Free Social Security Recipients from the Social Security Tax

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Workers of retirement age face confiscatory marginal tax rates exceeding 80 percent. A neglected but promising option for reducing this disincentive to work is to free individuals receiving social security retirement benefits from the burden of the social security payroll tax. This proposal seems natural and fair, could be implemented readily, and would substantially benefit elderly workers, especially the poorest of them, at modest cost.

Social security recipients should be freed from the burden of the social security payroll tax. Currently, employees are taxed 6.13 percent of earnings; employers contribute an equal amount. If this tax were eliminated, and if employers' contributions were transferred to employees, older workers could increase their before-tax earnings by an eighth, and their after-tax income by a fifth.[1]

Now that we have outlawed mandatory retirement at age sixty-five, it is time we reduced the confiscatory tax disincentive to work after this age. Up until age seventy-two, social security benefits are reduced by $1 for every $2 earned above $5,000.[2] Since social

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1. The transfer of employers' contributions to employees could be accomplished by requiring employers to add the appropriate amount to employees' paychecks. Alternatively, employees who qualify could be given an annual "refund" of their employers' contribution by filling out appropriate lines on their income tax returns.

2. The exact amount is $4,500 in 1979, $5,000 in 1980, $5,500 in 1981, and $6,000 in 1982 dollars thereafter. Before 1982, the penalty applies

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security benefits are not subject to income taxes, this penalty is particularly onerous: it represents a 50 percent marginal tax on earnings *on top* of the marginal rate of various federal, state, and perhaps local income taxes, *plus* the social security payroll tax. As a consequence, many workers in their mid-sixties to early seventies take home less than twenty cents of every additional dollar they earn.[3]

Such confiscatory taxation is clearly not in the interest of the elderly who wish to work and is almost certainly not in the interest of society as a whole. Life expectancy is increasing; the average male at age sixty-five can now expect to live to age eighty and the average female past age eighty-three. As a result of increased life expectancy and declining birth rates in the United States, the proportion of the population over age sixty-five is expected to steadily increase. Unless more of the elderly choose to work, the ratio of employed persons to retired persons will relentlessly decline. Either higher taxes will have to be levied on workers to support the retired, or the retired will receive less support. Given these trends and the economic, social, and mental hardships often caused by retirement, it would seem to be in nearly everyone's interest to lower the tax hurdle that deters employment after the age of sixty-two or sixty-five.

Eliminating the social security tax on social security recipients would not remove the tax barrier to work after age sixty-five, but it would considerably lower it. My friend, Rufus Jones, a widower, age sixty-six, expects to earn $15,000 this year. His marginal rate on federal and California state taxes is 33.4 percent, so that with

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through age seventy-two; afterwards, the penalty will only apply to social security recipients age seventy or under. Many individuals elect to begin collecting social security benefits at age sixty-two rather than sixty-five, even though this reduces the benefits by 20 percent. For such individuals, the disincentive to work therefore starts at age sixty-two. The Social Security Administration provides various disability, survivors, hospital, and medical care benefits, but this article focuses solely on reitrement benefits.

3. See Richard J. Zeckhauser and W. Kip Viscusi, "The Role of Social Security in the Income Security of the Elderly," in *The Crisis in Social Security*, ed. Michael J. Boskin (San Francisco: Institute for Contemporary Studies, 1977). Perversely enough, high-income earners face much lower marginal tax rates. The social security payroll tax is only levied up to a fixed amount, some $25,900 in 1980. Furthermore, after social security benefits are exhausted by the 50 percent penalty on earnings, additional earnings are not penalized.

the social security tax and the 50 percent social security penalty, he effectively takes home less than eleven cents on his last dollar of earnings. If he were freed from the social security tax, he would take home nearly twenty-four cents, more than twice as much.

Altogether Rufus Jones would take home an additional 12.26 percent of $15,000, or some $1,840. Since he currently pays more than $5,000 in income taxes, social security tax, and property tax, this $1,840 would increase his after-tax income by nearly 20 percent.

Other Advantages

Eliminating the social security tax for social security recipients would not only give individuals like Rufus Jones some extra income and an increased incentive to work, it would also end an egregrious unfairness in the social security program. Why should a worker who is receiving social security benefits have to continue to pay social security taxes? The underlying logic of the social security system is that retirement benefits should vary with the total amount of a worker's contributions to the system. Once a worker elects to begin receiving retirement benefits, however, further payroll-tax payments add nothing to benefits.

An additional plus is that freeing social security recipients from the social security tax would be an appropriate first step in a more general overhaul of the regressive aspects of the payroll taxation system. Beginning such reform with the elderly would seem particularly felicitous since (1) the social security program is designed primarily to aid the elderly, (2) the incidence of poverty is especially high among the elderly, and (3) the proposal (as documented later) would be inexpensive.

A further advantage of the proposal is that it could be implemented readily, and without precluding subsequent adoption of such other suggestions for reducing work disincentives for the elderly as scaling down the penalty on earnings, raising the maximum amount that can be earned before benefits are reduced, or substantially increasing benefits to those who delay retirement.

No Tax versus a Reduced Penalty

Eliminating the social security tax is similar in its marginal tax effects to lowering the penalty rate on earnings from 50 percent to

37.74 percent, but there are some important differences between the two approaches that would seem, on the whole, to make eliminating the social security tax the more advantageous policy option.

First, lowering the penalty rate would not help anyone making $5,000 or less, since the penalty is only exacted on earnings above this amount. If the social security tax were eliminated, however, semiretired individuals making $1,000 a year would take home an extra $123; those making $3,000 a year, an extra $368; and those making $5,000 a year, an extra $613.

Second, terminating the social security tax would increase the after-tax income of those making over $5,000 a year by $613 more than the increase gained by lowering the penalty rate.

Third, lowering the penalty rate would not help those over age seventy-two (through 1981) or over age seventy (after 1981), since they are not subject to the earnings penalty. Eliminating the social security tax, however, would benefit all social security beneficiaries who choose to work. In effect, removing the burden of the social security tax would raise the incomes of those who desire employment in their middle and late sixties, and then, coupled with the end of the earnings penalty, would additionally augment the income of those who want to keep working into their seventies.

Fourth, eliminating the social security tax would decrease effective marginal tax rates only up to the maximum income subject to social security tax. (In 1980, this income level is $25,900; in 1981 and thereafter, it is the equivalent of $29,700 in 1981 dollars.) Decreasing the penalty on earnings, however, would reduce marginal tax rates on incomes substantially higher than these levels. For example, in 1980 an upper-income couple might well be entitled to $15,000 per year in social security benefits. If so, lowering the penalty on earnings to 37.4 percent would somewhat reduce their marginal tax rates all the way up to earnings of $45,000 per year. If their annual earnings were, say, $40,000, they would still collect some $150 per month in social security benefits. Terminating the social security tax, on the other hand, would provide a benefit of 12.26 percent of $25,900, or some $3,175, to all those making more than $25,900. Since this amount is constant, it would have no effect on marginal tax rates and would constitute a diminishing proportion of total income as income increases.

Cost to Government

In sum, given its likely political appeal and its various advantages relative to reducing the penalty rate on earnings, freeing social security recipients from the social security tax would seem to be an attractive option. But what would it cost? Social security taxes currently collected from social security recipients amount to roughly 3 percent of total social security receipts, or about $3 billion per year.[4] To the extent, however, that terminating the social security tax encouraged more social security beneficiaries to work, the Social Security Administration would recover part of this loss. Since the 50 percent penalty on earnings above $5,000 is some four times greater than the 12.26 percent payroll tax, receipts would increase by $4 for every $1 lost in payroll taxes on earnings above $5,000. Furthermore, if more people worked, income tax receipts would rise. The net loss in governmental revenue would consequently be considerably less than $3 billion—and, indeed, if the incentive effects were strong enough, there could even be a net *gain* in governmental revenue.

4. In 1977, some 2.9 percent of the labor force was age sixty-five or over (*Statistical Abstract of the United States* [1978] table 646, p. 400). In 1975, the salaries and wages of workers age sixty-five and over amounted to 2.96 percent of total salaries and wages (U.S., Internal Revenue Service, *Individual Income Tax Returns, 1975* table 1.4, p. 13, and table 4.1, p. 116). The proportion of social security receipts from social security recipients probably amounts to a roughly similar percentage. Total social security receipts ("old age and survivors insurance" tax receipts) amounted to $69 billion in 1977 and $14 billion in the twelve months ending August 1978 (*Social Security Bulletin* 42 (January 1979): 52, table M–4).