

BACKGROUND

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Raising the Social Security Payroll Tax Cap: Solving Nothing, Harming Much

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Abstract

Social Security is an insolvent program that demands immediate reform—but raising the payroll tax cap should not be an option. Static revenue projections conceal the true impact of raising the Social Security payroll tax. What may seem like an easy way to improve the program's long-run finances would, instead, reduce incomes, slash non-Social Security tax revenues, stimulate higher government spending, and do little to improve Social Security's solvency. Policymakers need to reform Social Security now, curbing costs and returning the program to its original intent of preventing poverty in old age. Raising the payroll tax cap would increase costs, move the program further from its original goals, and hurt individual incomes, tax revenues, and economic growth in the process.

Although often brushed aside as the lesser of our nation's entitlement problems, the Social Security and Disability Insurance Programs' \$13.4 trillion (and rising) unfunded liability demands substantial reform.¹ Raising the payroll tax cap (from its current level of \$117,000) should not be an option. Raising, or even eliminating, the payroll tax cap would not solve Social Security's financial shortfalls, but would impose economically damaging marginal tax rates on middle-income and upper-income earners. Such onerous taxes would reduce incomes and overall economic growth while generating very little net revenue. Furthermore, Congress would immediately spend any additional payroll tax revenue, leaving no improvement in future budget deficits, giving merely the appearance, on paper, of financial improvement in Social Security.

KEY POINTS

- Social Security's \$13.4 trillion (and rising) unfunded liability demands substantial reform. Raising the payroll tax cap (from its current level of \$117,000) should not be an option—static revenue projections conceal the true impact of raising the Social Security payroll tax.
- Raising, or even eliminating, the payroll tax cap would not solve Social Security's financial shortfalls, and would impose economically damaging marginal tax rates on middle-income and upper-income earners.
- Such onerous taxes would reduce incomes and overall economic growth while generating very little net revenue—merely giving the appearance, on paper, of financial improvement in Social Security.
- Policymakers need to reform Social Security now, curbing costs and returning the program to its original intent of preventing poverty in old age. Raising the payroll tax cap would increase costs, remove the program further from its original goals, while reducing individual incomes, tax revenues, and economic growth.

This paper, in its entirety, can be found at <http://report.heritage.org/bg2923>

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Social Security: Not Serving Its Original Purpose

Social Security was designed to provide income support to a relatively small percentage of the population: those who lived beyond the average life expectancy and were therefore less likely to be able to work or have sufficient savings. Life expectancy in the United States has increased by 17 years since Social Security's inception, and medical advancements have allowed individuals to work longer.² Without corresponding adjustments in eligibility and benefits, however, Social Security has transformed into a potentially decades-long income subsidy for the masses.

In 1940, when monthly Social Security benefits were first distributed, less than 7 percent of the population was age 65 or older. Today, that figure has doubled to 14 percent, and by 2050, the share of Americans 65 and above will have more than tripled to 22 percent. Social Security simply cannot continue to finance lengthier retirements for a rising percentage of the population.

Furthermore, Social Security is not serving its intended purpose of preventing poverty in old age. Despite working and paying Social Security taxes for 35 years or more, some retirees do not receive enough Social Security benefits to keep them out of poverty. In 2012, nearly 4 million people—9 percent—ages 65 and older were living in poverty.³

Current Cap: Historically Consistent and Higher than Other Countries'. The current Social Security payroll tax cap is \$117,000 for 2014. This cap covers approximately 83 percent of wages, with roughly 94 percent of all workers earning less than

the cap.⁴ Those who would like to raise the cap are pushing for an increase to cover at least 90 percent of all wages, which would more than double the current cap to about \$240,000.⁵

There is little rationale for raising the cap to cover 90 percent of earnings, and even less reason to eliminate it completely. The creators of the Social Security program did not advocate a tax cap; rather, they recommended that everyone with earnings above three times the average wage be exempt from Social Security altogether.⁶ These individuals would neither pay Social Security taxes nor receive Social Security benefits. This recommendation was likely rooted in Social Security's original intent to prevent poverty in old age. Individuals who earn more than three times the national average are unlikely to need government-provided social insurance to keep them out of poverty in retirement.

The existence of the tax cap in its current form not only curtails excessively high and economically damaging marginal tax rates, it also prevents workers with very high incomes from receiving unnecessarily high benefits.

Those who endorse a 90 percent tax cap point to a single year—1983—when the Social Security tax cap covered 90 percent of earnings. But 1983 was an historical anomaly (caused by a significant increase in the tax cap in 1977). Since Social Security's inception, the tax cap has covered an average 84 percent of earnings—nearly the same as the 83 percent of earnings the tax cap covers today.⁷

Not only is the current wage cap in line with its historical average, it is also significantly higher than

1. The 75-year OASDI shortfall between already-promised benefits and expected payroll tax revenues is \$10.6 trillion, but paying the \$2.8 trillion of IOUs in the trust fund will also draw from general fund revenues, bringing the true 75-year OASDI unfunded obligation to \$13.4 trillion. U.S. Social Security Administration, *The 2014 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*, July 28, 2014, <http://www.socialsecurity.gov/OACT/TR/2014/index.html> (accessed July 28, 2014).

2. Congressional Budget Office, "Raising the Ages of Eligibility for Social Security and Medicare," *Issue Brief*, January 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/01-10-2012-Medicare_SS_EligibilityAgesBrief.pdf (accessed February 10, 2014).

3. U.S. Census Bureau, "Historical Poverty Tables—People," Table 3. "Poverty Status, by Age, Race, and Hispanic Origin," <http://www.census.gov/hhes/www/poverty/data/historical/people.html> (accessed February 21, 2014).

4. Estimates from the 2013 Social Security Trustees Report show that the tax cap covered 83.1 percent of all taxable earnings in 2012, and that in 2011, 93.8 percent of workers had earnings below the tax cap (the percent of workers below the cap was not available for 2012). Social Security Administration, "Annual Statistical Supplement to the Social Security Bulletin, 2013," Table 4.B, March 2014, <http://www.ssa.gov/policy/docs/statcomps/supplement/2013/index.html>, (accessed March 6, 2014).

5. The Urban Institute, "Raising the Taxable Maximum," June 2013, http://www.urban.org/retirement_policy/sstaxableminimum.cfm (accessed July 2, 2013).

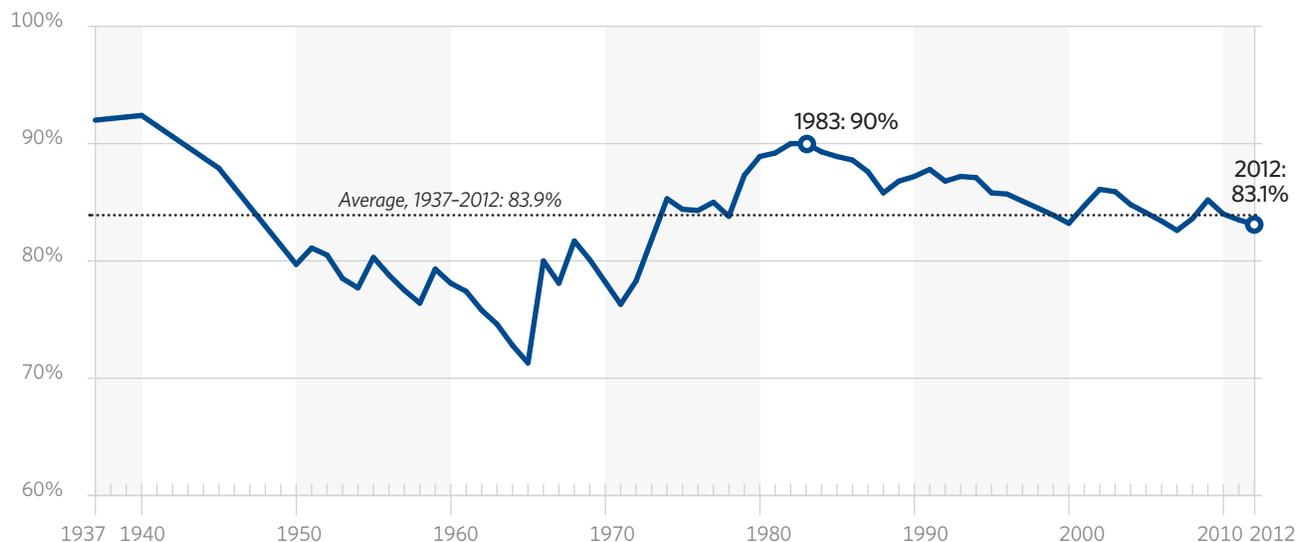
6. The Committee on Economic Security, "Report of the Committee on Economic Security, Need for Security," December 1934, <http://www.ssa.gov/history/reports/ces/ces5.html> (accessed July 1, 2013).

7. Social Security Administration, "Annual Statistical Supplement to the Social Security Bulletin, 2013," Table 4.B.

CHART 1

Current Social Security Cap Is Close to Historical Average

CAP AS A PERCENTAGE OF EARNINGS



Note: Some figures between 1937 and 1950 have been interpolated.

Source: Social Security Administration, 2013 Trustees Report, Table 4.B1, <http://www.ssa.gov/policy/docs/statcomps/supplement/2013/4b.pdf> (accessed February 21, 2014).

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the tax caps of other large, industrialized countries. In 2008, the United States' Social Security wage cap equaled about 2.5 times the average wage, compared to 2.0 times the average wage in Germany, 1.5 in Japan, 1.2 in the U.K., and equal to the average wage in Canada.⁸

Cap Increase: Whose Taxes Would Rise?

According to a study by the liberal Center for Economic and Policy Research, if the payroll tax cap were increased to cover 90 percent of earnings or eliminated entirely, about 5.2 percent of workers would face an immediate tax increase.⁹

But this represents only a snapshot in time. A 2011 report by the Social Security Administration estimated that between 20 percent and 25 percent of individuals born after 1951 will earn above

the taxable maximum at some point in their working careers.¹⁰ This means that one out of every four workers would pay higher taxes over their lifetime if the cap were raised or eliminated.

Marginal Tax Rates Would Soar. Raising the payroll tax cap to cover 90 percent of earnings would amount to a massive tax increase on middle-income and upper-income earners.

A single person with \$125,000 in earnings would see his combined federal income and payroll tax rate jump from 30.9 percent to 43.3 percent, and would pay an additional \$1,400 in taxes. A single-earner married couple with two children and \$125,000 in earnings would see their marginal tax rate jump from 32.9 percent to 45.3 percent, and would also pay an additional \$1,400 in taxes. The marginal tax rate of a married couple with two children and two earners each mak-

8. Organization for Economic Co-operation and Development (OECD), "Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries," <http://www.oecd.org/els/social/pensions/PAG> (accessed July 1, 2013).

9. Nicole Woo, Janelle Jones, and John Schmitt, "Raising the Social Security Payroll Tax Cap: How Many Workers Would Pay More?" Center for Economic and Policy Research, January 2013, <http://www.cepr.net/index.php/publications/reports/raising-the-social-security-payroll-tax-cap-how-many-workers-would-pay-more> (accessed July 1, 2013).

10. Social Security Administration, "The Evolution of Social Security's Taxable Maximum," September 2011, <http://www.ssa.gov/policy/docs/policybriefs/pb2011-02.html> (accessed July 1, 2013).

CHART 2

U.S. Has Higher Social Security Cap than Other Industrialized Nations



Source: OECD, "Pensions at a Glance 2011: Retirement-Income Systems in OECD and G20 Countries," <http://www.oecd.org/pensions/pensionsataglance2011.htm> (accessed June 10, 2014).

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ing \$125,000, would rise from 36.8 percent to 49.2 percent, and they would pay \$2,800 more in taxes.

Marginal tax rates and total tax increases would be even more dramatic for those considered "rich" by President Barack Obama's standards.¹¹ If the payroll tax cap were increased to cover 90 percent of earnings, the marginal tax rate for a married couple with two children and \$400,000 in earnings would rise from 44.2 percent to 56.6 percent, while their total tax liability would increase by as much as \$35,500.¹²

Adding on state and local income taxes would bring middle-income to upper-income tax rates well above 50 percent. In California, the state with the highest top income tax rate, a single-earner married couple with two children and \$125,000 in total earnings would face a combined marginal tax rate of 54.6 percent.¹³ Despite this family earning only half as much as the current Administration considers rich, 55 cents of every additional dollar that family earns would be taken away in taxes.

For those considered rich, adding on state and local income taxes would bring the top marginal tax rate in the United States to 70.3 percent (57.0 percent federal taxes and 13.3 percent California state taxes).

All taxes are distortionary, meaning they alter individuals' behavior as well as total economic output. High marginal income tax rates are particularly distortionary for high-income, highly skilled workers. Whereas lower-skilled workers with lower incomes are constrained in their ability to cut back on work when marginal tax rates rise (because they must maintain some minimal level of income), more highly skilled, higher-income workers generally have more flexibility to work less when marginal tax rates rise. But when workers cut back on work and receive less take-home pay, they also tend to cut back on savings and investment. Less work, lower incomes, smaller savings, and less investment are harmful to economic growth, which in turn, is detrimental to tax revenues.

11. President Obama has identified as "rich" single people earning \$200,000 or more, and married couples earning \$250,000 or more.
12. The current marginal rate of 44.2 percent for a family of four consists of: 35 percent income tax, 2.9 percent Medicare tax, 0.9 percent Affordable Care Act (ACA) Medicare surtax, 4.4 percent personal exemption phase-out tax, and 1.1 percent itemized deductions phase-out tax. The maximum income tax increase of \$35,500 accrues to a married couple with two children, one earner, and \$400,000 in income.
13. The couple's federal marginal income tax rate would equal 45.3 percent, and its California income tax rate would equal 9.3 percent.

TABLE 1

Change in Federal Tax Rates if Payroll Tax Cap Increased to 90 Percent

Family Type	Total Earnings	Current Marginal Federal Tax Rate	Marginal Federal Tax Rate with 90 Percent Payroll Tax Cap
Single	\$125,000	30.9%	43.3%
Married, single-earner	\$125,000	32.9%	45.3%
Married, dual-earner	\$250,000	36.8%	49.2%
Married, dual-earner	\$400,000	44.2%	56.6%

Source: Author’s calculations based on 2014 federal tax law and a proposal to raise the Social Security payroll tax cap to cover 90 percent of earnings (an increase in the cap from \$117,000 to about \$240,000).

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A Conduit for More Government Spending.

Raising the Social Security payroll tax cap would create a double whammy for budget deficits. Not only would it reduce non-Social Security tax revenues due to lower incomes (caused by employers reducing wages in return for higher payroll taxes as well as workers’ behavioral responses), it would also result in higher government spending.

Multiple economic studies confirm that Social Security surpluses have not contributed to lower public debt, but rather to more non-Social Security government spending.¹⁴ This is because Social Security surpluses have served as a means of financing other forms of government spending, to the tune of more than \$1 trillion since Social Security’s inception, without having to borrow from the public and without recording an overall budget deficit. One estimate shows that as much as 100 percent of Social Security trust fund surpluses have been offset through higher non-Social Security government spending or lower taxes.¹⁵

TABLE 2

Eliminating the Social Security Payroll Tax Cap in California: Top Marginal Tax Rates Could Exceed 70 Percent

If the payroll tax cap is eliminated, combined federal and state income taxes in California would rise to 55 percent for many upper-income married couples, and California’s millionaires would pay marginal rates over 70 percent.

	Married couple, total earnings \$125,000	Total earnings \$1,000,000 or More
Federal income base rate	25.0%	39.6%
Social Security	12.4%	12.4%
Medicare	2.9%	2.9%
Obamacare	0.0%	0.9%
PEP	0.0%	0.0%
Pease	0.0%	1.2%
Child tax credit phaseout	5.0%	0.0%
California state income tax	9.3%	13.3%
Total	54.6%	70.3%

Source: Author’s calculations based on 2014 tax law and proposal to eliminate the Social Security payroll tax cap.

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If the payroll tax cap is increased or eliminated, it will provide an influx of tax revenues to the Social Security system, turning today’s cash-flow deficits into cash-flow surpluses. But those added revenues will not be put into a Social Security “lockbox.” Rather, the additional revenues will allow the federal government to spend precisely that much more without having to borrow from the public. Spending those new payroll tax revenues while also crediting them to the Social Security Trust Fund is double counting. Double counting is an accounting trick where the federal government essentially

14. Kent Smetters, “Is the Social Security Trust Fund Worth Anything?” National Bureau of Economic Research Working Paper No. W9845, July 2003, <http://www.nber.org/papers/w9845> (accessed July 2, 2013).

15. John B. Shoven and Sita Nataraj, “Has the Unified Budget Undermined the Federal Government Trust Funds?” National Bureau of Economic Research Working Paper No. 10953, December 2004, <http://www.nber.org/papers/w10953> (accessed July 2, 2013).

spends the same dollar twice. Higher payroll taxes could finance current spending, while at the same time extend the life of the Social Security Trust Fund. However, since the trust fund has no economic value, the government will have to borrow or raise taxes to pay benefits in the future. If added payroll tax revenues are used for higher spending, raising the payroll tax cap could actually increase, rather than decrease, U.S. debt.¹⁶

Raising or Eliminating the Cap Will Not Fix Social Security

Despite claims to the contrary, raising or eliminating the payroll tax would not fix Social Security's long-run financial imbalance. According to the Social Security Administration, even if the tax cap were eliminated completely and no new benefits were credited to those who pay higher taxes (fundamentally altering the contributory nature of Social Security), this massive tax increase would still fall \$2 trillion short of eliminating Social Security's estimated 75-year actuarial deficit (an improvement of 82 percent).¹⁷ Furthermore, the improved solvency from eliminating the payroll tax cap would be front-loaded, providing annual cash-flow surpluses until 2024, followed by endless and growing deficits in the out years. By 2088, Social Security's annual cash flow deficit would equal more than 2 percent of taxable payroll (an improvement of 55 percent compared to not eliminating the payroll tax cap).¹⁸

Less aggressive options would do even less to solve Social Security's shortfalls: Eliminating the cap while crediting those who pay higher taxes with higher benefits would provide cash flow surpluses until 2024 and would leave \$3.6 trillion of Social Security's 75-year actuarial deficit unresolved (an improvement of 66 percent); raising the cap to cover 90 percent of earnings without increasing bene-

fits would fail to generate a single year of cash-flow surpluses while leaving \$7 trillion in deficits (an improvement of 34 percent); and raising the cap to 90 percent and increasing benefits would also not produce cash-flow surpluses and would leave \$7.8 trillion in Social Security's 75-year actuarial deficit (an improvement of 27 percent).¹⁹

Again, these smaller financial improvements would be front-loaded. By 2088, the annual cash-flow improvements would be: 36 percent for eliminating the cap and increasing benefits; 24 percent for increasing the cap to cover 90 percent of earnings without increasing benefits; and 14 percent for increasing the cap to 90 percent and increasing benefits.²⁰

But these figures represent static revenue projections, which assume that neither employers nor employees who face higher taxes will alter their behavior. In reality, employers will reduce employees' wages (including shifting some compensation to untaxed benefits) and employees will alter their work effort. These changes will reduce static revenue projections.

How Much Revenue Would There Really Be?

It is easy to estimate how much new revenue might be raised by increasing the taxable maximum—this is a simple multiplication of earnings above the “tax max” times the 12.4 percent payroll tax rate—but, estimating how much revenue will be raised after employers shift incomes and employees change their behavior is more complicated.

For starters, there are behavioral effects, such as workers choosing to work less and employers shifting compensation to untaxed benefits, which reduce tax revenues. The degree to which revenues decline depends on the magnitude of behavioral responses from those affected by the tax increase. Under a relatively low wage elasticity of 0.2, the net revenue

16. If all surpluses are spent and higher payroll taxes are credited with higher benefits, net federal U.S. debt will rise.

17. According to the 2014 Social Security Trustees' report, the 2013 OASDI 75-year actuarial deficit amounted to 2.88 percent of taxable payroll (\$10.6 trillion). The Social Security Administration estimates of payroll tax reforms had projected that eliminating the tax cap in 2013 without increasing benefits would have reduced the 75-year actuarial deficit by 86 percent, to 0.37 percent of taxable earnings. The estimated \$1.3 trillion in remaining deficits is calculated by multiplying the 86 percent ratio by the 2013 deficit of \$10.6 trillion, and then subtracting that figure from \$10.6 trillion to get the remaining imbalance. This same method is used for all reform estimates contained in the 2013 Social Security Administration report on Payroll Tax Rates. Social Security Administration, “Provisions Affecting Payroll Tax Rates,” Tables E2.1, E2.2, E3.1, and E3.2, <http://www.ssa.gov/oact/solvency/provisions/payrolltax.html> (accessed November 19, 2013).

18. Ibid.

19. Ibid.

20. Ibid.

TABLE 3

Effect of Raising Payroll Tax Cap on Social Security's 75-Year Shortfall: Four Scenarios

Proposal	Reduction in 75-Year Shortfall
Eliminate cap, no new benefits	86%
Eliminate cap, credit new benefits	70%
Raise cap to cover 90 percent of earnings, no new benefits	36%
Raise cap to cover 90 percent of earnings, credit new benefits	28%

Source: Social Security Administration, "Provisions Affecting Payroll Tax Rates," Tables E2.1, E2.2, E3.1, and E3.2, <http://www.ssa.gov/oact/solvency/provisions/payrolltax.html> (accessed July 1, 2013).

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gain—including Social Security, Medicare, and other federal and state income taxes—from raising the Social Security payroll tax cap to cover 90 percent of earnings would be only 52 percent of the static revenue projection.²¹ In other words, for every dollar of new revenue credited to Social Security as a result of raising the payroll tax cap, 48 cents in combined federal and state taxes would be lost, resulting in a net revenue gain of only 52 cents.

Many economists have found that marginal tax rate elasticities are much higher than 0.2, particularly for high-income earners. Economist Martin Feldstein, for example, considers an elasticity of 0.5 for middle-income and high-income earners to be a reasonable, if not conservative estimate, based on

existing studies.²² Under an elasticity of 0.5, economists Jeffrey Liebman and Emmanuel Saez found that the net revenue increase from raising the payroll tax would fall to just 10 percent of the static revenue projection.²³ In other words, for every dollar of new revenue that static estimates credit to Social Security as a result of raising the payroll tax cap, 90 cents would be lost in combined federal and state taxes, leaving only 10 cents in net revenue.

With an elasticity of 0.5, raising the payroll tax cap would approach the revenue-maximizing Laffer rate, meaning the higher taxes could actually reduce, rather than increase, net tax revenues. Indeed, as Liebman's and Saez's estimates show, with an elasticity of 0.8, raising the payroll tax cap to cover 90 percent of earnings would result in a net *decline* in tax revenues of about one-third the static revenue projection.²⁴

Aside from behavioral effects, there is also the direct-incidence effect. Standard economic assumption is that employees bear the full burden of employer-paid taxes through lower wages.²⁵ Thus, when employers are faced with an additional 6.2 percent tax on wages above the current tax cap, they will reduce affected wages by that amount. Lower wages not only reduce the amount of new Social Security tax revenue, but revenue from Medicare taxes, and federal, state, and local income taxes as well.

Setting aside all potential behavioral effects, Liebman and Saez estimate that incidence shifting would reduce actual net revenue gains by 20 percent if the tax cap were raised to cover 90 percent of earnings and by 24 percent if the cap were eliminated completely.²⁶

The Social Security Administration estimates suggest that raising or eliminating the payroll tax cap could solve anywhere from 28 percent to 86 percent

21. Ibid.

22. Martin S. Feldstein, "Effects of Taxes on Economic Behavior," National Bureau of Economic Research *Working Paper* No. W13745, January 2008, <http://www.nber.org/papers/w13745> (accessed July 2, 2013).

23. Jeffrey Liebman and Emmanuel Saez, "Earnings Responses to Increases in Payroll Taxes," National Bureau of Economic Research *Retirement Research Center Paper* No. NB 04-06, September 2006, <http://www.nber.org/aging/rrc/papers/onb04-06.pdf> (accessed February 18, 2014).

24. Liebman's and Saez's simulation predicts a static revenue gain of 170. They estimate that with an elasticity of 0.8, raising the payroll tax cap to cover 90 percent of earnings will generate a Social Security static revenue gain of 118, but a static revenue loss of 173 from Medicare and federal and state income tax revenues, for a net revenue loss of 55, or 32.4 percent (55/170 = 32.4).

25. Liebman and Saez, "Earnings Responses to Increases in Payroll Taxes."

26. Ibid. The Liebman and Saez simulations are based on a 1996 earnings sample, with the results scaled to 2004 earnings levels. At the time of their analysis, in 2006, the Social Security payroll tax cap covered 86 percent of earnings, which is the same level it covered in the most recent estimate from 2009.

TABLE 4

Raising the Social Security Payroll Tax Cap Would Cause Other Federal, State, and Local Tax Revenues to Fall

NET REVENUE EFFECTS UNDER DIFFERENT ELASTICITIES

Proposal	Static Estimate	Portion of New Revenue Retained After Incidence and Behavioral Effects		
		Elasticity = 0.0	Elasticity = 0.2	Elasticity = 0.5
Raise cap to cover 90 percent of earnings	\$1.00	\$0.80	\$0.52	\$0.10
Eliminate cap	\$1.00	\$0.76	\$0.46	\$0.00

Source: Jeffrey Liebman and Emmanuel Saez, "Earnings Responses to Increases in Payroll Taxes," September 2006, <http://elsa.berkeley.edu/~saez/liebman-saezSSA06.pdf> (accessed June 27, 2013).

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of Social Security's 75-year actuarial deficit and generate cash-flow surpluses until 2024. However, even conservative estimates of behavioral responses and incidence shifting suggest that net revenue gains from increasing or eliminating the payroll tax cap would be far less than 50 percent of static estimates, and stronger effects could actually reduce net tax revenues.²⁷

Conclusion

Social Security is an insolvent program that demands immediate reform—but raising the payroll tax cap should not be an option. Static revenue projections conceal the true impact of raising the Social Security payroll tax. What may seem like an easy way to improve the program's long-run finances would, instead, reduce incomes, slash non-

Social Security tax revenues, stimulate higher government spending, and do little to improve Social Security's solvency.

Policymakers need to reform Social Security now, curbing costs and returning the program to its original intent of preventing poverty in old age. Raising the payroll tax cap would increase costs, move the program further from its original goals, and hurt individual incomes, tax revenues, and economic growth in the process. Raising the cap is a lose-lose move.

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27. These estimates assume that the full reduction in net tax revenues resulting from an increase in the payroll tax cap is attributed to the Social Security program. Although Social Security's finances can be improved through a payroll tax hike, such a hike will cause a direct decline in other government finances, such as Medicare, and federal and state tax revenues. Thus, these revenue declines should be attributed to Social Security tax increases.