SAINT LOUIS UNIVERSITY SCHOOL OF LAW

SAINT LOUIS UNIVERSITY SCHOOL OF LAW
Legal Studies Research Paper Series

No. 2023-04

Unbundling Social Security from the Payroll Tax

Henry Ordower
Saint Louis University School of Law

Unbundling Social Security from the Payroll Tax*

Henry Ordower, Professor of Law

Saint Louis University School of Law

As the U.S. emerged from the Great Depression, President Franklin Roosevelt signed the Old Age Security and Disability Income (OASDI) legislation into law. OASDI created a federal social security system.[1] This new system assured a subsistence income to many retired or disabled individuals and their families. Creation of the system was an appropriate, probably necessary, governmental intervention following the devastating human costs of the Great Depression's economic displacements. While general revenues funded the earliest benefits, the introduction of OASDI included a discrete, long-term funding mechanism that may have avoided some cost-based, public and legislative objections to it. The funding mechanism consisted of contributions by those who might receive benefits from the system and matching contributions by their employers. Under the Federal Insurance Contributions Act (FICA),[2] the employee and employer involuntary contributions constitute a dedicated tax.

The concept underlying the contributory program was: "contributory old-age insurance as a way of preventing dependency in old age and thereby reducing reliance on needs-tested assistance."[3] When social security became law, neither individual retirement accounts nor other retirement plans were common.[4] Today the structure of social security is an anachronism. The concept of a contributory governmental program is both redundant and obsolescent in a world of federal income tax encouraged and supported, contributory private and portable retirement programs.[5] Social security has become a primary resource for those without other retirement plans, many of

*Thank you to the Beaumont Fund of Saint Louis University for funding this research. Thanks also to Ilene Ordower for editorial assistance and Vincent Jones, a recent SLU Law graduate, for research assistance, and to the participants at the Law and Society Conference in Lisbon, the Berkeley Poverty Law Conference, and the LLRN5 Conference for helpful comments.

[1] President Roosevelt signed the Social Security Act, H.R. 72-60, Pub. L. 74–271, 49 Stat. 620, into law August 14, 1935.

[2] FICA is chapter 21 of 26 USC, the Internal Revenue Code of 1986, as amended (the "Code"). The Social Security website acknowledges and explains FICA as a tax rather than a contribution to an individual account. https://www.ssa.gov/people/materials/pdfs/EN-05-10297.pdf. Sections of the Code in the following will be designated I.R.C. § followed by a number.

[3] Martha A. McSteen, Fifty Years of Social Security (1985), available at https://www.ssa.gov/history/50mm2.html.

[4] Melissa Phipps, The History of Pension Plans in the U.S., the balance (Updated on October 14, 2021), available at https://www.thebalancemoney.com/the-history-of-the-pension-plan-2894374#:~:text=The%20First%20Modern%20U.S.%20Pension%20Plans,-The%20American%20Express&text=Banking%20and%20railroad%20companies%20were,%2C%20Goodyear%2C%20and%20General%20Electric.

[5] Among plans are individual retirement accounts to which contributions are deductible under I.R.C. §219, and various employer sponsored plans under I.R.C. §§401 and 403 also providing for federal income tax deductible contributions. The Consolidated Appropriations Act, 2023, Division T, Secure 2.0 Act of 2022, Pub. L. 117-328 (Dec 29, 2022) added significant incentives for private retirement plans. A summary of those retirement plan expansions is at https://www.finance.senate.gov/imo/media/doc/Secure%202.0_Section%20by%20Section%20Summary%2012-19-22%20FINAL.pdf.

whom use the social security benefits for their basic living needs. Preserving social security for those without other adequate retirement resources is crucial.

Estimates of the continuing adequacy of the social security trust fund to continue inflation adjusted benefits disclose that sometime in the 2030 - 2039 decade, the trust fund will cease to be solvent.[6] At that time, benefits from the system will decline to eighty percent or less of their then current level based on estimates of social security tax receipts[7] unless tax revenue increases or benefits otherwise decline. To preserve social security as a welfare program primarily for older individuals and to ameliorate the distributional inequity of funding social security across income and wealth levels, this article recommends unbundling the benefit side of social security from its longstanding payroll tax funding mechanism. The article recommends replacing the payroll tax revenue with a budget allocation from general revenues accompanied by both revenue raisers and benefit limitations. Income tax rate increases linked to repeal of the FICA tax and tax expenditure limitations would enhance income tax revenue. Modifying social security benefits from their current overinclusive, entitlement structure for all to moderately needs-based entitlement possibly freed from the constraint of the current contribution requirement that makes social security underinclusive would help provide the older population an income facilitating dignified aging.

In part I, this article discusses the history of social security and its funding with a dedicated tax relative to regressive taxation generally as the discussion seeks to contextualize the changing significance of that dedicated tax relative to other elements of the overall federal tax system. Part II explores the political and theoretical context of the benefit and redistribution theories of taxation in relation to social security and the positioning of social security among governmental subsidies. In part III, the article considers the current financial limitations of the social security trust fund and the literature emphasizing the economic threats to social security. This part recommends replacing the social security tax with adjustments to individual and corporate income taxes to increase general revenue and limiting benefits based on the adequacy of each individual's economic resources and need for social security benefits. General revenue would fund social security fully. Part IV considers the impact of repeal of a separate, dedicated social security tax on non-economic threats to social security that privatization proposals pose and recent legislation that nudges and supports increasing use of private retirement plans. Part IV also discussed the role the social security tax plays in the shift from employment to independent contracting. Part V concludes acknowledging the ongoing concern that any significant change to improve the benefit formula or the funding mechanism for social security might jeopardize the willingness of politicians to maintain the system at all.

This article contributes to the literature addressing the stressed social security trust fund losing its ability to meet ongoing payments soon by seeking to move the discussion from expanding revenue for the trust fund to replacing the funding mechanism with a less regressive alternative. It further contributes by suggesting adjustments in the benefit formula to take into account the

[6] Social Security, Summary: Actuarial Status of the Social Security Trust Funds (released June 2022), available at https://www.ssa.gov/policy/trust-funds-summary.html.
[7] Id.

availability of alternative retirement plans for much of the population. With those many other retirement plans, the time seems right to prod social security toward an inclusive, needs-based system so critical to modern developed economies characterized by substantial income and wealth disparities in their populations.

I. Social Security History and Regressive Taxation.

The Social Security Act of 1935[8] provided funding for state programs of retirement assistance and direct federal payments to qualified individuals. A qualified individual under the act was an individual who was at least 65 years old, had received $2000 or more in wages after 1936, before reaching age 65, and was employed at least five days after 1936.[9] Wages were defined as remuneration for performance of personal services in employment, but employment excluded both agricultural labor and household labor.[10] While the exclusion of agricultural and household labor from the definition of employment was facially neutral, it prevented societal groups with large numbers of workers in those fields from participating in the major new benefit. Both people of color and women tended to find household and agricultural work and, accordingly, did not qualify for social security benefits.[11] Social security's coverage has expanded to both household labor and agriculture[12] although considerable non-compliance with the requirement to withhold and pay social security taxes for household workers continues and results in missed opportunities for participation in social security[13] and the frequent failure of household workers to claim the earned income credit.[14]

The Social Security Act of 1935 included an income tax at the rate of one percent of the first $3,000[15] of an employee's wages each year from 1937 to 1942, increasing in 1942 to two percent and again in 1949 to three percent.[16] Since the personal exemption from the income tax was $4 thousand in the early years of social security, employees found their income that otherwise was exempt from the income tax became subject to the social security tax. However, income in

[8] Act of August 14, 1935 [H. R. 7260] https://www.ssa.gov/history/35act.html#TITLE%20VIII ("SSA 1935").
[9] SSA 1935 Section 210(c).
[10] Id. Sec. 210(a), (b). Government employees and ministers also were excluded from the employment definition and a few other categories of personal services.
[11] Gordon, Linda (1994). Pitied But Not Entitled: Single Mothers and the History of Welfare. Free Press. Harvard University Press 1995; Robert C. Lieberman, Shifting the Color Line: Race and the American Welfare State, Harvard U Press (2001). But, see, Larry DeWitt, The Decision to Exclude Agricultural and Domestic Workers from the 1935 Social Security Act, Social Security Bulletin, Vol. 70, No. 4, 2010 (arguing the exclusions were a matter of administrative complexity and convenience in introducing a new retirement system).
[12] I.R.C. §3121(b) includes a narrow group of exclusions from the definition of employment. Foreign agricultural labor, for example, is excluded, as are various student workers.
[13] For most retiring workers, 40 work credits are necessary to draw social security benefits. An individual receives a work credit for each calendar quarter in which they pay social security tax. Social Security, Social Security Entitlement Requirements, available at https://www.ssa.gov/ssi/text-entitle-ussi.htm#:~:text=You%20can%20receive%20Social%20Security,do%20not%20need%20work%20credits.
[14] I.R.C. §32 (provides a refundable tax credit for low wage workers but requires filing a tax return and reporting income from employment). With respect to Latinx workers, Luisa Grillo-Chope and Carlos Ramos, Domestic Workers Working Hard to Sustain American Families, Compromising Their Social Security, National Council of LaRaza (2006) https://unidosus.org/wp-content/uploads/2021/07/41906_file_WP_DomesticWkrs_FNL.pdf.
[15] SSA 1935 Sec. 811. The legislation expressly refers to the tax as an income tax, not a contribution.
[16] Id. Sec 801.

excess of the personal exemption became subject to the regular income tax but not the social security tax unlike currently where the income is subject to both the income and social security taxes. Collection of the non-deductible income tax[17] was through withholding.[18] A matching excise tax was imposed on employers.[19] Unlike most governmental expenditure programs at federal level, social security was designed with its own dedicated tax providing funding independent of general revenue, a feature likely to have protected the social security program as it was becoming a necessary and broadly supported government program across political lines.

The employee/employer matching tax has characterized the social security system continually since enactment. Whether employers bore the incidence of the employer's share of the tax or passed it on to their employees in the form of lower wages and benefits has been a matter of debate. Some prominent economists, including Milton Friedman,[20] concluded that the employee bore both the employee's and the employer's share of the tax. The view that the employee bore both the employer's share also featured in the design of the earned income credit when the initial credit amount was set at ten percent providing a refund of the social security tax for those who qualified for the refundable tax credit.[21]

When the Social Security Act of 1935 took effect in 1937, the tax on income from all sources including interest and dividends in excess of the personal exemption ranged progressively from 4 to 79 percent, reaching 50 percent at income of $74,000.[22] Although the social security tax was burdensome for those taxpayers at the lower end and may have diminished their standard of living, the burden was in exchange for the assurance of continuing income after age 65. More significant was that the rate of tax was low relative to the rate of income tax to which high income taxpayers were subject. The spread between the social security tax rate and the maximal income tax rates has narrowed significantly since 1937. In 2023, the Social Security tax rate (combined employee/employer portions) is approximately one-third of the highest marginal income tax rate compared with one-thirty eighth in 1937.[23]

As accompanied by social security retirement benefits, contributions resemble those individuals commonly make voluntarily to private retirement plans in exchange for future benefits. Some

---

[17] Id sec 803.
[18] Id sec 802.
[19] Id sec 804. Employers with eight or more employees were subject to an additional one percent tax in 1937, increasing to two percent in 1938 and three percent in 1939. Id. Sec 901.
[20] Milton Friedman 1965. "Transfer Payments and the Social Security System," 11 *The Conference Board Record* 7-10 (1965).
[21] Congressional Research Service, The Earned Income Tax Credit (EITC): Legislative History (April 28, 2022), available at https://sgp.fas.org/crs/misc/R44825.pdf. For the ten percent peg of the earned income credit, the legislative history ties the credit amount to the sum of the employee and employer shares of the payroll tax: "[t]he bill provides for a refundable credit of 10 percent of earned income up to a maximum of $400-- closely matching the employee and employer social security tax on the first $4,000 of income." S. REP. 94-36, Summary, S. Rep. No. 36, 94TH Cong., 1ST Sess. 1975, 1975 U.S.C.C.A.N. 54, 1975 WL 12340 (Mar. 17, 1975) to P.L. 94-12, TAX REDUCTION ACT OF 1975, 89 Stat 26 (MARCH 29, 1975).
[22] Tax Foundation, Historical U.S. Federal Individual Income Tax Rates & Brackets, 1862-2021 https://taxfoundation.org/historical-income-tax-rates-brackets/ (August 24, 2021).
[23] 12.4 percent with a maximum ordinary income tax rate of 37 percent compared with 2 percent relative to 79 percent in 1937.

politicians have focused on that resemblance to argue for maintenance of individual account balances and privatization of the accounts to give individuals investment control over their accounts and the opportunity to enhance their own benefits if invested successfully.[24] The social security arrangement provides the individual with a life annuity if the individual has paid social security tax for at least ten years during their lifetime before claiming retirement benefits.[25] While the annuity amount increases as a function of the individual's earnings subject to the FICA tax, the annuity is not limited by the individual's retirement account balance as it would be if social security were comparable to private, defined contribution retirement plans.[26] Social security more closely resembles the rapidly disappearing, private, defined benefit retirement plans that used to be common for major corporate employers. Those plans applied an earnings-based, as opposed to an account balance, formula to determine a lifelong annuity for the retiring employee.[27] Both under social security and defined benefit plans, the individual does not own an account balance which would pass to the beneficiaries of the individual's estate when the individual dies. Accordingly, the individual participant may receive no benefit from social security or a defined benefit plan if they die before retirement age.[28] Unlike private plans, participation and payments under FICA are involuntary.[29]

Since 1937[30] in the U.S., a social security system providing retirement income for millions of individuals and similar systems in many other countries, some enacted substantially earlier that the U.S. system,[31] form an indispensable and integral feature of modern economies. Such systems limit impoverishment of retired and disabled individuals in countries worldwide. Funding of those systems with a dedicated tax on wages and self-employment income is commonplace but regressive. Historically that funding mechanism was sensible and possibly essential to overcome political objections relating to their cost when the systems were first

---

[24] Patricia E. Dilley, "Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization," 41 *B.C. L. Rev.* 975, 1035 (2000) (forcefully rejecting the misleading notion of social security as a defined benefit pension plan). Deborah A. Geier, "Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income," 22 *Va. Tax Rev.* 1 (2002). This article will return to this discussion in part IV infra.
[25] Monthly payments, now adjusted annually by the increase in the cost of living, and continuing until the recipient's death or longer if the recipient has a surviving spouse or dependent children who continue to receive all or part of the annuity.
[26] I.R.C. §401(k) and I.R.C. §403(b) plans, for example. Under defined contribution plans the retiring employee may annuitize their plan balance but the annuity amount is limited by the retiring individual's plan balance and the annuity amount the balance may buy.
[27] IRS, Defined Benefit Plan, available at https://www.irs.gov/retirement-plans/defined-benefit-plan.
[28] Social Security provides a survivor benefit to a surviving spouse and dependent children and defined benefit plans often include a survivor benefit for a spouse or other life partner.
[29] For certain employees, participation in Social Security is voluntary. I.R.C. §3121(b)(8) (ministers excluded from definition of employment but may elect to participate).
[30] Enacted in 1935, the system did not begin to pay benefits until 1937.
[31] These include many European countries, for example, Belgium 1900, Denmark 1899, Germany 1891, United Kingdom 1908. Social Security, Social Security Programs Throughout the World, available at https://www.ssa.gov/policy/docs/progdesc/ssptw/.

introduced. Continuation of that regressive funding mechanism should no longer be essential to thwart political objections to the system.[32] Social security is politically popular.

If the funding for social security is inconsistent with current societal needs, as this article argues, altering the funding seems unquestionable if the change will maintain and protect this system which has become so solidly a part of modern economies. Where the income and wealth disparities among participants in the society are considerable, as they are in the U.S,[33] maintenance of social security has become critical to avert impoverishment in old age among the less affluent members of the society. Maintenance of social security should not continue to be carried disproportionally by those at the low and moderate ends of the income and wealth spectrum who depend on it for retirement security. The mechanism for funding social security by matching benefits with specific tax payments is aberrant among federal government subsidy programs.[34]

Like the U.S., most countries structured their dedicated tax with a flat rate on wages or self-employment income to a ceiling amount and no tax on wages or self-employment income exceeding that ceiling.[35] Such taxes, the FICA tax included, are facially neutral and tied into wages in funding continuing income for workers following retirement. Nevertheless, the FICA and similar taxes are not neutral in their impact. They burden low- and moderate-income workers disproportionally to high income individuals and contribute to, rather than ameliorate, poverty

---

[32] During his State of the Union address, President Biden bantered with the Republicans in Congress about Social Security and drew the conclusion, whether justified or not, that there was no opposition to continuation of Social Security in its current form. The White House, State of the Union Address (sound recording), https://www.whitehouse.gov/state-of-the-union-2023/ beginning at minute 38. Analysis of the address in light of increasing stress on the social security funding appears in Jim Tankersly, As Lawmakers Spar Over Social Security, Its Costs Are Rising Fast, The New York Times (2/16/23), available https://www.nytimes.com/2023/02/15/us/politics/social-security-costs-biden-republicans.html?te=1&nl=the-morning&emc=edit_nn_20230216.

[33] Diego Mendez-Carbajo, Income and Wealth Inequality, Economic Research of the Federal Reserve Bank of St. Louis (Sept 2022) available at https://research.stlouisfed.org/publications/page1-econ/2022/09/01/income-and-wealth-inequality; Chad Stone, Danilo Trisi, Arloc Sherman And Jennifer Beltrán, A Guide to Statistics on Historical Trends in Income Inequality, Center on Budget and Policy Priorities (UPDATED January 13, 2020) available at https://www.cbpp.org/research/poverty-and-inequality/a-guide-to-statistics-on-historical-trends-in-income-inequality; Assistant Secretary for Economic Policy Benjamin Harris and Economist Sydney Schreiner Wertz, Racial Differences in Economic Security: The Racial Wealth Gap, U.S. Department of the Treasury (September 15, 2022) available at https://home.treasury.gov/news/featured-stories/racial-differences-economic-security-racial-wealth-gap.

[34] Unlike social security taxes, user fees rarely if ever maintain the infrastructure of an entire administrative function. Instead, they supplement the revenue of an agency and assist it to perform a specific and limited task for the specific benefit of the user fee payer who voluntarily engages with the agency. A filing fee for using a court to resolve a dispute is a user fee but the court would operate from an appropriation of general revenue without the filing fees.

[35] The tax is a little more complex than described. Employers of individuals with more than one employer in a year each pay the employer's share of the tax so that the employers' shares in the aggregate may exceed the wage cap for such an employee.

except at retirement.[36] In the U.S. today, the FICA tax is a 7.65 – 15.3 percent minimum tax[37] on the income from wages and self-employment of individuals whose income is all from services and remains under the wage cap.[38] The taxes reach substantially all the income of low- and moderate-income workers while missing large portions of the income of high-income wage earners and those who have income from capital. That disparity in the reach of the tax widens further as the individual's income from all sources or sources other than performance of services grows,[39] such that the tax is regressive relative to income and wealth and trends toward increasing regressivity as income and wealth disparities increase. In addition, that tax regressivity intensifies as the social security tax rate rises and as marginal income tax rates decline.[40]

---

[36] Ariel Jurow Kleiman, Impoverishment by Taxation, 170 U.Pa.L.Rev. 1389, 1477 - 80 (2022); Henry Ordower, Taxes in Kimberley L. Kinsley and Robert S. Rycroft, editors, Inequality in America: Causes and Consequences 309 (Santa Barbara, June, 2021).

[37] The minimum tax concept is under intensive discussion and development in light of the agreement by 137 countries to impose a 15 percent minimum tax on the income of multi-national enterprises. OECD, The Pillar Two Rules in a Nutshell, available at https://www.oecd.org/tax/beps/pillar-two-model-rules-in-a-nutshell.pdf. The fifteen percent rate may seem low when compared with the higher effective minimum tax rates imposed in many countries on the incomes of low to moderate income individuals derived from the combination of payroll taxes and value-added taxes. For example, in the UK, if one combines the 12 percent gross earnings tax with the UK general 20 percent value-added tax and assumes the individual has income from only wages and must consumes all their income for ordinary living expenses, the minimum combined wage and VAT could be as high as 29.6 percent of wages (88 percent net consumable wages after wage tax * 20 percent VAT = 17.6 percent + 12 percent wage tax = 29.6 percent in the aggregate). Housing is exempt from VAT, as is much food, so the rate for most is between 12 and 29.6 percent.

[38] The range for wage earners reflects a variety of assumptions concerning the degree to which employers may shift the burden of the employer's share of the tax to employees. For self-employed individuals who pay the full tax, half the tax is deductible from their gross income. I.R.C. §164(f). The deduction reduces the effective rate by one-half of their maximum marginal rate of tax. For example, a taxpayer in a 14 percent bracket reduces the effective FICA tax by just over one percent (.14 * .5 * 15.3 = 1.07).

This article focuses on the social security tax and not the Medicare tax even though both taxes are collected in the same manner and include employee/employer matches. The Medicare tax now diverges from the social security tax. It has no wage ceiling, and, by virtue of I.R.C. §1411, effective 2013, it reaches high-income taxpayers' income from investments and passive activities as well.

[39] A simplified example illustrates this observation. Assume A earns $100,000 in wages and B earns $300,000 in wages. A's effective rate of tax on wages is 6.2 percent (ignoring the likelihood that A's employer will shift all or part of the employer's share of the FICA tax to A) and B's effective rate of tax on wages is 3.3 percent because in 2023 the rate is zero on B's wages exceeding $160,200. The disparity grows wider is B also has income from property and A has little or none.

[40] In 1968, the maximum income tax rate on income from all sources other than net capital gain (the excess of net long term capital gain over net short term capital loss) was 70 percent in the U.S. and in 1969, the maximum rates split so that income from the performance of services was limited to 50 percent under I.R.C. §1362. The split ended in 1982 and the maximum rate for all income was set at 50 percent, declining to 28 percent in 1987 (but including net capital gain). Since 1987, a preferential rate for net capital gain reappeared and assumed additional complexity with differing rates favoring intangible investment products, see I.R.C. §1(h), and a general computation rate reaching 38.6, but currently 37 percent. See I.R.C. §1.

The Social Security tax itself always has been regressive.[41] Yet, when combined with Social Security benefits, the net effect of the tax and benefits together is, arguably, mildly progressive.[42] The relative burden of the Social Security tax among all tax collections, however, has grown, and the degree of its regressivity has become more dramatic than when first enacted. Progressivity in income tax rates has diminished, wealth and estate or inheritance taxes retreated, and, worldwide, regressive consumption taxes have become more prominent. The increasing degree of regressivity reflects a more generalized shift of tax burdens from capital to labor over the years since the first social security programs were introduced.[43]

Against the backdrop of the trend toward regressive taxes and the accompanying shift of taxation from capital to labor, social insurance systems have embedded themselves into the psyche of developed nations and into national budgets as a non-discretionary, non-negotiable expenditure. It seems unlikely that the U.S. President would have persuaded Congress to enact a social security system without providing a separate funding mechanism for it and it may be just as unlikely that a President today could persuade Congress to discontinue social security.

The wage ceiling that accompanied its enactment introduced moderate regressivity into the overall income-based tax world. Many economic and political experts today emphasize that the separate funding mechanism is critical to the system. Some argue, for example, that the system is politically popular because taxpayers see in social security a tangible benefit from the government for the taxes they pay. No similar correlation in the U.S. tax system exists although many other countries that provide universal health care, child support supplements, cost free higher education enable taxpayers to observe a direct benefit from other taxes as well.[44] Nevertheless, regressive distribution of a limited tax burden amidst general progressivity to facilitate growth of a welfare program benefiting those adversely affected by that limited regressive tax is not the same as continuing that regressivity as surrounding tax burdens become flat or similarly regressive and the social security benefits flow to taxpayers generally, not just those who have the financial need for the welfare assistance.

Part II. Social Security and the Benefit and Redistribution Theories of Taxation; Delivery of Governmental Subsidies.

Debate concerning the structure and purpose of tax systems is relentless and often politically polarizing. Some view the fundamental function of a tax system, in addition to paying for

---

[41] Alva Myrdal, Nation and Family, New York: Harper & Bros., 1941; Jacobus tenBroek and Richard B. Wilson, "Public Assistance and Social Insurance - A Normative Evaluation," UCLA Law Review , April 1954; Eveline M. Burns, Social Security and Public Policy, New York: McGraw-Hill Book Company, Inc., 1956, p. 159.

[42] Ernest C. Harvey, Social Security Taxes—Regressive or Progressive? 18 National Tax Journal 408 (1965); C. Eugene Steuerle and Karen E. Smith, Research Report: Social Security & Medicare Lifetime Benefits and Taxes: 2022, Tax Policy Center (2023), available at https://www.taxnotes.com/tax-notes-today-federal/social-welfare-taxation/tpc-report-examines-lifetime-social-security-and-medicare-taxes/2023/02/16/7fyvz?highlight=steuerle.

[43] Henry Ordower, Immigration, Emigration, Fungible Labour and the Retreat from Progressive Taxation in Dominic De Cogan and Peter Harris, ed., Tax Justice and Tax Law: Understanding Unfairness in Tax Systems, ch. 8, 133 (Oxford, Hart Publishing 2020).

[44] Compare Denmark with universal healthcare, child supplements and a bevy of other observable governmental benefits accompanying high and steeply progressive income tax rates, a substantial, regressive value added tax and a separate regressive tax to fund social insurance programs.

governmental services, is to redistribute wealth and to level disparities in income and wealth so that all members of a society may live comfortably.[45] That view and its implementation based on an ability to pay principle led to the steeply progressive income tax rates of the 20th century, which estate and wealth taxes in developed economies supplemented through much of the century.[46] Opposition to the ability to pay principle prevailed in the latter part of the 20th century emphasizing that any conclusion that the marginal utility of money declines as one becomes wealthier was misplaced.[47] Rather, the current politically prevailing view became that concentrated wealth facilitated investment, risk taking for development, and productivity beneficial to the society as a whole as evidenced by declining progressivity in income tax rates, repeal or diminution of estate and wealth taxes, and reliance on consumption taxes.[48] In the E.U., the value-added tax is the only major, broad-based tax which the member states have agreed to harmonize.[49]

Widespread enactment of value-added taxes demonstrates the acceptance with little objection of regressive tax structures where taxpayers associate them with an array of government benefits.[50] Similarly, social security taxes represent that opposing view of taxation that holds that taxpayers should pay in relation to their consumption of governmental benefits. Where the benefits are transparent, direct, and easily measurable, as they are in the case of social security, a dedicated tax to fund those benefits seems compelling. But while the connection between tax and benefit is seemingly straightforward, it also is misleading. Most government benefit consumption is indirect and difficult to measure[51] and in the U.S. is delivered indirectly through the tax system in the form of deductions, credits and exclusions.[52] Neutral tax law language frequently

---

[45] Walter J. Blum and Harry Kalven, Jr., The Uneasy Case for Progressive Taxation, 19 The U. Chgo. L. Rev. 417 (1952).

[46] Josh Boak, What's the so-called 'wealth tax' in Biden's proposed bill, and how would it work?, PBS (Oct 27, 2021), available at https://www.pbs.org/newshour/nation/whats-the-so-called-wealth-tax-in-bidens-proposed-bill-and-how-would-it-work.

[47] Scrooge McDuck certainly would have supported this claim. Wikipedia entry Scrooge McDuck at https://en.wikipedia.org/wiki/Scrooge_McDuck.

[48] I do not intend to discount the importance of the administrative convenience in collection of value added taxes to their proliferation.

[49] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (providing for vat harmonization among other matters concerning VAT), replacing Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes).

[50] Meik Wiking, Why Danes Happily Pay High Rates of Taxes, US News and World Report (Jan 20, 2016), available at https://www.usnews.com/news/best-countries/articles/2016-01-20/why-danes-happily-pay-high-rates-of-taxes.

[51] For example, the military protects the lives and property of all who are present in a country and is one of the largest expenditures in the U.S. It raises complex consumption questions. Does one who owns more property consume more of the military protection or is each life the same and consumes an equal amount – a deeply philosophical inquiry.

[52] U.S. Dept. of the Treasury, Office of Tax Analysis, Tax Expenditures (June 3, 2021), for example, available at https://home.treasury.gov/system/files/131/Tax-Expenditures-FY2022.pdf. The introductory paragraph reads:

> The Congressional Budget Act of 1974 (Public Law 93–344) requires that a list of "tax expenditures'' be included in the budget. Tax expenditures are defined in the law as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.'' These exceptions may be viewed as alternatives to other policy instruments, such as spending or regulatory programs.

obfuscates the distributional imbalances in the tax-based benefits.[53] Supporters of the shift of taxation from capital to labor eschew discussing a benefit theory except where it supports an argument for reducing or eliminating the benefits of those whom they feel consume without paying adequately[54] but fail to see or choose to ignore the tax benefits many affluent taxpayers capture and monetize.

Many tax benefits that affluent individuals receive disproportionally to less affluent individuals appear in the annual lists of tax expenditure estimates.[55] Unlike social security payments which are a governmental subsidy to individuals delivered in cash to the recipients,[56] the earned income credit, and a small number of other refundable tax credits that might result in a cash payment, few tax expenditures involve a direct cash payment to the tax expenditure recipient other than a refund of overpaid withholding or estimated tax.[57] Rather most benefits are tax deductions or credits enabling tax expenditure beneficiaries to reduce the amounts they must pay in taxes.[58] Others tax expenditure benefits are even less visible because they require no reporting of receipt at all. All are heavily weighted in favor of affluent individuals. Examples include the realization requirement for taxing gain from property,[59] the new fair market value basis given to property a decedent owned at death,[60] and the exclusion of the rental value of owner-occupied residential

---

[53] Dorothy Brown is a leading voice exposing the distributional inequities in otherwise neutral tax language. Dorothy A. Brown, *The Whiteness of Wealth: How the Tax System Impoverishes Black Americans — And How We Can Fix It* (New York, 2021). And recent work by the Tax Policy Center provides data on disparity in the value of itemized deductions to white people in comparison with people of color. Benjamin R. Page, Tracy Gordon & Aravind Boddupalli (Tax Policy Center), Providing Changemakers The Data They Need To Tackle Racial Inequities In The US Tax Code (2023) available at https://www.taxpolicycenter.org/taxvox/providing-changemakers-data-they-need-tackle-racial-inequities-us-tax-code.

[54] Welfare mothers, for example. Collins Dictionary online, entry https://www.collinsdictionary.com/dictionary/english/welfare-mother. Ellen Reese, Backlash against Welfare Mothers Past and Present, (UCalPress 2005).

[55] U.S. Dept. of the Treasury, Office of Tax Analysis, Tax Expenditures, supra note 52.

[56] One definition of subsidy is "a grant by a government to a private person or company to assist an enterprise deemed advantageous to the public." Merriam Webster Dictionary online. https://www.merriam-webster.com/dictionary/subsidy

[57] Refunds of overpaid withholding taxes or estimated payments are not a benefit or subsidy but simply the return of an amount designed to smooth the collection of tax by estimating the amount the taxpayer will owe when they make the required computation following the close of the tax year. The amount of advanced payment has no impact on the computation of the taxpayer's tax amount. If the estimate is too large, the taxpayer may recover the overpayment, a concept quite different from a tax provision that affects the computation of tax as a deduction, credit, or exclusion would. Historically, taxpayers in some instances under I.R.C. §172, the net operating loss provision, might carry a tax benefit back to previous years so that it adds a deduction to the earlier year's computation, reduces the amount owed for the earlier year, and the taxpayer would receive a cash refund of an earlier year's tax payments.

[58] The mortgage interest deduction for individuals under I.R.C. §163, accelerated depreciation deductions for property used in one's trade or business under I.R.C. §168, and various deferrals of realized gains on the exchange of property for other property including I.R.C. §1031 (like-kind exchanges of real property), I.R.C. §351 (transfers of property to corporations in exchange for shares), I.R.C. §721 (exchange of property for partnership interests or limited liability company memberships), are often cited examples of tax benefits requiring return filing to claim.

[59] I.R.C. §1001(c) (requiring a sale or exchange of the property before a taxpayer must include the increase in the value of the property in their income). Exceptions exist but they are limited. One exception is I.R.C. §1256 (requiring taxpayers to mark their commodities positions to market annually and include gains in income).

[60] I.R.C. §1014. $505,450 billion. Item 68 in the Tax Expenditure list, supra note 52.

property, without regard to the number of residences the individual owns.[61] In each example, the size of the subsidy increases with the individual's income or wealth. In the case of a deduction, it diminishes income otherwise taxable at the individual's maximum marginal income tax rate so that its value increases with income. Similarly, a subsidy increases with wealth insofar as it correlates with the growth in the value of the property on which the tax is deferred or excluded. The correlation with wealth manifests itself clearly for owner-occupied residential property since residential property's use value which goes untaxed increases as the market value of the property increases. The tax benefit is that it is not income for tax purposes.

Government subsidies in the U.S. tend to fall into one of three subsidy classes: welfare, targeted and development, and non-specific. Welfare-type subsidies include the earned income credit administered through the federal income tax, some non-tax subsidies for housing, food and medical assistance, loans for education and housing, social security and Medicare. When first enacted, the exclusion of life insurance proceeds from gross income[62] also may have been viewed as a welfare subsidy designed to encourage private purchase of life insurance to support widows and orphans following the death of the family breadwinner. The income exclusion subsidy has broadened to encompass a tax planning opportunity for businesses that own life insurance on key employees and more closely resembles the non-specific subsidies.[63] Welfare subsidies other than some loan programs, social security and Medicare are means tested.

Targeted and development subsidies usually encourage investment in activities deemed to offer specific necessary societal benefits. Most are supported with tax expenditures. Examples include tax credits for electric vehicles, historically (and somewhat ironically), accelerated tax deductions[64] and percentage depletion allowances for carbon fuels.[65]

Non-specific subsidies also are delivered through the tax system. The three addressed above[66] relating to timing of taxable gain on property, exclusion of taxable gain from income, and exclusion of use value from income may be matters of administrative convenience emanating from the difficulty and complexity of determining value.[67] They also may be more intentionally designed to encourage individuals to preserve and grow investment capital to promote general economic stability and growth in the national economy. Or the subsidies may simply support individuals who, because of their wealth and power, are best able to influence tax policy and limit their own tax liability. The carried interest conundrum is an example of heavy lobbying to

[61] No statute exists, but the U.S. Treasury estimates that the 10-year subsidy from 2020 – 2030 will be $1,645,980 billion. Item 59 in the Tax Expenditure list, supra note 52.
[62] I.R.C. §101.
[63] For a period of time, some businesses carried life insurance on rank-and-file employees that provided a non-taxable windfall to the business when an employee died. Congress limited the exclusion to executive and highly compensated employees by adding subsection (j) to §101 in 2006. Pub. L. 109–280, § 863(a) (2006).
[64] Intangible drilling cost deduction I.R.C. §263(c).
[65] I.R.C. §631
[66] Supra notes 59 -61 and accompanying text.
[67] Brian Galle, David Gamage, and Darien Shanske, Solving the Valuation Challenge: The ULTRA Method for Taxing Extreme Wealth, 72 Duke L.J. ___ (2023) (proposing tax payments in the form of a notional share in the business).

preserve a tax benefit.[68] These non-specific subsidies tend to have no limits, while welfare subsidies are tightly limited and targeted subsidies are limited by the nature of engagement in the targeted activity.

While social security is one among many governmental subsidies, it is unusual among subsidies as it has a discrete delivery system and much of its funding is from targeted general taxes on wages paid by those who eventually will draw the benefits (and their employers). The tax bears resemblance to a user fee but user fees customarily pay for a more specific and limited service to the taxpayer[69] rather than something akin to a broad social welfare program like social security. Relative to most other subsidies for individuals, the distinctiveness of the social security benefit and tax suggests that either there must be a compelling justification for that distinctiveness or that social security's aberrance reflects that it has not been modernized to coordinate better with other governmental subsidies. If the justification for social security's uniqueness among governmental subsidies is primarily historical and political, it is inconsistent with current methods of delivering and funding subsidies. Reevaluating its structure and funding to harmonize better with more modern government subsidies seems to be in order. The moment for reassessment also would seem opportune insofar as anticipated demands on social security are increasing but available revenue from the existing funding mechanism appears poised to fall behind the funding demands.[70] Either the tax must increase in rate or base or, alternatively, the benefits must diminish.

Of the many governmental subsidies, only social security and Medicare are supported with a dedicated tax rather than the general revenue produced primarily by the federal income tax.[71] Setting a specific revenue source aside to provide funding for a specific program is common and sometimes helps overcome public or legislative reluctance to impose or increase a tax.[72] Conceptually, the dedicated revenue structure prevents legislatures from diverting the amount of those revenues to another purpose. Although the social security surplus has been invested in U.S. treasury instruments such that the actual revenue, when received, has been used for purposes other than social security benefits, the record of the revenue exists and, presumably, assures that those funds will be available for social security benefits when needed.

---

[68] Becky Sullivan, A tax loophole made fund managers rich. Closing it may help pay for the climate bill to lobbying by hedge and private equity fund industry, NPR (August 3, 2022) available at https://www.npr.org/2022/08/03/1115218183/carried-interest-close-tax-loophole.

[69] Tax Foundation, User Fee, available at https://taxfoundation.org/tax-basics/user-fee/.

[70] Tankersly, As Lawmakers Spar Over Social Security, supra note 32.

[71] In 2021, individual income taxes provided more than half the federal revenue of more than $4 trillion and corporate income tax added approximately $372 billion so that income taxes produced more than $2.4 trillion, roughly 60 percent of revenue. The social security and Medicare taxes added $1.3 trillion, more than 30 percent of revenue. Income taxes, social security, Medicare, individual and corporate income account for about 90 percent of federal revenue. Individual and corporate income taxes apply to the constitutionally permissible tax base, with tax expenditure exceptions: "all income from whatever source derived." Const. amend. XVI; I.R.C. §61. The social security tax, also an income tax, applies to a the far narrower base of income from the performance of human services.

[72] Examples include gasoline taxes devoted to road improvement, gambling taxes to education.

The appeal of dedicated tax revenue weakens, however, when the dedicated revenue source proves inadequate to its task, a status that the social security tax is approaching rapidly.[73] Tying the benefit to a revenue source becomes a barrier to adequate funding of the benefit since it requires increasing a specific, limited tax and is likely to generate a separate political debate. It is not a question of a national priority to fund social security among many governmental programs but a question of increasing the tax specifically funding that program.[74] Without the dedicated tax, social security might have to vie for its place among governmental priorities in allocation of expenditures. But social security expenditures remain popular and are viewed as essential expenditure. The social security benefits seem likely to maintain their place among expenditure priorities. Questions of benefits would remain separate from questions concerning the funding base as full integration into the federal budget would make social security a budget item contributing, albeit significantly, to the overall government funding needs.

Seeking to uncouple funding from the social security benefits risks opening both benefits and funding to adverse revision. Leaving benefits linked to funding risks compelling reduction in benefits if tax increases do not keep pace. Funding benefits from general revenues removes the direct entitlement link that currently emanates from the ready visibility of identifiable individual contributions to the social security system. Removing that entitlement link introduces opportunities to limit benefits for those with abundant resources without social security. The next part considers how to replace the revenue loss from integrating social security funding into general revenue.

Part III. Three Ways to Replace Lost Revenue Equitably

A. Modifying income tax rates. Repeal of the social security and Medicare taxes reduces government revenue by nearly one-third, about $1.3 trillion in 2021[75] as the 15.3 percent wage and self-employment taxes disappear. While this article focuses on the social security portion of the payroll tax, continuing the Medicare payroll tax while repealing the social security tax retains unnecessary tax complexity, so this article recommends repealing both and integrating social security and Medicare into general revenue funding through adjustments to the primary revenue sources of the individual and corporate income taxes. Repealing both taxes would simplify the Code further by facilitating the repeal of the supplemental tax on net investment income.[76]

---

[73] Tankersly, As Lawmakers Spar Over Social Security, supra note 32. And cite to revenue estimates on the exhaustion of the social security trust fund.
[74] An increasingly rich literature recommending various adjustments to the tax formula, the benefit formula, the wage cap has developed in recent years. Examples of very recent literature include Stephanie Hunter McMahon, Employment Taxes in Crisis: In Practice, Enforcement, and Insolvency, 75 TAX LAW. 187 (2021) (examining the effects and public perceptions of changes and payment deferrals of employment taxes); Claire Y. Nash, Social Security Reform: A Promise Kept, 177 TAX NOTES FEDERAL 973 (NOV. 14, 2022) (proposing a cap on benefits and the tax to encourage private investment for retirement of the tax savings resulting from the tax cap);.Committee for a Responsible Federal Budget, Principles for Social Security Reform (Jan 30, 2023), available at Principles for Social Security Reform | Committee for a Responsible Federal Budget (crfb.org) (recommending increases in rates and base).
[75] Note 71, supra.
[76] I.R.C. §1411.

A minimalist change in other taxes would be to increase the rates of the individual and corporate income taxes by all or a portion of their respective 15.3 percent wage and self-employment tax reductions. Rate changes would increase the primary revenue sources of the individual income tax and the corporate income tax. The full 7.65 percent tacked onto each marginal bracket for individuals, including the zero bracket and the reduced rates for net capital gain,[77] provides a more inclusive tax base since it reaches all net investment income and has no wage cap. Funding social security becomes part of the moderately progressive income tax structure.

If, however, one concludes that the employer bears the employer tax rather than passing it on to the employee, the employer share would not affect the net income or wealth of the employee. Repeal of the employer tax would be unnecessary to diminish the regressive effect of the FICA tax. Uncertainty concerning who bears the employer tax[78] and general tax simplification goals favor repeal of both the employer and the employee tax and replacement of the revenue in other ways. Repeal also is likely to remove the distortive effect of the social security tax on the labor market. The employer tax no longer would be a disincentive[79] to increasing wages since wages would not be subject to an employer tax.[80] Similarly, choosing to employ workers rather than relying on independent contractors no longer would draw a wage tax.

The social security tax certainly is not the sole driver of business decisions to prefer independent contracting to employment relationships. Independent contractors in some instances may have had sufficient bargaining power to demand greater compensation to offset the additional cost to them of paying both the employer and the employee share of the tax through the self-employment tax.[81] Other obligations of employment that favor independent contracting nevertheless continue, including some income tax rules that prohibit benefit discrimination in favor of highly compensated employees. Those obligations are more limited as non-employees are not entitled to the benefits.[82]

A shortfall in revenue from the repealed self-employment tax might arise without the supplemental tax since taxpayers who are employees and taxpayers who are independent contractors would pay income tax at identical rates after repeal while before repeal independent contractors paid the self-employment tax rate which was twice the employee rate. A revenue shortfall also may arise as corporations in a loss position previously paid employment taxes but no income tax and after repeal would pay no income tax. Similarly, individuals might have zero

[77] I.R.C. §1(h).
[78] See discussion supra accompanying note 20.
[79] The cost to a corporate employer of the employer share of the wage tax is 6.04 percent. Each additional dollar of wages increases the payroll tax but is offset in part by additional business expense under I.R.C. §162. The deduction decreases the income tax by 21 percent of the employment tax amount at the current corporate flat tax rate of 21 percent. The disincentive of the 6.04 percent tax leads the employer in some instances to prefer non-employees to employees.
[80] Certainly, other factors contribute to preference in many instances for independent contractors over employees, but the social security no longer would be a factor.
[81] I.R.C. §1401. That additional tax cost is not the full 7.65 percent, however, as it is offset in part by the deduction value of half the self-employment tax at the non-employee's marginal income tax rate. I.R.C. §164(f) and note 38 supra for the computation.
[82] I.R.C. §132(j)(1), (m)(2), for example.

or negative net income, but that status is unlikely to include wage earners[83] so that the repeal of the FICA tax and income tax increase for low-income employed individuals would remain unchanged and a small number of individuals with negative investment income simply would not experience the desired increase in tax with the broader base.

As to low-income wage earners who are not otherwise subject to the income tax, the shift to an income tax of 7.65 percent rather than a FICA tax would seem to be a matter of indifference. They would remain able to claim the earned income credit[84] that in effect would offset the increased income tax as it offsets all or part of their FICA tax currently.[85] The need for a genuine, zero-tax bracket for non-working, low-income individuals might be met with a limited expansion of the earned income credit or a parallel credit to protect a subsistence minimum from tax so that low income individuals would not experience a tax increase from repeal of the FICA tax even where other taxpayers with income primarily from services might experience a tax increase as their limited amounts of investment income are drawn into the increased rates.

Such considerations, however, suggest that an across the board and level rate increase is inappropriate. Instead, graduation of the rate increase is a compelling need that would improve tax distribution. Repairing tax distribution to return to a tax system that is consistent with the underlying ability to pay principles is a fundamental goal of FICA repeal.[86] Unless that graduation is steep, however, repeal of FICA might still generate a significant federal revenue shortfall in the absence of other revenue and benefit adjustments and require adjustments to tax expenditures and social security benefits as this article recommends in the next paragraphs.

B. Revising tax expenditures. Whether adjusting marginal income tax rates is adequate to provide full funding for social security, longstanding tax expenditures favoring affluent taxpayers and having no compelling policy justification other than administrative convenience should be reviewed and repealed or otherwise limited. Revision of tax expenditures is compelling in light of findings that the distribution of those expenditures favors white taxpayers over black and Hispanic taxpayers very substantially.[87]

Estimates of the percentage of various tax benefits delivered to white taxpayers[88] reach 92 percent in the case of the preferential rates for net capital gains and dividends,[89] 91 percent for

---

[83] Existing limitations on deductible capital losses under I.R.C. §1211 and passive activity losses under I.R.C. §469 prevent many individuals from incurring taxable losses.
[84] I.R.C. §32
[85] The maximum credit rate currently ranges from 7.65 to 45% of earned income so that it no longer is linked to refund of the social security tax except for credit claimants without dependent children. I.R.C. §32(b)(1).
[86] See part II supra.
[87] U.S. Dept. of Treasury (prepared by Assistant Secretary for Tax Policy Lily Batchelder and Deputy Assistant Secretary for Tax Analysis Greg Leiserson), Disparities in the Benefits of Tax Expenditures by Race and Ethnicity (Jan 20, 2023), available at https://home.treasury.gov/news/featured-stories/disparities-in-the-benefits-of-tax-expenditures-by-race-and-ethnicity, and based on a more extensive analysis: Julie-Anne Cronin, Portia DeFilippes and Robin Fisher, Tax Expenditures by Race and Hispanic Ethnicity: An Application of the U.S. Treasury Department's Race and Hispanic Ethnicity Imputation, Office of Tax Analysis Working Paper 122, U.S. Department of the Treasury (January 4, 2023) Tax Expenditures by Race and Hispanic Ethnicity: An Application of the U.S. Treasury Department's Race and Hispanic Ethnicity Imputation.
[88] Cronin et al, Tax Expenditures, supra note 87.
[89] I.R.C. §1(h).

the deductibility of charitable contributions,[90] and 90 percent for the qualified business income deduction.[91] The capital gains benefit and the charitable contribution benefit increase in value with the taxpayer's marginal tax bracket such that they are counter-progressive. The qualified business income deduction is proportional. Those three benefits were estimated at $146 billion, $71 billion, and $57 billion, respectively, in 2021. These distributional disparities are readily measurable.

From a policy perspective, the charitable contribution deduction may encourage giving to organizations that provide support for needy individuals, hospitals, research for medical innovation, churches, universities and other institutions. Application of charitable contributions provides some justification for preserving the charitable contribution deduction. A closer look at the charitable contribution expenditure, however, might disclose that, because the deduction is limited to itemizers,[92] relatively few gifts yield a tax benefit. And given the wide range of organizations that qualify for the charitable contribution deduction, many charities do not provide critical services that people universally would deem essential and not available by other means. A limited number of affluent donors capture the bulk of the tax expenditure for the charitable contribution deduction currently and determine where the tax expenditure is directed.[93] While those donors' choices in many instances may be commendable, they reflect the donor's personal interests without vetting through the lens of public participation or political engagement.

The qualified business income deduction is primarily a tax adjustment to limit the incentive to choose corporate form with its twenty-one percent marginal rate over other business entity forms and its repeal would undermine no compelling policy interest. The capital gain preference has been part of the tax law since the Revenue Act of 1921,[94] except for the years 1987-91,[95] and has been debated continually. Many arguments exists for its continuance.[96] Consistent with greater

[90] I.R.C. §170. This item does not measure the amount of individual charitable contributions and conclusions about amounts must consider that for taxpayers who do not itemize deductions, the charitable contribution deduction provides no tax benefit because it is an itemized deduction (with a $300 deduction for non-itemizers in 2020 increasing to $600 in 2022 for married individuals filing joint returns but discontinued after 2021. I.R.C. §62(a)(22), now repealed). In 2018, only 11.4% of taxpayers itemized their deductions. IRS, SOI Tax Stats — Tax Stats-at-a-Glance, available at https://www.irs.gov/statistics/soi-tax-stats-tax-stats-at-a-glance.
[91] I.R.C. §199A.
[92] Distributions to charitable organizations from the individual retirement accounts of individuals who are at least 70-1/2 years old continue to yield a tax benefit, however. The distributions, otherwise includable in the individual's income, are excludable. I.R.C. §408(d)(8). How ironic to be able to receive non-taxable social security benefits while avoiding inclusion of distributions from one's individual retirement account by directing the funds to charity. Compare I.R.C. §265 (disallowing deductions for expenses incurred in producing tax exempt income).
[93] A donor may select any qualifying charitable organization and, through the tax deduction, effectively redirect governmental revenues equal to the donor's marginal rate of tax times the amount of the contribution to the donor's selected charity.
[94] 42 Stat. 227 (November 23, 1921).
[95] The Tax Reform Act of 1986, Pub.L. 99-514 (October 22, 1986), reduced the maximum tax rate on ordinary income to 28 percent and eliminated the net capital gain rate preference. A net capital gain rate preference returned in 1990. Tax Foundation, Federal Capital Gains Tax Rates, 1988-2013, available at https://taxfoundation.org/federal-capital-gains-tax-rates-1988-2013/.
[96] Walter J. Blum, A Handy Summary of Capital Gain Arguments, 35 Taxes 247 (1957).

emphasis on distributional fairness in taxation,[97] its distributional disparity in favor of affluent individuals suggests the capital gains preference is a sound target for diminution or repeal.

Many other tax expenditures that also favor high-income and wealthy individuals could be limited as to produce additional revenue. Among them, the longstanding new basis at death rule,[98] earlier repealed in part and soon reinstated,[99] lacks a policy basis other than administrative difficulty of long-term recordkeeping and the argument that subjecting the full value to the estate tax should eliminate an income tax on the unrealized gain in the property.[100] The latter argument is appealing, but not compelling, in that all property is subject to the estate tax, including high basis property, and it has the adverse consequence of encouraging taxpayers to hold appreciated assets until death when disposition of those assets before death might be better for the owner and the owner's family or for the broader economy.[101]

The tax expenditure that excludes the use value of owner occupied, residential real estate[102] skews heavily in favor of wealthy individuals. Not only does the exclusion favor owners over renters generally as renters must pay rent from sources such as wages that are subject to the income tax while residential use for owners is free of tax, but also wealthier individuals are likely to have more valuable homes than less wealthy owners and wealthier individuals often own multiple homes thereby increasing the amount of the excluded use value. Valuation of the use value for specific property and taxpayers may be uncertain, making the restriction or elimination of the tax expenditure difficult.[103] Imputation of income is rare in the tax law although not without precedent. The Code expressly imputes interest income under a variety of circumstances,[104] and several Code provisions require imputation of income to a taxpayer other than the person receiving a payment, whether the payment otherwise is income or not.[105]

Other tax expenditures also favor high-income and wealthy individuals over less affluent individuals, including, among others, qualified retirement plans,[106] the mortgage interest

---

[97] For example, the Treasury studies cited supra notes 87-91and accompanying text.
[98] I.R.C. §1014.
[99] The Tax Reform Act of 1976, Pub.L. 94-455 (Oct. 22, 1976) repealed the step-up in basis rule but a concerted lobbying effort supported by the estate planning industry participants, life insurance and trust industries led to reversal one year later.
[100] Temporary repeal of the estate tax in 2010 was accompanied by elimination of the step-up for property received from the estates of decedents who died during the no estate tax year. The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub.L 107-16 (June 7, 2001) phased out the estate tax and the step-up in basis rule for individuals dying in 2010.
[101] Compare, the policy underlying the like-kind exchange provision, I.R.C. §1031, facilitating disposition of real property so that it may be used to its highest and best purpose without the seller having to continuing holding underutilized property to avoid recognizing gain.
[102] Tax Expenditures, supra note 52, item 59 (estimated at $130 billion in 2021, nearly $2 trillion during the 2020 decade).
[103] Henry Ordower, Income Imputation: Toward Equal Treatment of Renters and Owners in Anthony C. Infanti, editor, CONTROVERSIES IN TAX LAW: A MATTER OF PERSPECTIVE (Ashgate Press, 2015) (recommending construction of a value database for income imputation) .
[104] I.R.C. §7872.
[105] I.R.C. §482 (commensurate with income standard); I.R.C. §951A (imputing income from a foreign entity to its owners).
[106] I.R.C. §401.

deduction,[107] exclusion of gain on the sale of a personal residence.[108] Adjustments to many expenditures through phase-out or phase-down structures comparable to the phase-out for the earned income credit[109] would generate additional revenue that could support social security and Medicare. Limitations on existing tax expenditures would supplement the income tax revenue produced by the rate adjustments that would accompany the repeal of the separate FICA tax. Repeal of the FICA tax also provides an opportunity to reevaluate the coverage of the social security benefit possibly to limit benefits for those who have adequate resources without social security.

C. Limiting benefits; Integrating with tax delivery. Social security benefits are integrated with the normal income tax. Long excluded from gross income without an express statutory exception,[110] as much as 85 percent of a taxpayer's social security benefits are included currently in gross income. The inclusion is a function of the amount of income the taxpayer receives from all sources and includes tax exempt interest.[111] The inclusion functionally confirms a needs-based assessment that higher income taxpayers do not need the full benefit so that as much as the maximum income tax percentage may be recaptured through the income tax.[112]

The inclusion in gross income of as much as 85 percent of the social security benefits of higher income taxpayers ties the social security benefit formula to the individual's income from other sources. Repeal of the FICA tax would break the connection between involuntary contributions to social security and the conclusion that each taxpayer paying into that system is entitled to payments from that system. Instead, the social security system could limit benefit payments to those who lack abundant resources without social security.

Models within the income tax law already exist for limitations on benefits as the individual's income grows. At the lower end of the income spectrum, the earned income credit has an embedded phase-out provision that reduces the credit for otherwise eligible taxpayers as their income increases.[113] The qualified business income deduction phases out rapidly for taxpayers who derive their qualified business income from a specified service trade or business as their income from all sources exceeds a threshold amount.[114] Other phased limitations appeared in the

---

107 I.R.C. §163(h)(2)(D) (qualified residence interest).
108 I.R.C. §121.
109 I.R.C. §32(a)(2)(B).
110 I.R.C. §86 includes a portion of the social security benefits in gross income for some taxpayers and assumes social security benefits, like other welfare payments, are generally excludable from gross income. I.T. 3194, 1938-1 C.B. 114 (excluding lump sum Social Security benefits).
111 I.R.C. §86(b)(2) includes tax exempt interest in modified adjusted gross income that is used in determining the taxable portion of social security benefits.
112 When added to the Code as part of a revision of social security, revenue produced by I.R.C. §86 was directed into the social security and Medicare trust funds. H.R. CONF. REP. 98-47 (MAR. 24, 1983), H.R. Conf. Rep. No. 47, 98TH Cong., 1ST Sess. 1983, 1983 U.S.C.C.A.N. 404, 1983 WL 25298, P.L. 98-21, SOCIAL SECURITY AMENDMENTS OF 1983.
113 I.R.C. §32. In 2023, the maximum credit is $7430. The credit fully phases-out for taxpayers at $63,698 of adjusted gross income. Credit maximums and phaseouts differ with filing status and eligible dependent children. IRS, Earned Income and Earned Income Tax Credit (EITC) Tables, available at https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/earned-income-and-earned-income-tax-credit-eitc-tables.
114 I.R.C. §199A(d)(3).

relationship between itemized deductions and tax bracket increases[115] and more recently for the economic relief payments during the early period of the Covid pandemic.[116]

Similar approaches could be used for social security benefits by either phasing them out based on the previous year's adjusted gross income from all sources, as was done with the economic relief payments, or, more sensibly, delivering social security benefits through the federal income tax system, as is the case with many other government subsidies,[117] and phasing the benefit out in a manner comparable to the earned income credit. Using the IRS's infrastructure to deliver social security has the appeal of a single agency administering and auditing the payment system rather than using both the Social Security agency and the Internal Revenue Service.

Narrowing the class of recipients may diminish public commitment to delivering the benefit among affluent individuals who no longer would receive social security payments, but probably not among the bulk of the low- and middle-income taxpayers. Following careful economic evaluation of which individuals no longer need receive a social security benefit, low, moderate, and moderately higher-income individuals would continue to receive a benefit, albeit possibly diminished at the upper income end. The phase-out of benefits might begin where the inclusion in gross income begins under existing law[118] and gradually phase the benefit out as income increases reaching full phaseout at $400,000.[119]

Elimination of the payroll tax would facilitate inclusion of all older adults into the social security system. Such inclusion would transform social security into fundamental poverty relief for the aged and, potentially, contribute to limiting homelessness among older adults. Removal of affluent recipients from the class receiving monthly social security benefits would free those funds for more general poverty relief for older adults.[120]

Including adults who did not contribute payroll taxes in social security does not have the same connotations as welfare for working age individuals. For working age individuals there was a questionable narrative concerning "welfare mothers"[121] abusing welfare benefits, rather than accepting employment, that accompanied contraction of the historical welfare system.[122] Welfare benefits came to depend on the earned income credit and the earned income credit is a function of earnings from employment or self-employment. Delivery of the largest welfare benefit

---

[115] Alan D. Viard, The Basic Economics Of Pease and PEP, 146 Tax Notes 805 (2015).
[116] Dept. of the Treasury, Economic Impact Payments, available at https://home.treasury.gov/policy-issues/coronavirus/assistance-for-american-families-and-workers/economic-impact-payments.
[117] Tax Expenditures, supra note 52.
[118] I.R.C. §86
[119] $400,000 is an arbitrary choice piggybacking on President Biden's commitment to raise taxes only on those with incomes exceeding $400,000.
[120] The suggested model of inclusion resembles proposals for a universal basic income for older adults. Compare, Benjamin M. Leff, EITC For All: A Universal Basic Income Compromise Proposal, 26 Wash. & Lee J. Civ. Rts. & Soc. Just. 85 (2019); Miranda Perry Fleischer and Daniel J. Hemel, The Architecture of a Basic Income, 87 University of Chicago Law Review 625 (2020); Henry Ordower, Uniform International Tax Collection and Distribution for Global Development, a Utopian BEPS Alternative, 12 Columbia J of Tax L 126 (2021).
[121] Supra note 54, and accompanying text.
[122] Bruce D. Meyer and Dan T. Rosenbaum, Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers, 116 Quarterly J Econ 1063 (2001).

depended through the credit became employment dependent.[123] It seems unlikely that individuals would eschew work, income from work, and accompanying payments of income tax while they wait to reach an age at which they might receive social security benefits.

Some combination of increased income tax rates, preferably integrated and consistent with the graduated and progressive income taxes, diminution of tax expenditures, preferable those that provide no subsidy for indisputably critically needed activities, and a reduction or elimination in benefits for those who have ample retirement resources without social security would provide the revenue necessary to sustain social security benefits for those who need the benefits to support dignified aging. In the next part, this article turns to the political attacks on social security that the existing system invites and the revised system might avoid and to other benefits that might accompany the separation of benefits from a dedicated tax.

Part IV. **Collateral Benefits of Unbundling; Countering Threats to Social Security.**

A. Countering the Privatization Threat. Assuming, as this article does, that the social security benefit system is sufficiently integral to the popular expectations in economies worldwide that it has become a sticky benefit,[124] social security will survive the substantial alterations in funding and the introduction of needs-based limitations of benefits that this article recommends. While the greatest immediate threat to social security is adequacy of funding and the looming projected reduction of benefits,[125] a further threat lies in proposals to privatize social security.[126] Despite considerable reasoned opposition to privatization of all or part of the social security tax payments,[127] there is a continuing interest in privatizing social security accounts.[128] Recent legislation emphasized expansion of private retirement plan availability, required certain employers to create retirement plans for their employees, and directed some governmental payments into private plans.[129] While that legislation is designed to encourage savings for

[123] I.R.C. §32.
[124] Aaron Nielson, Sticky Regulations, 85 U Chicago L Rev 85 (2018) (discussing regulations that change very slowly).
[125] Supra note 6 and accompanying text discussing the exhaustion of the social security trust fund in the middle of the next decade.
[126] Barry P. Bosworth and Gary Burtless, Privatizing Social Security: The Troubling Trade-Offs, Brookings Policy Brief Series (1997); C. Eugene Steuerle, Privatizing Social Security: A Third Option (Part 1 of 2), Part One: Basic Rationale (1996), available at Privatizing Social Security: A Third Option (Part 1 of 2): Part One: Basic Rationale (urban.org).
[127] Geier, Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income, supra note 24; Dilley, Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization, supra note 24; Deborah A. Geier The Payroll Tax Liabilities of Low- and Middle-Income Taxpayers, 106 TAX NOTES 711 (FEB. 7, 2005) available at https://www.taxnotes.com/tax-notes-federal/employment-taxes/payroll-tax-liabilities-low-and-middle-income-taxpayers/2005/02/07/pty4?highlight=steuerle%20privatizing%20social%20security.
[128] Lew Blank (Data for Progress Blog), Voters Overwhelmingly Oppose GOP Efforts to Privatize Social Security (12/22/22) available at https://www.dataforprogress.org/blog/2022/12/22/voters-overwhelmingly-oppose-gop-efforts-to-privatize-social-security.
[129] Supra note 5, The Consolidated Appropriations Act, 2023, Division T, Secure 2.0 Act of 2022, Pub. L. 117-328 (Dec 29, 2022) added significant incentives for private retirement plans. A summary of those retirement plan expansions is at https://www.finance.senate.gov/imo/media/doc/Secure%202.0_Section%20by%20Section%20Summary%2012-19-22%20FINAL.pdf.

retirement, a commendable goal of enhancing individuals' long term financial security, the legislation indirectly supports proponents of privatization by bolstering the private retirement system while leaving the general public retirement system of social security in financial jeopardy.

Where individuals view their FICA payments as a mandatory retirement savings contribution, rather than simply a generalized tax obligation, their perceived ownership of those retirement savings leading to an entitlement to payments from social security on retirement gives them a reasonable interest in investing their savings as they wish. Those individuals may imagine that they will capture an improved return if permitted to control investment of their own social security savings. Privatization of their individual accounts may be an appealing choice. The countervailing consideration becomes governmental protection of the individually owned accounts so that the owners do not waste the assets and become dependent on the state in their old age. Perceived account ownership results in rejection of the need for a general fund to support retirement funding for all. Unbundling social security from a designated tax would diminish any argument for ownership of discrete social security account balances and undercut the threat that privatization poses.

B. The Independent Contracting Problem. As part of a larger problem within labor regulation, repeal of a social security tax would relieve some pressure for individuals to choose service structures that define them as independent contractors rather than employees. Employers, whether they effectively pass the employer's share of the payroll tax on to their employees, avoid liability for the employer's share and the obligation to withhold the employee's share if the engage services from independent contractors rather than employees. Where definitional ambiguity permits a business to avoid characterizing a worker as an employee, many businesses encourage individuals to contract as independent. Introduction of the qualified business income deduction in 2018 exacerbated the independent contracting problem by providing an incentive for independent contracting. A business owner, albeit subject to an exclusive contract with a single business, may claim the qualified business income deduction but an individual engaged in the trade or business of an employee could not claim the deduction.[130] Absent any additional tax liability for an employer once social security comes from general revenue, employers may still prefer independent contracting to avoid other labor law responsibilities but the argument of additional social security tax no longer will be part of that analysis. And some employers may encourage individuals to choose employment, rather than independent contracting, so that the employer may have greater control over how and when the employee performs services[131] and use the wages paid as part of the employer's base for the qualified business income deduction.[132]

Part V. Conclusion.

[130] I.R.C. §199A(d)(1)(B).
[131] Dept. of Health and Human Services, Office of Child Support Enforcement, What's the Difference Between an Independent Contractor and an Employee?, available at https://www.acf.hhs.gov/css/training-technical-assistance/whats-difference-between-independent-contractor-and-employee#:~:text=A%20business%20may%20pay%20an,company%20does%20not%20withhold%20taxes (describing the relationship and obligation differences).
[132] I.R.C. §199A(b)(2)(B).

To avoid reductions in social security benefits, some alteration in the social security tax is critical. Whether an increase in the FICA tax rate, an increase in the wage ceiling, or inclusion of some or all investment income in the FICA tax base will become the subject of active debate to preserve benefits, each possible remedy poses the political risk that some will object to the change and seek to reduce benefits or otherwise undermine the social security system by returning to the debate for privatization. This article views social security as an essential public welfare program and not a universal, supplemental public retirement savings program. With political risks accompanying any effort to revitalize or preserve social security for those who depend upon it for a dignified old age, directing the debate toward the adjustments this article recommends may pose only minimal additional political risk. Shift to general revenue funding with graduated income tax rate changes, reduction in tax expenditures that favor high-income, high net worth individuals, and paring benefits for those with ample alternative resources for a comfortable old age are changes that would improve the distribution of tax burdens among taxpayers and in part diminish the tax system's contribution to impoverishment.[133]

[133] Supra note 36.