S. Hrg. 103-316

TAXATION OF SOCIAL SECURITY BENEFITS

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

MAY 4, 1993

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

71-835—CC WASHINGTON : 1993

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-043332-0

CONTENTS

OPENING STATEMENTS

COMMITTEE PRESS RELEASE

ADMINISTRATION WITNESSES

PUBLIC WITNESSES

ALPHABETICAL LISTING AND APPENDIX MATERIAL SUBMITTED

COMMUNICATIONS

TAXATION OF SOCIAL SECURITY BENEFITS

TUESDAY, MAY 4, 1993

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Daniel Patrick Moynihan (chairman of the committee) presiding.

Also present: Senators Bradley, Rockefeller, Daschle, Conrad, Packwood, Durenberger, and Grassley.

[The press release announcing the hearing follows:]

[Press Release No. H–17, April 30, 1993]

SENATE FINANCE COMMITTEE TO HOLD HEARINGS ON THE TAXATION OF SOCIAL SECURITY BENEFITS

WASHINGTON, DC—Senator Daniel Patrick Moynihan (D–N.Y.) today announced that the Senate Committee on Finance, which he chairs, will hold hearings on the President's proposal regarding the taxation of Social Security benefits.

The hearing is scheduled for *10:00 A.M. on Tuesday, May 4, 1993,* and will be held in room SD–215 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Moynihan said: "The President has proposed that we tax Social Security benefits more like we tax private pensions. It is a reasonable proposal. Our purpose will be to give it a full and fair hearing and to hear views from all perspectives."

Under current law, up to one-half of an individual's Social Security benefit is subject to income tax if the individual has countable income in excess of $25,000 per year ($32,000 for a couple). The President has proposed to tax up to 85 percent of a recipient's Social Security benefit, using the same income thresholds. Currently, about 23 percent of recipients pay income tax on their benefits.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. A very good morning to our distinguished witnesses and to our guests. We are here this morning to take testimony on a proposal by the administration to increase the taxation of Social Security benefits for persons above a certain income threshold.

I would like also to note that that is part of the administration's tax proposals. Also part, and not very much attended, if I could say to my colleagues, is the proposal to raise some $29 billion by removing the income ceiling of the health insurance payroll tax. It is under the Federal Insurance Contribution Act.

I do not know why this has not received more attention because it is so plainly a use of the payroll taxes—and I see Senator Durenberger nodding—as a source of general revenue without even any pretense otherwise.

The combined revenues of the Social Security trust funds are in surplus and will continue in surplus for many, many years. This is simply a way of raising revenues for other purposes, other than social insurance. This proposal has not been discussed and I hope our witnesses will mention it.

We are dealing here with the proposal by the President as part of his deficit reduction plan to increase the tax on Social Security benefits for couples with a joint income of $32,000, individuals $25,000, taking it from 50 percent to 85 percent.

The practice of taxing benefits at all dates back to the proposal of the 1979 Social Security Advisory Council which said the time had come to do this and the work of the Greenspan Commission, as we call the President's Commission on Social Security Reform in 1982 and the subsequent enactment in 1983.

I was a member of that Commission, as was our distinguished Republican leader, Senator Dole, and we decided the time had come to do what the earlier Commission had proposed. At that time we could estimate that for a life time an employee would have paid into Social Security about 8.7 percent of his or her benefits and to tax them at 50 percent was certainly not out of the order of treatment of pension funds generally. Nor would 85 percent be, since at least for the present and the prospective future it would be quite awhile before benefits paid in amounted to more than 15 percent.

On the other hand, the proposal to do this is intended clearly as part of deficit reduction. It is designed to raise revenue, just the same way the proposal to increase health insurance contributions by taking off any limit on them is a proposal to increase revenue.

We are at risk, at least I think, of losing a connection between a contributory social insurance program we have had since 1935 and moving towards a need-based welfare conditioned system. I do not know if Senator Durenberger or Senator Packwood agrees with me, but I think the issue is out there and it needs to be discussed.

With that, save to take notice, that the fourth edition of Social Security by Myers is now available for the perusal of all in a mere 927 pages, anything you need to know about Social Security can be learned from one of our most distinguished and beloved officials who came to this city from the University of Minnesota.

Mr. MYERS. Iowa.

The CHAIRMAN. No, but you were working with Professor Woody who came from Wisconsin.

Mr. MYERS. Wisconsin.

The CHAIRMAN. In 1934 to design this system, and here he is still writing about it. I think it could be noted that the group that worked with Professor Woody probably did not exceed 10 persons. Would that be about right?

Mr. MYERS. About 20.

The CHAIRMAN. Those 20 people did a good job and it is a great honor that one of them is going to be testifying for us this morning.

Senator Packwood?

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

Senator PACKWOOD. I notice in Mr. Myer's testimony that he recommends that the proceeds from the Social Security tax increase go to the general fund, instead of the Social Security trust fund.

Where the money goes is a valid issue. Indeed, it does start to move Social Security towards a means test. In all, I think we have probably means tested Social Security when we first started to tax it. In essence, we have gone at it backwards. Those who are slightly richer, they will not get as much of Social Security. We will take it away in taxes.

The CHAIRMAN. Excepting that an actuary would say we are now treating this benefit in the same way we treat other insurance.

Senator PACKWOOD. The same way you would treat other pension income.

The CHAIRMAN. Other pension income.

Senator PACKWOOD. That is correct. No matter how you cut it and slice it, it takes more money away or leaves less money in the hands of middle and upper income recipients.

The CHAIRMAN. It does.

Senator Durenberger?

OPENING STATEMENT OF HON. DAVE DURENBERGER, A U.S. SENATOR FROM MINNESOTA

Senator DURENBERGER. Mr. Chairman, just two comments. One is that because we are hearing Secretary Riley this morning on Education 2000 I am going to step out from time to time. But I will be back to participate this morning.

The second is on your initial observation relative to the removal of the cap on the HI tax. The really bothersome thing about it, of course, that we point out that it has just become a tax on income. But the bothersome thing is it is tax only on wage income.

The CHAIRMAN. Yes.

Senator DURENBERGER. And the unfairness of that, I trust, is not lost on anybody in this country and I know we sort of started this back in 1990 by raising the limit to $124,000.

The CHAIRMAN. We did.

Senator DURENBERGER. So we are not without some responsibility here. But I agree, it is something we need to deal with.

The CHAIRMAN. And it is possible to get the same result in terms of revenue by just raising the income threshold for all OASDI/HI taxes and we might want to explore that.

Well, with that, we want to welcome our first panel, noting that Mr. Hardock of the Office of the Assistant Secretary for Tax Policy, the Department of the Treasury is here. With him is Dr. Marina Weiss, who is the Deputy Assistant Secretary for Health Policy. And, of course, a mainstay of the Finance Committee staff for all these years.

Also Lou Enoff, who is the Acting Commissioner of Social Security and without in any way denigrating that position, I think it should be noted that there is no Commissioner of Social Security. The administration has not chosen to nominate one. The position has been vacant since last September, the longest such period in the history of the system. And to this Senator, a matter which is difficult to understand.

I failed to note the presence, the faithful attendance of Senator Conrad, who is here. Would you like to make an opening statement?

Senator CONRAD. No. [Laughter.]

The CHAIRMAN. Done.

Mr. Hardock, you are in the middle, so why don't you start?

STATEMENT OF RANDOLF HURST HARDOCK, OFFICE OF THE ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, ACCOMPANIED BY MARINA L. WEISS, PH.D., DEPUTY ASSISTANT SECRETARY FOR HEALTH POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. HARDOCK. Thank you, Mr. Chairman and members of the Committee. I am pleased to be here today to present the views of the Treasury Department on the administration's proposal regarding the taxation of Social Security benefits.

As you know, that proposal would revise the rules for taxing Social Security benefits, to make them more consistent with the rules for taxing benefits under private retirement plans.

I have a longer written statement that I would ask be included in the record in full.

The CHAIRMAN. Without objection.

[The prepared statement of Mr. Hardock appears in the appendix.]

Mr. HARDOCK. Let me emphasize at the start that the Social Security proposal should not be viewed in isolation, but should be seen as part of the President's overall program to revitalize the Nation's economy. An indispensable element of that program is deficit reduction.

As President Clinton has said, for more than a decade, large Federal budget deficits have been draining the pool of private savings and cutting into the rate of capital formation. The net result has been a slowdown in the rates of growth of productivity and real incomes of the American worker.

To turn this situation around, it is essential to shrink future Federal budget deficits. This cuts the government's demands on the financial markets, reduces interests rates, and stimulates private investment. Already there have been sizable declines in long-term interest rates, due in large part to favorable market reaction to the administration's budget deficit reduction proposals.

In achieving deficit reduction, we must ensure that all groups contribute and do so equitably. The current proposal was designed with that principal clearly in mind.

The OASDI programs under the Social Security system provide monthly benefits to retired workers, to disabled workers under age 65, and to their survivors and dependents. OASDI benefits are funded in part through employer contributions, in part through employee contributions, and in part through earnings on those contributions. Employer contributions are made on a pre-tax basis while employee contributions are made on an after-tax basis.

Under current law, the full amount of any retirement and disability benefits provided under a private retirement plan is generally subject to tax when it is received. However, if a retirement plan provides for after-tax employee contributions, a percentage of each periodic payment received is excluded from gross income. The percentage excluded is generally the ratio of the amount of the employee's after-tax contributions to the total benefits that the employee could expect to receive, calculated when the payments first began. This ratio is generally called the exclusion ratio. For private pensions the exclusion ratio is reduced to zero once the employee's investment in the contract has been fully recovered. Similarly, if the employee dies before the investment has been fully recovered, the unrecovered amount may be deducted in the employee's last taxable year.

These rules ensure that contributions to a retirement plan and earnings on those contributions are taxed once and only once.

Although the OASDI programs provide benefits that are essentially equivalent to the retirement and disability benefits under private retirement plans, they are not taxed in the same manner under current law.

First, most lower-income taxpayers are completely exempt from tax on their Social Security benefits. Social Security benefits are only included in income and, hence, subject to tax for taxpayers with modified adjusted gross incomes above thresholds of $25,000 for individual taxpayers and $32,000 for married taxpayers filing a joint returns.

In effect, taxpayers with incomes under those thresholds have a 100 percent exclusion ratio. In 1990, about 83.6 percent of returns with Social Security benefits were exempt from tax on those benefits under this rule.

Moreover, taxation of Social Security benefits above the $25,000 and $32,000 thresholds is phased in. Under current law, higher income taxpayers are required to include in gross income the lesser of 50 percent of their Social Security benefits or a phase-in amount based on one-half of their income above the thresholds.

The administration's proposal would make the rules for taxing Social Security benefits more consistent with the rules for taxing benefits under private retirement plans, by increasing the maximum taxable portion of Social Security benefits from 50 to 85 percent.

In effect, this change would reduce the minimum exclusion ratio for higher-income taxpayers who are subject to tax on their benefits from 50 to 15 percent. The Social Security Administration has calculated that, under the economic and demographic assumptions used for projecting the actuarial soundness of the Social Security system over the next 75 years, and assuming no changes in current law, no groups of past, current, or future retirees would have exclusion ratios higher than 15 percent.

Additional receipts resulting from the change would be paid into the hospital insurance (HI) trust fund, which is otherwise expected to be exhausted in 1999.

The administration's proposal would place higher income retirees with high lifetime earnings and long earnings histories in approximately the same position as they would be under the tax rules applicable to private retirement plans.

But by maintaining the current income thresholds, most retirees would be unaffected by the administration's proposal. Significantly, the proposal would not subject any Social Security recipients to tax on their benefits if their benefits are not already subject to tax.

The administration's proposal will affect primarily higher-income taxpayers. Of those expected to receive Social Security benefits in 1994, 4.4 million are projected to have family economic incomes over $75,000. Within that group of the highest income elderly, those paying additional tax will pay an average of $90 per month in additional taxes, representing almost 70 percent of the total revenue raised by the proposal.

Available data suggests——

The CHAIRMAN. Mr. Hardock——

Mr. HARDOCK. I have one paragraph left.

The CHAIRMAN. I do not want to interrupt you. But I do want to know, why are we talking about persons with family economic incomes over $75,000? What does that have to do with your proposal?

Mr. HARDOCK. This is to illustrate who will be paying most of the additional tax.

The CHAIRMAN. Why are you illustrating it at $75,000 and not $25,000?

Mr. HARDOCK. One could also illustrate it at $25,000.

The CHAIRMAN. You could, Mr. Hardock, and it is not very welcome. This committee does not welcome that sort of evasion. You are proposing to increase the tax on person who have adjusted gross incomes of $25,000; and you come before this committee talking about people with family economic incomes of $75,000.

That is not forthright, sir. And I am going to have to say to you, I am disappointed. But go ahead.

Mr. HARDOCK. I am sorry, Mr. Chairman. We would be glad to provide you with that information.

The CHAIRMAN. You surely will if you want us to take it up at all.

Mr. HARDOCK. We will certainly do so.

The CHAIRMAN. Thank you.

[The information appears in the appendix.]

Mr. HARDOCK. Available data suggest that filers in these income categories generally have high net worths, averaging over $1 million.

The committee has requested comments on the Lautenberg amendment to the budget resolution, expressing the sense of the Senate that the Finance Committee should try to avoid any increases in taxes on OASDI benefits for beneficiaries with incomes of less than $32,000 for individual taxpayers and $40,000 for married couples filing joint returns.

The Treasury Department understand that if the amendment were followed, the administration's proposal would only apply to beneficiaries with incomes over those dollar thresholds, while beneficiaries with incomes under those thresholds would continue to be subject to current law without any change in the base amounts under current law.

Based on that understanding, the Department does not support the higher threshold specified in the Lautenberg amendment. The change suggested would work against the goal of parity between recipients of OASDI benefits and those under private pension plans.

Also, the proposed modifications would add significant complications to the rules for calculating the extent to which Social Security benefits are taxed. Those complications would apply for all individuals, even though a relatively small number of taxpayers would benefit from the proposal.

Mr. Chairman, that concludes my formal statement. I would be pleased to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. Hardock.

Dr. Weiss?

Dr. WEISS. I do not have a statement for the record, Mr. Chairman.

The CHAIRMAN. All right.

Mr. Enoff?

STATEMENT OF LOUIS D. ENOFF, ACTING COMMISSIONER OF SOCIAL SECURITY, BALTIMORE, MD

Mr. ENOFF. Thank you, Mr. Chairman. I appreciate the opportunity to be here. I think that the most assistance I could provide today would be to review the history of Social Security taxation and to talk about the administration's proposal and its impact on the Hospital Insurance (HI) trust fund and on Social Security beneficiaries.

With your permission, I would submit my entire written statement for the record.

The CHAIRMAN. Please. We would be happy to do that.

Mr. ENOFF. Thank you.

[The prepared statement of Mr. Enoff appears in the appendix.]

Mr. ENOFF. As you indicated earlier, this issue, whether Social Security benefits should be taxed, and if so, to what degree, is not a new one. Even though the IRS in 1941 ruled that Social Security benefits were not taxable income, many questioned this decision. They wondered why private pension benefits should be taxed as ordinary income once an employee had recovered his or her own contributions, and why Social Security benefits should have tax-free treatment.

The 1979 Advisory Council on Social Security agreed and concluded that Social Security benefits should be treated more like private pensions for tax purposes. The Advisory Council recommended that one-half of Social Security benefits be included in taxable income for Federal income tax purposes. The rationale was that employers pay 50 percent of the total Social Security contribution on employees' wages.

In 1983, as you previously mentioned, the bipartisan National Commission on Social Security, the Greenspan Commission, recommended, as you well know, that one-half of Social Security benefits be subject to taxation, with the revenues being credited to the OASI and DI trust funds.

This recommendation was intended to improve the financial soundness of the Social Security reserves which then were badly in need of improvement, as we recall. The law as it currently stands does say that up to one-half of Social Security benefits are included in taxable income for those taxpayers whose combined income is above the threshold of $25,000 for individuals or $32,000 for married couples filing joint returns.

The administration proposes to increase the ceiling from 50 percent to 85 percent. The amount of benefits to be taxed would be the lesser of 85 percent of benefits or 85 percent of the excess of the taxpayer's combined income over the threshold amount.

It's important to reiterate that the threshold levels do not change and, therefore, those whose benefits are not subject to taxation under current law will not be subject to taxation under the administration's proposal.

The rationale for this proposal parallels the reasoning used by the 1979 Advisory Council on Social Security because raising the ceiling to 85 percent brings the tax treatment of Social Security benefits more closely in line with tax treatment of private and public service pensions.

Setting the level at 85 percent ensures that no group of workers would be taxed more than they would be under private pension rules. The additional revenue generated would be $1.7 billion in fiscal year 1994 and $23.3 billion over the next 5 years. That increased revenue would be credited to the Hospital Insurance Trust Fund and would improve its financial position.

That trust fund, according to our latest report, is projected to be exhausted in 1999. So, in summary I would say that there are two points that I would make in my testimony. Number one, this proposal does not increase the number of beneficiaries paying taxes on their Social Security benefits. Number two, it does bolster the fiscal health of the Hospital Insurance Trust Fund.

With that, I would conclude, Mr. Chairman.

The CHAIRMAN. Thank you very much for very careful testimony.

I just want to raise two points. First, we have just learned from the Joint Committee on Taxation that they estimate that this tax measure will raise $32 billion over the 5-year period. You have just said your estimate is $23.3 billion, which is what we understand it to be.

Is this news to you?

Mr. ENOFF. This is news to me. Let me check with the Chief Actuary. Have you heard that?

[Pause.]

Mr. ENOFF. Mr. Ballantyne informs me that it may be using a different basis or assumption. I'm going to ask Mr. Ballantyne to join me since he's the Chief Actuary of the Social Security Administration.

The CHAIRMAN. Mr. Ballantyne, we welcome you.

Mr. ENOFF. Why don't I just let him repeat what he told me.

The CHAIRMAN. You aren't trying to pass the buck, are you?

Mr. ENOFF. No, I am not. But I am trying to allow the expert to speak.

Mr. BALLANTYNE. Mr. Chairman, I think that estimate was based on different assumptions and I believe it's on a liability basis, while the $23.3 billion is on a collection basis. But the $23.3 billion is the estimate from the Treasury Department.

The CHAIRMAN. Well, I know that. [Laughter.]

We both know that. But why?

Mr. BALLANTYNE. Well, the Treasury Department may have——

The CHAIRMAN. Well, you find out because we have absolute confidence in you.

Mr. BALLANTYNE. Our estimate was very close to the Treasury estimates, about the same as the Treasury estimates. So I think it is a good estimate.

Mr. ENOFF. Our estimate was within $1 billion, as I recall. But we will certainly go back and check.

The CHAIRMAN. $9 billion. Straighten it out. Will you, Harry? I am sure you will.

Now what is this business of the trust funds being exhausted in 1997?

Mr. BALLANTYNE. HI——

Mr. ENOFF. Yes, in 1999.

The CHAIRMAN. The combined trust fund paid for by the payroll tax, Federal Insurance Contribution Act, they aren't going to be exhausted for this century or well into the next 3 decades. I mean we have always talked about the combined trust funds. We have shifted percentages back and forth.

I guess we have three accounts, isn't that right, in which we put this tax?

Mr. ENOFF. Well, DI, OASI and HI.

The CHAIRMAN. And HI, right.

Mr. ENOFF. The three we are talking about.

The CHAIRMAN. And we have shifted back and forth as one seemed to fill up and another seemed to slow down. What is the combined state of the trust funds?

Mr. BALLANTYNE. Well, I think the combined funds—I am not sure of the exact date, but I think it will probably be between 2015 and 2020 that they would become exhausted.

[The information requested follows:]

Based on the intermediate assumptions in the 1993 Trustees' Reports, the combined OASI, DI, and HI Trust Funds are expected to be exhausted in 2013.

The CHAIRMAN. That is right. Not insolvent, but, you know, the surplus will have been paid out, which is what you said, somewhere between 2015 and 2020. So I do not think it helps to come before this committee talking about one particular account, one of the three trust funds when the trust funds in the whole are more than solvent.

What will the Federal Government spend in the way of Social Security surplus next year as if it were general revenue? I will tell you, about $85 billion. All right?

Mr. ENOFF. You are talking about what we would receive and would lend to the general revenues out of the trust fund?

The CHAIRMAN. Yes.

[The information requested follows:]

Based on the intermediate assumptions in the 1993 Trustees' Reports, the excess of income over outgo in fiscal year 1994 is estimated to be $59.7 billion.

Mr. ENOFF. Yes, correct. I was trying to make sure I understood you first.

The CHAIRMAN. Sure.

Mr. ENOFF. That is correct.

The CHAIRMAN. I do not want to question you more. This is not a quiz. These trust funds are in surplus. They are in surplus well into the next century. This surplus was put in place in the Social Security amendments of 1977. No administration since—none, not Carter, not Reagan, not Bush, and now not Clinton—has made any provision for the use of this to save the surplus. Rather, it is now unabashedly being used as general revenue.

We are using payroll taxes to pay the interest on a $4 trillion debt, now going to $5 trillion.

Now, could I ask you all about the proposal to increase the health insurance contribution? It has no relationship to benefits whatever.

Bob Myers began in 1935 a contributory social insurance system. That is why people have Social Security numbers, that is why they have their accounts. What do you want to say about this proposal on health insurance which raises $29 billion? Does the trust fund need it?

Mr. ENOFF. Mr. Chairman, you have expressed your views on whether the trust fund needs it. I think the arguments are the same as to those that apply in the case of the transfer of the 85 percent taxation of Social Security trust funds. Legislative language would be needed to transfer funds from the OASI or DI Trust Funds.

The CHAIRMAN. Well, sure.

Mr. ENOFF. To the HI Trust Fund.

The CHAIRMAN. We know that. The legislative language is one sentence.

Mr. ENOFF. Exactly. Legislative language is needed either way. But under current law, the HI Trust Fund——

The CHAIRMAN. We do not. The committee has been handling this legislation for 57 years.

Senator Packwood?

Senator PACKWOOD. Let me ask you an arcane, however, procedural question. If this money went into the Social Security old age fund and then we pass legislation to transfer it to the HI fund, that would be subject to a 60 point of order on the floor, would it not?

Mr. HARDOCK. That is correct, Senator Packwood.

Senator PACKWOOD. And so instead of going the route we would normally go, which would be circuitous if you take it directly from the tax revenues to the HI fund, it obviates the 60 point of order.

Mr. HARDOCK. I am not sure that that would be the normal course. The normal course would take the additional revenue and put it where you think it belongs directly.

Senator PACKWOOD. It is unusual—I am trying to remember, and refresh my memory, where we have taken taxes and given it to a different, an unrelated trust fund. Tell me when we have done this before with Social Security.

Mr. ENOFF. Unrelated?

Senator PACKWOOD. Well, what in essence you are taking is the taxes on the Social Security and you are putting them in the HI fund rather than the Social Security fund.

Mr. ENOFF. Well, I think I would agree with the Chairman that the trust funds are related.

Senator PACKWOOD. Well, all right. We have not done it in that fashion. There are three separate funds. They are all part of Social Security. That I understand.

Mr. ENOFF. That is correct. There has only been one taxation of benefits provision, the 1983 provision: 50 percent taxation and the revenues went to the OASI and DI funds.

Senator PACKWOOD. And not the HI fund?

Mr. ENOFF. Not to the HI fund at that time. That is correct.

Senator PACKWOOD. I have no other questions.

The CHAIRMAN. I could say thank you, Senator Packwood. Again, to say to you, you know, the Joint Committee on Taxation, their estimates of April 23 put this measure as bringing in $31,998,000,000.

Now you ought to know about this when you come before this committee. You ought to have some view of why it happened. We will await your view in writing. But we ought to have it by the end of the day.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman and members of the panel. What percentage of Social Security recipients pay no tax under current law on their Social Security benefits?

Mr. ENOFF. About 76.

Mr. BALLANTYNE. Between 22 and 24 percent pay taxes.

Senator CONRAD. Between 22 and 24 percent pay. So between 76 and 78 percent pay nothing on their Social Security benefits under current law?

Mr. ENOFF. That is correct.

Senator CONRAD. What would happen under the administration proposal?

Mr. ENOFF. The percentage would remain the same, Senator. The amount that is paid by those who pay would go up.

Senator CONRAD. And so 76 to 78 percent of Social Security recipients would pay nothing on their Social Security benefits under the administration proposal?

Mr. ENOFF. That is correct.

Senator CONRAD. And the 22 to 24 percent that do pay something would see an increase in what they pay?

Mr. ENOFF. That is correct.

Senator CONRAD. Can you give us some sense of how much of an increase they could expect?

Mr. ENOFF. I can tell you the average and, of course, no one is average. But the average is $720 in taxes that they pay now and I think that would go up to about $1,270.

Senator CONRAD. So they currently would be paying, those 22 to 24 percent of Social Security recipients who pay something, under current law would see an increase and the increase would be in the $550 range per year on average?

Mr. ENOFF. That is correct.

Senator CONRAD. What is, in your mind, the best argument that you have heard to do this?

Mr. ENOFF. Well, I think the rationale is certainly that private pensions are taxed in this manner; and this would make the taxation of Social Security benefits conform to the taxation of private pensions. That is, exempting that portion that the employee contributes.

Senator CONRAD. And what is the strongest argument you believe you have heard against this proposal?

Mr. ENOFF. Well, the only question would be the taxation of someone at a lower income. And, of course, $25,000 in income is above the average wage. So I am not sure I could characterize as strong any of the arguments that I have heard against this proposal.

Senator CONRAD. And a single person with $25,000, how much additional would they be expected to pay?

Mr. ENOFF. Of course it depends on their benefit.

Senator CONRAD. Let's assume they had an $8,000 Social Security benefit.

Mr. ENOFF. Okay. I will do a rough calculation. But the Chief Actuary has his calculator here, so I will let him give me a number rather than trust my math.

Mr. BALLANTYNE. Well, I have an example. If the benefit is $8,000, and if his other income is, say, $22,000, so he is just barely above the threshold, then the excess is $1,000; and the amount to be included over present law would be $350, which at 15 percent would be $52.50 for that one example.

Senator CONRAD. $52.50 for that example?

Mr. BALLANTYNE. Right.

Senator CONRAD. What if you had a couple that was $32,000—$8,000 Social Security benefit?

Mr. BALLANTYNE. $8,000 in benefits at $32,000. Assuming that they have $32,000 in other income, which is—let's take $30,000 in other income. I have not worked this one out.

Senator CONRAD. That is fine.

Mr. BALLANTYNE. You include half of the $8,000. It brings them up to $34,000. So they have $2,000 in excess.

Senator CONRAD. $1,700 times 15 percent, that would be——

Mr. BALLANTYNE. $1,700 would be taxable—$700 more than under present law, which at 15 percent is $105 more for the couple.

Senator CONRAD [continuing]. $105 that they would expect. All right. I just wanted to get those things in perspective.

Thank you, Mr. Chairman.

The CHAIRMAN. We thank you. And not for the first time we note that our newest member is a former tax commissioner. [Laughter.]

The CHAIRMAN. Thank you, Senator Conrad.

Senator Grassley?

Senator GRASSLEY. Thank you, Mr. Chairman.

The administration has made the argument that the increase in the appropriation for the low income heating assistance program and also the expanded earned income tax credit will offset the other increases in taxes such as BTU tax and Social Security tax and I suppose other taxes as well.

Now you probably know that that argument will not entirely apply to this group of citizens that the increased Social Security tax will apply to because, you know, you have to be under $5,000 without kids to get an earned income tax credit and a lot of these people are older Americans that live off of interest and investment and would not qualify for the earned income tax credit either.

Have you or the administration run any numbers of how many older Americans will not have these new taxes mitigated by other provisions of the President's plan like the earned income tax credit?

Mr. HARDOCK. The impact of the energy tax will be passed through to an extent in increased Social Security COLAs in future years. That will benefit all senior citizens. The proposals that the President has put on the table to offset the impact of the energy tax have been targeted towards those that would be most affected, the lowest income portion of the population.

The group that is affected by the changes in the taxation of Social Security are not low income. They are the highest 20 percent of senior citizens by income, many of whom have substantial wealth.

Senator GRASSLEY. Well, I would like to acquaint you with at least one constituent I know very personally, who in 1940 started working for F.W. Woolworth—that is a New York corporation—for $8 a week. Worked there for 46 years and retired at about $16,000.

You know, it is not what money you make, it is how much you spend that makes a difference, it is whether or not you put money away to save. And I suppose this constituent saved a lot, even from a relatively low income.

This constituent would have paid $641 more this past tax year if she would have had to pay on 85 percent on her Social Security as opposed to 50 percent of her Social Security.

You know, it is one thing to inherit a lot of money. It is another thing to work hard and save because you do not spend a lot. And it seems to me that, in this particular motion, we have said to those people who have worked hard, saved money, lived very frugally, that now all of a sudden you are rich and you can pay more taxes. That just is not true.

We are talking about a lot of people that know that Social Security is only a foundation for building a retirement plan and they know throughout a life time they have had to work and save so that they would have other income if they wanted to live fairly decently during retirement.

And not all these people are high income, I hope you realize. And that maybe those that are high income have lived frugally throughout a life time to save for retirement and now we are going to take it away from them.

Mr. Chairman, I have no further questions at this time.

The CHAIRMAN. Thank you, Senator Grassley.

No member of this committee is more informed on matters concerning the hospital insurance trust fund than Senator Rockefeller and we turn now to you, sir.

Senator ROCKEFELLER. Mr. Chairman, you are inaccurate in that you know five times more than I do. But I appreciate the compliment.

Mr. Hardock, let me ask you this. We have a budget deficit crisis, do we not?

Mr. HARDOCK. The President certainly believes so.

Senator ROCKEFELLER. If you are going to solve a budget deficit we have to do some hard, tough things. It always interests me that in Congress we are very good at saying in general terms that we have to reduce the budget deficit, but when it gets down to making tough decisions it is harder for us to say and do.

Now in 1983 our Chairman was—were you not, you were Chairman of that?

The CHAIRMAN. I was a member of the Commission.
Senator ROCKEFELLER. A member of the Commission.
The CHAIRMAN. Yes. Alan Greenspan was Chairman then.
Senator ROCKEFELLER. That is right. And they made at that time, was it not, the historic decision to make it at 50 percent?
The CHAIRMAN. That is correct.
Senator ROCKEFELLER. That was at that point.
Now back before 1983 I do not know what our budget deficit was. Less than $100 billion, was it not?
Mr. HARDOCK. That sounds about right.
Senator ROCKEFELLER. It was on the way up. Has not one of the guiding principles been in American history that if you are going to solve a problem that affects the whole Nation, and in fact the deficit is the kind of problem which could bring the entire Nation down and the deficit reduction package if we fail to pass it, it could bring this Nation down. I mean it really could.
Mr. HARDOCK. We are in a very serious budgetary crisis.
Senator ROCKEFELLER. And the voters understand that, the Clinton voters, the Perot voters understand that, and the Republicans understand that, too.
Now has it not also been our principle generally that when we go at very hard problems that we all should try to ensure that—everybody does their share, nobody has to do everything, but nobody gets off scott free?
Mr. HARDOCK. That is correct, to try and identify proposals that are fair.
Senator ROCKEFELLER. And is it not correct that the rate of poverty for children in 1990 in this country, for example, is 20 percent?
Mr. HARDOCK. You would know best given you are Chairman of the Children's Commission.
Senator ROCKEFELLER. It was. And that the general rate of poverty in 1990 was 14 percent; and the rate of poverty for seniors was 12 percent. Then, therefore, the proposition that my mother, who recently died, was paying 50 percent rather than 85 percent and that were she living and others—and my mother obviously would be a rather exaggerated example—but there are a lot of people who have means—you cannot assume that they do not want to be a part of the solution of the country which they helped build. Is that not correct?
Mr. HARDOCK. I think that is correct. We have heard from many people who are very supportive of the program.
Senator ROCKEFELLER. And you get the tremendous criticism when you begin to do things which are unfair, which was what happened with catastrophic health care, although to me was one of the greatest bills this Congress ever passed. With that bill, we made the mistake of putting everything on one group of people.
And what we are doing here is we are going to all groups of people. In other words, we are considering corporate income. We are considering personal income. We are considering an energy tax. And then we have to look to everybody.
Mr. HARDOCK. That is correct. One of the first points I made in my statement is we need to look at this proposal as part of the

overall President's program and the sacrifices that are being requested of all Americans.

Senator ROCKEFELLER. One of the concerns that I think you would have is the Medicare trust fund and what is going to happen to it. If this were to fail to pass, this proposal with respect to Social Security, what would be the affect on the Medicare trust fund?

Mr. ENOFF. I think this proposal by itself would add about a little more than a year to the life of the Medicare trust fund, which is now due to go broke in 1999. This proposal by itself would add a little over a year to that.

Mr. HARDOCK. Senator, I think that Senator Moynihan addressed this issue a little bit earlier. Clearly, if no change is made, the HI trust fund is in serious jeopardy before the end of the century.

The money raised from this proposal and other proposals in the President's budget will extend the period of time prior to the funds going broke. There are other mechanisms that could be used, as the Chairman has mentioned to avoid that result.

Ultimately, the problems of the HI trust fund have to be dealt with through comprehensive health care reform, and you are working very hard towards that end.

Senator ROCKEFELLER. Right. I guess I would just end what isn't really questioning, but just sort of thoughts, that back in 1983 we had a tremendous crisis and the country met it and it was called Social Security. Now we have got an impending crisis called Medicare and we have an immediate crisis called the budget deficit.

Three or 4 years ago I was not as conscious of the budget deficit as I am today. I now see budget deficit as stopping all possible things that might happen in Appalachia, for example, or across the country.

And so we have this next crisis now 10 years after the Social Security crisis and we have to solve it. And as far as I know, there are not any easy ways to do that. And as far as I know, Senators do not want to vote on tax increases on anybody for any reason ever. And when we do, sometimes it is because we really do have to. It would seem to me this is one of those cases.

I thank the Chair.

The CHAIRMAN. I thank Senator Rockefeller, not least for the novel notion that if you are going to get anybody mad at you, you might as well get everybody mad at you. It makes perfect sense. [Laughter.]

Senator Bradley?

Senator BRADLEY. Thank you very much, Mr. Chairman. I wonder if anyone at the table could take Senator Grassley's example of a taxpayer who would end up paying $631 more because the amount of Social Security subject to tax would go from 50 to 85 percent, and tell me how much income that person would be making, roughly?

We can go on and then I will come back to you for the answer, unless you already have it.

Senator GRASSLEY. It is $641.

Senator BRADLEY. Sorry, $641.

Senator GRASSLEY. And remember, the point was that I was trying to make, this person's low income throughout their working years of 46 years at F.W. Woolworth, all 46 years were at F.W. Woolworth.

The CHAIRMAN. Not showing $8 a week?

Senator GRASSLEY. No, he started out at $8 a week and ended at about $16,000 a year.

Senator BRADLEY. But, you know, most of us are low income at one time, when we start.

Senator ROCKEFELLER. Not all of us. [Laughter.]

Senator GRASSLEY. Even at $15,000——

Senator BRADLEY. I was hoping he would make my point. [Laughter.]

So if you could just calculate that.

Mr. ENOFF. I think Mr. Ballantyne can give you a calculation. It does depend though——

Senator BRADLEY. I know there are a lot of contingencies. But basically what we want to get is just a rough area. I will come back to you. Raise your hand when you have it.

Could you tell me if we moved to 85 percent from 50 percent, how will this compare with the way private pensions are treated?

Mr. HARDOCK. They will be roughly the same.

Senator BRADLEY. Could you explain why that is so?

Mr. HARDOCK. The IRS computes the taxation based on the proportion that has been contributed by the wage earner. That is the basis that this would be going.

Senator BRADLEY. You mean that the normal private pension usually contributes about 15 percent of the actuarial expected benefits, something like that?

Mr. HARDOCK. In the case of the private plan, an actual exact calculation is constructed. The 15 percent used as a proxy in Social Security taxation in the President's proposal essentially is a worst case example, using the assumptions that the Social Security actuary has determined are appropriate.

For most people, if we actually applied the private pension rules completely to Social Security benefits, significantly more revenue would be raised, more taxes would be raised. For example, there are no $25,000 and $32,000 thresholds on the private side. So, the Social Security rules are still significantly more generous than the rules on the private side.

This proposal moves it closer to the private side rules for high income taxpayers. The President did not want to increase the level of tax paid by the about 80 percent of Social Security recipients who were not in the higher income classes. He did not feel they could afford it. Many of them obviously cannot.

Senator BRADLEY. But in no case will the people who will be asked to pay an increased tax on their Social Security be treated less generously than a private pension plan; is that correct?

Mr. ENOFF. Yes.

Senator BRADLEY. And no one who will be asked to pay more under this proposal is not now paying tax. Is that correct?

Mr. HARDOCK. Yes, sir.

Senator BRADLEY. The only people who are paying tax now are those who are already in the upper 20 percent.

Mr. HARDOCK. That's correct.

Senator BRADLEY. Do you think that we could have any serious deficit reduction proposal without touching entitlements in some way?

Mr. HARDOCK. I think that the question of cutting spending is very important and entitlement programs are a part of the President's budget. I think there is a dispute on how Social Security is treated in that debate.

Senator BRADLEY. Why do you think this is a better approach than delaying the cost of living adjustment or spreading it over a longer period of time?

Mr. HARDOCK. With respect to the affected individuals, this is much more progressive. If you were comparing the two proposals, this affects high income Social Security beneficiaries.

The COLA would affect, for example, a poor widow with low income living on nothing but her Social Security check. This would have no affect on that person.

Senator BRADLEY. And no affect on, what, 80 percent of the Social Security recipients?

Mr. HARDOCK. Correct. Whereas, as COLA adjustment——

Senator BRADLEY. Would affect 100 percent of Social Security recipients. How many senior citizens if you did a COLA adjustment would be pushed below to the poverty level?

Mr. ENOFF. We have that number. I am going to have to supply it to you for the record though, Senator. I do not have it with me.

[The information requested follows:]

If there were no cost-of-living adjustment for January 1994, 260,000 beneficiary families would be pushed below the poverty level in 1994.

Senator BRADLEY. Before we go, do you have your calculation?

Mr. BALLANTYNE. It would be other income of about $30,540, if the Social Security benefit is about $16,000 for a couple. Then their total income would be about $46,540 and I think the increase in the tax would be around $640 at a marginal tax rate of 28 percent.

Senator BRADLEY. So you would have to be earning in total about $46,000, over $46,000?

Mr. BALLANTYNE. Yes.

Senator GRASSLEY. This particular instance is a single person.

Mr. BALLANTYNE. Okay, single. Then it would have to be a different amount.

The CHAIRMAN. Well, why don't we ask Mr. Ballantyne to give us an example. You do not have to do it this instant. But by the end of the day, you will have it. You are moving very well already.

[The information requested follows:

The income of a single person paying $641 more in taxes on benefits under the proposal, depends on several factors. One example is attached.

INCREASE IN TAXES ON BENEFITS FOR A SINGLE TAXPAYER RECEIVING SOCIAL SECURITY BENEFITS, UNDER THE PROPOSAL TO TAX UP TO 85 PERCENT OF BENEFITS

	Present law	Proposal	Increase
Social Security benefit:			
Monthly	$645	$645	
Annual	7,740	7,740	
Other income	27,670	27,670	
Other income plus half of benefits	31,540	31,540	
Excess over $25,000	6,540	6,540	

INCREASE IN TAXES ON BENEFITS FOR A SINGLE TAXPAYER RECEIVING SOCIAL SECURITY BENEFITS, UNDER THE PROPOSAL TO TAX UP TO 85 PERCENT OF BENEFITS—Continued

	Present law	Proposal	Increase
Taxable amount of benefits	3,270	5,559	$2,289
Tax, @ 28%	916	1,557	641
Total income before taxes	35,410	35,410	....
Total income after Social Security tax	34,494	33,853	−641
Total income after Social Security tax as a percent of total income before taxes	97.4%	95.6%	−1.8%

Senator GRASSLEY. Mr. Chairman, could I ask one more question?

The CHAIRMAN. Of course you could. Yes.

Senator GRASSLEY. I want to get back to the questions about what might be the cumulative impact, whether or not in your research you have had any data on the cumulative impact on elderly of the projected increases of the percentage of Social Security benefits subject to income tax, plus proposed BTU tax, plus the proposed Medicare premium increases in the President's budget.

How many people might be affected and what the impact might be.

Mr. HARDOCK. I am not aware of any specific data that have been collected, focusing entirely on the elderly. There are data that have been prepared on various income classes equally across the board to all taxpayers on the energy tax, for example.

In this proposal, we have found that for those with income under $40,000 per year, only about 3.5 percent would be paying any additional amounts, and they would be paying an average of $23 a month.

Senator GRASSLEY. I guess another thing that would concern me would be about the cumulative impact and not only of those Federal taxes, but of State taxes, where there is an integration of the Federal income tax and the State income tax on this very same group of people. I do not suppose you have anything on that either.

Mr. HARDOCK. That would be another factor to take into account.

Dr. WEISS. I would like to make one point, Senator Grassley, with respect to the premium increases. While they do represent an increase over current law, as a consequence of the 1990 amendments, the premium increase that is currently written into the law would expire, and this is simply a continuation of the percentage of premium that was established in the 1990 budget summit agreement.

So it is a continuation of a current structure.

Senator GRASSLEY. Without a cap. As opposed to the cap that was in the 1990. On the Medicare premium there was a gap at $125,000 or $130,000.

Dr. WEISS. No, sir. I am speaking to the issue of the premium paid by beneficiaries on a monthly basis.

Senator ROCKEFELLER. Mr. Chairman?

The CHAIRMAN. Yes.

Senator ROCKEFELLER. Could I just add.

The CHAIRMAN. Please.

Senator ROCKEFELLER. See, this is very interesting. I will ask this question of Dr. Weiss. With this line of questioning, we can say in other words, now let us take the BTU tax, and let us take this tax, and let us take another tax and add them up. And that is sort of like saying that is the only thing going on in government.

One of the things we are considering simultaneously is health care reform. Dr. Weiss, for seniors, for example, it is generally considered around town if one puts one's ear to the rail, there is a reasonable chance there may be a prescription drug benefit in the comprehensive benefit package. There may be some home and community-based health care.

Dr. WEISS. Those are certainly options under consideration, Senator.

Senator ROCKEFELLER. And what would be the affect, for example, on the same seniors that Senator Grassley is discussing were these proposals become to come into law at about the same time that the Senator is predicting that these tax increases might become law?

Dr. WEISS. Well, I think it is fair to say that the options for how they might be financed, these additional benefits, are still open. But, obviously, there is contemplated a rather dramatic increase in the scope of benefits under the Medicare program for the elderly, yes.

Senator ROCKEFELLER. Yes. So I mean in some things we sacrifice as we try to restore our country to health and in some things we also for other reasons we gain and life is like that.

Thank you, Mr. Chairman.

The CHAIRMAN. Life is like that. We thank you very much, Mr. Hardock, Dr. Weiss, Mr. Enoff, and Mr. Ballantyne. You take your calculators back to the room and by the end of the morning we will know all of those things.

But we do want to hear from you about the discrepancy between the estimates from the Treasury and the Joint Committee on Taxation. There is $9 billion, which is not a small amount.

Mr. HARDOCK. We will try to get you an answer to that by the end of the day.

[Information requested appears in the appendix.]

The CHAIRMAN. We are now going to hear a panel of distinguished witnesses, some of whom have been involved with the Social Security system from its inception, others have worked with it for long and productive years. We have Robert Ball and Robert Myers, two eminences.

My goodness, it takes a lot of people from the Treasury to back up one witness.

We are going to hear from Dr. Letitia Chambers, who is president of Chambers Associates; Dr. Eugene Steuerle, who is with The Urban Institute; and Professor Jonathan Forman, a new title for an old friend.

I am going to ask the former witnesses to let us proceed now. All right, that about does it. In the order that they are listed in the witness list, we begin with Robert Ball, the Commissioner of Social Security from 1962 to 1973, and a man who joined the program in the 1930's, I believe, and has remained close to it, committed to it, ever since.

We will just go right ahead. Is that all right with you, Senator Packwood?

Senator PACKWOOD. Yes, Mr. Chairman.

The CHAIRMAN. We will just hear all of our witnesses. I will invite you to comment, if you will, on this matter of taking off any income ceiling for the hospital insurance portion of the payroll tax, which seems to me to be a discouraging omen. We are using the payroll tax for general revenue purposes in a very unashamed manner. But that might not be your view and we want to hear it in any event. Mr. Ball?

STATEMENT OF ROBERT M. BALL, COMMISSIONER OF SOCIAL SECURITY (1962–1973), WASHINGTON, DC

Mr. BALL. Mr. Chairman, if I may submit my statement for the record.

The CHAIRMAN. Please do. That will be the case with each of you.

Mr. BALL. And then I will summarize quite briefly, I think.

[The prepared statement of Mr. Ball appears in the appendix.]

Mr. BALL. I have waited a long time for this proposal. I have been for taxing Social Security benefits in the same way that government career plans and private pensions are taxed for 30 years.

When Stanley Surrey was Assistant Secretary for Tax Policy in the Kennedy administration, he and I tried to get Social Security benefits taxed. I was a member of the 1979 Advisory Council that recommended they be taxed. In neither case did we make any converts on the Hill.

Then you will remember that in the 1983 recommendations by the National Commission on Social Security Reform, I among others, was quite influential in getting them taxed, at least to the point of 50 percent.

The CHAIRMAN. Could I just interject to say I was an Assistant Secretary of Labor when Stanley Surrey was Assistant Secretary of Treasury. He not only tried to get these benefits taxed, he tried to get everything taxed. [Laughter.]

Mr. BALL. I was only speaking of agreement with him on this.

The CHAIRMAN. He was a wonderful man, but he did love to tax. [Laughter.]

Mr. BALL. One might wonder why somebody who spent most of his career in developing and defending Social Security would want to tax the benefits. You might say, well, that is the equivalent of a cut in benefits, which I have always opposed and the reason is really two-fold.

One, I think it is a matter of tax equity. I see absolutely no reason why Social Security should not be taxed like other pension income, which, as you all will remember, is simply that you tax that part of the benefit which exceeds what people themselves have paid. That is the general rule.

The CHAIRMAN. Mr. Hardock referred to that as the exclusion ratio.

Mr. BALL. Yes. And the other reason though may not be so immediately obvious. I have been for taxing Social Security benefits over the years also because I think it strengthens the philosophical base of the Social Security program.

It seems to me treating it like all other earned pensions makes clear that Social Security is part of that group of plans and is not a welfare program. If you give it special tax treatment, there is a danger that people will then start thinking of it as a different kind of benefit.

I think taxing the benefits like private pensions and like career government plans helps to defend it against means testing, against benefit cuts, like COLA cuts and so on. And so I am for it for Social Security reasons as well as for tax equity reasons.

And, Mr. Chairman, this line of reasoning is supported by the early Treasury rulings on the exclusion of Social Security from taxation. I know the committee is aware of it, but if I could remind others, there is no law excluding Social Security benefits from taxation. It is entirely a matter of a Treasury ruling in the early days.

The CHAIRMAN. 1940, was it not?

Mr. BALL. Yes, it actually came up two or three times in the very early days.

But the kinds of analogies that they used in their reasoning was that Social Security wasn't earned. They said, for example, that strike benefits are taxable and then they went to some length to show that strike benefits were really related to what people had earned and that that was the reason for taxing them. When they came to Social Security they said it was not taxable and by implication was not an earned right.

Now the way the law was set up gave some reasonableness to that kind of an interpretation. The people who first proposed Social Security were quite concerned about its being held unconstitutional in the Supreme Court. It was a very conservative court, you will remember. It was clear that Congress could pay benefits. It was clear that it could tax.

But what was not quite clear was whether you could put the two together in a new social insurance program which the United States had never had before. So instead of putting the two together and having the benefits clearly grow out of what was paid, they put them in entirely different titles and the benefits look, if you look at the Act, as if they have nothing to do with the taxing provisions that are in the Act.

So Treasury looked at the law and said in effect, by implication, this is a gratuity. It does not come out of the taxes. And, therefore, it is not earned. I think it is time we overturned that. Social Security is clearly a benefit that grows out of past earnings. It is clearly a right that people have because they have worked in the past and also have contributed toward the benefits.

I think the rule that applies to pensions, whatever it may turn out to be, I have no brief for the present rule on private pensions or the present rule on contributory government plans. If you want to change the rule, fine.

My point is entirely that Social Security ought to be treated the same way. It is the same kind of a benefit. Now it is a big administrative problem if you do it exactly the same. We are talking about 42 million monthly benefits. The computation problems that would be involved in doing it in detail are just not worth it. So the 15 percent is an approximation of what is done in other contributory pensions, but always in favor of the beneficiary.

No Social Security beneficiary is going to pay more than 15 percent of the value of benefits, who is now contributing or who will be contributing for a very considerable time in the future. In fact, the actuaries are not sure that anybody will ever contribute more than 15 percent of the benefits.

So most people are actually going to be contributing less than the 15 percent and they get a break by this rough way of doing it. But nobody is disadvantaged.

I would just end, Mr. Chairman, by saying that I think it is time that the first Treasury ruling on a mistaken notion was overtaken law that firmly establishes Social Security as an earned right and a benefit that is entitled to be taxed as an earned right.

The CHAIRMAN. Thank you very much, sir.

If I could just take a moment of the committee's time to recall that this is a moment where we have an opportunity to be open and speak straight forward about a somewhat murky beginning here.

The idea of Social Security as a tax was suggested to Frances Perkins, then-Secretary of Labor, by Chief Justice Harlan Stone, as she recounts in her autobiography, at a reception. She explained that there was, indeed, this proposal that Bob Myers was working on, but that the Supreme Court kept turning them down, calling it unconstitutional.

And Justice Stone in what is possibly an irregular action, leaned over and said, "The taxing power, my dear, all you need is the taxing power." And that is why this legislation began in the Committee of Ways and Means and came to the Committee on Finance.

I think the court would no longer so rule, or have any difficulty with such measures as a straightforward social insurance. But that is the origins and we have a chance to straighten them out.

Dr. Chambers, you are next and most welcome, of course.

STATEMENT OF LETITIA CHAMBERS, PH.D., PRESIDENT, CHAMBERS ASSOCIATES, WASHINGTON, DC

Dr. CHAMBERS. Thank you, Mr. Chairman. I am president of a consulting firm, Chambers Associates, and I want to state for the record that I am here to day as an individual and not on behalf of any clients of the firm.

Taxing Social Security benefits is an issue for this committee, not because of any policy flaws or problems with Social Security but because the new administration and the Congress are attempting to bring annual deficits under control.

Social Security spending is not responsible for the deficit, as you have pointed out many times, Mr. Chairman. And, in fact, Social Security receipts will exceed spending by over $60 billion in fiscal year 1994. This issue is important because if this proposal is adopted, America's seniors should understand why they are being asked to pay higher taxes.

It is not because Social Security needs additional financing, nor is it because Social Security spending has any relationship to the current deficit problem. The Clinton administration proposal acknowledges that fact by proposing to post an amount equal to the additional revenue to the hospital insurance trust fund, not to the Social Security trust fund as under current law.

Everyone should understand the implications of this decision. The reduction of $1.7 billion in fiscal year 1994 in the income of seniors whose income exceeds the thresholds and of $17.5 billion over the next 4 years, will be used to help finance the health care of all seniors.

If this proposal is enacted, it is imperative that the administration and this committee keep in mind, as the health reform package is put together, this increased contribution of seniors to the cost of their health care.

This administration is placing emphasis on implementing budget and tax policies that will be fair. From that perspective, the administration's proposal is far preferable to alternative reductions in the income of seniors, such as reducing Social Security COLAs.

Our firm has recently completed a study that looks at marginal and average tax rates that seniors pay, using the 85 percent taxation issue. And if one looks at taxation of benefits strictly from a tax policy perspective, and not from an overall tax and benefit policy perspective, it does have some disparities.

Seniors will pay higher average and marginal tax rates than nonseniors of comparable incomes due to this taxation of benefits. Marginal rates are particularly affected by the interaction of the retirement earnings test and the increase in the amount of benefits that are subject to tax.

But policy makers should not look at this strictly from a standpoint of tax policy and the horizontal equity of one group against another. It should be considered from a benefit policy perspective. In that way, I believe the administration's proposal is fully justifiable.

We have done another study that looks at the impact that the lack of indexing the threshold has on the incomes of seniors and how this increase of 85 percent of taxation will impact on seniors because the thresholds are not indexed. That is a real concern that this committee should be concerned with, if they choose to enact the administration's proposal.

It should be a accompanied by at least an indexation of the threshold amounts. Those subject to this tax are generally described as high income elderly, although it also applies to those of moderate incomes. Unlike the personal exemption, the standard deduction, and brackets in the Federal income tax, the thresholds at which Social Security first becomes subject to taxation are not indexed.

A decade ago when the thresholds were set at $25,000 for individuals and $32,000 for couples, that was certainly a higher income level than it is today. Over the decade 1983 through 1992, the consumer price index increased 40.8 percent. So there has been a significant loss in buying power for seniors because the thresholds have not been indexed.

There is another problem that I think the committee should look at if you intend to enact this proposal. That is, in the out years at an 85 percent rate, there will probably be some double taxation on income. That is, some people who paid the maximum contribution rate and have already paid taxes on their payroll tax contributions, when they get their Social Security benefits back over a life time, those life time benefits, the 15 percent non-taxed portion, will be less than the actual amount that they paid in that was taxable.

And clearly, if you are going to enact this proposal, I believe the committee should look at some way to tie the future rate to an actuary's projection so that no one is paying a double tax.

In conclusion then, Mr. Chairman, I would like to just summarize that I believe taxing benefits at 85 percent is a reasonable proposal if the thresholds are indexed for the future; if there are steps taken to avoid double taxation; and finally, if the committee and the administration keep in mind that we are already increasing the taxation of seniors to pay for health care and that any financing options that you are look at with regard to health reform should take that into account.

The CHAIRMAN. Dr. Chambers, a very fair point which we have to address.

[The prepared statement of Dr. Chambers appears in the appendix.]

The CHAIRMAN. Bob Myer's recent tables, of course, raise this question. During your years at the Budget Committee, you learned a lot, obviously. Thank you very much.

John Forman, you are very welcome and we are happy to have you here. Will you proceed, Professor Forman?

STATEMENT OF PROF. JONATHAN B. FORMAN, J.D., UNIVERSITY OF OKLAHOMA COLLEGE OF LAW, NORMAN, OK

Professor FORMAN. Thank you, Mr. Chairman. It is good to see you again. It was my privilege before entering full-time teaching to serve in all three branches of the Federal Government, most recently as your Tax Counsel on this very committee.

The CHAIRMAN. Yes, sir.

Professor FORMAN. I am glad to see you have ascended to the Chairmanship and I think there are good possibilities for reform in the coming years.

Although I am a tax lawyer by trade, I also have degrees in psychology and in economics. This background has made me attentive to how government policies affect individual behavior.

In particular, I have learned that high tax rates discourage people from working and so have an adverse impact on the productivity and wealth of our Nation.

My message today is this. Senators, if my generation is ever to see a return of prosperity, then our Nation needs to find ways "to make work pay" for all Americans, young and old, rich and poor, black and white, women and men.

Unfortunately, President Clinton's proposal to tax 85 percent of Social Security benefits would subject thousands of elderly workers to confiscatory tax rates. These high tax rates would discourage the elderly from working just when our Nation is trying to grow its way out of a recession.

For example, consider George, a hypothetical individual who is 65 years old. George receives $25,000 a year in interest on his hard-earned savings, and he also receives $10,000 a year in Social Security retirement benefits. Should George work the holiday rush at the Macy's department store and earn another $1,000 of income? Probably not!

If the Clinton proposal is enacted, George would have to pay the Federal Government almost $600 in income taxes and Social Security taxes, leaving him with just over $400 after taxes. That is an effective marginal tax rate of almost 60 percent, even before city and State income taxes take their share.

Worse still, many middle-class elderly workers are also subject to the Social Security retirement earnings test. Those workers could face effective marginal tax rates of over 100 percent. That is, some elderly workers would actually be worse off if they earned $1,000 than if they had not worked that extra time at all.

How can the problem of high tax rates on elderly workers be solved? At the outset, I must admit that the fault does not lie with the Clinton proposal. Rather, the high tax rate problem is the result of the combination of income taxes, the income taxation of Social Security benefits, Social Security taxes, and the retirement earnings test. The Clinton proposal just exacerbates this problem by raising the inclusion rate from 50 percent to 85 percent.

In fact, by itself, the Clinton proposal to tax 85 percent of benefits actually makes sense. In a pure income tax system, Social Security benefits would be taxed like private pensions and taxing 85 percent of Social Security benefits is a pretty good approximation of that tax treatment.

So what is my solution? I would tax 85 percent of Social Security benefits, but I would also eliminate the $25,000 and $32,000 income floors of current law. I would not index them as Dr. Chambers has suggested. Rather, I would rather eliminate the thresholds altogether.

This solution would essentially tax Social Security benefits like annuities for all the elderly. But it would, fortunately, keep tax rates low on elderly workers. And the standard deductions and personal exemptions would protect low-income beneficiaries from any income tax liability on their benefit.

In conclusion, let me note that the Finance Committee has jurisdiction over all four components of this high tax rate problem—income taxes, the income taxation of Social Security benefits, Social Security taxes, and the retirement earnings test.

While messing with Social Security is never easy, the time has come to develop some meaningful coordination among these provisions. Senators, let's make work pay for the elderly.

Thank you.

The CHAIRMAN. Thank you, Professor Forman. And thank you for your very able viewpoint and contribution to Tax Notes, which is the first professional statement we have had on this subject.

Professor FORMAN. Thank you, Mr. Chairman.

[The prepared statement of Mr. Forman appears in the appendix.]

The CHAIRMAN. And now we turn to Bob Myers. Those of you who do not have Social Security, if you have the third edition of Social Security, you will make mistakes which you will regret. The fourth edition is now available, and anyone who wishes to be up-to-date in this subject is well advised to go to your nearest bookstore. I do not think it is in the Book-of-the-Month Club, but you never know. [Laughter.]

And certainly the Wharton School Pension Research Council is honored once again by your continuous and remarkable labor.

Mr. Myers?

STATEMENT OF ROBERT J. MYERS, CHIEF ACTUARY, SOCIAL SECURITY ADMINISTRATION (1947-1970), SILVER SPRING, MD

Mr. MYERS. Thank you very much, Mr. Chairman. As to the income taxation of Social Security benefits, I believe it to be perfectly reasonable and logical that they should be subject to income tax, just like any other income. Of course, there should be taken into account the part of the benefits that were actuarially purchased by the individual's own after-tax contributions.

This general statement of theory is fine. However, when people have had tax breaks for a long time, it is difficult to take them away. At times, this must be done gradually or phrased in.

This, as you will recall, Mr. Chairman, is the reason that the thresholds were not indexed in the 1983 legislation. The intent was to put the thresholds in and let them be not indexed so that, in essence, over the years they would gradually wither on the vine. Then, in the very long run, in essence, there would no longer be any thresholds.

Personally, I did not like the idea of the thresholds, but I saw the practical reasons for doing it that way.

The CHAIRMAN. I want to note for the record that Mr. Myers was the Staff Director for that Commission, a major part.

Mr. MYERS. As to the income taxation of private pensions and annuities, this has been done in different ways over the years. The changes in methodology have generally been guided much more by budget policy than logic.

I think that it is fair to say that now private pensions are unfairly taxed from an actuarial standpoint. The idea from a budget standpoint was to get the taxes in as soon as possible—in other words, to front load them, rather than to spread them out over the full possible life span.

I believe that Social Security benefits should be taxable in such amounts as are not actuarially purchased by the employee contributions rather than in the somewhat unfair way in which private pensions are taxed.

Specifically, neither interest on such contributions, nor indexing of them, should be taken into account, and the purchased amounts should be determined in the same way as the computations were made in the paper that I wrote jointly with Bruce Schobel, which was the subject of a hearing before this committee several weeks ago.

For simplicity and for fair treatment of the beneficiaries, the proportion not purchased, and thus the proportion taxable, should be for the lowest case—a maximum earning, single person, retiring at age 65 currently.

On that basis, the proportion of benefits which is not purchased would have been 85 percent several years ago. But it is now more nearly 80 percent and will decline in the future to about 72 percent ultimately. This compares to a figure of about 85 percent if they are taxed like private pensions, which I think would be somewhat unfair.

The present 50 percent basis, as you know, Mr. Chairman, is founded on a simplistic and erroneous premise. But it was used as a good political compromise and a good way of phasing in to a very difficult, but logical, conclusion.

The administration proposal illogically and inconsistently uses the 85 percent factor in only two ways and retains the 50 percent factor in another way. This was done for a very intentional reason—so that no additional people would have their benefits taxed.

In other words, some people close to the boundary would have to pay taxes if the 85 percent factor—or an 80 percent factor—were used throughout. But again, these people have been getting a tax break in the past, and I think that it should be phased out.

So, in conclusion, I suggest that the factor currently should be 80 percent, to be used throughout the computation procedure, with decreasing factors in the future, going down to about 72 percent ultimately.

Most importantly, the additional income taxes should not be transferred back to the Social Security trust funds or as the administration recommends, to the Hospital Insurance Trust Fund, but rather should be used to reduce the general budget deficit.

I maintain that if the money is transferred back, say, to the Hospital Insurance Trust Fund, this does not really reduce the budget deficit one cent. It just puts more of the government debt in the trust fund and less in public hands.

You asked for views on the elimination of the maximum taxable earnings base for the Hospital Insurance system. I certainly believe that this would be very undesirable. In fact, I think that it was undesirable to split it off as it was done in 1991 and have different bases for the two programs. Old-age, Survivors, and Disability Insurance and Hospital Insurance.

I think that there is a lot to be said for consistency, as well as for the fact that I believe you mentioned, Mr. Chairman. There is a limit to how much should be done for the sake of general revenues or for social adequacy. There should be some balance that people should have some relationship, although not a direct relationship, in benefit protection and what they pay in contributions.

Certainly this move for the Hospital Insurance tax base is in the wrong direction, and desirably the two bases should be brought back together. In fact, perhaps the base for Social Security is now a little too low because it has deteriorated somewhat relatively.

We have set a goal of 90 percent as the proportion of the total payroll that should be taxable. In 1993, this proportion is more nearly 87 or 88 percent. So if anything is to be done with the earnings bases, they should be brought together and should be put at a consistent and logical level.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you and thank you not least for reminding us of the 90 percent rule of thumb that we have tried and which has required us to raise the levels from time to time and this may be the moment to do so again.

[The prepared statement of Mr. Myers appears in the appendix.]

The CHAIRMAN. I take your point particularly that this money should go to the general revenues because this is a legitimate taxation of pension benefits, what Mr. Ball said and what you said. And in that sense, it belongs in the general revenue of the government.

Dr. Steuerle, you are going to wind up our panel. We welcome you back to this committee, sir.

STATEMENT OF C. EUGENE STEUERLE, PH.D., SENIOR FELLOW, THE URBAN INSTITUTE, WASHINGTON, DC

Dr. STEUERLE. Thank you, Senator. I do not envy the role to be played by this committee. Large deficits, it seems to me, are an important symptom, but not really the cause, of our inability to recapture control of our government expenditure and tax policy.

Our political accounting unfortunately treats running the government on credit as if it has no cost. Whereas, if we decide to pay for what we do as a government, we imply there are only going to be losers—those who pay. Our economic accounting, if we were allowed to use it, on the other hand, would indicate that getting the deficit under control would create as many winners as there are losers.

If the deficit is to be brought under control, however, few are going to be able to avoid bearing some of that burden. As Senator Rockefeller spoke earlier, because of their growing economic importance, due in no small part to the success of past government programs, those who are elderly or near elderly are not likely to be exempted from participating in a variety of efforts to deal with national problems.

Outside of defense and interest on the debt, they now receive close to one-half of government expenditures and their share continues to grow. Meanwhile, many of the non-elderly, particularly families with children—and I know many members of this committee have particular concern for that group—have higher poverty rates, less wealth and higher taxes than many elderly families.

My discussion, therefore, treats taxation of the benefits in the context of alternative means by which the Congress may ask the elderly and near elderly to share in deficit reduction.

Compared to other options for contributing to deficit reduction by the elderly, taxing Social Security benefits has a number of advantages. First, as has been discussed earlier, and I will not repeat that discussion, it affects mainly the better off portion of the elderly.

But there is a related advantage. The way income taxation works, the proposal would most likely affect the elderly at a point in their life when they are best able to afford it. That is, our income tax thresholds rise over time with the price index. But it turns out that elderly incomes often do not rise as fast, in part because their pensions are not usually indexed for inflation at all.

Now it turns out that the elderly, if we take into account their entire life span, often live for close to 2 decades. In fact, if I can take an extreme example, a couple who retire at age 62 today, the longer living of the two is likely to live for 25 years. That means that we will be providing a Social Security pension to at least one member of this couple for an average of about 25 years. And this couple, although well off at which the point they start in retirement, are often not nearly as well off later on in the retirement years.

Therefore, taxing Social Security benefits has the advantage, as I say, of reducing net benefits most in early years of retirement when the elderly are better off. Contrast that, if you will, to reducing the consumer price index—in particular, to proposals to reduce the consumer price index consistently over time. The latter would affect many of the poorest of the elderly. It would affect many of the older of the elderly.

If compounded over 10, 20, 25 years, a cut back in indexing could have a dramatic impact upon the well-being of the old elderly, those who have significant needs and are likely to fall back on SSI and Medicaid.

Taxing Social Security benefits also might be justified because of what I believe to be some of the unintended affects caused by the way Social Security has redistributed income. For some currently elderly individuals at high incomes, we have provided a transfer on the order of hundreds of thousands of dollars, above and beyond what they contributed to Social Security, what their employer contributed to Social Security, and the interest on those contributions.

Although this rationale for taxing benefits of current and near-future retirees might apply to those retired today, it is less applicable to those retiring in the next century. Nonetheless, there are problems that we must confront as we move into the first decades of the next century, and we must also look at the benefit levels that we provide to the elderly during those years.

Here taxing Social Security benefits again seems to me to be among the fairest ways to reduce net benefits we will be providing to those elderly in the future.

Taxation of benefits is also appealing on horizontal equity grounds. Consider, for example, a couple with about $25,000 of income. Their Federal income and Social Security tax bill today will be on the order of about $450. A young four-person family—that is, a family with twice as many members—with equal income by contrast, will typically face a Federal tax burden on the order of several thousand dollars or perhaps 10 times higher.

Another horizontal equity argument is made by comparing Social Security with private pensions. It is my belief that as a general rule of thumb taxing 85 percent of benefits is a reasonable way to provide comparable treatment between private pensions and public pensions.

Even then, the taxation of Social Security benefits or OASDI benefits would ignore the fact that we provide very generous tax treatment of Medicare benefits. And if we took those into account, we might even justify a higher figure than 85 percent of cash benefits.

Now both Ms. Chambers and Mr. Forman have raised a particular problem in the way we phase-in the taxation of Social Security benefits. That is, we phase it in at a way that tends to double the tax rate during the phase-in period.

Without going into the details on this, I agree with the problems they raise. But I would like to suggest to the committee that there are technical ways in which we can deal with this problem—in particular, by providing a credit for the elderly or some similar device that would give the committee the opportunity not to tax most of the elderly, but would not create this particular phase-in problem.

We can discuss this further with either the staff or with the committee as they desire.

In conclusion, the taxation of Social Security benefits is justified in part under the theory that those with equal incomes should pay equal taxes. Many proposals before this committee, it seems to me, would move in the opposite direction by granting favorable treat-

71-35 O - 93 - 2

ment to selective taxpayers who have equal or greater ability to pay tax than others not so favored.

Mr. Chairman, you mentioned the taxation of HI benefits. I also believe that this, too, would violate our normal standard of taxing equals equally, in particular because I believe it is unfair to self-employed individuals.

If we ask the elderly to help bear the burden of deficit reduction on the principle that those with equal income should pay equal taxes, then I hope this committee will give the same consideration to other parts of the deficit reduction package as well.

Thank you.

[The prepared statement of Dr. Steuerle appears in the appendix.]

The CHAIRMAN. We thank you Dr. Steuerle. That is a very impressive computation there, that a high income, one earner couple retiring in 1995 will have paid OASDI and Medicare taxes sufficient to buy benefits worth $231,000. But under current law they can expect to receive back from Social Security an annuity and Medicare benefits worth $482,000, which is a net transfer of over one-quarter of a million dollars.

I mean that system that began modestly in 1935 is providing very large transfers still. I think you pointed out that apart from defense, the interest on the debt, half of the budget of the Federal Government represents transfer payments of one kind or another to the elderly who have, I am happy to say, long lives, as I am getting a little elderly myself. But it was a very powerful statement.

Senator Packwood?

Senator PACKWOOD. Running through all of the testimony today is the argument that we should treat Social Security like private pension funds, except, of course, you have a threshold amount in Social Security.

If we are going to treat them like pension funds, then why are not the revenues put into the general fund as Mr. Myers suggests instead of for some reason saying we want to treat them similarly for purposes of taxation, but we do not want to treat them similarly otherwise?

I will start with Professor Forman and just work across.

Professor FORMAN. Well, I do agree with Mr. Myers that we should perhaps put the income from taxing benefits into the general revenues. Essentially, I view the Social Security program like a private pension and the benefit of having it is like just having income like having private savings. So I would do it that way.

But the 1983 Social Security compromise was to instead apply those funds to help offset what seemed to be a near-term concern in the old age and survivors insurance trust fund.

Senator PACKWOOD. Mr. Ball?

Mr. BALL. Well, there would be no taxation of Social Security benefits today if they did not go into the OASDI fund. The only reason that the Commission was willing to consider it, and the Congress in turn willing to consider it, was because it helped solve the financing problem of Social Security. So it had to go into the fund.

On a completely purest basis, I think that is probably hard to defend. But if you put it in general revenue, you have got to find an equivalent source of financing for Social Security. Later on the taxation of benefits is worth about eight-tenths of a percent of payroll.

I suspect that the reason that the administration proposal is to put it into the hospital insurance fund has as much to do with the Senate rules governing the super-majority votes as it does with a thought through decision to send it to the hospital insurance fund because it is somewhat short of money. We do not get enough out of it for financing hospital insurance for that to be a good reason for putting it there.

Senator PACKWOOD. Dr. Chambers?

The CHAIRMAN. Having heard Dr. Myers' view.

Senator PACKWOOD. I did not mean to skip Dr. Myers. I know his position, yes.

Dr. CHAMBERS. Well, the fact that the solvency of the Social Security system as put in place after the 1983 Commission included the taxation of benefits as a major source of income to the fund is the justification for it going to the fund.

I do not think that we should modify the policy decision that these revenues are maintained in the Social Security system. Moving it to the HI system still maintains it as a part of the general system, and I think that is an appropriate decision if the committee decides to do that.

But I think it would be inappropriate to place it in the general fund given the overall financing mechanism for Social Security solvency in the out years and its relationship to the taxation of benefits.

Senator PACKWOOD. We just put it in the trust fund and we spend it anyway.

Dr. CHAMBERS. Well, that is another problem that I think is a serious problem. That is that we are masking——

Senator PACKWOOD. But sooner or later we will have to redeem the bonds and pay them out of the general fund.

Dr. CHAMBERS. Right. We are masking Federal deficit spending with Social Security trust fund surpluses, as both you and the Chairman have pointed out on a number of occasions. I know you had a bill last year that related to that issue, which is a major problem, although it is a different issue from what we are addressing today.

Senator PACKWOOD. Dr. Steuerle.

Dr. STEUERLE. Senator, as a matter of tax principles, I believe income taxes should always be put in the general funds. The Income tax is one of the means by which we provide for many of the needs of our society and it seems to me that those elderly who can pay income tax as well as the non-elderly must contribute to those general needs.

I should also point out that one reason why we have this sense of paralysis by the Federal Government is in part because we are starting to put so much money in our trust funds that the Congress is left with a much smaller proportion of total revenues that it can reallocate over time as it finds new needs in society to which it should put funds.

So as a matter of principle it seems to me, Social Security taxes are fine for the trust funds. But income taxes belong in general revenues.

Senator PACKWOOD. We had some hearings on this earlier. At the moment, you count Social Security, Medicare, Medicaid, other retirement programs, mainly military and civilian, and interest on the debt we are at 54 percent of our total budget. In 10 years we are at 69 percent of the total budget.

Of course, although the civil service is not a trust fund, the bulk of it is health spending or trust fund spending. And you are right, we are going to squeeze and squeeze and squeeze education and environment and everything else, assuming we are going to keep up with the trust fund obligation of payment.

Each year we will either come to the solution that we have to raise the level of taxation generally so that we look more like Europe and tax 40 or 42 percent or 45 percent of our gross national product to provide benefits or some very valuable services are going to get squeezed out.

Professor Forman, run by me again your figures on the 103 percent taxation level.

Professor FORMAN. Yes, Senator. The problem is that an individual who makes about $25,000 a year is facing the 28 percent income tax bracket. So if he earns another $1,000 he will have to pay $280 in tax on that $1,000.

Unfortunately, under the President's proposal, earning that extra $1,000 could also push another $850 of his Social Security benefits into his taxable income. Then he would have to pay 28 percent times $850 or roughly $238 in tax on that, in addition to the $280. On top of that, there is 7.65 percent Social Security tax, which would be $76.50.

Finally, if this individual is age 62, 63, or 64 then they face what is called the Social Security retirement earnings test. What happens then is that if you earn more than about $7,500 a year, you start to lose $1 of benefits for each $2 that you earn. That is an effective tax rate of close to 50 percent—it appears to be a 50 percent marginal tax rate, but there is a partial offset because of the interaction with the income taxation of benefits. So my figure came out for that individual, and not for all elderly workers, but for that individual, he would face a tax rate of 103.5 percent.

Now the Social Security retirement earnings test could result in some increase in his benefits down the line. But in the immediate short-term, he would be better off not working.

Senator PACKWOOD. Do the rest of you agree with his theory?

Mr. MYERS. No, I do not. I think that, although at the very end Professor Forman did mention that there is recomputation of benefits, so as to increase them in recognition of some benefits being withheld, certainly for somebody between ages 62 and 65, the benefits are recomputed at age 65 to fully recognize the benefits which were withheld. So that the person who worked from age 62 to age 65 gets a proper actuarial recomputation so that the benefits lost are compensated for by the actuarial value of the additional benefits that will be paid from age 65 on.

Between ages 65 and 70 at the present time, the additional credits for working are not on an actuarial basis. But, in present law, they are scheduled in about 15 years to get up to that level. Then, a person by working and losing benefits under the retirement earnings test really is not losing. Rather, income would be redistributed so that more is put in the retirement years and less in the years when the person is at least partially working.

Senator PACKWOOD. Any other comments?

Dr. STEUERLE. Senator Moynihan and Mr. Myers would probably remember this better than I do. But as I recall, in the 1983 Social Security amendments, and I was working at Treasury at the time, what boxed us in partly to the current formula was that President Reagan came out and said he would not accept taxation of anyone below $25,000 of income.

So the number $25,000 became a magical number. It was an easy statement for people to understand. At the Treasury at the time, we were trying to propose some alternative ways that would provide roughly the same amount of revenues and the same progressivity but would not quite have this phase-in problem.

But, of course, we then got boxed in partly because of that $25,000 statement, which then got taken up to the committees where they had to come into a phasing formula that would lose as little revenues as possible, yet protect the Social Security trust funds.

But I think there are technical ways to eliminate this phase-in problem, in part by providing a credit that can give you roughly the same amount of progressivity. But I will not deny that these alternative means would create some winners and losers relative to any proposal, including the President's.

The CHAIRMAN. Mr. Ball wanted to make a statement.

Mr. BALL. Mr. Chairman, the exempt amount in the taxation of Social Security benefits is really the result of experience. I originally along with Stan Surrey, I said, proposed the taxation Social Security benefits and 40 percent of Social Security beneficiaries would not have paid a tax anyway and would not today because of the progressive nature of the income tax. So they are protected that way.

It is the right policy not to have any income floor at all, but to have the income tax itself protect low income people. But in the original proposal the propaganda machines went to work and it was as if we had proposed an excise tax on Social Security benefits so that everybody, no matter how low their income, was going to have to pay it.

So I came to the conclusion that the only practical thing to do was make absolutely clear to the country that lower income people are not going to have to pay a Social Security tax.

Now if you do not index it—it would be a terrible idea to index it—but if you do not index it, this is just a way of phasing of the proper policy, which is to tax Social Security benefits like private pensions without any special lower floor, but to depend on the income tax to protect low income people.

The CHAIRMAN. Could I note that not for the first time Ronald Reagan turns out to have been a very wise man in the matters.

I think we are going to have to hear our other Senators now. Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman.

I have in front of me a CRS report that shows marginal tax rates on additional income for age seventy individuals with $8,000 annual Social Security benefit. I do not know if you can see that from here. But what it shows is what Dr. Forman was talking about and Dr. Steuerle also reported, which is you do have a spike in the marginal rates, roughly in the area of $26,000 to $29,000 a year.

That is a substantial spike that Dr. Steuerle reported as well as Dr. Forman. I would be very interested to now if there is agreement at least with respect to that. Mr. Myers, do you agree that there is a spike in the marginal rates because of the phase-in?

Mr. MYERS. I believe that there is some spike. But I think that that analysis does not take into account the actuarial value of the additional benefits that will be paid later because of the benefits that were withheld.

Of course, on the average, this is a very real factor. Some people might get more and some less. But I think that it is something that should be taken into account. I think that point answers the spike argument.

Senator CONRAD. So let me ask you this, does the recomputation that occurs later, does it target those that are affected by the spike? That is, is there a perfect matching here of the recomputation to those who are affected by the marginal tax rate spike that you see here?

Mr. MYERS. Yes, there is. I think that the reason for that spike is because those people had benefits withheld. The people who had benefits withheld are the ones who get a recomputation later that raises their life-time benefits.

Senator CONRAD. And the recomputation comes at age 65?

Mr. MYERS. For those under age 65, it comes at age 65. Ideally, it should come every year. However, years ago when this procedure was legislated, it was thought that, to do it annually, was too much administrative work. I think that the Social Security Administration could now do it every year, as is done under the same circumstances after age 65.

For example, if somebody files a claim at age 65 and then goes to work for 6 months in the next year, then in the following calendar year the benefit is recomputed to allow for that 6 months of benefits that were withheld. At the present time, there would be an increase of about 2 percent in their life-time benefits just for that 1 year's loss of 6 months of benefits.

Senator CONRAD. Dr. Forman, would you want to respond to that?

Professor FORMAN. Senator Conrad, I think that Mr. Myers is correct, that the recomputation may well take care of the problem of the retirement earnings test. To the extent that the spike is caused by the retirement earnings test, a recomputation will fix it for people who live long enough.

On the other hand, I do not think Mr. Myers means to suggest that there is not roughly a 60 percent marginal tax rate on Social Security beneficiaries who make between $25,000 and $30,000, caused by the combination of income taxes and Social Security taxes.

My view of it is that since the Tax Reform of 1986 it really is only the poor and the elderly that face extraordinarily high tax rates. The very wealthy frequently face tax rates of no more than 28 percent, and then only when they sell their capital gains property.

Senator CONRAD. Dr. Steuerle, would you agree with Dr. Forman's observation with respect to this point?

Dr. STEUERLE. I believe that is correct. I have not seen the analysis, Senator Conrad. But I believe the spike in that report is due mainly to the income tax and Social Security tax. A separate issue is how do the elderly count the earnings test and do they add this onto the calculation when they determine whether they are going to work or not.

Senator CONRAD. Well, Mr. Chairman, I think they have put their finger here on a problem that is a real problem. And to the extent we can, we ought to try to address it because I think it does create a disincentive for people to work who are in this category.

I would hope very much that we would take advantage of the expertise that is here and try to work this problem out.

The CHAIRMAN. I think you are absolutely right, sir.

Dr. Steuerle, you said you would offer to help us out in this regard.

Dr. STEUERLE. That is right. I can help you out in the economics, Senator. But the politics still are not easy, as you may well know.

The CHAIRMAN. We do politics. [Laughter.]

I think Senator Conrad is absolutely right.

Professor FORMAN. Mr. Chairman, let me just add that I think Dr. Steuerle is correct that there is a technical solution to this problem. I would be happy to help the committee as well.

The CHAIRMAN. Good. As you have done before.

Senator Grassley?

Senator GRASSLEY. I want to highlight a point that somebody on the panel made earlier. That is this problem of changing rules in the middle of the game. I know whenever we pass a tax law we are always changing rules in the middle of the game.

But for a large proportion of a population, you know, that still have opportunities in life to make decision on work and decisions on investments and savings, they can sometimes mitigate negative impact of increased taxes on their life.

But in this instance, we have so many people who are past the period of work. They cannot change the past work experiences and their savings decisions are already made. They are unable to make up for this lost income.

I just would like to have some reflection on this point. If there is a justification for it, so be it. If it is bad, maybe the opinions to that extent will help us change the President's proposal in that regard.

But my point is made partly because in my State of Iowa where we are the third highest percentage of retired people in the 50 states, we are finding a higher and higher number of people outliving their savings. They thought that they were safe for retirement and then all of a sudden are not.

Betty Grandquist, our director of the Iowa Department of Elder Affairs, keeps pretty good track of this. She says that is an increasing phenomenon. So when we are going to raise tax on these people, it is really coming out of their savings, it is coming out of their life, the period of time which they would be able to have some of their own resources.

So I would appreciate any sort of justification you can give me for it. If not, to what extent do you think it is wrong.

Professor FORMAN. Senator, I cannot resist starting off on this one. My generation of wage earners and taxpayers is basically transferring millions of dollars to the current generation of retirees. So I do not think it is too much to ask that they pay a fair share of taxes by having their Social Security benefits taxed, to the extent that those amounts represent income.

Under legislation that Senator Moynihan added in, I think, it was 1991, the Social Security Administration will soon begin to tell beneficiaries what their income is and how much of their benefits come from the taxes that they paid.

While I certainly acknowledge that it is much harder to tax people on their income than simply to tell them what their income is, taxing elderly on their income would represent a little bit more fairness to my generation of working taxpayers.

Dr. CHAMBERS. But it seems to me that the question that Senator Grassley was raising was not one of whether or not one generation is paying another, but what about the individual who has made personal life decisions on how much mortgage he is going to pay and what kind of bills he has encumbered. How are individuals going to meet this decrease in their income, which will occur basically, by having to pay greater taxes.

Senator GRASSLEY. That is exactly my point.

Dr. CHAMBERS. And clearly, that is an individual problem that is of a duration until people can adjust their living standard. For that reason, some people have suggested that this proposal should be phased in. That instead of going from 50 to 85 it should go from 50 to 60 to 70 to 85 over the course of 2 or 3 years.

That is something the committee might want to look at, although it will not raise the money in the budget period that is anticipated. Given that there is a difference in opinion as to how much this proposal raises, there may be a little room there.

But clearly, when you are talking about the impact on individuals who have to pay more, that is a different issue than when you are talking about aggregates in the economy, and the committee has to be aware of that.

Senator GRASSLEY. Either one of you, Mr. Myer or Mr. Ball?

Mr. BALL. Senator Grassley, you have raised a couple of points there. It is absolutely true, and it needs some attention, and I do not have a good proposal, that people are much worse off in the older age group among the elderly, that is in the 85 and beyond, than they are in the younger age group at 65 and 70.

They use up their resources and it is a big problem we have to address.

Mr. Steuerle made a good point about this. That is, when we get to the policy of the income tax, the protection of low income people does help the older group who tend to be low income people. And the phase-in, there is a phase-in in this proposal. It may not be sufficient for your purposes.

But the right policy is not to have these thresholds at all. The thresholds unindexed are there for a phase-in. That is a phase-in and only 40 percent would pay any tax anyway.

The CHAIRMAN. Mr. Myers and Dr. Steuerle both wanted to say something to Senator Grassley. Please do.

Mr. MYERS. Senator Grassley, I appreciate your concern this way. When I talk in theory that they should be completely taxable, I realize both the public relations and the humane policy that, even though people have been getting a tax break, then if you take it away from them, it can be very difficult for them.

So phase-ins are often desirable even though they conflict with logic and consistency. And, as suggested, not only should thresholds be a phase-in device if they are kept unindexed, but also this is the case in the "sense of the Senate" resolution that was passed sometime ago which said that the 50 percent taxable-proportion rate should apply $7,000 or $8,000 above the threshold. That is another good phase-in device, although it conflicts with theory.

I would once again repeat that I think that the 85 percent factor is too high. It should be 80 percent if the benefits are taxed properly because the 85 percent factor—being based on the way that private pensions are taxed—is really somewhat actuarially unfair.

The CHAIRMAN. Dr. Steuerle?

Dr. STEUERLE. Senator, I think you raise a very good point. But it seems to me that it is a point that applies throughout a deficit reduction package. That is, in the budget agreements we have been having for a number of years, we focus on 3 years and 5 years and we tend to force all our efforts into meeting some target for that period.

If a long time ago we had decided, let's get the budget in order for the 6th year, through the 10th year, through the 15th year, we would not be in this situation today. And part of our problem is, we do box ourselves in with short run fixes.

As opposed to what Mr. Ball and Mr. Myers did in many of the Social Security acts, and Senator Moynihan as well, focusing on 75 year actuarial projections. It gave us a much longer term projective. It wasn't necessarily a perfect measure, but it was a measure that forced looking at the long term.

If we looked at the long term in deficit reduction, it might be easier to phase-in things. However, if we are going to look at 3-year and 5-year numbers, I should point out that there are many people who are going to be either receiving fewer benefits or paying higher taxes, and many people who have even lower incomes than the ones that would be affected by this proposal.

The CHAIRMAN. Bob Ball, you wanted to say something?

Mr. BALL. Mr. Chairman, I just wanted to comment on what Bob said about 80 percent or some other number instead of 85. What I would emphasize is that equal treatment of Social Security and private pensions and career government pensions. I hold no brief for the present treatment of those other plans.

If it turns out that you think it is better to treat all the plans in a way that results in 80 percent, then do it. But at present, the present treatment of private pensions and government career pensions give you the 85 percent number, and equal treatment calls for that.

The CHAIRMAN. These two have been squabbling with each other over these things for 50 years. [Laughter.]

And to a great benefit to us all.

Senator Durenberger?

Senator DURENBERGER. Mr. Chairman, thank you. I am sorry that I have been coming in and out. I am actually here because some of my favorite people are on this panel and the next panel. Out of respect to them, I wanted to stick around and listen to the discussion and the debate.

I have been going upstairs to listen to the Secretary of Education discuss the goals of Education 2000 and so forth. And in between I am reading one of my favorite magazines, The Economist, who has these incredibly challenging headlines. Like today this issue is, "I am Boris Yeltsin and I claim my $43 billion." That will get you to read anything.

But inside it says we need to rethink the way we do aid to countries like Russia and so forth. And as I am going back and forth between what are we going to do with education and health care reform and this, I say to myself, somebody has to help me redefine security.

If, in fact, Chuck Grassley has got people in Iowa that are spending down at some point all of their savings and so forth, and if Mr. Forman in his generation does not even believe there is going to be a Social Security for him—he may not, but people his age do—and of the young people who work for me—none of them think there is going to be any Social Security there for them, we have a larger security problem in this country, an income security problem.

Of all the people I know, the Chairman of this committee is probably the best able to comprehend, articulate and argue for, but I cannot find anybody else in a town like Washington, DC who can think about them in these kinds of larger terms.

We spend our time refusing to break the paradigm and sitting here and debating the origins of Social Security and who promised whom what. Like last year, we were debating what did Harry Truman say to John L. Lewis so that we could pay all of these coal miners free health care, and all of their relatives and anybody who lived in their homes for more than 30 days free health care, because Harry Truman made a promise to John L. Lewis in 1947.

I used to get frustrated by the subject. I do not anymore. But I get frustrated sometimes by the politics of it. As a member of this committee you learn a lot about the so-called notch and you learn that there is not the notch that a lot of the public thinks there is, you know.

There is a 1916 and 1917 notch, but that is about it for the notch. So when the wonderful people come up over 65, that senior citizen day at the state fair, and say what are you going to do about the notch, and I say, there is no notch. And they say, well, 235 of your colleagues say there is a notch. You know, there are 235 politicians in this town that have decided that for one reason or another there is a notch and we ought to spend $300 billion of Mr. Forman's generation's money on resolving all of this.

So I am sensitive. But when my friend, Judy Brown, gets up to talk about AARP, I am sensitive to the fact that somewhere in America there is a couple that makes $38,000 in annual income, plus $13,500 in Social Security and they are going to suffer from a $700 tax increase.

I do not necessarily call that suffering. But to them, you know, I am sure it is significant, particularly in the context of promises made. And it is only by way of arguing that I have come to believe that we can deliver on all of the promises made to everybody—the promises made to the guys in the fox holes about free health care for the rest of their life, and the promises made to everyone else.

We are going to have to find a different way to do it. We just have to find a different way to do that. That is the challenge of serving on this committee because we seem to do practically all of the—we do the economics, we do the earnings, we do the fringe benefits, we do the tax policy, we do the social insurance policy, we do health care policy. We do so much of this policy that provides for the security of Americans.

And yet, at some point in time I hope here we break the paradigm or find the new paradigm or whatever. And with the help of the experts such as we have on this panel, we find ways to deliver on all of these promises so that the kids or the younger generation know that when they reach the age that they need that security that it is going to be there for them.

The CHAIRMAN. Yes, sir. Does anybody want to answer that?

Mr. BALL. It is not so much an answer, Mr. Chairman, as a comment that says I know one way not to do that. I was going to say it earlier but I was intimidated by your lights. I am no longer intimidated by them. [Laughter.]

I think it would be a great mistake to look for money by taking the cap off the health insurance base. I think that would be a destructive act in terms of a social insurance plan. The present hospital insurance plan is already so progressive that it makes me nervous.

The top person last year paid 13½ times as much as a $10,000 worker for exactly the same benefit. And yet, it is a social insurance plan where we want to maintain some kind of connection between what people pay and what they get. So I think that proposal of the administration is a big mistake.

I would go the other way. I think it was a mistake to raise the maximum base in hospital insurance at all. I would reduce that, raise the base as far as OASDI is concerned to what Bob was saying, to get back to taking 90 percent of earnings. That is about $80,000 on each, which gives you more money than just taking the cap off hospital insurance.

Mr. Chairman, I would, while on that subject, would probably go somewhat further and say there is no reason why you should not shift among the three trust funds—hospital insurance, and disability insurance, and old age and survivors insurance—and you can make them all—for a short run of 10 or 15 years and maybe more—adequate and put the old age and survivors disability insurance back on a pay-as-you-go basis, as you were advocating in recent years.

And use the annual surplus in OASI to shore up the hospital insurance and the disability insurance.

The CHAIRMAN. Which, indeed, we are thinking of. If I can say to Senator Durenberger and Senator Packwood, we only came upon this Saturday morning when we got the bill. It has been there, but it has not been needed. It was not reported.

We are already thinking in terms of going back, getting up to 90 percent, maybe bringing down HI, having a level payment on both. And at least trying to keep the connection between what you pay in and what you get out. This is a contributory system. It is what President Roosevelt wanted.

Dr. Steuerle?

Dr. STEUERLE. I would just add another reason, Senator, for opposing the HI tax increase. As a matter of income taxation, the self-employed who report income on Schedule C pay tax on both income from wages and income from capital. That is, there is no distinction on Schedule C between their types of income.

What this means is that someone who receives interest, who owns corporate stock and has divided income, would not pay an HI or Social Security tax. But self-employed persons, would pay an additional HI tax on this capital income simply because they had invested the capital in their own companies.

It seems to me that therefore, the removal of the HI cap also goes against income tax principles as well.

The CHAIRMAN. As it does. I think we want to hear from Judith Brown and others so we will have to close here with great thanks.

But before you leave, did Bob Myers want to have the last word? Why not? You were here. You arrived in 1934. You are entitled to have that.

Mr. MYERS. Thank you, Mr. Chairman. Just as a factual matter, I think that a $75,000 base next year would have the Social Security taxes apply to 90 percent of the total payroll in covered employment. I think that Bob Ball's figure of $80,000 was a little on the high side.

The CHAIRMAN. There you ~~are,~~ they have been dickering all these years to great public advantage. May I make one point on behalf of this panel, this committee.

You were just up in, it would have been Labor and Human Resources, and you are hearing a Secretary of Education say that by the year 2000 the United States will be first in mathematics and science in the world. Yes? Right?

Senator DURENBERGER. He didn't say it today.

The CHAIRMAN. Those are the goals for the year 2000?

Senator DURENBERGER. Yes.

The CHAIRMAN. You know, you would go to jail for saying something like that in another context. [Laughter.]

That is absolutely not true. It is never going to happen. If we can stay in the second division, that will be an achievement. But at least we do not traffick in that sort.

Thank you all very much. Thank you, Professor Forman, for coming all the way from Norman and we are once again in your debt and validly so.

And now we are going to have a final twosome, who will be with us. Judith Brown, who is chairman of the board of directors of the American Association of Retired Persons, the largest membership organization in the nation, other than some religious denominations.

Ms. BROWN. That is right.

The CHAIRMAN. Judith Brown, of course, is from Edina, Minnesota, where Senator Durenberger comes from. And Ron Pollack is the executive director of Families USA. Good morning to both of you, or slightly good afternoon. You are first on our list, Ms. Brown, so you go right ahead.

STATEMENT OF JUDITH N. BROWN, CHAIRMAN OF THE BOARD OF DIRECTORS, AMERICAN ASSOCIATION OF RETIRED PERSONS, EDINA, MN, ACCOMPANIED BY EVELYN MORTON AND DAVID CERTNER, LEGISLATIVE DIVISION

Ms. BROWN. Thank you very much. Good morning. I appreciate the committee's accommodating our schedule today. As you know, I am Judy Brown, Chairman of the Board of AARP and we really thank you for the opportunity to appear here today.

AARP has long supported fair and responsible deficit reduction legislation and the administration's efforts are, therefore, to be commended. Older Americans are willing to share in the efforts to lower the deficit if they perceive the proposals to be fair.

The Association believes, however, that the proposal to tax 85 percent of Social Security benefits represents misdirected policy with a substantial negative impact on the middle income older taxpayers. It is first important to emphasize that Social Security is not contributing to the Federal deficit.

The CHAIRMAN. Amen.

Ms. BROWN. In fact, Social Security is currently building a reserve that will be needed to pay future benefits.

Second, let me describe the impact of the proposed Social Security change on older taxpayers. Income tax increases under the administration's plan generally hit only wealthy taxpayers. In contrast, under the Social Security tax proposal, older taxpayers face disproportionate tax increases at substantially lower income levels.

The impact is particularly onerous for persons in the current 15 percent tax bracket. To illustrate this point, I draw your attention to charts A and B. Chart A shows the percentage of single returns subject to the increased tax that are currently in the 15 percent bracket. Over 800,000 returns or roughly 41 percent of all single returns are subject to the increased tax.

Chart B shows the same information for joint filers. Over half of all taxpayers affected are currently in the 15 percent tax bracket, or almost 1.8 million joint returns. These are not our rich older seniors.

In total, about 4.3 million taxpayers, almost half of all beneficiaries affected by the proposal, are currently in the 15 percent tax bracket. To make matters worse, almost 400,000 of those beneficiaries will find themselves pushed into the higher tax bracket.

While many debate the precise meaning of middle income, surely those people in the 15 percent tax bracket are not wealthy. Yet, these older taxpayers have been targeted for additional tax as the wealthy elderly.

Moreover, because people in this income group count Social Security as a major source of income the tax proposal actually hits the middle income group the hardest.

Chart C illustrates the percentage tax increase faced by beneficiaries as to each income group. You will note that single filers between $30,000–40,000 AGI face an average income tax increase of over 18 percent. For taxpayers in the $40,000–50,000 group, the average tax increase is about 14 percent.

In contrast, those between $100,000 and $200,000 a year of income see a 6 percent increase, while those over $200,000 see less than a 2 percent increase. This middle income group of elderly taxpayers has little ability to make up the lost income.

Additional work is often not a viable option and their other income sources cannot be easily shifted to earn more income. This middle income group is already feeling the squeeze from skyrocketing medical costs and lost income due to declining interest rates.

Add to that State and local income and property taxes, and the normal costs of maintaining a household, and a tax increase from $700 to $1,000 will be significant.

These losses are permanent and will accelerate, what, for most in this group, is already a time of declining income levels. This group also will feel the affect of higher Medicare premiums and other tax increases in the President's package, most notably the energy tax.

Many face increased State taxes as well. In total, older middle income taxpayers are the only non-wealthy group of taxpayers to experience large tax increases under the President's plan. These tax increases may be larger than the taxes faced by some in the proposed 36 percent tax bracket.

It is easy to see why many older Americans do not perceive this as fair. In fact, recent public opinion surveys indicate that opposition to the increase in taxation of benefits is substantial among all age groups. In addition, opposition to this proposal has increased over time among both supporters and opponents of the President's plan.

The CHAIRMAN. Very striking. Why doesn't your associate put those numbers up, too, those bar charts?

Ms. BROWN. We do not have those.

In conclusion, AARP supports deficit reduction based on the concept that each must do their fair share. Consistent with this goal, we strongly believe there is a need to protect middle income older taxpayers from disproportionate tax increases.

While the Senate is currently on record in support of the Lautenberg Exxon resolution that would raise the thresholds, the Association believes more can and should be done.

We look forward to working with this committee to modify the package to reduce the disproportionate impact on Social Security beneficiaries. I would take any questions that you might have for me at this time.

[The prepared statement of Ms. Brown appears in the appendix.]

The CHAIRMAN. We will hear Mr. Pollack and then we will begin questioning.

Could you introduce your associate?

Ms. BROWN. This is Evelyn Morton from our Legislative Division with AARP.

The CHAIRMAN. Good morning, Ms. Morton. And?

Ms. BROWN. David Certner, also from our Legislative Division.

The CHAIRMAN. Good morning to both of you.

Mr. Pollack?

STATEMENT OF RON POLLACK, EXECUTIVE DIRECTOR, FAMILIES USA, WASHINGTON, DC

Mr. POLLACK. Mr. Chairman, Senator Durenberger, let me first apologize for any role I played in shortening the time period of the Bob and Bob Show. I have enjoyed hearing that show for many years and I think we all would have enjoyed hearing their continued dialogue.

Let me also say that I do not come here on the behest of some of the contributors of Families USA, a good portion of whom might be adversely affected by the particular proposal we are focusing on. But I come here in support of that proposal, nonetheless.

You will see attached to my statement an analysis that we prepared at the time the administration was considering proposals to cut Social Security, including a possible COLA freeze.

The CHAIRMAN. Yes.

Mr. POLLACK. We looked at a comparison of what a COLA freeze would do versus increase in taxation for those currently taxed as Social Security. That is really the point of departure of my testimony.

The taxation increase, we believe, is far more equitable and is deserving of consideration. Elderly persons with moderate incomes are far more dependent on Social Security benefits than those with higher incomes. Elderly persons with incomes between the poverty line and 150 percent of the poverty line depend on Social Security benefits for $4 out of every $5 of their income.

In contrast, elderly persons with incomes over $50,000 receive less than 20 percent of their incomes from Social Security benefits. Thus, eliminating the Social Security COLA would have had the greatest impact on low and moderate income seniors and persons with disabilities who receive Social Security benefits and would have had the least impact on higher income beneficiaries.

Of the amounts of spending cuts achieved through a COLA freeze, 47 percent would come from beneficiaries with incomes below $20,000; and another 33 percent from beneficiaries with incomes between $20,000–40,000.

In total, four out of five, 80 percent of the dollars raised from a COLA freeze would come from Social Security beneficiaries with incomes under $40,000. Unlike deficit reduction measures brought about by freezing or reducing the Social Security COLA, increased taxation of Social Security benefits would raise most revenue from higher income beneficiaries.

Eighty-four percent of the revenue raised would come from beneficiaries with incomes above $40,000 a year. Less than three out of ten Social Security beneficiaries nationwide would be affected by this change at the end of the 5-year time period, ending in fiscal year 1998; and the average annual income of those affected would be over $61,000.

This approach would throw no one below the poverty line, no one below 150 percent of the poverty line—unlike a freeze in the COLA, which would significantly increase the number of people below poverty and below 150 percent of poverty.

Now if I may refer you, Mr. Chairman and Senator Durenberger, to the first chart attached to my written statement. You will see the distributional impact in 1998 dollars. You will see that for the first two income levels, less than $10,000 and less than $20,000, almost half of Social Security beneficiaries fit this category, 48.2 percent.

Of course, none of them would be affected by this particular tax. In the next group, $20,000–40,000 of income, only approximately one-quarter of the beneficiaries in that particular income group would be affected. And only about 15 percent of the entire revenues raised by this tax would come from that category of people.

The CHAIRMAN. This is your table I?

Mr. POLLACK. Yes, that is correct.

The CHAIRMAN. Yes.

Mr. POLLACK. And you will see that for the last two groups, the group at $40,000–60,000 and those with $60,000 or higher, 84 percent of the revenues from this tax would come from that group of people.

Finally, if I may refer you to——

The CHAIRMAN. I am not as quick as you are here. You are saying that the amounts involved will be——

Mr. POLLACK. The percentage of the revenue raised for the group between $40,000–60,000 is 36 percent.

The CHAIRMAN. Is 36 percent, yes. And then about half comes from $60,000 or more.

Mr. POLLACK. $60,000 or more.

The CHAIRMAN. Yes.

Mr. POLLACK. So if you aggregate those two income groups——

The CHAIRMAN. That is it. I see. The 85 percent.

Mr. POLLACK. It is just slightly under 85 percent.

The CHAIRMAN. Yes.

Mr. POLLACK. If I may just refer you to one more table.

The CHAIRMAN. Please, take your time. You waited all morning. And the two Bobs are listening. You should know that.

Mr. POLLACK. Then I have to be very careful.

The CHAIRMAN. They are right behind you. Be very careful.

Mr. POLLACK. I am afraid I may be graded afterwards by one of the two Bobs at least.

If I may refer you to a table two tables back, we looked at what the impact would be again in fiscal year 1998 for elderly beneficiaries. And if you look at the top of that chart, you would see that in 1998 there would be slightly less than 35 million elderly OASDI recipients, of which about 9,500—or 27 percent—would be impacted by this increased tax.

The average income for that group would be $61,552 and the average additional tax, again in 1998, would be $641. If you take that as a percentage of their overall income, it is slightly in excess of 1 percent of their income.

Now as you could see, Mr. Chairman and Senator Durenberger, we have broken this down on a state-by-state basis so that in New York, for example, there are between 2.6 and 2.7 million elderly OASDI beneficiaries expected in 1998, of which slightly less than 700,000 would be impacted by this additional tax, or just over a quarter, 26 percent, would be affected.

The average income of a person affected in New York would be approximately $65,000; and the average added tax to such an individual would be $710, about 1.1 percent of their income.

A similar phenomenon occurs in Minnesota. In Minnesota there are 635,000 expected OASDI beneficiaries 65 years of age or higher, of which 177,000 would be taxed, or about 28 percent. Their average income would be a little under $57,000 and the amount of the tax would average $567, or about 1 percent of their income.

In conclusion, I would say that, to the extent that this committee feels that the entitlement programs need to share in the process of dealing with the deficit, we believe this is an equitable way of doing it. It targets those who are most capable of affording this additional burden.

[The prepared statement of Mr. Pollack appears in the appendix.]

The CHAIRMAN. Thank you very much, Mr. Pollack and Ms. Brown. We have a difference of viewpoint here. And yet, I think we are both getting very—it is very helpful to us to get this data that you have produced.

Since Ms. Brown has come all the way from Edina, why don't you begin the questioning?

Senator DURENBERGER. Mr. Chairman, I appreciated the testimony of both and particularly Ron's additions. We have two sets of impact charts, but I found the one that made the comparison particularly helpful.

I do not have a specific question, but just a compliment. I think both of them were at other hearings already this morning, if I understand correctly, which means they definitely have something to contribute to our deliberations and I appreciate it a great deal.

The CHAIRMAN. Well, I do. I have to say those are very powerful tables, sir. You are finding that the average income unit per person affected by this proposal would be $61,000.

Mr. POLLACK. Yes, in 1998 dollars.

The CHAIRMAN. And you inflate it, what, 3 percent?

Mr. POLLACK. Approximately 3 percent, the projections that CBO has provided the Congress.

The CHAIRMAN. What is the Lewin VHI model? You say the Lewin VHI estimates.

Mr. POLLACK. Lewin VHI has been used very broadly both by the administration and by wide variety of organizations, ranging from the Heritage Foundation to the Brookings Institution. I think they are generally viewed as a bipartisan or nonpartisan agency that has in the past provided very good numbers, particularly in the area of health care.

The CHAIRMAN. Well, then I would ask Ms. Brown, would you agree with Mr. Pollack's tables? I mean, is that the data you have or would you want to go and take them home with you as it were and look them over?

Ms. BROWN. Well, I think he is talking about averages. Whereas, we are focusing on those people who have adjusted gross incomes of $50,000. What we are saying is, if you tax Social Security at 85 percent as proposed, you are going to disproportionately affect particularly those people whose incomes are between $30,000–40,000 a year.

What happens with these people is that as you well know, when you are retired your income for the most part is about as high as it is going to go.

The CHAIRMAN. Yes.

Ms. BROWN. Inflation is not going to make it about as high as it is going to go. You are going to need to spend more money every year to buy the same things and older people have particularly seen that in the arena of health care and just general utilities and other things.

So if you push more people from the 15 percent tax bracket who are not wealthy into the 28 percent tax bracket, you automatically set yourself up to fail with those people because they are going to have to spend down their resources more quickly.

Then you will find yourself with more people who are forced to do the kinds of things that older people simply do not want to do, which is the problem of Medicaid and welfare and all of that. As you well know, older people, their one fear in life is I want to take care of myself. I want to be self-sustaining.

And by the additional tax, which will go on forever, and probably increase, I think you disproportionately affect people in the 15 percent tax bracket and may push more of them to the wrong side of the fence, which is more costly to the government ultimately also.

The CHAIRMAN. In the end, yes. I was going to say that our dear, now deceased, mother-in-law, who was a member of the American Association of Retired Persons, all she wanted in her life was to be on her own and she was until a rather sudden and very costly illness.

But when it was all over with, for about 3 months we kept getting little checks from the American Association of Retired Persons for this little benefit and that little benefit. It was remarkable.

And yet, the case of dealing with the deficit is overwhelming. You understand what we live with here. We had in a sense in the earlier discussions the question of cutting the COLA was raised and this issue is raised. And it wasn't raised as, you know, one or the other. But we did make it very clear that we just—there was no case for a reduction in the benefit, which was a lot of cutting the COLA, cost of living adjustment, would do. And not just one time but indefinitely, the rest of your life.

We have this before us. The President has asked us to do it. We see your public opinion polling. It is obviously against it. I suspect that will be the—I do not know what provisions in this tax bill we would get a majority for. But we are instructed to raise $272 billion by June 18. That was not necessarily our idea.

Yes, I voted for that. If we do not take care of this deficit, it is going to start taking care of us. And the people who will be most affected by it are the elderly. I will put it to you—not to you because we have no adversarial relation at all—once you get a debt as large as ours, growing up and going at a trillion dollars per Presidential term, even with this tax proposal, President Clinton's debt will increase by $1 trillion in 4 years.

Once that is done, gets up, the temptation of government—and you just feel it already almost, is to get rid of the debt by inflation. It is called monetizing the debt. You are going to have 1,000 percent inflation and 2 years time you have no debt left.

Mind you, you do not have any economy left either. And the people who are wiped out are the people who have put savings aside. That is something that, you know, it has gone up in time and in a great decade back there, but it is over. As you see, it is not an easy choice that we are asked to make. But we hope we will make a responsible one.

We will be the more so. It will be more informed because of your testimony. We thank you very much indeed.

Ms. BROWN. If I might, Senator?

The CHAIRMAN. Please.

Ms. BROWN. You know, I have testified before you quite frequently over the years.

The CHAIRMAN. You certainly have and you are always welcome.

Ms. BROWN. And I always appreciate your time and all the things that you have done. The older people have sacrificed before for this country. They will sacrifice now and we will sacrifice again. We are the parents and grandparents of America.

The CHAIRMAN. Yes.

Ms. BROWN. So we, like you—you are a parent and a grandparent—we also, we want the deficit to be taken care of. The caution is, let's not throw the baby out with the bath water. Let's not take people who are on the border and push them over the edge so that they cannot live their lives out in a reasonable way because we in the long run will pay more for that if we do not do it properly.

The CHAIRMAN. Exactly. I could not more agree. Mr. Pollack, did you want to comment?

Mr. POLLACK. No, sir.

The CHAIRMAN. I want to thank you both for your computation. It was very helpful to us. We will now adjourn so that I can show pictures of my grandson. [Laughter.]

[Whereupon, at 12:35 p.m., the above-entitled hearing was adjourned.]

[The prepared statements of Senators Rockefeller and Hatch appear in the appendix.]

APPENDIX

Additional Material Submitted

Prepared Statement of Robert Ball

Mr. Chairman and members of the Committee.

My name is Robert Ball. I was Commissioner of Social Security from 1962 to 1973. Prior to my appointment by President Kennedy, I was a civil servant at the Social Security Administration for nearly twenty years. Since leaving the government, I have continued to write and speak about Social Security, health insurance and related programs. I was staff director of an Advisory Council on Social Security to this Committee in 1948 and a member of statutory Advisory Councils in 1965, 1979 and 1991. Together with the Chairman and several members of this Committee, I was also a member of the National Commission on Social Security Reform, whose recommendations served as the basis for the important 1983 Amendments to the Social Security Act. I am currently the Chair of the Board of the National Academy of Social Insurance, but I am testifying today entirely as an individual.

I strongly support the President's proposal to apply income tax rates to 85 percent of the Social Security benefit for persons who are above the income thresholds in present law: $25,000 for single taxpayers and $32,000 for couples. And I support his proposal that the increased income be allocated to the Hospital Insurance Trust Fund.

I have long believed that the same tax policy that applies to contributory private pensions and contributory government career plans should,to the extent possible, also apply to Social Security: namely, that benefits that exceed what the beneficiary has paid in should be taxed. Beneficiaries have already paid a tax on their own contributions and contributions should not be taxed again, but the rest of the benefit has not been taxed and should be as a matter of tax equity.

I have had this view for a long time. My first attempt to get Social Security taxed was with the late Stanley Surrey, Assistant Secretary of the Treasury for Tax Policy in the Kennedy Administration, when he and I tried, but without the slightest success. Secondly, as a member of the 1979 Advisory Council on Social Security, which recommended taxing benefits,but again without making any converts on Capitol Hill, and finally as a member of the National Commission on Social Security Reform in 1983 where I was quite instrumental in getting the Commission to recommend taxing 50 percent of the benefit for those above the income threshold in present law.

One might well ask why I, who have made a career of developing and defending Social Security, would want to have benefits taxed? Why isn't that just like the benefit cuts that I have consistently opposed? The answer is that I see taxing Social Security benefits, not only as fair, but as a way to identify the program with all other earned retirement income, and therefore another way of making clear that Social Security is not welfare but similar to all other earned pensions. I believe that taxing Social Security benefits as other retirement income is taxed strengthens the philosophical foundation of the program as an earned right and helps to hold off proposals for means-testing or cutting basic benefits or the cost-of-living adjustment. Treating Social Security just like all other benefits paid as a right, rather than giving it special tax treatment emphasizes its special character as a contributory system paying its own way.

This line of reasoning is supported by the history of the tax exemption. There is no law on this, only early Treasury rulings based on what I consider the mistaken notion that Social Security was some kind of gratuity and therefore not taxable to the recipient. This original interpretation had some basis in the way the law was set up. To reduce the possibility of constitutional challenge, the titles in the law granting benefits were entirely separate from the titles imposing taxes. There was no doubt that Congress could grant benefits and there was no doubt that Congress could levy taxes, but there was concern that connecting the two in a social insurance system—a new concept in the United States of 1935—might be overturned by the conservative majority on the Supreme Court. Well if the benefits didn't grow out of the taxes paid, there was a basis for thinking of them as a government grant and not taxable. In the early Treasury ruling, the Treasury referred to previous rulings on such income as precedents.

I think this concept is damaging to Social Security, so for philosophical reasons, as well as for tax equity, I would treat Social Security like any other pension.

But then you might well ask, why the exemption for lower income people? Here the answer is "experience." Without the low income exemptions, about 40 percent of beneficiaries wouldn't pay taxes anyway because of the progressive features of the income tax, but it might not be clear to low income people that this was the case. When Stan Surrey and I first proposed taxing Social Security benefits, the propaganda machines stirred up everyone, regardless of income, as if the proposal were for an excise tax on Social Security benefits. So in recent years I have favored an explicit income exemption to make it absolutely clear that the tax wouldn't apply to those with the lowest income. But I have favored keeping these thresholds unindexed so that gradually more people would pay, and finally Social Security taxation would come to depend on the general provisions of the income tax to protect low income people. I believe this is the correct policy but that we should get there gradually. It would be too much of a reduction in what Social Security beneficiaries have been counting on to do this all at once. The important thing, I believe, is to get started in the right direction.

One further departure in the Social Security proposal from a strict application of pension tax policy, is the substitution of a general figure, 85 percent of the benefit, for individual calculations. I am told that individual calculations would be difficult for Social Security to do and, of course, the numbers are massive—nearly 42 million monthly beneficiaries. Thus it has seemed best to use an approximation for the amount by which the benefit exceeds what the contributor has paid. I am assured by the government actuaries, however, that the approximation favors the beneficiary—that no one now contributing and no new contributors for far into the future, at least, will pay more than 15 percent of the value of the benefits calculated over the life expectancy of the contributor in the same way that Treasury would calculate other contributory pensions for tax purposes. Almost all will pay less. The question here is equality. To do it the same way. I take no position of whether there might be better ways to make the calculations, say by using present value calculations, etc. The whole point is to do what Treasury does for other plans, and according to the Social Security actuaries who have checked their method with Treasury that gives you the 85 percent figure.

Those of you who are wondering how this can be reconciled with calculations that are showing high paid single male workers coming close to paying for the full value of their benefits even now, need to be reminded of the wonders of compound interest. Compound interest is included in "money's worth" calculations but not in calculating the extent to which benefits exceed what workers have paid in, and that is all the difference. The interest in the case of private pensions and government career plans has not been previously taxed but is in retirement.

Finally, let me say that my concern is for treating Social Security like other retirement income. If you decide to change the way other pensions are taxed, then I would favor treating Social Security the same way. It is equality I want for Social Security, and I am not prepared to argue one way or another that you have found the best approach to taxing retirement income generally.

The President's proposal seems to me a reasonable way to reduce the deficit some $23 billion over the next five fiscal years. I favor this objective, but the major reasons for my strong support are (1) tax equity and (2) strengthening Social Security philosophically by treating it like any other earned retirement benefit. It is time the early Treasury rulings on this point were overturned by legislation.

Mr. Chairman and members of the Committee, thank you for the opportunity to testify on this important matter.

Prepared Statement of Judith Brown

The American Association of Retired Persons (AARP) appreciates the opportunity to present its views regarding the Administration's proposal to increase the percentage of Social Security benefits subject to federal taxation. AARP commends the chairman for holding this hearing and hopes it will help the Finance Committee and the Senate evaluate the impact of this proposal upon older taxpayers.

I. BACKGROUND

Prior to 1983, Social Security benefits were not taxed because they were regarded as a "gift" by the Internal Revenue Service. From time to time, consideration was given to taxing these benefits, especially after the 1979 Advisory Council on Social Security recommended such action and the Social Security system faced insolvency.

The Social Security Amendments of 1983 provided for taxation of benefits effective 1984. This change was an important component of a carefully crafted compromise in which current workers and employers (through increased payroll taxes) and retirees all contributed to secure Social Security's fiscal integrity. Since the provision to tax benefits was enacted to help restore the fiscal soundness of the system, the revenue raised from taxing benefits is credited to the Old Age, Survivors and Disability Insurance (OASDI) trust funds.

The 1983 Social Security legislation specified that single taxpayers with adjusted gross incomes (AGI) of $25,000 (including tax exempt interest and half of their Social Security benefits), and joint filers with incomes in excess of $32,000, were to be taxed on the lesser of half of their benefits or half the amount of income in excess of these thresholds. The percentage of benefits subject to federal taxation was set at up to fifty percent of benefits in recognition of the fact that employees pay half of the Social Security (FICA) taxes in after tax dollars.

When benefits were first taxed, about eight percent of beneficiaries were affected. Since the thresholds for taxation do not rise with inflation, the number of beneficiaries taxed on their benefits has risen to 22 percent in 1993. By the turn of the century, almost one in three beneficiaries will pay tax on their Social Security. The thresholds were not indexed deliberately in order to provide the Social Security trust funds with increasing revenue in the future when the number of beneficiaries rises dramatically and the number of workers declines.

II. THE ADMINISTRATION'S PROPOSAL

The President has proposed raising the percentage of benefits subject to taxation from 50 percent to 85 percent. The Administration estimates that this change would yield about $23 billion over five years. Although the revenue from taxing 50 percent of benefits is credited to the Social Security trust funds, the revenue raised from taxing the additional 35 percent of benefits would be directed to the Hospital Insurance (HI) trust fund (Medicare Part A). Such a policy undertaken as part of comprehensive health care reform may have merit; however, simply to divert this revenue to HI absent reform is unwise.

President Clinton's efforts to reduce the federal deficit are to be commended. Older Americans understand that deficit reduction is essential to our nation's economic well-being. AARP has long supported fair and responsible deficit reduction efforts. However, the Association has some major concerns with the Administration's taxation of benefits proposal. First, we must not lose sight of the fact that Social Security is *NOT* contributing to the deficit. On the contrary, Social Security is building a substantial reserve, collecting more each year than is needed to pay benefits and administrative expenses. Second, those hardest hit by the Administration's proposal are middle income taxpayers.

III. EFFECT OF THE PROPOSAL ON OLDER TAXPAYERS

For middle income older taxpayers—those with adjusted gross incomes of $30,000 to $50,000—the impact of the proposed change is particularly onerous. For them, the amount of lost income is significant and difficult (if not impossible) to replace. At their age, work—a common way to augment income—may not be a realistic option, and shifting assets into potentially more profitable investments carries greater risk. In fact, older Americans income erodes significantly over time, and this tax increase accelerates that trend. (See Charts 1 and 2)

About 2.6 million older "tax filing units" are currently in the lowest tax bracket, paying taxes at the 15 percent rate (see Charts 3 and 4). Nearly 400,000 older tax filers would be pushed into the higher tax bracket (28 percent), not because of increased income, but simply because a larger portion of their Social Security benefits would be subject to taxation. Of these, about 130,000 are single filers and 250,000 are joint filers.

For most in the $30,000–$50,000 income group, Social Security is the predominant or a major income source. On average, Social Security represents around 25 percent of their gross income. Pensions, which generally are not fully indexed for inflation, are about 22 percent of income. Wages (of a beneficiary or a spouse) represent around 18 percent of income, and taxable interest is around 19 percent. Because a significant portion of these beneficiaries' income is fixed, their ability to augment or adjust their income stream is constrained. This limited flexibility has been compounded by the precipitous decline in interest rates over the past several years.

Those in this middle income group who derive a greater share of their income from Social Security will be hit harder than higher income retirees because a much greater percentage of their overall income will be subject to new taxation. The dollar amount of their income tax increase can be as high as $1,000.

After state taxes, local property taxes, higher out-of-pocket costs for health care and the normal costs of maintaining a household are accounted for, another several hundred to a thousand dollars in new tax liability represents a significant loss.

Social Security represents only 20 percent of the income of filers with incomes between $50,000 and $75,000. For tax filers with incomes of $75,000 or more, Social Security is less than 8 percent of their total income, about half the amount they derive from either taxable interest or capital gains. In short, as beneficiaries' incomes rise, the importance of Social Security declines and the impact of a tax increase on higher income beneficiaries is less onerous. As a result, a tax described as affecting only "the wealthy" or "better off" elderly falls hardest on middle income beneficiaries.

Table A illustrates how this proposal creates additional inequities and, in essence, creates "cliffs." For example, if you compare single filers with $5,000 in Social Security benefits and $30,000 in other income to those with the same amount of Social Security and $50,000 in other income, the tax increase is the same even though their total income is different. Individuals with $100,000 in other income and $5,000 in Social Security benefits have a tax increase that is only $52 more than beneficiaries with one-third their income. Further, a $5,000 difference in other income (from $25,000 to $30,000 in total income) results in a tripling in the amount of new taxes for some single filers. (Married filers experience comparable tax increase inequities.)

IV. THE DISPROPORTIONATE SHARE

For elderly taxpayers, particularly the 4.3 million people (2.6 million "tax filing units") currently in the 15 percent tax bracket, the additional Social Security tax is a tax increase not borne by any other non-wealthy group under the Administration's package. In fact, the Administration's budget plan is based on the idea that the bulk of individual income tax increases should fall on those with the highest incomes—except as it affects older persons.

In particular, the Administration proposes to add a higher 36 percent marginal tax rate that would only apply to taxable income in excess of $140,00 for a couple and $115,000 for an individual. The Administration's plan would lift the current $135,000 cap on wages subject to the Medicare Hospital Insurance (HI) portion of FICA payroll taxes. To further improve the progressivity of the income tax structure, the Administration's proposal would also place a 10 percent surtax on taxable income in excess of $250,000.

These tax changes, which affect fewer than two percent of taxpayers, are intended to ensure that the bulk of individual tax increases are to be paid by those who are affluent. The Administration has taken great pains to insulate the bulk of middle-income taxpayers from income tax increases.

In contrast, older taxpayers would face significant tax increases at substantially lower income levels. The *average* income tax increase as a result of the Social Security change for individuals in the $30,000 to $40,000 AGI range is over 18 percent (See Chart 5). Many elderly couples under $50,000 of AGI will be experiencing tax increases over $1,000.

In addition to these benefit tax increases, older Americans are subject to all other tax increases (most notably the energy tax), as well as Medicare premium increases under the Administration's budget plan. These increases, which will not be offset for most older taxpayers, already reduce the available income of older Americans.

Other tax consequences will result from the proposal to tax 85 percent of benefits. For older taxpayers living in the many states that directly tax Social Security or piggyback on the federal income tax system, state tax liability will rise. By including a greater percentage of Social Security in AGI, other deductions based on AGI (particularly the medical deduction) will be reduced. The compounding effect results in an even greater tax bite on a group which is clearly middle income, *not* wealthy.

In addition to the actual dollar increase, the proposal also raises marginal tax rates, particularly for older workers, to excessive levels. It is actually possible—taking into account income taxes, payroll taxes, and the Social Security earnings limit—to lose money by earning extra income. While the hypothetical case may be unusual, it underscores the excessive marginal tax rates that will occur. In effect, these rates will discourage additional earnings, and will act as an impossible hurdle for some desiring additional employment income.

Raising the taxable percentage of Social Security will also exacerbate the marriage penalty that exists with the current thresholds for single and joint filers so close together.

In total, older middle-income taxpayers are the only non-wealthy group of individuals that will experience a large tax increase under the budget plan. Almost half of these taxpayers are in the lowest tax bracket. For those closest to the current thresholds, the resulting tax increases from the Social Security proposal may be larger in both percentage and dollar terms than the tax increases on those in the proposed higher 36 percent tax bracket.

Some may argue that because of the existing partial exclusion of Social Security benefits from taxation, the tax burden of older Americans is too low. AARP believes that this is not the case. The *average* 62 year old retiree has a life expectancy of about 20 more years. Without wages, even a middle income retiree will have an uphill fight to remain middle income. As life expectancy increases, older persons will be hard pressed to maintain their standard of living over a longer lifetime. A reduced tax burden at retirement (of which an important component is the partial exclusion of Social Security) is wholly appropriate to maintain income adequacy as income declines (See Charts 1 and 2). Indeed, the Social Security cost-of-living adjustment (COLA), which helps older persons keep up with inflation, is nullified for these middle income taxpayers. Under the proposal, middle income older persons will pay in taxes an amount that roughly equals the value of 2 COLAs *every year*. These middle-income older persons are not likely to see their incomes grow in the future, but will experience an erosion of assets and buying power over time.

A reduced overall tax burden at retirement is appropriate and a long-time feature of the tax code. However, recent changes in the tax code have led to increased taxation of middle income older Americans. The Tax Reform Act of 1986 eliminated the extra exemption for persons over the age of 65 (replacing it with a smaller increased standard deduction for non-itemizers), and also cut back on one of the most important deductions for older persons, the medical deduction (raising the threshold from 5 percent of AGI to 7 1/2 percent of AGI). In addition, the Social Security Amendments of 1983 require that tax-exempt interest income be included in calculating the amount of Social Security benefits that is taxed. This provision, which may push beneficiaries over the tax thresholds, essentially requires (albeit indirectly) these taxpayers to pay tax on their tax exempt income. Given these recent changes, and the need for older persons to maintain an adequate income stream over their remaining lifetimes, the current tax burden at retirement is not "too low."

Finally, the overall thrust of this package is deficit reduction through shared sacrifice. Proponents of this package have attempted to limit the impact on the middle income taxpayer and ease the burden on lower income taxpayers. A Social Security tax increase that significantly impacts middle income older taxpayers falls far short of these goals.

V. THE RATE FOR TAXING SOCIAL SECURITY BENEFITS

When the National Commission on Social Security Reform (the Greenspan Commission) analyzed proposals to tax Social Security benefits, considerable attention was devoted to the appropriate percentage of benefits that should be subject to taxation. The level was set at up to 50 percent because the employee paid half of the contributions with after tax dollars. Those who are taxed on their benefits understand this rationale, even if they do not always agree with it.

The Greenspan Commission reviewed proposals to tax 85 percent of benefits. The higher taxation level was advanced because it would more closely conform the tax treatment of Social Security benefits with the taxation principles that apply to private pensions. However, Social Security is different from a private pension. It is an almost universal social insurance program established by the government to provide income protection to workers and their families if the wage earner retires, becomes disabled or dies. Given Social Security's unique features, it is not necessary to have parallel treatment to private pensions.

Post-Greenspan Commission analyses of the 85 percent level suggest that it may be too high. The Congressional Budget Office (CBO) has pointed out that the 85 percent level reflects the nominal value of payroll tax contributions and fails to adjust them for inflation. CBO suggests that a 60 percent rate would take inflation into account. A recent analysis by former chief actuary, Robert Myers, notes that the 85 percent rate represents double taxation. He recommends an initial 80 percent rate (for nominal, not inflation adjusted dollars), followed by a declining percentage until it reaches 72 percent in the next century.

Raising the percentage of benefits taxed represents a benefit reduction for 22 percent of current beneficiaries and for many of those approaching retirement. It heightens the anxiety of today's workers about the availability and value of their Social Security retirement benefits. While the "value" of Social Security for current workers is often understated because disability and survivor benefits are omitted from most analyses, workers' concerns about the impact of these proposals upon their retirement income security are understandable.

VI. THE PUBLIC'S REACTION

AARP asked the ICR Survey Research Group to track public opinion about the Administration's overall deficit reduction package and about the taxation of benefits proposal in particular. As Chart 7 indicates, opposition to the increase in taxation of benefits is substantial among *all age groups.* (These findings are consistent with other polling data). Chart 8 shows that opposition to this proposal has increased over time. Furthermore, as depicted on Chart 9, even among those who find the package acceptable, opposition to this proposal remains considerable. The taxation of benefits proposal is becoming increasingly unpopular. Americans of all ages understand how this proposal reduces the economic well-being of current and future beneficiaries.

VII. CONCLUSION—THE NEED FOR MODIFICATION

Many older Americans understandably are worried about the income they would lose if this proposal becomes law, and they have expressed this both to the AARP leadership and to their elected officials. Generally, they are not asking to be exempted from a deficit reduction package; they are simply asking that the sacrifice be commensurate with other taxpayers and with their ability to pay now and in the future.

To the 67 year old widow whose income in 1994 will be $26,809, plus Social Security benefits of $9,145, a $625 tax increase (an 18 percent income tax increase) represents a significant loss. When she reads that a non-elderly professional with triple her level of income will not have an income tax increase, it is little wonder that she feels she is being asked to sacrifice more than her fair share. For the couple that recently called AARP, with about $38,000 in annual income plus nearly $13,500 in Social Security, an almost $700 tax increase (a 14 percent income tax increase) means they will have less money to help support their disabled daughter and her husband.

While AARP supports "fair share" for deficit reduction based on the concept of shared sacrifice, the Association strongly believes there is a need to cushion middle income older persons from disproportionate tax increases. While some could argue that the 8 percent of beneficiaries affected by the $25,000/$32,000 thresholds established in 1983 were comparatively affluent, few would argue that a tax increase that affects 22 percent of beneficiaries—almost half of whom are in the 15 percent tax bracket—is a tax only on the rich.

Options for change have already begun to surface. The Senate is currently on record in support of the Lautenberg-Exon resolution that would raise the thresholds to $32,000/$40,000 (single/joint) for the higher 85 percent tax level. While clearly a step in the right direction, this proposal would protect only about half of the taxpayers in the fifteen percent bracket. More can and should be done to insulate middle income older Americans from disproportionate tax increases.

AARP remains committed to deficit reduction and the long-term improvement of our nation's economy. The Association is prepared to work with the Committee to improve the Administration's deficit reduction package and to reduce its disproportionate impact on middle income older Americans.

TABLE A

Additional Federal Income Tax Liability in 1994 Under the President's Proposal

Annual social security benefit					
	$5,000	**$10,000**	**$15,000**	**$20,000**	**$25,000**
Other Income*	**Additional tax liability**				
Single					
$0-15,000	0	0	0	**	**
20,000	0	0	$ 131.25	**	**
25,000	$131.25	$ 262.50	579.00	**	**
30,000	490.00	980.00	1,225.00	**	**
35,000	490.00	980.00	1,470.00	**	**
40,000	490.00	980.00	1,470.00	**	**
50,000	490.00	980.00	1,483.50	**	**
75,000	542.50	1,085.00	1,627.50	**	**
100,000	542.50	1,085.00	1,627.50	**	**
Joint					
$0-15,000	0	0	0	0	0
20,000	0	0	0	0	$ 26.25
25,000	0	0	26.25	$ 157.50	288.75
30,000	26.25	157.50	288.75	420.00	551.25
35,000	262.50	420.00	551.25	682.50	813.75
40,000	262.50	525.00	1,047.50	1,536.50	1,944.00
50,000	490.00	980.00	1,470.00	1,960.00	2,450.00
75,000	490.00	980.00	1,470.00	1,960.00	2,450.00
100,000	490.00	1,085.00	1,627.50	2,170.00	2,712.50

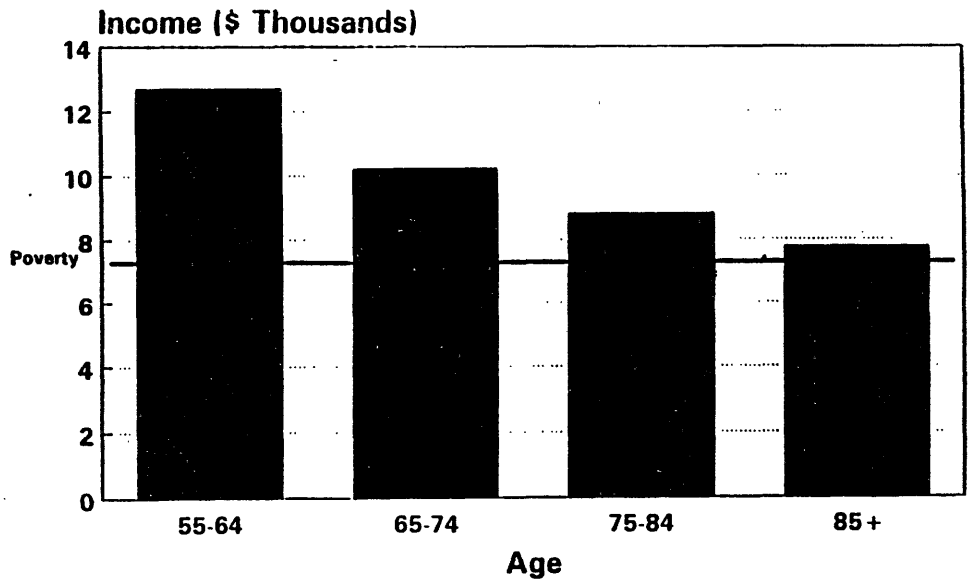
* Adjusted gross income *excluding* social security. *Total* income would be equal to other income *plus* social security. It is assumed no tax-free interest is received.

** Virtually no single individual currently receives this level of benefits. Very few receive $15,000 in yearly benefits.

Source: Congressional Research Service, May 15, 1993

CHART 1

Median Income: Non-Married Persons 1990



Source: Bureau of Labor Statistics
Prepared by AARP Public Policy Institute

Poverty threshold age <65: $6,880
Poverty threshold age 65+: $6,268

CHART 2

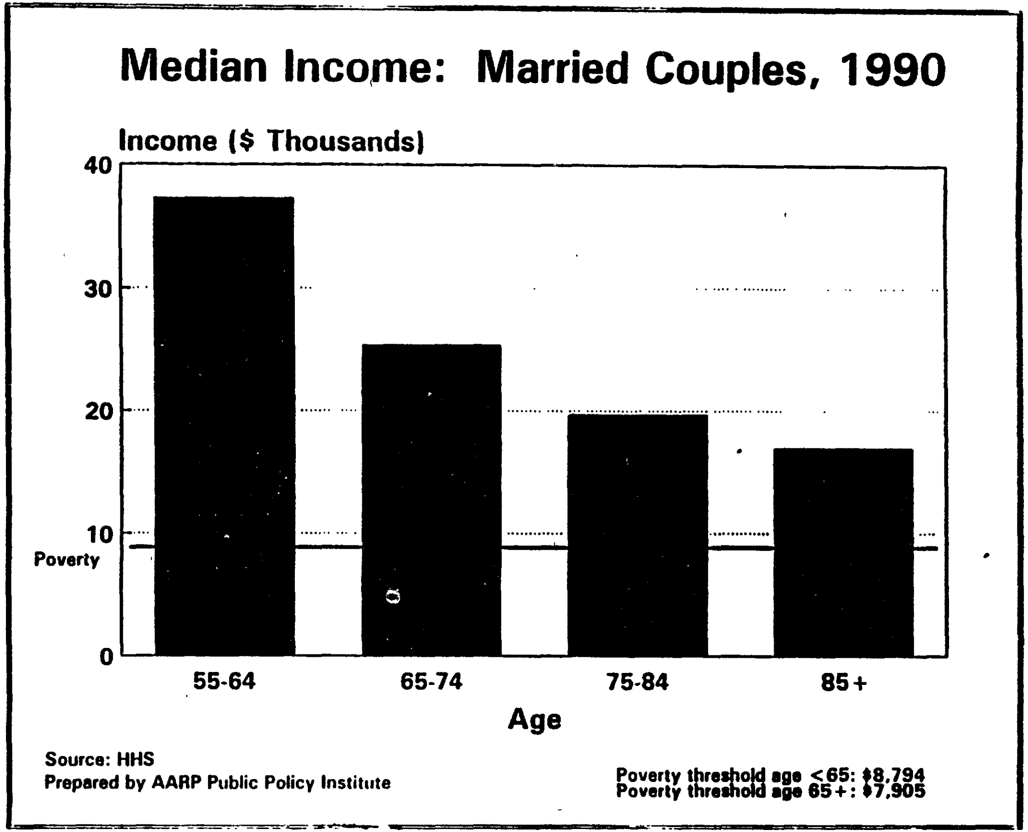
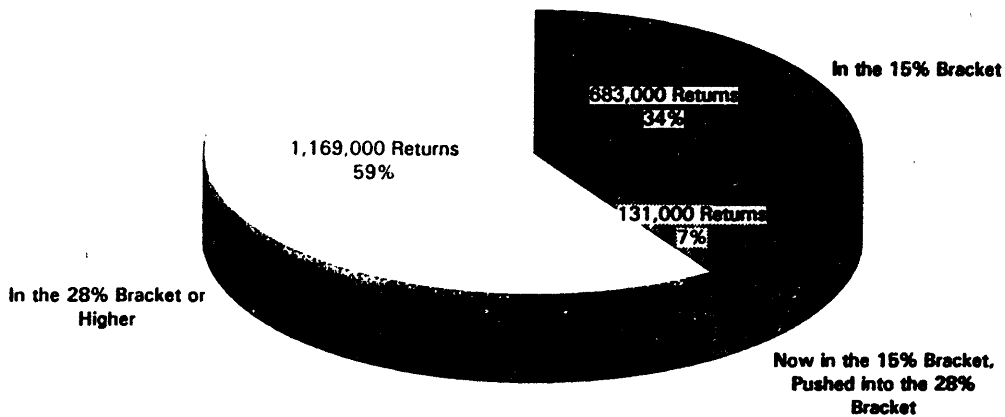

Median Income: Married Couples, 1990
Income ($ Thousands)
40
30
20
10
Poverty
0
55-64
65-74
75-84
85+
Age
Source: HHS
Prepared by AARP Public Policy Institute
Poverty threshold age <65: $8,794
Poverty threshold age 65+: $7,905

CHART 3

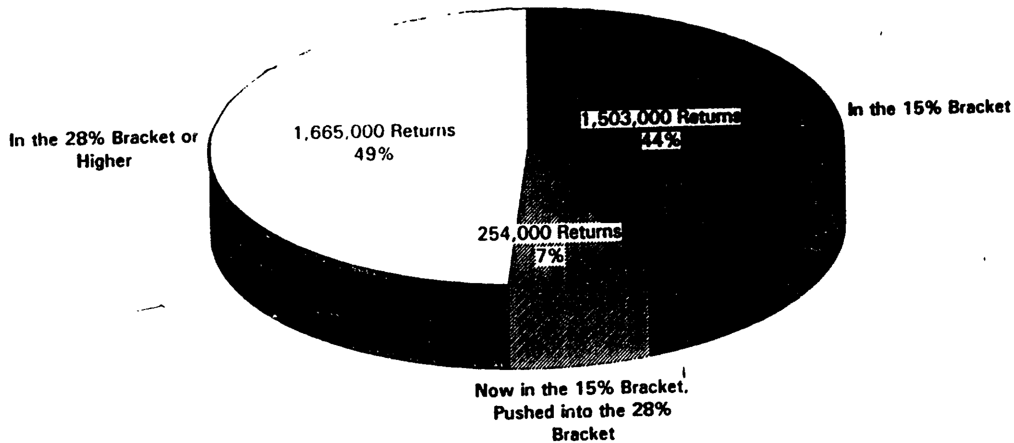
Administration's Proposal to Tax 85% of Social Security Benefits:
Tax Bracket of Affected Beneficiaries
Single Returns



Source: Price Waterhouse for AARP, April 27, 1993

CHART 4

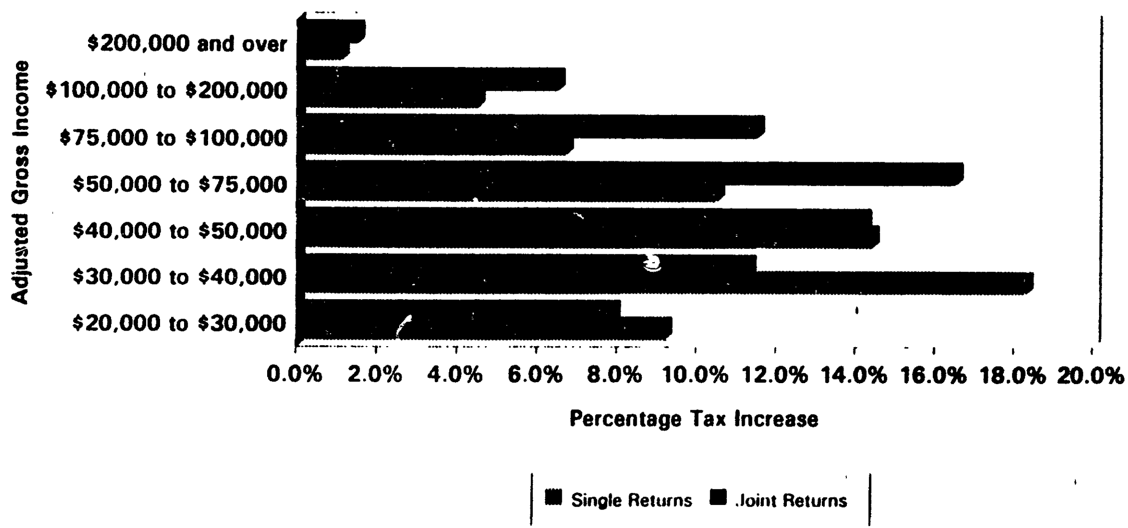
Administration's Proposal to Tax 85% of Social Security Benefits:
Tax Bracket of Affected Beneficiaries
Joint Returns



Source: Price Waterhouse for AARP, April 27, 1993

CHART 5

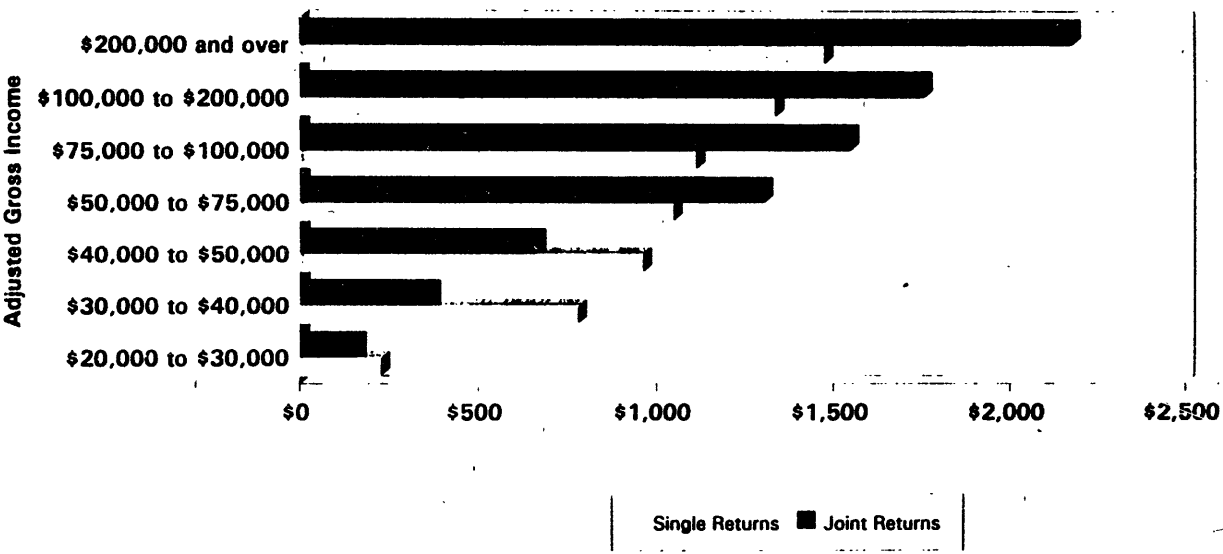
Administration's Proposal to Tax 85% of Social Security Benefits: Average Income Tax Increase in 1994 by Income Class (Average Percentage Increase)



Source: Price Waterhouse for AARP, April 14, 1993

CHART 6

Administration's Proposal to Tax 85% of Social Security Benefits: Average Social Security Tax Increase in 1994 by Income Class (Average Dollar Amount)

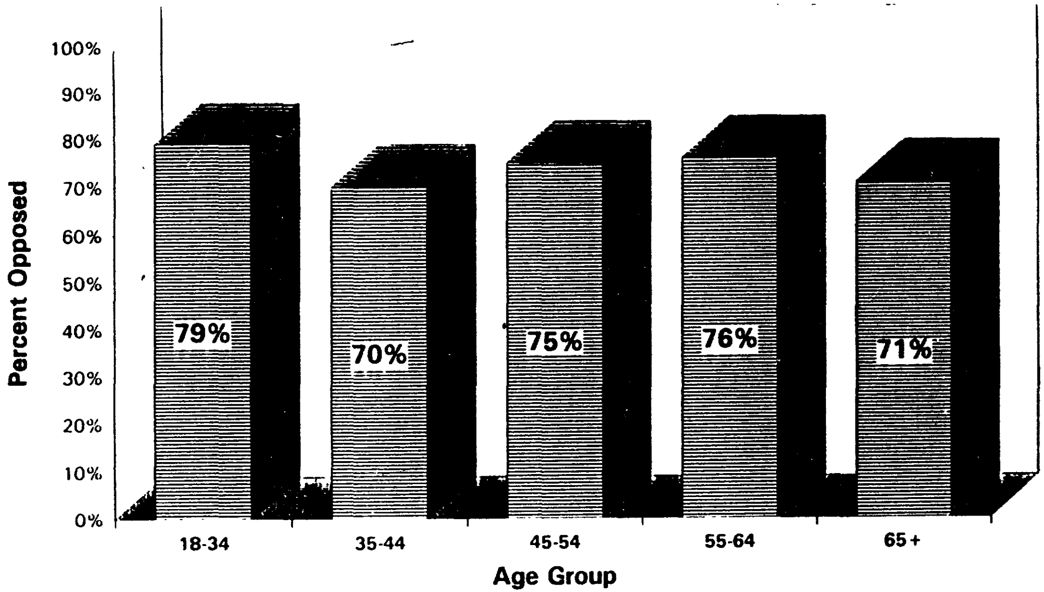


Source: Price Waterhouse for AARP, April 14, 1993

71-835 O - 93 - 3

CHART 7

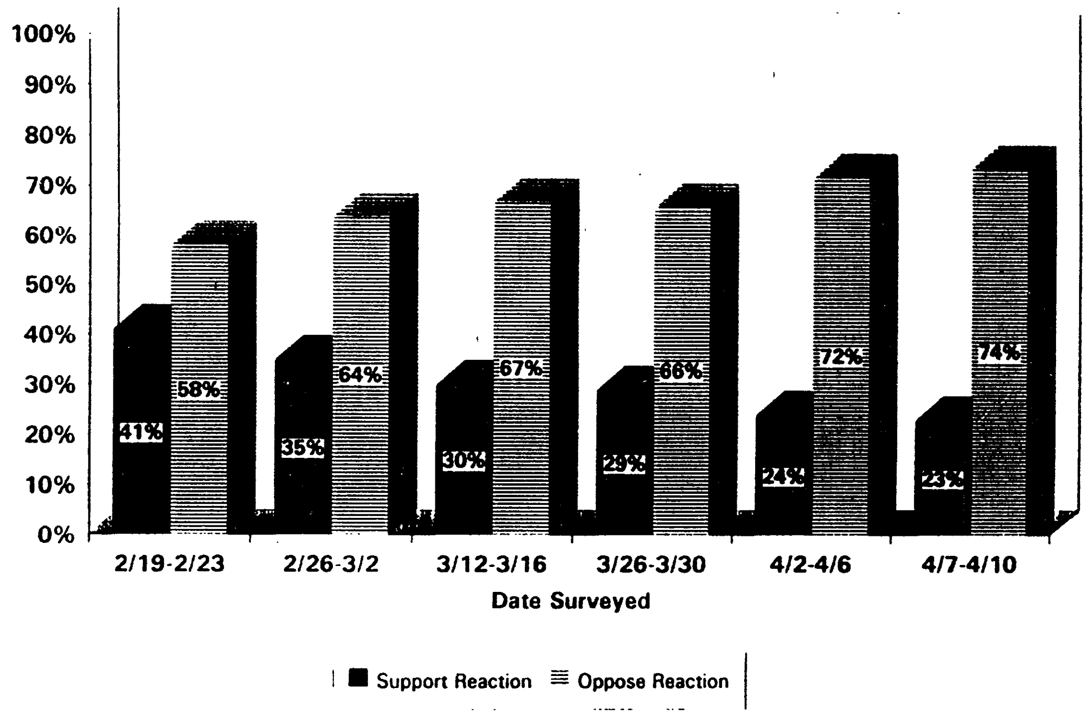
Opposition to Increased Taxation of Social Security Benefits by Age



Source: ICR for AARP, April 1993

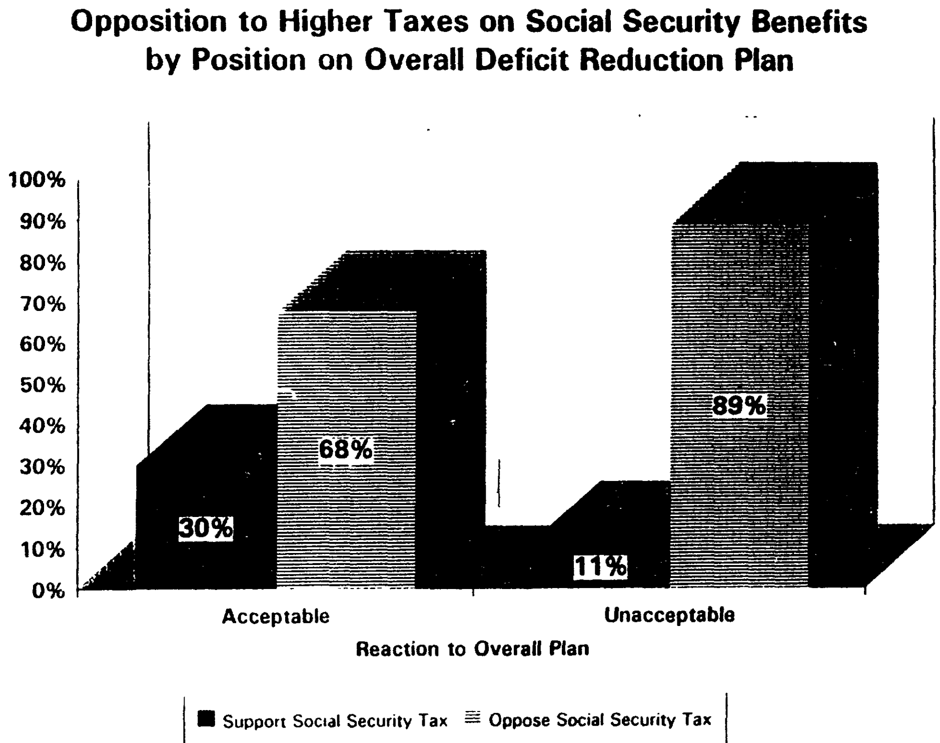
CHART 8

Trends in Reaction to Higher Taxes on Social Security Benefits



Source: ICR for AARP, April 1993

CHART 9



Source: ICR for AARP, April 1993

PREPARED STATEMENT OF LETITIA CHAMBERS

Mr. Chairman, I am honored to be asked to testify before this Committee on the issue of taxation of Social Security benefits. I am president of Chambers Associates Incorporated, a public policy consulting firm that specializes in tax and fiscal policy issues. I am appearing today as an individual and not on behalf of any client of the firm.

The Clinton Administration has proposed to increase the amount of Social Security benefits subject to taxation from 50 to 85 percent for individuals with annual incomes above a threshold of $25,000 and above $32,000 for couples filing jointly. The Administration proposes to credit the Medicare Hospital Insurance fund with an amount equal to the revenue from this tax. This differs from the current law taxation of benefits where an amount equal to the proceeds is posted to the Social Security Old Age and Survivors and Disability Insurance funds.

At the inception of the Social Security system, the issue of whether benefits should be taxed was raised. In 1938, before benefits were even paid and again in 1941, the Internal Revenue Service ruled that benefits were not taxable. This practice continued until Congress mandated taxation of up to 50 percent of benefits above the specified thresholds as a part of the Social Security Act Amendments of 1983, which restored the solvency of the Social Security system. One policy rationale for this change was made by the 1979 Social Security Advisory Council when it recommended "that the current tax treatment of private pensions is a more appropriate model for the tax treatment of social security . . ." and that while it would be too complicated to do so in the exact same fashion, " rough justice" would be served by taxing 50 percent of benefits. Another rationale is that the employer share of the social security tax is not included in a worker's taxable income during his or her working years.

The policy decision before this Committee today is not whether Social Security benefits should be taxed like private pensions, that policy has already been adopted, but rather how the tax should be calculated. Because Social Security is not comparable to any other public or private pension or insurance program, there is no specific precedent to be followed, so some rather arbitrary decisions must be made to arrive at a level which could be termed comparable. Later in my testimony I discuss the issue of alternative assumptions and ways to calculate a comparable level. However, it is important first to make explicit why this policy change is under consideration.

The new Administration and the Congress, faced with a national debt that has tripled in only a dozen years, are attempting to bring the annual deficits under control. In addition, the current budget structure has allowed Social Security trust fund surpluses to mask or hide part of the annual deficits in general fund spending. Mr. Chairman, you have made an outstanding contribution in making this fact clear to the American people. Social Security spending is not responsible for one penny of the $264.1 billion deficit projected for Fiscal Year 1994, and in fact, Social Security receipts will exceed spending by $60.3 billion. Social Security receipts are projected to continue to exceed spending, building the total surplus, until the year 2025 when the surpluses will be needed to finance benefits. This issue is important because the Federal government should make clear to America's seniors why they are being asked to pay higher taxes. It is not because Social Security needs additional financing. Nor is it because Social Security spending of its dedicated trust fund revenues has any relationship to the current deficit problem.

The Clinton Administration's proposal contains a tacit acknowledgement that Social Security is not part of the deficit problem, by proposing to post an amount equal to the additional revenue from this proposal not to the Social Security Trust Fund but to the Hospital Insurance trust fund. Under current law, the Hospital Insurance trust fund is projected in the Clinton budget to run a deficit of $0.85 billion in fiscal year 1994. The Administration proposal to increase the percentage of Social Security subject to taxation will bring $1.7 billion into the trust fund in Fiscal Year 1994, more than eliminating the deficit.

Everyone, including America's seniors, should understand the implications of this decision. The reduction of $1.7 billion in fiscal year 1994 in the incomes of seniors whose incomes exceeds the thresholds and of $ 17.5 billion through fiscal year 1997 will be used to help finance the health care of all seniors. If this proposal is enacted, I hope that the Administration and this Committee will keep in mind this increased contribution of seniors to the cost of their health care as the health reform package is put together.

This Administration is placing long-overdue emphasis on implementing budget and tax policies that will be fair, particularly to the middle class. From that perspective, the administration's proposal to increase the taxation of Social Security benefits is far preferable to alternative reductions in the income of seniors, such as reducing Social Security COLA's. At the same time, as I will discuss later in my testimony, a slight adjustment to the Administration's proposal may make it far more equitable over the long run.

Chambers Associates recently completed a study, *The Marginal and Average Tax Rates America's Seniors Pay,* for the National Committee to Preserve Social Security and Medicare. This study measured the impact of the following taxes and effective benefit reductions or spending cuts on Americans age 62 or older with earnings:[1]

- Social Security Payroll Taxes,
- Federal Income Taxes,
- The Retirement Earnings Test for beneficiaries age 62 through 69, and
- Taxation of Social Security Benefits.

We analyzed the impact of these taxes on four age groups: under age 62, 62 through 64, 65 through 69, and age 70 or older. We analyzed earnings levels between $100 and $50,000. We measured the cumulative impact of these four taxes on average and marginal tax rates in 1991 for individuals with average Social Security benefits.

The average rate results are not surprising, but dramatic. Average tax rates as a percentage of earnings for married individuals filing jointly, while reaching 21 percent at $50,000 of earnings for couples under age 62, peak at around 56 percent for retirees age 62 through 64, who have $30,000 in earnings, at 47 percent for those age 65 to 69 with earnings of $50,000, and at 25 percent for those over age 70, whose earnings are $40,000 or more. These large swings in average rates are due primarily to the Retirement Earnings Test rather than taxation of benefits.

The imposition of 85 percent benefits taxation does not have a dramatic impact on the average tax rates because of the interaction between these two taxes. Whether 85 percent of benefits or 50 percent of benefits are subject to the Federal income tax is immaterial if the Retirement Earnings Test has taxed away all of a Social Security recipient's benefits. For a single individual in 1991 between age 62 and 64, once earnings reached $27,000, Social Security benefits were phased out.

Thus, the impact on average taxes of increasing taxation of benefits to 85 percent shows up primarily in the group 70 and over, which is no longer subject to the Retirement Earnings Test. Average tax rates as a percentage of earnings for single individuals age 70 and above begins to increase under the 85 percent option starting at earnings of $17,500 or more. The divergence stabilizes at 2 to 3 percentage points of additional average taxes paid above current law.

The marginal tax rate (as opposed to average tax rates discussed above) for persons age 62 and over with earnings who receive average Social Security benefits is never lower than it is for other taxpayers with the same level of annual earnings for all income levels studied. The marginal tax rate is calculated as the income loss at each additional dollar of earnings. The maximum differential occurs at annual earnings around $25,000.

At that point, Social Security benefits are subject to taxation. In addition, beneficiaries between ages 62 and 69 are subject to the earnings test. The earnings test alone represents a marginal tax rate of either 33.3 percent or 50 percent, depending on age. The Social Security tax on earnings is 7.65 percent. The taxation of Social Security benefits is a marginal tax rate of 15.5 percent if 50 percent of benefits are subject to taxation[2] or a marginal tax rate of 26.4 percent if 85 percent of benefits are subject to taxation.[3]

The interaction of these rates explains why the marginal tax rate under current law is 74.2 percent for single individuals age 62 through 64, and 54.2 percent for individuals age 70 or older with annual earnings of $25,000. In contrast, at that level of earnings the marginal tax rate for individuals under age 62 was 22.6 percent.

As earnings continue to increase, the marginal tax rate that Social Security recipients pay declines to the level that non-Social Security recipients pay on the same level of earnings (38.65 percent). This occurs once Social Security benefits have been taxed away due to the earnings test or are taxed at the maximum amount under taxation of benefits. This clearly violates a conventional notion of tax equity—that marginal benefits should not be higher for lower income earners than for higher.

[1] The Retirement Earnings Test reduces benefits paid and is generally referred to as a spending reduction while taxation of benefits takes back benefits given and in the past has been generally referred to as a tax. Whatever one calls either of these, whether spending cuts or tax increases, is really irrelevant, because the impact—reducing benefit income—is the same.

[2] The highest income tax rate (31 percent) times $0.50.

[3] The highest income tax rate (31 percent) times $0.85.

In conclusion, both the average and marginal tax rates for seniors at the same level of earnings is higher than it is for non-seniors. However while this may violate the tax principle of horizontal equity, i.e., treating individuals with similar income in a similar fashion, the increased cash available to social security recipients from benefits justifies in my view taxing a portion of benefits as if it were income.

My concern about the taxation of Social Security benefits is what will happen over time. Those subject to this tax are generally described as higher income elderly. Actually, the income thresholds hardly allow one to live the life of Riley. In addition, every year, the definition of who pays the tax changes automatically. Unlike the personal exemptions, standard deductions, and brackets in the Federal income tax, the income thresholds at which Social Security benefits first become subject to taxation are not indexed. A decade ago, they were set at $25,000 for an individual and $32,000 for a couple filing jointly. Over the decade, 1983 through 1992, the Consumer Price Index increased 40.8 percent. Thus, in terms of purchasing power, the thresholds are already dramatically lower than when Congress made Social Security benefits subject to taxation.

Another study that Chambers Associates did for the National Committee to Preserve Social Security and Medicare shows the impact over time of the failure to index these thresholds.[4] We measured the impact over time of the taxation of Social Security benefits for workers with average wage histories who retire at their normal retirement age, which is currently 65 and will gradually increase to 67.

We found that for the baby boom and succeeding generations, the current law procedures for taxation of Social Security benefits become will less increasingly progressive. As soon as a taxpayer becomes liable for Federal income taxes, a significant percentage of his or her benefits will be subject to taxation. When workers born after the mid-1970's with average wage histories first reach the income tax threshold, their Social Security benefits subject to taxation will represent a larger proportion of taxable income than other income. In the attached appendix, the implications of this declining progressivity are analyzed in detail.

Therefore, I would suggest, a modest change to the Administration's proposal to reduce the inter-generational inequities in the current law which the Administration's proposal would exacerbate. This change is simply to conform the thresholds at which benefits first become subject to taxation to the same indexing procedures used for the standard deduction, the personal exemptions, and the tax brackets. The revenue loss from this modification would be modest. This simple reform will ensure that time does not impose a hidden tax on America's seniors, making taxation of Social Security benefits more regressive.

I mentioned earlier in my testimony that Chambers Associates had prepared a paper which looked at the impact of various methods for calculating level of taxation of benefits under alternative assumptions concerning pension comparability. In this study, which has been made available to staff, current law taxation of 50 percent of benefits was compared to the level of taxation under five alternative types of private pension investments and the way they are taxed. The analysis was done for three birth years: 1930, 1950 and 1970 and for those with no retirement earnings and for those with modest retirement earnings. Using the results of this study, one could make a case for any level of taxation of benefits from 35 percent to 86 percent, depending on which assumptions one adheres to.

While I believe that increasing taxation of benefits to 85 percent is rather arbitrary, it is not unreasonable if thresholds are indexed so that lower income seniors are not affected in future years. However, there is a problem with the 85 percent figure in the out years which this Committee may want to address if it adopts this proposal. All proposals to tax benefits have been based on an attempt to tax untaxed benefits. A tax rate of 85 percent will result in the out years in some double taxation for beneficiaries who earned the maximum wage base, and whose payroll tax contributions, which were included in taxable income in the year earned, as a proportion of total lifetime benefits will exceed the 15 percent non-taxed portion. In order to avoid this problem in the future, the Committee may want to tie the tax rate in the future to a calculation by the Social Security actuaries of the proportion which the taxed contribution is of total lifetime benefits for those who earned the maximum wage base. This would not have a revenue impact over the budget period but would avoid double taxation of income in future years.

---

[4] Chambers Associates, Incorporated, *Taxation of Social Security Benefits: A Concept Paper on Alternative Policy Options* (January, 1993). See the Appendix to this testimony for a technical details on the methodology which was used to develop the estimates in the following section of this testimony.

CONCLUSIONS

The Clinton administration proposal to increase the portion of Social Security benefits subject to taxation to 85 percent is designed to approximate the taxation of private pension plans. This is a reasonable and appropriate change.

However, in future years, making up to 85 percent of benefits subject to taxation will exacerbate the fact that the thresholds above which benefits are taxed are not indexed. Each year, the level of buying power at which the tax is instituted will decline, thus subjecting over time this tax to lower and lower levels of income. Taxing 85 percent of benefits should be accompanied by a policy change to index the Social Security threshold levels; otherwise this tax will hit lower middle income seniors, as well as middle and upper income seniors.

In future years, the 85 percent level of taxation will cause some income to be taxed twice. Some retirees will pay taxes on a portion of their benefits which are giving back to them payroll tax contributions for which income taxes were paid in the year in which they were earned. The Committee should write the legislation so that any double taxation in the out years is avoided.

Finally, placing an amount equal to the revenues from this tax in the Health Insurance Trust Fund, rather than the Old Age and Survivors and Disability Funds, is a significant policy change. The fact that seniors at middle incomes and above are being asked to pay more for the health care of all seniors by this action should be taken into account in considering financing options for health care reform.

APPENDIX

Failure to Index the Thresholds. The thresholds of $32,000 for married couples and $25,000 for individuals were not indexed to changes in the Consumer Price Index. This was a significant omission because during the 1980's, the Congress and the Reagan administration sought to index most of the tax code to the consumer price index. The major exceptions were the threshold by which Social Security benefits become subject to Federal taxation and changes in asset value over time simply due to inflation. Figure 1 below shows the impact over time of the taxation of Social Security benefits for single workers with average wage histories who retire at their normal retirement age, which is currently 65 and will gradually increase to 67 for workers born in 1960 or later.

The upper line shows the non-Social Security income level at which 50 percent of Social Security benefits become subject to taxation. This level was $29,506 for a worker who was born in 1926 and retired in 1991 at his or her normal retirement age of 65. For a worker born in 1983 who retires at his or her normal retirement age of 67 in the year 2050, the non-Social Security income level in 1991 dollars at which 50 percent of Social Security benefits become subject to taxation is $10,455. In other words, allegations that the taxation of Social Security benefits only affect affluent seniors are questionable today and will become increasingly out of touch with economic reality.

The lower line shows the non-Social Security income level at which Social Security benefits first become subject to taxation. This level was $20,494 for a worker who was born in 1926 and retired in 1991 at his or her normal retirement age of 65. For a worker born in 1983 who retires at his or her normal retirement age of 67 in the year 2050, the non-Social Security income level in 1991 dollars at which Social Security benefits first become subject to taxation is $4,249.

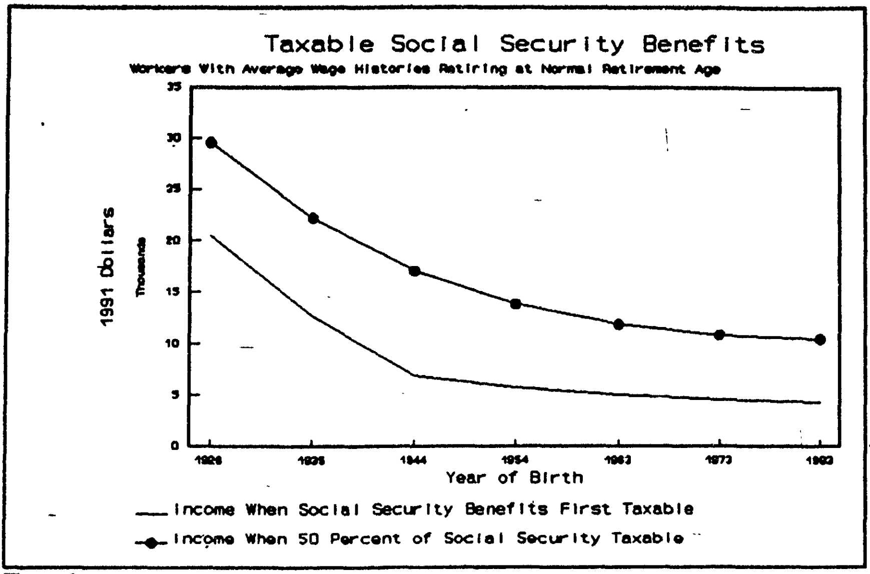


Figure 1

The taxation of Social Security benefits will create horizontal inequities between persons with similar wage histories in constant dollars who were born at different times. Currently, the Social Security benefits of persons with relatively small non-Social Security income are not subject to Federal taxation. For an individual to be subject to taxation, his or her income must be greater than the sum of the standard deduction and personal exemption (both of which are indexed to the Consumer Price Index). As long as this tax liability threshold is greater than the sum of Social Security benefits subject to taxation and other income, individual is not subject to Federal taxes.

For example, a single worker born in 1926 with an average wage history who retired at age 65 in 1991, in which year the sum of the standard deduction and personal exemption was $6,400, would have an annual Social Security benefit of $9,012. In that year Social Security benefits became subject to taxation when annual non-benefit income reached $20,494.

Contrast a worker born 18 years later in 1944 who retires in 2010 at age 66, the normal retirement age for his or her cohort. Like the individual born in 1926, this person has an average wage history. In 1991 dollars, his or her annual Social Security benefit would be $10,543, and the non-Social Security income level at which benefits would become subject to taxation would have declined to $6,885 in 1991 dollars. This has occurred because average Social Security benefits would have increased as real wages grew, the standard deduction and personal exemption would have increased because they are tied to the CPI, but the income thresholds for taxation of Social Security benefits would not have changed. In this scenario the worker with an average wage history would pay taxes on a portion of his Social Security benefits at the same wage as he or she becomes liable for Federal income taxes.

Figure 2 shows the impact of this inequity. The example shown is the same as in Figure 1, a single retiree with average benefits and other income that is sufficient to make taxable income equal to the tax threshold, the sum of the personal exemption and the standard deduction. Unlike Figure 1 which reflected all numbers in 1991 dollars, Figure 2 uses nominal dollars. The line, "Tax Liability Threshold," is the sum of the standard deduction and personal exemption. This line shows the income level at which a tax liability begins. The line, "Non-Social Security Income," shows the maximum level of other income before any Social Security benefits become subject to Federal taxation. The line, "Taxable Social Security benefits," shows the amount of benefits subject to Federal taxation. To the left of the intersection of the lines, "Tax Liability Threshold," and "Non-Social Security Income," there is no tax liability for Social Security benefits for a single worker with an average wage history. This occurs because the sum of the standard deduction and personal exemption is below the maximum level of income before any Social Security benefits are subject to taxation. But to the right of the intersection of these two lines, the sum of the standard deduction and personal exemption becomes higher than the non-Social Security income level at which benefits first become subject to taxation. As a result, the amount of Social Security benefits subject to taxation increases each year, as shown in the line, "Taxable Social Security benefits." The liability for each year is the amount by which the line, "Tax Liability Threshold," exceeds the line, "Non-Social Security Income." This liability is the same as the "Taxable Social Security benefits" line.

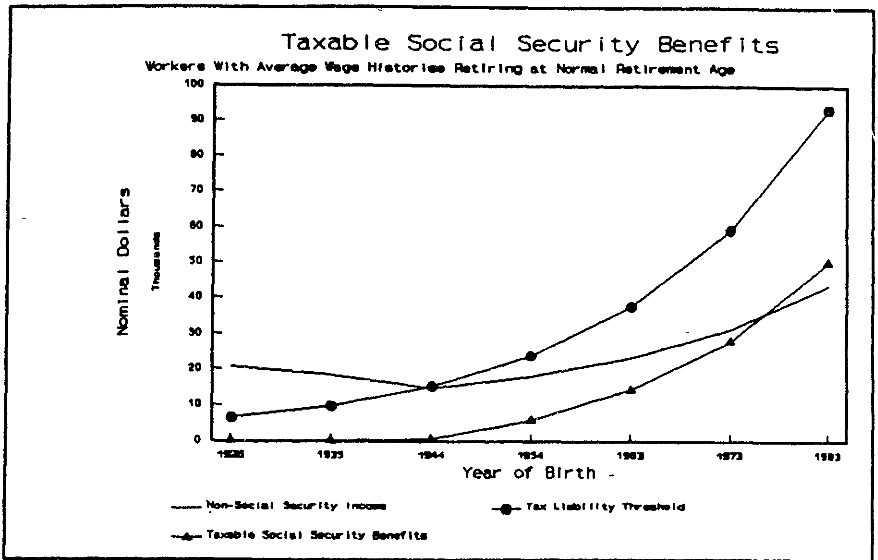


Figure 2

Figure 2 illustrates the fact that for the baby boom generation, the current law procedures for taxation of Social Security benefits become less progressive over time. As soon as a taxpayer becomes liable for Federal income taxes, a significant percentage of his or her benefits will be subject to taxation. When workers born after the mid-1970's with average wage histories first reach the income tax threshold, their Social Security benefits subject to taxation will represent a larger proportion of taxable income than other income.

METHODOLOGY

The average earnings history is based on the Social Security Administration's Average Wage Index. The benefit and tax liability projections for the out-years are based on the Intermediate Assumptions in the 1991 Annual Report of the Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (May 1991). Benefits were calculated using the Social Security Administration's PIA Calculation Program (Version 1992.1). The tax calculations are based on a model developed by Chambers Associates.

The non-Social Security income level at which Security benefits are first subject to taxation is the non-indexed income threshold for taxation of Social Security benefits ($25,000 for an individual and $32,000 for a couple) minus 50 percent of Social Security benefits. The derivation of this formula is as follows:

(1) the basic formula for calculating the amount of benefits subject to taxation is:

For an individual filer: $0.5(0.55 + Y - 25{,}000) = X$
For a married couple filing a joint return: $0.5(0.55 + Y - 32.000) = X$
When,
S = Social Security benefit,
Y = Non-Social Security income, and

X = Social Security benefit subject to taxation.

Therefore, if X = \$1, or one dollar of Social Security benefits are subject to taxation, Y = 25,001 − 0.55.

Under this formula, when Social Security benefits exceed \$50.000 or more a year in nominal dollars, \$.50 of the first dollar of benefits would in theory be subject to Federal income tax. This will not necessarily occur because the two items that determine the tax threshold—the value of the personal exemption(s) and standard deduction—are both indexed. Thus, tax liability under this formula will be negative for an individual with an average wage history retiring in 2010 or later.

To ensure that there is a positive tax liability, non-Social Security income was increased to the point at which the sum of X and Y equalled the personal exemption and standard deduction.

(2) To derive the formula for the non-Social Security income level at which 50 percent of Social Security benefits are subject to taxation, assume that X = 0.5Y. Substituting this value of X in the basic formula and solving for Y yields:

Y = 0.55 + 25,000

Prepared Statement of Louis D. Enoff

Mr. Chairman and Members of the Committee:

I am pleased to be here to discuss the Administration's proposal regarding the taxation of Social Security benefits. In my testimony today, I would like to describe how the Administration's proposal will change the way that Social Security benefits are taxed. I will then discuss the history of the taxation legislation and the reasoning which supports the Administration's proposal.

Current Law

Let me begin by briefly describing the current provisions for taxing Social Security benefits. Under current law, up to one-half of Social Security benefits are included in taxable income for those taxpayers whose combined income is above a certain threshold. The combined income is made up of adjusted gross income, tax-exempt interest income and half of Social Security benefits. The thresholds are \$25,000 for individuals, \$32,000 for married couples filing joint returns, and zero for married persons filing separate returns. The precise portion of Social Security benefits subject to tax is the lesser of: one-half of the benefits, or one-half of the amount by which the taxpayer's combined income exceeds the threshold amount.

The current taxation provisions were enacted as part of the Social Security Amendments of 1983, and were designed to help restore the Old-Age and Survivors Insurance program to financial solvency. The revenue derived from the taxation of Social Security benefits is credited to the OASI and DI trust funds.

Administration Proposal

The Administration is proposing that the maximum portion of Social Security benefits subject to income taxation be increased from 50 percent to 85 percent. Under the proposal, the amount of benefits to be taxed would be the lesser of 85 percent of benefits or 85 percent of the excess of the taxpayer's combined income over the threshold amount. As under present law, the threshold amounts would be \$25,000 for individuals, \$32,000 for married couples filing joint returns, or zero for married persons filing separate returns. Because the threshold amounts and the calculation of the combined income do not change from current law, the proposal would not subject any taxpayers to tax on their benefits who are not already subject to tax.

The increased revenue generated by the proposal would be credited to the Hospital Insurance (HI) Trust Fund, which is expected to be exhausted in 1999. The additional source of revenue for the HI fund would improve its financial position and help to continue the payment of benefits to Medicare beneficiaries beyond 1999.

Revenues from Taxation of Benefits

Under the current law provisions for taxing Social Security benefits we estimate that about 9 million beneficiaries will pay taxes on their Social Security benefits for tax year 1994, at an average payment of about $720 each. The tax on benefits is expected to bring in $6.4 billion to the OASI and DI trust funds in fiscal year 1994 and $35.1 billion over the next five years.

The Administration's proposal would not change the number of beneficiaries who must include their Social Security benefits in taxable income. However, the average payment would increase to about $1,270. As indicated in the President's FY 1994 budget, the proposal is expected to generate an additional $1.7 billion in fiscal year 1994, and $23.3 billion over the next five years. This additional amount would be credited to the HI trust fund.

Historical Background

The question of taxing Social Security benefits is not a new one. As early as 1941, the Internal Revenue Service ruled that Social Security benefits were not taxable income. However, because a worker's after-tax contributions to Social Security, as in most private pensions, represent only a relatively small portion of the total benefits that will be paid, some analysts questioned the tax-free treatment of Social Security benefits. Some saw this treatment as inconsistent with the tax treatment of pension benefits, which generally are taxed as ordinary income after an employee has recovered his or her own contributions to the pension plan.

The 1979 Advisory Council on Social Security considered the issue of taxing Social Security benefits and concluded that Social Security benefits should be treated more like private pensions for tax purposes. Under SSA's estimates made at that time, employees then entering the workforce would make payroll tax payments equal to, at most, about 17 percent of the benefits they could expect to receive. (Subsequently, this estimate was updated for later economic and demographic assumptions and for changes in the Social Security program to a level of 15 percent.) Because SSA's records do not contain precise data on individual social security tax payments which would permit calculation of contribution amounts for each beneficiary, the Advisory Council recommended that a single maximum percentage of benefits be set as subject to taxation.

In 1983 the bipartisan National Commission on Social Security Reform (NCSSR) recommended that one-half of Social Security benefits be subject to taxation, with the revenues generated to be credited to the OASI and DI trust funds. The taxation provision was one of a number of the NCSSR recommendations to restore the financial soundness of the OASDI trust funds.

Rationale for Administration Proposal

The Administration's proposal to include as taxable income up to 85 percent of an individual's Social Security benefit above the existing threshold would bring the tax treatment of benefits more closely in line with the tax treatment of private and public service pensions. In setting this level, we wanted to be sure that no group of workers would be taxed more than they would be under private pension rules. Current estimates show that if private pension rules were applied to Social Security benefits, the maximum amount of lifetime benefits that any group of workers would be able to exclude from taxation would generally be about 15 percent.

We think that the Administration's proposal provides fairer tax treatment of retirement benefits for higher earners, because the tax treatment of Social Security benefits and private and public pensions would be more similar. Thus, this proposal is consistent with the view that income from analogous sources should, in general, be treated equally for tax purposes.

Conclusion

We believe that bringing the tax treatment of Social Security benefits more in line with the treatment of private pensions, as suggested by the 1979 Advisory Council, is a fair proposal. By maintaining the current threshold amounts, it protects individuals with lower incomes from having their benefits subject to taxes, while providing needed revenue to the Hospital Insurance Trust Fund. The additional revenue would improve the financial position of the fund and help to continue the payment of benefits to Medicare beneficiaries beyond 1999. It is appropriate that revenues from this additional tax on the elderly be put toward a program which serves the elderly.

We recognize that this proposal will require sacrifice by higher-income individuals who get Social Security benefits, but we think that this sacrifice is reasonable and equitable.

PREPARED STATEMENT OF JONATHAN BARRY FORMAN

Mr. Chairman and Members of the Committee:

My name is Jon Forman, and I am a Professor of Law at the University of Oklahoma. Prior to entering full-time teaching, it was my privilege to serve as an employee in all three branches of the federal government, most recently as tax counsel to the Honorable Senator Daniel Patrick Moynihan, now Chairman of this Committee.

Although I am a tax lawyer by trade, I also hold Master's degrees in psychology and in economics. This background has made me attentive to how government policies affect the behavior of individuals. In particular, I have learned that high tax rates discourage people from working and so reduce our nation's productivity and wealth.

My analysis of President Clinton's proposal to tax 85 percent of Social Security benefits has led me to conclude that enacting the Clinton proposal would subject thousands of elderly workers to confiscatory tax rates./1 Those high tax rates would discourage work and induce premature retirements, just when the country is trying to grow its way out of a recession. While my remarks today will focus on the Clinton proposal to tax 85

---

1. The details of my analysis appear in the attached article: Jonathan B. Forman, Does Bill Clinton Really Mean to Subject Elderly Workers to Confiscatory Tax Rates?, 59 Tax Notes 119 (1993).

percent of Social Security benefits, I have a larger point to make, as well: If we, as a nation, ever hope to see a return of prosperity, then we need to find ways of "making work pay" for all Americans -- young and old, poor and rich, black and white, women and men.

Under the current rules for taxation of Social Security benefits, single taxpayers with incomes over a $25,000 income floor and married couples with incomes over a $32,000 income floor are required to include in their taxable incomes as much as 50 percent of their Social Security benefits. President Clinton would increase that inclusion percentage to 85 percent.

The problem is that taxing 85 percent of Social Security benefits would significantly increase the effective marginal tax rates imposed on thousands of elderly workers. For example, consider George, a single individual age 65 who receives $25,000 per year in taxable pension and investment income and $10,000 per year in Social Security benefits. Should George work the holiday rush at Macy's and earn an additional $1,000? That $1,000 would be subject to federal income tax at the 28 percent rate and Social Security taxes at the 7.65 percent rate. In addition, the Clinton proposal would cause another $850 (up from $500 under current law) of his Social Security benefits to be taxed at the 28 percent rate. All in all, on his $1,000 of earnings George would have to pay the federal government $594.50 in taxes and get to keep just $405.50 (an effective marginal tax rate of 59.45 percent). Of course, that's before city and state income taxes.

Worse still, elderly workers who are subject to the Social Security retirement earnings test could face even higher tax rates. Workers age 65 through 69 would face tax rates on their earned income as high as 89 percent, and workers under age 65 would face tax rates on earned income as high as 103.5 percent.

How could the problem of high effective marginal tax rates on elderly workers be solved?

At the outset, it is worth noting that the Clinton proposal to tax 85 percent of Social Security benefits is not the specific cause of this high tax rate problem. Rather, high tax rates would result from the combination of income taxes, Social Security taxes, the Social Security retirement earnings test, and the Clinton proposal to tax 85 percent of Social Security benefits.

The good news is that your Committee has jurisdiction over all four components of this high tax rate problem: income taxes, the income taxation of Social Security benefits, Social Security taxes, and the Social Security retirement earnings test. The bad news is that there is no simple solution to the problem of high tax rates on elderly workers.

Of course, rejecting the Clinton proposal to tax 85 percent of Social Security benefits would avoid any increase in tax rates on elderly workers, but then Congress would have to find $23 billion elsewhere. Moreover, taxing 85 percent of Social Security benefits actually makes sense. In a pure income tax system, Social Security benefits would be taxed like private pensions, and taxing 85 percent of Social Security benefits is a pretty good approximation of that tax treatment./2

My solution to the problem of high tax rates on elderly workers is two-fold. I would tax 85 percent of Social Security benefits, but I would also eliminate the $25,000 and $32,000 income floors./3 Together, these changes would keep marginal income tax rates on elderly workers low. For example, if we eliminated the income floors and taxed 85 percent of Social Security benefits, then, when my hypothetical worker George earned $1,000, his taxable income would go up by just $1,000 (not $1,850), and his marginal effective income tax rate would be just 28 percent (not 51.8 percent).

Moreover, the Congressional Budget Office recently estimated that eliminating the income floors and taxing 85 percent of Social Security benefits would raise $112.5 billion over five years -- far more than the Clinton proposal by itself./4 Standard deductions and personal exemptions would protect low-income Social Security beneficiaries from income tax liability on their benefits. For example, in 1993, an elderly couple will not have to pay any income tax unless the couple's taxable income exceeds $12,300 (the sum of a $6,200 basic standard deduction, two $700 additional standard deductions for the elderly, and two $2,350 personal exemptions). Thus, if Congress were to eliminate the income floors and tax 85 percent of Social Security benefits, an elderly couple whose only source of income was Social Security benefits would not pay any income tax until the couple received more than $14,470 in Social Security benefits ($12,300 = $14,470 x .85). By way of comparison, the Department of Health and Human Services' 1993 poverty income guideline for a family of two is just $9,430.

---

2. Roughly 15 percent of the benefits paid to Social Security beneficiaries can be attributed to the nondeductible Social Security tax "contributions" that they have paid over their careers (e.g., the employee portion). See Senator William V. Roth, Jr., Double-Taxing Seniors of Today and Tomorrow, 58 Tax Notes 1543 (1993); Robert J. Myers, Is the 85-Percent Factor for Taxing Social Security Benefits Perpetually Correct?, 58 Tax Notes 1545 (1993); Gerard M. Brannon, The Strange Precision in the Taxation of Social Security Benefits, 58 Tax Notes 1803 (1993); and Yvonne Hinson & Daniel P. Murphy, Is the 85-Percent Social Security Inclusion Ratio High Enough?, 59 Tax Notes 571 (1993).

3. Alternatively, I would tax Social Security benefits precisely like private pensions. See Jonathan B. Forman, Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-earner Couples, 45 Tax Lawyer 915 (1992). Taxing Social Security benefits like private pensions has the advantage of telling current Social Security beneficiaries how little of their current benefits are attributable to their past Social Security tax contributions and how much of their current benefits are really income. Still, telling people how much income they have is one thing; taxing them on that income is quite another.

4. Rev-13 Increase Taxation of Social Security and Railroad Retirement Benefits, in U.S. Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (1993).

Nevertheless, the political problem is that eliminating the $25,000 and $32,000 income floors could mean income tax increases for many moderate-income Social Security beneficiaries with incomes below those income floors. Of course, given how much new revenue would be raised by eliminating the floors, there would be plenty of money available to at least partially offset those income tax increases. For example, Congress could raise the amount of the additional standard deduction for the elderly or raise Social Security benefit amounts.

Another possible solution to the problem of high tax rates on elderly workers would be to relax or repeal the Social Security retirement earnings test. Unlike eliminating the income floors (or taxing Social Security benefits like annuities), repealing the Social Security retirement earnings test would be immensely popular with the elderly. Unfortunately, it would also be incredibly costly, and none of the benefits would go to the nonworking elderly -- those who are most likely to be in need.

Finally, I want to suggest one change that I think could be achieved at a relatively low cost. Your Committee could develop legislation to better coordinate the Social Security retirement earnings test and the income taxation of Social Security benefits. Both the retirement earnings test and the income taxation of benefits are mechanisms that means-test Social Security, and when they overlap, confiscatory tax rates can result. The two mechanisms should be coordinated so that an extra dollar of earned income would not both reduce Social Security benefits and increase the amount of remaining Social Security benefits that are subject to income taxation. For example, in 1993, moderate-income single workers age 65 through 69 might be required to count no more than $10,560 of earned income towards their $25,000 income floor. Then, when the Social Security retirement earnings test starts to apply (earnings in excess of $10,560), additional income taxation of Social Security benefits would stop.

In conclusion, I know that "messing with Social Security" is never politically easy. Nevertheless, I think that the time has come to develop some meaningful coordination among the various tax and Social Security benefit provisions that affect elderly workers. We need to "make work pay" for the elderly.

TAX ANALYSTS®

viewpoint

DOES BILL CLINTON REALLY MEAN TO SUBJECT ELDERLY WORKERS TO CONFISCATORY TAX RATES?

by Jonathan Barry Forman

Jonathan Barry Forman is a professor at the University of Oklahoma College of Law.

Under current law, single taxpayers with incomes over $25,000 and married couples with incomes over $32,000 are required to pay federal income taxes on as much as 50 percent of their Social Security benefits. President Clinton would increase that inclusion percentage to 85 percent. The 85-percent inclusion percentage is intended to roughly approximate the portion of Social Security benefits that would be taxed if Social Security benefits were taxed like private pensions.[1] While I favor taxing a greater percentage of Social Security benefits, I am concerned that the Clinton proposal would impose confiscatory tax rates on the earned income of thousands of elderly workers.[2] These high tax rates would discourage work and induce premature retirements, just when the country is trying to grow its way out of a recession.

Consider George, a single individual age 65 who receives $25,000 per year in taxable pension and investment income and $10,000 per year in Social Security benefits. Should George work the holiday rush at Macy's and earn an additional $1,000? That $1,000 would be subject to federal income tax at the 28-percent marginal tax rate and Social Security taxes at the 7.65-percent rate. In addition, the Clinton proposal would cause another $850 (up from $500 under current law) of his Social Security benefits to be taxed at the 28-percent rate. All in all, on his extra $1,000 of wages, George would have to pay the federal government $594.50 in taxes and get to keep just $405.50 (a marginal tax rate of 59.45 percent). Of course, that's before city and state income taxes.

Things could be a lot worse. Consider Ron, a single individual age 65 who receives $14,000 per year in taxable pension and investment income and $10,000 per year in Social Security benefits. To supplement his income, Ron has been working part time and earns another $11,000 per year in wages. Should Ron work the holiday rush at Macy's and earn an additional $1,000? That $1,000 would be subject to federal income tax at the 28-percent rate and Social Security taxes at the 7.65-percent rate. In addition, the Social Security retirement earnings test would reduce Ron's Social Security benefits by roughly $333. (In 1993, for example, workers age 65 through 69 lose $1 of benefits for each $3 of annual earnings in excess of $10,560.) Moreover, under the Clinton plan, the additional $1,000 of wages would cause another $708 of his remaining $9,667 of Social Security benefits to be included in his income. All in all, federal taxes and Social Security benefit reductions would leave Ron with about $110 of net benefit from the extra $1,000 of wages (an effective marginal tax rate of roughly 89 percent).

Worse still, consider Jimmy, a single individual age 62 who receives $17,000 per year in taxable pension and investment income and $10,000 per year in Social Security benefits. To supplement his income, Jimmy has been working part time and earns another $8,000 per year in wages. Should Jimmy work the holiday rush at Macy's and earn an additional $1,000? That $1,000 would be subject to federal income tax at the 28-percent tax rate and Social Security taxes at the 7.65-percent rate. In addition, the Social Security retirement earnings test would decrease Jimmy's Social Security benefits by $500. (In 1993, for example, workers under age 65 lose $1 of benefits for each $2 of annual earnings in excess of $7,680.) Moreover, under the Clinton plan, the additional $1,000 of wages would cause another $638 of his remaining $9,500 of Social Security benefits to be included in his income. All in all, federal taxes and Social Security benefit reductions would leave Jimmy $35 worse off than if he had not earned the extra

---

[1]Roughly 15 percent of the benefits paid to Social Security beneficiaries is attributable to the nondeductible Social Security "contributions" that they paid over their careers (e.g., the employee portion). Note, however, two recent viewpoint articles have expressed concern that an 85-percent inclusion percentage may be too high for some individuals. *See* Sen. William V. Roth Jr., "Double-Taxing Seniors of Today and Tomorrow," *Tax Notes*, Mar. 15, 1993, p. 1543, and Robert J. Myers, "Is the 85-Percent Factor for Taxing Social Security Benefits Perpetually Correct?" *ibid.*, p. 1545.

[2]*See generally* Jonathan B. Forman, "Promoting Fairness in The Social Security Retirement Program: Partial Integration and a Credit for Dual-Earner Couples," 45 *Tax Lawyer* 915 (1992).

$1,000 of wages (an effective marginal tax rate of 103.5 percent). Moreover, if Jimmy were self-employed, his effective marginal tax rate would be even higher, as he would pay Social Security self-employment taxes at the 15.3-percent rate (actually an effective rate of about 12 percent because of the way self-employment taxes are computed).[5]

Admittedly, I chose these examples to highlight the problem of high effective marginal tax rates on certain elderly workers, and not all elderly workers would face such high effective marginal tax rates on their earned incomes. Still, none of the elderly workers in my examples have high gross incomes, yet each faces an effective marginal tax rate higher than even the most poorly advised millionaire. By comparison, the 36-percent rate that Clinton wants to impose on high-income individuals seems almost generous.

How can the effective marginal tax rates on elderly workers be brought under control?

How can the effective marginal tax rates on elderly workers be brought under control? Perhaps President Clinton's proposal could be reworked so that the formula for taxing 85 percent of Social Security benefits somehow disregards the earned income of elderly workers. In the alternative, repealing the $25,000 and $32,000 floors (or taxing Social Security benefits precisely like private pensions) would, in effect, push the income taxation of Social Security benefits lower down the income scale where marginal income tax rates are lower. Finally, repealing the Social Security retirement earnings test would also help reduce the high effective marginal tax rates on at least some elderly workers.

The good news is that the taxwriting committees have jurisdiction over all four pieces of the puzzle: income taxes; the income taxation of Social Security benefits; Social Security taxes; and the Social Security retirement earnings test. Of course, "messing with Social Security" is never easy, but it would appear that the time has come to develop some meaningful coordination among these provisions. It would be inexcusable if Congress were to increase the percentage of Social Security benefits subject to income taxation but fail to protect elderly workers from astronomical effective marginal tax rates on their earned income.

[5]Of note, the future benefits of elderly workers may be increased somewhat to take into account any Social Security taxes that they pay and any benefits that they lose as a result of the retirement earnings test.

letters to the editor

VIEWPOINT EXPANDED

To the Editor:

Pursuant to your request, I am happy to elaborate on the basis for the marginal tax rate computations in my recent viewpoint article, "Does Bill Clinton Really Mean to Subject Elderly Workers to Confiscatory Tax Rates?" *Tax Notes*, Apr. 5, 1993, p. 119. At the outset, please note that both my explanation of the Clinton proposal and my marginal tax rate computations were independently confirmed by an administration economist and by a noted private sector actuary.

My explanation of the Clinton proposal [was] independently confirmed by an administration economist.

Reconsider George, my hypothetical single individual, age 65, who receives $25,000 per year in taxable pension and investment income and $10,000 per year in Social Security benefits. Under current Internal Revenue Code section 86, George includes $2,500 of his Social Security benefits in his gross income. That $2,500 is the lesser of his section 86(a)(1) amount or his section 86(a)(2) amount. George's section 86(a)(1) amount is $5,000 — 50 percent of his $10,000 of Social Security benefits. George's section 86(a)(2) amount is $2,500 — 50 percent of his $5,000 section 86(b)(1) amount (being the excess of the sum of his $25,000 of modified adjusted gross income plus 50 percent of his $10,000 of Social Security benefits over his $25,000 section 86(c)(1) base amount).

The current version of the Clinton proposal would increase the first two percentages in the preceding paragraph to 85 percent but leave the third percentage at 50 percent. These changes meet the Clinton conditions that: (1) those taxpayers who already pay taxes on some of their Social Security benefits would have those taxes increased and (2) the number of people paying taxes on their Social Security benefits would not increase.

Consequently, under the Clinton proposal, George would have to include $4,250 of his Social Security benefits in his gross income. George's section 86(a)(1) amount would be $8,500 — 85 percent of his $10,000 of Social Security benefits. George's section 86(a)(2) amount would be $4,250 — 85 percent of his unchanged $5,000 section 86(b)(1) amount (being the excess of the sum of his $25,000 of modified adjusted gross income plus 50 percent of his $10,000 of Social Security benefits over his $25,000 section 86(c)(1) base amount).

Under the Clinton proposal, if George also earned $1,000, he would have to include $5,100 of his Social Security benefits in his gross income. George's section 86(a)(1) amount would still be $8,500 — 85 percent of his $10,000 of Social Security benefits. however, George's section 86(a)(2) amount would now be $5,100 — 85 percent of his $6,000 section 86(b)(1) amount (being the excess of the sum of his now $26,000 of modified adjusted gross income plus 50 percent of his $10,000 of Social Security benefits over his $25,000 of section 86(c)(1) base amount). Thus, earning $1,000 would cause another $850 of his Social Security benefits to be taxed ($850 = $5,100 - $4,250).

In effect, earning $1,000 would increase George's taxable income by $1,850 — $1,000 for the earnings plus $850 more of Social Security benefits. Consequently, since George is in the 28-percent income tax bracket, he would have to pay another $518 in federal income taxes ($280 on the $1,000 of earnings and $238 on the additional $850 of Social Security benefits). Put differently, George faces a 51.8-percent marginal income tax rate on each additional dollar earned (.518 = $518 / $1,000). Add George's 7.65-percent Social Security payroll tax, and you get George's effective marginal tax rate of 59.45 percent.

My article also showed that workers subject to the Social Security retirement earnings test could face even higher effective marginal tax rates. For example, reconsider Ron, my hypothetical individual, age 65, who receives $14,000 per year in taxable pension and investment income, $11,000 per year of earned income, and $10,000 per year in Social Security benefits. Like George in paragraph 4 of this letter, Ron would have $25,000 of modified adjusted gross income and $10,000 of Social Security benefits, and he would have to include $4,250 of his Social Security benefits in gross income.

If Ron earns another $1,000, he would face an effective marginal tax rate of about 89 percent. He would have to pay another $280 in income taxes on that additional $1,000 ($280 = .28 x $1,000), another $76.50 in Social Security taxes on that additional $1,000 ($76.50 = .0765 x $1,000), and he would lose another $333 in Social Security benefits as a result of the Social Security retirement earnings test ($333 = .333 x $1,000). As more fully explained in the next paragraph, Ron would also owe another $198 in income taxes on an additional $708 of Social Security benefits that would become taxable to him ($198 = .28 x $708). All in all, federal taxes and Social Security benefit reductions would leave Ron with about $110 of net benefit from the additional $1,000 of earnings (again, an effective marginal tax rate of roughly 89 percent).

The computation of Ron's effective marginal tax rate is complicated by the interactions between the retirement earnings test and the income taxation of benefits.

The computation of Ron's effective marginal tax rate is complicated by the interactions between the retirement earnings test and the income taxation of benefits. Basically, Ron's additional $1,000 of earnings would increase the amount of his taxable Social Security benefits; however, that increase would be partially offset by the decrease in Ron's potentially taxable Social Security benefits. In effect, when Ron earns another $1,000 he would have to include $4,958 of his Social Security benefits in gross income computed as follows: Ron's section 86(a)(1) amount would be $8,217 — 85 percent of his remaining $9,667 of Social Security benefits. Ron's section 86(a)(2) amount would be $4,958 — 85 percent of his $5,833 section 86(b)(1) amount (being the excess of the sum of his now $26,000 of modified adjusted gross income plus 50 percent of his remaining $9,667 of Social Security benefits over his $25,000 section 86(c)(1) base amount). Thus, earning another $1,000 would cause another $708 of Ron's Social Security benefits to be taxed ($708 = $4,958 − $4,250).

Finally, my article showed that Jimmy, a hypothetical 62-year-old Social Security beneficiary, would face an effective marginal tax rate of 103.5 percent on his additional earnings. Jimmy's effective marginal tax rate computation tracks the above computation for Ron, except that Jimmy would lose $1 of benefits for each $2 of additional earnings. Accordingly, there is no need to detail Jimmy's effective marginal tax rate computation.

I hope that this letter helps your readers better understand how effective marginal tax rates on elderly workers are computed.

Sincerely,

Jonathan Barry Forman
Professor of Law
University of Oklahoma
Norman, Okla.
April 7, 1993

PREPARED STATEMENT OF RANDOLF H. HARDOCK

Mr. Chairman and Members of the Committee: I am pleased to be here today to present the views of the Department of the Treasury on the Administration's proposal regarding the taxation of Social Security benefits. As you know, that proposal would revise the rules for taxing Social Security benefits to make them more consistent with the rules for taxing benefits under private retirement plans, by generally increasing the amount of Social Security benefits subject to tax.

Let me emphasize at the start that we should not view the Social Security tax proposal in isolation but should see it as an integral part of the President's overall program to revitalize this Nation's economy. An indispensable element of that revitalization program is deficit reduction. For more than a decade now, large Federal budget deficits have been draining the pool of private savings, cutting into the rate of capital formation by the Nation's industry, and causing us to become dependent upon an unreliable flow of savings from abroad. The net result has been a slowdown in the rates of growth of productivity and real incomes of the American worker, and in the process we have become the world's leading debtor nation.

To turn this situation around, it is essential to shrink future Federal budget deficits. This cuts the government's demands on the financial markets, reduces interest rates, and stimulates private investment. Already there have been sizable declines in long term interest rates, attributable in large part to favorable market reaction to the Administration's budget deficit reduction proposals.

In achieving deficit reduction, we must insure that all groups contribute and do so equitably. The current proposal was designed with that principle clearly in mind.

CURRENT LAW

The old age and survivors and the disability insurance (OASDI) programs under the Social Security system provide monthly benefits to retired workers, to disabled workers under age 65, and to their survivors and dependents. OASDI benefits are funded in part through employer contributions, i.e., the employer share of OASDI taxes under the Federal Insurance Contributions Act (FICA), in part through employee contributions, i.e., the employee share of OASDI taxes, and in part through earnings on those contributions. Employer contributions are made on a pre-tax basis—that is, they are not included in the employee's income or FICA wages—while employee contributions are made on an after-tax basis.[1]

Under current law, generally the full amount of any retirement and disability benefits provided to an employee under a private retirement plan is included in the employee's gross income and subject to tax when it is received. However, if a retirement plan provides for after-tax employee contributions, a percentage (called the exclusion ratio) of each periodic benefit received by an employee is excluded from the employee's gross income. The exclusion ratio is generally the ratio of the nominal amount of the employee's after-tax contributions (called the employee's investment in the contract) to the total benefits that the employee could expect to receive when the payments first began. The exclusion ratio is reduced to zero once the employee's investment in the contract has been fully recovered under these rules; similarly, if the employee dies before the investment has been fully recovered, the unrecovered amount may be deducted in the employee's last taxable year.

These rules ensure that contributions to a retirement plan and earnings on those contributions are taxed once and only once: when they are paid into the plan in the case of after-tax employee contributions, and when they are paid out of the plan in the case of employer contributions and plan earnings. These rules apply equally to retirement plans maintained for Federal and State employees and to plans for employees of private employers.

Although the OASDI programs provide benefits to the employee that are essentially equivalent to the retirement and disability benefits under a private retirement plan, they are not taxed in the same manner under current law. First, most lower-income taxpayers are completely exempt from tax on their OASDI benefits, since generally no OASDI benefits are included in gross income for taxpayers with adjusted gross incomes (plus tax-exempt interest, certain foreign-source income, and 50 percent of OASDI benefits) below a $25,000 base amount ($32,000 in the case of a married couple filing a joint return). In effect, such taxpayers have a 100 percent exclusion ratio. In 1990, about 83.6 percent of returns with OASDI benefits were exempt from tax on those benefits under this rule.

[1] Self-employed individuals are subject to a similar system which places them in essentially the same position as employees. While they pay both the employee and the employer shares of OASDI taxes, half of their contributions are excluded from their income tax and Social Security tax wages.

Furthermore, under current law higher-income taxpayers are only required to include in gross income the lesser of (1) 50 percent of their OASDI benefits or (2) a phase-in amount equal to the excess of their adjusted gross incomes (plus tax-exempt interest, certain foreign-source income, and 50 percent of OASDI benefits) over the base amounts described above. In effect, they have an exclusion ratio between 50 and 100 percent. By contrast, if OASDI benefits were subject to the same rules as benefits under a private retirement plan, few if any taxpayers would have an exclusion ratio as high as 50 percent. In fact, the Social Security Administration has calculated that, under the economic and demographic assumptions used for projecting the actuarial soundness of the Social Security system over the next 75 years, and assuming no changes in current law (other than the normal annual increases in the FICA wage base), no groups of past, current or future retirees would have exclusion ratios higher than 15 percent. In addition, only current or future groups of retirees with high lifetime earnings and long earnings histories would have exclusion ratios as high as 15 percent, and a large majority would have significantly lower exclusion ratios.

The disparity in treatment between OASDI benefits and benefits under a private retirement plan has been recognized since the taxation of OASDI benefits was first proposed by the Advisory Council on Social Security in 1979. Based on then-current law, some members of the Council argued unsuccessfully that, "to correspond with the tax treatment of private pensions, the taxable part of the Social Security benefit should be 83 percent" rather than 50 percent, corresponding to an exclusion ratio of 17 percent.

ADMINISTRATION PROPOSAL

The Administration's proposal would make the rules for taxing OASDI benefits more consistent with the rules for taxing benefits under private retirement plans, by increasing the maximum taxable portion of OASDI benefits from 50 to 85 percent.[2] In effect, this change would reduce the minimum exclusion ratio for higher-income taxpayers who are subject to tax on their benefits from 50 to 15 percent. The portion of adjusted gross income and OASDI benefits in excess of the base amounts that taxpayers in the phase-in range (*i.e.*, taxpayers whose income or OASDI benefits are not high enough to require them to include the full 85 percent of OASDI benefits in gross income) are required to include in gross income would also be increased from 50 to 85 percent.[3] Additional taxes resulting from the increase would be paid to the hospital insurance (HI) trust fund, which is expected to be exhausted in 1999. Other taxes on OASDI benefits would continue to be paid to the Social Security trust fund.

The Administration's proposal would place higher-income retirees with high lifetime earnings and long earnings histories in approximately the same position as they would be under the tax rules applicable to private retirement plans, while continuing the relatively favorable treatment of other higher-income retirees with lower lifetime earnings or shorter earnings histories.

Most retirees would be unaffected by the Administration's proposal. The proposal would not change the portion of OASDI benefits that is used to determine whether a taxpayer is exempt from tax on his or her OASDI benefits. Thus, the proposal would continue to exempt the great majority of taxpayers from tax on their OASDI benefits. More importantly, it would not subject any taxpayers to tax on their benefits who are not already subject to tax.

The Administration's proposal would have minimal effects on lower-income taxpayers. Of the tax filers projected to receive OASDI benefits in 1994, 22.9 million (or 67 percent) are projected to have family economic incomes of less than $40,000.[4] Only 790,000 (or about 3.5 percent) of these filers will be liable for additional tax on their OASDI benefits under the Administration's proposal. They will pay $220 million in additional taxes, or an average of $23 per month, representing 4.5 percent of the total revenue raised by the proposal. The remaining 96.5 percent of filers in this category will have no additional tax liability. Overall, filers in this category (in-

---

[2] An alternative that has been suggested is to calculate exclusion ratios with respect to OASDI benefits on an individual basis in essentially the same way as private pensions. However, this would be difficult to implement quickly and would impose significantly higher tax burdens on many individuals, especially lower-income individuals, than under current law or the Administration's proposal.

[3] Corresponding changes would be made to the treatment of OASDI-equivalent benefits under the Railroad Retirement system, which are subject to the same tax rules as OASDI benefits under current law.

[4] "Family economic income" is a broad measure of the income of a family that has long been used by the Treasury Department to describe the distribution of tax burdens.

cluding both filers with taxable OASDI benefits and those without) will pay an average of 83 cents per month more in additional taxes overall.

The Administration's proposal will primarily affect higher-income taxpayers. Of the tax filers projected to receive OASDI benefits in 1994, 4.4 million (or 12.8 percent) are projected to have family economic incomes of over $75,000. These filers will pay an average of $90 per month in additional taxes, representing almost 70 percent of the total revenue raised by the proposal. Available data suggests that filers in these categories generally have high net worths, probably averaging over $1 million.

In conclusion, the Administration's proposal regarding the taxation of Social Security benefits will move towards greater equality in tax treatment between recipients of OASDI benefits and participants in private retirement plans without subjecting any taxpayers to tax on their benefits who are not already subject to tax on those benefits.

LAUTENBERG AMENDMENT

The Committee requested comments by the Department of the Treasury on the Lautenberg amendment to the budget resolution (S. Con. Res. 18), expressing the sense of the Senate that the Finance Committee should try to avoid any increases in taxes on OASDI benefits for beneficiaries with incomes of less than $32,000 ($40,000 for married couples filing joint returns). The Department of the Treasury understands that, if the amendment were followed, the Administration's proposal would only apply to beneficiaries with incomes over these dollar thresholds, while beneficiaries with incomes under these thresholds would continue to be subject to current law without any change in the base amounts under current law.

The Department of the Treasury does not support the higher thresholds specified in the Lautenberg amendment because they would work against the goal of parity between recipients of OASDI benefits and recipients of benefits under a private retirement plan, and would create new disparities among recipients of OASDI benefits, by creating a new class of taxpayers entitled to preferential treatment (in addition to those who are already exempt from tax on their OASDI benefits because their incomes are below the base amounts under current law). It would also significantly complicate the rules for calculating the extent to which OASDI benefits are taxed for all individuals currently subject to the tax, while producing a relatively small savings for only a small number of individuals.

CONCLUSION

Mr. Chairman, that concludes my formal statement. I will be pleased to answer any questions that you or other Members may wish to ask.

DEPARTMENT OF THE TREASURY
WASHINGTON

MAY 10 1993

The Honorable Daniel Patrick Moynihan
Chairman
Senate Committee on Finance
Washington, DC 20510

Dear Chairman Moynihan:

Last week, at the Finance Committee hearing on the Administration's proposal to change the formula for the taxation of social security benefits, you raised two questions. First, you requested additional information about the causes underlying the differences in the revenue estimates of the Administration's proposal that have been prepared by the Joint Committee on Taxation (JCT) and the Department of the Treasury. Second, you asked for further data on the distributional impact of the Administration's proposal. This letter responds to your questions.

The Treasury Department revenue estimate for the social security proposal is $23.3 billion over the budget period. The JCT revenue estimate is $31.9 billion over the same period. The Treasury's Office of Tax Analysis, after discussions with the staff of the JCT, informs me that the discrepancy is explained almost entirely by different model projections of the number of taxpayers who will have some portion of their social security benefits included in adjusted gross income (AGI) over the budget period, as well as the income of these taxpayers. The JCT assumes that there are more returns with modified AGI above the $25,000 and $32,000 threshold amounts, and that more income is attributable to these returns. Consequently, the JCT projects that a higher percentage of social security benefits will be added to AGI and that a slightly higher average marginal tax rate will apply to this income.

In response to your second question, enclosed is a table showing the distributional impact of the social security proposal across a range of income classes. This table was prepared by the Treasury's Office of Tax Analysis.

I hope that this information will be helpful to you and the Committee. Let me take this opportunity to thank you on behalf of the Department of the Treasury for your invitation to testify before the Finance Committee on this issue.

Sincerely,

Randy Hardock

Randolf Hurst Hardock
Office of Tax Policy

Enclosure

71-835 O - 93 - 4

Administration's Proposal for Increasing the Amount of Social Security Benefits Subject to Tax

(1994 Income Levels)

Family Economic Income Class (000)	All Filing Units with Social Security Benefits		Filing Units with Additional Tax on Social Security Benefits				
					Additional Tax on Social Security Benefits		
	Number (Millions)	Percent Distribution (%)	Number (Millions)	Percent of All Units (%)	Amount ($B)	Percent Distribution (%)	Average Per Month ($)
0 – 25	16.3	47.5	------------	------------	See Footnote (1)	------------	------------
25 – 30	2.5	7.4	0.11	4.2	0.03	0.5	19
30 – 35	2.2	6.4	0.26	11.6	0.06	1.3	21
35 – 40	1.9	5.5	0.34	17.8	0.11	2.3	28
40 – 45	1.6	4.6	0.37	23.2	0.12	2.5	28
45 – 50	1.3	3.9	0.46	33.8	0.16	3.3	30
50 – 75	4.0	11.6	2.14	53.8	1.07	21.6	42
75 & over	4.4	12.8	3.10	70.6	3.37	68.1	91
Total (2)	34.3	100.0	6.83	19.9	4.95	100.0	60

Department of the Treasury
Office of Tax Analysis

May 9, 1993

(1) The number of filing units with additional tax on Social Security benefits in this income class is too small to be reliable. These units are included in the total line.

(2) Filing units with negative incomes are included in the total line but not shown separately.

Prepared Statement of Senator Orrin G. Hatch

Mr. Chairman, I am pleased that you are continuing this series of hearings on President Clinton's tax proposals. Today's topic, the proposal to increase the taxation of Social Security benefits, is an important one to many in my home state of Utah.

When telling the American people about his economic plan this past February, President Clinton said that his proposed income tax increase would only affect those with adjusted gross incomes above $100,000, and that only 1.2 percent of American families would see their income taxes increase.

However, the proposal to tax 85 percent of Social Security benefits would increase the taxes paid by senior American individuals earning as little as $25,000 a year and by couples earning only $32,000 a year. This is a fraction of the $100,000 figure he quoted during his State of the Union address—not to mention the $200,000 figure he cited during last year's campaign.

This tax increase will immediately affect about 22 percent of all Social Security recipients and, since the $25,000 and $32,000 thresholds are not indexed for inflation, this proportion will increase to about 30 percent by 1998.

Mr. Chairman, increasing the portion of benefits subject to tax would increase the marginal tax rate for middle income retirees by 5 to 30 percentage points, and some working seniors will face rates in *excess of 100 percent.* President Clinton's proposal will mean that senior citizens will pay an average of $483 in additional tax revenues. For someone earning $32,000, this is outrageous.

Let me share with you two examples of how this proposal will affect Utah seniors. The first example is a couple who worked hard all of their lives side by side running a small furniture store in a Northern Utah town. They were moderately successful and have now retired on their Social Security benefits, a salary from the wife's part-time job, and the dividends and interest they earn each year from their savings and IRAs. Under the current law, this couple would pay income taxes of $4,950, including tax on half of their Social Security. Under the President's proposal to tax 85 percent of the Social Security benefits, though, the tax would be $6,403. This is $1,453 higher, Mr. President—an increase of almost 30 percent!

The President's plan doesn't even ask the very wealthy to pay 30 percent more. Why are we putting a heavier burden on the backs of our seniors than on the very wealthy?

The second example is a senior who continues to work as a self-employed carpenter and who manages to earn enough to land in the 28-percent tax bracket. Under this proposal, of every additional dollar he earns, he would not only lose 33.3 cents in Social Security benefits, due to the earnings limit, but also would have to pay 28 cents in federal income tax, 15.3 cents in Social Security payroll tax, 20 cents under this new proposal, and 7.2 cents in Utah state income tax.

The bottom line is that for each additional dollar of income, this senior would pay more than $1.03 in taxes. By earning another dollar, he would actually end up three cents poorer than before. Do we want to punish senior citizens for working?

I believe that we should be repealing the earnings limit, not increasing the penalty for those working toward retirement. The current tax treatment of retirees already creates enormous disincentives to work and save. President Clinton's proposal only exacerbates this flaw and further penalizes those who have saved to provide for their retirement.

Mr. Chairman, whether the money raised by this proposal goes into the Social Security trust fund, or to the Medicare trust fund, as Secretary Bentsen indicated to this committee in February, this proposal is improper. The Social Security trust fund currently has a huge surplus of over $300 billion, and this surplus is growing every year. As you so eloquently expressed it in 1991, Mr. Chairman, the use of this money for other than Social Security purposes is "thievery." I share your view.

If the money is to go to the Medicare trust fund, then why is this proposal on a deficit reduction bill? Bailing out the Medicare trust fund is a separate problem, more properly handled with health care reform. Let's not raise funds from our seniors in the name of deficit reduction and then not use it for that purpose.

Mr. Chairman, I am very concerned about this proposal. It would push many senior citizens into a higher tax bracket, would create disincentives for seniors to work, and punish those who have worked and saved for their retirements.

Prepared Statement of Robert J. Myers

Mr. Chairman and Members of the Committee: My name is Robert J. Myers. I served in various actuarial capacities with the Social Security Administration and its predecessor agencies during 1934–70, being Chief Actuary for the last 23 of those years. In 1981–82, I was Deputy Commissioner of Social Security, and in 1982–83, I was Executive Director of the National Commission on Social Security Reform. In 1983–85, I was Chairman of the Railroad Unemployment Compensation Committee, and in 1987–90, I was Chairman of the Commission on Railroad Retirement Reform.

I shall first describe the past history of the income taxation of Social Security benefits. Then, I will give my views as to why this should be done more fully than under present law, and various ways in which such a change could be made. Finally, I will discuss the very important matter of what should be done with the proceeds of such increased taxation.

HISTORY OF INCOME TAXATION OF SOCIAL SECURITY BENEFITS

In the early 1940s, the Bureau of Internal Revenue issued a ruling that OASI Benefits were not subject to income tax. This was done largely on the ground that they were considered as gratuities from the government (based, probably, on the fact that the benefits and the taxes which finance them in large part are in different titles of the Social Security Act).

From time to time, proposals have been made that the benefits should be included in taxable income, just as are private pensions in contributory plans. The basis usually advocated was that 50% of the benefits should be so included—on the simplistic, and erroneous, grounds that the employee taxes (which are made out of after-tax income) "purchase" half of the benefits. This would be more generous treatment than that provided in a defined-contribution plan with equal employer and employee contributions, under which less than 50% of the pension comes from employee contributions (as a result of the interest earnings on the employer-employee contributions), and so more than 50% of the pension must be included in taxable income.

Even though a portion of OASDI benefits is included in taxable income for income-tax purposes, a substantial proportion of the beneficiaries would not pay any income tax. Many have little or no other income, and the effect of personal exemptions and deductions will very often result in no income-tax liability.

Several times in the years preceding the 1983 Act, the Congress passed unanimously (or close thereto) nonbinding resolutions to the effect that never, never would OASDI benefits be made subject to income tax. Nonetheless, because sources of additional resources were needed to solve the financing crisis in 1983, the legislation of that year included such a provision, with the proceeds of the income taxation of benefits being returned to the OASDI Trust Funds.

Some who favored this income-tax procedure as to the treatment of OASDI benefits did so on the grounds that it was good tax policy. They, however, questioned the return of the additional taxes resulting to the OASDI Trust Funds, which they viewed as general-revenue financing, the first injected into the program on a continuing basis. Such procedure of returning the taxes to the pension fund is not followed for private pension plans, so such persons saw no reason why it should be done for OASDI—other than on the weak grounds that the trust funds "need the money."

Some view the taxation of OASDI benefits as introducing a means or income test into the program. Others view it as a reduction in benefits for higher-income persons, and thus as the introduction of more social adequacy at the expense of less individual equity. Still others view the current procedure as good tax policy accompanied by poor Social Security policy, as a result of introducing general revenues into the long-range financing. of the OASDI program.

In the last few years, because of the problems with the General Budget, proposals have been made to make more of the OASDI benefits be subject to income tax. The goal has been to have such benefits be taxable in the same general manner as private pensions. However, for administrative simplicity (as well as all necessary data not being available to beneficiaries), the proposals frequently have been that 85% of the benefits—rather than the current 50%—should be taxable.

WHY SOCIAL SECURITY BENEFITS SHOULD BE ADEQUATELY TAXED

I believe that, in theory, Social Security benefits should be properly subject to income tax. This should apply to the benefit exclusive of the part which may be said to arise from the individual's Social Security contributions, which came out of after-tax income. In practice, some approximations or transitional arrangements may be necessary in order to achieve administrative simplicity and ease of application.

I do not view such income taxation as a needs or-means test, or as a reduction in benefits, but rather such taxation is merely good, equitable tax policy. Persons with low and moderate incomes will not be adversely affected by including the proper portion of Social Security benefits in their income for income-tax purposes, because they will not pay any income taxes anyhow—as a result of personal exemptions and the standard deduction.

HOW SOCIAL SECURITY BENEFITS SHOULD PROPERLY BE SUBJECT TO INCOME TAX

Assuming that Social Security benefits should be subject to income tax, other than the portion arising from the individual's post-tax contributions, there are several ways in which this income taxation can be done.

One method would be to follow exactly the same procedure as is used in connection with contributory private pensions. I reject this because it is too complicated, even if it were done on a rough approximate basis. I also reject this procedure because it is not done in an actuarially equitable manner, but rather it has been geared to the needs of the federal government, so as to bring in as much money as quickly as possible, rather than being equitably averaged out over the individual's lifetime.

I believe that the proper basis of income taxation of Social Security benefits is to consider the portion thereof which is "actuarially purchased" by the individual's past contributions (without regard to interest or to indexing so as to reflect wage inflation over the years). In other words, I would follow the basis used in the money's-worth computations that Bruce D. Schobel and I did in a paper that was the subject of a hearing before this Committee on March 11. The procedure to be followed is to tax no higher portion of the Social Security benefit than the proportion of the benefit which was "actuarially purchased" by the individual's total contributions in the past for the case of a person who currently attains age 65 and has had maximum taxable earnings as an employee ever since age 21.

On this basis, rough justice would prevail at the present time if 80% of the benefit were to be taxed. This basis could be continued for the next 5 years, and then the proportion should be decreased to 78% in 1998–2007, 76% for the following 10 years, 74% for the next 10 years, and ultimately 72% (after 2027). Such a schedule should be written into the law and, of course, should be modified from time to time as the contribution rates are changed from those in present law.

The underlying basis for the percentage factors which I recommend is described in my paper "Is the 85-percent Factor for Taxing Social Security Benefits Perpetually Correct?" from *Tax Notes,* March 15, 1993 (copy attached). I might mention that the 85% basis was correct about 5 years ago, but—as mentioned previously—this rate declines slowly over time.

It seems inappropriate to consider past contributions either accumulated with interest, or else indexed to reflect changes in earnings levels, for the purpose of determining the "purchased" benefit for income-tax purposes. My belief is based on the fact that no income taxes were levied in the past on such increments to the nominal contributions.

A "sense of the Senate" amendment was adopted on March 24, urging continuation of the 50% tax rate on the first $7,000 above the present threshold for single persons and $8,000 for married couples filing jointly. This would have the effect of phasing in the additional tax proposed in a gradual manner and thus would have certain appeal, even though in theory going to the full 80% rate immediately seems proper.

The present procedure for the income taxation of Social Security benefits is to include in adjusted gross income the smaller of (1) 50% of the benefits for the year or (2) 50% of the excess of the sum of (A) "preliminary" adjusted gross income, (B) tax-exempt interest, and (C) 50% of the benefits for the year, over the statutory thresholds ($25,000 for single persons and $32,000 for married couples filing joint returns). Quite consistently and logically, the 50% factor for Social Security benefits is used throughout.

President Clinton has proposed that the 50% factor should be increased to 85% in the first two instances above, but not for determining the excesses over the thresholds. Apparently, the reason for this is so that *no additional persons* will pay income taxes on their benefits as compared with present law. In my opinion, this inconsistent treatment is undesirable, and any change in the percentage factor should be applicable throughout in all three places. After all, the logic underlying the factor is that it is the smallest proportion of the benefit which has not been "actuarially purchased" by any individual with her or his own contributions exclusive of interest. Such a procedure will, of course, produce more income-tax revenues than if the 50% factor is retained for measuring the excesses.

WHAT SHOULD BE DONE WITH PROCEEDS OF INCREASED INCOME TAXATION OF SOCIAL SECURITY BENEFITS?

A very important matter is what should be done with the proceeds of the increased income taxation of Social Security benefits. This is not often discussed. As is well known, these income taxes under the present provision are returned from the General Fund of the Treasury to the OASDI Trust Funds. Although this is not at all logical—because the income taxes on private pensions do not revert to such plans—it was intentionally done as one of the measures to solve the financing crisis of the OASDI program in 1983. Accordingly, I would recommend continuing this procedure for the portion of the income taxes based on the 50% rate, but any additional income taxes should remain in the General Fund and thus assist in diminishing our horrendous budget deficit.

It is most important to note that receipts from the income taxes on benefits under the present provisions do not reduce the federal budget deficit by a single penny! On the other hand, I believe that the additional income taxes on benefits should be treated just the same as other income taxes and be applied against federal general expenditures, and thus reduce the federal budget deficit.

It has been suggested that the new, additional income taxes on Social Security benefits should be diverted from the General Fund to the HI Trust Fund. This is presumably because the trust fund needs more money over the long run. For the reasons given previously, I oppose any such diversion because these income taxes, like any others, should be used for general purposes. The financing problems of the HI Trust Fund should be solved directly and openly.

CONCLUSIONS

I recommend that the rate of taxation on Social Security benefits should be increased from the present 50% to 80% for the next 5 years, with scheduled decreases in such rate in subsequent years, until eventually such rate would be 72%. This same percentage rate should also be applicable in determining the portion of Social Security benefits which is added to the sum of the "preliminary" adjusted gross income and the tax-exempt interest in determining the amount over the statutory thresholds, which amount is multiplied by the percentage rate and then added to the "preliminary" adjusted gross income to produce the "final" adjusted gross income.

TAX ANALYSTS®

viewpoint

IS THE 85-PERCENT FACTOR FOR TAXING SOCIAL SECURITY BENEFITS PERPETUALLY CORRECT?

by Robert J. Myers

Robert J. Myers served as chief actuary of the Social Security Administration from 1947 to 1970. He served as deputy commissioner, Social Security Administration from 1981 to 1982, and as executive director, National Commission on Social Security Reform from 1982 to 1983.

Currently, there are many strong advocates, including the Clinton administration, for increasing the income taxation of Social Security benefits.

Under present law, such taxation is done by including in adjusted gross income (AGI) the smaller of (a) 50 percent of the benefits or (b) 50 percent of the excess of the preliminary AGI, plus interest on tax-exempt bonds, plus 50 percent of the benefits over certain statutory thresholds. Such thresholds are $25,000 for single persons, $32,000 for married persons filing a joint return, and zero for married persons filing separate returns, unless they lived apart throughout the entire year (in which case they will be considered single persons). The thresholds were intentionally not indexed (unlike many elements in the Social Security program) when this provision was added to the Social Security Amendments of 1983. The result will be that the thresholds will very gradually "wither away" over time, in real terms. At present, about 20 percent of beneficiaries pay income taxes on their benefits, and eventually about 40 percent will.

The idea of increasing the 50-percent factor to 85 percent has been put forth in earlier years, as, for example, in the author's article, "The 'Proper' Basis For Taxing S.S. Benefits," in the October 1989 issue of *The Actuary* (the newsletter of the Society of Actuaries). That paper also gave the actuarial basis for the 85-percent factor — namely, that no past or near-future retirees would have paid employee Social Security taxes (from their after-tax income), without considering interest thereon, totaling as much as 15 percent of the present value of their benefits as of the time of retirement at age 65 (considering both mortality and a real interest rate of 2 percent, so as to take into consideration the cost-of-living adjustments).

The 85-percent basis is intended to approximate roughly, at best, what benefits would be taxed if they were treated in the same way as private pensions are currently. The question then arises as to whether the 85-percent factor is adequate and equitable both at present and over the long run.

First, let us consider a single person who entered covered employment at age 22 in 1950 and who had maximum covered earnings in all years thereafter until retiring at age 65 in early 1993, with a monthly benefit of $1,128. The total employee Old-Age and Survivors Insurance (OASI) taxes paid amounted to $36,760.45 (the taxes for disability insurance and hospital insurance are properly excluded, because the individual had, or will have, protection under these programs). The annuity-purchase factor (the lump sum that produces an annuity of $1 per year) on a unisex basis using projected future (lower) mortality rates and 2-percent interest is 14.4864. (This factor, as well as the projected demographic and economic ones used in the subsequent analysis, are taken from the author's joint paper with Bruce D. Schobel, "An Updated Money's-Worth Analysis of Social Security Retirement Benefits," *Transactions*, Society of Actuaries, Vol. XLIV, 1993.) The purchasable annuity is thus $211 per month, or 18.7 percent of the actual benefit.

It thus appears that the 15-percent factor for the near future is now on the low side if it is desired to assure that virtually all reasonably possible cases are not inequitably treated. However, relatively few would be significantly adversely affected by the 85-percent basis.

Now, let us consider a single person who entered covered employment at age 22 in 1982, retiring at the "normal retirement age" of 67 in 2027, after having had maximum taxable earnings in all years. (It is assumed that the present law, including the contribution rates, remain unchanged.) The total employee OASI taxes, under the assumptions made, amount to $304,653, and the applicable purchasable-annuity factor is 14.4632, so that the purchasable benefit is $1,755 per month. The monthly benefit actually payable, under the assumptions made, is $6,872, so that the purchasable benefit is 25.5 percent of the actual total benefit.

This indicates that, although a factor of 80 percent (rather than 85 percent) would be reasonable for the next few years, it should be modified over the long run. Good "rough justice" would prevail if an 80-percent basis were to apply until 1997, and then 78 percent in 1998-2007, 76 percent in 2008-17, 74 percent 2018-27, and 72 percent after 2027. Such a schedule should be written into the law — and should be modified from time to time if the tax rates are changed from those in present law.

A subsidiary matter is what should be done with the additional income tax receipts if the present 50-percent basis is changed. They might merely go back into the OASI and DI Trust Funds, as is done with the receipts on the 50-percent basis — as a result of the "consensus deal" struck in 1983. Decidedly preferable, however, such additional receipts should be left in the general treasury. Then, they would truly help to reduce the budget deficit and prevent the increase in the national debt that would otherwise result if the monies had gone back into the trust funds and were used to purchase government bonds that would otherwise have been sold to the general public.

PREPARED STATEMENT OF RONALD F. POLLACK

Mr. Chairman & Members of the Committee:

Thank you for inviting me to testify before your Subcommittee. Families USA is a non-profit organization devoted to protecting the security of America's families.

My testimony this morning will focus on a report that we issued in February (see attached). This report contrasts the impact of a Social Security COLA freeze as compared to the impact of increased taxation of Social Security benefits.

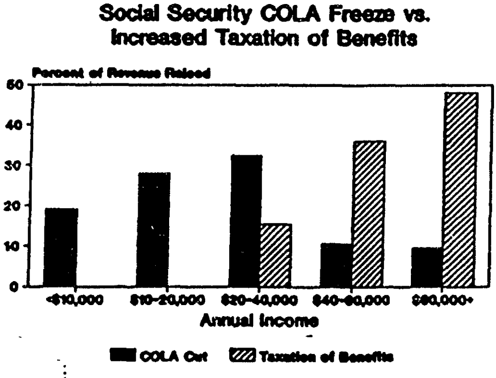
Our conclusion is as follows:

Currently, Social Security beneficiaries pay taxes on half of their Social Security benefits if their adjusted gross income is over $25,000 for single person[]s and $32,000 for couples. An alternative means of raising revenue for deficit reduction is to increase to 85 percent the amount of Social Security income subject to taxation (keeping the income thresholds the same). This would have the effect of taxing the full actuarial value of Social Security benefits and would thus equalize the tax treatment of Social Security and private pension benefits.

Unlike the deficit reduction measures that freeze or reduce Social Security COLA's, increased taxation of Social Security benefits would raise most revenue from higher-income beneficiaries. *Eighty-four (84) percent of the revenue raised would come from beneficiaries with incomes above $40,000 a year.* Less than three out of ten Social Security beneficiaries nationwide would be affected by this change, and *the average annual income of those affected would be over $61,000.* This approach would throw no one below the poverty line or below 150 percent of the poverty line.

SOCIAL SECURITY AND DEFICIT REDUCTION

The Clinton Administration is currently considering how the Social Security program can contribute to deficit reduction. Administration officials and Members of Congress are looking at two different ways of raising revenue from Social Security beneficiaries—reductions in the Social Security cost-of-living adjustment (COLA) and increased taxation of Social Security benefits. These two options would have opposite impacts on Social Security beneficiaries in different income groups.



Cuts in the Social Security COLA

Each January Social Security benefits are increased by the amount the consumer price index increased the previous year, so that Social Security benefits keep pace with inflation. In 1992 the cost-of-living rose by three percent and so the 1993 COLA adjustment equalled that amount. The Congressional Budget Office projects that the cost-of-living will increase three percent in 1993 and 2.7 percent for each of the next four years. Since most private pensions do not increase with inflation, this COLA adjustment is one of the few means retirees have of maintaining their standard of living.

Many elderly persons have very moderate incomes and depend heavily on Social Security benefits to meet their daily living expenses. As of 1991, 20 percent of elderly persons lived in households with incomes under 125 percent of the poverty line, as compared with 17 percent of non-elderly persons. Twenty-seven (27) percent of elderly persons lived in households with incomes between 125 and 150 percent of the poverty line, as compared with 23 percent of non-elderly persons.

Elderly persons with moderate incomes are far more dependent on Social Security benefits than those with higher incomes. Elderly persons with incomes between the poverty line and 150 percent of the poverty line depend on Social Security benefits for four out of every five dollars of their income. In contrast, elderly persons with incomes over $50,000 receive less than 20 percent of their income from Social Security benefits.

Thus, eliminating the Social Security COLA would have the greatest impact on the low- and moderate-income seniors and persons with disabilities who receive Social Security benefits and would have the least impact on higher-income beneficiaries.

Eliminating the Social Security COLA for one year in 1994 would permanently push 289,000 Social Security beneficiaries (of which 228,000 are seniors) below the poverty line—a meager $6,990 in annual income for an individual and $8,815 for a couple. If the inflation rate exceeds three percent in 1993, many more persons would be pushed into poverty. For example, if inflation is four percent, approximately 400,000 beneficiaries would fall below the poverty line. The key income safety net program for aged persons and persons with disabilities, the Supplemental Security Income (SSI) program, would not help these people since federal SSI eligibility standards are about 25 percent below the poverty line.

Additionally, a one-year COLA freeze would permanently push 342,000 beneficiaries (of which 305,000 are seniors) below 150 percent of poverty, with many more people affected if inflation exceeds three percent.

Of the amounts of spending cuts achieved through a COLA freeze, 47 percent would come from beneficiaries with incomes below $20,000 and another 33 percent from beneficiaries with incomes between $20,000 and $40,000. In total, four out of five (80 percent) of the dollars raised from a COLA freeze would come from Social Security beneficiaries with incomes under $40,000.

An alternative form of a COLA cut—reducing the COLA adjustment by one percent a year for five years—would have an even harsher impact on low- and moderate-income Social Security beneficiaries. Under this approach, 482,000 beneficiaries (of which 429,000 are seniors) would be permanently pushed into poverty and another 566,000 beneficiaries (of which 528,000 are seniors) permanently pushed below 150 percent of poverty. Of the Social Security funds cut by such a COLA reduction, 46 percent would come from beneficiaries with incomes below $20,000 and a total of 79 percent from beneficiaries with incomes below $40,000.

Taxation of Social Security

Currently, Social Security beneficiaries pay taxes on half of their Social Security benefits if their adjusted gross income is over $25,000 for single persons and $32,000 for couples. An alternative means of raising revenue for deficit reduction is to increase to 85 percent the amount of Social Security income subject to taxation (keeping the income thresholds the same). This would have the effect of taxing the full actuarial value of Social Security benefits and would thus equalize the tax treatment of Social Security and private pension benefits.

Unlike the deficit reduction measures that freeze or reduce Social Security COLAs, increased taxation of Social Security benefits would raise most revenue from higher-income beneficiaries. *Eighty-four (84) percent of the revenue raised would come from beneficiaries with incomes above $40,000 a year.* Less than three out of ten Social Security beneficiaries nationwide would be affected by this change, and *the average annual income of those affected would be over $61,000.* This approach would throw no one below the poverty line or below 150 percent of the poverty line.

INCREASED TAXATION OF SOCIAL SECURITY BENEFITS
NATIONAL ESTIMATES FOR 1998
AVERAGE BUDGET SAVINGS BY INCOME GROUP
(all amounts in 1998 dollars)

Income Range	Number of Persons in Tax Filing Units (in thousands)	% of Persons in Tax Filing Units	% of Revenue Raised	Number of Persons Affected (in thousands)	% of Income Group Affected
Less than $10,000	8,163	20.9%	0.0%	0	0.0%
$10,000-$20,000	10,650	27.3%	0.0%	0	0.0%
$20,000-$40,000	12,313	31.5%	15.4%	3,478	28.2%
$40,000-$60,000	4,284	11.0%	36.1%	4,273	99.7%
$60,000 or more	3,672	9.4%	48.1%	3,672	100.0%
All Income Groups	39,082	100.0%	99.7%	11,423	29.2%

Note: Age 62 and over.

SOURCE: Lewin-VHI estimates based on data from the March 1988 to 1992 Current Population Survey, the Brookings/ICF Model, the Congressional Budget Office and the Social Security Administration.

SOCIAL SECURITY COLA CUT
NATIONAL ESTIMATES FOR 1998
AVERAGE BUDGET SAVINGS BY INCOME GROUP
(all amounts in 1998 dollars)

Income Range	Number of OASDI Beneficiaries (in thousands)	% of Beneficiaries	Per Beneficiary Loss from 1994 COLA Freeze	% of Dollars Cut from 1994 COLA Freeze	Per Beneficiary Loss from 1% Annual COLA Cut	% of Dollars Cut from 1% Annual COLA Cut
Less than $10,000	12,019	26.4%	$140	19.1%	$265	18.5%
$10,000-$20,000	11,862	26.1%	208	28.0%	399	27.6%
$20,000-$40,000	13,159	29.0%	218	32.5%	428	32.8%
$40,000-$60,000	4,607	10.1%	205	10.7%	420	11.3%
$60,000 or more	3,799	8.4%	223	9.7%	455	9.9%
All Income Groups	45,446	100.0%	$194	100.0%	$378	100.0%
Additional Number Below Poverty						
Poverty Level			289,000		482,000	
150% Poverty			342,000		566,000	

Note: All OASDI Beneficiaries.

SOURCE: Lewin-VHI estimates based on data from the March 1988 to 1992 Current Population Survey, the Brookings/ICF Model, the Congressional Budget Office and the Social Security Administration.

EFFECT OF TAXING 85% OF OASDI BENEFITS ON ELDERLY
STATE LEVEL ESTIMATES, [illegible]

	Elderly Receiving OASDI (thousands)	Elderly Persons Affected (thousands)	% of Elderly Persons Affected	Average Unit Income Per Person Affected	Average Federal Tax Added Per Person
UNITED STATES	34,773	9,517	27%	$61,552	$641
Alabama	571	103	18%	$53,272	$526
Alaska	27	11	40%	$77,207	$706
Arizona	571	199	35%	$60,156	$643
Arkansas	387	84	22%	$58,328	$651
California	3,358	1,135	34%	$65,422	$672
Colorado	460	130	28%	$55,914	$676
Connecticut	502	164	33%	$64,883	$662
Delaware	88	23	27%	$54,252	$612
District of Columbia	66	19	29%	$69,957	$591
Florida	2,569	794	31%	$59,639	$609
Georgia	814	203	25%	$60,268	$694
Hawaii	138	46	33%	$64,842	$653
Idaho	136	36	26%	$58,696	$542
Illinois	1,559	417	27%	$65,875	$629
Indiana	812	185	23%	$50,652	$654
Iowa	499	139	28%	$60,368	$686
Kansas	384	118	31%	$56,515	$595
Kentucky	557	116	21%	$57,125	$605
Louisiana	513	105	21%	$63,560	$612
Maine	169	42	25%	$56,771	$484
Maryland	578	209	36%	$66,440	$664
Massachusetts	864	246	28%	$62,742	$622
Michigan	1,210	321	27%	$58,358	$613
Minnesota	635	177	28%	$56,692	$567
Mississippi	362	55	15%	$61,086	$670
Missouri	746	175	23%	$63,489	$632
Montana	104	27	25%	$53,810	$541
Nebraska	254	84	33%	$63,598	$689
Nevada	132	42	32%	$56,380	$572
New Hampshire	138	38	28%	$57,689	$575
New Jersey	1,141	322	28%	$61,041	$651
New Mexico	182	60	33%	$66,429	$646
New York	2,650	696	26%	$64,926	$710
North Carolina	932	207	22%	$60,961	$636
North Dakota	98	27	27%	$53,356	$661
Ohio	1,530	395	26%	$58,660	$612
Oklahoma	467	132	28%	$58,646	$555
Oregon	446	145	33%	$60,259	$659
Pennsylvania	2,104	507	24%	$61,162	$664
Rhode Island	171	51	30%	$52,789	$601
South Carolina	460	92	20%	$62,248	$637
South Dakota	122	30	25%	$53,879	$566
Tennessee	749	152	20%	$66,205	$619
Texas	1,843	481	26%	$64,228	$676
Utah	169	49	29%	$52,756	$574
Vermont	76	24	31%	$58,202	$587
Virginia	672	192	29%	$68,866	$659
Washington	582	229	39%	$58,736	$597
West Virginia	312	57	[illegible]	$47,770	$507
Wisconsin	819	212	[illegible]	[illegible]	$639
Wyoming	47	15	[illegible]	[illegible]	$600

SOURCE: Lewin-VHI estimates based on data from the March [illegible] Survey, the Brookings/ICF Model, the Congressional Budget Office and the Social Security Administration.

IMPACT ON ELDERLY OF COLA FREEZE IN 1994 AND ANNUAL COLA MINUS 1% 1994-1998 STATE LEVEL ESTIMATES, 1998

State	Elderly Persons Receiving OASDI Benefits	Number of Persons Moved Below Income Levels By 1994 COLA Freeze		Number of Persons Moved Below Income Levels By COLA-1% 1994-98	
		100% of Poverty	150% of Poverty	100% of Poverty	150% of Poverty
UNITED STATES	34,773,000	228,000	305,000	429,000	528,000
Alabama	571,000	9,800	6,000	15,000	8,300
Alaska	27,000	NA	NA	NA	NA
Arizona	571,000	2,800	5,300	4,900	6,200
Arkansas	387,000	8,400	3,700	11,100	6,000
California	3,358,000	16,400	22,300	32,300	44,800
Colorado	460,000	7,200	3,300	15,700	5,300
Connecticut	502,000	NA	1,800	NA	5,000
Delaware	88,000	NA	NA	1,400	1,300
District of Columbia	66,000	NA	NA	NA	NA
Florida	2,569,000	19,900	16,400	26,600	38,400
Georgia	814,000	5,500	11,700	12,900	11,200
Hawaii	138,000	2,200	2,700	2,500	3,200
Idaho	136,000	1,000	1,800	2,600	2,300
Illinois	1,559,000	5,400	19,400	15,800	30,9[illegible]
Indiana	812,000	12,700	10,100	18,100	1[illegible],700
Iowa	499,000	NA	3,700	5,200	13,000
Kansas	384,000	1,900	5,900	3,300	3,900
Kentucky	557,000	6,200	10,700	9,300	16,500
Louisiana	513,000	5,400	7,600	11,400	12,000
Maine	169,000	NA	1,500	1,300	2,000
Maryland	578,000	1,200	3,000	4,600	6,400
Massachusetts	864,000	4,300	7,200	7,400	11,900
Michigan	1,210,000	4,200	8,700	11,400	16,900
Minnesota	635,000	NA	1,700	4,900	4,200
Mississippi	362,000	5,800	4,500	9,300	10,200
Missouri	746,000	4,100	5,600	9,700	10,500
Montana	104,000	NA	1,600	NA	1,800
Nebraska	254,000	2,400	1,600	3,100	2,700
Nevada	132,000	NA	NA	1,900	1,800
New Hampshire	138,000	1,800	1,200	1,900	2,600
New Jersey	1,141,000	5,800	8,300	10,200	18,500
New Mexico	182,000	1,500	NA	3,000	2,000
New York	2,650,000	15,000	22,200	29,800	39,200
North Carolina	932,000	8,200	10,100	12,300	17,600
North Dakota	98,000	NA	NA	1,100	NA
Ohio	1,530,000	5,500	12,200	12,200	19,200
Oklahoma	467,000	3,900	8,600	5,100	11,900
Oregon	446,000	2,300	4,100	3,900	3,900
Pennsylvania	2,104,000	8,600	14,200	15,100	32,300
Rhode Island	171,000	NA	2,700	1,600	3,600
South Carolina	480,000	4,600	4,800	7,400	5,800
South Dakota	122,000	1,900	1,100	3,300	2,100
Tennessee	749,000	5,500	6,600	10,600	15,700
Texas	1,843,000	17,500	17,100	34,400	23,900
Utah	169,000	NA	2,200	1,600	3,400
Vermont	76,000	NA	NA	NA	NA
Virginia	672,000	6,100	2,400	14,300	2,300
Washington	582,000	NA	3,500	[illegible]500	[illegible]
West Virginia	312,000	NA	3,700	[illegible]	[illegible]
Wisconsin	819,000	4,000	9,200	[illegible]500	[illegible]
Wyoming	47,000	NA	NA	[illegible]	[illegible]

SOURCE: Lewin-VHI estimates based on data from the March 1988 to 1992 Current Population Survey, the Brookings/ICF Model, the Congressional Budget Office and the Social Security Administration.

PREPARED STATEMENT OF SENATOR JOHN D. ROCKEFELLER IV

Mr. Chairman: Today's hearing on Social Security taxation is part of the historic challenge facing our committee. It will help to determine if we are willing to work with President Clinton to make the tough decisions required to truly grapple with our enormous budget deficit.

No one in the committee or in Congress favors increased taxes, especially on senior citizens who are living on fixed incomes.

But we must be frank. We must face the reality of a budget deficit of $320 billion that is spiraling out of control. If don't act now to reduce the deficit, we will mortgage the future of our grandchildren and great grandchildren.

President Clinton has faced the challenge, by proposing a budget that will reduce our deficit by more than $1,000 billion to $206 billion by 1997. It's a bold, tough package that seeks a fair balance by asking many Americans to contribute more to our country's future. It will not be easy to ask individuals to contribute more, but we have to ask if we truly want to reduce the deficit. And everyone will benefit as we curb the deficit.

The Congress supported Clinton's basic outline by passing the budget resolution 54-45. But as we examine the individual components of this package, we will be sorely tested and politically pushed.

Today we will hear from Administration officials, experts and advocates about the impact of the President's plan on seniors. We need to keep in mind, that this proposal will only affect seniors who already pay some tax on their Social Security benefits—the vast majority of seniors whose incomes are below the current threshold for taxation now, won't be asked to contribute another dime. The money raised from seniors by this proposal is targeted to help shore up the Medicare Trust Fund which could be depleted soon after the year 2000.

In 1983, when Congress reached an historic agreement to save the Social Security system, part of the bipartisan deal included the provision to make 50 percent of Social Security benefits taxable for seniors with incomes over $25,000. While I wasn't in the Senate at that time, as many of the distinguished members of this panel were, I know this was an essential bipartisan effort to address a desperate problem—the solvency of the Social Security system.

A decade later, we face another desperate problem—our budget deficit. Again, we need an historic, bold effort to address the solvency of our country.

Our debate needs to be reasonable and balanced rather than alarmist and political. We need thoughtful consideration of the options and consequences.

We must keep in mind the magnitude of our nation's deficit problems, and the expectation of the American people that we in Congress are willing to make the tough decisions required to cut the deficit.

PREPARED STATEMENT OF C. EUGENE STEUERLE [1]

Mr. Chairman and Members of the Committee: The role to be played by this Committee over the next few years in helping to regain control over the U.S. budget is not an enviable one. Large deficits are an important symptom, although not the cause, of our inability to recapture control over government's expenditure and tax policy. Our political accounting, unfortunately, is not up to the task: it ignores the cost associated with buying on credit and the shifting of burdens onto future taxpayers, whereas every proposal to reduce the stock of future debt is identified only as creating losers. A true economic accounting, on the other hand, would indicate that getting the deficit under control probably creates more winners than losers.

It is mainly in the context of a broader deficit reduction package that I wish to discuss the taxation of social security benefits—the subject of testimony today. The current federal deficit is about $1,250 per person or $3,300 per household per year in the United States. The debt and its interest costs grow from year to year in ways that both increase taxes and cut back on the ability of government to direct expenditures toward new needs.

If this deficit is to brought under control, few are going to be able to avoid bearing some of the burden. Because of their growing economic importance—due in no small part to past policy successes—those who are elderly and near-elderly are unlikely to be exempted from participating in efforts to deal with national problems. Outside of defense and interest on the debt, they now receive about one-half of all federal

[1] I would like to thank Jon Bakija for his assistance in the preparation of this testimony. Portions are taken from *Retooling Social Security for the 21st Century*, which is being co-authored with Jon Bakija.

government expenditures and their share continues to grow. Meanwhile, many of the non-elderly—particularly families with children—have higher poverty rates, less wealth, and higher taxes than many elderly families, and their share of expenditures continues to decline. The discussion in this testimony, therefore, treats the taxation of benefits in the context of alternative means by which the Congress may ask the elderly and near-elderly to share in deficit reduction.

BACKGROUND

Prior to the passage of the 1983 Social Security Amendments, all social security benefits, no matter how large or how well-off the recipient, were free from income taxation. The 1983 legislation reversed over 40 years of history and required that up to one-half of OASDI benefits be made subject to taxation for people whose incomes exceed certain thresholds—$25,000 for a single person and $32,000 for a married couple. These income thresholds are not indexed. As the thresholds gradually decline in real value over time, more and more retirees will find that at least some of their social security benefits are subject to taxation.

Whether the taxation of benefits should be regarded as a net reduction in benefits or an increase in taxes is arbitrary. A nontaxable benefit of $10,000 is worth the same to a recipient as a taxable benefit of $12,500, on which $2,500 of tax is paid. Whether the net amount of money being transferred to each retiree is decreased through taxes on benefits or through an equal size reduction in payments, the consequences for the retiree, the budget, and the economy are essentially the same. As an aside, President Reagan threw his support behind taxation of benefits in 1983 because he was persuaded it was effectively a "spending reduction," rather than a "tax increase." The U.S. government itself classifies the favorable treatment of social security benefits as a tax expenditure, that is, an expenditure administered through the tax system.

ABILITY TO PAY DURING RETIREMENT YEARS

Compared to other options for contributing to deficit reduction by the elderly, taxing social security benefits mainly affects the better-off portion of the elderly. Even if the special social security thresholds were eliminated completely, other thresholds in the income tax—personal exemptions, the standard deduction, the special deduction for the elderly, and, possibly, a special tax credit for the elderly—would insure that many elderly lost little or no net benefits due to increased taxation. If the thresholds are retained, and the percent of social security benefits subject to taxation are increased to 85 percent, as proposed by the Clinton Administration, then only a minority of the elderly would be affected at all.

Another advantage of taxing benefits, relative to other options, is that it would affect the elderly at a point in the life cycle when they are best able to afford it. Progressive income taxation typically has a diminishing impact as an elderly person ages. Total income, including work earnings and unindexed pension income, often declines in real terms in later years of retirement. Meanwhile, exemptions, standard deductions, and rate brackets in the income tax are indexed for inflation. Accordingly, a larger share of income falls into a lower tax bracket or becomes exempt from taxation. Thus, income taxation allows retirees to keep more of their benefits when their needs are likely to be greater—that is, when they get older.

By contrast, most other benefit reduction options, such as a cut-back in cost-of-living adjustments or an across-the-board reduction in benefits, would tend to have a proportionate or even increasing effect throughout the remaining life of the retiree. Our retirement systems in the United States have not adapted well to much longer life spans and earlier retirement ages. For a typical couple retiring at age 62, social security benefits are now provided for *an average of 25 years* (the average length of time until both spouses die). Many individuals are misled to believe that adequate income at age 62 or 65 will be sufficient two decades later—when, often, it is not. Cutting back on cost-of-living adjustments likely would exacerbate this problem, as well as create related problems for SSI and Medicaid.

Taxation of social security benefits for current and near-future retirees might also be justified because of some unintended effects caused by the way social security has redistributed income. As Jon Bakija and I have shown in work at the Urban Institute, most current retirees who earned very high incomes during their careers are receiving hundreds of thousands of dollars of transfers above and beyond the fair annuity value of their contributions—that's beyond the sum of contributions made by them, contributions made on their behalf by employers, and interest on those contributions (see Table 1). Many are receiving net transfers beyond what many poor elderly and nonelderly are receiving or ever will receive. For example, a high-income one-earner couple retiring in 1995 will have paid OASI and Medicare taxes sufficient to buy benefits worth $231,000. Under current law they can be expected to receive back from social security annuity and Medicare benefits worth $482,000, producing a net transfer of over one-quarter of a million dollars—a larger transfer than will be received by lower-income couples. These subsidies are difficult to justify under any principle. They represent neither a fair return on contributions nor a redistribution according to need.

This rationale for taxing the benefits of current and near-future retirees is less applicable to those retiring during the next century. Most high-income workers retiring a few decades into the next century can be expected to receive considerably less than a full actuarial return on their social security contributions. Any additional taxation of benefits at that time will simply make an already progressive system that much more progressive. On the other hand, high-income couples retiring two decades from now are expected to receive social security and Medicare benefits with a value (in current dollars) that approaches $700,000. Those retiring in four decades are projected to receive over $1 million in benefits in today's dollars.

EQUAL TREATMENT OF EQUALS OR HORIZONTAL EQUITY

Taxation of benefits is also appealing on horizontal equity grounds. Consider, for example, a 65-year-old retired couple with $10,000 in social security benefits and $15,000 in pension and interest income in 1993. Since almost all their income is exempt from taxation, their federal tax bill will at most be $450. A young, four-person family with $25,000 in work earnings, by contrast, typically faces a federal tax burden more than ten times as large, at $5,235. The younger family must shoulder a much larger share of the burden of supporting our national government, despite the fact that their income is identical and their needs are likely to be substantially greater than those of a two-person family. (See Table 2 for a comparison of effective federal tax rates by income quintiles in the population.)

Another horizontal equity argument is made by comparing social security with private pensions. Contributions to private pensions and social security receive fairly similar income tax treatment; employee contributions are taxable, while contributions made by a firm on a worker's behalf are exempt from taxation. Interest on all contributions are deferred from taxation. Except for previously taxed employee contributions, however, all private pension benefit payments are subject to income taxation. As a general rule of thumb, it is usually argued that 85 percent of OASI benefits would have to be included in taxable income to achieve comparable treatment between public and private pensions.

One must be careful with the private pension analogy. The 85 percent figure, for instance, is not always accurate. For the most part, moreover, social security does not accumulate funds. Some would view social security more as an income transfer system than a pension system. This logic was applied in the 1983 Amendments to justify taxation of one-half of benefits. That is, one-half of social security transfers would be taxed to employees, while transfers from employers would be treated as taxable to recipients. Under that theory, only the generous income thresholds remained a source of special tax treatment.

On the other hand, the debate over OASDI tends to obscure the generous tax treatment of Medicare. Here much of transfer itself avoids income taxation, as it is taxable neither to the taxpayer nor the recipient.

For a variety of reasons, therefore, taxation of social security benefits is one of the more appealing choices among an array of unpleasant options to ask the elderly to share in a deficit reduction effort.

THE PHASE-IN PROBLEM

One problem with current policy is that taxation "phases in" in a way that significantly increases the marginal tax rate on earned income in the phase-in range, thereby reducing the incentive to work more than is necessary. Within this phase-in range, for every dollar earned, an additional $1.50 becomes subject to taxation (one dollar of earned income plus 50 cents of social security benefits). For those in the 28 percent bracket, the marginal tax rate on earned income in this range is effectively increased to 42 percent (1.5 x 28 = 42).

If this committee does decide to increase the taxation of social security benefits, I hope that it will give some attention to remedying this problem. For example, the special threshold and phase-in range could be eliminated and offset in part by maintenance or adjustment of the tax credit for the elderly or by an adjustment in the benefit formula itself.

CONCLUSION

Taxation of social security benefits is justified in part under the theory that those with equal incomes should pay equal taxes. Many proposals before this committee would move in the opposite direction by granting favorable treatment to selective taxpayers who have equal or greater ability to pay tax than others not so favored. My sense is that many of the elderly are willing to help bear the burden of deficit reduction if they believe that principles are being applied evenly and fairly throughout the population. My hope is that the Committee will give due consideration to this concern in putting together an overall package of deficit reduction.

TABLE 1—VALUE OF SOCIAL SECURITY BENEFITS AND TAXES FOR HIGH-INCOME COUPLES

[In constant 1992 dollars. Converted to present value at age 65 using a 2 percent real interest rate. Adjusts for the chance of death in all years after age 21.]

	Year couple turns 65		
	1980	1995	2010
I. ONE-EARNER COUPLE, HIGH WAGES:			
OASI Benefits	$257,000	300,000	388,000
OASI Taxes	70,000	166,000	310,000
OASI Net Transfer	187,000	134,000	78,000
Medicare Benefits	84,000	182,000	292,000
Medicare Taxes & Premiums	16,000	65,000	164,000
Medicare Net Transfer	68,000	118,000	128,000
Total Benefits	**341,000**	**482,000**	**680,000**
Total Net Transfer	**255,000**	**251,000**	**206,000**
II. TWO-EARNER COUPLE, HIGH & AVERAGE WAGES:			
OASI Benefits	265,000	307,000	392,000
OASI Taxes	122,000	268,000	465,000
OASI Net Transfer	143,000	38,000	−73,000
Medicare Benefits	84,000	182,000	292,000
Medicare Taxes & Premiums	22,000	87,000	228,000
Medicare Net Transfer	63,000	95,000	64,000
Total Benefits	**349,000**	**489,000**	**684,000**
Total Net Transfer	**206,000**	**134,000**	**−10,000**

Source: Eugene Steuerle and Jon Bakija ***Retooling Social Security for the 21st Century.*** (Washington, DC: Urban Institute Press, forthcoming).

Includes both employer and employee portions of OASI and HI payroll taxes. Excludes disability benefits and taxes. Medicare taxes also include SMI premiums and the estimated portion of income taxes used to finance SMI. Assumes HI payroll taxes are set at rates necessary to keep the system solvent on a pay-as-you-go basis after 1995, and SMI premiums remain tied to 25 percent of program costs after 1995. Couples are assumed to be the same age, and to have two children, born when the parents are aged 25 and 30. Workers are assumed to work continuously from age 21 to age 65. High-wage workers are assumed to earn the maximum wage subject to OASI taxes in each year ($57,600 in 1993), while average-wage workers are assumed to earn the average national wage in all years (about $23,700 in 1993). Includes the actuarial value of all OASI and Medicare workers and survival benefits payable over a lifetime. All benefit and tax amounts are weighted according to the probability of survival from age 21. Does not include the effect of income taxation on OASI benefits. Medicare recipients are assumed to receive insurance protection in each year after age 65 which is equal in value to the average Medicare outlay per enrollee in that year. OASI taxes are set at current-law rates.

All projections are based on the intermediate (alternative II) assumptions in the 1992 Social Security Trustees Reports.

TABLE 2—EFFECTIVE FEDERAL TAX RATES BY QUINTILE AND AGE OF UNIT HEAD—1992

[In percent]

Income quintile	Age 65 or over	Under age 65
Lowest	3.1	10.3
Second	4.9	18.4
Middle	7.9	22.1
Fourth	12.4	23.9
Highest	23.1	27.5
All quintiles	16.3	24.7

NOTE: Income quintiles are for the total U.S. population. Includes all federal taxes.

SOURCE: Sammartino, Frank and Robertson Williams, "Trends in Income and Federal Taxes of the Elderly," paper prepared for 13th Annual Research Conference of the Association for Public Policy Analysis and Management, Bethesda, MD, October 24–26, 1991; based on the Congressional Budget Office tax simulation model.

COMMUNICATIONS

STATEMENT OF THE EXECUTIVE INTELLIGENCE REVIEW

The proposed tax hikes on on Social Security benefits, and proposed raid on Social Security Fund monies--to be replaced only by federal government obligations, are two initiatives now before Congress which should be rejected out of hand. These proposals are immoral and incompetent. Instead of studying what part of the population is be attacked, and weighing how to loot government trust funds, the Senate should lead the way in taking emergency measures to rebuild the economy with a multi-billion dollar infrastructure building program that will increase the tax base, and restore the physical economy at the same time. In our statement here, we provide first, the background to the proposal to raise taxes on Social Security benefits; and secondly, we point out the flim flam behind the proposal to take away money from the Social Security Fund, and "replace" it with government debt.

- Don't Tax Grandpa Out of Existence -

In 1984, Richard Lamm, the former Democratic Governor of Colorado, may have shocked many people when he said that the elderly have a duty to die and get out of the way of younger generations. But he was only enunciating publicly what had by then become the behind-the-scenes consensus of U.S. policymaking circles.

Over the past few years, there has been an endless flood of Lamm-style propaganda claiming that the U.S. spends far too much on the elderly through entitlement programs--Social Security and Medicare--and insisting that if we don't start putting the squeeze on those over 65, there won't be enough resources for the young.

The population is being inundated with the message that killing off grandma is the "politically correct" thing to do. If resources are limited, the argument goes, it's better to put granny on an ice floe than it is to let junior starve. If little Johnny is to have a decent life, then Grandpa must give up his.

In 1987, Daniel Callahan, a leading "bio-ethicist" and director of the influential Hastings Center, wrote a book called "Setting Limits," which exemplifies the mentality behind the attack on the elderly.

Callahan maintained that there is a natural life span of approximately 75 years--which is complete nonsense-that the government should not spend one penny on any life-extending medical treatment for people over that age. To do so, he said, would both violate "nature," and, much more importantly, would be too expensive for society.

"If the young are to flourish," Callahan wrote, "then the old should step aside in an active way.... The acceptance of their aging and death would be a principal stimulus to do this." "Government," he went on, "cannot be expected to bear, without restraint, the growing social and economic costs of health care for the elderly. IT MUST DRAW LINES... Our common social obligation to the elderly is only to help them live out a natural life span; that is, the government is obliged to provide deliberately life-extending health care ONLY to the age which is necessary to achieve that goal [which, in Callahan's view, is about 75]. He then went on to say that he believes that an "age-based standard for the termination of life-extending treatment would be legitimate," and that "The meaning and significance of life for the elderly themselves is best founded on a sense of LIMITS to health care."

That same year, Peter Peterson, a very prominent Wall Street banker and chairman of the board of the New York Council on Foreign Relations, published a book called "On Borrowed Time," which advanced many of the same arguments as Callahan.

Peterson, whose former business partner, Roger Altman, now serves in the number two post at the U.S. Treasury Department, has since gone on to play a pivotal role in shaping the debate over the fate of the nation's elderly. In particular, Peterson has attempted to pit the young against the old, lying that there are limited resources, and insisting that the only way for the young to survive is by limiting the elderly's consumption.

In a speech to the American Assembly in 1991, Peterson blamed what he called the "vast entitlement programs for the elderly" for the ballooning growth in the U.S. budget deficit. He claimed that, U.S. national interest "is best served by programs that direct public resources toward investment and youth--not toward consumption and age...." And he said that, "To ensure that the right redirection of resources is made," he said, the U.S. should move toward progressive taxation of Social Security benefits, now before the Senate, and adopt other measures, which would have the effect of driving up the death rate among those over 65. Ross Perot and Paul Tsongas echo this them, demanding that Social Security and Medicare be slashed in order to free up resources for investment in the young.

To bolster these contentions, a number of leading Establishment policy institutes issued guidelines for the incoming Administration, recommending the same lethal policies. One of the most chilling of these was a report published in the early fall of 1992 by the Center for Strategic and International Studies here in Washington, which argued for massive cuts in the federal budget, especially in Medicare and Medicaid. The report complained that "approximately 30% of total Medicare dollars are spent on patients in the last year of their lives," and warned that "comprehensive health care reform will not be complete without a social consensus on care for the terminally ill." Translated into plain English, this means that the elderly and terminally ill must be hurried to their graves, for the sake of deficit reduction.

- Shock Troops for Euthanasia -

This Nazi-style campaign against the elderly has accelerated tremendously in the last six months. Peter Peterson has personally established several supposedly grass-roots groups to lobby for deep reductions in Social Security and Medicare, as part of an across-the-board austerity program for the U.S. One of these is the Concord

Coalition, which Peterson co-founded together with Paul Tsongas, former Senator Warren Rudman, and Washington "insider" attorney, Lloyd Cutler. Even more insidious is another of Peterson's so-called "grass-roots" groups, "Lead ... or Leave." This is a group of blood thirsty yuppie punks which Peterson, Ross Perot, Lee Iacocca and some other moneybags set up last summer for the express purpose of fomenting a "generational war" of the young against the old. Richard Lamm himself is on the board of Lead or Leave, along with Massachusetts Governor William Weld.

It is quite clear from Lead or Leave's propaganda, that they are consciously intended to replicate the Hitler youth movement, which campaigned relentlessly for the extermination of Germany's elderly, and mentally and physically handicapped. Lead or Leave is going to the very colleges and universities which, like Stanford, are teaching students that it is "politically incorrect" to hold human life sacred, and telling these same students that their futures depend on stopping their "greedy" and no longer productive parents and grandparents from using up too much of the world's supposedly limited resources. Lead or Leave is trying to enlist young people, who have already been softened up by years of miseducation, into a shock troop against the new "enemy," their own mothers and fathers.

It is out of this euthanasia movement that the proposal comes to tax Social Security benefits. An income of $25,000 a year or more for a pensioner is hardly a princely sum, especially for an elderly person who frequently spends hundreds of dollars a month on prescriptions alone.

- Don't Loot the Social Security Fund -

If you look on page on page 31 of the 1300 page Administration budget proposal, in the section on ``Federal Borrowing and Debt,'' you will see the bald rationalization for looting the Social Security Fund.

Here, the argument is developed that the federal government issues debt for two principal purposes. It borrows from the ``public'' to finance the federal deficit. And, it issues debt to government accounts which accumulate surpluses. In which connection, it is stated, ``Borrowing from the public has a significant impact on the economy.... It has to be financed from the savings of households and businesses, the state and local sector, or the rest of the world.... However, issuing debt to government accounts does not have any of the economic effects of borrowing from the public. It is an internal transaction between two accounts, both within the government itself. It does not represent either current transactions of the government with the public or an estimated amount of future transactions with the public.''

- A Grand Jury Is In Order -

If the Justice Department was actually a defender of the law, a grand jury ought to be convened to get to the bottom of that. If Congress were doing what the Constitution framed its responsibilities among the three branches of government to be, committees would even now be investigating. Such a statement tells us that the government's finances are run in ways no different than what Michael Milken was doing with Drexel Burnham Lambert, or what his friends did with Executive Life Insurance.

The parallel is not extreme. If a corporation replaced the assets of its pension fund with holdings of its own bonds, claiming, while it liquidated its revenue-producing economic activities, that the interest paid on the bonds would guarantee the future integrity of the pension fund, those responsible would rightly be prosecuted for embezzlement, preferably before the corporation's doors were locked by officers of the bankruptcy courts.

Such is the kind of activity which the authors of Clinton's budget claim ``does not have any of the economic effects of borrowing from the public.'' They know as much about economics as they evidently do about the law. Like Milken before them, it will not be too long before they find out that the effects of bankruptcy are very real.

The Social Security trust fund's receipts are based on monies docked from the wage bill of the employed. The funds represent economic activity performed by those who work. They are supposed to add to an asset base accumulated since the fund was established under Franklin Delano Roosevelt and earmarked to pay retirement benefits for those same present-day contributors. The Social Security trust fund is the biggest of those whose assets are being stripped and replaced by holdings of government debt. Currently, the fund runs a surplus of about $90 billion per annum.

Convert that surplus into holdings of Treasury debt. Funds dedicated to one purpose are transferred to current expenditures, such as debt service payments, while the Treasury paper inserted into the fund is supposed to provide the basis for future continuing retirement payments. Come the day, can you live off government bonds? Milken would probably say yes. Are they edible? Will they pay the rent? Will they pay medical bills?

- Backed by the Full Faith and Credit -

The fraud's defenders will no doubt point to the cited section: ``Debt is the most explicit and legally binding obligation of federal government.'' How dare you question the faith and credit of the U.S. government? Never in more than 200 years have obligations incurred by the federal government been repudiated. Nor, it might be replied, has so much federal debt been replaced by so much more federal debt, as it has been since 1978. Nor have so much of the real assets of the country, based on the labor of its population, been converted recklessly into future commitments to issue more government debt

In the current fiscal year, fully one-third of the government's outstanding debt ($1,092.8 trillion) is held by government agencies. That sum, almost sufficient to finance six months of the government's activities, represents receipts of government trusts which, like the so-called Social Security surplus of about $90 billion per annum, have been fraudulently converted for purposes other than those for which they are legally dedicated, on the basis of a promise that they will in the future be restored. By 1998, that sum is assumed to increase to $1,681.8 trillion, while remaining at approximately 30% of the total debt. The increase in that account over the five years of the Administration's projections is larger than any one year's worth of anticipated receipts from federal individual income taxes.

Tax receipts from individuals are estimated to increase more than 30% over the five years of the plan--faster even than personal income, or GDP, is supposed to increase. Yet the sums fraudulently converted from revenue into future promises to pay back, are slated to increase about 60% faster than revenues from individual tax receipts, and faster still than GDP or personal income.

This is the same profile of absolute lunacy which has been imposed in the name of ``reducing the budget deficit'' every time that battle cry has been raised since 1981. If obligations are permitted to increase faster than revenues, and if current receipts are converted into future claims against future receipts, which is what Treasury debt is, faster than either revenue or obligations in the form of debt increase, the result is insolvency and bankruptcy, and can be nothing else.

Acceptance of such an approach is not limited to government. Look at the opinion polls. Don't they mean that the ''majority'' view, that deficit reduction ought to be a top priority, is also, in effect, majority concurrence with the methods of a Michael Milken?

It is past time that the lesson was learned that the whole approach is insane. There is only one way to straighten out the federal government's budget. Forget the expenditure side, cut out the swindles and the frauds, and concentrate on increasing the revenues. When all types of unemployment are added together, even the government recognizes that unemployment is over 17%. Launch a high technology infrastructure-building program, create millions of jobs, and restore the tax base.

STATEMENT OF THE NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Mr. Chairman, Members of the Committee: This statement is submitted by the National Rural Electric Cooperative Association (NRECA) on behalf of the 25 million consumers served by 1,000 consumer-owned, nonprofit rural electric systems in 46 states.

INTRODUCTION

Rural electric systems continue to provide high-quality, central station electric service while operating under the traditional disadvantages of low consumer density, distance, weather and high investment per consumer.

Rural electric systems continue to confront another obstacle, that of rate disparity. Seventy percent of rural electric systems' rates are higher than their neighboring utilities. Rates are higher for several reasons -- much of rural electric systems' generating capacity was built in response to the energy crisis of the 1970s and during a period of high interest and rapid inflation; much of it was built to comply with the Clean Air Act of 1972, and as a consequence has state-of-the-art pollution control; rural electric systems serve primarily residential consumers and do not enjoy the ratio of industrial and commercial loads of municipal and investor-owned utilities.

The Clinton Administration has proposed for FY 1994 and subsequent years an energy tax based on the content of energy as measured in British Thermal Units (Btus) that will be an additional burden for rural electric consumers.

We are concerned that if such a tax is to be levied, it be applied fairly and that it not unduly burden rural Americans.

In addition, such a tax should be flexible enough in its design and administration to accommodate the various energy sources of electricity generation in this country. For example, about 75 percent of the generating capacity owned by rural electric systems is coal-fired, which means that rural electric systems are very dependent on coal as a fuel source. However, a small but growing number of systems are investing in the use of photovoltaic cells to power remote irrigation and stock watering facilities. The proposed tax must not act as a drag on developing technologies in energy production and use.

At our Annual Meeting in Dallas in February, delegates passed a resolution addressing this very subject, and I quote from it:

"Because of the federal government's burgeoning budget deficit, there have been reductions in assistance to state and local governments, resulting in pressures at the federal, state and local levels to find revenues. Accordingly there have been numerous revenue raising proposals at all governmental levels.

"We oppose any new federal tax on energy or energy sources that unfairly burdens rural electric consumers or negatively impacts national economic growth. . .

"We call upon Congress and the Administration to develop a federal tax structure that increases federal revenues in a manner that will fairly and equitably distribute the burden of federal taxation over all classes of taxpayers."

The nation's rural electric systems commend the Clinton Administration for its willingness to discuss aspects of the tax with the country's energy users and producers. However, we do still have some concerns.

1. Pass-Through Issues

We commend the Secretary of the Treasury for his public acknowledgement that the ultimate users of energy will bear a large portion of the proposed Btu tax. It can be no other way. Energy is one of the basic "productive inputs" in our economy and as such, must be paid for by all those who use it.

We therefore recommend that no attempt be made to preclude energy suppliers, including rural electric systems, from recording the proposed Btu tax's impact on a consumer's bill.

We are concerned that the Administration's proposal to couple a utility's pass-through of its Btu tax as a condition to its use of accelerated depreciation and other federal corporate tax incentives will have unintended, deleterious affects. We intend to comment to the Treasury Department on this matter, but we would like to take this opportunity to bring some of these difficulties to the attention of the Committee.

First, NRECA and its member systems are uncertain whether the Internal Revenue Code is the proper instrument with which the federal government should indirectly compel state utility regulators to allow the proposed Btu tax to pass through to the end user of energy. We would hope that a path could be found to allow full pass-through without upsetting the interplay of state and federal powers.

Second, the Administration proposal to change normalization for utilities during the period the proposed Btu tax is not passed through could adversely affect rural electric system consumer-members. Organized as cooperatives or other not-for-profit corporations, rural electric systems are bound to supply power reliably at the lowest possible cost consistent with sound business practices. This operating philosophy sometimes means that rural electric systems purchase power from neighboring utilities to meet some of the rural electric systems' consumer-members' needs. Any attempt to preclude pass-through of the Btu tax at the retail level by removing tax benefits to regulated investor-owned utilities would only force wholesale rates upward. Heretofore, unexpected wholesale price changes could jeopardize long-standing power supply contracts or delivery arrangements, thus endangering the rural electric systems' ability to reliably suppiy power.

2. Rural Impact of the Proposed Btu Tax

As stated previously, because rural electric systems are dependent on coal-fired generation, their electricity rates will go up, as will retail rates across the country. However, 70 percent of rural electric systems will continue to have higher rates than neighboring utilities.

Rural consumers also drive longer distances using more fuel and therefore would bear a burden imposed by higher gasoline prices necessitated by the tax.

In addition, independent farmers have virtually no way to "pass through" the increased burdens (direct on fuel consumed in farming and indirect in higher commodity transportation prices and other farming costs) to the "end users" of food and fiber. Their commodities must compete on the world market. One of the reasons American agriculture is so competitive with the rest of the world and why that sector of our economy continues to maintain a positive balance of trade is because agricultural inputs are competitively priced. If the costs of those inputs rise (energy used directly in farming as well as fertilizer, for example), the farmer will have to fully absorb those costs and farm income will decline.

Therefore NRECA recommends that the off-road use of diesel and gasoline in farming be exempted from the proposed Btu tax, or that farmers get a tax credit for their fuel use, similar to the provisions for off-road use embodied in the federal diesel fuel excise tax.

3. Alternative Methods of Energy Production or Generation

The members of NRECA have expressed concerns to the Administration over some innovative energy and fuel generation technologies they are involved in and, on the whole, have been received well and many of their concerns have been answered.

However, we believe that further clarification is needed in the tax treatment of energy generated and used in all kinds of energy storage technologies, not just pumped storage hydroelectric generation, which the Administration proposes to exempt. One NRECA member, Alabama Electric Cooperative (AEC) of Andalusia, Alabama, owns and operates the only compressed-air electric generation facility in the country. AEC employs off-peak electric energy generated from its nearby Lowman plant to compress air into a man-made cavern. That air is later released and superheated with natural gas fired burners during peak times to power generators that produce cheaper electricity. This electricity is cheaper for the consumer-members of AEC's distribution system members because the air was compressed with the cheapest electricity available: off-peak energy. Furthermore, the use of compressed air does not pollute and offers, where applicable, a reliable way to provide what is usually the most expensive electricity: peaking power. We would recommend that electricity generated from compressed air storage be treated identically to electricity generated by pumped-storage hydro and that a credit or exemption as a feedstock be granted for any fuel used to superheat the air.

In addition, we believe that further clarification is needed on the Administration's proposal to exempt fossil fuels used as feedstocks, as well as its proposed exemption for energy used to generate energy or fuel, especially related to fuel cells, batteries, electric thermal storage and other energy storage technologies. For example, fuel cells represent an emerging, cost-competitive technology to produce electricity in some situations.

As a broader concern, we believe that some provision must be made within the proposed framework of any energy tax to reward the wise, efficient use of energy and fuels. A "one size fits all" approach simply will not work. In addition, some decision-making provision must be made for new and emerging technologies.

4. Alternative Methods of Energy Use

NRECA also recommends that some recognition of advanced energy uses called "electrotechnologies" be made under any energy tax framework. Such advanced technologies improve the wise and efficient use of energy by using electricity in applications where it is more efficient than other end-use fuels, such as electric arc furnaces, plasma-fired technology and induction heating.

Further, there has been, in some cases, a 20-year history of encouraging residential end users to heat with electricity using off-peak energy such as dual fuel (dual heat) systems and electric thermal storage units. Such systems allow consumers to use electricity as their primary heating source and switch over to the alternate only during times of peak electricity usage, thereby enabling power suppliers to manage or shave their peaks and make the most efficient use of existing generating capacity. NRECA's members actively participate in these programs and feel strongly that they should not be disadvantaged under any energy tax.

INLAND WATERWAYS FEE

Finally, another proposal to be phased in over the next four years would also affect rural electric rates, and that is an additional $1 per gallon fuel tax to fully recover operation and maintenance costs of the shallow-draft inland navigation system. The current tax of 19 cents per gallon pays for half of inland navigation construction and rehabilitation projects.

This proposal will substantially affect the cost and competitiveness of coal. The increased shipping costs will only serve to raise the cost of coal and will affect a utility's decision on where to purchase the coal. The increased cost will adversely impact rural electric systems that must ship coal from one region of the country to another. These increased costs will be borne by the ultimate consumers, who will also be affected by the increased costs of groceries and raw materials. We would recommend no change in the fee other than that scheduled in current law.

The same resolution cited earlier and approved by voting delegates at NRECA's 1993 Annual Meeting contains the following language: "We oppose . . . any federal tax which punitively targets coal, as compared with the taxation of other fuels used to generate electricity." We believe that this additional fuel tax does target, although perhaps inadvertently, coal.

Again, rural electric systems and their consumers understand all too clearly the implications of huge federal deficits, and we are willing to do our fair share to reduce those deficits.

In conclusion, rural electric systems respectfully ask this Committee and the Congress to ascertain that rural Americans are treated fairly and equitably in any tax proposals to reduce the federal deficit. Rural electric systems and rural electric consumers are willing to do their fair share to deal with budget deficits and ask only to be treated equitably.

Thank you.

STATEMENT OF THE RETIRED OFFICERS ASSOCIATION

On behalf of The Retired Officers Association, an organization representing over 386,000 active, retired and reserve military personnel and their families, the following statement is submitted in opposition to H. Con Res. 64.

The provision contained in H. Con. Res. 64, which suggests an increase from 50% to 85% on Social Security benefits as a revenue measure appears to strike at the very heart of the middle income families who have, historically, borne the brunt of America's deficit burdens. Raising the taxable amount to 85% results in a very real increase in federal income taxes of up to 30% for social security annuitants. The potential tax increase associated with taxing 85% is detailed in the enclosure prepared for our Association by the accounting firm of Ernst and Young.

This "seniors tax", which resembles the inequitable 1988 Medicare Catastrophic surtax, far exceeds the 10% surtax President Clinton plans to impose on the wealthy who earn in excess of $250,000. In our opinion this is not a sharing of the pain, but rather an unacceptable increase in the sacrifices our senior citizens are being asked to endure.

We respectfully request that the Committee spearhead an effort to reject, or at least, modify the proposal. As a minimum, we suggest increasing the income threshold at which the Social Security tax kicks in to an amount consistent with the growth of inflation since 1983 when the tax was first imposed. That would translate to a threshold of about $32,000 for a single taxpayer and $40,000 for a couple. An alternative such as raising the earned income subject to taxes under the Old Age and Survivors and Disabilities Insurance system, is certainly less onerous than subjecting senior citizens to such a heavy tax burden. Finally, in the interests of shared sacrifice, no Social Security annuitant should be subjected to a tax increase that exceeds 10%.

We thank the Committee for its leadership and concern in this area and we stand ready to work with you as you seek to find alternate solutions to the proposal.

Enclosure

Impact of Increasing Taxable Social Security Annuity to 85%
Clinton/ Budget Resolution (Couple)

Taxable Amount	50%	85%			50%	85%			50%	85%		
Soc Sec Annuity:	$9,000	$9,000			$13,000	$13,000			$19,000	$19,000		
Income From All Sources	Federal Inc Tax	Federal Inc Tax	$ Diff	% Diff	Federal Inc Tax	Federal Inc tax	$ Diff	% Diff	Federal Inc Tax	Federal Inc Tax	$ Diff	% Diff
$24,000	$1,800	$1,800	0	0	$1,800	$1,800	0	0	$1,913	$1,991	$78	4%
$28,000	$2,438	$2,464	$26	1%	$2,587	$2,719	$132	5%	$2,813	$3,101	$288	10%
$32,000	$3,338	$3,574	$236	7%	$3,488	$3,829	$341	10%	$3,713	$4,211	$498	13%
$36,000	$4,238	$4,684	$446	11%	$4,388	$4,939	$551	13%	$4,613	$5,321	$708	15%
$40,000	$4,875	$5,348	$473	10%	$5,175	$6,280	$1,105	21%	$5,636	$7,351	$1,715	30%
$44,000	$5,566	$6,448	$882	16%	$6,126	$7,400	$1,274	21%	$6,966	$8,828	$1,862	27%
$48,000	$6,686	$7,568	$882	13%	$7,246	$8,520	$1,274	18%	$8,086	$9,948	$1,862	23%
$52,000	$7,806	$8,688	$882	11%	$8,366	$9,640	$1,274	15%	$9,206	$11,068	$1,862	20%

Source: Ernst and Young April 8, 1993