OLDER TAXPAYERS' RESPONSE TO TAXATION OF SOCIAL SECURITY BENEFITS

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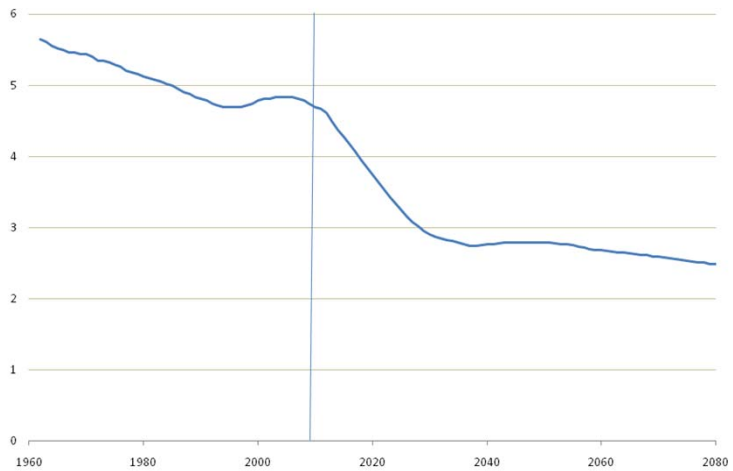
The Issue

- Aging baby boomers
  - See chart →
- Tax provisions may discourage work by older Americans
  - Social Security Earnings Test
  - Taxation of Social Security Benefits

Ratio of Working Age Adults to those 65 and Over

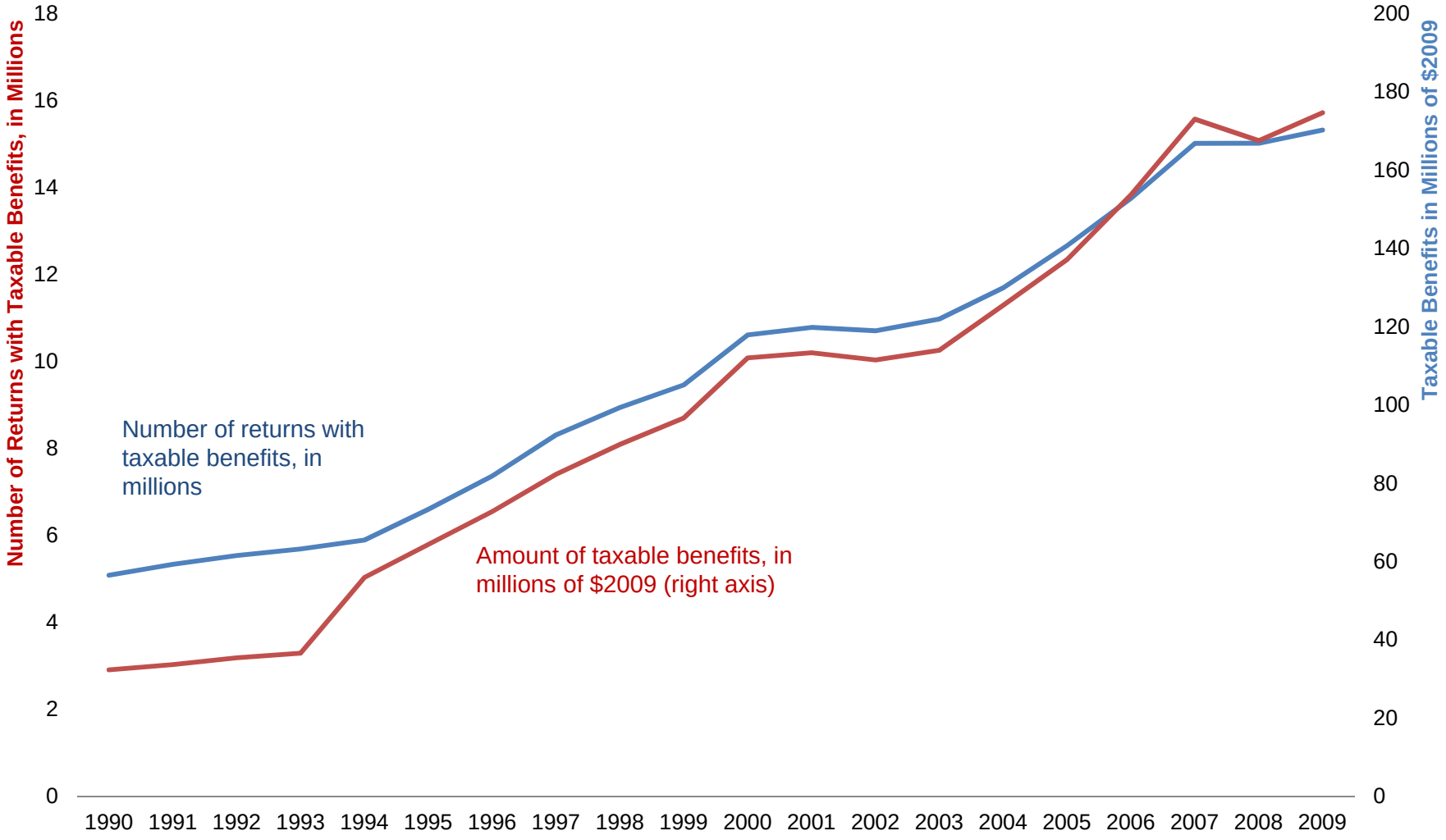


Source: Congressional Budget Office, 2009.

Taxation of Social Security benefits

- Older workers whose other income plus half of Social Security benefits, so-called Modified Adjusted Gross Income (MAGI), exceeds a threshold must include a portion of Social Security in taxable income.
  - Raises marginal effective tax rates by 50% or 85% of the statutory tax bracket in the affected ranges of income
  - The threshold has been fixed in nominal terms since 1993; in real terms it has declined by 38%
  - If compensated labor supply elasticity > 0, we would expect some older workers (especially those near the kinks) to reduce earnings
    - They might also realize less net capital income, engage in legal tax shelters (tax avoidance), or understate their income (tax evasion).
    - Slemrod (1990) suggests that avoidance responses would be more prevalent.
    - Ample evidence (e.g., Saez 2010) suggests that self-employed will be more likely to respond than wage earners
      - They have more control over hours/intensity of work and they have more opportunity to misreport their income.

Number of Returns with Taxable Social Security Benefits, and Amount in $2009, in Millions, 1990-2009

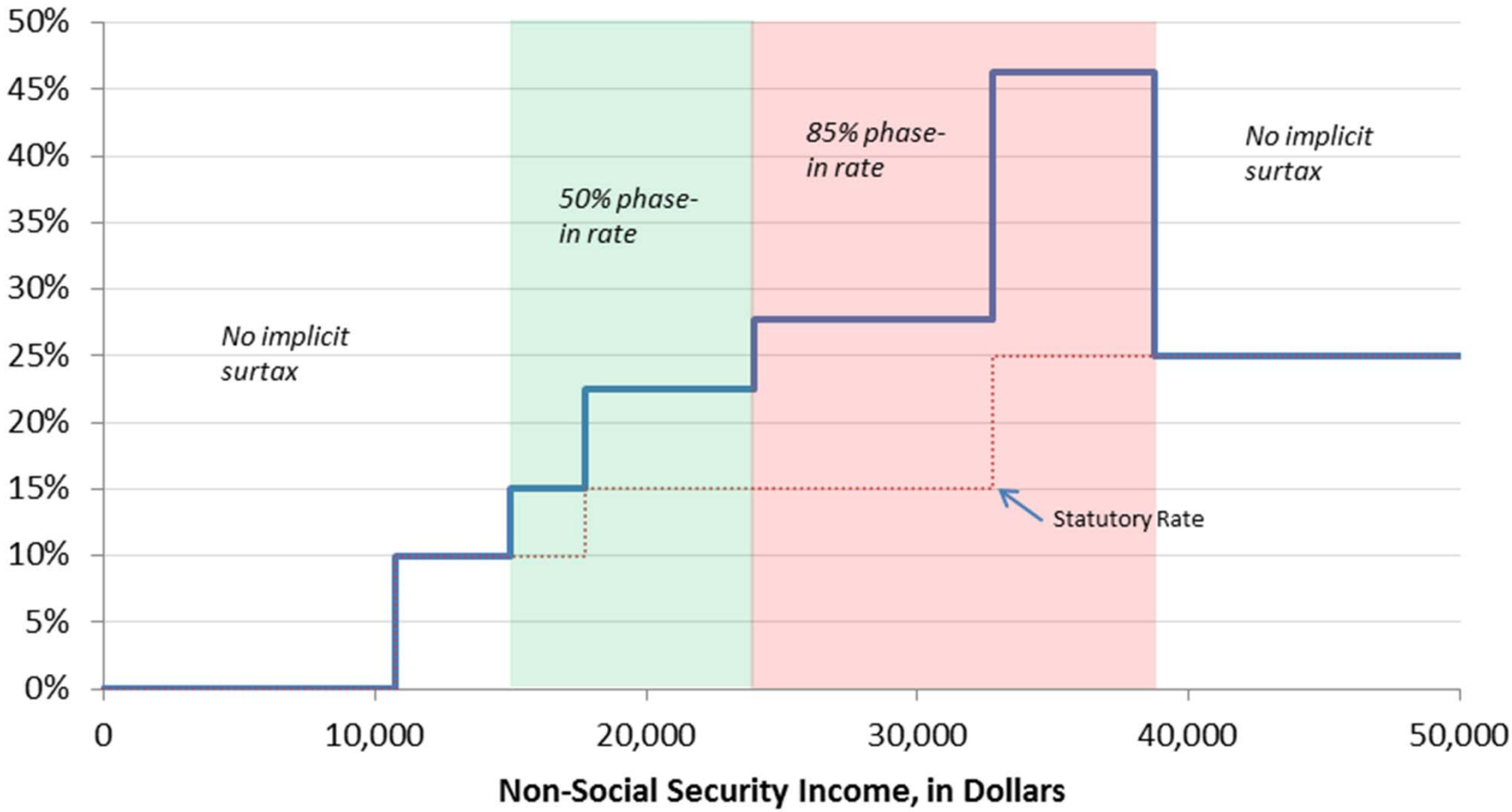


Source: IRS, "Selected Income and Tax Items for Selected Years (in Current and Constant Dollars)" and authors' calculations, http://www.irs.gov/file_source/pub/irs-soi/09intba.xls`

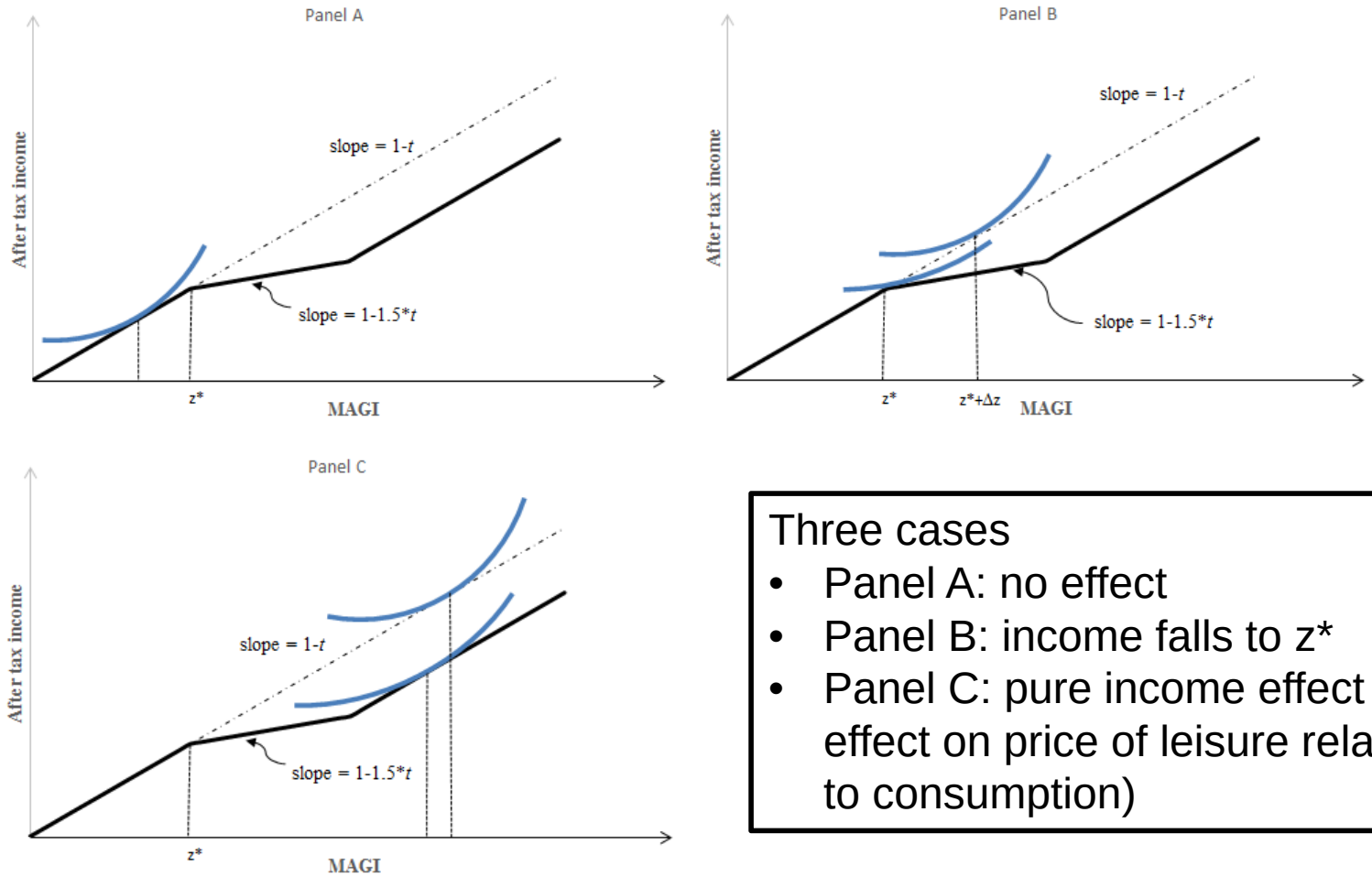
Taxation of Social Security Benefits (cont.)

- Social Security benefits are phased in at a 50% rate for taxpayers with MAGI above $25,000 for single filers ($32,000 for joint filers), and by 85% for single filers with MAGI above $34,000 ($44,000 joint) until 85% of benefits are included in taxable income.
  - MAGI is Adjusted Gross Income (AGI) plus tax-exempt bond interest and one-half of Social Security benefits
- The 50% threshold was first introduced in 1983 as part of the Greenspan Social Security reforms. Revenue raised was devoted to the Social Security trust fund.
- The 85% threshold was introduced in 1993. The additional revenue is allocated to the Medicare trust fund.

Effective MTR on Earnings for Single non-Itemizer, Age 66 or Older, 2010



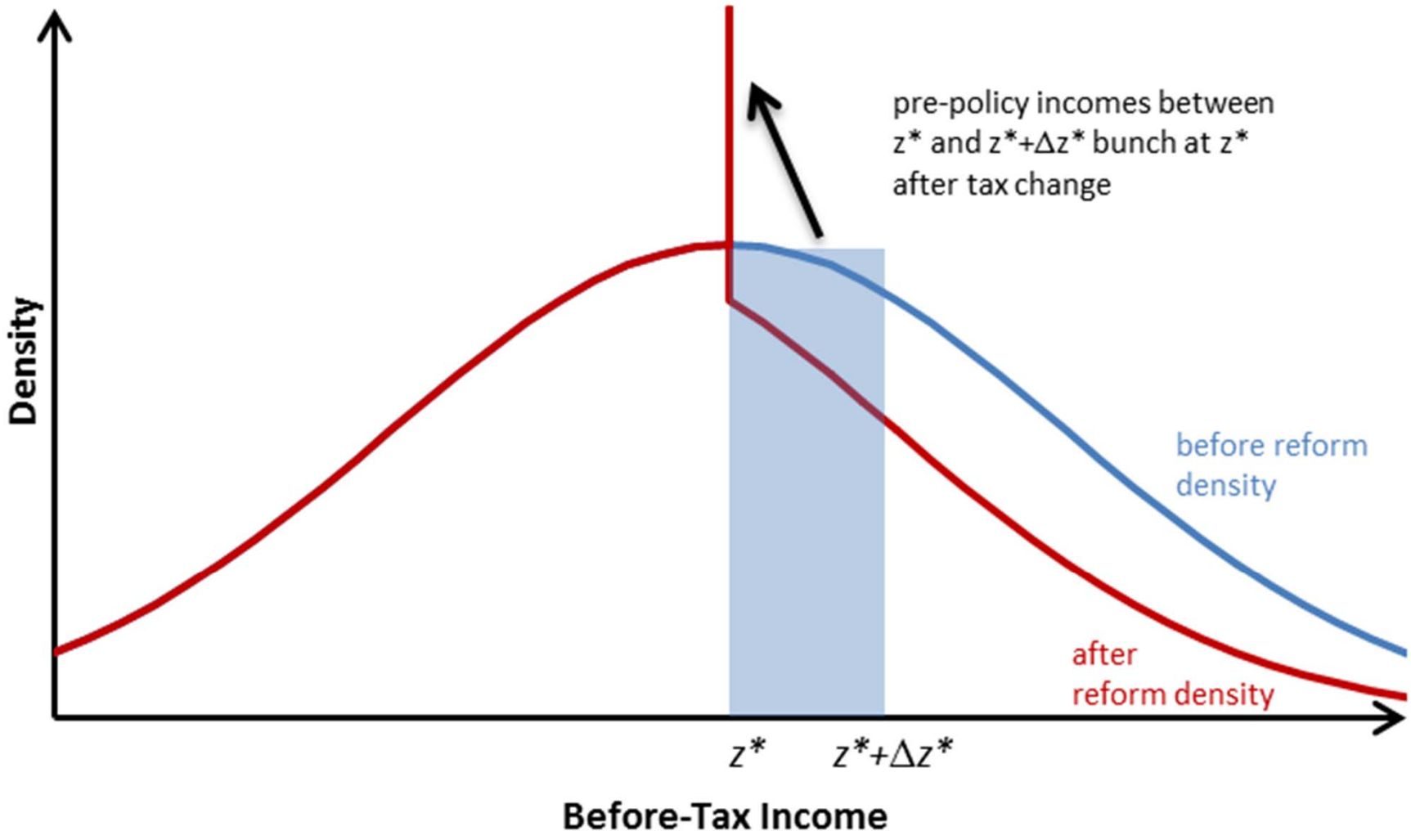
Effect of Introducing a Kink in the Budget Constraint



Three cases

- Panel A: no effect
- Panel B: income falls to z*
- Panel C: pure income effect (no effect on price of leisure relative to consumption)

Predictions of Simple Utility Maximization Model



The Real-World Effects of Taxing Social Security Benefits are Ambiguous

- On the one hand, we might expect larger responses than to income tax rates because it is easier to predict MAGI (and manipulate it) than taxable income
- On the other hand, the law is so complicated that people may not know how to respond to it
  - Optimal taxation by misdirection?
- Previous work (Burman, Coe, Tian 2012) found no effect
  - Data limitations raised doubts about those findings
- This time we have better data: large panel of individual income tax returns from 1999-2008

1999 SOI Edited Panel Sample Sizes, 1999-2008

Tax Year	Total Sample		Subsample with Primary Taxpayer Age 62 and Over	
	Unweighted	Weighted	Unweighted	Weighted
1999	112,823	153,578,941	23,535	28,574,758
2000	112,804	153,904,818	24,797	29,666,609
2001	112,783	154,187,313	25,990	30,637,473
2002	112,528	154,118,136	27,282	31,720,317
2003	112,058	153,648,715	28,536	32,640,930
2004	111,144	152,282,996	30,269	34,106,473
2005	110,048	150,512,455	31,918	35,426,133
2006	108,946	148,771,365	33,380	36,666,559
2007	107,844	147,034,343	34,740	37,831,748
2008	106,655	145,134,423	36,530	39,309,668

Note: Total sample excludes returns receiving disability payments and those where the primary taxpayer is younger than 23.

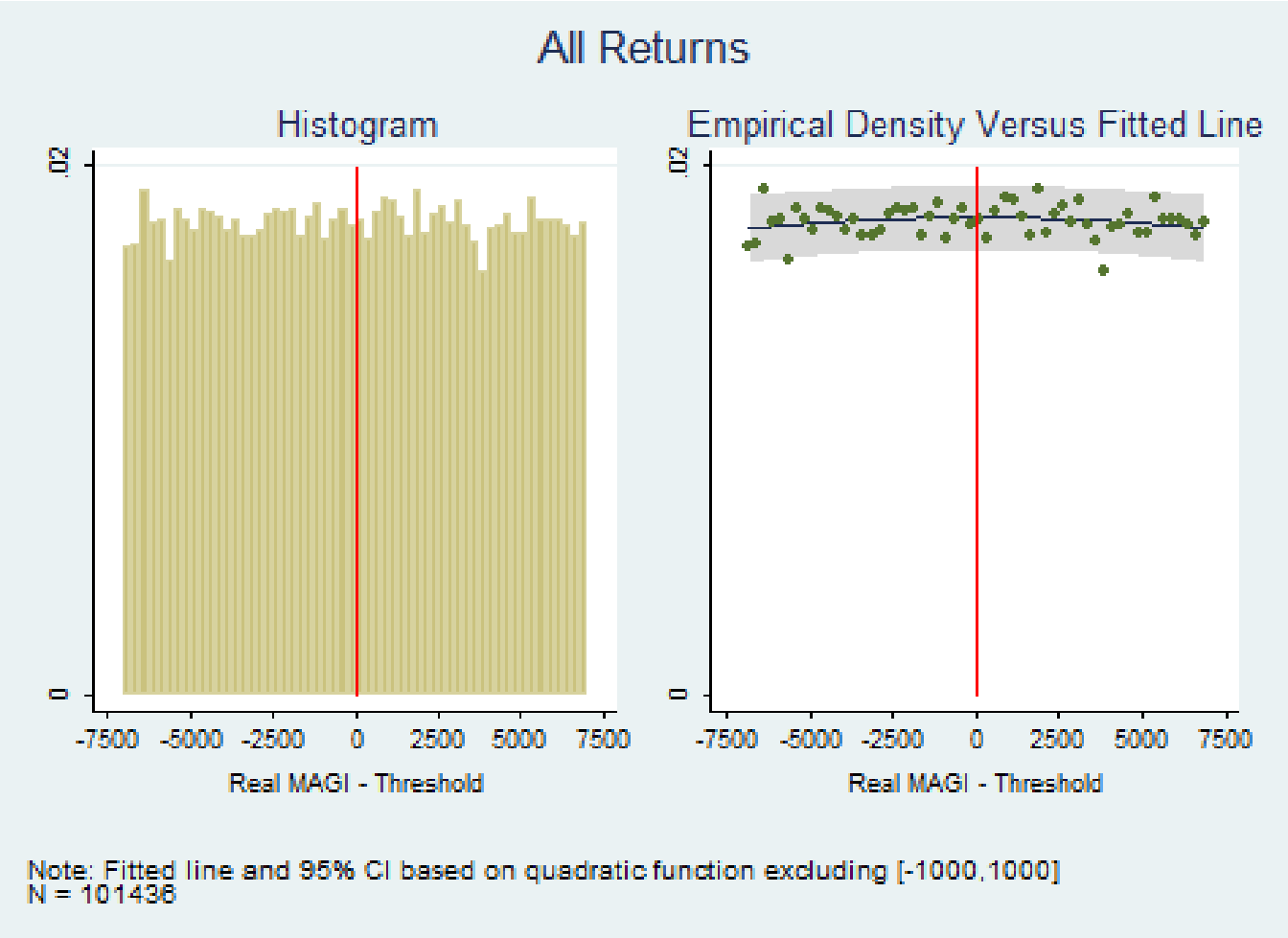
Summary Statistics, Pooled Sample: 1999-2008

	Married			Single	
	Unweighted	Weighted		Unweighted	Weighted
Number of Returns	755,087	906.9M		352,546	606.3M
Self-employed (%)	28.0	19.0		9.6	7.3
With SSB income (%)	23.5	21.4		20.1	18.6
Social Security Benefit ($)	24,371	20,489		15,171	13,711
SSB in AGI ($)	14,802	8,605		5,415	3,036
MAGI ($)	3,146,938	110,823		1,050,723	37,518
Wage earners					
Wage income ($)	508,710	75,881		112,727	27,040
Self-employed					
Self-employment income ($)	428,950	37,070		341,050	20,111
Wage income ($)	1,085,714	65,144		646,428	17,189

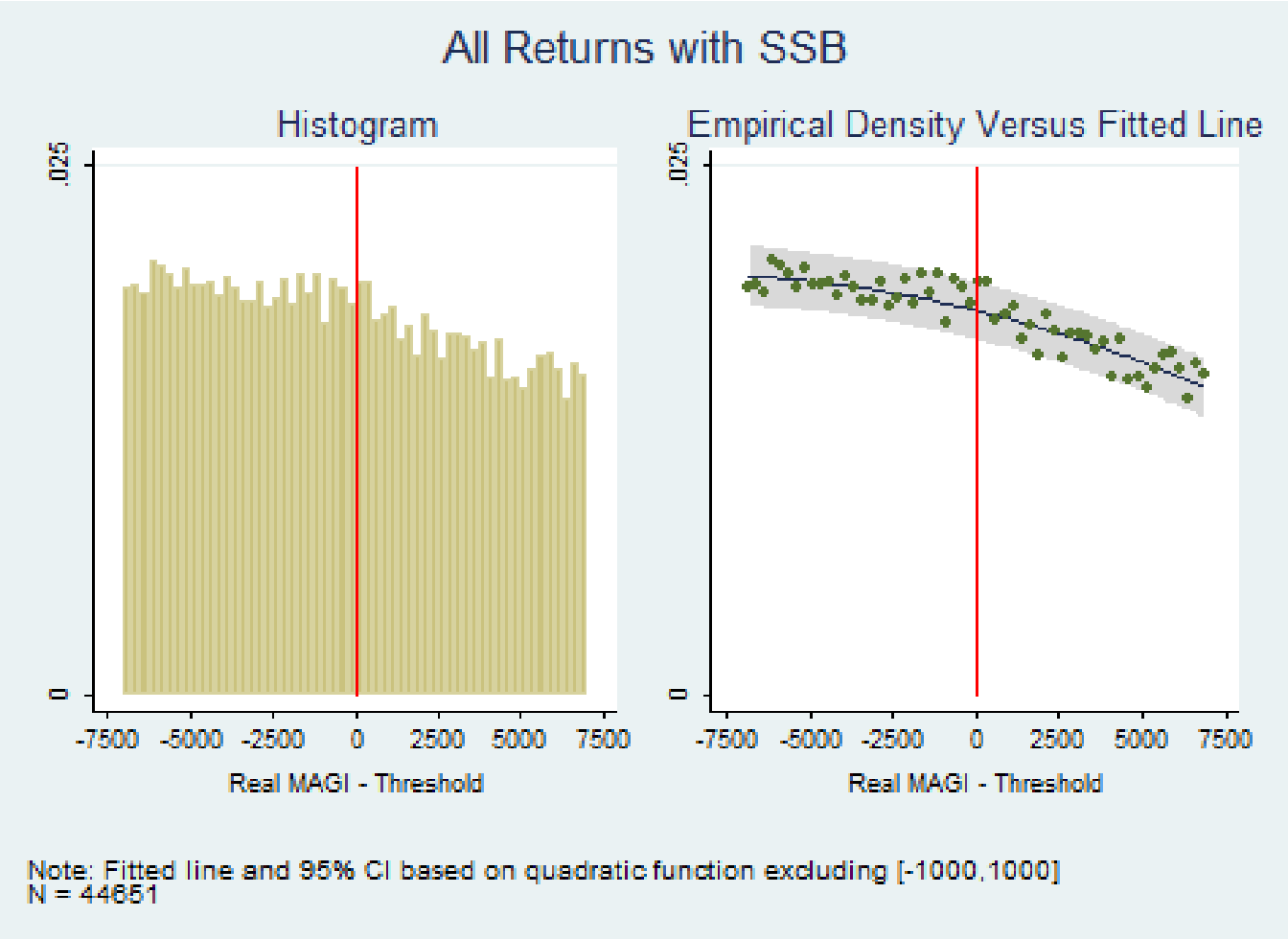
Empirical Approach: Look for Evidence of Bunching of Income at Kink Points

- Taxation of Social Security Benefits creates an incentive to reduce MAGI below the thresholds set in the law
- If taxpayers are aware and sensitive to the economic incentives, there should be bulge in the empirical density function of income to the left of the MAGI threshold
- Researchers have often found evidence of such bunching
  - EITC phaseout: Saez (2010)
  - Danish tax system: Chetty (2011)
  - SSET: Friedberg (2000)
- Saez and Chetty found that self-employed were much more responsive than wage earners

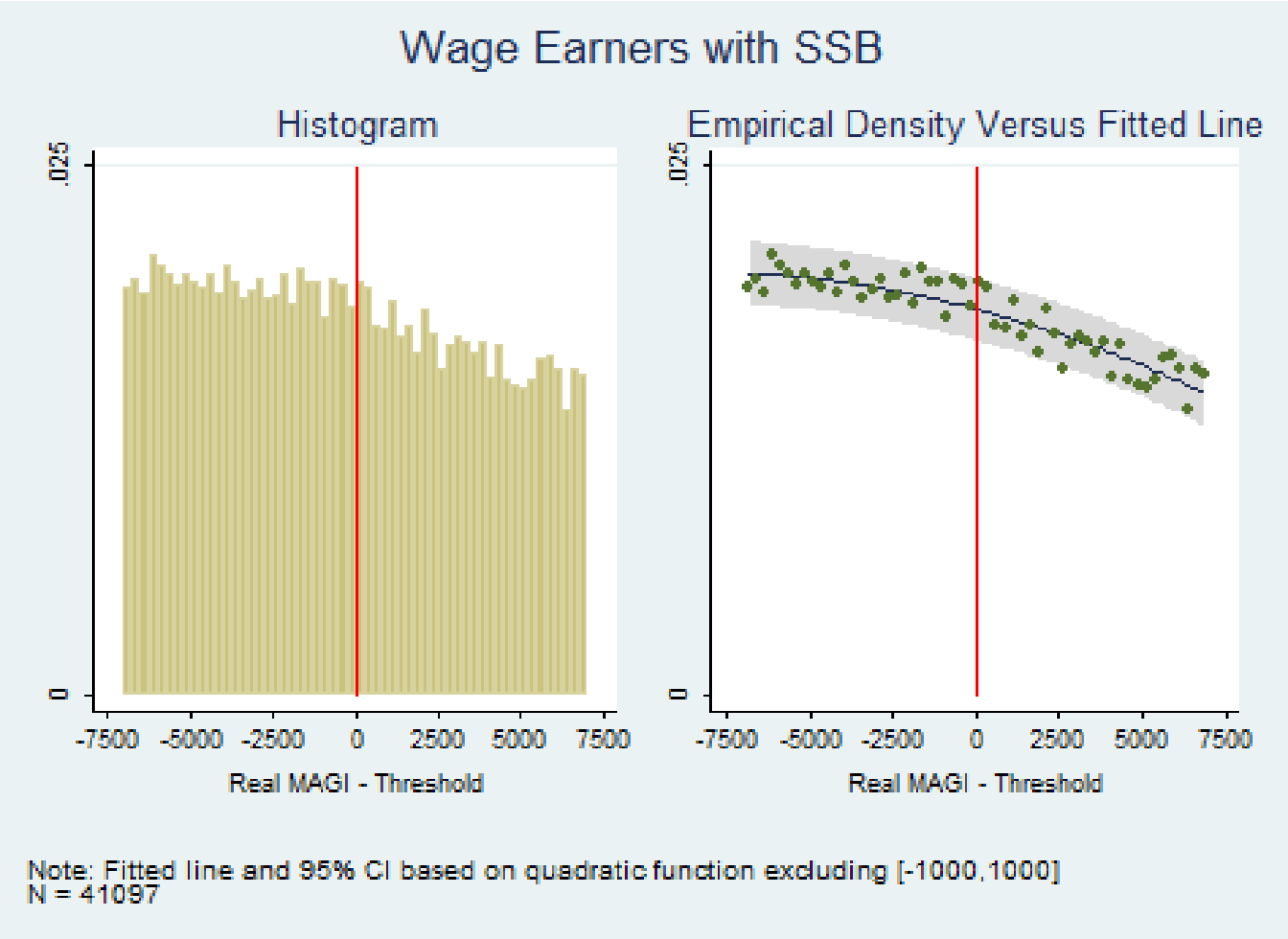
All Returns, No bunching (as expected)



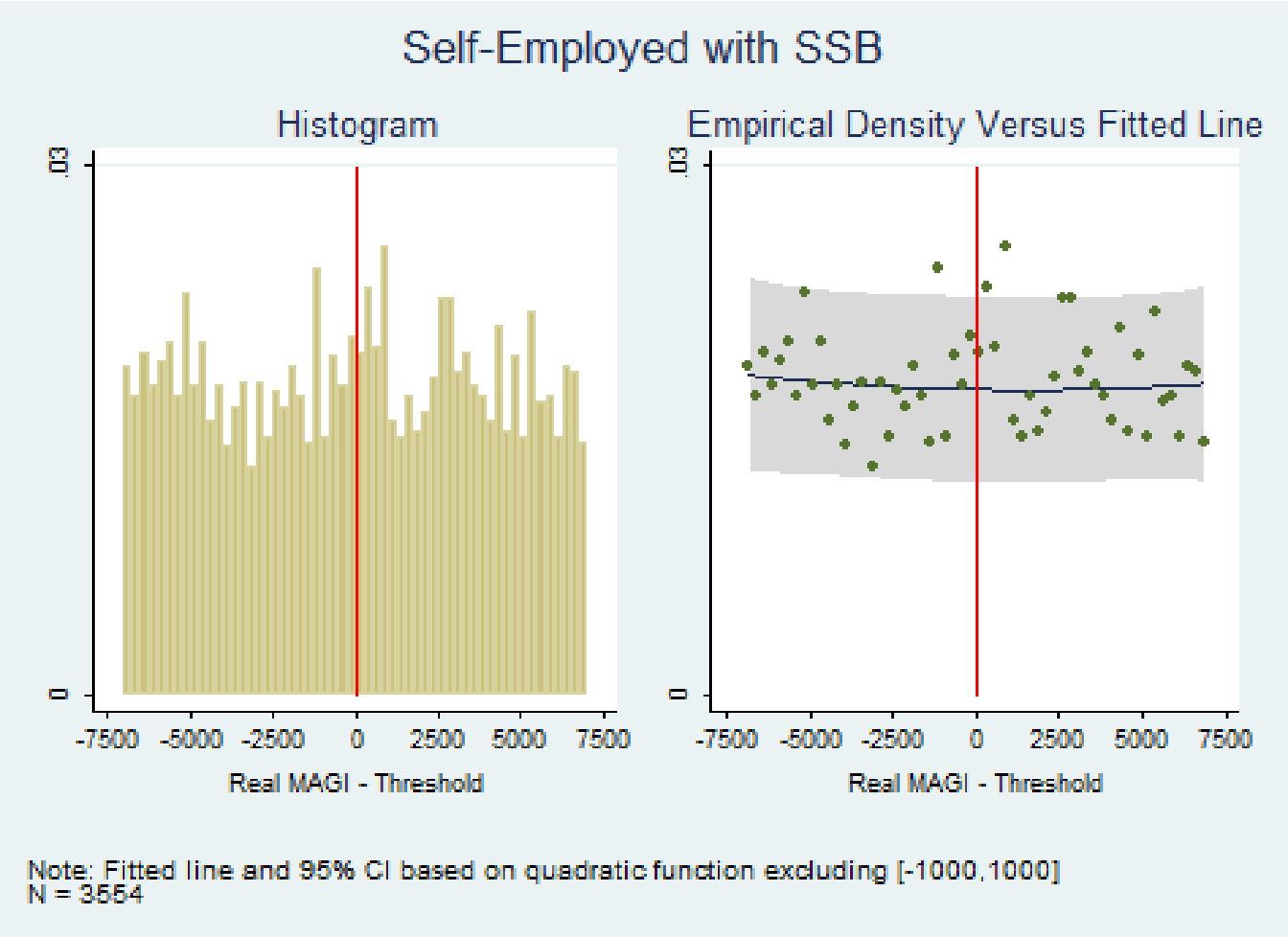
No evidence of bunching for those with Social Security Benefits



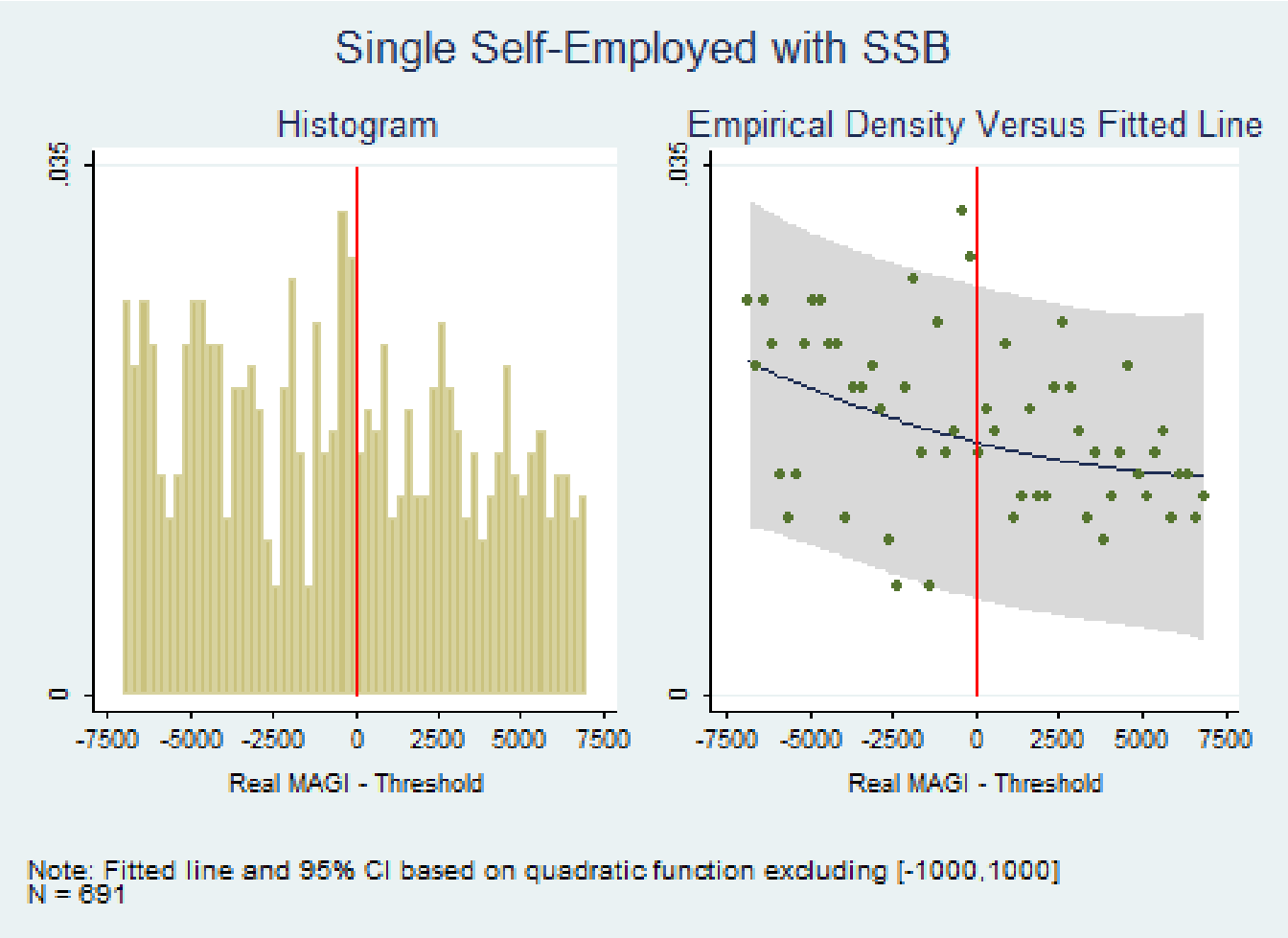
Nor for wage earners



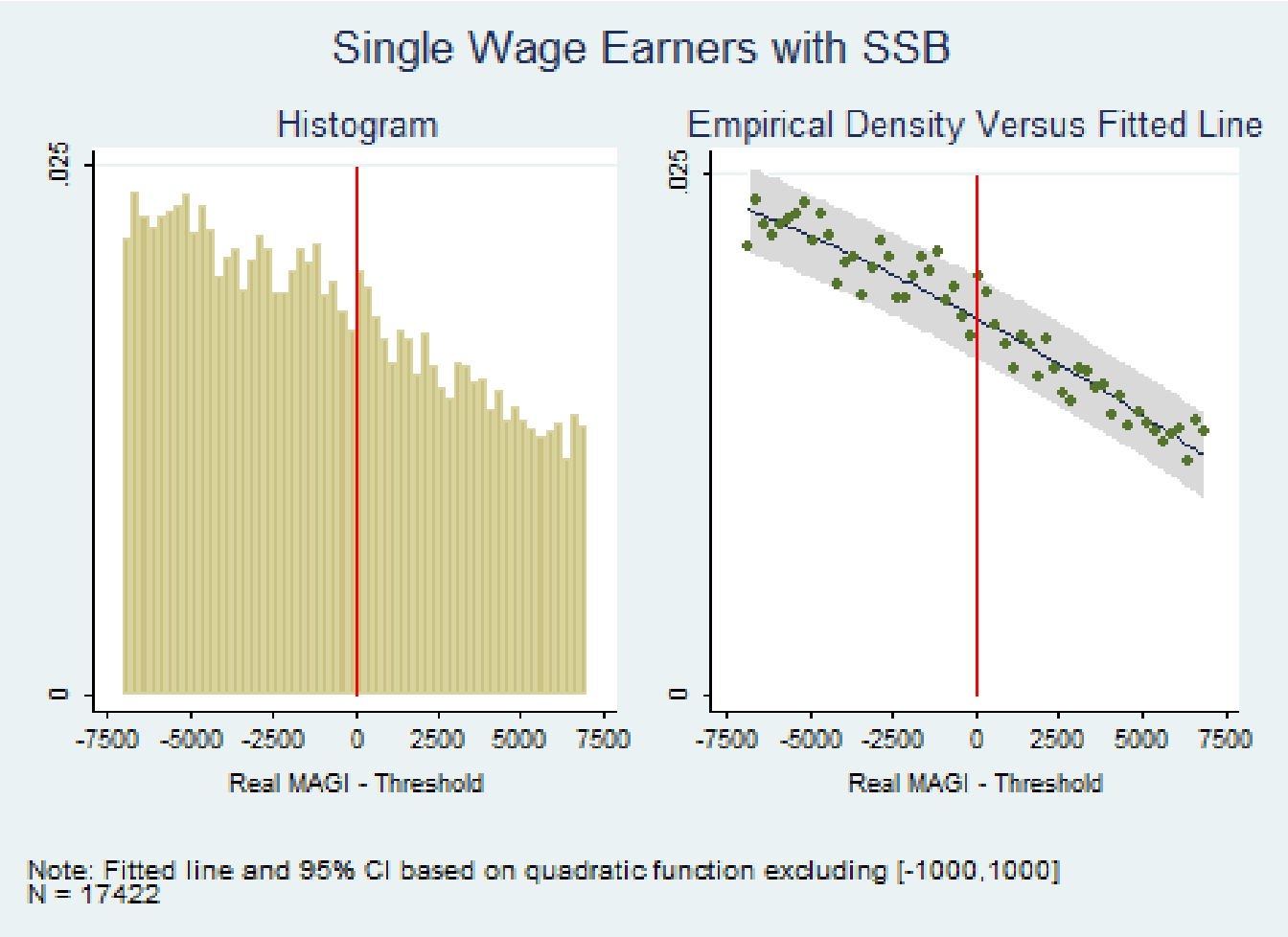
Self-employed show no obvious pattern



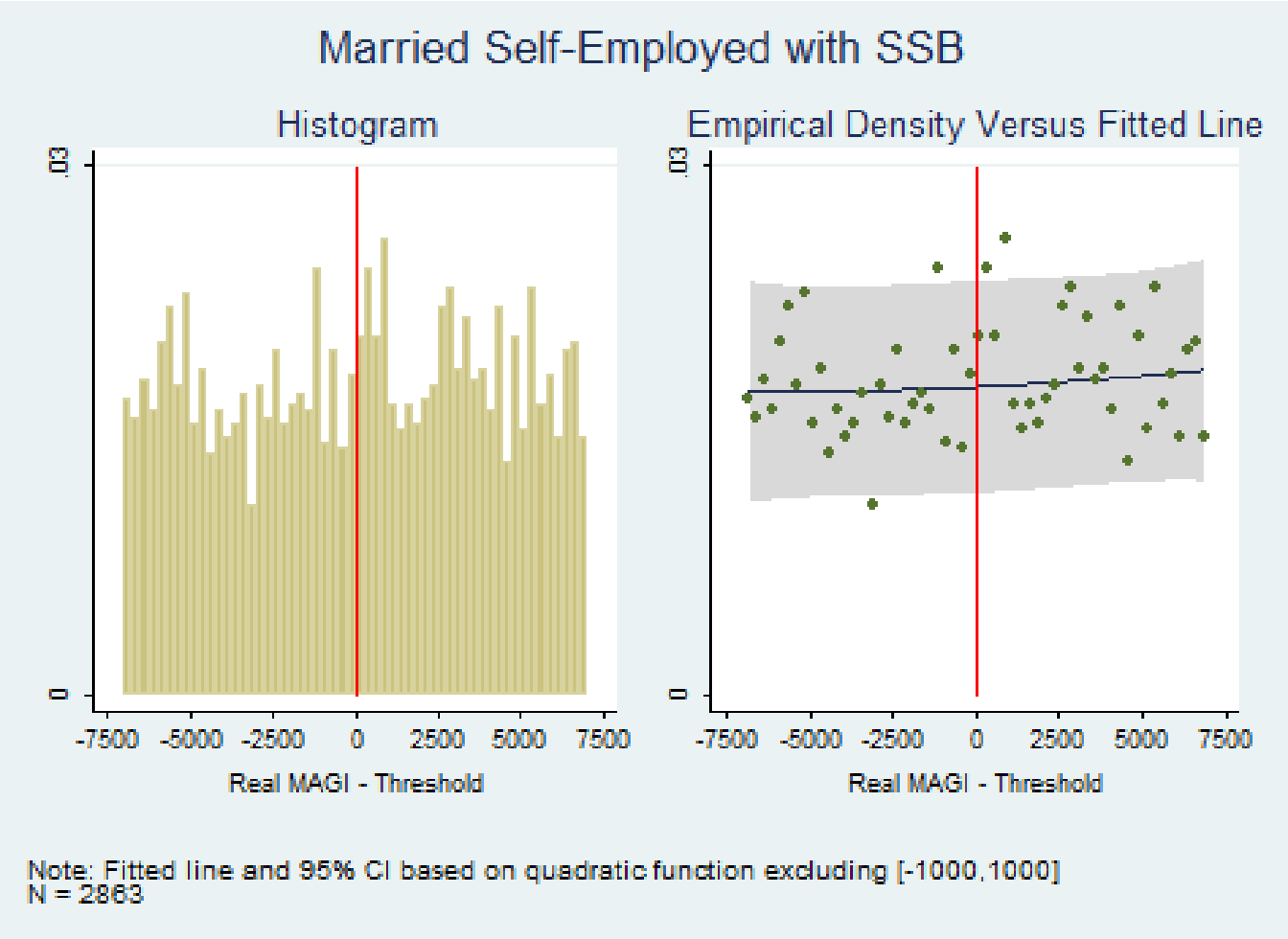
Single self-employed is the only group that shows statistically significant bunching, but it is very small



No apparent response for single wage earners



Nor for married workers



Conclusions

- Using administrative data from tax and information returns to examine the distribution of Social Security recipients in the neighborhood of the taxation thresholds, we find very little response to the taxation of benefits.
- We examined married and single individuals with and without self-employment income.
- Only single, self-employed people show any evidence of reducing income to avoid the tax.
  - This makes sense because we'd expect single self-employed people to have most control over MAGI
  - But the response is much smaller and less precisely estimated than Saez (2010) found to the phase-out of the EITC.
- Overall, the findings suggest that older taxpayers have little understanding of the incentive effects of taxing Social Security.