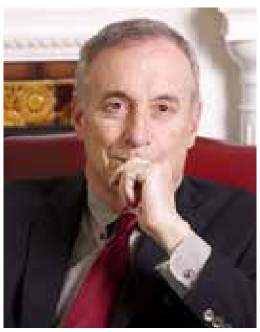
Goodman Institute
Turning Ideas Into Policy

Work disincentives imposed by the federal government on working seniors are encouraging retirement, whether they want it or not.

Some Older Workers Face Astronomical Tax Rates

People in their 60s who keep on working can face extremely high tax rates – much higher than the rates faced by millionaires and billionaires, according to a new study.

For example, senior workers earning an average income can easily lose more than half of their earnings to higher taxes and reduced government benefits. In some cases, workers can lose 95 cents out of each dollar they earn.



Laurence J. Kotlikoff
Boston University and
The Fiscal Analysis Center

This is unfortunate. Millions of elderly citizens are mentally and physically capable of making major contributions to our economy. We are all made worse off when these people are pushed out of the labor market by policies that encourage them to retire.

Current year marginal tax rates on wages.

The study finds that the Social Security System is one of the most important sources of penalties for working seniors. For example:

- Beyond a certain income level, early retirees from age 62 to 66 lose 50 cents of Social Security benefits for each dollar they earn – a 50 percent tax rate.
- From Jan. 1st in the year in which they turn 66 until their 66th birthday, they lose 33 cents of benefits for each dollar of wages – a 33 percent tax rate.

Working seniors earning an average income can lose up to 95 cents out of each dollar to higher taxes and reduced government benefits.

These taxes are on top of income, payroll and other taxes. Although the government begins adding the benefit reduction back once the worker reaches the normal retirement age, many seniors don't realize that or don't understand it.

If we abolished these "earning penalties" the government would probably be a net winner. Seniors would work more and earn more, and the other taxes they pay would more than make up for any short term revenue loss.

Another impediment to work is the Social Security benefits tax:

- Beyond a certain threshold, seniors must pay income taxes on 50 cents of Social Security benefits for each dollar they earn – increasing their marginal tax rate by 50 percent.

- If they earn even more income, they will reach a point where they must pay income taxes on 85 cents of Social Security benefits for each dollar they earn – increasing their marginal tax rate by 85 percent.

When the Social Security benefits tax is added to the earnings penalty, the tax rate on moderate-income seniors can actually reach 95 percent. (See Figures I, II and III)

Figure I

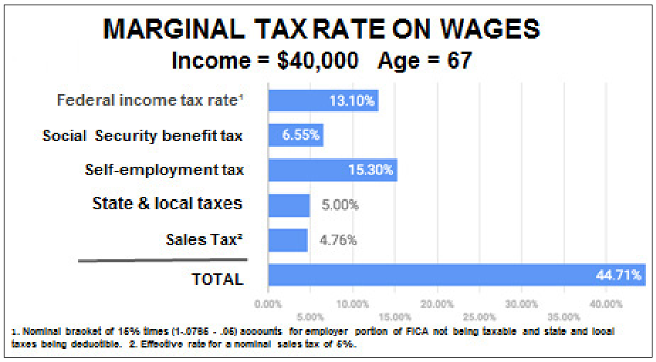


Figure II

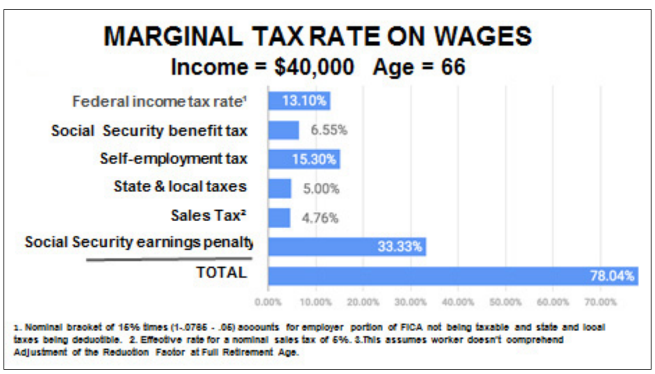
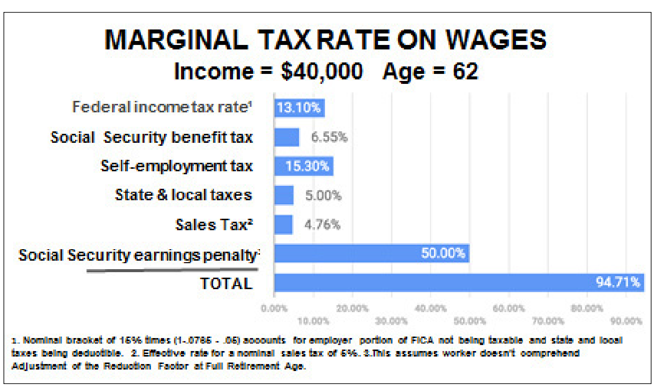


Figure III

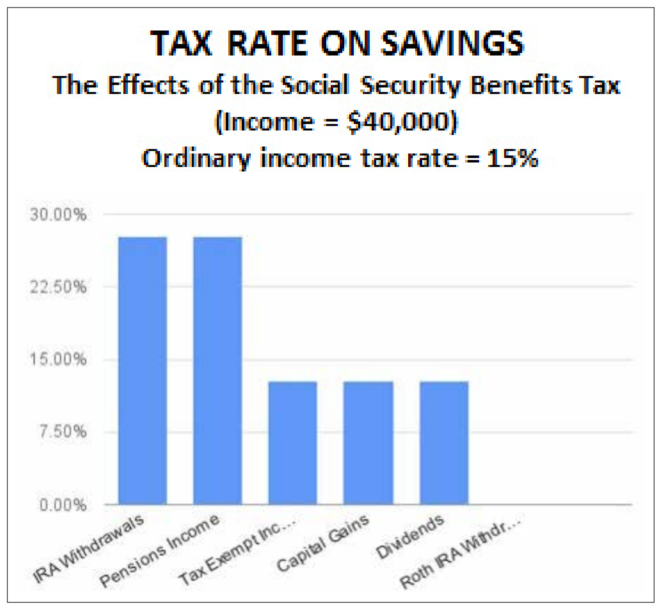


Current year marginal tax rates on savings.

The Social Security benefits tax also imposes very high rates on savings. As Figure IV shows, for someone in the 15% bracket for ordinary income:

- The Social Security benefits tax can increase the tax rate on pension income and IRA withdrawals from 15% to 27.75%
- It can raise the tax on capital gains and dividend income from zero to 12.75%
- Tax exempt income can also be taxed at a rate of 12.75%.

Figure IV



These high marginal tax rates only hit in the middle of the income ladder. They don't affect the work incentives of the rich or the poor.

Lifetime marginal tax rates.

Most people don't spend all the income they earn in the year they earn it. Instead, workers, particularly seniors, tend to save in order to even out their consumption over their remaining years of life. So when considering the benefits of work, the senior must consider not only the current year effects, but also the taxes on income from savings in future years. Additionally, the deicsion to work is affected by numerous other entitlement programs, including Medicaid and Medicare.

To compute the effects of earning, say, an additional $1,000, the study started with the Federal Reserve's Survey of Consumer Finances – a sample of households of different sizes and ages and with different levels of income and assets. It then did three unique things:

- Using The Fiscal Analyzer, the authors calculated the impact of 30 different federal and state tax and entitlement programs.
- They then calculated the lifetime effects of these programs as reflected in a lifetime marginal net tax rate.
- They also calculated anticipated income and consumption for all possible lifetimes (each weighted by the probability of its occurring), in order to arrive at the true expected value of lifetime consumption for each wage earner.

The poorest 65-69 year olds who earn an additional $20,000 by working face a marginal net tax rate that ranges from 8.8 percent to 627.9 percent!

For example, if a worker earns an additional $1,000 and the expected lifetime consumption rises by $700, the lifetime marginal net tax rate is 30 percent.

Marginal tax rates.

Consider the effects of earning an additional $1,000 for just one year for individuals age 50 to 79. The marginal tax rates are in the 30 to 40 percent range for the lowest one fifth (measured by the sum of net worth plus human wealth), rising to near or above 40 percent for the second and third quintiles, and close to or above 50 percent for the next two quintiles. Among the richest 5 percent and 1 percent, median marginal net tax rates can exceed 60 percent.

There is also an enormous dispersion in marginal net tax rates among households with the same level of resources. For example, nearly one fifth of elderly in the lowest one-fifth face marginal net tax rates above 60 percent. Yet, almost a quarter face marginal net tax rates below 20 percent. In the top fifth, a full third of elderly are in 60 percent or higher marginal net tax brackets, whereas 14 percent are in brackets below 40 percent.

Maximum and Minimum Marginal Net Tax Rates.

In the case of the poorest 65-69 year olds, those who earn an additional $20,000 (say, by taking a full or part-time job) face a marginal net tax rate that ranges from 8.8 percent to 627.9 percent!

The household with a marginal lifetime net tax rate of 8.8 percent is a single woman, age 66, with a five year old child in her care. Her primary source of income is Social Security, but she also receives Food Stamps and Supplemental Security Income. She owns a modest home and has a small mortgage. The low marginal tax rate she faces is due to her having the child in her home. If she earns an additional $20,000 in the current year, her federal taxes will decrease. Indeed, she'll receive a federal income tax refund due to the Child Tax Credit and the Earned Income Tax Credit. Her Food Stamp benefits will, however, be reduced in the current year but that is more than offset by the refund, leaving her with a small positive marginal net tax rate.

Some Older Workers Face Astronomical Tax Rages

The household with the marginal lifetime net tax rate of 627.9 percent is a married couple whose husband is age 65 and wife is age 61. The husband is currently collecting Social Security and has modest self-employed income of roughly $8,000 per year. The wife is disabled and receives Social Security Disability Income. They own a modest home with no mortgage. Their high marginal tax rate is due to the loss of their Medicaid benefits in the years prior to the wife reaching age 65. The additional $20,000 in the current year increases their Modified Adjusted Gross Income, which determines their Medicaid eligibility. The additional labor earnings in the current year eliminate their current-year Medicaid eligibility. But, since they save a portion of the additional income and, as a result, have more assets and asset income after the first year, they also lose Medicaid eligibility in future years. Indeed, they lose it for four years in a row.

Conclusion: Is Uncle Sam inducing the elderly to retire?

Based on the work disincentives the federal government imposes on the elderly, the answer seems clearly to be yes. But an open question is the extent to which the elderly correctly perceive these disincentives. Given the complexity and interactions of our fiscal system, it's hard to believe that policymakers themselves are cognizant of the level and spread of the work disincentives they are imposing on the elderly.

Goodman Institute
FOR PUBLIC POLICY RESEARCH

6335 W Northwest Hwy - #2111 • Dallas, TX 75225 • email: info@goodmaninstitute.org • +1 214 302.0406