T R E A S U R Y

I N T E R O F F I C E   M E M O R A N D U M

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From: Ann Parcell
PARCELLA
Dept: Revenue Estimation
Tel No:

TO: Lowell Dworin (DWORIN)

CC: Joel Platt (PLATT)

additional

Subject: SS beneficiaries affected by tax on benefits

The number of social security beneficiaries (or recipients) estimated to pay some tax on their benefits in 1996 is 22.5 percent. The number of beneficiaries estimated to pay tax on their benefits in 1996 because of the law change in OBRA '93 is 13.5 percent.

Note that the taxpayers counted in the 13.5 percent are also counted in the 22.5 percent.

Barr may have had these figures at 1994 or 1995 levels, or these figures for 1996 may have been rounded.

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CRS Issue Brief

Social Security: President Clinton's Proposal to Increase Taxation of Benefits

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by
Geoffrey C. Kollmann
Education and Public Welfare Division

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Social Security: President Clinton's Proposal to Increase Taxation of Benefits

SUMMARY

Until 1984, social security benefits were exempt from income tax. For years many analysts advocated that the tax treatment of social security be the same as for other pension income. Pension benefits are fully taxable except for the proportion of lifetime benefits attributable to the worker's contributions. As part of a financial rescue package, Congress enacted a provision in 1983 making up to one-half of benefits taxable for upper income recipients. Under the 1983 law, a portion of social security benefits is included in taxable income of taxpayers whose adjusted gross income, plus tax-exempt interest income, combined with 50% of their benefits, exceeds $25,000 for individuals and $32,000 for married couples filing joint returns (or zero for married persons filing separately). By design, these thresholds are not indexed to rise with inflation or wage growth. In 1993, the amount of benefits to be taxed is the lesser of one-half of benefits or one-half of the excess of the taxpayer's combined income over the threshold. The proceeds are credited to the social security trust funds.

In his FY1994 budget, President Clinton proposed that the taxable proportion of social security benefits be increased to 85% effective in 1994. The proposal was projected to generate $32 billion in new revenues over the next 5 years, with the proceeds credited to Medicare's Hospital Insurance (HI) trust fund. The House approved the President's proposal as part of H.R. 2264, the 1993 omnibus budget reconciliation bill, but shifted the revenues therefrom to the General Fund. The Senate version limited the proposal to recipients whose threshold incomes exceed $32,000 (single) or $40,000 (couple), with proceeds going to the HI trust fund. Conferees on the bills approved the Senate version but further raised the thresholds to $34,000 (single) and $44,000 (couples), and this became final law (P.L. 103-66). It is projected to generate $24.6 billion in revenues over the next 5 years.

Proponents of taxing social security more fully argue that, as well as reducing the Government's fiscal problems, it promotes tax equity by treating social security the same as private pension and civil service benefits. Moreover, they often assert that social security should be included in efforts to control the costs of "entitlements," and that increased taxation of benefits would be the most equitable and effective way to implement *de facto* benefit reductions. They say that by concentrating more of the burden on higher income households than would broader measures that would also affect the poor (e.g., cuts in cost-of-living adjustments), taxing benefits more fully would align them better with "need."

Opponents argue that increased taxation of benefits is unfair because it would reduce incomes of those who cannot change past work and savings decisions. They contend that it would change the rules in the middle of the game, penalizing recipients who made decisions based on current law. Regardless of abstract considerations of tax equity, many beneficiaries would regard increased taxation as simply a reduction in the benefits they had been promised. They also object to the concept of indirect means testing because they view social security as an "earned right," not as welfare where need determines the level of benefits. Finally, they maintain that increasing taxation of benefits grossly distorts marginal tax rates and provides a strong disincentive for many beneficiaries to work.

MOST RECENT DEVELOPMENTS

On Aug. 10, 1993, President Clinton signed into law a provision making up to 85% of social security benefits taxable for recipients whose income plus one-half of their benefits exceed $34,000 (single) and $44,000 (couple), effective in 1994.

BACKGROUND AND ANALYSIS

Old Law (Effective in 1993)

A portion of social security and tier I railroad retirement (analogous to social security) benefits are included in taxable income of taxpayers whose adjusted gross income, plus tax-exempt interest income, combined with 50% of their benefits, exceeds $25,000 for individuals and $32,000 for married couples filing joint returns (or zero for married persons filing separately). These thresholds are not indexed to rise with inflation or wage growth. The amount of taxable benefits is the lesser of one-half of benefits or one-half of the excess of the taxpayer's combined income over the threshold. Currently, about 22% of beneficiaries pay tax on their benefits. The proceeds are credited to the social security trust funds.

Example 1 to the right illustrates how the provision works in 1993. The taxable portion of a $10,000 annual benefit for a single taxpayer who has $32,000 in adjusted gross income would be computed thus: 1/2 x $10,000 = $5,000 (one-half of the social security benefit), + $32,000 (adjusted gross income) = $37,000, minus $25,000 (the threshold for single taxpayers) = $12,000 (the excess over the threshold), x 1/2 = $6,000. However, because 1/2 of the benefits is the most that can be taxed, $5,000 would be the amount of social security that would be added to the taxpayer's other taxable income.

Example 1: Old (1993) Law	
Adjusted gross income	*$32,000*
½ of benefits	*+5,000*
Total	*37,000*
Less: exempt amount	*-25,000*
Excess	*12,000*
Taxable benefits	*5,000*
(½ of excess, or ½ of benefits, if lower)	

If in this example the beneficiary's adjusted gross income were, say, $29,000, the sum of one-half the social security benefit ($5,000) would be added to $29,000 = $34,000 minus $25,000 = $9,000 divided by 2 = $4,500 in potentially taxable benefits. Because $4,500 is less than one-half of the social security benefit, it would be the amount of benefits subject to the income tax. If his 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 Beneficiaries and Trust Funds

Because of the $25,000 and $32,000 thresholds, beneficiaries 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 degrees of income, the number and proportion of beneficiaries who are projected under current law to pay taxes on their benefits in 1994, and the amount of taxes they will pay.

TABLE 1. Effect of Taxing Social Security Benefits Under Current Law, by Income Class, 1994

Level of individual or couple income[a]	Number of social security 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	8,757	0	.0%	0
$10,000 to $15,000	5,450	0	.0	0
$15,000 to $20,000	4,473	0	.0	0
$20,000 to $25,000	3,784	0	.0	0
$25,000 to $30,000	3,338	110	3.3	10
$30,000 to $40,000	4,598	1,214	26.4	347
$40,000 to $50,000	2,636	2,257	85.6	827
$50,000 to $60,000	1,405	1,377	98.0	836
$60,000 to $75,000	1,314	1,297	98.7	1,181
$75,000 to $100,000	897	894	99.6	1,087
$100,000 to $200,000	739	737	99.8	939
At least $200,000	256	252	98.5	378
All	37,647	8,138	21.6	5,604

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

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

a. Cash income (based on income 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 the Federal Civil Service Retirement System and private pension plans. 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 when earned. The employer's contributions to the system, however, are not considered part of the employee's gross income and can be deducted 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 of workers entering the workforce in 1979 the most anyone would pay in nominal payroll taxes during his or her lifetime would be equal to 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 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 the current arrangement of determining the amount of benefits to be taxed, so that the tax on benefits would rise gradually as a person's income rose above the thresholds.

In recent years pressure to solve the Governments's mounting fiscal problems has led to calls to subject a greater share of benefits to taxation. Many supporters of doing so maintain that social security should be treated like private and civil service pensions. In 1990, the Social Security Administration's Office of the Actuary determined that, if these 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 rules applicable to private and civil service 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 far simpler and 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 assure 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.

President Clinton's Proposal

As part of his plan to cut the Federal fiscal deficit, President Clinton proposed on Feb. 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." The proposal was included in his FY1994 budget submitted Apr. 8, 1993. The Joint Committee on Taxation (JCT) projected that it would generate $32 billion in new tax revenues over 5 years. The proceeds would not have been credited to the social security trust funds, as under current law, but to the Medicare Hospital Insurance program, which has a less favorable financial outlook than does social security. Doing so also would have avoided procedural obstacles that could have been raised in the budget reconciliation process. (For a complete discussion of these procedures, see CRS Report 93-23 EPW, *Social Security: Its Removal From the Budget and Procedures for Considering Changes to the Program.*)

The President's proposal would have worked as illustrated in **Example 2** to the right. (To contrast with 1993 law, it uses the same individual as depicted in Example 1 on page 1.) Just as under the law in 1993, only social security recipients whose 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 1993 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. **Table 2** shows some examples of the projected additional tax liability that would have applied under this proposal to individuals and couples with selected income and benefit levels.

Example 2: President's Proposal	
Adjusted gross income	*$32,000*
½ of benefits	*+5,000*
Total	*37,000*
Less: exempt amount	*-25,000*
Excess	*12,000*
Taxable benefits	*8,500*
(85% of excess, or 85% of benefits, if lower)	

TABLE 2. Additional Federal Income Tax Liability in 1994 Under the President's Proposal

Other income[a]	Annual social security benefit				
	$5,000	$10,000	$15,000	$20,000	$25,000
	Additional tax liability[b]				
			Single		
$0-15,000	0	0	0	c	c
20,000	0	0	$ 131.25	c	c
25,000	$131.25	$ 262.50	579.00	c	c
30,000	490.00	980.00	1,225.00	c	c
35,000	490.00	980.00	1,470.00	c	c
40,000	490.00	980.00	1,470.00	c	c
50,000	490.00	980.00	1,483.50	c	c
75,000	542.50	1,085.00	1,627.50	c	c
100,000	542.50	1,085.00	1,627.50	c	c
			Joint		
0-15,000	0	0	0	0	0
20,000	0	0	0	0	$ 26.25
25,000	0	0	26.25	$ 157.50	288.75
30,000	26.25	157.50	288.75	420.00	551.25
35,000	262.50	420.00	551.25	682.50	813.75
40,000	262.50	525.00	1,047.50	1,536.50	1,944.00
50,000	490.00	980.00	1,470.00	1,960.00	2,450.00
75,000	490.00	980.00	1,470.00	1,960.00	2,450.00
100,000	490.00	1,085.00	1,627.50	2,170.00	2,712.50

a. Adjusted gross income ***excluding*** social security. ***Total*** income would be equal to other income ***plus*** social security. It is assumed no tax-free interest is received.

b. Based upon adjustments in tax brackets, personal exemptions, and standard deductions due to a projected inflation rate of 3%. Individuals are assumed to be age 65 or older and use the standard deduction.

c. Virtually no single individual currently receives this level of benefits. Very few receive $15,000 in yearly benefits.

Table 3 shows the distributional effects of the President's proposal on families with benefits. Note that these are *averages*, and do not necessarily indicate the actual tax liability of persons in these income brackets.

TABLE 3. Distribution of Tax Increases in 1994 Under President's Proposal

Level of family income	Average annual tax increase	% change in Federal taxes	% change in after-tax income	% of families in income category
Less than $10,000	$ 0	0.0%	0.0%	11%
$10,000-$20,000	0	0.0	0.0	25
$20,000-$30,000	1	0.1	0.0	19
$30,000-$40,000	62	1.6	-0.2	13
$40,000-$50,000	237	3.7	-0.6	8
$50,000-$75,000	565	5.3	-1.1	10
$75,000-$100,000	869	4.8	-1.2	4
$100,000-$200,000	1,005	3.2	-0.9	3
$200,000 or more	1,399	0.9	-0.4	1

Source: Congressional Budget Office.

H.Con.Res. 64, the FY1994 Concurrent Budget Resolution, passed by the House by a vote of 243 to 183 on Mar. 18, 1993, included the additional revenue from the President's proposal. (The budget resolution estimated the increased revenue to be $32.0 billion over 5 years.) Earlier the House had rejected by a vote of 135 to 295 an amendment by Representative Kasich that would have provided spending reductions to reduce the deficit without increasing revenues (which effectively would have deleted the President's proposal). It also rejected by a vote of 20 to 409 a similar amendment by Representative Solomon.

The Senate, by a vote of 54 to 45, agreed to H.Con.Res. 64 on Mar. 25, 1993, after inserting in lieu thereof the text of S.Con.Res. 18, the Senate companion measure. The Senate version included an amendment, approved by a vote of 67-32, by Senators Lautenberg and Exon expressing the sense of the Senate that the revenues set forth in the resolution assume that the Finance Committee would make every effort to find alternative sources of revenue before imposing additional taxes on the social security benefits of recipients with threshold incomes of less than $32,000 (single) and $40,000 (couples). In other words, under this scenario, the proportion of benefits subject to taxation was to increase from 50% to 85% only after an individual's or couple's adjusted gross income plus one-half of social security exceeded new thresholds of $32,000 and $40,000. The thresholds for taxing 50% of benefits were to remain at the current law levels of $25,000 and $32,000. Earlier, the Senate rejected by a vote of 47-52 an amendment by Senator Lott that would have deleted from the resolution the revenue projected from the President's proposal.

On Mar. 31, 1993, and Apr. 1, 1993, respectively, the House and Senate approved the conference report on H.Con.Res. 64. It included the sense of the Senate resolution. The Senate Committee on Finance held a hearing on the President's proposal on May 4, 1993. On May 13, 1993, by a party-line vote of 24-14, the House Committee on Ways and Means approved the President's proposal, but modified it so that the additional proceeds would be credited to the General Fund instead of to Medicare. This measure was included in H.R. 2264, the 1993 omnibus budget reconciliation bill, passed by the House on May 27, 1993.

Senate's Proposal

On June 18, 1993, the Senate Finance Committee approved its version of the budget reconciliation package by a party line vote of 11-9. It included the Lautenberg-Exon amendment creating second-tier thresholds of $32,000 and $40,000. Using the same circumstances as illustrated in Examples 1 and 2, **Example 3** shows how this proposal would have worked. Note that benefits taxable as under old (pre-1994) law were to be limited to $3,500 (single) or $4,000 (couple) because the 50% rate would apply only between the first and second tier thresholds (e.g., $32,000 - $25,000 = $7,000 x ½ = $3,500). The proposal was projected by JCT to produce revenues of $26.3 billion over 5 years, which would have been credited to Medicare's HI trust fund. About 5.6 million recipients (15%) would have been affected (about two-thirds of the number affected by the House-passed measure). During the markup of the package, the Committee rejected an amendment by Senator Grassley to strike all tax increases on social security benefits.

Example 3: Senate Proposal	
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 old law (lower of 50% of excess, 50% of benefits, or $3,500)	*3,500*
85% of excess above new threshold ($37,000 - $32,000 x 85%)	*4,250*
Total benefits taxable (taxable portions above old and new thresholds, or 85% of benefits, if lower)	*7,750*

On June 24, 1993, the Senate approved (50 to 49) the budget reconciliation bill. It included the increase in the taxation of benefits as passed by the Finance Committee. During consideration of the bill, the Senate rejected an amendment by Senator Lott to delete the taxation of benefits provision. It also rejected an amendment by Senator DeConcini to increase the 85% thresholds to $37,000 (single) and $54,000 (couple), and an amendment by Senator McCain to direct that the proceeds of increased taxation of benefits be credited to the social security trust funds.

On July 14, 1993, the House voted 415 to 0 to instruct its conferees on the bill to accept the Senate version of taxation of benefits.

Conferees' Proposal and New Law

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 tier thresholds at $34,000 (single) and $44,000 (couple). The proposal is projected by JCT to produce revenues of $24.6 billion over 5 years, and affect 13% (about 5 million) of social security recipients. The measure was included in the final version of the reconciliation bill passed by the House on Aug. 5, 1993, by a vote of 218-216. On Aug. 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 Aug. 10, 1993. **Example 4**, which again uses the same circumstances as depicted in Examples 1, 2, and 3, shows how the new law works. Again, note that benefits taxable as under old law (i.e., only 50% of benefits are taxed) are limited to $4,500 (single) or $6,000 (couple), e.g., $34,000 - $25,000 = $9,000 x ½ = $4,500. **Table 4** shows examples of the additional tax liability in 1994 under the new law.

Example 4: New (1994) 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 (lower of 50% of excess, 50% of benefits, or $4,500)	*4,500*
85% of excess above second threshold ($37,000 - $34,000 x 85%)	*2,550*
Total benefits taxable (taxable portions above first and second thresholds, or 85% of benefits, if lower)	*7,050*

TABLE 4. Additional Federal Income Tax Liability in 1994 Under New Law

	Annual social security benefit				
	$5,000	$10,000	$15,000	$20,000	$25,000
Other income[a]	Additional tax liability[b]				
			Single		
$ 20,000	--	--	--	c	c
25,000	--	--	--	c	c
30,000	--	98.00	343.00	c	c
35,000	490.00	980.00	1,183.00	c	c
40,000	490.00	980.00	1,470.00	c	c
50,000	490.00	980.00	1,483.50	c	c
75,000	542.50	1,085.00	1,627.50	c	c
100,000	542.50	1,085.00	1,627.50	c	c
			Joint		
$ 20,000	--	--	--	--	--
25,000	--	--	--	--	--
30,000	--	--	--	--	--
35,000	--	--	--	52.50	183.75
40,000	--	127.50	221.25	360.50	768.00
50,000	490.00	980.00	1,470.00	1,960.00	2,450.00
75,000	490.00	980.00	1,470.00	1,960.00	2,450.00
100,000	490.00	1,085.00	1,627.50	2,170.00	2,712.50

a. AGI, and assuming no tax-free interest is received.

b. Based upon adjustments in tax brackets, personal exemptions, and standard deductions due to a projected inflation rate of 3%. Individuals are assumed to be age 65 or older and use the standard deduction.
c. Virtually no single individual currently receives this level of benefits. Very few receive $15,000 in yearly benefits.

Because the new law incorporates both old and new rules, the computation of total taxable benefits can be complicated. (For an explanation of how the taxable portion of benefits will be computed, see CRS Report 93-336 EPW, revised Sept. 2, 1993.)

Table 5 shows the distributional effects of the new law proposal on families with benefits. Again, these are *averages*, and do not necessarily indicate the actual tax liability of persons in these income brackets.

TABLE 5. Distribution of Tax Increases in 1994 Under Proposal to Tax Up to 85% of Benefits Above Thresholds of $34,000 and $44,000

Level of family income	Average annual tax increase	% change in Federal taxes	% change in after-tax income	% of families in income category
Less than $10,000	$ 0	0.0%	0.0%	11%
$10,000-$20,000	0	0.0	0.0	25
$20,000-$30,000	0	0.0	0.0	19
$30,000-$40,000	7	0.2	0.0	13
$40,000-$50,000	85	1.3	-0.2	8
$50,000-$75,000	431	4.0	-0.8	10
$75,000-$100,000	823	4.5	-1.1	4
$100,000-$200,000	1,001	3.2	-0.9	3
$200,000 or more	1,398	0.9	-0.4	1

Source: Congressional Budget Office.

Arguments for Increased Taxation of Benefits

The Financial Perspective

Support for increasing taxes on benefits derives to a large degree from the need to solve the Government's fiscal problems. In 1983, the pressure to tax benefits came from pressure to prevent social security's imminent insolvency. In contrast, today social security's financing is in much better shape and the trust funds are accumulating large surpluses. (There is, however, a long-range financing problem -- the trust funds are projected to draw down rapidly when the baby boom retires, becoming depleted around 2036). Thus, current proposals to increase the level of taxation arise from the need to solve the Government's overall fiscal crisis. The call is for sacrifice in order to reduce the gap between the Government's income and its outgo. As social security constitutes 20% of what the Government spends, many believe that it must share in putting the Government's fiscal house in order.

As a general matter, the exclusion of the bulk of social security benefits from taxation causes the Government to forego collecting large amounts of potential revenue.

Table 6, which reflects the law before enactment of P.L. 103-66, shows the magnitude of these projected foregone revenues (economists refer to them as tax expenditures).

TABLE 6. Tax Expenditures Due to the Partial Exclusion of Social Security From Income Taxation
(in billions of dollars)

Fiscal year	Estimated revenue lost
1993	$24.5
1994	25.7
1995	27.0
1996	28.3
1997	29.7
Total	$135.2

Source: U.S. Congress. Senate. Committee on the Budget. *Tax Expenditures*. S.Prt. 102-119, 102nd Congress, 2nd Session. Nov. 1992. Prepared by the Congressional Research Service. Washington, U.S. Govt. Print. Off., 1992. p. 521.

In contrast, at the time the Bureau of Internal Revenue made its rulings on the tax-free status of benefits in 1938 and 1941, it was estimated that the resulting revenue loss was only $3 to $4 million per year, even then a modest sum.

The revenue effects of the taxation provision *in old law* were of significant magnitude in both the short and long run. Before enactment of P.L. 103-66, it was projected that taxing benefits would generate $35.6 billion in the FY1994-98 period (based on the alternative II assumptions in the 1993 Social Security Trustees' report). In the long run (75 years), it would generate income equal to 0.59% of taxable payroll -- over 4% of the system's total income over that period. (Taxable payroll is the amount of earnings in the economy subject to the social security tax; it is used in long-range forecasts because projected wage and price growth renders costs expressed in dollar terms essentially meaningless.)

The new law is projected to produce an additional $24.6 billion in FY1994-1998. If the proceeds were credited to the social security rather than to the Medicare HI trust fund, they would improve the long-run financial picture of social security by 0.40% of taxable payroll. As social security's long-run deficit is projected to be 1.46% of taxable payroll, all else being equal the proposal would cut that deficit to 1.06% of payroll, or by 27%. Crediting the additional revenue to the HI trust fund helps to shore up a system that otherwise is projected to become depleted in 1999.

Often there is confusion about social security's effect on Government financing. Some opponents of crediting the proceeds of taxing benefits to the social security trust funds assert that, because the 1990 Budget Enforcement Act placed social security "off budget," the extra revenue would do nothing to reduce the budget deficit. Rather, it merely would increase the size of the social security trust funds. This point of view reflects a common perception that the trust funds represent a sort of separate pool of money outside of the normal flow of the Government's financial operations. In fact, social security revenues are collected in common with all other Government revenue and deposited in the U.S. Treasury. The program's benefits and financial expenses are also paid from the Treasury. If social security's income exceeds its expenditures, this "surplus" is credited to the trust funds in the form of U.S. Government securities, but the money itself is used to pay for whatever other expenses the Government has. There is no separate pool of money set aside for social security.

This is not to say that the trust funds are ephemeral; so long as they show a positive balance they represent authority and an obligation for the Treasury to issue benefit checks in those periods when the program's outgo exceeds its income. The point is that, all else being equal, extra revenue produced by taxing social security means that more money will flow into the Treasury and be used to pay for Government operations. This additional money would enable the Government to borrow less from private financial markets (the public), and therefore reduce pressure on interest rates. Thus, the financial operations of the Government, and the objectives of fiscal policy, are directly affected by social security's financing, regardless of how the program is portrayed in the budget.

Policy Considerations

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 of its adherents would go further than merely raising the proportion of benefits that are taxable, i.e., they see no logical reason for the $25,000 and $32,000 thresholds). 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 and more prosaic way, many people think it is unacceptable that even millionaires get to exclude one-half 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 taxes than do current workers, especially when payroll taxes are included. For example, a retired elderly couple with an income of $30,000 ($13,000 of which is social security) pays Federal taxes that are about one-eighth of the Federal taxes paid by a working couple with $30,000 in earnings.

In his book, *Social Security: Today and Tomorrow*, former Commissioner of Social Security Robert Ball endorsed taxing benefits with the following justification:

> ... social security beneficiaries, who may have paid relatively little toward the cost of their benefits, get an unwarranted tax break. The exemption, of course, helps only those who are the best off, since low-income beneficiaries would not pay an income tax even if social security benefits were included in gross income. Taxation of social security benefits should approximate the approach that is taken in the taxation of private pensions and benefits paid by other government retirement systems.

More recently, Mr. Ball has testified that treating social security more like private pensions would strengthen social security as an institution, because it would emphasize that social security payments are not welfare, but earned benefits. This would help hold off proposals to cut benefits.

Proponents say that if social security should be included in efforts to control the costs of "entitlements," increased taxation of benefits would be the most equitable and effective way 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 this is to be done, 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 than would broader measures that would also affect the poor (such as cutting the annual cost-of-living-adjustment), taxing benefits more fully would align them better with "need." 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 *de facto* reduction in benefits scaled to bear heaviest on better-off recipients.

Arguments Against Increased Taxation of Benefits

Social Security Should Not Be Included in Deficit Reduction Measures

Opponents argue that social security should not be included in deficit reduction measures because it is different from other Government programs. First, social security has its own source of funding, the payroll tax. Second, far from contributing to the budget deficit, social security is running surpluses and is projected to do so for another two decades. Third, regardless of arguments that taking social security out of the budget did not change the nature of Government financing, Congress took this action in large part to isolate the program from budgetary pressures, based on widespread agreement that it is wrong to change its revenues or benefits because of concern about a budget deficit that is really due to problems in financing general fund programs. They say this concern was justified, considering that the new law credits revenues not to social security, but to Medicare.

Some opponents go further and argue that, even if social security were not accumulating surpluses, it would be wrong to make changes to the program based on budgetary concerns. 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. Changes to these benefits should not be made due to problems that lay outside the social security system, but only for sound programmatic reasons.

Deliberalization

Opponents argue that increased taxation of benefits is unfair and could impose financial hardship because it would lower incomes of those who cannot change past work and savings decisions. They contend that the rules have been changed 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 beneficiaries regard increased taxation as simply a reduction in the benefits they had been promised. As shown in **Table 4**, the impact can appear quite large. For example, a single individual with a $10,000 annual benefit and other income of $35,000 in 1994 would pay almost $1,000 more in income taxes than under current law. Also, these increases affect many middle-income people, not just the "rich" such as those who are the target of the proposed marginal income tax rates rate hikes included in the budget bill.

Special Nature of Social Security

Opponents object to 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.

Effect on Marginal Tax Rates and Incentives to Work

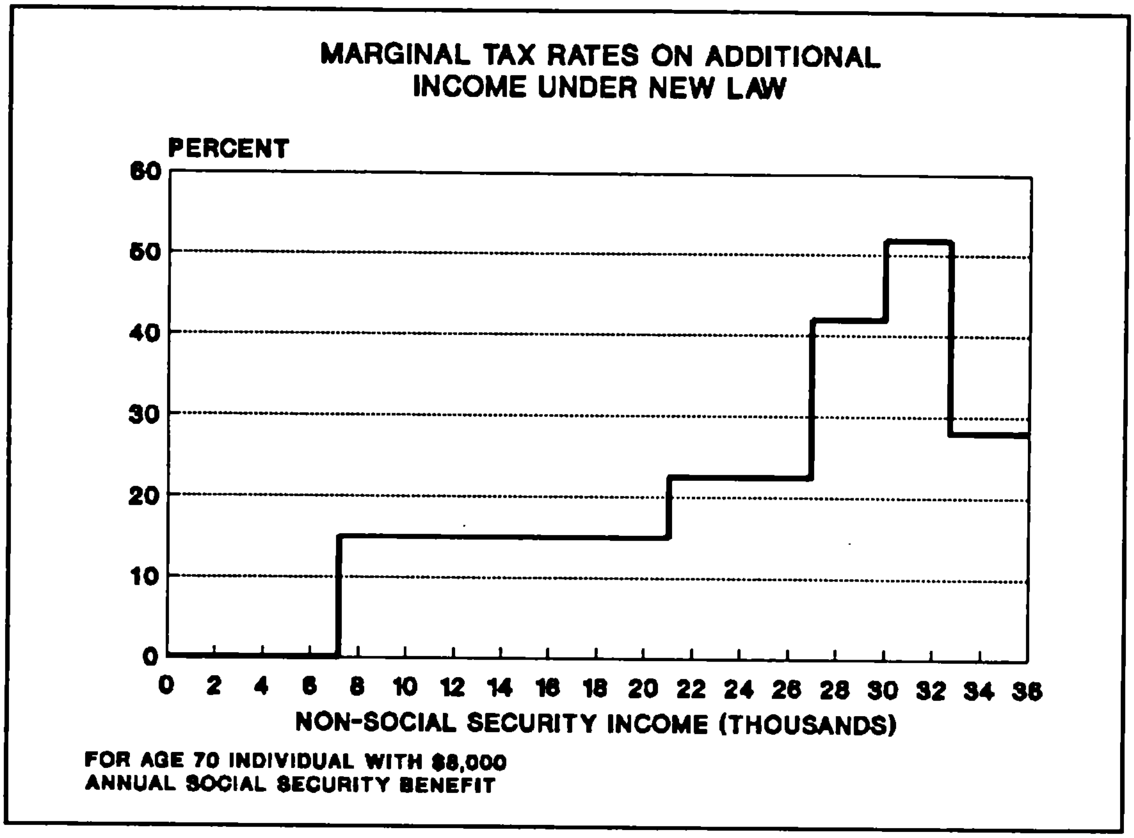
While some opponents see additional taxation of benefits as a benefit reduction, others see it as merely an increased tax. To them it is not a decrease in Government spending, but a revenue raiser.

As a tax increase, they say it exacerbates a problem that already existed under the law: distortions of marginal income tax rates. For example, the law in 1993 has the effect of increasing the marginal tax rate by at least 50% for additional income that falls between the 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, 15% becomes 22.5%, and 28% becomes 42%). Once fully one-half 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 distortion will be heightened under the new law because its effect will be to subject $1.85 to tax for each dollar earned above the threshold amount (e.g., 15% would become 27.75%, and 28% would become 51.8%). This effect on marginal income tax rates is shown on **Chart 1** on the following page. As it illustrates, there would be an even larger bulge 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.

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

Opponents say the new law would particularly discourage work effort when its interaction with the social security earnings test is included. Under this test, if a beneficiary under age 70 has earnings from work that exceed an annual exempt amount ($10,560 for recipients age 65 through 69, and $7,680 for those under age 65, in 1993), his or her benefits are reduced. For recipients under age 65, $1 of the social security benefit is withheld for every $2 of the "excess" earnings. For those ages 65-69, $1 is withheld for every $3 of excess earnings. Another way of looking at it is that each dollar of income above the exempt amount reduces a dollar of benefits by 50% (33% for those ages 65-69). The earnings test applies only to earned income and not to savings, investments, and the like.

CHART 1.



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 were to cause a beneficiary not only to lose a portion of his benefits 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 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 CRS Report 89-40 EPW, *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 (retirement test plus Federal, State, and local income taxes and social security taxes) to over 100%, so that the individual would lose money from working.

LEGISLATION

H.Con.Res. 64

FY1994 Concurrent Budget Resolution. Passed House Mar. 18, 1993; passed Senate Mar. 25, 1993. Conference agreement passed House Mar. 31, 1993. Passed Senate Apr. 1, 1993.

H.R. 2264

1993 omnibus budget reconciliation bill. Passed House May 27, 1993; passed Senate June 24, 1993. Conference agreement passed House Aug. 5, 1993. Passed Senate Aug. 6, 1993.

P.L. 103-66

1993 omnibus budget reconciliation bill. Signed into law on Aug. 10, 1993.

FOR ADDITIONAL READING

U.S. Library of Congress. Congressional Research Service. *Social security: Issues in taxing benefits under current law and under proposals to tax a greater share of benefits*, by Geoffrey Kollmann. [Washington] 1989. 60 p.
CRS Report 89-40 EPW

---- *Social security: Its removal from the budget and procedures for considering changes to the program*, by David Koitz. [Washington] 1993. 10 p.
CRS Report 93-23 EPW

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

MEMORANDUM

April 11, 1991

SUBJECT : **Arguments For and Against Recent Proposals to Reduce Social Security Taxes**

FROM : David Koitz
Specialist in Social Legislation
Education and Public Welfare Division

This memorandum was prepared in response to many requests for a summary of arguments for and against recent proposals to reduce social security taxes, notably S. 11, introduced by Senator Moynihan, et al., on January 3, 1991.

BACKGROUND

The tax rate for Old Age, Survivors, and Disability Insurance (OASDI), paid both by employee and employer, rose from 6.06 percent in 1989 to a permanent rate of 6.2 percent in 1990. This hike was the last in a series of increases enacted through various pieces of legislation dating back to the early 1970s. The combined tax rate of 12.4 percent is higher than needed to cover today's OASDI expenditures, which are consuming only 85 percent of the revenues collected at that rate. (The 12.4 percent figure does not include the rate for the Hospital Insurance (HI) portion of medicare, which adds another 2.9 percent--1.45 percent each, employee and employer--bringing the total OASDHI rate to 15.3 percent.)

TABLE 1. Social Security Tax Rates Under Current Law
(in percent)

	Employee rate					Combined rate
Year	OASI	DI	OASDI	HI	Total	Employee/Employer
1988-89 . . .	5.53	0.53	6.06	1.45	7.51	15.02
1990	5.6	0.6	6.20	1.45	7.65	15.3
2000	5.49	0.71	6.20	1.45	7.65	15.3

This memorandum was prepared by the Education and Public Welfare Division to enable distribution to more than one congressional client.

Various proposals have been made by Senator Moynihan and others to bring the current 6.2 percent OASDI rate down to 5.1 percent or 5.2 percent, resulting in a cut in the relative tax bite for most workers of 17.7 percent or 16.1 percent, respectively. The proposals would not alter the HI rate. Senator Moynihan's original bill would have made the reduction over a 2-year period, while a later one would phase it in over 5 years. The "pay-as-you-go" concept underlying the proposals envisions a social security tax system where neither sizeable surpluses nor deficits would be allowed to occur. This is in contrast to current law, where substantial surplus tax receipts are expected until 2015 or so, after which expenditures would outrun them. Eventually, these proposals would lead to a tax rate of 8.1 percent (in 2050 and later), as the rate was adjusted upward to keep pace with growing costs arising from the retirement of the post-World War II baby boomers and subsequent retirees.

The latest proposal of Senator Moynihan, incorporated in S. 11, would offset some of the near-term revenue loss from the rate cut by increasing the social security taxable earnings base (the maximum amount of earnings subject to the tax each year). This would temper the tax reduction for workers whose earnings exceed the current law base but fall below the proposed higher base. Workers with earnings equal to or higher than the new base would pay just slightly less than under current law.

TABLE 2. Changes in Social Security Taxes Resulting From S. 11

	Increase or decrease in social security taxes for worker with earnings (in percent)			
Year	Below current law base	Equal to current law base	Half-way between current law base and base proposed in S. 11	Equal to or higher than base proposed in S. 11
1992	- 8.1	- 8.1	-4.1	-0.2
1996	-16.1	-16.1	-8.3	-0.5

The Current Social Security Tax Structure

Financing for the OASDI and HI programs is provided primarily by flat-rate taxes levied on payrolls and self-employment income, commonly referred to as FICA (for Federal Insurance Contributions Act) and SECA (for Self-Employment Contributions Act) taxes. More than 95 percent of the work force is required to pay them. The FICA tax is levied on a worker's earnings and is paid both by employees and employers; the SECA tax is levied on net self-employment income. (The rate for the self-employed is the same as the combined employee/ employer rate; however, only 92.35 percent of net self-employment earnings is subject to the SECA tax, and half of the SECA taxes so computed is deductible for income tax purposes.) It is not levied on investment and other forms of nonwork income. Both the FICA and SECA rates have three components: one for OASI, a second for DI, and a third for HI. These taxes are not levied on earnings above the taxable earnings base (in 1991, $53,400 for OASDI and $125,000 for HI). The base rises each year to reflect increases in average earnings in the economy. It is estimated that 94 percent of all covered workers have earnings below the base for OASDI and that 88 percent of all earnings in covered jobs are taxable.

How Would S. 11 Alter Social Security Taxes?

S. 11 would bring the employee/employer rate down from 6.2 percent to 5.2 percent in three steps over the next 5 years (equivalent reductions also would be made in the self-employment rate). It would start with a rate of 5.7 percent in July 1991, then 5.5 percent in 1994, and 5.2 percent in 1996. It would stay at 5.2 percent until 2010 and then begin rising in steps until it reached 8.1 percent in 2050. The middle column in the following table shows how the rate would change over the long run. The bill also increases the taxable earnings base from $53,400 this year to $60,600 next year and in steps to $82,200 by 1996 (about $13,000 higher than projected under current law). Although increasing the base would raise revenue, it also would raise future expenditures because it would increase the amount of earnings counted in calculating benefits for higher paid workers. The net effect of the near-term rate cuts and base hikes, however, is an estimated *reduction* in social security tax revenues of $190 billion cumulatively for calendar years 1991-96 (estimate provided by the Office of the Actuary, Social Security Administration (SSA), January 23, 1991).

The proposal represents a pay-as-you-go approach to financing social security that would have the tax rate adjusted in the future to keep social security revenues fairly close to the immediate obligations of the program. An approach that envisions frequent adjustments illustrates the dimensions of the tax rate changes that would have to take place over the long run under current cost projections (using the Intermediate II-B forecast of the 1990 Trustees' Report). *If social security were financed exclusively from the social security tax* (i.e, ignoring income taxes from taxing social security benefits and interest on trust fund securities), the tax rate would be approximately the cost rate, meaning that the combined employee/employer rate could be dropped today from 12.4 percent to about 10.6 percent. Over the next 15 years it would stay at about the same level, and then begin a fairly rapid ascent, reaching 12.25 percent in 2015, 15.33 percent in 2025, and even higher levels by the middle of the century (see right-hand column of Table 3).

In layman's terms, a system financed exclusively by the social security tax would permit the relative tax bite to be cut by 15 percent or so for the next 10 years (from 12.4 percent today to about 10.56 percent in 2000), after which it would have to climb by 61 percent (from 10.56 percent in 2000 to 17.0 percent in 2055). However, since social security taxes would continue to be supplemented by income tax revenues from taxing social security benefits and, to a small extent, by interest earnings, S. 11 contains tax rates that are slightly lower than a "pure social security tax" arrangement. Under S. 11, the tax bite for the average taxpayer would be cut by 16.1 percent by 1996 and raised by 56 percent in steps from 2005 to 2050.

TABLE 3. Comparison of OASDI Tax Rates Under Current Law and S. 11, 1991-2055
(employee/employer combined)

Calendar Year	Current law	(S. 11) (Moynihan)*	Cost rate
		(in percent)	
1991	12.40	12.40	10.64
2000	12.40	10.40	10.56
2005	12.40	10.20	10.59
2010	12.40	11.20	11.08
2015	12.40	12.40	12.25
2020	12.40	13.60	13.86
2025	12.40	15.00	15.33
2030	12.40	15.60	16.28
2040	12.40	15.80	16.55
2050	12.40	16.20	16.70
2055	12.40	16.20	17.00

Source: 1990 OASDI Trustees' Report, Intermediate II-B forecast.

* The social security tax would continue to be supplemented by income from taxation of benefits to achieve a match with the cost rate.

TABLE 4. Potential Changes in Worker's Social Security Taxes Under S. 11

Relative* Wage Level	Current law (6.2% rate)	Increases and reductions in worker's annual OASDI taxes under S. 11: 1992	1996	2015	2020	2035
$10,000	$ 620	-$50	-$100	0	$60	$160
$20,000	1,240	-100	-200	0	120	320
$30,000	1,860	-150	-300	0	180	480
$40,000	2,480	-200	-400	0	240	640
$50,000	3,100	-250	-500	0	300	800

*Wages will rise over time, but they were fixed in this table to show the relative change in the tax bite in today's terms.

ARGUMENTS FOR THE PROPOSAL

Collecting more social security taxes than are needed deceives the public. Support for the tax-cutting proposal in the 101st Congress arose in part from the belief that the surplus social security taxes were masking the Federal deficit. While this was settled by removing social security from the budget process as part of the new Budget Enforcement Act (Title 13 of P.L. 101-508), at the root of the issue is the public's misperception that the surplus taxes are deposited and saved in the social security trust funds. Actually, the money goes into the U.S. Treasury, and out again almost immediately to pay for whatever obligations the Government has. (The trusts are credited with an equivalent amount of securities.) Supporters of the proposed tax cut argue that crediting the taxes to the trust funds, but using them for something else, deceives the public. Hence, they contend that the portion of the taxes not being used for social security purposes should not be levied.

Even though social security was removed from the budget, its surplus taxes are still covering deficits for the rest of the Government. Although Congress enacted major deficit reduction measures in the 101st Congress, it removed the explicit goal of eliminating the deficit from the budget process. The deficits of the rest of the Government have since grown worse, and surplus social security taxes continue to cover them without an end in sight--i.e., the money still goes into the Treasury even though it is not counted in the official Federal budget. Even counting an estimated $482 billion in deficit-reduction measures enacted in 1990, the Congressional Budget office (CBO) is now estimating cumulative unified budget deficits of $1,062 billion for the FY 1991-95 period, compared to $949 billion in deficits for that period estimated less than a year ago--the deficits are over $100 billion worse. Proponents of the social security tax cut argue that it is only by keeping the surplus tax dollars from coming into the Treasury that action will be taken to eliminate the deficits for the rest of the Government.

A social security tax cut would be a near-term economic stimulus. It is argued that a social security tax cut today, in the midst of a recession, would give a needed near-term stimulus to the economy by putting more disposable income into the hands of consumers and by reducing the cost of labor (i.e., through a reduction in the employer's share of the tax). A recent Congressional Research Service (CRS) analysis of S. 11, using the "base case" economic forecast of Data Resources Incorporated (DRI, January 1991), estimated that with enactment of the tax cut the gross national product (GNP) would grow at a 3.9 percent rate in 1992, rather than a 3.5 percent rate, and that the unemployment rate would be 6.3 percent on average, instead of 6.5 percent, which would translate into 300,000 more people working in the economy.

Social security has generally been financed on a pay-as-you-go basis, and the recent shift to a partially-funded system was never fully examined. Throughout most of its history, social security has been financed on a pay-as-you-go basis. Although substantial surpluses for the 1990-2015 period began appearing in social security trustees' reports in the late 1970s, the program's income during 1955-87 rarely varied by more than 10 percent of its outgo. In 1991, total income credit to the trust funds is projected to exceed outgo by 25 percent or more, and the yearly surpluses will rise to 38 percent in 2000 and 43 percent in 2010, after which they will decline. In 1983, when reforms were enacted to shore up the social security system, there was little recognition that the proposals Congress was enacting to restore the system to long-range actuarial balance would do so by creating large surpluses followed by large deficits. Moreover, there was little expectation that there would be large surpluses in the short run (i.e., 1983-89). The economy was in a recession in 1983 and the measures enacted then were largely designed to keep the system solvent through the remainder of the decade under pessimistic conditions. In effect, Congress did not examine and make explicit decisions to have large surpluses, nor did it have an informed debate about whether they would be desirable and how they would be used by the Government.

The proposal would improve the progressivity of the Federal tax system. Some proponents of the tax cut consider social security taxes to be "regressive," or at least not as progressive as the income tax, which has a graduated rate schedule and is levied on other income besides earnings from work. They argue that the public firmly believes in the principle that the Federal tax burden should be based on "ability to pay," and that it wants the rich to carry more of it. This view is reflected in S. 11, where the social security tax rate is cut but the taxable earnings base is increased to offset the tax reduction for high wage earners--the bulk of the tax relief falls on people with annual earnings below the taxable earnings base, who comprise 94 percent of all workers covered by the system. A March 1991 Wall Street Journal/NBC poll found that by a 55-37 percent margin respondents favored cutting the social security tax for individuals who earn less than $60,000 a year and raising it for those who earn more.

Proponents further contend that for many families, social security taxes are greater than income taxes--for an estimated 77 percent if both the employee and employer share are counted, 38 percent if only the employee's share is counted--and that other taxes, income taxes in particular, should be used to finance that portion of the Government's spending now financed with the surplus social security receipts.

A social security tax cut is fairer to the "common man" than a capital gains tax cut. Others contrast a social security tax cut to the Administration's push for a capital gains tax reduction. They argue that if Congress is to consider tax reductions, a social security cut would give more relief to working people than a capital gains cut, which would heavily benefit those with substantial income from assets--i.e., the wealthy.

The social security surpluses are an invitation for new spending. Currently, the existence of large Federal budget deficits acts as a fiscal constraint on Government spending, but if the deficits were reduced to a more manageable level in the next few years, pressures could mount for new spending initiatives. Significant pressures already have been built up to liberalize the annual earnings limit for social security recipients (i.e., the earnings test) and to increase benefits for recipients who feel they were adversely affected by benefit computation changes enacted in 1977 (i.e., the "notch" babies). Because excess social security taxes would be a potential source of revenue to pay for these initiatives, proponents of the tax cut assert that the surpluses would encourage expansions of social security benefits--the creation of which could worsen the system's long-range problems--or for other new social programs.

Pay-as-you-go social security financing will show the true cost of the system in the long run. Proponents point out that a pay-as-you-go approach to financing social security would give the public a better sense for the system's long-run costs by having tax rate increases scheduled for the next century. In the long run, projected tax receipts are inadequate to cover benefits, but the projected buildup of the trust funds makes it appear as if the resources will be there. Since the trust funds hold only Government securities (promissory notes or IOUs from one arm of the Government to another), in themselves they would not provide the money to the Government to pay for these future benefits. Other taxes would have to be raised, other spending reduced, or borrowing increased. Hence, proponents contend that scheduling future social security tax rate increases would show the public more directly that the money for future benefits will have to come out of the economy at that time.

A "super majority" is not needed in the Senate to pass the measure. From the standpoint of whether the measure is legislatively feasible, proponents argue that one of the tax cut's major hurdles in the Senate--overcoming a procedural objection against cutting social security revenues without offsetting measures that requires a super majority to waive (60 votes in this case)--can be avoided by including the measure in the budget resolution for FY 1992. They argue that once the budget resolution is reported to the Senate, it would be in order for the Senate to consider an amendment, *and pass it by simple majority*, to reflect the impact of the tax cut in the social security figures now required to be contained in budget resolutions. When the actual tax cut measure came to the floor later, they contend it would not be subject to objections that it violated the budget resolution figures or social security allocations to the Finance Committee made pursuant to the resolution.

A social security tax cut will not trigger sequestration of funds for any other programs. With social security removed from the budget totals and not being counted under the new "caps" for discretionary spending nor under the pay-as-you-go rule for entitlement spending and revenues, reductions in social security taxes will not trigger automatic sequestration of funds in other Government programs.

ARGUMENTS AGAINST THE PROPOSAL

Cutting the social security tax rate will subject the program to financing "risks." Critics of the tax cut argue that it subjects the program to potential financing risks, even though in dollar terms a large contingency reserve is now posted to the social security trust funds. Having gone through two major financing scares in the late 1970s and early 1980s, the public still is apprehensive about the long-run viability of the program--despite the repeated reports of surpluses. Another round of financial problems could do severe and perhaps final damage to the program's credibility. Trust fund balances that initially appeared to be very large in the past turned out to be inadequate, and it would be hard to predict how much of a reserve would be adequate to cushion the program from a series of economic setbacks such as occurred in the early 1980s. Some contend that today's reserves, equaling 10 to 11 months' worth of expenditures or 80-90 percent of annual expenditures, is much too low and that a reserve balance of 150 percent of annual outgo must be achieved--not estimated--before any thought can be given to pay-as-you-go financing. The OASDI programs opened the 1970s with a reserve balance of more than 100 percent. However, if Congress had not acted in 1977, on a combined basis the programs would have been insolvent by 1981; DI actually would have been insolvent in 1979. Using the Intermediate II-B assumptions of the 1990 Trustees' Report, the Social Security Administration's actuaries recently estimated that under S. 11, a reserve balance of 100 percent would not be achieved until late 1992 or early 1993 and that a reserve of 150 percent would not be achieved until after the year 2000. Under the Trustees' pessimistic assumptions, they estimate the reserves would be exhausted in 2005, meaning the system would be technically insolvent.

Pay-as-you-go financing is inherently risky. Critics further argue that experience has shown pay-as-you-go financing to be inherently risky as a long-range funding approach for social security. Partial funding--i.e., having a substantially but not "fully" funded system--provides a cushion against "adverse" events" that are not anticipated (i.e., birth rates turning out to be lower than expected or productivity growth being slower). Every few years since the early 1970s, long-range social security estimates have been adjusted to reflect lower birth rates and lower real wage growth. If these trends continue and the estimates upon which a partially-funded system was designed turn out to be optimistic, the partially-funded system could easily slip into a pay-as-you-go system or worse. Critics contend that from a political perspective, it is easier to cut tax rates if unexpected windfalls occur than to raise rates if unexpected shortfalls emerge.

The tax cut is fiscally irresponsible. Critics also argue that it is "fiscally irresponsible" to enact such large tax reductions--$190 billion cumulatively by 1996 under S. 11--when the Government is already borrowing huge amounts, $300 billion or more annually, to make ends meet. While the tax cut proposal reopened the debate about how social security should be financed, they argue that the issues involve more than the appropriate level of social security taxes. They point out that if the revenue loss is not offset, it would merely lead to more Government borrowing from the public, and, in turn, reduce the amount of resources available in the credit markets for investment. Although the tax cut would have a modest stimulative impact on the economy in 1992, they warn that the additional borrowing it caused would impair, rather than bolster, the nation's savings rate, and thus would not prepare the nation for the demands of the next century. The consensus among economists is that the accumulation of past deficits has already imposed a large mortgage on future generations. Cutting social security taxes now without offsetting tax increases or spending cuts would make that amount larger. The analysis done by CRS using the DRI "base case" forecast shows that beginning in 1992, both short- and long-term interest rates would be higher under the proposal, and that after 1992 GNP growth would be slower. The interest rate on 10-year Treasury securities would be 7.9 percent in 1996 under S. 11, compared to 7.4 percent under current law. Real GNP would increase by 2.6 percent in 1993 under S. 11 (compared to 2.8 percent under current law), 2.8 percent in 1994 (compared to 2.9 percent under current law), and 2.2 percent in 1995 (compared to 2.5 percent under current law). Moreover, any increase in employment attributable to the tax cut would last only through 1993.

If the resources can be found to cover the revenue loss, where are they? Critics argue that while proponents say the money to make up for the tax cut "can still be found," the proposal itself does not advance any source. It stands alone as a major revenue loser--$190 billion cumulatively from CY 1991-96. They ask: "if it can be found, where is it?" They contend that it has been difficult enough for Congress to achieve substantive reductions in Government borrowing from the credit markets without giving up any receipts; thus, they ask where the other part of the proposal is--the painful part. Even with an increase in the taxable earnings base to $82,200 by 1996, the revenue loss would still be large. They contend that since only 12 percent of earnings in covered jobs exceeds the base, even if *all* earnings were taxed, not enough money would be raised to cover the 16.1 percent tax cut proposed by S. 11.

With social security now removed from the budget, the stage is set to really "save" its surpluses. Critics argue that depositing social security taxes in the U.S. Treasury does not necessarily mean they always will be spent. They contend that using the surplus receipts to reduce Government borrowing from the public is tantamount to saving them, since less Government borrowing means that more money is available in the economy for investment. The Federal budget process now ignores social security, since the program has been removed from all aspects of the budget totals, and Congress can now clearly attend to the deficits for the rest of the Government. A major step in that direction was taken in 1990 with enactment of the 5-year $482 billion deficit-reduction package. Critics argue that even though the deficit has grown larger in the near-term, both the Congressional Budget Office (CBO) and the Administration show it declining substantially over the next 6 years. If Congress adheres to the budget enforcement procedures it adopted last year, CBO shows the "on-budget" deficit dropping from $369 billion in FY 1991 to $194 billion in 1996. If social security surpluses (and small ones for the postal service) are counted, the deficit drops from $309 billion, to $66 billion, or from 5.5 percent to 0.9 percent of

GNP. In other words, the stage is set for social security to contribute substantially to the nation's savings rate by reducing Government borrowing from the public.

The social security tax is not regressive. Critics contend that social security's relative progressivity or regressivity should not be measured by the tax alone. They argue first that any tax regressivity is more than offset by a progressive benefit schedule that pays more social security benefits per tax dollar to low earners than high-wage earners. A recent CRS analysis shows that minimum earners retiring at 65 today can expect to recover the value of their taxes with interest in 3.0 years, whereas average earners would recover them in 4.1 years and high earners in 5.2 years. Thus, when the social security system is looked at as a whole--taxes and benefits together--it can be termed progressive. Also, critics point out that for the 94 percent of the workforce whose earnings fall below the earnings base, the tax actually is proportional on earnings, and that for families with children with annual earnings up to about $21,000, the Earned Income Tax Credit (EITC) offsets some or all of their social security taxes. Although the EITC is an income tax provision, it was partly motivated as an offset to social security taxes paid by low-income families.

Raising the earnings base will increase benefits for well-off future recipients, who do not need additional social insurance protection. Raising the taxable earnings base is often viewed as a revenue measure, but it also increases benefits for those affected since their benefits are based on their average career earnings. In effect, critics argue that it would raise benefits, and the future cost of the system, for people who are generally well-off and not in need of additional social insurance protection.

The increase in the taxable earnings base will weaken support for the system. Even though high-wage earners would get more benefits from the proposed increase in the taxable earnings base, critics contend that the rate of return on those additional tax dollars would not be favorable. The additional countable earnings (the additional amount upon which the tax was levied) would be converted into benefits in the lowest bracket of the social security benefit formula (the last countable dollar of earnings is converted at the lowest rate). The long-range replacement rate--a retiree's initial social security benefits compared to his or her final year's earnings--would drop from 27 percent under current law to 25 percent under S. 11. They argue that this would further erode support for the system among high-wage earners who already get the lowest rate of return from it.

Opinion polls suggest that the public is not clamoring for a payroll tax cut. When the social security tax cut idea received national media attention last year, the public showed little enthusiasm for it. A Peter Hart/Robert Teeter poll found in January 1990 that by a 53-39 percent majority, respondents opposed canceling the 1990 social security tax hike. A similar Yankelovich finding showed the margin to be 67-29 percent. A Boston Globe poll done at the same time found by a margin of 7 to 2 respondents were against Senator Moynihan's initial tax cut proposal. In answer to a question about tax cut preferences, a CBS/New York Times poll found respondents preferring an income tax cut to a social security cut by a margin of 78-14 percent. When asked in May 1990 what was the "least fair" tax, Gallup respondents rated the income tax and local property taxes as far more objectionable than the social security tax (the property tax was judged least fair by 28 percent, the income tax by 26 percent, and the social security tax by 15 percent). Critics argue that these polls reflect the public's mood that social security should not be "messed" with, that if "the system isn't broke, don't fix it."

The surplus social security taxes may be needed to shore up medicare. While social security is projected to have large surpluses for many years, the HI portion of Medicare is projected to become insolvent shortly after the turn of the century. Some critics of the tax cut argue that it is better to keep the surplus OASDI taxes flowing, that it is easier to keep the overall tax rate constant at 7.65 percent with the idea that a greater portion of it may have to be allocated to HI in 10 years than to cut the tax rate today only to have to raise it again later.

Federal employees would not benefit from the tax cut; some would see their take-home pay fall. While the social security tax cut is designed to give tax relief, its effects would not be uniform. Federal employees, in particular, would see no increase in their take home pay. Those in the old Civil Service Retirement System would see no change since they pay civil service contributions, not social security taxes. Even the growing proportion of Federal workers who pay social security under the new Federal Employees Retirement System (FERS) see no increase in their take-home pay. Their system is designed so that FERS contributions rise as social security taxes decline. Higher paid covered workers actually would see their take-home pay decline because their FERS contributions would rise more than their social security taxes would decline.

Enacting the proposal would weaken social security discipline. Critics point out that Congress traditionally has altered social security with a watchful eye on its financial condition. Generally, liberalizations were adopted after extensive debate, and frequently they were phased in so that their financial consequences could be assessed as their impact grew. The DI program is a case in point where, both in 1967 and 1980, Congress took action to alter aspects of the program that threatened to propel the program out of control. This ongoing concern for fiscal discipline was reflected again last year when Congress made revisions to the budget process. Congress enacted new so-called "firewall" procedures to ensure that social security's financial condition was not eroded by runaway spending or tax cut measures when it took social security out of the budget. To the extent the new firewall procedures are by-passed through technical "loopholes" or are deliberately overridden by "fear" of the consequences of opposing a tax cut, it could open the flood gates for other spending or tax cut measures that could erode the financial condition of the system.

Enacting the proposal would weaken the budget process. Critics also argue that if Congress should ignore or override the firewall procedures, social security would be looked at as a new way of avoiding the fiscal constraints of the budget process. They contend that proposals would emerge to redesign or alter social security taxes and benefits to achieve many unrelated objectives, proposals that would not otherwise muster the support for the difficult reallocations required by the regular budget process. And if taken to an extreme, they argue that these actions would intensify public apprehension about the system.

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Social Security Tax Debate

Updated March 2, 1993
(Archived)

by
David Koitz and Geoffrey Kollmann
Education and Public Welfare Division

CONTENTS

Social Security Tax Debate

SUMMARY

The social security tax rate is higher than needed to meet today's social security costs. Various bills considered by the 101st and 102nd Congresses to bring the rate more in line with actual costs reopened the debate about how social security should be financed and treated in the Federal budget and about whether social security taxes should be cut to stimulate the economy. Notable among them were bills introduced by Senator Moynihan to establish a "pay-as-you-go" social security system under which the social security tax rate was to be cut from 6.2% (the current rate for employee and employer each) to 5.1% or 5.2%. Later, in 2010, it was to be raised gradually to an eventual level of 8.1% to keep pace with steep cost increases arising from the retirement of the post-World War II baby boomers and subsequent generations.

Support for the idea of cutting the tax originally arose from the complaint that the surplus social security taxes were "masking" the Federal deficit and being spent on other programs. It also came from those who see social security taxes as regressive and wanted to force Congress and the Administration to consider increasing income taxes. Others contended that if the surpluses were allowed to continue, pressure would mount to spend them, thereby exacerbating the system's long-range problems. They wanted to remove this temptation and, at the same time, give the public a clearer perception of the higher taxes the system will need in the next century. Yet others contrasted a social security tax cut to proposals by the Bush Administration to cut the capital gains tax -- i.e., more tax relief would go to workers if social security taxes were reduced -- and argued that it would help stimulate the sluggish economy through increased consumer spending . Critics pointed out that without making up for the revenue loss, the immediate tax reduction would increase the Government's borrowing from financial markets, and thereby reduce the amount of resources available for private investment; it would have impaired the nation's savings rate, rather than bolstered it. They asserted that the surplus receipts should be used to reduce the budget deficit on the grounds that the Government then would borrow less, making more money available for investment. With regard to the tax cut's impact on the economy, they contended that its stimulative effects would be short-lived, because higher government borrowing caused by the tax cut eventually would have put pressure on financial markets and led to higher interest rates. They further argued that if the economic assumptions upon which the tax cut were based proved to be optimistic, the social security system's financial solvency would be threatened.

Although the Senate took up Senator Moynihan's proposal twice, once in 1990 and again in early 1991, both times it was set aside over procedural objections. Later, however, as the recovery from the recession weakened, new calls were made for tax cuts to stimulate the economy. In reaction, Congress passed a package of tax changes early in 1992 that included income tax credits based on the level of one's social security taxes (H.R. 4210). Social security taxes were not to be directly affected. The tax package died, however, when President Bush vetoed the bill on Mar. 20, 1993. President Clinton's first budget (submitted to Congress in February 1993) did not propose changes in social security taxes.

Most Recent Developments

President Clinton's budget and economic plan, announced on Feb. 17, 1993, did not propose changes in social security taxes.

BACKGROUND AND ANALYSIS

A Few Basics About Social Security Financing

Financing for social security and the Medicare Hospital Insurance (HI) program is provided by flat-rate taxes levied on payrolls and self-employment income, commonly referred to as FICA (for Federal Insurance Contributions Act) and SECA (for Self-Employment Contributions Act) taxes. More than 95% of the work force is required to pay the tax. The FICA tax is levied on a worker's earnings and is paid both by employees and employers; the SECA tax is levied on net self-employment income. Investment and other forms of non-work income is not affected. Both the FICA and SECA rates have three components: one for Old Age and Survivors Insurance (OASI), a second for Disability Insurance (DI) -- and a third for HI.

The tax is not levied on earnings above a taxable earnings base (in 1993, $57,600 for OASDI and $135,000 for HI). The base rises each year to reflect increases in average earnings in the economy. Approximately 9 out of every 10 workers have earnings below this level.

Table 1. Social Security Tax Rates Under Current Law (in percent)

	Employee Rate					Combined rate
	OASI	DI	OASDI	HI	Total	Employee/Employer
1988-89	5.53	0.53	6.06	1.45	7.51	15.02
1990	5.6	0.6	6.20	1.45	7.65	15.3
2000	5.49	0.71	6.20	1.45	7.65	15.3

The rate for the self-employed is the same as the combined employee/employer rate; however, only 92.35% of net self-employment earnings is taxable and half of the SECA taxes so computed is deductible for income tax purposes.

Putting the Issue in Context

Where do surplus social security taxes go?

Contrary to popular belief, social security taxes are not deposited in the social security trust funds, but (like all other Government revenues) in the U.S. Treasury.

Each day, they flow into 15,000 depository accounts maintained by the Government with financial institutions across the country and, along with many other forms of tax revenues, become part of the Government's operating cash pool. In effect, once the taxes are received, they become indistinguishable from other monies paid into the Treasury. The social security taxes are accounted for separately through the posting of Federal securities to the social security and HI trust funds -- which is basically a bookkeeping entry by the Treasury. The accounts -- the trust funds -- do not receive or hold money. Similarly, benefits are not paid from the trust funds, but from the Treasury. As the checks are paid, a corresponding amount of securities are written off the trust funds -- basically another bookkeeping entry.

When more social security taxes are received than spent, the balance of securities on the trust fund ledgers rises. In essence, the trust funds represent a form of IOU -- a promise by the Government that, in order to pay social security benefits, it will obtain resources in the future equal to the value of the securities.

What is the purpose of the trust funds?

Generally speaking, the securities posted to a Federal trust fund represent "permission to spend." As long as a trust fund has a balance of securities posted to it, the Treasury Department can keep issuing checks for the program. The money itself doesn't come from the trust fund. In a sense, the mechanics of a Federal trust fund are similar to those of a bank account. The bank takes in a depositor's money and then loans it out. The depositor's account balance is raised, and as long as there is a positive balance posted to it, the depositor can keep writing checks that the bank must honor (regardless of how it used the depositor's money). In social security's case, social security taxes flow into the Treasury, and the social security trust funds are credited with Federal securities. The Government then uses the money to meet whatever expenses are pending at the time. The fact that this money is not set aside for social security purposes does not dismiss the Government's responsibility to honor the trust funds' account balances. As long as there are balances posted to the funds, the Treasury Department must continue to issue the social security checks. For instance, for more than 10 years from the early 1970s to the mid-1980s, social security's tax receipts were consistently lower than the program's outgo. Social security benefits continued to be paid because there were balances posted to the social security funds. The key point is that the trust funds themselves do not hold financial resources to pay benefits -- rather, they provide authority for the Treasury Department to use its current receipts and amounts borrowed from the public to pay them.

The significance of having trust funds for social security is that they represent a long-term commitment of the Government to the program. While the trust funds do not hold "resources" that the Government can call on to pay social security benefits, their balances represent and have served as financial claims against the Government -- claims on which the Treasury has never defaulted, nor used as a basis to finance anything but social security expenditures.

Does taking social security out of the budget change where the surplus taxes go?

Legislation enacted in 1990 (the Budget Enforcement Act, included in P.L. 101-508) removed social security from the budget and from calculations of the budget deficit. In large part this was done to prevent social security from masking the size of the deficit and to protect it from budgetary cuts. It was based on the supposition that Congress would act *differently* in trying to achieve deficit-reduction targets if social security surpluses were not counted in reaching the budget totals; i.e., that Congress would ignore social security in devising the nation's overall fiscal policies. *It was not done to change where social security taxes go.* The Federal budget is not a cash management account -- it is simply a statement or summary of what policymakers want the Government's financial flows to be during any given time period. Whether this summary is presented in a unified or fragmented form will not *in and of itself* change how much money is received and spent by the Government, and it will not alter where Federal tax receipts *of any sort* go. Social security taxes will go into the Treasury regardless of whether the program is counted in reaching budget totals. Social security taxes will go elsewhere only if Congress decides they will go elsewhere.

Are surplus social security taxes giving the Government more money to spend?

The fact that surplus social security taxes are used by the Government to meet other financial commitments does not necessarily mean that the Government has more money to spend than it would have if these receipts were not available. Decisions about social security and the finances of the rest of the Government have not been made in isolation of one another and those decisions have had overlapping influences. Social security taxes are only one form of Federal taxation. Increases in social security taxes may have made it more difficult for Congress to raise other forms of taxes. For instance, social security taxes were raised in 1977 to shore up the program's financing, but the following year income taxes were reduced to offset the impact of these hikes. Similarly, the Earned Income Tax Credit (EITC) is intended in part to offset the social security tax bite on low-income workers with children. Hence, other taxes may have taken the place of the surplus social security taxes if social security tax rates were lower than they are now. Thus, whether these surplus taxes are allowing the Government to spend more is a matter of conjecture.

Do surplus social security taxes permit the Government to borrow less from the public ?

Today, the Government is spending more than it is taking in through taxes, and it covers the shortfall by borrowing money. No single activity of the Government determines the size of this shortfall. To say surplus social security taxes are reducing the amount that must be borrowed assumes that all other spending and taxation decisions have been made without any regard for social security's income and outgo, and vice versa. If increases in social security taxes over the past decade have contributed to reductions in other taxes, or kept other taxes from rising, they may have added little to the Government's total revenues. By the same token, when social security taxes are smaller than the program's spending -- as they were for all but 5 fiscal years after 1957 and through 1984 -- it is not clear that this shortfall causes the Government to borrow more than it would otherwise. Government borrowing from the public caused by deficits is not clearly linked to any particular aspect of what the Government does. It borrows as it needs to, for whatever obligations it has to meet. Thus, whether surplus social security taxes are currently allowing the Government to borrow less from the public than it otherwise would is purely conjecture.

Is the current era of surpluses a new phenomenon for social security?

The original Social Security Act in 1935 was designed to build a large fund over several decades to help finance future benefits. Amendments enacted in 1939 attempted to alter this approach -- to move it toward a pay-as-you-go system -- but with robust receipts stemming from the economic expansion of the subsequent war effort, it was many years before the program's receipts came into alignment with its expenditures. During the early 1940s, social security receipts were 6 or 7 times the program's expenditures, and even at the end of the decade they were still 2 1/2 times the outgo. It was not until FY1957 that receipts and outgo came close to a 1-to-1 relationship. In most years after FY1957, up through 1984, tax receipts fell slightly below the program's outgo. Thus, while the collection of surplus social security taxes is not a new phenomenon, it has not been a cause for debate for many years.

What legislation caused the surpluses?

One of the misconceptions concerning today's surpluses is that they were caused by the 1983 Social Security Amendments, particularly by tax increases enacted then. Actually, actuaries and analysts had known for years that the cost of social security would rise in the future because of the post-World War II baby boom and subsequent drop in the birth rate. This was reflected in the 1972 Social Security Amendments, which called for a series of increases in the tax rate raising it from 5.15% (employee/employer, each) in 1972 to an ultimate rate of 5.85% in 2011. Amendments in 1973 raised the ultimate rate to 5.95%. Amendments in 1977 accelerated these increases and raised the ultimate rate to 6.2%, effective in 1990, as part of a package of tax and benefit changes to shore up the system. The 1983 amendments, again attempting to shore up the system's financing with tax and benefit changes, left the 6.2% rate in place for 1990, but phased in part of the increase in 1988 and 1989 (they also accelerated a 1985 increase into 1984). Even before the 1983 amendments, surpluses were projected to occur in or around the turn of the century; the 1983 amendments simply made them larger.

Did Congress legislate them intentionally?

Did Congress deliberately adopt a policy of building a social security fund with surplus taxes to provide money to meet higher social security costs in the future? Did it think that the surplus taxes would indeed materialize and be "saved" in some real sense by being invested in Federal securities? An examination of the record of committee proceedings leading up to the 1983 amendments, and the earlier deliberations of the National Commission on Social Security Reform (a bipartisan panel set up in 1981, whose recommendations served as a basis for the 1983 amendments) shows only passing references to the possibility of future surpluses. The record does not show that Congress actually considered building a fund or how such a fund would save resources. Congress and the Commission were concerned about whether their proposals would keep the system's income and outgo in balance under pessimistic economic conditions through the end of the decade. While modest near-term surpluses were estimated to result under a middle-of-the-road economic forecast, greater emphasis was placed on whether the changes would keep the program solvent under a pessimistic scenario. Although solvency would be maintained, the latter showed very little difference between projected income and outgo.

As for the long-run problem, the attention of Congress and the Commission was drawn to an *average* financial imbalance over the following 75 years. It was widely understood that the program was in immediate trouble, and that a long-range deficiency would emerge at some point well after the turn of the century. But when the long-range problem was discussed, it was usually in terms of an average 75-year shortfall, or the effect that various measures would have on that average, not on how the proposals would affect the program's income and outgo year by year. The public record does not indicate that Congress was shown what the amendments would do to the year-by-year pattern of income and outgo after 1992. Getting rid of the average deficit was the goal. This emphasis made discussion of the system's financing problem simpler -- it consisted of a short-run problem of a given amount of dollars and a long-range problem expressed as an "average" 75-year shortfall. This was of no minor utility in a highly charged political atmosphere, where a rapidly changing baseline, many sets of projections, and an exhaustive list of proposals created enormous difficulties in reaching agreement.

How much surplus was projected?

The 1992 Social Security Trustees Report, issued in April 1992, showed that under all of its three forecasts, social security tax receipts would exceed the program's expenditures through the year 2000. Under the Alternative II forecast, often cited as the middle-of-the-road forecast, tax receipts in 1992 were projected to be $25 billion (or 8%) larger than expenditures. They were to be $60 billion (12%) larger in the year 2000, with the peak spread of $81 billion occurring in 2010. (Note: this discussion of the short-range situation and the long-range one that follows represent a theoretical combined forecast for both the old age and survivors portion and the disability portion of the program. There actually is a separate trust fund for the disability portion, which the trustees projected would become insolvent by 1997 if remedial action was not taken.)

Sometime in the 2015-2020 period, expenditures were projected to exceed tax revenues. The shift from surpluses to shortfalls resulted from swings in the system's relative costs. When shown in terms of the tax rate that would have to be imposed each year on the nation's payrolls to cover the expenditures, the costs were projected to remain fairly steady between 1992 and 2005, and then rise by 50% between 2005 and 2035. Put another way, if social security were financed on a pure pay-as-you-go basis and exclusively from the payroll tax, the combined tax rate (employee and employer) could have been reduced from 12.4% of the nation's payrolls in 1992 to 11.2% by 2005, and then raised again to nearly 17% by 2035. In terms of the relative effect on the economy of these swings, the program's costs were projected to drop from 4.93% of gross national product (GNP) in 1992 to 4.71% in 2005, but then rise to 6.72% by 2035 (representing a 43% increase in social security's relative share of GNP).

TABLE 2. Long-Range OASDI Costs
(Expressed as % of taxable payroll and GNP)

Year	Taxable payroll	GNP
1992	11.50	4.93
2000	11.24	4.75
2010	11.66	4.85
2020	14.25	5.83
2030	16.58	6.65
2040	16.86	6.64
2060	17.84	6.76

Source: 1992 Trustees Report, Alternative II forecast.

However, under the law social security tax receipts were **not** projected to fall and rise in tandem with the system's costs. The tax rate was scheduled to remain level at 12.4% indefinitely. As a result, the system's tax receipts were projected to be higher than would be needed to finance projected costs through 2015, and when coupled with income credited to the trust funds for interest, the system's total income was projected to exceed its outgo through 2023. The nominal size of the trust funds (i.e., the accumulated IOUs) would peak then at $5.6 trillion. In real (uninflated) terms, the peak would have occurred in 2018 at $1.8 trillion in 1992 dollars.

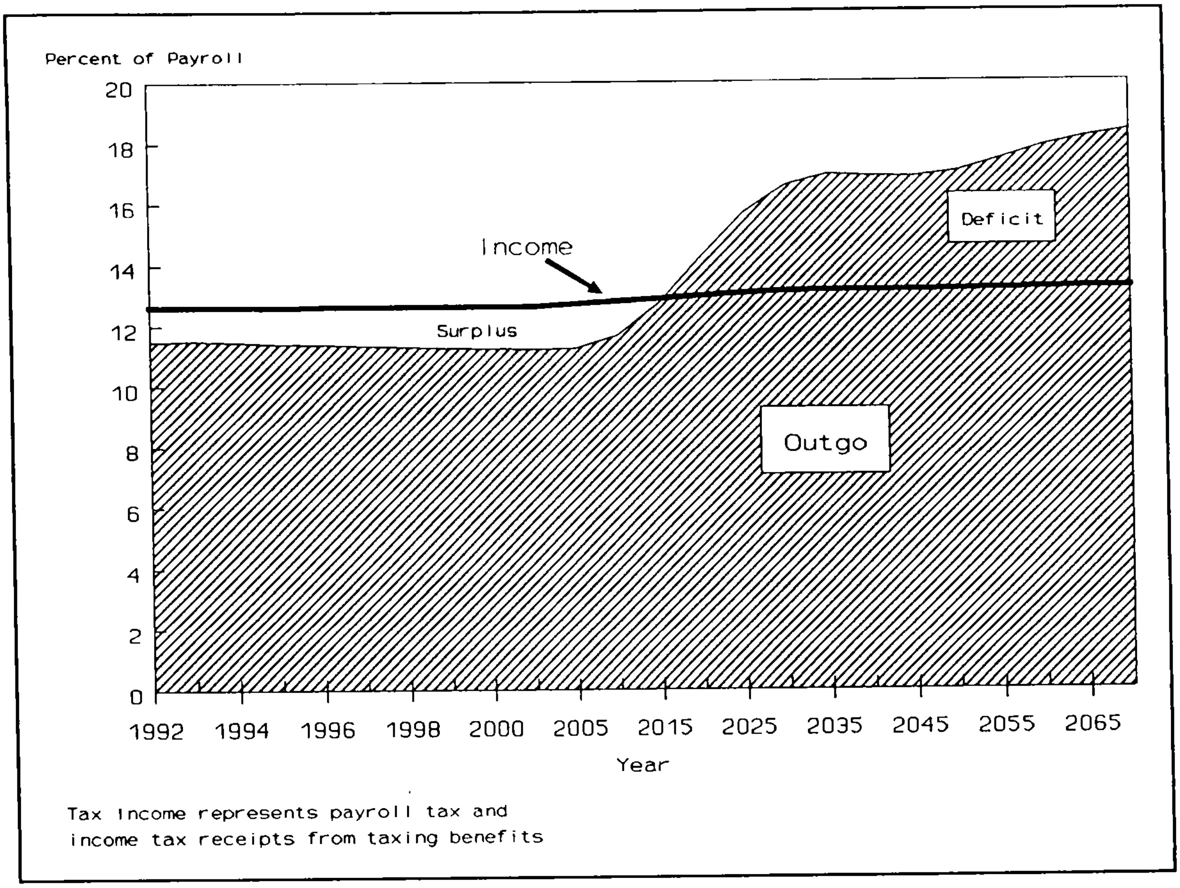
For the period after 2015, tax receipts were projected to be smaller than outgo, but the system would presumably draw on its large trust fund balances. However, the trust fund holdings would simply represent a claim on the Government's other resources. *How to obtain these resources poses a major long-range policy question.* Basically, the Government would have three options: raise other taxes, cut other expenditures, or increase its borrowing from the public. Presuming one or more of these actions were taken, the system's reserve would offset the shortfall in its revenues until 2036, at which point the system would have exhausted its reserves and be technically insolvent (meaning that social security taxes would have to be raised or benefits would have to be cut).

TABLE 3. Long-Range OASDI Trust Fund Operations

Calendar year	Income (excl. interest*)	Outgo	Difference	Interest	Trust Fund Balance
			Dollars (in billions)		
1992	$ 313	$ 291	$ 22	$ 25	$ 328
1995	378	343	35	34	516
2000	513	457	55	62	998
2010	917	836	81	172	2,916
2020	1,568	1,725	-157	324	5,341
2030	2,623	3,320	-698	266	4,159
2035	3,401	4,385	-984	57	565

* Payroll taxes, income from taxation of benefits, and "payments from the general fund".
Source: 1992 Trustees Report, Alternative II forecast.

CHART 1. Projected Social Security Costs and Income, 1992-2070



Source: 1992 Trustees Report.

The 1992 forecast reflects the effect of the post-World War II baby-boom generation's retirement and an aging population. During the next few decades, the baby boomers will be in their prime productive years, and the baby-trough generation of the 1930s will be in its retirement years. These two factors are projected to keep the ratio of workers to social security recipients fairly stable for the next 20 years. However, when the baby boomers retire, the number of workers per recipient is projected to fall from 2.9 in 2010 to 2.0 in 2030 and even lower later.

TABLE 4. Long-Range Ratio of Workers Per Social Security Recipient

Workers per social security recipient

1992	2010	2020	2030	2040	2060
3.2	2.9	2.4	2.0	2.0	1.8

Source: 1992 OASDI Trustees Report, Alternative II forecast.

How would a pay-as-you-go system (e.g., Senator Moynihan's proposals) alter the situation?

The social security tax rate (excluding the HI portion), paid both by employee and employer, rose from 6.06% to 6.2% in 1990 (see Table 1.). It is higher than needed to meet today's social security costs, which in 1992 consumed only 93% of the combined employee/employer rate of 12.4%. Bills introduced by Senator Moynihan -- S. 2016 and S. 3167 in the 101st Congress, S. 11 in the 102nd Congress -- would have cut the rate to bring it more in line with actual costs. Under S. 11 the tax rate would first have fallen to 5.2% and then risen in steps to 8.1% in 2050 and later. Initially, the proposal would have lowered the rate to 5.7% in July 1991, 5.5% in 1994, and 5.2% in 1996. The rate would have begun rising in 2010. The bill as introduced also would have increased the taxable earnings base in steps to $82,200 by 1996 (about $15,000 higher than projected under current law) to offset part of the near-term revenue loss from the cut in the tax rates. Although the latter measure was intended to raise revenue, it also would have raised future expenditures because it would have increased the amount of earnings used to calculate the benefits of higher-paid workers.

The Moynihan proposals are variants of the so-called pay-as-you-go approach. At one extreme are proposals that would have the tax rate adjusted frequently to keep social security revenues fairly close to the immediate obligations of the program. At the other extreme are proposals that call for adjustments at longer intervals with small surpluses occurring in the intervening periods that would gradually fall until the next increase took place. The latter might involve only 3 or 4 changes in the tax rate over the next 30 or 40 years.

An approach that envisions frequent adjustments illustrates the dimensions of the tax rate changes that would have to take place over the long run under current cost projections (again, the Alternative II forecast of the 1992 Trustees report). The combined employee/employer rate could be dropped from 12.4% today to a low point of 11.0% in the 2000 - 2005 period -- after which it would begin a fairly rapid ascent to 17.5% in 2070. In layman's terms, a pure pay-as-you-go system would permit the relative tax bite to be cut by 13% or so for the next 15 years (from 12.4 today to about 11.0%), after which it would have to climb by 59% (from 11.0% in 2005 to 17.5% in 2070). In other words, taxes could be lower than currently scheduled in the near term, but they would have to be substantially higher than scheduled in the long run. (It should be noted that Senator Moynihan's bill, S. 11 in the 102nd Congress, was based on projections contained in the 1990 trustees' report, which were considerably more favorable than those in the 1992 report. Under the 1992 projections, the tax cut in the near term would have to be notably smaller than contained in S. 11, and the ultimate tax rates for the long run would have to be notably higher if the system's solvency were to be maintained.)

The Issues

The proposals advanced by Senator Moynihan reopened the debate about how social security should be financed, but the issues involved more than the appropriate level of social security taxes. Foremost were two questions: if more social security taxes are being collected than are needed for social security spending, how should they be used; and if they are not to be collected, what, if anything, should take their place?

At the root of the issues is the public's perception that the surplus taxes are deposited and saved in the social security trust funds. Actually, the money goes into the Treasury, and out again almost immediately. Supporters of the tax cut argued that crediting the taxes to the trust funds, but using them for something else, deceives the public. Hence, they asserted that surplus social security taxes should not be levied. Support for the cut also came from those who think the social security tax is "regressive," or at least not as progressive as the income tax, which has a graduated rate schedule and is levied on other income besides earnings from work. They contended that for many families, social security taxes are greater than income taxes, and that other taxes should be used to finance that portion of the Government's spending now financed with the surplus social security receipts. This perspective was reflected in S. 11 (Senator Moynihan's bill in the 102nd Congress), where the taxable earnings base would have been raised to increase the social security tax paid by high earners.

Others contended that the surpluses are just an invitation for new spending. They saw them as a potential source either for expanded social security benefits -- the creation of which could exacerbate the system's long-range problems -- or for other new social programs. Currently, large Federal budget deficits are a constraint, but if the deficits were eliminated or reduced to a more manageable level, they feared that pressure would mount for new spending initiatives. Yet others pointed out that a pay-as-you-go approach would give the public a clearer perception of the way the program's financing actually works. In the long run, projected tax receipts are inadequate to cover benefits, but the portrayal of large trust funds makes it appear as if actual resources will be on hand to pay the benefits. They contended that scheduling future social security tax rate increases would show the public more directly that the money for future benefits will have to come out of the economy at that time.

Critics of the proposal pointed out that if its revenue loss were not offset, the tax cut would merely increase the overall deficit and lead to more Government borrowing from the public, thereby reducing the amount of resources available for private investment. Early in 1991, the Social Security Administration estimated that enactment of S. 11 would have reduced social security's income by $179 billion over FY1991-96. Critics warned that the increase in the deficit would impair, rather than bolster, the nation's savings rate, and thus would not prepare the nation for the demands of the next century. A Mar. 19, 1991 report by the Congressional Budget Office concluded that a cut in the payroll tax would lead to a short-term spurt in economic activity, but in the longer term it would produce lower savings, investment, and GNP growth. Critics also pointed out that it was difficult enough for Congress to achieve substantive reductions in Government borrowing from the credit markets even with surplus social security receipts. They argued that using the surplus receipts to reduce Government borrowing is tantamount to saving them, since less Government borrowing means more money is available for private investment.

Others argued that cutting the tax rate today subjects the program to potential financing risks. They argued that the public is still apprehensive about the long run survivability of the program -- despite the repeated reports of surpluses -- and another round of financial problems could do severe damage to the program's credibility. Trust fund balances that initially appeared to be large in the past turned out to be inadequate, and it would be hard to predict how much of a reserve would be adequate to cushion the program from economic setbacks. In 1991, the Social Security Administration's actuaries estimated that, using pessimistic economic assumptions, S.

11 would exhaust the combined OASDI funds' balances by 2005. (It would likely be sooner under the 1992 trustee's report assumptions.) Yet others argued that while social security is projected to have large surpluses, the HI portion of Medicare is projected to become insolvent sometime shortly after the turn of the century, and the surplus OASDI taxes may need to be allocated to that program. Finally, critics contended that the social security program as a whole is not regressive -- the regressiveness of the tax is offset by a progressive benefit schedule that pays more social security benefits per tax dollar to low wage earners than high wage earners. Moreover, for the 90% of the workforce whose earnings fall below the earnings base, the tax is proportional on earnings, and for families with children with annual earnings up to $22,370, the Earned Income Tax Credit (EITC) offsets some or all of their social security taxes.

Congressional Action

When Senator Moynihan first made his proposal early in 1990 (through introduction of S. 2016), it gained immediate media attention. Congressional interest mounted and numerous other bills and ideas followed. Representative Gephardt suggested that maybe a tax credit (to offset a portion of the social security tax), rather than an actual social security tax cut, should be considered. Senator Hollings suggested cutting the tax rate along the lines proposed by Senator Moynihan but making up the revenue loss with a value added tax (VAT). Senator Sasser would have cut the rate contingent upon making even larger cuts in the Federal budget deficit. Senator Symms would have provided a worker with a credit against social security taxes and directed the surplus portion of the taxes into individual savings accounts. Representative Porter suggested a somewhat similar approach.

Despite the variety of measures, most of the media's and congressional attention was directed at Senator Moynihan's bill. The proposal, however, did not immediately gain the endorsement of congressional leaders or the Administration, and a number of major interest groups opposed it. While the Democratic National Committee supported it and media attention lingered through much of the winter, by early spring the proposal had lost a good deal of its momentum. The near-term revenue loss for the Government and concern for social security's financial solvency were the principal objections. Senator Moynihan pressed on, however, and the Senate leadership agreed to bring his proposal (in a somewhat modified form, incorporated in S. 3167) to a vote in the fall. Although he appeared to have the sentiment of the Senate in his favor, his bill was set aside on Oct. 9, 1990 by a vote of 54 to 44 over an objection that it violated the revenue targets in the FY1991 Budget Resolution -- 60 votes were needed to waive the objection.

While failing to get congressional support, the tax cut measure did draw attention to how social security surpluses were affecting calculations of the Federal budget deficits. Throughout the spring and summer of 1990, congressional interest in removing social security from calculations of the deficit intensified. Although removing it from the budget would not change the tax rate or where social security taxes go when they reach the Government, the proposal responded to the criticism that surplus social security money was "masking" the deficits. By midsummer, sentiment in favor of the idea peaked with a 96-2 vote on a housing bill in the Senate (on an amendment by Senator Heinz to S. 566) to preclude an increase in the Federal debt ceiling until social security was removed from the budget process, and in a 413-15 vote on a debt ceiling increase bill (H.R. 5355) in the House to remove the program from the budget process beginning in FY1992. While neither of these votes led to enactment of the measure, when Congress enacted a $500 billion deficit reduction package later in the fall (P.L. 101-508), which included major changes to the budget process itself (the Budget Enforcement Act of 1990), it removed social security from the deficit calculations and exempted it from the new budget rules. These changes were accompanied by new congressional procedures for considering social security legislation (referred to as "firewall" provisions) that were intended to keep the social security trust fund balances from being eroded by benefit expansions or tax reductions that might otherwise be easier to pass with social security no longer affecting the budget totals.

Interest in the tax cut measure re-emerged early in 1991, as various bills to cut the social security rates were introduced when the 102nd Congress convened. Again attention was focused primarily on Senator Moynihan's proposal (modified and reintroduced as S. 11), which received a boost when Majority Leader Mitchell endorsed it and promised to allow it to come to a vote on the Senate floor. The opportunity arose on Apr. 24, 1991, in consideration of the FY1992 budget resolution (S.Con.Res. 29). Senator Moynihan introduced an amendment to revise downward the social security trust fund income figures contained in the resolution to reflect the revenue that would be lost due to his proposed tax cut. If passed, the amendment would have paved the way for later consideration of the measure. The Administration opposed it, saying that the revenue loss could threaten social security's solvency. By a vote of 60 to 38, the Senate adopted a motion by Senator Domenici to table the amendment. Opponents predicted that the strength of this vote made further consideration of the proposal unlikely, at least in the near term. Shortly after the vote, the Senate passed by voice vote an amendment by Senators Domenici and Sasser that would require a 60-vote majority to overcome an objection to changing social security if the change would reduce social security income or increase social security outgo from the levels underpinning the FY1992 budget resolution.

Later in 1991, however, as the recovery from the recession weakened, new calls emerged for tax cuts to stimulate the economy. Among them was a package of tax changes (H.R. 3730) proposed by House Ways and Means Committee Chairman Rostenkowski that included tax credits based on the level of one's social security taxes. Unlike the earlier Moynihan measures, the Rostenkowski proposal would not affect social security taxes directly and it would offset the revenue losses by increasing income taxes for those with high incomes. Other proposals included renewed calls by Senator Moynihan and others for an explicit social security tax cut, as well as a package offered by a group of House Republicans (H.R. 3130), which, in addition to cutting capital gains taxes, would have relaxed the social security earnings test (permitting social security recipients ages 65-69 to earn more without losing benefits). The Congress adjourned on Nov. 27, 1991 without acting on the proposals, although the House Ways and Means and Budget Committees and Senate Finance Committee held hearings during the adjournment period on various measures to stimulate the economy.

In January 1992, when Congress reconvened, President Bush announced an economic recovery plan which included numerous provisions, but none affecting social security. However, Chairman Rostenkowski's proposal (to provide a credit based on one's social security taxes) and other social security changes were still being actively considered as part of alternative economic stimulus packages. In February 1992, the

House passed a modified version of Chairman Rostenkowski's tax package (H.R. 4210), including the tax credit idea. An alternative tax bill passed by the Senate did not include the measure, but a scaled-down version of the proposal was included in a compromise tax package agreed to by House and Senate conferees. The tax package died, however, when President Bush vetoed the bill on Mar. 20, 1992.

President Clinton's budget and economic plan, announced on Feb. 17, 1993, did not propose changes in social security taxes.