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Tax on Social Security Benefits Providing More Trust Fund Revenue

By Peter R. Orszag

Since 1984, Social Security benefits have been partially subject to federal income tax. The share of benefits subject to tax depends on an expanded measure of income: adjusted gross income plus tax-exempt bond interest and one-half of Social Security benefits. Benefits are only subject to tax if this expanded income measure exceeds $25,000 (single) or $32,000 (married filing jointly). Above these thresholds, up to 50 percent of benefits are included in taxable income if the income measure is below $34,000 for singles or $44,000 for joint filers. For those with higher incomes, legislation enacted in 1993 increased the maximum inclusion rate to 85 percent of benefits; the 85 percent factor was intended to approximate the tax treatment of private pensions.

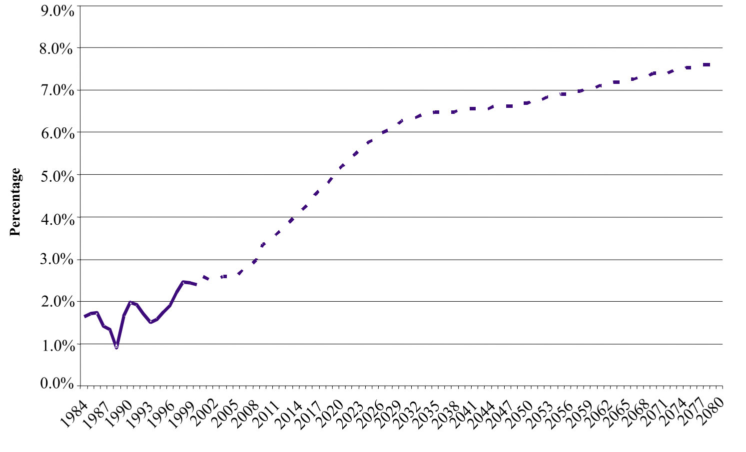
By design, more beneficiaries will be subject to tax over time. The Congressional Budget Office estimates that only about one-third of beneficiaries were taxed on at least part of their Social Security benefits in 2000. Since the expanded income thresholds are not indexed for inflation (and also since real incomes among beneficiaries tend to increase from one generation to the next), more and more beneficiaries will be affected in the future.

The taxes collected through these provisions are credited to the Social Security and Medicare Trust Funds. The taxes generated from including up to 50 percent of benefits in taxable income are credited to the Social Security Trust Funds, and any additional taxes generated from including up to 85 percent of benefits in taxable income are credited to the Medicare Hospital Insurance Trust Fund.

These taxes are projected to account for an increasing share of Social Security and Medicare revenue over time. For example, the figure shows that revenue from the income taxation of benefits represented 1.6 percent of noninterest Social Security revenue in 1984. In 2002, income taxation of benefits is expected to account for 2.6 percent of noninterest revenue. Under the intermediate cost projections of the Social Security actuaries (shown by the dotted line in the figure), the ratio is expected to reach 6 percent by 2030 and almost 8 percent by 2080.

The income taxation of benefits also produces mechanical interactions between income tax changes and the revenue credited to the Social Security and Medicare Trust Funds: Reductions in marginal tax rates, all else equal, reduce the revenue credited to the Trust Funds. Estimates from the Tax Policy Center model suggest that the marginal tax reductions from the Economic Growth and Tax Relief Reconciliation Act of 2001 will reduce the revenue credited to the Social Security and Medicare Trust Funds by $2.5 billion (or about 5 percent) in 2010.

Taxation of Benefits as Share of Noninterest Social Security Revenue



Sources: Author's calculations based on Table VI.A4 and Table IV.B7 of *2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*.

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