UPDATE

The Heritage Foundation Backgrounder

214 Massachusetts Avenue, N.E. Washington, D.C. 20002-4999 (202) 546-4400

6/4/93 | Number 193

HOW CLINTON'S BUDGET PLAN TAXES THE ELDERLY

(Updating *Backgrounder Update* No. 192, "The House Budget Reconciliation Bill: Making a Bad Budget Even Worse," May 25, 1993; *Backgrounder* No. 942, "Why Higher Tax Rates on Income Will Slow Growth, Cost Jobs," May 25, 1993; *Backgrounder* No. 932, "Taxes, Spending, Gimmicks, and Snake Oil: Why Bill Clinton's Budget Is Bad for America," March 16, 1993.)

The House of Representatives last week passed its budget reconciliation bill (H.R. 2141) enshrining the Clinton Administration's tax and spending proposals. Many elderly Americans are unaware that buried in the plan (section 14215) is a discriminatory tax increase on middle-income senior citizens who depend for their retirement on money from sources other than Social Security—such as individual retirement accounts (IRAs), 401(k) plans, bank certificates of deposit (CDs), mutual funds, pensions, or wages from part-time employment.

The tax actually is a special surtax on the elderly, designed to increase automatically every year at twice the rate of inflation. Moreover, it is levied on what the tax code calls "provisional income." The surtax effectively double-taxes every investment a worker undertakes to provide for his or her retirement—particularly tax-sheltered savings such as IRAs, 401(k) plans, and municipal bonds.

Earlier this year, the White House was calling this new surtax a "spending reduction" in Social Security. Officials tried to justify that deception as follows: They said the Reagan Administration had used such a budget concept in 1984 when tax receipts were deposited back into the Social Security trust fund to help rebuild reserves.

But the new tax increase has very different implications for the elderly because it does nothing to help assure the fiscal integrity of the Social Security system. The report issued by the House Ways and Means Committee to accompany H.R. 2141 makes clear that lawmakers and the public were misled by the White House's original characterization. The key point is that new tax revenue will not be credited to the Social Security trust funds. It will simply go to the federal government's General Fund, to be spent on other programs. When tax money collected is not deposited back into the trust fund from which it came, it hardly can be called a "spending reduction." It is simply a surtax on the savings and pensions of middle-income elderly people.

How the Surtax on "Provisional Income" Hits IRAs and Pensions

The "provisional income" tax is a comprehensive levy on all the income and savings (such as IRA withdrawals) of senior citizens in the middle range of income. Significantly, it includes everything normally exempt. The tax is calculated on a separate schedule based on income that includes regular income and taxable withdrawals from IRA and 401(k) plans, taxable interest from savings, dividends, rents, and capital gains from investments. But it also includes tax-exempt interest on municipal bonds, certain foreign source income, as well as half of the retiree's tax-exempt Social Security pension.

The effect of this surtax is to place America's middle-income elderly in a special, higher bracket by virtue of their age. For instance, if an individual younger than retirement age receives $1 from savings, the income tax will take 15 cents in the lowest tax bracket. But some Americans must also calculate a surtax on their "provisional income," and a second 15 cents on the same $1 of savings would be due under the surtax. And if that tax-

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

payer were just below the 28 percent tax bracket, the government's income calculation would push the elderly American into the next highest bracket and the higher marginal tax rate would apply.

The surtax is targeted on middle-income retirees because it applies only over a range of income that falls between a fixed threshold and a variable cap. The threshold is $25,000 ($32,000 for joint returns, and not indexed for inflation). The cap is indexed for inflation and will go up every year; it is currently equal to 50 percent of one's Social Security pension. The Clinton Administration proposes to increase the cap dramatically this year, from 50 percent to 85 percent of the Social Security amount, which will elevate the cap even more in future years. Only "middle income" elderly Americans are subject to this surtax—those with incomes above the cap are not liable for the surtax.

A Stealth Tax, Growing with Inflation

The surtax on "provisional income" is designed to start off at a modest level, taking money from only a few retirees. But gradually it will grow to encompass more and more less-well-off Americans over age 65. The silent effects of inflation will cause an insidious deepening of the surtax threshold. Since the threshold amount of $25,000 is not indexed for inflation, it will drop in real terms each year, encompassing millions of additional elderly Americans. Today most Social Security pensions are under $12,000 per year. But at today's inflation rate, most Social Security pensions by the year 2015—when the baby boom generation begins to pass age 65—will be greater than the threshold and everything a retiree has saved may be subject to the surtax.

Example 1

Take the example of a retired store manager whose retirement income is $36,000. His lifetime earnings from wages and salary were near, but not above, the maximum wage base for Social Security tax. He receives a modest pension from his former employer, and managed to accumulate savings in a tax-sheltered 401(k) account during his working life (which is now held as an IRA). In addition he has invested in some tax-exempt municipal bonds and taxable certificates of deposit.

	Actual Income	Provisional Income Amount
Tax Exempt Income		
Untaxable Social Security	$ 9,000	$4,500
Municipal Bond Income	2,000	2,000
	$11,000	
Taxable Income		
Pension from Employer	$18,000	$18,000
Taxable Interest from CDs	2,000	2,000
IRA withdrawals during year	5,000	5,000
Total	$25,000	$31,000
Threshold		(25,000)
Taxable Amount		6,000
ELDERLY SURTAX @ 15%		**$ 900**

Example 2

A married, retired plant manager with an engineering firm, whose retirement income is $59,400, would pay the maximum surtax. His lifetime earnings from wages and salary were always above the maximum wage base for Social Security tax. He receives a generous pension from his former firm, and managed to accumulate savings in a tax-sheltered 401(k) account during his working life (which is now held as an IRA). In addition he has invested in tax-exempt municipal bonds and taxable certificates of deposit.

	Actual Income	Provisional Income Amount
Tax Exempt Income		
Untaxable Social Security	$20,300	$10,150
Municipal Bond Income	2,000	2,000
	$22,300	
Taxable Income		
Pension from Firm	$30,100	$30,100
Taxable Interest from CDs	2,000	2,000
IRA withdrawals during year	5,000	5,000
Total	$37,100	$49,250
Threshold		(32,000)
Taxable Amount		17,250
ELDERLY SURTAX @ 28%		**$ 4,830**

If this individual had a one-time capital gain from the sale of his home, which put him into the top 36 percent tax bracket, his surtax that year would be $6,210, or $1,380 higher.

In addition, the cap on the surtax rises with inflation because the amount of an American's cost-of-living (COLA)-adjusted Social Security pension determines how much other income is subject to this surtax. The retiree's annual cost of living increase for inflation in future years will raise the surtax cap by 85 cents for every dollar of inflation.

How Congress Will Discourage Retirement Planning

Because Americans take responsibility for their lives with different degrees of prudence, a government policy that punishes hard work and saving, and rewards shortsightedness, will have long-run social consequences undermining independence for senior citizens and the national savings rate. Stiff new taxes on those elderly Americans who look to the future and prepare for their own retirement makes it harder for senior citizens to be self-sufficient, to live without imposing a burden on their neighbors or their children, and to leave a legacy of achievement behind.

When Social Security was established, it was described explicitly as a supplement to private savings and a family's own financial planning for retirement. It has never been seen as a replacement for someone's own prudence and responsibility to plan ahead. The Clinton Administration's proposal will reverse this long-standing policy. It will discourage private savings and preparation for retirement by imposing a discriminatory tax on anyone who takes life-long responsibility seriously.

To be sure, there is a constant debate as to whether older Americans are, on average, net beneficiaries (meaning they "take out" more than they have "put in") from Social Security, and whether they generally have a greater net worth—and are thus "richer" than younger Americans. This debate becomes very confused when ideas of "fairness" are based on questions of "rich versus poor." Although most Americans who currently receive Social Security pensions are net beneficiaries, due to low tax rates in earlier years and generous COLA provisions, this windfall does not exist for anyone under age 45 today. Indeed, except for the very poorest wage earners, Social Security benefits will not return them even a fair yield on their investment after age 65 (for women the bias is even more severe).[1]

The Confused Philosophy of "Tax Fairness"

The tax increases advocated by the Clinton Administration are proposed in the name of "tax fairness"—some people are better off than others. Americans understand the concept of fairness in sports, in "equality before the law," and as members of a school or club where everyone has equal rights in the sense that everyone obeys the same rules. A progressive income tax, however, imposes unequal rules: Some people must pay higher tax rates. These unequal tax rates are justified on the basis of "ability to pay." This is sometimes known as the Willie Sutton principle, after the famous 1930s bank robber. Asked why he held up banks, Sutton responded, "That's where the money is." The apparent reason for increasing the surtax on "provisional income" is because some people have accumulated savings during their lifetimes and others have not.

But placing an additional tax on some older Americans because they have accumulated savings and investments during a lifetime of work, and therefore might be considered "rich" in comparison with a young worker just out of school, newly married, and heavily in debt, confuses all of the issues of wealth and poverty with the normal behavior of both rich and poor throughout a lifetime. An elderly "poor" person might well have more financial resources than a young "rich" person. Fairness and ability to pay are very different concepts. Tax fairness could more properly support a proportional income tax, which would follow an equal rule and take the same "fair" percentage from everyone who receives income.

---

1 See Michael J. Boskin, "Concepts and Measures of Earnings Replacement During Retirement," in J. Shoven and D. Wise, eds., *Issues in Pension Economics* (Chicago: University of Chicago Press, 1987).

Conclusion

Whether Social Security should remain a tax-exempt pension, or whether it should be taxed like any private pension can be debated. But the method adopted in the House budget reconciliation bill to calculate the tax on "provisional income" means a higher tax rate on savings and investment—thus a tax on each American's preparation for retirement and self-sufficiency in old age, and a penalty on savings.

Joe Cobb
John M. Olin Fellow