The Effects of Collecting Income Taxes on Social Security Benefits

John Bailey Jones, Yue Li

PII: S0047-2727(18)30004-5
DOI: doi:10.1016/j.jpubeco.2018.01.004
Reference: PUBEC 3853

To appear in: *Journal of Public Economics*

Received date: 11 November 2016
Revised date: 19 September 2017
Accepted date: 12 January 2018

The Effects of Collecting Income Taxes on Social Security Benefits

John Bailey Jones[a,*], Yue Li[b]

[a]*Federal Reserve Bank of Richmond, Richmond, VA 23219, USA*
[b]*Department of Economics, University at Albany, SUNY, Albany, NY 12222, USA*

Abstract

Since 1983, Social Security benefits have been subject to income taxation, a provision that can significantly increase the marginal income tax rate for older individuals. To assess the impact of this tax, we construct and calibrate a detailed life-cycle model of labor supply, saving, and Social Security claiming. We find that in a long-run stationary environment, replacing the taxation of Social Security benefits with a revenue-equivalent change in the payroll tax would increase labor supply, consumption, and welfare. From an ex-ante perspective an equally desirable reform would be to make the portion of benefits subject to income taxes completely independent of other income.

JEL classifications: E21, H24, H55, I38

Keywords: Social Security, Labor Supply, Taxation

1. Introduction

The sustainability of the Social Security system has been a pressing concern for several decades. Even after a number of reforms, the system's trust fund is expected to be depleted in 2035 (Social Security Administration, 2016a). Many observers also fear that Social Security unduly discourages labor supply and private saving. The extensive literature on potential Social Security reforms thus continues to grow. There are nonetheless provisions of Social Security that remain relatively unexamined. In this paper, we focus on one such provision, the income taxation of Social Security benefits.

According to the Congressional Budget Office (Congressional Budget Office, 2015), in 2014 about half of Social Security recipients owed income taxes on their Social Security benefits. An important feature of these taxes is that the amount of Social Security benefits subject to taxation is an increasing function of the beneficiaries' "combined" income, which includes earnings.[1] At

*Corresponding author
Email addresses: john.jones@rich.frb.org (John Bailey Jones), yli49@albany.edu (Yue Li)

[1]Combined income is the total of adjusted gross income, interest on tax-exempt bonds, and 50% of Social Security benefits and Tier I Railroad Retirement Benefits.