

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

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In recent years, proposals have been made to tax Social Security and Railroad Retirement Tier I benefits in ways that are more similar to the way that private and public employee pension plans are taxed. Several alternatives are possible:

- Include 93 percent of Social Security benefits in adjusted gross income (AGI);
- Include 85 percent of benefits in AGI;
- Include 50 percent of benefits in AGI; or
- Include 60 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, one other option is discussed: 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 non-taxable 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 a fixed dollar exclusion.

Under the tax code, a pension or profit-sharing 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 delayed until the employee retires. Similarly, in "salary reduction plans" (for example, 401(k) or 403(b) plans), taxation on contributions voluntarily made by an employee to a retirement plan also is delayed until retirement.¹ (Individual

1. These before-tax amounts deposited by employees into salary reduction plans are technically called "elective deferrals."

Retirement Accounts (IRAs) also are a type of retirement plan in which taxation of investment earnings and, under certain circumstances, an individual's voluntary contributions can be delayed 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 non-elective pension plan and a second plan that depends on employee contributions. Until the growing use of section 401(k) in recent years, employer contributions to the latter type of plan depended upon the employee voluntarily making contributions from his or her after-tax income.

An annuity from a pension, therefore, may be characterized as deriving from up to three different sources: (1) before-tax (mostly employer) contributions; (2) after-tax employee contributions; and (3) interest or other investment income earned on both employer and employee contributions. Interest or other investment income earned on either after-tax or before-tax contributions is not includable in income until the pension is actually drawn down.²

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-

2. Economically, results differ between annuity amounts attributable to before-tax contributions and annuity amounts attributable to after-tax contributions. For amounts attributable to before-tax contributions, the taxpayer is allowed to defer paying a tax on the wages he invests for retirement savings, which deferred tax is repaid with interest when the savings are used for consumption in retirement. Thus, the net value of the taxpayer's investment is usually determined by the taxpayer's tax rate in retirement; more importantly, the interest or other investment income earned by that net investment is not taxed. In this first (or "consumption tax treatment") case, the taxpayer is able to consume from the annuity an amount equal to $(1-t_r)W(1+r)^n$, where t_r is the taxpayer's tax rate in retirement, W are wages diverted into contributions, and $(1+r)^n$ is the plan's investment return for n years. For the amount attributable to after-tax contributions, the net value of the taxpayer's investment (or "basis") is determined by the taxpayer's tax rate when working, and the investment income on that basis is taxed in a tax-deferred manner. In this second case (or "deferred annuity" treatment), the taxpayer is able to consume from the annuity an amount equal to $(1-t_r)(1-t_w)W(1+r)^n + t_r(1-t_w)W$, where t_w is the taxpayer's tax rate while working and the other terms are as previously described. For more discussion, see Chapter I, *Tax Policy for Pensions and Other Retirement Savings*, Congressional Budget Office (April 1987).

-tax contributions will be excluded ("recovered") when the pension is drawn down as either a lump sum or as an annuity. In the case of annuity payouts, a percentage of every year's payments is excluded from 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.³ This rule is designed to assure that after-tax contributions are not taxed twice.

In Social Security, an individual who is an employee pays one-half of the payroll tax from after-tax income. The other half is paid by the individual's employer, and the employee is not liable for current income taxes on the employer's share.⁴ 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 after-tax 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

3. Before the Tax Reform Act of 1986, a special three-year rule also applied. If an annuitant would recover within three years an amount equal to after-tax contributions, then that much of the annuity's initial payments were excluded from adjusted gross income.

4. The self-employed pay a payroll tax that equals the combined employer-employee payroll tax but are allowed to deduct one-half of that combined tax in calculating their income tax liability.

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 redistributive 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 has been estimated by the Social Security Administration's actuaries to be as high as 15 percent. For workers who benefit from the program's redistributive 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 two ways:

- A particular exclusion ratio could be calculated for each beneficiary (and survivor) in a manner analogous to the general rule for exclusion ratios; or
- 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 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 exclusion ratios in these and other situations could be devised, the resulting administrative complexities could become burdensome. The application of a uniform 7 percent, however, would have the disadvantage of double taxing a portion of benefits for many beneficiaries, around 8 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 85 percent of all benefits should be taxed. 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. 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 being applied to all benefits has been justified on the grounds that it is consistent with the basic redistributive 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 after-tax employee payroll contributions and half from before-tax employer contribution taxes, therefore half of one's benefits have already been taxed. The 1979 Social Security Advisory Council recommended this position, and in the 1983 Social Security Amendments, 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 approximately 85 percent of

benefits should become includable in AGI.⁵ 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 value real value constant. In its November 1984 tax reform plan the Treasury proposed that after-tax contributions to qualified pension plans should be adjusted for inflation in the setting of exclusion ratios, as part of its recommendation to adjust capital gains and other investment returns for inflation. 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 long-term economic assumptions for Social Security, 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 15 percent exclusion being applied to all benefits would instead apply a 30 percent to 40 percent exclusion to benefits, depending on the exact inflation assumption.

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, 15 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 36 percent; and if the inflation assumption is changed to 6 percent, it becomes approximately 11 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 relative-

5. The actual figure used in the 1979 Advisory Council Report was 83 percent of benefits. Changes in long-term assumptions since then have made 85 percent the appropriate percentage for this approach.

ly narrow range of 28 percent (6 percent inflation) to 36 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.

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 payments would be fully taxable. The recent growth in section 401(k) and similar arrangements has moved many private sector plans in that direction already. Adoption of the President's Commission's proposal for Social Security would cause a considerable loss in income tax revenues unless the new deduction for employee payroll contributions were offset in some manner--by, for example, 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 non-elderly. Another possible offset might be a one- or two-year freeze on tax bracket indexing in the income tax on the grounds that the new deduction for payroll taxes would have roughly the same effect.

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. Alternatively, only wage and salary income would be taxed and investment income would become tax-exempt. 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 before-tax contributions plus interest thereon. By excluding from taxation benefits in retirement that equal after-tax contributions with interest, the result--in present value terms--is approximately equivalent to having excluded the contributions from taxation when made during employment.

