Case Study #10: The Exclusion of Social Security Retirement Benefits from Taxable Income

By
Michael Schuyler, PhD & Stephen J. Entin

These results are part of an eleven-part series, The Economics of the Blank Slate, created to discuss the economic effects of repealing various individual tax expenditures. In these reports, Tax Foundation economists use our macroeconomic model to answer two questions lawmakers are considering:

1. What effect does eliminating these expenditures have on GDP, jobs, and federal revenue?
2. What would be the effect on GDP, jobs, and federal revenue if the static savings were used to finance tax cuts on a revenue neutral basis?

Key Points:

Eliminating the partial exclusion of Social Security retirement benefits from taxable income would:

- Increase tax revenues by $19.3 billion on a static basis;
- Result in a negligible effect on GDP; and
- Produce slightly more revenues ($19.5 billion) on a dynamic basis;
- Increase employment by the equivalent of approximately 12,000 full-time workers; and
- Produce little change in hourly wages.

Ending the partial exclusion and trading the static revenue gains for individual rate cuts would:

- Allow for an across-the-board rate cut of 1.9 percent;
- Boost GDP by $30 billion per year; and
- Boost federal revenues by $7.1 billion on a dynamic basis;
- Increase employment by the equivalent of approximately 180,000 full-time workers; and
- Produce little change in hourly wages.

The federal government began taxing a portion of Social Security benefits in 1983 and increased the tax in 1993. The method of assessing the tax is complicated and generates extremely high marginal tax rates relative to what the tax collects.
At low incomes, benefits are tax free. However, once a taxpayer’s income reaches a threshold of $25,000 for a single filer, or $32,000 for joint filers, Social Security benefits start being brought into taxable income, at a rate of 50 cents of benefits for every extra dollar of income over the threshold until half of benefits are taxable. When incomes exceed $34,000 for a single filer, and $44,000 for joint filers, the benefits are added to income at a rate of 85 cents of benefits for every extra dollar of income over the threshold, until 85 percent of benefits are taxable.

If a beneficiary is in the first tier and earns an extra $1 of interest income, the person’s taxable income will rise by $1.50 ($1 of interest and 50 cents of Social Security). Because an extra $1 of interest (or any other type of income) increases the tax base by $1.50, the effective tax rate is 150 percent of the statutory tax rate on that other, non-benefit income. That is, someone in the 15 percent bracket experiences an effective rate of 22.5 percent on the extra dollar of interest or other income earned. In the second tier, the effective tax rate is 185 percent of the statutory rate. A taxpayer in the 25 percent bracket faces an effective tax rate of 46.25 percent on other income while his or her benefits are being phased into taxable income.

The Joint Committee on Taxation and the Treasury see a tax expenditure here because the phase-in only partially removes the exemption. The Treasury reasons that if the benefits were treated as normal income, an allowance would be made for the return of previously taxed contributions, but they "generally do not exceed 15 percent of benefits."1 It is not clear if the JCT regards normal treatment as taxing all Social Security benefits or would, like Treasury, make an adjustment for the return of prior contributions.

Following Treasury’s suggestion, it was assumed here that the tax expenditure would be removed by taxing Social Security benefits as ordinary income, after 15 percent of benefits had been excluded as a return of contributions. In a conventional revenue estimate that holds the economy’s size fixed, the Tax Foundation’s model estimated this change would raise $19 billion. (See Chart 1.)

We then ran our model again under the dynamic assumption that tax changes can lead to changes in the labor supply, aggregate capital stock, and GDP. The outcome was almost the same as before, with revenue up by about $19 billion and GDP essentially unchanged. This may appear counterintuitive, because adding

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more benefits to ordinary taxable income would push some filers into higher tax brackets; by itself that
should reduce the incentive to work and save, modestly reduce GDP, and lose some of the expected revenue.

However, this revised method of taxing benefits would end the phase-in’s interaction with other income and
would avoid the rate spike of 150 percent or 185 percent that many Social Security recipients experience
under current law over the range of income in which the benefits are currently phased in. On net, effective
marginal tax rates would be little changed. In short, because of the inefficiency of the current phase-in, the
tax expenditure could be ended, federal revenue increased, and the tax code simplified at no cost in terms of
economic growth.

The revenue gain could finance a 1.9 percent across-the-board reduction in marginal tax rates.\(^2\) (For example, the 25 percent rate
would drop to 24.5 percent.) As
shown in Chart 2, the model estimates that the increases in the capital stock and labor supply
flowing from the rate cut would generate a $30 billion rise in GDP, once the economy had fully
adjusted. Moreover, because of the revenue reflow from a larger economy, tax collections would expand by $7 billion.

An alternative for lawmakers to consider—and a more generous one than the ordinary income tax treatment
outline above—is to exclude a set dollar or percentage amount of Social Security benefits from taxable
income (greater than a 15 percent exclusion for lower income beneficiaries) and then add any benefits over
that amount to taxable income.\(^3\) If the exclusion amount was adjusted so that the total tax on Social Security
benefits stayed the same as it is now, the change would be revenue neutral on a static basis. However,
eliminating the income-related phase-in also eliminates the current tax rate spike. As a result, the change
would spur growth and pick up some revenue while simplifying the income tax.

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\(^2\) We assume proportional cuts in all of the ordinary income tax bracket rates but no cuts in the lower tax rates on capital gains
and qualified dividends.

\(^3\) For example, exempt the first $8,000 in benefits for each retiree claiming his or her own benefits (up to $16,000 for a married
couple when both worked) and $12,000 for a couple claiming the spousal benefit. Simply add any benefits above these levels to
taxable income (but only up to half of total benefits, because only half of the payroll tax contributions were deductible by the
employer as a business cost, while the employee contributions were not deductible and were made after income taxes).
Finally, we determined the impact of these scenarios on employment and wages. We found that taxing Social Security benefits as ordinary income would increase employment by the equivalent of about 12,000 full-time workers with little change in the hourly wage. With the rate cut offset, employment would increase by the equivalent of about 180,000 full-time workers, again with little change in the hourly wage.