

Report for Congress

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Social Security: Taxation of Benefits

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Geoffrey Kollmann
Specialist in Social Legislation
Domestic Social Policy Division

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Summary

Until 1984, Social Security was exempt from the federal income tax. For years many analysts advocated that it be treated like other pensions, whose benefits are fully taxable except for the portion attributable to the worker's contributions. To help restore the program's solvency, in 1983 Congress made up to 50% of benefits taxable for taxpayers whose income plus 50% of their benefit exceeds \$25,000 for individuals or \$32,000 for couples. The proceeds are credited to the Social Security trust funds. In 1993, President Clinton proposed that up to 85% of Social Security benefits be taxable (the proportion said to be the least anyone would pay under the rules applying to other pensions). The 1993 omnibus budget reconciliation bill (P.L. 103-66) limited the measure to recipients whose threshold incomes exceed \$34,000 (single) or \$44,000 (couples), with proceeds from this measure going to Medicare.

Repeal of the 1993 provision was part of the Republican "Contract with America," and was approved by the House as part of the omnibus budget reconciliation bill (H.R. 2491) but was not included in the final law. Subsequently, with Social Security again facing long-range financing problems, proposals have been made to increase taxation of benefits further. The 1994-1996 Advisory Council on Social Security recommended that taxation of benefits should be increased, as did two bills in the 105th and 106th Congresses. There also continues to be pressure to repeal or mitigate the effects of the taxation of Social Security benefits. In the 106th Congress, 15 bills were introduced that would reduce taxes on benefits. On July 27, 2000, the House of Representatives approved H.R. 4865, which, effective in 2001, would have repealed the 1993 provision, thus lowering the maximum amount of benefits subject to taxation from 85% to 50%, and would have replaced the resulting reduction in revenue to Medicare with general fund transfers. In the 107th Congress, 10 bills have been introduced that would liberalize the taxation provision.

Proponents of repeal argue that taxation of benefits is unfair, as it changed the rules in the middle of the game, penalizing recipients who relied on old law and who cannot change past work and savings decisions. Regardless of abstract arguments about tax principles, many recipients regard increased taxation as simply a reduction in the benefits they had been promised. They see taxation of benefits as an indirect means test, which they oppose because they view Social Security as an "earned right," unlike welfare, where need determines the level of benefits. Finally, they maintain that it grossly distorts marginal tax rates and provides a strong disincentive for many recipients to work.

Opponents of repeal argue that it would be a giveaway for well-off recipients that would weaken the Social Security and Medicare trust funds. It would enlarge an inequitable tax advantage for Social Security benefits, especially when the after-tax income of recipients is compared to that of working families with the same gross income. Moreover, they say that if benefits must be cut to restore solvency to Social Security and Medicare, taxing benefits is the most equitable and efficient way to implement *de facto* benefit reductions. They say that it concentrates more of the burden on higher income households, and thus better aligns benefits with need, than would broader measures that would also affect the poor.

Contents

Current Law	1
Effect on Recipients and Trust Funds	3
History	3
P.L. 103-66	5
Treatment of Nonresident Aliens	8
Proposed Changes in Taxation of Benefits	8
Contract with America	8
Support and Opposition	8
Recent Proposals	8
Legislation in the 107 th Congress	9
Arguments for Taxation of Benefits	10
The Financial Perspective	10
Tax Equity	10
Alignment of Benefits with Need	12
Arguments Against Taxation of Benefits	12
Deliberalization	12
Special Nature of Social Security	12
Effect on Marginal Tax Rates and Incentives to Work	13

List of Figures

Figure 1. Total Federal Tax Burden Under Current Law	11
Figure 2. Marginal Tax Rates on Additional Income	14

List of Tables

Table 1. Effect of Taxing Social Security Benefits Under Current Law by Income Class, 2000	3
Table 2. Additional Federal Income Tax Liability in 2002 Under P.L. 103-66 ..	7

Social Security: Taxation of Benefits

Current Law

In general, the Social Security and tier one Railroad Retirement (analogous to Social Security) benefits of most recipients are not subject to the income tax. However, up to 85% of Social Security and tier one Railroad Retirement benefits can be included in taxable income for recipients whose “provisional income” exceeds certain thresholds.

“Provisional income” is adjusted gross income, but modified to include otherwise tax-exempt “interest” income (i.e., interest from tax-exempt bonds), plus one-half the Social Security benefit. The thresholds below which no Social Security or tier one benefits are taxable are \$25,000 (single), \$32,000 (couple filing joint return) and \$0 (couple filing separately).

The tax on benefits when provisional income exceeds these thresholds depends on the level of the provisional income. If it is between the \$25,000 or \$32,000 threshold and a second level threshold of \$34,000 (single) or \$44,000 (couple), the amount of benefits subject to tax is the lesser of: (1) 50% of benefits; or (2) 50% of income in excess of the first threshold. If income is above the second threshold, the amount of benefits subject to tax is the lesser of:

- (1) 85% of benefits; or
- (2) 85% of income above the second threshold, plus the smaller of:
 - (a) \$4,500 (single) or \$6,000 (couple); or
 - (b) 50% of benefits.

For couples filing separately, taxable benefits are the lesser of 85% of benefits or 85% of provisional income.

Neither the first nor second level thresholds are indexed to rise with inflation or wage growth.

This tax treatment differs from that of private and public pension benefits, in which all benefits that exceed the nominal amount (i.e., actual dollars unadjusted for inflation or interest) of the employee’s contribution are fully taxable. It was projected that about 32% of Social Security recipients paid income tax on their benefits in 2000.

The proceeds from taxation of Social Security and tier one benefits at the 50% rate are credited to the Social Security trust funds and the Railroad Retirement

system, respectively. Proceeds from taxation of Social Security benefits and tier one benefits at the 85% rate are credited to the Hospital Insurance trust fund of Medicare.

Example 1 below illustrates how the provision currently works. The taxable portion of a \$10,000 annual benefit for a single taxpayer who has \$32,000 in adjusted gross income is computed thus: First, provisional income is determined ($\frac{1}{2} \times \$10,000 = \$5,000$ [one-half of the Social Security benefit], + \$32,000 [adjusted gross income] = \$37,000). Because this amount is over the second-level threshold of \$34,000, 85% of the difference between provisional income and the second-level threshold ($\$37,000 \text{ minus } \$34,000 = \$3,000 \times 85\% = \$2,550$) is added to the lesser of (a) \$4,500 or (b) \$5,000 (50 % of benefits). In this case $\$2,550 + \$4,500 = \$7,050$.

Example 1: Current Law	
Adjusted gross income	\$32,000
½ of benefits	+5,000
Total	37,000
Less current law	
exempt amount	-25,000
Excess	12,000
Taxable benefits based on	
first threshold	4,500
(lower of 50% of excess, 50% of benefits, or \$4,500)	
85% of excess above	
second threshold	2,550
[\$37,000 - \$34,000] x 85%	
Total benefits taxable	\$7,050
(taxable portions above first and second thresholds, or 85% of benefits, if lower)	

If in this example the recipient's adjusted gross income were, say, \$28,000, provisional income would be \$33,000 (one-half the Social Security benefit [\$5,000] plus \$28,000 = \$33,000). Because this sum is less than the applicable second level threshold of \$34,000, the amount of benefits subject to tax is the lesser of (a) 50% of benefits (\$5,000) or (b) 50% of the difference between provisional income and the first-level threshold ($\$33,000 \text{ minus } \$25,000 = \$8,000 \text{ divided by } 2 = \$4,000$). Because \$4,000 is less than one-half of the Social Security benefit, \$4,000 would be the amount of benefits subject to the income tax. If the recipient's other income were less than \$20,000, he would pay no tax on his Social Security benefits because the combination of one-half of his Social Security (\$5,000) and his other income would be less than the threshold of \$25,000.

Effect on Recipients and Trust Funds

Because of the \$25,000 and \$32,000 thresholds, recipients with low incomes are largely unaffected by the taxation of benefits. Of those affected, the majority have annual incomes of \$50,000 or more. **Table 1** shows, for varying levels of income, the number and proportion of recipients who are projected to pay taxes on their benefits in 2000, and the amount of taxes they are projected to pay. These are *averages*, and do not necessarily indicate the actual tax liability of persons in these income brackets.

Table 1. Effect of Taxing Social Security Benefits Under Current Law by Income Class, 2000

Level of individual or couple income ^a	Number of SS recipients (in thousands)	Number affected by taxation of benefits (in thousands)	Percent of recipients affected by taxation of benefits	Aggregate amount of taxes on benefits (in millions)
Less than \$10,000	7,410	0	0%	0
\$10,000 to \$15,000	5,064	0	0%	0
\$15,000 to \$20,000	4,244	0	0%	0
\$20,000 to \$25,000	3,408	0	0%	0
\$25,000 to \$30,000	2,964	105	4%	\$12
\$30,000 to \$40,000	4,747	1,490	31%	\$506
\$40,000 to \$50,000	3,702	3,189	86%	\$1,761
\$50,000 to \$100,000	5,749	5,605	97%	\$8,833
\$100,000 and more	2,133	2,128	100%	\$6,187
All	39,421	12,517	32%	\$17,299

Source: Congressional Budget Office, based on the Current Population Survey (CPS).

Note: Aggregate benefits, recipients and revenues are understated by about 10% because of benefits paid abroad, deaths of recipients before March interview, and exclusion of institutionalized recipients.

^a Cash income (based on income, including Social Security, of tax filing unit), plus capital gains realizations.

History

Until 1984, Social Security benefits were exempt from the federal income tax. The exclusion was based on rulings made in 1938 and 1941 by the Internal Revenue Service (IRS). The reasoning then appeared to be that: (1) the lack of an explicit provision to tax benefits implied that Congress did not intend for them to be taxed; (2) the benefits were intended to be “gifts” made in aid of the general welfare, not

annuities; and (3) taxing benefits would defeat the underlying purposes of the Social Security Act.

Under these rules, the treatment of Social Security was similar to that of other types of government transfer payments (such as Aid to Families with Dependent Children, Supplemental Security Income, and black lung benefits), but in sharp contrast to that of benefits under private pension plans, the Federal Civil Service Retirement System, and other government pension systems. Benefits from these other pension plans are fully taxable except for the proportion of total lifetime benefits (using projected life expectancy) attributable to the employee's own contributions to the system (and on which he or she had already paid income tax). Both the value of the lifetime contributions and expected benefits are computed in nominal (i.e., current) dollars.

Under Social Security, the worker's contribution to the system is his or her share, or one-half, of the payroll tax, officially known as the Federal Insurance Contributions Act (FICA) tax. The amount the worker pays into the Social Security system is taxed as income when earned. The employer's contributions to the system, however, are not considered part of the employee's gross income and are deductible from the employer's gross business income as a business expense. In other words, neither the employee nor the employer pays taxes on the employer's contribution. Thus, under the old law the benefits resulting from the payment of payroll taxes were not only tax free, but arose from income partially sheltered from taxation.

For years many analysts questioned the basis for the IRS rulings and advocated that the tax treatment of Social Security be the same as for other pension income. The 1979 quadrennial Advisory Council on Social Security debated whether Social Security benefits should be subject to taxation. A majority concluded that the original IRS ruling was wrong and that the tax treatment of private pensions was a more appropriate model for tax treatment of Social Security. They estimated that the most anyone who entered the workforce in 1979 would pay in nominal payroll taxes during his or her lifetime would equal 17% of the Social Security benefits he or she would ultimately receive. (This was the most any individual would pay; in the aggregate workers would make payroll tax payments amounting to substantially less than 17% of their ultimate benefits.) Because of administrative difficulties involved in determining the taxable amount of each individual benefit, the Council recommended instead that half of everyone's benefit be taxed. They justified this ratio as a matter of "rough justice" and noted that it coincided with the portion of the tax (the employer's share) on which income taxes had not been paid.

However, it was only after the Social Security system was threatened with insolvency in the early 1980s that taxing benefits received serious political attention. The 1982 National Commission on Social Security Reform proposed that, beginning in 1984, one-half of Social Security cash benefits and tier I benefits payable under the Railroad Retirement Act be taxable for individuals whose adjusted gross income, excluding Social Security cash benefits, exceeded certain thresholds, with the proceeds of such taxation credited to the Social Security trust funds. The Commission deliberately did not include any provisions for indexing the threshold amounts. It was understood that as nominal incomes rise, as they nearly always have, increasing proportions of Social Security recipients would be affected by the

proposal. The Commission's proposal had an obvious "notch" problem, in that the extra dollar of income that would put one over the threshold would have had the effect of subjecting fully one-half of Social Security benefits to taxation. In enacting the 1983 Social Security Amendments (P.L. 98-21), Congress essentially adopted the Commission's recommendation, but substituted an arrangement for determining the amount of benefits to be taxed that imposed the tax on benefits gradually as a person's income rose above the thresholds. Under this arrangement, the amount of taxable benefits was the lesser of one-half of benefits or one-half of the excess of the taxpayer's provisional income (see above) over thresholds of \$25,000 (single) and \$32,000 (couple).

In subsequent years, pressure to solve the government's mounting fiscal problems led to calls to subject a greater share of benefits to taxation. Many supporters of doing so maintained that Social Security should be treated like private and public pensions. In 1990, the Social Security Administration's Office of the Actuary determined that, if these pension tax rules were applied to Social Security, the ratio of total employee Social Security payroll taxes to expected benefits (all in nominal dollars) for current recipients would be, on average, about 4% or 5%. For workers entering the workforce today and for the next decade, the ratio would be, on average, about 7%. Because Social Security benefits replace a higher proportion of earnings of workers who are lower paid and have dependents, and because women have longer life expectancies, the workers with the highest ratio of taxes to benefits would be single, high-paid males. The ratio for these workers entering the workforce today would be 15%.

Strict application of the tax rules for private and public pensions was seen to present practical administrative problems, however. Determining the proper exclusion would be complex; for example, it is possible that several people may receive benefits based on the same worker's account. It was recognized that a simpler and more practical approach would be to approximate the effect of applying private pension rules by subjecting a set percentage of Social Security benefits to the income tax. Taxing 85% of benefits (the portion of benefits on which tax would not have been paid for single, high-paid males) was suggested because it would ensure that no one would have a higher percentage of benefits subject to tax than if the tax policy for private and civil service pensions were actually applied. It also would ensure that no one was taxed twice on the same income (i.e., no "double taxation").

P.L. 103-66

As part of his plan to cut the federal budget deficit, President Clinton proposed on February 17, 1993, that the proportion of benefits subject to taxation should be increased from 50% to 85%, effective in 1994. His budget document said this would "move the treatment of Social Security and Railroad Retirement tier I benefits toward that of private pensions." Just as under then current law, only Social Security recipients whose provisional income (modified adjusted gross income plus one-half of their benefits) exceeded the thresholds of \$25,000 (single) and \$32,000 (couples) were to pay tax on their benefits. Also as under current law, the first step was to add one-half (not 85%) of benefits to adjusted gross income. However, 85% of the difference between the resulting figure and the thresholds was to be compared to 85% of the Social Security benefits, and the lesser of the two figures was to be the amount

of benefits taxed. Structured this way, the measure was meant not to affect recipients currently exempt from paying taxes on benefits.

The proposal was included in President Clinton's FY1994 budget. The proceeds would not have been credited to the Social Security trust funds, as under then current law, but to the Medicare Hospital Insurance program, which has a less favorable financial outlook than does Social Security. Doing so also avoided possible procedural obstacles (budget points of order that can be raised regarding changes to the Social Security program in the budget reconciliation process). This measure was included in the 1993 Omnibus Budget Reconciliation Act (OBRA) passed by the House on May 27, 1993.

The Senate version of the bill adopted the 85% measure, but imposed it only after an individual's or couple's AGI plus one-half of Social Security exceeded new thresholds of \$32,000 and \$40,000. When the House and Senate versions of the budget package were negotiated in conference, the conferees modified the Senate taxation of Social Security benefits provision by setting the second level thresholds at \$34,000 (single) and \$44,000 (couple). At that time, the proposal was projected by the Joint Committee on Taxation to produce revenues of \$24.6 billion to the HI trust fund over 5 years, and affect about 13% (about 5 million) Social Security recipients. On August 6, 1993, the Senate passed the bill by a vote of 51-50. President Clinton signed the measure into law (as part of P.L. 103-66) on August 10, 1993. **Table 2** shows examples of the additional tax liability of recipients in 2002 under P.L. 103-66. **Table 2** also can be used to illustrate the reduction in tax liability that would occur if the 1993 provision were repealed, effective in 2002.

**Table 2. Additional Federal Income Tax Liability in 2002
Under P.L. 103-66**

	Annual Social Security benefits				
	\$5,000	\$10,000	\$15,000	\$20,000	\$25,000
Other income^a	Additional tax liability^b				
Single Filers					
\$20,000	—	—	—	c	d
\$25,000	—	—	—	c	d
\$30,000	—	\$52.50	\$264.75	c	d
\$35,000	\$472.50	\$945.00	\$1,140.75	c	d
\$40,000	\$472.50	\$945.00	\$1,417.50	c	d
\$50,000	\$472.50	\$945.00	\$1,417.50	c	d
\$75,000	\$525.00	\$1,050.00	\$1,575.00	c	d
\$100,000	\$525.00	\$1,050.00	\$1,575.00	c	d
Joint filers					
\$20,000	—	—	—	—	—
\$25,000	—	—	—	—	—
\$30,000	—	—	—	—	—
\$35,000	—	—	—	\$52.50	\$183.75
\$40,000	—	\$127.50	\$221.25	\$315.00	\$446.25
\$50,000	\$262.50	\$525.00	\$835.50	\$1,608.00	\$2,362.50
\$75,000	\$472.50	\$945.00	\$1,417.50	\$1,890.00	\$2,362.50
\$100,000	\$472.50	\$945.00	\$1,417.50	\$1,890.00	\$2,362.50

^a Adjusted gross income excluding Social Security, and assuming no tax-free interest is received.

^b Individuals are assumed to be age 65 or older and use the standard deduction.

^c Very few single individuals currently receive this level of benefits.

^d Virtually no single individual currently receives this level of benefits.

Because the new law incorporated both old and new rules, the computation of total taxable benefits can be complicated. (For a detailed explanation of how the taxable portion of benefits is computed, see archived CRS Report 93-336, *Determination of Taxable Social Security Benefits Under New Law: A Fact Sheet*, by Geoffrey Kollmann.)

Treatment of Nonresident Aliens

Citizenship is not required for receipt of Social Security benefits. Aliens may receive benefits provided they have engaged in covered employment and otherwise meet eligibility requirements. However, aliens residing outside the United States are subject to different tax withholding rules. Because the U.S. Government does not know the amount of other income of these individuals on which to base a tax rate, Section 871 of the Internal Revenue Code imposes an arbitrary rate of tax withholding (30%) on almost all the U.S. income of nonresident aliens, unless a lower rate is fixed by treaty. Thus, 30% of 85% of a nonresident alien's Social Security is subject to income tax withholding (i.e., the thresholds do not apply).

Proposed Changes in Taxation of Benefits

Contract with America

During the 1994 Congressional campaign, Republican leaders pledged that if they gained control of the House of Representatives they would enact certain measures contained in a "Contract with America." One such measure promised to repeal the OBRA 1993 provision over a period of 5 years. The percentage of Social Security and Railroad Retirement tier one benefits subject to income tax would drop from 85% to: 75% in 1996; 65% in 1997; 60% in 1998; 55% in 1999; and 50% in 2000. For nonresident aliens, the percentage of benefits subject to income tax withholding would likewise drop gradually to 50%. The measure was included in the 1995 omnibus budget reconciliation bill approved by the House. However, the Senate version did not repeal the OBRA 1993 provision. The conference agreement reflected the Senate's position, so the provision was not included in the final version of H.R. 2491 passed by Congress (but vetoed by President Clinton).

Support and Opposition. In 1995, the National Committee to Preserve Social Security and Medicare stated that the organization favored repeal of the 1993 provision. The American Association of Retired Persons originally opposed enactment of the 1993 law, and did not change its position. The National Council of Senior Citizens said it did not favor repeal unless a way were found to replace the revenue that would be lost to the Medicare trust fund. The AFL-CIO and the coalition Save Our Security opposed repeal. So did Robert Ball and Robert Myers, former Commissioner and Chief Actuary, respectively, of the SSA.

Recent Proposals

Subsequently, with Social Security again facing long-range financing problems, proposals have been made to increase taxation of benefits further. Although the 1994-1996 Advisory Council on Social Security could not agree on a common solution to Social Security's long-range financing problems, splitting into three factions, it did recommend that the income thresholds be repealed, and two of the factions also recommended that all benefits in excess of contributions be taxable. Bills to restore solvency to the system introduced by Senator Moynihan (S. 1792 in the 105th, and S. 21 in the 106th, Congress) also proposed full taxation of benefits.

There also continues to be pressure to repeal or mitigate the effects of the taxation of Social Security benefits. In the 106th Congress, 15 bills were introduced that would liberalize the taxation provision. Ten (H.R. 48, H.R. 107, H.R. 688, H.R. 3438, H.R. 4865, S. 137, S. 286, S. 482, S. 488, S. 2180) would have repealed the 1993 provision, returning the maximum amount that can be subject to taxation to 50% of benefits. Two (H.R. 761, S. 2304) would also have repealed the 1983 provision, and thus would restore the original tax-free status of Social Security benefits. Two would have removed certain income from the computation of how much of the benefit is taxable. H.R. 291 would have excluded income from municipal bonds, and H.R. 3857 would have excluded income from workers' compensation. One, H.R. 3437, would have indexed the thresholds so that they would rise each year in proportion to the rate of inflation.

On July 13, 2000, during consideration of H.R. 8, the Death Tax Elimination Act, the Senate adopted by a vote of 58-41 an amendment by Senator Grams that would have repealed the 1993 provision effective in 2001. However, this amendment was later dropped in order to make the Senate version of the bill identical to the House-passed version.

On July 19, 2000, the Committee on Ways and Means approved H.R. 4865, a bill that, effective in 2001, would have repealed the 1993 provision, thus restoring the maximum amount of benefits subject to taxation to 50%, by a vote of 22-15. For nonresident aliens, the percentage of benefits subject to income tax withholding likewise would drop gradually to 50%. Preliminary estimates were that about 20% (about 9 million) of Social Security recipients would have been affected by H.R. 4865. The loss of revenue to the Medicare trust funds this would produce was estimated to be \$44.6 billion over 5 years. To compensate, the bill provided that an amount equal to what the 1993 provision would have generated would be calculated by the Treasury Department and such amount would be credited to the HI trust fund through a permanent appropriation from the general fund. The Committee also approved an amendment requiring that the Treasury Department report to Congress annually the amount and timing of such transfers. On July 27, 2000, the House approved H.R. 4865 by a vote of 265 to 159. A Democratic alternative, which would have raised the thresholds at which the 85% taxation applies to \$80,000 (single) and \$100,000 (couple), with the general fund reimbursing the HI trust fund for the resulting foregone revenue, was rejected by a vote of 169-256. The tax reductions in this proposal would have applied only in years when the non-Social Security and Medicare surplus (i.e., the budget surplus excluding Social Security and Medicare), was adequate to cover the general fund reimbursement of the HI trust fund.

Legislation in the 107th Congress. So far in the 107th Congress, 10 bills have been introduced that would alter the taxation of Social Security benefits. Five (H.R. 122, H.R. 192, H.R. 2548, H.R. 4789, and S. 237) would repeal the 1993 provision, returning the maximum amount that can be subject to taxation to 50% of benefits. Three, H.R. 1532, H.R. 4790, and S. 181, would also repeal the 1983 provision, and thus would restore the original tax-free status of Social Security benefits. H.R. 2106 would increase the thresholds at which up to 85% of the benefit begins to be taxed by raising them to \$80,000 and \$100,000, respectively. H.R. 209 would exclude income from municipal bonds from the computation of how much of the benefit is taxable.

Arguments for Taxation of Benefits

The Financial Perspective

Those who oppose full or partial repeal of taxation of benefits refer to the large loss of income that this would impose on Social Security and Medicare. They point out that it was the projected loss to Medicare of \$46 billion over 10 years that led the Senate and conferees to reject the House measure in the 1993 OBRA bill. The 2002 report of the HI Board of Trustees projects that the HI trust fund will become insolvent in 2030. The loss of the revenue – \$48 billion in the next 5 years, \$122 billion in the next 10 years – that would be caused by repealing the 1993 OBRA provision would make this problem worse. The long-range effects also would be substantial. Over the next 25 years, it would lose revenue equal to between 0.2% and 0.3% of taxable payroll. (Taxable payroll is the amount of earnings in the economy subject to the HI tax; it is used in long-range forecasts because projected wage and price growth renders costs expressed in dollar terms essentially meaningless.) The effect would be larger in subsequent years because over time larger proportions of recipients will have income above the non-indexed thresholds. They also express concern that replacing the income from taxing benefits with general revenue appropriations would weaken the Medicare program. They argue that financing the program with a dedicated tax is more reliable and buttresses the conception that Medicare is an “earned right.” They argue that using a general revenue appropriation weakens this link and makes the program look more like welfare. They also express fear that the permanent loss of the revenue to the government caused by repeal of the 1993 provision, especially when combined with other tax cuts and spending increases currently being proposed, could lead to the return of general fund deficits if the economy does not continue its current high rate of growth.

In addition to the HI trust fund losses, the revenue loss to Social Security also would be substantial if the taxation of benefits were totally repealed – \$77 billion in the next 5 years, \$191 billion (not including interest) over the next 10 years. Over the next 75 years, it would lose revenue equal to 0.7% of taxable payroll, thus increasing Social Security’s long-range deficit by 37%.

Many supporters of benefit taxation say that, if anything, taxation should be increased, not reduced. If Social Security benefits were taxed in the same manner as private pensions, the long-range financing problem would be reduced by about 21%.

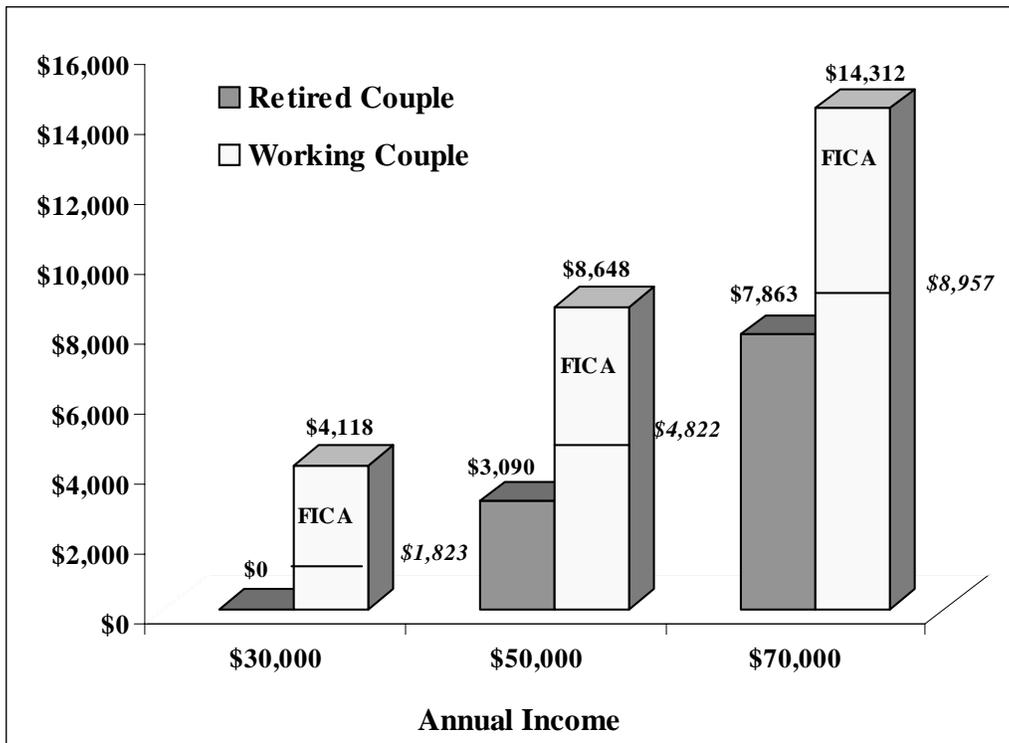
Tax Equity

Economic theory generally supports the idea of treating Social Security benefits similarly to other retirement income. Because equal income, regardless of source, theoretically represents equal ability to pay taxes, it is considered unfair to confer an advantage on one source of income over another. From this perspective, income is income and should be equally taxed. Thus, many adherents would go further than merely raising the proportion of benefits that are taxable; i.e., they see no logical reason for the income thresholds, and they point out that eliminating these thresholds would eliminate the distortion in marginal tax rates they cause – see below. From this point of view, exclusions from the tax base produce inequities. Besides the

instance where two individuals have the same total income but pay different taxes because one has more Social Security income than the other, there is the instance where exclusion of Social Security from progressive taxation is worth relatively more to those who, because of other taxable income, are in higher tax brackets. Put another way, many people think it is unacceptable that even millionaires would get to exclude all or part of their Social Security benefits from the income tax.

In the same vein, they say it is unfair that Social Security recipients pay substantially less tax than do current workers, especially when Social Security and Medicare taxes under the Federal Insurance Contributions Act (FICA) are included. **Chart 1** contains illustrations that compare the total federal tax burden (income and FICA taxes) of retired versus working couples under current law. It shows, for example, that a retired elderly couple with an income of \$30,000 (\$15,000 of which is Social Security) pays no federal taxes, whereas a working couple with \$30,000 of earnings pays \$4,118. A retired elderly couple with an income of \$50,000 (\$15,000 of which is Social Security) pays about 36% of the federal taxes paid by a working couple with \$50,000 in earnings. Because most states do not tax Social Security and many grant extra exclusions for pension income and additional exemptions for the elderly, this disparity is larger when state income taxes are included. If the 1993 provision is repealed, critics say, the advantage higher-income Social Security recipients would receive relative to workers would be even greater.

Figure 1. Total Federal Tax Burden Under Current Law



Retired couple receives \$15,000 annually in Social Security benefits. All income of working couple is from earnings. Each couple takes the standard deduction—retired couple takes the additional standard deduction for the elderly. Figures are for 2002.

Alignment of Benefits with Need

Proponents say that, if Medicare and Social Security's long-range financing problems are to be addressed in part by selective benefit cuts, taxation of benefits is among the most equitable and effective ways to do so. They point out that many advocates of reducing government spending usually try to structure their proposals so that the poor and/or lower middle-income recipients are protected from benefit cuts. When developing the details of how to accomplish this, they often conclude that the income tax system is the easiest and most effective way to protect the less well-off from loss of income.

A variation of this perspective is that benefit cuts should be concentrated on those most able to afford them. By concentrating more of the burden on higher income households, taxing benefits more fully aligns them better with "need" than would broader measures that would also affect the poor (such as cutting the annual cost-of-living-adjustment). Thus, many regard taxation of benefits as an indirect "means test," but without the cumbersome and intrusive administrative process a direct means test would entail. From this point of view, taxing benefits is seen not as a tax increase, but as a *de facto* reduction in benefits scaled to bear most heavily on better-off recipients.

Arguments Against Taxation of Benefits

Deliberalization

Opponents of taxation of benefits argue that it is unfair and imposes financial hardship because it lowers incomes of those who cannot change past work and savings decisions. They contend that it changes the rules in the middle of the game, with the heaviest impact on older workers and current retirees who made decisions based on old law and who may be living in large part on their Social Security. Regardless of abstract considerations of tax equity, many recipients regard increased taxation as simply a reduction in the benefits they had been promised. As shown in **Table 2**, the impact can be substantial. For example, today a single individual with a \$10,000 annual benefit and other income of \$35,000 pays \$945 more in income taxes than he or she would had the 1993 provision not been enacted. Also, these increases affect many middle-income people, not just the "rich."

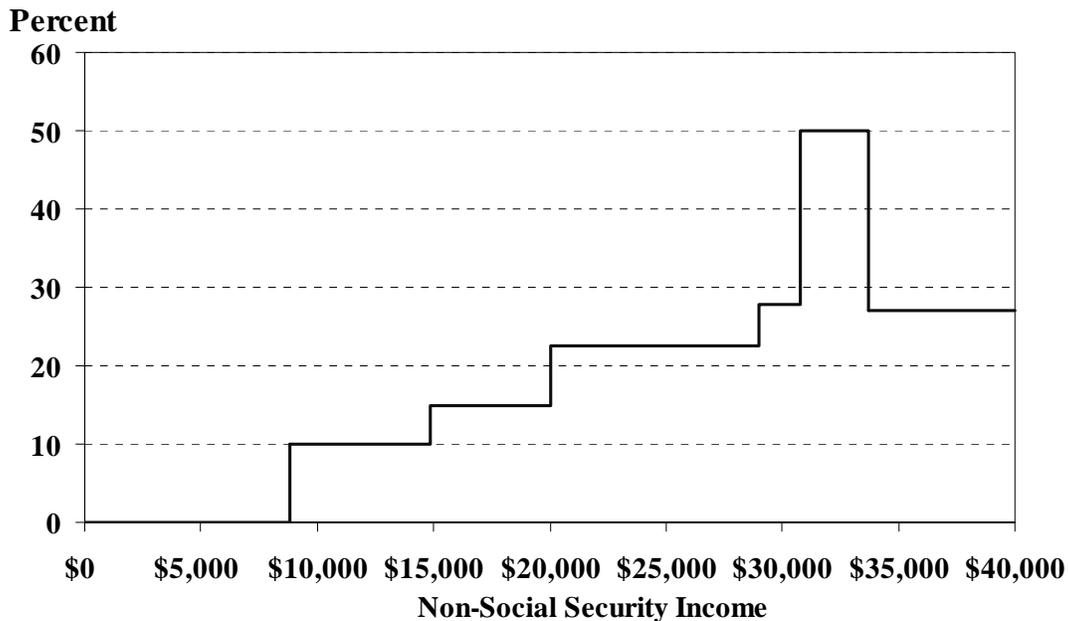
Special Nature of Social Security

Opponents argue that Social Security is different from other government programs. They maintain that Social Security is unique because it is a "social contract" across generations, in which citizens have paid into the system over their working lives in exchange for promised benefits. They object to the argument that taxing benefits is the best way to align benefits with need. They dislike the concept of indirect means testing because it makes Social Security appear more like welfare, where need determines the level of benefits. They dispute that Social Security and private pensions are analogous, saying that they serve different purposes. They assert that, as the country's only national social insurance system, which provides a bedrock

level of protection to nearly all workers and their families from loss of income due to the death, retirement, or disability of the worker, Social Security is special and should be so treated. To them, the 1993 provision was simply a measure designed specifically to reduce the budget deficit. Now that budget deficits have been eliminated, the time is right to repeal what they see as an onerous tax on senior citizens.

Effect on Marginal Tax Rates and Incentives to Work

Some critics see taxation of benefits as a benefit reduction; others see it as merely an increased tax. As a tax increase, they say it greatly distorts marginal income tax rates. For example, the pre-1993 provision has the effect of increasing the marginal tax rate by at least 50% for additional income that falls between the first level thresholds (\$25,000 or \$32,000) and the point at which fully one-half of benefits is taxable. The reason is that for each dollar earned above the threshold amount, \$1.50 becomes subject to tax. Thus, on that extra dollar of income, the effective marginal tax rate is 50% higher (e.g., 10% becomes 15%, 15% becomes 22.5%, and 27% becomes 40.5%). Under the 1993 provision, for income above the second level thresholds the effect is to subject \$1.85 to tax for each dollar earned above the second level threshold amount (e.g., 10% becomes 18.5%, 15% becomes 27.75%, and 27% becomes 49.95%). Once fully 85% of the benefit becomes taxable, however, each extra dollar of income is taxed only at the marginal rate in the bracket into which it falls. This effect on marginal income tax rates is shown by **Chart 2**. As it illustrates, there are large and erratic changes in the effective marginal income tax rates between the threshold where Social Security benefits become taxable and the point where they have been taxed to the limit allowable.

Figure 2. Marginal Tax Rates on Additional Income

Note: Age 65 Individual with \$10,000 Annual Social Security Benefit

Thus, some critics argue that this approach grossly distorts the progressive tax structure, discriminates against those with higher incomes, and is a strong disincentive to work, save, and invest.

Opponents say the 1993 law particularly discourages work effort when its interaction with the Social Security earnings test is included. The earnings test reduces the benefits of recipients who earn income from work above a certain sum (the “exempt amount”). With modifications, this “earnings test” has been in place since the beginning of the program, but, effective in 2000, it no longer applies to individuals when they attain the full retirement age.¹ For recipients below the full retirement age, the law provides that recipients who will not attain the full retirement age in 2002 may earn up to \$11,280 a year in wages or self-employment income without having their benefits affected. For earnings above these amounts, recipients lose \$1 of benefits for each \$2 of earnings. There is a different reduction factor and exempt amount in the year recipients attain the full retirement age. In 2002, these individuals can earn up to \$3000 a year in the months before they attain the full retirement age. For earnings above these amounts, they lose \$1 in benefits for each \$3 of earnings. Another way of looking at it is that each dollar of income above the exempt amount reduces a dollar of benefits by 50% (in the year a person attains the full retirement age, the reduction is 33% for months before attainment). The earnings test applies only to earned income and not to savings, investments, and the like.

¹For more on the earnings test and proposals to liberalize or eliminate it, see CRS Report 98-789, *Social Security: Proposed Changes to the Earnings Test*, by Geoffrey Kollmann, updated regularly.

A frequent criticism of the earnings test is that it often creates a strong financial disincentive to work, or to increase work effort beyond minimal levels. There is a strong disincentive to work if earnings would cause a beneficiary not only to lose a portion of his benefit but also to become liable for payment of income taxes for all or part of his remaining Social Security as well.

Actually, the combination of the Social Security earnings test and the taxing of benefits provision has a smaller effect on marginal *income* tax rates than just the taxing of benefit provision alone. The reason is that the earnings test, by reducing benefits for each extra dollar earned, automatically decreases the amount of Social Security benefits that can be taxed. In other words, the two “taxes” are not additive. The interactive effects are complicated (see archived CRS Report 89-40, *Social Security: Issues in Taxing Benefits Under Current Law and Under Proposals to Tax a Greater Share of Benefits*). Nevertheless, under some scenarios the effect of additional income from work is to increase the effective marginal tax rate (earning test plus federal, state, and local income taxes and Social Security taxes) to over 100%, so that the individual loses money from working