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Executive Summary

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DO OLDER TAXPAYERS RESPOND TO THE TAXATION OF SOCIAL SECURITY BENEFITS?

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Social Security benefits are taxed under a complex regime that raises marginal effective tax rates by up to 85 percent. The tax on benefits is effectively a Social Security earnings test (SSET), but applies at all ages with no actuarial adjustment to future benefits. While previous research found that the labor supply of retirement-age workers is significantly affected by the SSET and the implicit taxes created by the SS benefit formulas, the taxation of benefits has been thus far largely ignored.

OASDI benefits may be subject to income taxation if modified adjusted gross income (MAGI)[1] exceeds $25,000 for single ($32,000 for married) households. Above that threshold, the taxable portion of benefits phases in at a 50 percent rate until MAGI reaches a second threshold ($34,000 for singles/ $44,000 for married), beyond which the phase-in rate increases to 85 percent of benefits included in income. The Greenspan Commission created the 50-percent phase-in to shore up Social Security's finances in 1983. All the income tax revenues attributable to the taxation of benefits were initially earmarked for the OASDI trust fund. In 1993, with Medicare facing a shortfall, the 85-percent phase-in was enacted and the additional revenues (over and above the original 50-percent phase-in) were allocated to the HI trust fund.

The thresholds for taxation have been fixed in nominal terms since their inception. Since the thresholds are not adjusted for inflation, they decrease in real terms over time, unlike federal income tax brackets and many other income tax parameters. As a result, taxation of Social Security affects an increasing proportion of older workers over time as nominal incomes rise relative to the fixed threshold, pushing people into higher tax brackets. Now, about one-third of Social Security beneficiaries pay income taxes on part of their benefits (Hinden 2011). In 2010, $22 billion of revenue was raised from the benefit tax, almost eight times the nominal amount raised in 1984.

The partial taxation of benefits significantly raises marginal tax rates for many taxpayers. Taxpayers with low Social Security benefits or modest amounts of other income are not affected. However, as either benefits or other income increase, marginal tax rates increase quite dramatically. For example, a single person with $15,000 of non-Social Security income and $19,900 of Social Security benefits has none of

[1] MAGI is defined as adjusted gross income (AGI) plus tax-exempt interest plus one-half of Social Security benefits.

her Social Security included in income; her marginal income tax rate equals the statutory rate of 10 percent. If her Social Security benefit increases by $100, her marginal tax rate would increase to 15 percent. At higher income levels, the marginal effective tax rate can increase by as much as 21 percentage points (for taxpayers in the 25-percent statutory bracket affected by the 85-percent phase-in rate).

This paper examines three different margins on which individuals could respond to the taxation of Social Security benefits. First we look for "bunching at the kink-points" – or individuals adjusting their taxable income (MAGI) to just under the points where they would experience a large change in their marginal tax rate. Second, we look for whether individuals respond to the taxation of benefits by changing their claiming age. How individuals would respond is ambiguous. Some people could claim early in order to lower their annual Social Security benefit payments to keep under the tax thresholds. Others could delay their Social Security benefit claiming in order to avoid taxation of benefits now while they are working or have substantial income from other sources. Finally we examine the effect of the taxation of benefits on the number of hours worked after the Full Retirement Age (FRA).

Due to the complex nature of the tax and the measurement error of computing the tax rate from public use data, we take a multi-pronged approach to estimate the impact of taxation of benefits on individual behavior. We employ both difference-in-difference and instrumental variable techniques. Our findings are largely consistent: we find little evidence of individuals responding to the taxation of Social Security benefits. This is somewhat surprising considering the strong labor supply effects others have found of the Social Security earnings test. One possibility is that older people simply don't understand the rules, which are complex. Another is that there is a response, but we can't measure it because of noise in the dataset. A third is that people understand the rules and are simply unresponsive. The difference between this work and what others have found in response to the SSET warrants further investigation.

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