REFORMING SOCIAL SECURITY

Option: Tax All Salary Reduction Plans

Employees now pay Social Security and Medicare payroll taxes on their contributions to tax-preferred employer-sponsored retirement accounts, such as 401(k) plans. They do not, however, pay these payroll taxes on their contributions to some other types of benefit plans at work, like Flexible Spending Accounts. Collecting payroll taxes on contributions to all such benefit plans would increase the Social Security program’s funding, as well as increase the earnings used to calculate the Social Security benefits of workers who have those benefit plans. If you contributed $2,000 to a Flexible Spending Account, you and your employer would pay the 6.2 percent payroll tax (or $124 each) on that money. Taxing these salary reduction plans for Social Security the same way we tax contributions to 401(k) plans is estimated to fill 10 percent of the funding gap.

Argument for:

Virginia Reno
National Academy of Social Insurance

Argument against:

David John
The Heritage Foundation

Virginia Reno

Congress should complete a reform it launched in 1983 by treating workers’ contributions to all employer-provided salary reduction plans as earnings that are subject to Social Security taxation and that count toward workers’ future benefits. In 1983, Congress followed the advice of an expert commission, led by Alan Greenspan, which recommended that workers’ contributions to 401(k) plans should be covered by Social Security. Otherwise, as 401(k) plans became more common, workers would lose some of their earned Social Security protection (including a portion of life and disability insurance and credits toward retirement benefits) and the Social Security trust funds would lose revenues needed to pay future benefits. The same argument applies today to other types of salary reduction plans.

Salary reduction plans allow workers to exclude from taxable income their out-of-pocket spending for health care, dependent care, or qualified commuting costs for parking, van pooling, or transit fares. Such plans were either nonexistent or rare in 1983 but have since become common. Treating all employee contributions to such plans as covered earnings for Social Security purposes (while maintaining their income-tax exemption) would—

- Provide consistent treatment between 401(k)s and other salary reduction plans;
- Reflect the intent of Congress;
- Fill 10 percent of the projected gap in Social Security’s finances; and
- Ensure that all of workers’ earnings count toward their future Social Security benefits.
Perspectives 26, June, 2012

AARP Public Policy Institute,
601 E Street, NW, Washington, DC 20049
www.aarp.org/ppi.
202-434-3890, ppi@aarp.org
© 2012, AARP.
Reprinting with permission only.

Social Security Reform Option: Tax All Salary Reduction Plans

David John

This would be a case of robbing Peter to pay Paul. Changing the tax treatment of salary reduction plans is a bad idea that would increase the cost of health care and other employee benefits, while also discouraging employers from offering the plans in the first place.

Salary reduction plans, which are also called cafeteria plans or flexible spending accounts, are designed to provide a tax subsidy that partly offsets the cost of health insurance and other employee benefits. They include the accounts that millions of Americans now use to pay for glasses, eye exams, medication, and a host of other needs. They can also help to pay for transportation expenses, life insurance, child care, and a number of similar services.

Because of these accounts, many employers are able to provide better health care insurance coverage than they could otherwise afford. This is especially true of smaller employers that cannot completely absorb the rising cost of their health care policies. Depending on the specifics of the plan, employees may pay a proportion of their basic health insurance premiums, or the full cost of insurance covering items such as dental, optical, or other health care needs. The plans also allow employees to tailor benefit packages to meet their own special needs and interests.

Under the current structure, both employees and employers receive a tax benefit for offering salary reduction plans. Employees benefit because the amount that they contribute is deducted from their taxable income. They are exempt from paying state and federal income taxes and federal payroll taxes on that amount. Employers benefit because they do not have to pay the matching payroll taxes or federal unemployment taxes on amounts deducted from the employees.

Supporters of eliminating the payroll tax exemption correctly point out that employee contributions would still be exempt from federal and state income taxes. However, their costs would still go up by more than 6 percent, an amount that could be significant to people who must count every cent in tough economic times.

What is worse, though, is that such a move would eliminate the incentive that employers have to offer these salary reduction plans. Those tax savings help to offset the employer’s cost of operating the plans. The result would almost certainly be fewer employers that are willing to offer this type of benefit. Individual workers would either have to buy the coverage themselves or to do without.

Eliminating the payroll tax exemption from cafeteria and flexible spending plans might marginally improve Social Security’s finances. However, if it comes at the cost of reduced family health care coverage, that cost may be too high.

Virginia Reno is Vice President of Income Security Policy at the National Academy of Social Insurance.

David John is a Senior Research Fellow at The Heritage Foundation.

NOTE: The estimated solvency effects in this Perspectives report are based on the intermediate assumptions in the 2011 Social Security Trustees Report.

The views expressed herein are for information, debate and discussion, and do not necessarily represent official policies of AARP.