Not Taxing Social Security: Implications and Lack of Good Pay-For's

John T.H. Wong

Agenda

1. The fundamental problem of retirement spending.
2. The impact of not taxing social security:
   - Fiscal.
   - Distributional.
   - Complexity.
3. "Taxing payroll taxes" as a pay-for.
4. The issues of taxing payroll taxes:
   - Insufficient.
   - Distributionally worse.
   - Unintuitive.

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Takeaways

1. Not taxing social security is fiscally bad.
2. Paying for it is distributionally bad.

The fundamental problem of retirement spending

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  - This is driven by both mediocre growth in the nominator and high growth in the denominator.
- One way to see elderly population growth is to look at the fastest growing (not shares) of the federal expenditures over the next 30 years (CBO 2025).
  - Medicare: 385%
  - Social security: 241%.
  - Medicaid: 219%.
  - Rest of expenditures: 197%.

Not taxing social security (benefits): what does it mean?

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  - And alleviates the fundamental problem of retirement spending.

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- **Not taxing social security means setting both of those rates to zero.**

Not taxing social security: fiscal impact

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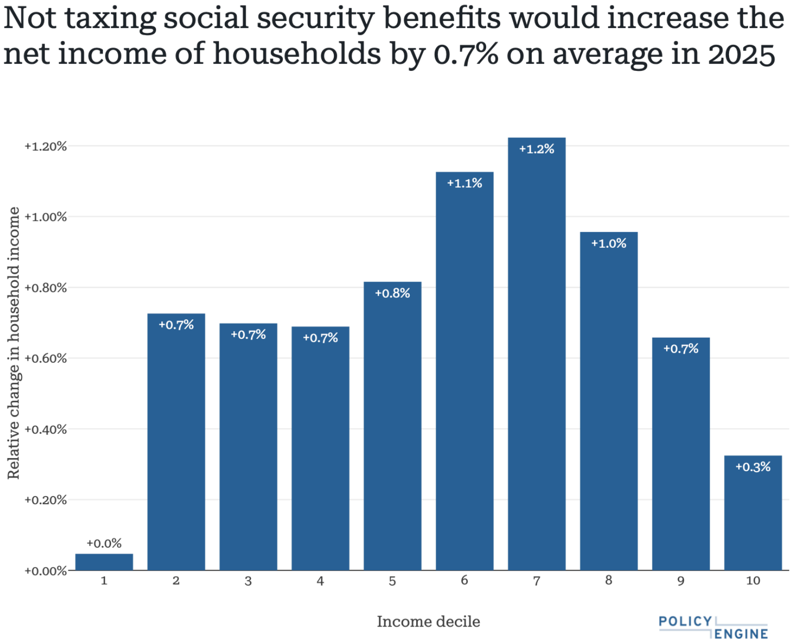
	2025	2026	2027	2028	2029
Savings ($bn)	-88	-108	-114	-119	-127

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

The policy costs $1.3 trillion over ten years.

Not taxing social security: distributional impact by income



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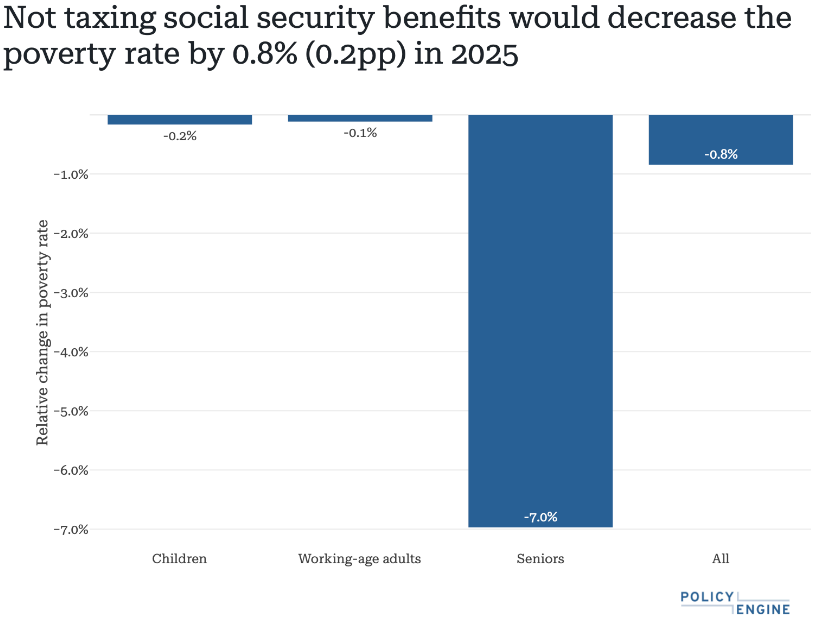

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- Thus, any reduction of the elderly's tax burden must come from a separate credit that is calculated based the tax you are about to pay.
    - This design has been confirmed by House Ways and Means Committee Chairman, Jason Smith.
- In practice, this means when you do your taxes,
    - You have to first calculate how much taxes you owe on your social security benefits.
    - And then calculate how much credit you get based on the tax you owe.

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  1. Tax all employer payroll contributions as employee's additional income; exempt all social security benefits from taxation.
  2. Tax only employer's *Medicare* payroll contributions as employee's additional income; set only the additional share of benefits subject to tax, to 0% (recall that it's currently at 35%; revenue goes to Medicare fund).

Fiscal impact

Option 1 does lead to a surplus

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

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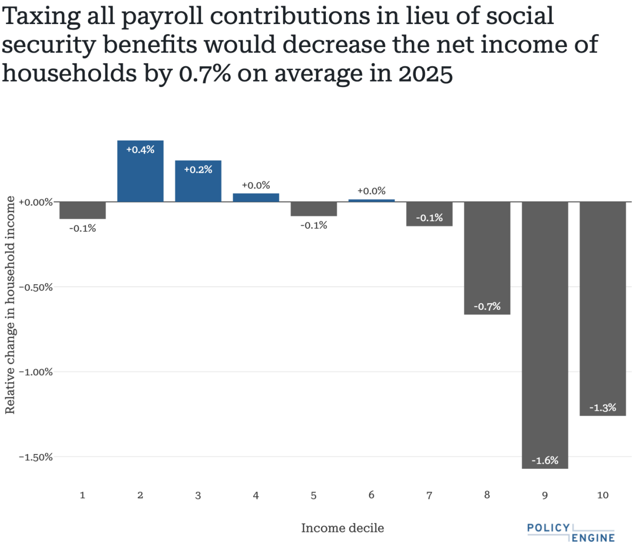
Option 2 does not add up at all

	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

Distribtuional impact of option 1, by income



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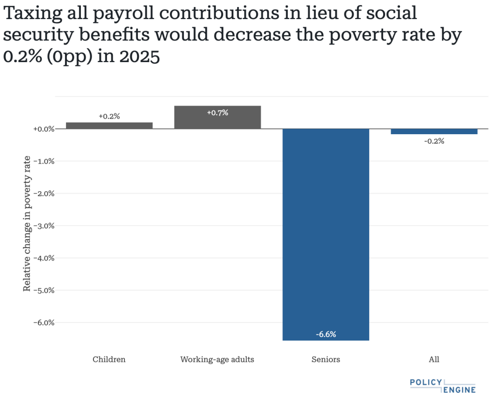

- Redistribution accrues exclusively to the elderly, at the cost of poverty among workers and children.
- Note that taxing payroll contributions is identical to a flat tax, so this distributional pattern is something that most revenue proposals will entail

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- Intuition fits reality:
  - The amount paid into social security and Medicare do not map one-to-one to how much you take out.
  - In fact, the government has taken money out of the trust funds to finance general expenditures before, so the payroll contributions aren't really stored in a separate pot of money.
- So taxing payroll contributions will be very unintuitive to taxpayers, to say the least.

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- Intuitively and economically, government payments are part of the tax-and-transfer system, and therefore *post-tax*.
    - But the law treats this class of payment as pre-tax, which clashes with intuition and output accounting.
- Instead of paying people a benefit and then taking it away, I think it's simpler and more honest to just reduce the benefit paid upfront.

Conclusion

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  - Refunding people after they pay the tax, after you pay them the benefit, is even worse, for fiscal and complexity reasons!
- Removing the tax and taxing workers more is fiscally better but worse for age-distributional and complexity reasons.