TO: Interested Policymakers and Fiscal Policy Analysts
FROM: John Wong
DATE: May 7, 2025
RE: Fiscal and Distributional Consequences of Eliminating Taxation on Social Security Benefits

Summary

Recent proposals to eliminate federal income taxation of Social Security benefits have raised significant fiscal and distributional concerns. This memo outlines:

- The demographic and fiscal pressures underlying retirement spending.
- The current structure of Social Security benefit taxation.
- The projected fiscal cost and distributional effects of eliminating this tax.
- The viability of a proposed pay-for: taxing payroll contributions as employee income.
- The practical and intuitive challenges posed by such a pay-for.

The analysis finds that not taxing Social Security benefits is fiscally irresponsible and disproportionately benefits wealthier retirees. Alternative funding mechanisms introduce substantial distributional tradeoffs and are unlikely to be politically palatable.

Background: The Fundamental Problem of Retirement Spending

Demographic trends make financing old-age entitlements increasingly difficult. The ratio of working-age adults per elderly person has fallen from **3.2–3.4 historically to just 2.7 today** (SSA 2024). Concurrently, spending growth for entitlement programs far outpaces revenue growth. Over the next 30 years (CBO 2025):

- **Medicare** projected to grow **385%**
- **Social Security** by **241%**
- **Tax revenue** by only **231%**

This structural imbalance — the *"Fundamental Problem of Retirement Spending"* — puts sustained fiscal pressure on federal finances.

How Social Security Benefits Are Currently Taxed

While payroll contributions for Social Security and Medicare are deducted pre-tax, benefits are partially subject to income tax upon receipt:

- **50% of benefits** are taxable for individuals with total income below **$25,000**.
  - Revenue is allocated to the Social Security Trust Fund.
- An **additional 35% of benefits** are taxed for incomes above **$25,000**.
  - Revenue is allocated to the Medicare Trust Fund.

This taxation partially offsets entitlement outlays in retirement and moderates net federal spending on elderly benefits.

Fiscal Impact of Eliminating Social Security Benefit Taxes

A simulation using **PolicyEngine** estimates the fiscal cost of exempting all Social Security benefits from taxation at approximately **$1.3 trillion over ten years**. The loss of revenue exacerbates entitlement-driven fiscal imbalances and accelerates trust fund depletion.

Distributional Effects

By Income:

Eliminating taxation of benefits disproportionately benefits higher-income households, as shown below:

(Insert distributional income impact figure here)

By Age:

Younger cohorts — who do not yet receive benefits — bear no direct benefit, while elderly households receive the full windfall:

(Insert distributional age impact figure here)

Potential Pay-For: Taxing Payroll Contributions

Some proposals suggest making employer payroll contributions taxable as employee income to offset lost revenue. Under current law, payroll taxes are treated as pre-tax *"contributions."* The proposal would redefine these as taxable income.

Two policy options were scored:

- **Option 1:** Tax all employer Social Security and Medicare payroll contributions.
- **Option 2:** Tax only employer Medicare contributions.

Fiscal Results:

- **Option 1** yields a ten-year surplus sufficient to offset benefit tax repeal.
- **Option 2** falls far short of required revenue.

Distributional and Practical Implications

Taxing payroll contributions operates as a flat tax on wages, disproportionately affecting working-age households and families with children. It would also intensify child poverty rates while delivering gains almost exclusively to retirees.

(Insert option 1 distributional charts by income and age here)

Moreover, this policy is likely to be unintuitive and politically unpopular. Payroll deductions are widely perceived as earmarked savings for retirement, though in practice they do not correspond directly to eventual benefits. Taxpayers are unlikely to accept the recharacterization of these deductions as taxable income.

Conclusion and Recommendation

Eliminating taxation of Social Security benefits would significantly worsen federal finances and deliver windfalls primarily to affluent retirees. Proposed pay-fors, such as taxing payroll contributions, introduce serious distributional inequities and public perception challenges.

Recommendation:

Policymakers should reject proposals to exempt Social Security benefits from taxation and maintain current law to help stabilize entitlement finances and avoid exacerbating fiscal imbalances.