American Academy of Actuaries

Issue Brief

Social Security Reform: Taxation Options

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Key Points

- Social Security was originally funded by a tax on the wages of covered workers plus interest on accumulated taxes not yet paid out as benefits. Later, a tax on the benefits of some beneficiaries was added.
- Both the tax rate and the limit on wages subject to taxation have been raised periodically to fund increases in the scope and amount of benefits.
- According to the 2021 Social Security Trustees Report, accumulated assets will be depleted by 2034 and income to the system thereafter will be insufficient to pay all scheduled benefits when due.
- Some or all of this shortfall can be averted by raising the tax rate on wages, increasing the limit on wages subject to taxation, broadening coverage to include all state and local government employees, increasing taxes on benefits, and/or creating new taxes dedicated to funding Social Security benefits.
- This issue brief explores a wide variety of proposals for increasing system revenue that have been made over the years by members of Congress, government-appointed panels and commissions, and outside experts.

The Social Security program has broad public support and has served as a financial safety net for older and disabled Americans for decades. However, the growing number of retirees—combined with fewer workers per retiree to support them—threatens the long-term solvency of the program.

To address the program's long-term solvency, policymakers have been considering various options for boosting the Social Security system's income or reducing scheduled benefits. The Social Security Committee of the American Academy of Actuaries has published several issue briefs that review options for improving Social Security's financial condition.

This issue brief focuses on proposed changes to the taxes that provide most of the system's revenue. Such changes can be part of reforms intended to address Social Security's financial situation.

Background

When the Social Security system was created in 1935, its designers intended that benefits and administrative expenses be financed entirely by a tax on the wages of covered workers plus any interest earned on accumulated taxes. The tax rate was set initially to build up a significant asset reserve beyond what was necessary to pay benefits and expenses when due, but not sufficient to prefund all future benefits and expenses. These assets were held in a trust fund invested in Treasury securities issued specifically for the purpose. When disability benefits were added in 1956, a separate disability trust fund was established.

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As the system matured, both the number of beneficiaries and average benefit amounts increased, so that assets built up in the early years—particularly during the high-employment years of World War II—were gradually drawn down, and funding changed to a pay-as-you-go basis, with the trust funds holding assets sufficient to pay benefits and expenses for only a short period. The Social Security Amendments of 1983 included tax rate increases that returned the system to a partial prefunding basis to avoid much larger tax rate increases that would have otherwise been required when the baby boom generation began retiring, then nearly three decades in the future. The resulting buildup of assets in the trust funds caused interest income to increase as well. The 1983 Act also introduced a third source of income. For the first time, a portion of the Social Security benefits paid to some beneficiaries became subject to federal income tax, and the additional revenue from this tax was shared between the Social Security and Medicare trust funds, as described below. In calendar year 2020, the payroll tax accounted for 89.6% of income to the system, interest income 6.8%, and the tax on benefits 3.6% (https://www.ssa.gov/oact/TR/2021/II_B_cyoper.html#94983).

Each year, the Social Security trustees publish a report showing the estimated financial status of the system over the next 75 years. According to the 2021 Trustees Report, current balances in the Social Security Trust Funds plus projected income will fall short of projected expenses by an amount equivalent to 3.54% of taxable payroll over the 75-year valuation period, using the trustees' intermediate, or best estimate, assumptions. (See the Academy's issue brief *An Actuarial Perspective on the 2021 Social Security Trustees Report*, September 2021.)

One way to remedy this deficit is to increase taxes that support the system. This issue brief describes various proposals for changing existing taxes or establishing new dedicated taxes that are listed on the website of Social Security's Office of the Chief Actuary (OCACT) at https://www.ssa.gov/oact/solvency/provisions/index.html. Other Academy issue briefs describe proposals for changing other components of the system, such as the benefit formula and the age at which unreduced benefits are first payable to non-disabled workers. All cost figures for proposals described in this issue brief are based

The 2022 Social Security Committee includes Amy Kemp, MAAA, ASA, EA—*Chairperson*; Janet Barr, MAAA, ASA; Gordon Enderle, MAAA, FSA; Sam Gutterman, MAAA, FSA, FCA, FCAS, HonFIA, CERA; Margot Kaplan, MAAA, ASA, FCA; Eric Klieber, MAAA, FSA; Alexander Landsman, MAAA, FSA, EA; Mahrukh Mavalvala, MAAA, FSA, EA; Gerard Mingione, MAAA, FSA, EA; Brian Murphy, MAAA, FSA, FCA, EA; Jeffery M. Rykhus, MAAA, FSA; and Keith Sartain, MAAA, FSA, EA.

on the same projection model used for the 2021 Trustees Report. These cost figures take into account the effects of the COVID-19 pandemic. These cost figures are not strictly additive: The net change in the deficit from adopting more than one of the proposals described below may not equal the sum of the changes in the deficit attributable to the individual proposals due to interactions among the proposals. For proposals published and originally effective before 2021, OCACT has advanced the effective and/or phase-in years in the original proposal by the number of years from the publication year to 2021 so that timing is comparable among all proposals.

Current Taxes Supporting Social Security

The current Social Security payroll tax rate is 12.4%, applied to wages and income from self-employment, together called "covered earnings," up to a maximum amount, the contribution and benefit base, often referred to as the Social Security wage base. The contribution and benefit base is $142,800 in 2021. For employed workers, the tax is split equally between employee and employer, while the self-employed pay the entire tax. The contribution and benefit base is adjusted each year in proportion to changes in the national average wage. The contribution and benefit base is also the maximum amount of earnings included in the Social Security benefit formulas.

Whether a beneficiary pays income tax on his or her Social Security benefit depends on annual adjusted gross income, including a portion of Social Security. If such income exceeds a specified threshold—$25,000 for a single person and $32,000 for a married couple filing jointly—up to 50% of the Social Security benefit is added to taxable income. Revenue from this tax goes to the Social Security trust funds. There is an additional tax up to 35% of the Social Security benefit if income exceeds $32,000 for a single person and $44,000 for a married couple, but the additional revenue from this tax goes to the Medicare Hospital Insurance (HI) trust fund. These thresholds, unlike most dollar limits and thresholds in Social Security and tax law, are not indexed to either price inflation or average wage growth so that, as wages increase, both the proportion of beneficiaries subject to the tax and the proportion of their earnings taxed increase over time.

Options for Changing Taxes Supporting Social Security

Payroll Tax Rate

In theory, changes to only the payroll tax rate could eliminate as much of Social Security's long-range deficit as policymakers choose. Of all the many proposals and bills for addressing this deficit, raising the tax rate best preserves the current system structure.

The following four proposals would increase the payroll tax rate, currently 12.4%, by 0.1 percentage points per year (split evenly between employee and employer) over a specified phase-in period until reaching an ultimate tax rate. None of these proposals would eliminate the entire long-range deficit.

A. Rep. Gwen Moore: *Social Security Enhancement and Protection Act* (2019)
B. Bipartisan Policy Center (BPC): *Securing Our Financial Future* (2016)
C. National Academy of Social Insurance (NASI): *Fixing Social Security: Adequate Benefits, Adequate Financing* (2009); Rep, John Larson: *Social Security 2100 Act* (2014)
D. Rep. John Larson, Sen. Richard Blumenthal, and Sen. Chris Van Hollen: *Social Security 2100 Act* (2019)

Table 1 summarizes these four proposals:

Table 1

Proposal	Tax Rate Increase Per Year	Phase-In Period	Ultimate Tax Rate	Deficit Reduction as Percent of Taxable Payroll	Deficit Reduction as Percent of Current Deficit
A	0.1%	2024–2029	13.0%	0.55%	16%
B	0.1%	2023–2032	13.4%	0.90%	26%
C	0.1%	2027–2046	14.4%	1.51%	43%
D	0.1%	2025–2048	14.8%	1.81%	51%

Contribution and Benefit Base

The payroll tax could generate additional income not only by increasing the tax rate, but also by increasing the earnings to which the tax applies. Raising the limit on earnings subject to the payroll tax does not require also raising the limit on earnings included in the benefit formulas; that is, the contribution base and the benefit base could be different amounts. If the contribution base were increased but not the benefit base, tax revenue would increase with no increase in benefits, similar to increasing the tax rate, except that the additional tax revenue would come only from workers with earnings in excess of the benefit base. This would break the close connection in the current system between contributions and benefits—a significant departure from the original program design that has been maintained to this day. This connection between contributions and benefits is a contributing factor in the widespread public support for Social Security. If, on the other hand, the additional earnings subject to taxation were also included in the benefit formula, benefits would increase as well, but the result would still benefit the system financially, for two reasons: because the additional wages included in the benefit formula would be at the high end of the earnings spectrum where the benefit formula percent is lowest; and because the additional tax revenue would start immediately, while the additional benefits would phase in gradually over time. (The benefit formula can be found at https://www.ssa.gov/oact/COLA/piaformula.html.)

The original contribution and benefit base in 1937 of $3,000 included about 90% of the earnings of covered workers at the time. Until 1972, Congress increased the contribution and benefit base periodically by legislation, but without consideration of the percentage of earnings subject to taxation. Starting in 1972, the contribution and benefit base was indexed by increases in the national average wage. The Social Security Amendments of 1977 included among its provisions three ad hoc increases to the contribution and benefit base—effective in 1979, 1980, and 1981—which were intended to restore the ratio of earnings subject to the payroll tax to 90%. Although the contribution and benefit base continued to be indexed by the national average wage after 1981, the taxable ratio has declined gradually because the wages of high earners increased more rapidly than the wages of low earners. By 2020, the latest year for which data is available, the taxable ratio had fallen to 82.4%.

Many reform proposals include a provision for increasing the contribution base to again restore the taxable percentage to 90%. The following four proposals would increase the contribution base by the national average wage index plus an additional 2 percentage points per year until the taxable percentage reaches 90%, after which the rate of increase would revert to the national average wage index. In all but Proposal C, the benefit base would increase in tandem with the contribution base, but in Proposal B, the formula percent applicable to newly taxable wages would be lower than the 15% that currently applies to the highest taxable wages. Proposal D would apply the increased contribution base to the employee's portion of the tax and eliminate the contribution base limit altogether on the employer portion.

A. BPC: *Report of Debt Reduction Task Force* (2010); NASI (2009)

B. National Commission on Fiscal Responsibility and Reform: *The Moment of Truth* (2010)

C. National Research Council, National Academy of Public Administration: Choosing the Nation's Fiscal Future (2010)

D. NASI: *Fixing Social Security: Adequate Benefits, Adequate Financing* (2009)

Table 2 summarizes these proposals:

Table 2

Proposal	First Increase Year	Increase Applies to Benefit Base?	Formula Percent Applicable to Increase	Deficit Reduction as Percent of Taxable Payroll	Deficit Reduction as Percent of Current Deficit
A	2022	Yes	15%	0.65%	18%
B	2023	Yes	5%	0.67%	19%
C	2024	No	0%	0.81%	23%
D	2022	Yes	15%	1.49%	42%

Two other recent proposals would increase the contribution and benefit base at a rate greater than under current law, but still short of taxing all earnings. Both would extend the 15% factor in the benefit formula to all the newly taxable earnings, so that the benefit base would remain the same as the contribution base. A bill by Rep. Patrick Murphy, the *Social Security Parent Penalty Repeal Act* (2016), would increase the contribution base at twice the rate of increase in the national average wage, but not less than 3%, beginning in 2023. This bill would reduce the long-term actuarial deficit by 1.06% of taxable payroll, eliminating 30% of that deficit. The 2016 BPC report would make four ad hoc increases to the contribution and benefit base ending in 2026 at $248,400 and increase the bases thereafter at the rate of increase in the national average wage plus 0.5%. This proposal would reduce the long-term actuarial deficit by 0.61% of taxable payroll, eliminating 17% of that deficit.

Some proposals would apply the payroll tax to earnings above a threshold much higher than the current contribution base. This would create a so-called "doughnut hole," because earnings would be taxed below the contribution base and above the new threshold, but not in between. However, the new threshold would not be adjusted for inflation, so that over time the contribution base, adjusted by increases in the national average wage, would approach and ultimately pass the threshold. When this happens, the doughnut hole would be filled, and all earnings would be subject to the payroll tax. Most of these proposals would provide a small additional benefit based on taxable earnings above the current-law contribution base through a new benefit formula separate from the current formula that applies a flat percent to the career average of such excess earnings. The following proposals meet these criteria:

A. Rep. John Larson, Sen. Richard Blumenthal, and Sen. Chris Van Hollen: *Social Security 2100 Act* (2019)
B. Rep. Charlie Crist: *Save Social Security Act* (2017)
C. Rep. Al Lawson: *Social Security for Future Generations Act* (2021)
D. Sen. Bernie Sanders and Rep. Peter DeFazio: *Social Security Expansion Act* (2019)

Table 3 summarizes these proposals:

Table 3

Proposal	Effective Year	New Tax Threshold	Formula Percent Applicable to Increase	Deficit Reduction as Percent of Taxable Payroll	Deficit Reduction as Percent of Current Deficit
A	2023	$400,000	2%	2.14%	61%
B	2023	$300,000	3%	2.26%	64%
C	2023	$250,000	2%	2.37%	67%
D	2022	$250,000	0%	2.47%	70%

Another set of proposals would remove the limit on taxable earnings with no phase-in starting in 2022. These proposals differ only in the benefit formula percent that would be applied to earnings above the current benefit base. The following proposals meet these criteria:

A. Social Security Advisory Board, *Request for Information* (2005)

B. National Academy of Social Insurance (NASI): *Fixing Social Security: Adequate Benefits, Adequate Financing* (2009);

C. Rep. Peter DeFazio: *Fair Adjustment and Income Revenue for Social Security Act* (2015)

Table 4 summarizes these proposals:

Table 4

Proposal	Effective Year	Formula Percent Applicable to Increase	Deficit Reduction as Percent of Taxable Payroll	Deficit Reduction as Percent of Current Deficit
A	2022	15%	2.00%	57%
B	2022	3%	2.34%	66%
C	2022	0%	2.58%	73%

Including All State and Local Government Employees

A third way the payroll tax can generate additional income is by making more workers subject to the tax. The Social Security Amendments of 1983 extended coverage to the previously excluded employees of the federal government and state and local governments. However, states were allowed to opt out of coverage for government employees at the state and local levels, and about a quarter of state and local government employees—representing about 4% of the labor force—are not covered by Social Security. Several proposals, the National Commission on Fiscal Responsibility and Reform's 2010 *The Moment of Truth* and the BPC's *Restoring America's Future* (2010), would extend mandatory coverage to all newly hired employees of state and local governments starting in 2022. This action would reduce Social Security's current deficit because additional tax revenue would start right away, while benefits to the newly covered workers would

start only many years in the future. However, the proposal would likely hurt the current finances of the public retirement programs in opt-out states because—even if benefit levels were reduced and some workers excluded altogether in recognition of their eligibility for Social Security benefits—diversion of funding to Social Security would start right away, while benefit reductions would phase in gradually over time. This proposal would reduce the long-term actuarial deficit by 0.14% of taxable payroll, eliminating 4% of that deficit.

Taxation of Benefits

The revenue that could be raised through additional benefit taxation is relatively modest, and two recent proposals would actually reduce revenue from this source, thus increasing the actuarial deficit. The *Social Security 2100 Act* (2019) bill by Rep. Larson, Sen. Blumenthal, and Sen. Van Hollen would replace the current income thresholds for benefit taxation described above to a single set of thresholds—$50,000 for a single person and $100,000 for a married couple, without future adjustment for inflation, effective in the 2023 tax year. The tax rate would increase with increasing income over the threshold up to a maximum rate of 85%. The HI trust fund would receive the same revenue as under current-law taxation of benefits, and all remaining revenue would fund Social Security benefits. This proposal would increase the long-term actuarial deficit by 0.17% of taxable payroll, expanding the deficit by 5%.

A bill by former Rep. Sam Johnson included in the *Social Security Reform Act* (2016) would phase out taxation of benefits to fund Social Security benefits altogether by raising the thresholds in steps starting in 2045 until no income is subject to taxation after 2054. Taxation of benefits to fund Medicare would remain unchanged. This proposal would increase the long-term actuarial deficit by 0.53% of taxable payroll, expanding the deficit by 15%.

The BPC's 2016 *Securing Our Financial Future* proposal to add to taxable income the currently untaxed 15% of Social Security benefits for taxpayers whose adjusted gross incomes exceed $250,000 for single persons and $500,000 for married couples filing jointly would have a negligible impact on the long-term deficit. A provision included in Mark Warshawsky's *Reform Proposal to Make Social Security Financially Sound, Fairer and More Progressive* (2008) would tax Social Security benefits in a manner similar to annuity benefits from employer-sponsored pension plans, reducing the long-term deficit by 0.21% of taxable income and decreasing the deficit by 6%.

New Dedicated Taxes

Two recent proposals would create new sources of revenue for Social Security rather than increasing or extending existing sources. The 2019 bill *Social Security Expansion Act* by Sen. Sanders and Rep. DeFazio would apply a 6.2% tax on investment income as defined under the Affordable Care Act (ACA), starting in 2023 for taxpayers whose adjusted gross incomes exceed $200,000 for a single person or $250,000 for married couples filing jointly. These income thresholds would not be adjusted for inflation. All proceeds from this tax would be used to fund Social Security. This proposal would reduce the long-term actuarial deficit by 0.96% of taxable payroll, eliminating 27% of that deficit.

A bill by Sen. Van Hollen included in the *Strengthening Social Security by Taxing Dynamic Wealth Act* (2019) would return the exemption thresholds and tax rates for the estate tax, gift tax, and generation-skipping transfer tax to their 2009 levels for deaths, gifts, and transfers after 2021. The thresholds would be $3.5 million for estates and $1 million for lifetime gifts and transfers, with no adjustment for inflation; the tax rates would range from 18% to 45%. All proceeds from these taxes (not just the increase over current law) would be used to fund Social Security. This proposal would reduce the long-term actuarial deficit by 0.60% of taxable payroll, eliminating 17% of that deficit.

As with raising the contribution base but not the benefit base, discussed above, introducing revenue sources not directly connected to benefits would break the close connection between contributions and benefits, thereby risking diminishing public support for Social Security.

Policy Questions

According to the 2021 Trustees Report, without some combination of benefit decreases and tax increases, the Social Security trust funds will be depleted in 2034, at which time benefits must be reduced across-the-board to the level that can be supported by current income, which in 2034 would be about 78% of scheduled benefits. Although no single proposed tax increase described above by itself eliminates the actuarial deficit, there are many combinations of tax increases that could achieve this end.

Congress might consider the following policy questions during the coming debate over Social Security solvency:

- How much of the actuarial deficit should be addressed by increasing taxes, and how much by reducing benefits? Other Academy issue briefs discuss possible mechanisms for reducing benefits, such as changing the benefit formula and raising the normal retirement age.

- To what extent should the answer to the preceding question be influenced by changes to Medicare, the other major social insurance program for the elderly and disabled, which also faces insolvency? For example, would an increase in the Medicare tax to help shore up that program make a tax increase in support of Social Security less acceptable to workers?

- Would breaking the link between the earnings taxed during a worker's career and the benefits the worker receives after retirement, either by setting the contribution base higher than the benefit base or introducing dedicated taxes on income unrelated to benefits, undermine popular support for Social Security?

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