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Income Tax Breaks for the Elderly—How Did We Get Here?

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Every state that has a personal income tax offers some form of preferential treatment of elderly tax payers. In fact, our recent study estimates that non-elderly, high income households pay approximately twice as much state income tax as an equivalent elderly household (Conway and Rork, 2008a). The federal government also offers preferential treatment, although federal tax breaks tend to be more modest and have shown a consistent decline in recent years. The 2008 presidential campaigns, however, suggest a reversal in this recent trend as both candidates offered additional federal tax breaks to the elderly, the most notable being Senator Obama's proposal to eliminate all federal income taxes on senior citizens with incomes less than \$50,000.

Elderly tax breaks cost the state and federal governments billions of dollars a year. For instance, a recent study found that exempting Social Security benefits from state taxation cost the state of California \$850 million in 1999 (Bernstein, 2004, p. 9). With the aging of the population, the costs of these tax breaks are certainly going to increase in the future. And yet, the rationale for these tax breaks is far

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Federal Taxes and the Elderly

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Society favors the elderly in many ways. They receive movie discounts, low cost transit tickets, senior airline fares (sometimes), and a host of other discounts, particularly if one is a member of the AARP. Those who write tax law are also very kind to their elders. State and local levels of government are particularly generous and often provide credits against real estate taxes, and partial or full tax exemptions for pensions and Social Security (Penner, 2000). The Federal government does not have many tax provisions that explicitly mention age, and not all that refer to age are beneficial, but tax law clearly favors Social Security income and saving for retirement. A few other minor provisions explicitly favor the elderly, but they are used by relatively few taxpayers. There are also proposals for tax reform that would disproportionately affect the elderly, almost by accident. For example, if society decides to rely more heavily on taxing consumption rather than taxing income, retirees will see their relative burdens increase because they generally consume a higher proportion of income than workers, and sometimes they consume more than 100 percent of income. Lastly, although they are not affected by it, the elderly have a considerable interest in estate taxation.

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Retirement Income and Retirement Plans

The Taxation of Social Security. Social Security benefits were not taxed at all until the program was almost 50 years old. Carl Shoup, an eminent public finance economist who worked at the U. S. Treasury in the 1930s, has said that there were discussions about taxing benefits when the program was started, but it was assumed that benefits would not amount to much and therefore it was not worth the administrative hassle to tax them. Today, Social Security is the largest single government program with total benefits far exceeding \$600 billion.

Benefits were first taxed as a result of the Social Security reforms of 1983. The recession of 1981-82 depressed payroll tax revenues and increased outlays as older people who became unemployed decided to apply for benefits earlier than previously planned. The Social Security system experienced a deficit and the Social Security trust fund was emptied. The Greenspan Commission was appointed to solve the problem.

There was an intense battle between Republicans—who wanted to solve the problem largely by cutting benefit growth—and Democrats who were more inclined to raise payroll tax revenues. After much debate, the Commission agreed to a combination of options, one of which subjected up to 50 percent of benefits to income taxation for those above certain income thresholds. It was a politically convenient option, because Democrats could define it to be a tax increase while Republicans could call it a benefit cut. A portion of the revenues derived from taxing benefits are deposited in the Social Security trust fund, thus reducing the long-run actuarial deficit faced by the system, and another portion is deposited in the Medicare Hospital Insurance trust fund.

The portion of benefits subjected to income taxation was increased to 85 percent for the more affluent by President Clinton's large budget deficit reduction package in 1993. Currently, single beneficiaries with more than \$25,000 in income and married beneficiaries with more than \$32,000 are required to include up to 50 percent of benefits in taxable income. Once income exceeds \$34,000 for singles and \$44,000 for married couples, up to 85 percent of benefits must be included in taxable income. The income thresholds are not adjusted for

inflation or wage growth. Consequently, more and more beneficiaries will see their benefits subjected to income taxation over time and the average tax payment will rise.

It is reasonable to ask why 85 percent of benefits is taken into taxable income at higher income levels instead of some higher or lower amount. The 15 percent that is not taxed is based on an estimate of the benefit portion that represents a return of the principal that was paid in when a person paid payroll taxes. The remainder of the benefit represents a reasonable return on tax payments plus any net subsidy received from other age cohorts.

If Social Security was a regular funded retirement system in which deposits of payroll taxes were invested and some rate of return was earned, it might be argued that it would be appropriate to bring less of the benefit into taxable income. In a regular private retirement account, a tax is paid on benefits if the contributions to the account were tax deductible, whereas no tax is paid if the contributions were not tax deductible. In Social Security, the one-half of the payroll tax that is paid by employers is tax deductible whereas the employee share is not. It might therefore be argued that only one-half of benefits should be taxed.

There is little resemblance, however, between a private pension plan and Social Security. Most important, Social Security is far from fully funded. It is mainly a pay-as-you-go system in which benefits for retirees are directly financed by the payroll tax payments of those who are working. Moreover, benefits are determined by a formula that is kinder to those who earned relatively low wages throughout a career. Thus, there is a looser connection between the amounts paid into the system and eventual benefits than in the typical private system. Consequently, Social Security benefits might be considered to be a pure intergenerational transfer payment in which case, there is an argument for bringing 100 percent of them into taxable income.

Private Retirement Accounts. Public policy toward retirement saving is mind numbing in its complexity. There are a large number of different accounts that have different rules and tax implications. There are 401ks, 403bs, traditional IRAs, Roth IRAs, SEPs, profit sharing Keoghs, money purchase Keoghs, and on and on. In addition, there are defined benefit plans set up by private employers and governments.

While defined benefit plans are disappearing from the private sector, they are still important at all levels of government.

At the risk of oversimplification, it can be said that tax law differentiates two types of retirement accounts. In one, contributions are deductible against taxable income. Then withdrawals are taxed. In general, withdrawals are not permitted without penalty until one is 59-1/2 years old, but minimum withdrawals are required after the age of 70-1/2. The required minimum withdrawal depends on life expectancy. If one bequeaths an account to an heir the withdrawal rate depends on the heir's life expectancy. Bequests to a trust must be withdrawn over five years. There are all sorts of complex exceptions to these rules.

In the other type of account, which can be called a Roth-type account, contributions are not deductible, but the earnings of the account and eventual withdrawals are tax free. There are no minimum withdrawal rules for Roth-type accounts.

Different types of accounts have different absolute limits on contributions and some have limits based on income. Limits can also depend on age with those 50 and over being treated more leniently than younger tax payers. Deductible IRA limits are phased out at higher income levels if the taxpayer benefits from an employer provided retirement plan.

There is considerable controversy in the economics literature as to whether the various tax advantages provided for retirement accounts actually increase retirement saving (Poterba, Venti, and Wise, 1998). A person can gain a tax advantage simply by shifting assets from a taxable account to a tax favored account. In the extreme, there sometimes can be an advantage to borrowing in order to contribute the maximum amount to a favored account. For example, one might decide to take out a larger mortgage with its tax deductible interest in order to put more money into an IRA.

Behavioral economists have pointed out, however, that saving decisions are not entirely rational (Sunstein and Thaler, 2008). When faced with the

opportunity to lower their tax burden substantially, people may elect to put money into a tax favored retirement account that they would otherwise spend. (It is well documented that people have more taxes than necessary withheld from income. On the surface, this seems irrational, but it seems that people appreciate the discipline provided by withholding, even though they get no interest on the amounts withheld.) Once in the account, the money cannot be withdrawn before age 59-1/2 without paying a penalty

and this probably helps to discipline the taxpayer. It has also been shown that if people are automatically enrolled in a retirement plan unless they take steps to opt out, they are more likely to participate than if they must take active steps to join.

If one is interested, however, in increasing national saving by using tax-favored accounts, it is not sufficient to argue on their behalf by claiming that

they increase personal saving. The existence of the accounts reduces tax revenues and that increases the budget deficit or Federal dissaving unless the tax loss is made up with other tax increases or spending cuts. Consequently, national saving will not be increased unless private saving goes up by more than any increase in the budget deficit.

Many elderly lost considerable amounts of money as a result of the financial crisis and recession of 2008. Stock market losses are mainly a concern of the affluent elderly. The lower half of the income distribution does not tend to save much for retirement and relies heavily on Social Security.

The median household over the age of fifty has 50 percent of retirement accounts invested in stock, but the equity portion of the account declines to 25 percent over the age of 70 (Johnson, Soto, Zedlewski, 2008). At its worst in 2008, the stock market had declined more than 40 percent from its peak in 2007.

Both candidates for president in 2008 thought it unfair that the minimum withdrawal provisions affecting most retirement accounts forced retirees to sell assets at unusually depressed prices. They promised to suspend the minimum withdrawal requirement--and in

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January 2009 Congress approved a temporary pension bailout that suspended the requirement that seniors take their 2009 required minimum distribution.

The Estate Tax

Very few estates – far fewer than 5 percent – have been liable for estate taxes since that tax began to be phased out by 2001 legislation. All potential heirs have an intense interest in whether their bequests will be subject to taxation, so the population interested in the future of the estate tax considerably exceeds the number of taxed estates. Although the tax liability faced by an estate does not depend on the ages of the decedent or the heirs, it is probably safe to say that it is mainly the elderly who are interested in estate tax policy.

Current estate tax law is most peculiar. By 2009, the estate tax exclusion had reached \$3.5 million and the top tax rate was 45 percent. The tax is scheduled to disappear in 2010, but then resume in 2011 with an exclusion of \$1.0 million and a top rate of 55 percent. Few believe that this will happen and there is likely to be a compromise before the end of 2009. The exclusion and tax rate are likely to be at least as generous as those existing in 2009. Meanwhile, the uncertainty makes estate planning extremely difficult.

Estate tax law is very complicated and fraught with loopholes. Much effort and expense working with lawyers is undertaken to reduce its burden or to eliminate it altogether. A number of countries, including Canada and Sweden, have done away with estate taxation. There are two arguments for retaining it. First, it is a means of taxing capital gains that have escaped taxation while investors were alive. Second, it reduces the number of rich, politically powerful family dynasties. The second purpose would be better served with an inheritance tax where the tax depends on the size of the bequest to individuals rather than on the size of the total estate. It would encourage people to distribute the estate to a larger number of heirs. A number of states have inheritance taxes. When Canada eliminated the estate tax, it solved the problem of untaxed capital gains by deeming capital gains to be realized at death and subjecting them to income taxation.

Two Minor Tax Provisions that Benefit Elderly Households

The Extra Standard Deduction. The Tax Reform Act of 1986 provides an extra standard

deduction for those 65 and over and for the blind. In 2008, the extra deduction is \$1,350 for a single person and \$1,050 each for a couple. This is added to the regular standard deduction of \$5,450 for singles and \$10,900 for couples. The extra standard deduction tends to focus tax relief on those with modest incomes, because more affluent taxpayers are likely to itemize their deductions and as a result, they get no benefit from this provision of the law.

Tax Credit for the Elderly. A very few elderly tax payers pay taxes on almost all of their retirement income whereas most receive a tax break on Social Security income, some veterans' benefits, and certain types of annuity and pension income. To level the playing field, a 15 percent, nonrefundable credit is provided to those 65 and over on a certain base if the household's income is largely taxable. The initial base in 2008 is \$5,000 for singles and \$7,500 on a joint return if both spouses are eligible for the credit. The base is reduced by one-half of adjusted gross income above \$7,500 if single and \$10,000 if married and filing a joint return. It is also reduced by any tax-favored retirement income. Very few taxpayers qualify for this credit.

The Future

During the 2008 presidential election campaign, candidate Obama promised that elderly with an income of \$50,000 or less would be exempted from all income taxation. On the other hand, he promised to raise taxes on all those with incomes above \$250,000 whether elderly or not. He also promised to raise the tax rate on dividends and capital gains from 15 to 20 percent for the same income group. Although the increased rate would apply to taxpayers of all ages, it would especially affect retirees partially or wholly living on income from savings outside tax-favored retirement accounts. Withdrawals from tax-favored retirement accounts are taxed at regular income tax rates, even if they are the result of dividends or capital gains.

Given the weak economy facing President Obama, he recommended postponing any tax increases until after the Bush tax cuts expire at the end of 2010. However, tax increases are very likely in the longer run. The costs of Social Security, Medicare, and Medicaid now constitute almost one-half of Federal noninterest spending. All three programs are growing faster than tax revenues. If the programs are

not reformed and tax burdens are not raised, budget deficits and the national debt will explode. The latter is likely to rise beyond 100 percent of the GDP within 25 years compared to a ratio of less than 40 percent at the end of fiscal 2008. There is a significant possibility that that much debt could cause a crisis in domestic and international capital markets.

It is highly probable that any solution to our long-run budget problem will involve both a slowdown in the rate of growth of Social Security, Medicare, and Medicaid benefits and an increase in tax burdens. Although those already retired will most probably be spared any reduction in promised Social Security benefits, the effect on their tax burdens will very much depend on exactly how the Congress chooses to raise more revenues.

To the extent that payroll taxes are raised, those that are fully retired will not be affected. There are, however, many proposals for increasing taxes on consumption and because the elderly typically consume an especially high proportion of income – sometimes more than 100 percent – consumption tax increases would be more burdensome than income tax increases. A new value added tax (VAT)—a consumption tax—similar to those in Europe, is often suggested for the United States. Some go further and suggest that such a tax be earmarked for Medicare. If the tax's rate had to be increased whenever Medicare costs grew faster than consumption, it would be a powerful incentive for getting control of costs by making the program more efficient, curbing benefits, or reducing payments to providers.

Most countries with a VAT try to ease the burden on the less affluent by lowering the burden on food and other necessities. The same goal can be achieved more simply and efficiently by providing a new refundable income tax credit aimed at lower income groups when a VAT is first imposed.

Conclusion

At the same time as the tax code favors the elderly, it attempts to favor numerous other social and economic goals. It is almost as though it is designed to raise revenues as an afterthought. The result is an extraordinarily complex law and volumes of regulations that reduce economic efficiency and tax households with the same income levels at widely varying rates. Even though the elderly are among the many groups favored by the tax code, it may well

be that they would be better off without the special favors, if the tax code had been simpler and more conducive to economic growth throughout their whole lifetimes.

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