trimmed in exchange for a phase-out of the earnings limit."

TABLE III

Estimated Real Benefit Amounts of Single Workers Retiring at Age 65[1] With Various Preretirement Earnings Levels[2]

(Based on Alternative II Assumptions)

	Constant 1995 Dollars			Percent of Earnings		
Calendar Year	**Low Earnings**	**Average Earnings**	**Maximum Earnings**	**Low Earnings**	**Average Earnings**	**Maximum Earnings**
1995	**6,255**	**10,322**	**14,424**	**58.2%**	**43.2%**	**23.8%**
2010	**6,828**	**11,293**	**17,610**	**56.2%**	**41.9%**	**27.2%**
2040	**9,152**	**15,160**	**24,025**	**56.0%**	**41.8%**	**27.6%**
2070	**12,169**	**20,205**	**31,976**	**56.0%**	**41.8%**	**27.6%**

[1] Retirement age at which full benefits are payable, currently 65, will rise to age 66 at the rate of two months per year for those reaching age 62 between 2000 and 2005 and to 67 for those reaching age 62 between 2022 and 2027.

[2] Low earnings equal 45 percent of average earnings. Average earnings assume worker earned national average covered earnings each year of his or her working life. Maximum earnings assume worker earned the SSA contribution and benefit base (maximum covered earnings) each year.

Source: *1995 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds, Table III.B5.*

Conclusion

Repealing or at least raising the Social Security earnings limit would produce important benefits. These include tax simplification, lower administrative costs and greater personal choice for the elderly. The change would also lead to more work, more saving and investment, more output of goods and services and more income for both individuals and the government.

Even if the impact on the federal budget is negative — or the current rules for scoring the impact of tax changes on revenue force Congress to assume that it is — this concern is overbalanced by the tremendous benefits to be had from this reform and can be alleviated by other minor adjustments to the benefit computation rules.

"The current limit and tax treatment impose mindless disincentives to work and save."

Reform of the earnings limit and Social Security benefits taxation is urgent. The current limit and tax treatment impose mindless disincentives to working and saving. If the object is fairness, it cannot be achieved with tax rates approaching or exceeding 100 percent. If the object is to turn Social Security into means-tested welfare, there are surely more efficient ways to do it.

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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 This tax rate continues until wages above the earnings limit reach twice the amount of benefits — at which time all benefits have been lost.

2 This tax rate continues until earnings in excess of the limit reach three times the amount of benefits.

3 Group health plans of employers with 20 or more employees are the primary payers and Medicare is the secondary payer for workers age 65 or older.

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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. Its 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.

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- Special taxes on the elderly have destroyed the value of tax-deferred savings (IRAs, employee pensions, etc.) for a large portion of young workers; and
- Man-made food additives, pesticides and airborne pollutants are much less of a health risk than carcinogens that exist naturally in our environment.

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