The Sneak-Attack Tax On Seniors

Fortune, March 1996

If you've listened much to the endless debates about balancing the federal budget, you've heard politicians and pundits argue in favor of 'means testing' government spending programs. The idea sounds simple: Citizens who are entitled to receive government benefits should get less, depending on how much other income they have. It even sounds reasonable. Why, after all, should rich retirees get Social Security checks that they don't really need while the aged poor struggle to make ends meet? In fact, we already have limited means testing. The government reduces Social Security benefits for those recipients under age 70 who earn more than a modest income. Today's budget cutters merely want to broaden and extend the idea enough to take a big slice out of future federal spending.

There are two fundamental problems with means testing. The first is that it is inherently unfair. Think about it: If two people earn the same income all their lives, but one spends it all and the other saves and invests, means testing gives the saver a lower benefit than the spender. The second problem--and this one makes the wider application of means testing fraught with peril--is that it reduces the incentive to work and encourages people to hide income.

To see how these perversities arise, consider what would happen if the government adopted the ultimate means test and simply cut off Social Security benefits to any retiree with more than, say, $25,000 in non-Social Security income. Take someone who earns $25,000 and who receives $8,000 in Social Security benefits. If that person earns an additional dollar, he would lose the whole $8,000 in benefits. His implied marginal tax rate on that last dollar of income would be 800,000%! Many older people would cut back on their work hours to keep their earned income under $25,000. Some would plead with their employers not to give them a pay raise. The incentive for these people to work 'off the books' would be huge.

Of course, the tax experts in Congress and at the U.S. Treasury understand this, so their bosses, the policymakers, aren't about to use that method. Instead, to avoid marginal tax rates well above 100%, they favor phasing out benefits past some income level. But even this more subtle form of means testing can still create punitively high marginal tax rates on additional income.

Take the so-called Social Security earnings penalty that exists already. This directly reduces benefits. Beneficiaries from ages 62 to 64 lose $1 in benefits for every $2 of wage and salary income they earn above $8,160 per year. That means that a 63-year-old receiving, say, $4,000 in benefits and earning $8,160 in salary will face a marginal tax rate of 50% on all wage and salary income above $8,160 but below $16,160. (After the $16,160 level, Social Security benefits would be zero and there would be no further tax.)

It gets worse. In addition, there's an explicit tax on Social Security benefits. For every dollar over a certain amount of 'modified adjusted gross income' (that's all non-Social Security income, including any tax-exempt interest, plus 50% of any Social Security benefits received), 50 cents of income becomes taxable. The threshold for a single retiree is $25,000. And remember--all this comes before adding on other taxes such as payroll and state income taxes.

Add up all these marginal tax rates and you reach a stunning conclusion. A single 63-year-old who makes $18,000 a year in dividend and interest income (not unusual for a person who has saved regularly through his previous 40 to 45 working years), and who earns a modest salary of $8,160, faces a marginal tax rate on salary income of more than 103%. To put it another way, after earning $100 and paying all the applicable taxes, the retiree ends up owing the government $3.65. The penalty is almost as stiff for Social Security recipients ages 65 through 69.

We need to cut Social Security and Medicare spending. They are, after all, the main cause of our large deficit and our growing debt. But there are better ways to do it. One would be to gradually increase the eligibility age from 62 to 65 for early retirement and from 65 to 70 for standard retirement--saving huge bucks while preserving work incentives for the elderly. Another would be to lower marginal tax rates on older people down to the rates the rest of us face by eliminating the earnings test while making all benefits taxable.

Those who favor means testing should examine the system we have now. It is means testing in action, and it isn't pretty.