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PROPOSAL REGARDING TAXATION OF SOCIAL SECURITY BENEFITS WOULD BENEFIT HIGHER-INCOME BENEFICIARIES WHILE REQUIRING $14 TRILLION IN GENERAL-REVENUE TRANSFERS OVER 75 YEARS

by Robert Greenstein

A proposal suddenly gaining traction on Capitol Hill would repeal a provision of law, enacted in 1993, under which Social Security benefits paid to higher-income beneficiaries are treated for tax purposes in essentially the same manner as private pension payments. This proposal was approved by the Senate on July 13 as an amendment to estate-tax legislation, on a largely party-line vote of 58-41. (It was subsequently removed from the estate-tax bill, along with all other amendments added to that bill on the Senate floor, so the Senate and House estate tax bills would be identical.) The leadership of the House Ways and Means Committee moved swiftly following Senate approval of this proposal to schedule a "mark-up" of the proposal as separate legislation on July 19. Passage of this proposal by both chambers now seems likely.

If enacted, the proposal would have two effects.

- It would cut income taxes for the one-sixth to one-fifth of Social Security beneficiaries with the highest incomes. Treasury estimates show that in 2001, only 16 percent of households with Social Security income — and 18 percent to 19 percent of Social Security beneficiaries — will be subject to the tax provision that the proposal would repeal.[1]

- It would require substantial transfers in perpetuity from the rest of the budget to the Medicare Hospital Insurance Trust Fund simply to keep Medicare's long-term solvency problems from getting worse. These transfers would total $13.7 trillion over the 75-year period used to measure long-term Medicare and Social Security solvency, according to estimates by the Medicare actuaries.[2] In other words, transfers far larger than those the Administration's budget proposes for Social Security and Medicare combined would have to be made, but unlike the Administration's transfers, these transfers would not extend the solvency of the Medicare Trust Fund a single day.

Why the Proposal Entails Large Transfers

All of the income tax revenues collected under the provision enacted in 1993 are deposited in the Medicare Hospital Insurance Trust Fund. If the provision enacted in 1993 were repealed and no other action were taken, Medicare would become insolvent about five years sooner than otherwise would be the case (in 2020 rather than 2025), and the loss of revenue to Medicare eventually would grow quite large. To avert such an outcome, the pending proposal, which was offered by Senator Rod Grams in the Senate, requires that transfers be made annually to the Medicare Trust Fund in

> *The proposal would require transfers from the rest of the budget to the Medicare Trust Fund that total $13.7 trillion over 75 years without extending Medicare solvency a single day.*

amounts equal to the amounts that the Trust Fund otherwise would lose as a result of the proposal.

Over the coming decade, deposits made into the Trust Fund as a result of the provision enacted in 1993 are projected to total approximately $100 billion. When the interest earned on the deposits is taken into account, the total gain to the trust fund exceeds $125 billion. Over the longer, 75-year period used to measure long-term solvency in Medicare and Social Security, the Trust Fund is slated to receive nearly $14 trillion in revenue under the current provision.

> *The amendment would either make long-term budgetary problems more serious or ultimately place Medicare financing at greater risk if Congresses facing budget shortfalls in future decades did not maintain the transfers.*

Replacing these lost revenues ultimately would place considerable strain on the rest of the budget. When the baby boomers have retired in large numbers, Social Security, Medicare, and long-term Medicaid costs will rise substantially. Moreover, the growth of the labor force — and hence the rate of economic growth in the United States — are expected to slow during that same period, as a result of the aging of the population. These factors underlie the Social Security and Medicare Trustees' long-term forecasts. They also mean that budgets may be very tight when the baby boomers are retired, with a potential return of sizable deficits. Legislation the House and Senate have passed to repeal the estate tax would add to these pressures since full repeal of the estate tax would take effect and cause a lose of $50 billion a year just as the baby boomers begin to retire in large numbers.

This raises the question of whether the general-revenue transfer mechanism in the proposal would succeed in protecting Medicare over the long term. There is a question as to whether today's Congress can effectively commit Congresses in future decades that may face daunting fiscal problems to continue the transfer of substantial sums to the Medicare Trust Fund to make up for losses incurred because of an action by a Congress back in 2000.

In short, the amendment would either make long-term budgetary problems more serious or ultimately place Medicare financing at greater risk. It would do so to give the one-sixth to one-fifth of Social Security beneficiaries with the highest incomes an income tax break that, as explained below, is unwarranted.

The Issues

Under Social Security legislation crafted by the Greenspan Commission and enacted under President Reagan in 1983, some 50 percent of Social Security benefits are counted as taxable income for single taxpayers with incomes above $25,000 and for married couples with incomes above $32,000. The 50-percent figure was selected largely because of the popular impression that beneficiaries have paid for half of their Social Security benefits themselves through their payroll contributions, with their employers having paid for the other half of their benefits.

This impression, however, is incorrect. As numerous CBO analyses have reported, on average, approximately 85 percent of the Social Security benefits that beneficiaries receive represent amounts in excess of what they paid into the system through the employee share of the payroll tax.

Under federal law, individuals receiving payments from a private pension plan pay income tax on the amount by which the pension payments they receive exceed the amounts they paid into the pension plan. As CBO and other analysts pointed out often in the 1980s and early 1990s, according the same tax treatment to Social Security benefits would entail making approximately 85 percent of Social Security benefits taxable.

In 1993, Congress acted to make the tax treatment of Social Security comparable to that of private pensions, although only for Social Security beneficiaries with relatively high incomes. When a taxpayer's income exceeds $34,000 for a single individual and $44,000 for a couple, 85 percent (rather than 50 percent) of the individual's Social Security benefit is considered taxable income. The income tax collected under this provision is placed in the Medicare HI trust fund.

As the Concord coalition noted in a policy statement issued July 13, 2000 that opposes repeal of the 1993 provision, "the rationale for the 50 percent level [enacted back in 1983] was that the other half was a payback of personal FICA contributions on which income taxes had already been paid. Policy experts endorsed the reform, which was modeled on the tax treatment of private pensions. But many noted that it didn't go far enough, since already-taxed FICA contributions in fact represent not 50 percent, but (at the very most) 15 percent of benefits. So in 1993 Congress took the next step and made 85 percent of benefits taxable over higher thresholds. Far from being a punitive tax on seniors, it was an attempt to spread the burden of paying for entitlement benefits more fairly among generations."

It also may be noted that under current law, with the provision enacted in 1993 in place, the elderly are taxed *less* than other households. CBO projects that in 1999, the middle fifth of *all* families paid 18.9 percent of income in federal taxes, while the middle fifth of families headed by an elderly individual (and not containing children) paid 10.6 percent of income. Among every income group, from the top fifth to the bottom fifth, elderly families pay a smaller percentage of income in federal taxes today than families as a whole do.

Dubious Arguments and Misunderstandings

During Senate floor debate on this measure on July 13, Senator Grams argued that repeal of the 1993 provision is needed because that provision is making it harder for seniors to pay for prescription drugs and other health care costs. Senator Grams also cited average Social Security benefits levels, which are modest, declaring that "the income that is derived from Social Security is often insufficient to maintain a decent retirement today." He cited elderly poverty rates, as well.

> *The provision of law the proposal would repeal simply ensures that Social Security benefits paid to higher-income beneficiaries are treated for tax purposes in essentially the same manner as private pension payments.*

The 1993 provision, however, does not touch anyone living on the average Social Security benefit or anything close to it, let alone anyone living in poverty. The beneficiaries it affects are not people with small incomes squeezed by rising drug or other health care costs. Moreover, the proposal to repeal the 1993 tax provision would, by draining substantial sums from the Treasury, make it more difficult for the government to finance adequate Medicare prescription drug coverage, as well as other improvements that ultimately should be included in the Medicare benefit package, such as coverage for catastrophic costs and some long-term care costs.

Finally, the 1993 provision is sometimes misunderstood in several other respects:

- The provision of law enacted in 1993 does not tax back 85 percent of Social Security benefits. Counting 85 percent of benefits as taxable income is not the same thing as taxing back 85 percent of the benefits. For a high-income taxpayer in the 31 percent tax bracket, for example, about one-quarter of the Social Security benefit is taxed back. (Some 85 percent of the benefit is taxed at a 31 percent rate, resulting in about one-quarter of the benefit being taxed back.) It may be noted when the Greenspan Commission, President Reagan, and the bipartisan Congressional leadership acted in 1983 to make 50 percent of Social Security benefits taxable, the top income rate was 50 percent, so one-quarter of Social Security benefits was taxed back from those in the top tax bracket. The proportion of benefits taxed back subsequently declined when income tax rates were lowered in the 1986 Tax Reform Act and then was raised back up for those at higher income levels as a result of the 1993 provision. Under current law, the maximum proportion taxed back, for extremely high-income individuals, is one-third of their Social Security benefit.

- In addition, it is not the case that under current law, 85 percent of Social Security benefits are counted as taxable income for *all* beneficiaries with incomes above \$34,000 for single filers and \$44,000 for a couple. Those are the income levels above which *any part* of the Social Security benefit must be multiplied by 85 percent (rather than 50 percent) and then added to taxable income. There is a phase-in range over which a gradually increasing share of the benefit is multiplied by 85 percent and then counted as part of taxable income.

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1. The figures for households and for beneficiaries are not identical. This is because some households have more than one Social Security beneficiary. A figure cited in an earlier version of this paper — that 22 percent to 23 percent of beneficiaries are currently subject to this tax provision — applies only to Social Security beneficiaries aged 65 and over. The more useful figures are those cited here, which represent the proportion of *all* Social Security beneficiaries subject to this tax provision, including disabled beneficiaries and the large number of beneficiaries who begin drawing Social Security benefits at age 62.

2. The \$13.7 trillion figure is in current dollars. In constant dollars, the figure would be smaller.