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

Summary

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

- The demographic 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 retirees. Alternative funding mechanisms introduce substantial distributional tradeoffs and are unlikely to be politically palatable.

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1 The Fundamental Problem of Retirement Spending

Demographic trends make financing old-age spending increasingly difficult. The ratio of working-age adults per elderly person has fallen from 3.2 historically to just 2.7 today, and is projected to fall to 2.4 by 2040 (OASDI Trustees 2024). Concurrently, spending growth for retirement programs far outpaces revenue growth. Over the next 30 years (Congressional Budget Office 2024):

- **Medicare** is projected to grow **5.4%** per year.
- **Social Security** by **4.2%**.
- **Tax revenue** by only **4.1%**.

This phenomenon is not shared by other federal spending categories:

- **Medicaid, CHIP, and ACA subsidies** are projected to grow **3.9%** per year.
- **Rest of expenditures** by **3.7%**.

The demographic imbalance is fundamental to retirement spending programs. Thus, they are particularly unsustainable and are the main drivers of a deteriorating fiscal outlook.

2 How Social Security Benefits Are Currently Taxed

Payroll taxes for Social Security and Medicare are legally considered to be contributions that are deducted pre-tax. Hence, benefits are partially subject to income tax upon receipt:

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

This taxation partially offsets net federal spending on elderly benefits.

3 Eliminating Social Security Benefit Taxes

3.1 Fiscal Effects

	2025	2026	2027	2028	2029
Savings ($bn)	-88	-108	-114	-119	-127

	2030	2031	2032	2033	2034	Ten year
Savings ($bn)	-130	-136	-142	-148	-155	-1267

A simulation made using PolicyEngine (n.d.) estimates the fiscal cost of exempting all Social Security benefits from taxation at approximately **$1.3 trillion over ten years**.[1] Given that the government is projected to add $21 trillion of debt over the coming decade even without policy changes (Congressional Budget Office 2024), this proposal would grow the amount borrowed by an additional 6%. The loss of revenue exacerbates fiscal imbalances driven by retirement spending.

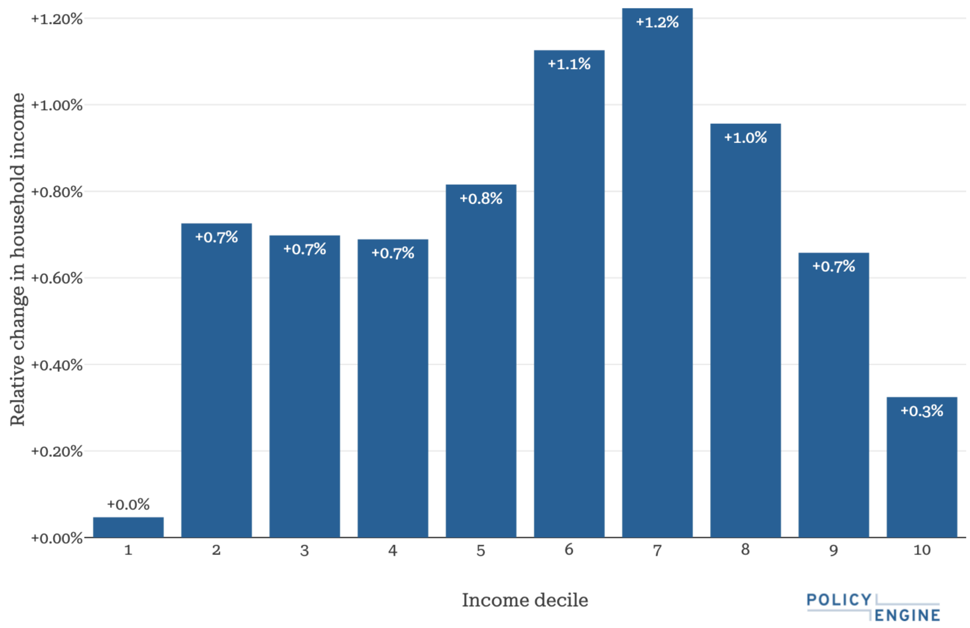
3.2 Distributional Effects

3.2.1 By Income

The increase in net income will be distributed across the income spectrum, with most income groups seeing a relative increase in net income. The increase is particularly high among upper-middle income payers, demonstrating that the most-taxed Social Security beneficiaries are relatively high-earning, even compared to the average worker.

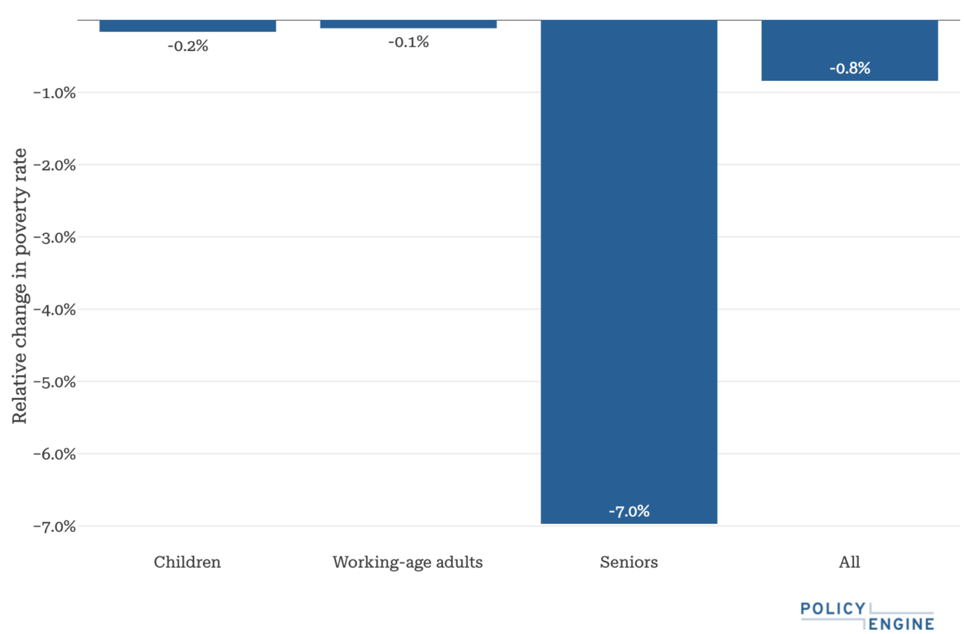
Eliminating taxation of benefits disproportionately benefits higher-income households, as shown below:

[1]PolicyEngine generates these estimates via microsimulation. This means applying federal and state tax and benefit rules to representative samples of the population, calculating outcomes for each household based on their unique characteristics, and aggregating results to estimate population-wide impacts. Note that all revenue and expenditure estimates are static rather than dynamic. That means they do not account for behavioral changes, particularly labor supply adjustments, in response to changes in tax and benefit policies.



3.2.2 By Age

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



3.3 Effects on Tax Complexity

Any bill to exempt Social Security benefits will very likely be passed by the GOP on a party line vote. This will require the use of the Senate's reconciliation procedure, such that only 51 votes are necessary for passage. However, changes to Social Security, including the taxation of its benefits, are banned under the rules of the reconciliation procedure. Thus, any bill to legislate the exemption of benefits cannot be a parametric reform that sets the aforementioned rates to 0%. Instead, the tax on benefits will still be levied, but that will be offset by a new tax relief program aimed at seniors. This policy design has been confirmed by House Ways and Means Chairman Jason Smith (American Enterprise Institute 2025).

This design will add further complexities to tax filing. It will be challenging to set the relief amount to be equal to the tax on benefits, since benefits are pooled with other sources of income and taxed at marginal rates.[2]

Thus, under any exemption regime, elderly filers will have to first compute the tax owed on benefits, and then the relief amount in a separate procedure. This will:

- Lengthen tax filing time
- Make accurate retirement planning almost impossible, since future retirees first have to (i) calculate their benefits, then (ii) estimate the benefits subject to tax, and now also (iii) estimate the relief they are eligible for.

4 Potential Pay-For: Taxing Payroll Contributions

To address the fiscal concerns posed by the tax exemption on benefits, 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,* half of which are funded by employers. The argument goes that employees are having their retirement funded but are not taxed for this additional compensation. The proposal would thereby broaden the definition of taxable income to include these contributions.

Two policy options were scored:

- **Option 1:**
  - Tax all employer Social Security and Medicare payroll contributions.
  - Exempt all Social Security benefits from taxation.
- **Option 2:**
  - Tax only employer Medicare contributions.
  - Exempt the Medicare portion of benefit taxation, i.e., set the additional share of taxable benefits from 35% to 0% for beneficiaries with combined income above the threshold.

[2] For a challenging example, consider cases where a taxpayer who would be taxed at a lower bracket if they had no benefits. In any given individual's case, it will be difficult to determine whether to attribute the higher rate to the taxpayer's Social Security benefits, or their non-benefit income. The law can be written to make this call arbitrarily. If the law decides to treat all benefits as the last margin of income, that will maximize the relief amount to seniors. But this will overpay taxpayers for whom the non-benefit income is the actual last margin income. This would be the case if, for example, a taxpayer started working a job after forming an expectation of what their benefit amount will be.

4.1 Fiscal Effects

Option 1 yields a ten-year surplus sufficient to offset benefit tax repeal.

	2025	2026	2027	2028	2029
Savings ($bn)	52	60	63	68	72

	2030	2031	2032	2033	2034	Ten year
Savings ($bn)	76	81	86	90	94	741

Option 2 falls far short of required revenue.

	2025	2026	2027	2028	2029
Savings ($bn)	-4	-8	-8	-8	-8

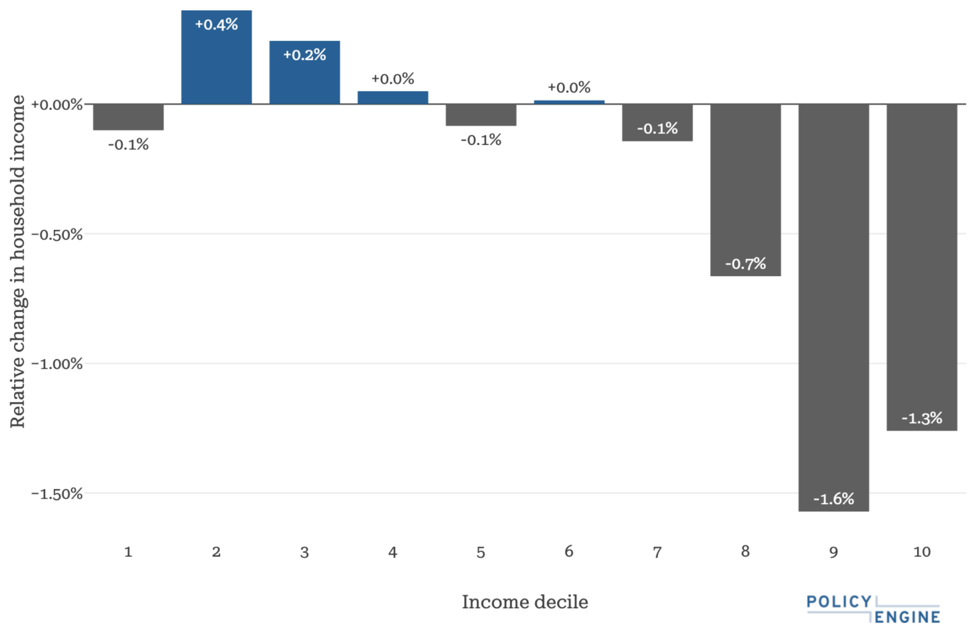
	2030	2031	2032	2033	2034	Ten year
Savings ($bn)	-8	-8	-8	-9	-9	-77

Note that all scores shown are static, i.e., they do not account for workers adjusting their behavior when facing higher tax rates. Actual savings achieved by a tax on payroll contributions will likely be lower.

4.2 Distributional Effects

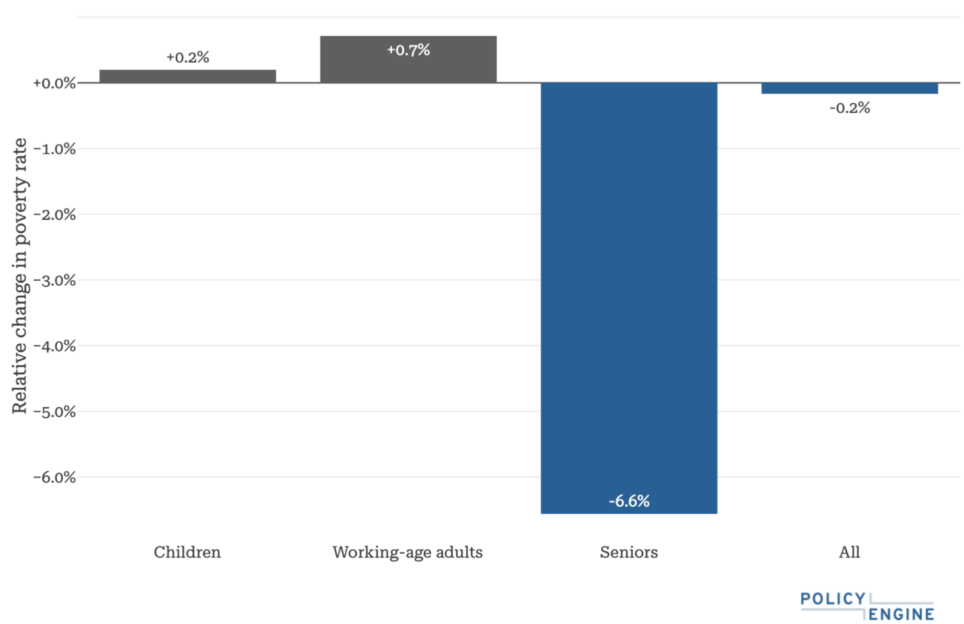
4.2.1 By Income

Focusing on Option 1, the tax on payroll contributions cancels out the net income gains in most income groups, while the 1st and top deciles both see decreases in net income.



4.2.2 By age

When we segment the population by age, we can more clearly see that the small relative income changes in lower income deciles actually conceal large changes across age within each income group:



Taxing payroll contributions to pay for exempting benefit taxation does two things: (i) the policy increases net benefits received by retirees, while (ii) putting the financing burden on working-age adults and families by increasing their tax liability. This combination of policies does reduce elderly poverty, but at the cost of increased poverty among working-age adults and children.

Also note that while the reduction in elderly poverty is larger in magnitude than the increase among working-age adults and children, this should be interpreted cautiously for the following reasons:

1. The households who will pay more taxes are by definition employed—since they are receiving employer payroll contributions. Thus, they are at lower risk of falling into poverty—but that does not imply they are not impacted by the tax increase.
2. Spending on elderly tends to generate far lower social welfare than spending on children (Hendren and Sprung-Keyser 2020), so putting the latter in greater poverty for lifting the former poses a complicated tradeoff that defies easy comparison.
3. As noted earlier, much of the increase in net income attributable to exempting benefits from taxation accrues to higher income households. Thus, the poverty reduction among seniors reflects only a narrow picture of the program's overall impact.

Finally, note that this proposal's adverse impact on younger age groups will be shared by any proposal to pay for benefit exemption. This is because taxing payroll contributions is economically similar to a generic progressive tax.[3] Any alternative revenue proposal will have the same, if not worse, impact on the net income of poor working-age adults and children.

4.3 Practical Considerations

Moreover, this policy is likely to be unintuitive and politically unpopular. Payroll contributions are widely perceived as a tax, not earmarked savings for retirement. Popular perception lines up with economic definitions, under which payroll deductions are considered a source of government revenue. It is also consistent with political reality, since contributions neither correspond directly to eventual benefits, nor are contributions insulated from government's general budget.[4]

Thus, taxpayers may be skeptical of the characterization of contributions as taxable income, and instead perceive that they are being taxed for paying a tax.

[3] Payroll contributions are levied similarly to a flat tax, in that all workers contribute (almost) the same share of income. Subjecting payroll contributions to ordinary income tax rates, which increases by income, will scale this flat rate downwards for lower earners. Thus, the resulting additional share of income taxed will increase by income, which is by definition progressive.

[4] In years when payroll contributions exceed benefit payments, the Treasury withdraws trust fund balances to finance general government expenditures (OASDI Trustees 2024). While the trust funds have been drawing on general government revenue in recent years, the fact is that the finances of the trust funds and the general budget are far less segregated than the structure implied by separate payroll contributions for Social Security and Medicare.

5 Conclusion

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 slow the growth in retirement spending and avoid exacerbating federal debt burdens.

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