AN ANALYSIS OF ALTERNATIVES FOR TAXING SOCIAL SECURITY AS A PRIVATE PENSION

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SOCIAL SECURITY AS A PRIVATE PENSION

In recent years, proposals have been made to tax Social Security and Railroad Retirement Tier I benefits in the same way that private and public employee pension plans are taxed. Three alternative ways to accomplish this end typically have been put forward:

- Include 93 percent of Social Security benefits in adjusted gross income (AGI);
- Include 83 (or 85) percent of benefits in AGI -- revised in this paper to 80 percent; or
- Include 50 percent of benefits in AGI.

The purpose of this paper is to describe the current tax rules governing taxation of qualified private or public employee pension plans and to discuss the logic behind each of these alternatives in light of those tax rules. In addition, two other options are outlined: allow beneficiaries a recovery of after-tax contributions adjusted for inflation; and exclude all contributions from AGI and include all benefits in AGI.

These various alternatives are discussed in the context of taxing Social Security as if it were a private pension. Social Security, however, was nontaxable until 1984, and the current method of taxing benefits applies only when an individual's or couple's combined income exceeds relatively high thresholds. For transition purposes, any one of these alternatives similarly could be combined with thresholds or an additional fixed dollar exclusion.

Under the tax code, a pension or other retirement income plan that meets various requirements concerning eligibility, participation, vesting, coordination with Social Security, and so on, is said to be "qualified." If a pension or similar plan is qualified, then taxation of the employer's contributions and of the interest or other investment income earned in the pension plan is deferred until the employee retires. Under certain circumstances, as in "cash or deferred compensation arrangements" (for example, 401(k) plans), taxation on contributions voluntarily made by an employee to a retirement plan also may be deferred until retirement. Individual Retirement Accounts (IRAs) also are a type of qualified retirement plan in which taxation of an individual's voluntary contributions and the earnings thereon is deferred until retirement.

Though most qualified plans in the private sector do not require employee contributions from already taxed income ("after-tax" contributions), required employee contributions are common in public employee retirement plans. Further, many private sector employers maintain both a basic pension plan and a supplementary plan. Until the growing use of Section 401(k) in recent years, employer contributions to the latter type of plan often depended upon the employee voluntarily making contributions from his or her after-tax income.

An annuity from a qualified pension, therefore, may be characterized as deriving from up to three different sources: (1) before-tax (typically only employer) contributions; (2) after-tax employee contributions; and (3)

interest or other income earned on both employer and employee contributions. Interest or other income earned on either before-tax or after-tax contributions is not taxed until the pension is actually drawn down.

For situations in which after-tax contributions to a pension plan have been made, section 72 of the Internal Revenue Code specifies that an amount equal to those after-tax contributions will be excluded from taxable income when the pension is drawn down either as a lump sum or as an annuity. In the case of most annuity payouts, a special three-year rule applies -- that is, if the annuitant will receive (or "recover") within three years an amount equal to those after-tax contributions, then that much of his or her initial payments is excluded from AGI. If recovery will take more than three years, then a percentage of every year's payments is excluded from taxable income. That percentage -- known as the "exclusion ratio" -- is the ratio of the employee's after-tax contributions to the sum of the expected payments under the annuity contract. These rules are designed to assure that after-tax contributions are not taxed twice.

In contrast to these special rules for pensions and other qualified retirement plans, the tax code generally does not defer taxation on savings. Income placed into savings, and the interest on other investment return on those savings, are taxed when they first accrue. (Returns in the form of capital gains, however, are not taxed until recognized.) In the limited circumstance of nonterm life insurance, though premiums are paid

from after-tax income, taxation of the investment return -- "inside build-up" -- is deferred until the policy is surrendered.

Using the long-term economic and demographic assumptions in the annual Social Security Trustees' Reports, The Office of the Actuary in the Social Security Administration has calculated that aggregate lifetime employee contributions for the cohort of workers now entering the labor force (who will retire between 2025 and 2030) will equal approximately 7 percent of their aggregate benefits. (As discussed more fully later, this average exclusion ratio is small because beneficiaries are receiving an implicit, and not previously taxed, rate of return on both their own and their employers' contributions.) Thus, the most literal application to Social Security of the tax treatment of qualified private pensions would require Social Security beneficiaries, on average, to include 93 percent of their benefits in AGI with no thresholds. The percent of potentially includable benefits under this rule would be even higher for those now on the beneficiary rolls or who will retire in the near future.

The calculation that only 7 percent of benefits, on average, will be a recapture of employee contributions strikes many people on first encounter as surprisingly small. It should be kept in mind, however, that because of the way wage growth in the Social Security system over time cumulatively affects benefits, relative to lifetime contributions, the program gives an implicit rate of return on both employee and employer contributions similar to the interest or other income earned on both kinds

of contributions in a private pension plan. Hence, roughly 50 percent of benefits in the future may be characterized as a return of never-taxed employer contributions and "interest" thereon, roughly 43 percent as the never-taxed "interest" on employee contributions, and only roughly 7 percent as a recovery of already taxed employee contributions.

Because of the adequacy or redistributional elements in the Social Security benefit formula, higher-income single people and two-earner couples receive fewer benefits relative to their contributions than do either lower-income individuals and couples or one-earner couples regardless of income. For higher income single individuals and two-earner couples, therefore, the ratio of employee contributions to expected payments, would be higher than 7 percent; in the most extreme case of the never married, high-income male, the ratio could be as high as 20 percent. (In recent years, the Social Security Administration has calculated the exclusion ratio for the never married, high-income male to be approximately 17 percent. Recent CBO recalculations that more accurately reflect the tax code and that take into account changes in Social Security law and forecasting indicate that this ratio may be closer to 20 percent.) For workers who benefit from the program's redistributional elements to some substantial degree, the ratio of employee contributions to benefits would be lower than 7 percent.

A 7 percent average exclusion could be applied to Social Security benefits in one of three ways:

- o Each beneficiary (and survivor) could recover tax free an amount equal to lifetime employee payroll contributions in a manner analogous to the three-year rule;
- o A particular exclusion ratio could be calculated for each beneficiary (and survivor) in a manner analogous to the general rule for exclusion ratios; or
- o A uniform 7 percent could be applied to all beneficiaries.

When this matter previously has been discussed, the Social Security Administration has advised against individually calculated recovery amounts or exclusion ratios. As a social insurance program serving a variety of purposes, Social Security contains provisions that do not exist in private or public employee pensions -- for example, several beneficiaries can simultaneously derive benefits from one worker's earnings history, an individual can derive his or her benefits from first one earnings history and then another, and some benefits are derived from two earnings histories. Though rules about how to allocate individual recovery amounts or exclusion ratios in these and other situations could be devised, the resulting administrative complexities could become excessively burdensome. The application of a uniform 7 percent, however, would have the disadvantage of double taxing a portion of benefits for many beneficiaries--around 13 percent of benefits in the most extreme situations.

Given these administrative constraints and in order to avoid any double taxation of employee contributions, a proposal often made is that 83 percent or 85 percent of all benefits should be taxed. (Occasionally, in previous analyses of this alternative, the more analytically precise figure of 83 percent has been rounded up to 85 percent.) By excluding from any taxation benefits on the order of 15 percent, the person who has the highest ratio of employee contributions to benefits would receive an appropriate exclusion, assuming current law for all other provisions. (As noted earlier, recent recalculations indicate that approximately 20 percent of benefits should be excluded for such people; thus, no more than 80 percent of benefits would be includable in AGI.) Other beneficiaries with lower ratios of employee contributions to benefits would continue to pay less tax than they would under a strict application of the general tax rules. In addition to its administrative simplicity, this exclusion of 15 percent to 20 percent being applied to all benefits has been justified on the grounds that it is consistent with the basic redistributional tilt in the Social Security benefit formula in favor of lower income workers.

The proposal most often suggested is that 50 percent of benefits should be included in AGI. Its main justification lies in the popular perception that, because the program is financed half from employee payroll contributions and half from employer contribution taxes, half of one's benefits have already been taxed. The 1979 Social Security Advisory Council recommended this position, and in the 1983 Social Security Amend-

ments, the Congress generally accepted its logic when it introduced the taxation of benefits going to high-income beneficiaries. (In the report of the 1979 Advisory Council, a minority of members, while voting for the 50 percent proposal, argued for the proposition discussed earlier that 83 percent of benefits should become includable in AGI. Other members rejected entirely the concept of taxing benefits.)

Yet a fourth option exists if the position is taken that the income tax should not tax gains that only have kept an asset's real value constant. In its November 1984 tax reform plan the Treasury proposed, as part of its recommendation to adjust capital gains for inflation, that after-tax contributions to qualified pension plans also should be adjusted for inflation in the setting of exclusion ratios. If this measure were ever adopted for private and public employee pensions, the consistent treatment for Social Security benefits would be that beneficiaries should be allowed to recover tax free an amount that equals their after-tax contributions adjusted for inflation. Using the current Social Security Administration's long-term economic assumptions, it appears that if after-tax employee contributions were adjusted for inflation, the resulting exclusion ratios are approximately twice the value of the unadjusted ratios. For example, the indexed option that parallels a 7 percent exclusion being applied to all benefits would instead apply a 14 percent exclusion to benefits. Similarly, the indexed option that parallels the 20 percent exclusion would instead apply a 40 percent exclusion.

An advantage to having an exclusion ratio rule that incorporates inflation indexing is that the result is much less sensitive to assumptions about inflation than is a rule based on nonindexed contributions. For example, taking as the norm the never married, high-income male, 20 percent is the appropriate nonindexed exclusion ratio assuming inflation averages 4 percent over the next 75 years. If the inflation assumption is changed to zero, the appropriate nonindexed exclusion ratio becomes approximately 43 percent; and if the inflation assumption is changed to 6 percent, it becomes approximately 15 percent. In contrast, if the exclusion ratio is one based on after-tax contributions being indexed to the year of retirement, then the result only varies within the relatively narrow range of 38 percent (6 percent inflation) to 43 percent (zero inflation). This relative small variance might allow, for example, a 40 percent exclusion ratio rule to be used without the need of frequent recalibrations in light of actual inflation. Nonetheless, any exclusion ratio rule would have to be adjusted from time to time in light of actual economic and longevity experiences. Such adjustments might be done, for example, every 10 years with the new calculation being applied to all retirees within the succeeding decade.

A final option sometimes put forward is that all contributions to retirement savings, whether made by an employer or an employee, should be excluded from current taxation. As a consequence, all disbursements from pension and other retirement plans would be fully taxed when received. This proposal has occurred in two different contexts -- as a modification

of the existing income tax, and as a consequence of a major revision of the base on which taxes are levied.

As a proposed revision to the existing income tax, the 1980 President's Commission on Pension Policy recommended that all contributions to qualified forms of retirement saving should be excluded from current income and all retirement disbursements should be fully taxable. The Commission also recommended that the same rule apply to Social Security. Thus, the distinction between before-tax and after-tax contributions to pensions and Social Security would cease to exist, and all pension and Social Security benefits would be fully taxable. The recent growth in section 401(k) plans has moved many private sector pensions in that direction already. Adoption of the President's Commission's proposal for Social Security would cause a considerable loss in revenues unless the new deduction for employee payroll contributions were accompanied by coincident taxation of most benefits going to current beneficiaries. Even in that case, absent another compensating change in tax rates or the tax base, a net loss in revenues likely would occur because the elderly, as a group, are in lower tax brackets than the nonelderly.

In the wider context of tax reform, many students of tax policy have proposed that, contrary to the general principles of an income tax, individuals should be allowed to exclude savings from current taxation. Savings plus the interest and other investment income earned on those savings then would become taxable only when drawn down for consumption. In

effect, the exceptional treatment now afforded qualified retirement savings in the current income tax would become the general rule for all savings, whether for retirement or for some other end, and regardless of whether made directly or through one's employer. An analogous treatment of Social Security in a personal consumption tax system would exclude both employee and employer contributions from the tax base when made and would include all Social Security payments in the tax base when received.

In moving to a consumption-based tax system, Congress might decide, however, that treating Social Security like private savings would create too great a net revenue loss and that, as a consequence, employee contributions to Social Security would have to continue to be made from after-tax income. In this context, Congress could also decide that, nonetheless, people over their lifetimes should not pay any more in taxes than if they had been allowed an exclusion for employee contributions to Social Security. This could be accomplished by only including 50 percent of benefits in the tax base--in effect, an amount equal to pre-tax contributions plus interest thereon. By excusing from taxation benefits in retirement that equal contributions with interest, the result -- in present value terms -- is approximately equivalent to having excluded the contributions from taxation when made during employment. From the government's perspective, however, the revenue loss would occur about 40 years hence rather than now.