Center for American Progress

Restore Tax Fairness for Social Security's Solvency

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Progressive Ideas for a Strong, Just, and Free America

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Introduction

In 1983, a commission chaired by Alan Greenspan recommended a number of changes to Social Security. The changes enacted under President Reagan put Social Security on a sound footing for the subsequent decades. At that time, Social Security collected payroll taxes on 90 percent of wages and salaries. By 2004, this ratio had dropped to 84.9 percent as high-wage earners saw above average wage increases that led to more of their money moving beyond the cap above which earnings are no longer subject to Social Security taxation, currently $90,000. Thus, because a small number of high-wage earners have experienced above average wage growth, they effectively receive a hidden tax cut.

A closer look at the data shows:

- Rising earnings inequality accounts for half of Social Security's shortfall. That is, had earnings inequality remained the same since 1983, such that a constant share of wages and salaries – 90 percent – had been subject to Social Security taxation, Social Security's shortfall would be 47.7 percent smaller.

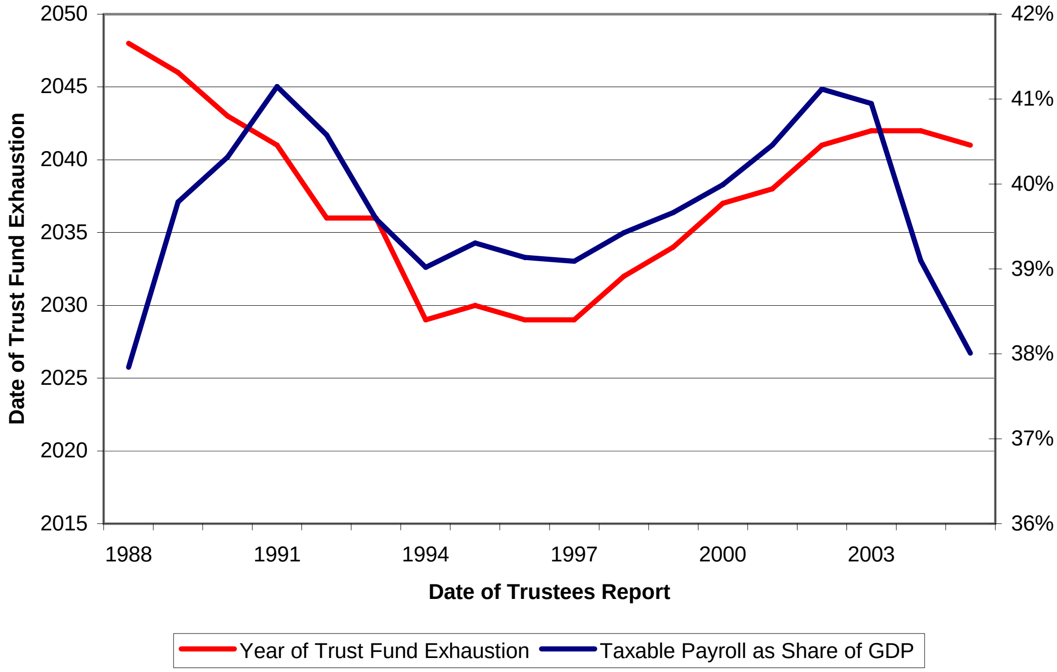
- If the cap is raised immediately, Social Security's solvency would improve markedly. An increase to 90 percent of wages and salaries would reduce Social Security's shortfall by 35.4 percent, while the complete elimination of the cap would make Social Security solvent for the next 75 years.

- Raising or eliminating the cap would restore tax fairness for Social Security. In 2002 – the last year for which data are available – 5.4 percent of taxpayers earned more than the Social Security cap. While the share of taxpayers with earnings above the cap has declined, the share of earnings above the cap has grown.

The Labor Market and Social Security

It is important to recognize that the performance of the labor market influences Social Security's future. For instance, from 2004 to 2005, the expected exhaustion date for Social Security's trust funds moved from 2042 to 2041 (SSA, 2005a). This partially resulted from a worse than expected labor market: wages grew by 1.2 percent instead of the expected 2.4 percent after inflation; employment growth was 1.1 percent instead of the forecast 1.7 percent; and wages as a share of total compensation (which includes other benefits such as health insurance) declined by 0.5 percent, rather than the projected 0.3 percent. Consequently, Social Security may receive fewer taxes than projected. For 2005, the trustees (SSA, 2005a) forecast that Social Security will receive $10 billion less in tax revenue than they predicted last year. This is nothing new. Social Security's outlook has typically followed changes in the share of wages and salaries relative to the economy that are subject to Social Security taxes (figure 1).

Figure 1: Taxable Payroll and Trust Fund Exhaustion Date

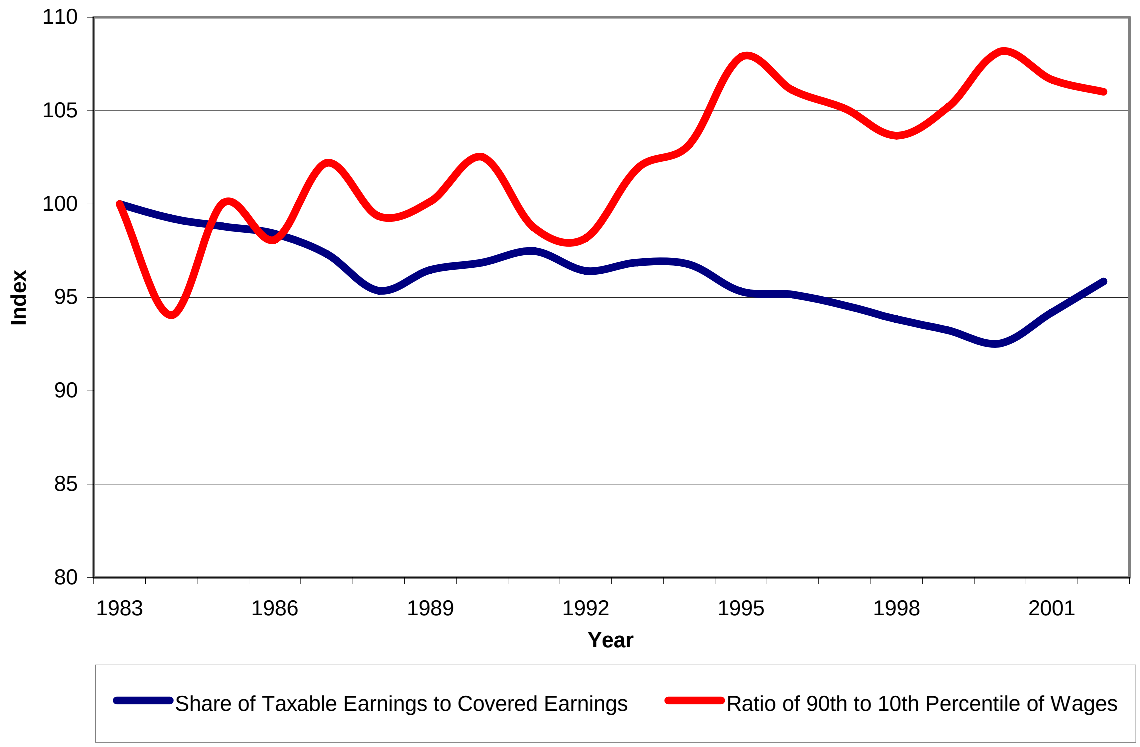


Sources: Social Security Administration, Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, various years, Washington, D.C.: SSA.

The role earnings inequality has played in Social Security finances is often overlooked in this discussion. In the last twenty years, high-income earners have seen much faster wage and salary increases than lower-income workers. However, Social Security taxes apply only to incomes below a specified cap. Because this cap grows each year with average wages, an ever growing share of salaries and wages of high-income earners is not subject to taxation. That is, we pay the price for rising earnings inequality with a smaller tax base for Social Security (figure 2).[1] From 1983 to 2004, the share of salary and wages that was subject to taxation dropped from 90.0 percent to 84.9 percent. This is a creeping tax cut for high-income earners, whose earnings rise faster than those of other workers.

[1] It is worth noting that this only captures one aspect of rising earnings inequality: higher incomes growing above average. If low earnings are growing below average, benefit levels are disproportionately rising relative to contributions. This effect is not captured here. Thus, the results presented here are only a lower bound estimate for the effects of rising earnings inequality on Social Security solvency.

Figure 2: Earnings Inequality and Social Security's Taxable Wage Share

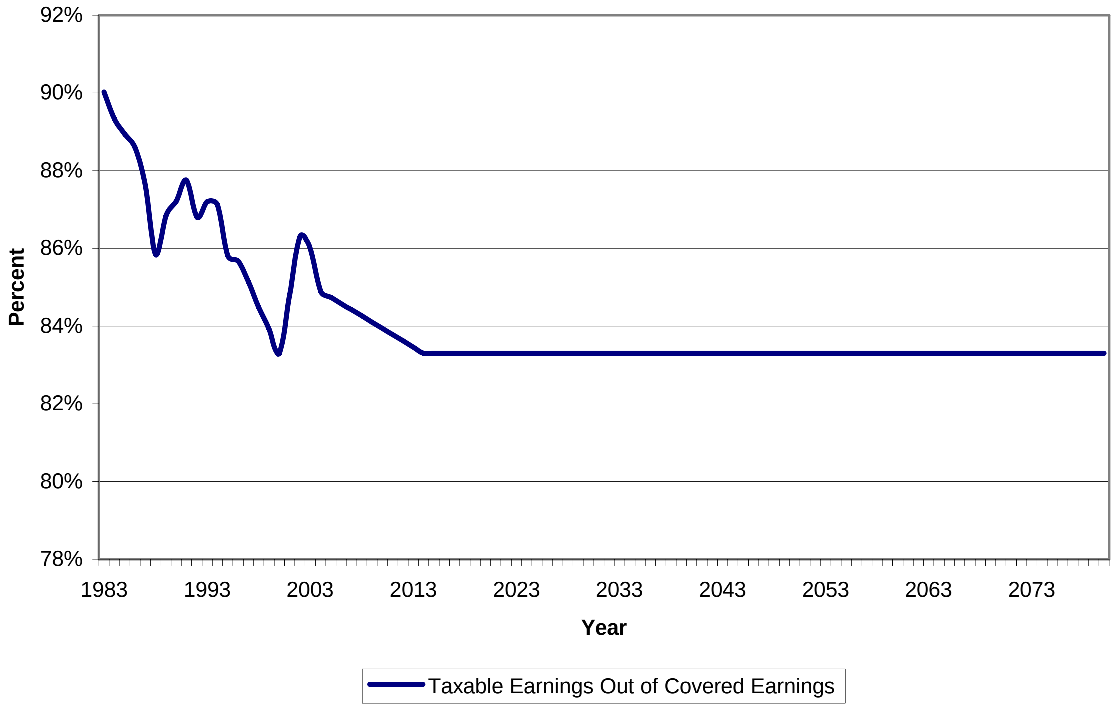


Notes: Both series indexed to 1983. Sources are SSA (2005b), CEPR (2004), and author's calculations.

Social Security's Solvency Improves When Higher Earners Pay Their Fair Share

If Social Security had continued to collect taxes on 90 percent of wages and salaries, its long-term outlook would have been significantly better. The share of salaries and wages that were taxed by Social Security taxation declined from 90.0 percent in 1983 to 84.9 percent in 2004. The Social Security trustees project that it will further decline to 83.3 percent over the next ten years (figure 3). At that time, Social Security would collect taxes on wages and salaries as share of GDP that are 6.7 percentage points lower than at the time of the last major Social Security reform. One reasonable policy response would be to raise or even eliminate the cap. For instance, restoring the cap, such that at least 90 percent of wages and salaries are subject to Social Security taxation, would bring, at a minimum, Social Security's finances back to where they were in the early 1980s.

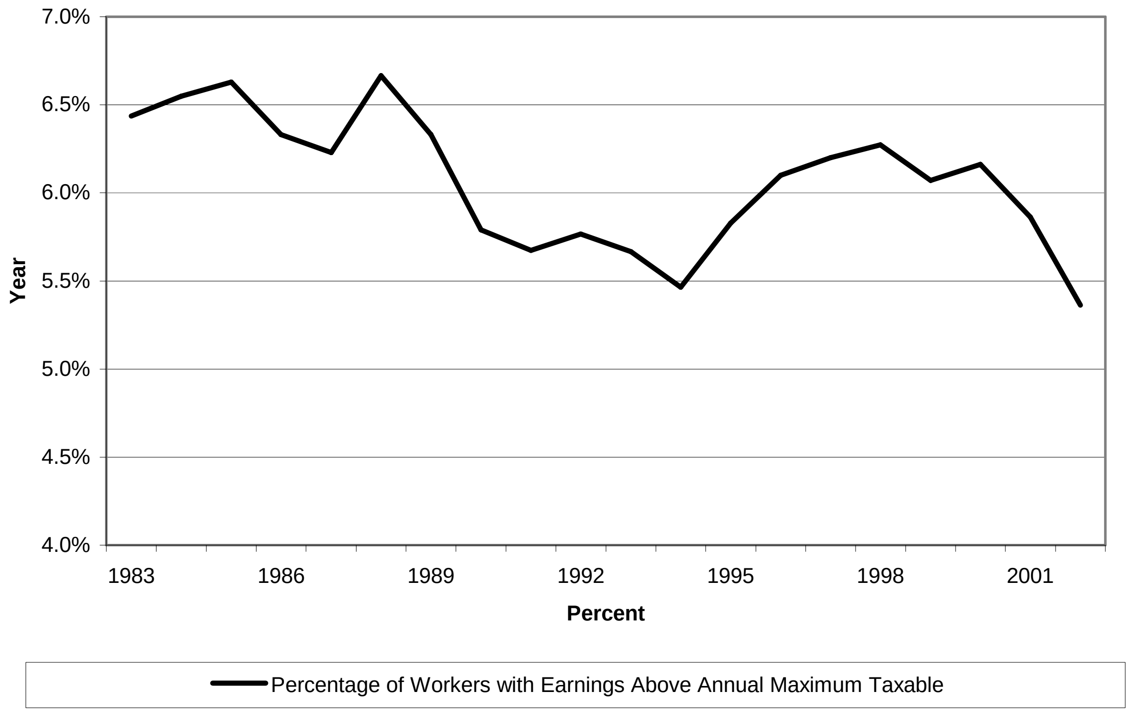
Figure 3: Taxable Earnings out of Covered Earnings



Sources: SSA (2005a, 2005b).

As the cap stands currently, the 94.6 percent of workers, whose wages and salaries fall below the cap – currently $90,000 – pay Social Security taxes on all of their earnings. At the same time, 5.4 percent of taxpayers – the richest taxpayers – elude taxation, down from 6.5 percent in 1983 (figure 4). Higher-income earners have essentially enjoyed a growing break from paying Social Security taxes because their wages and salaries have risen faster than those of the average American worker. This violates basic tax fairness.

Figure 4: Percentage of Workers with Earnings Above Annual Maximum Taxable

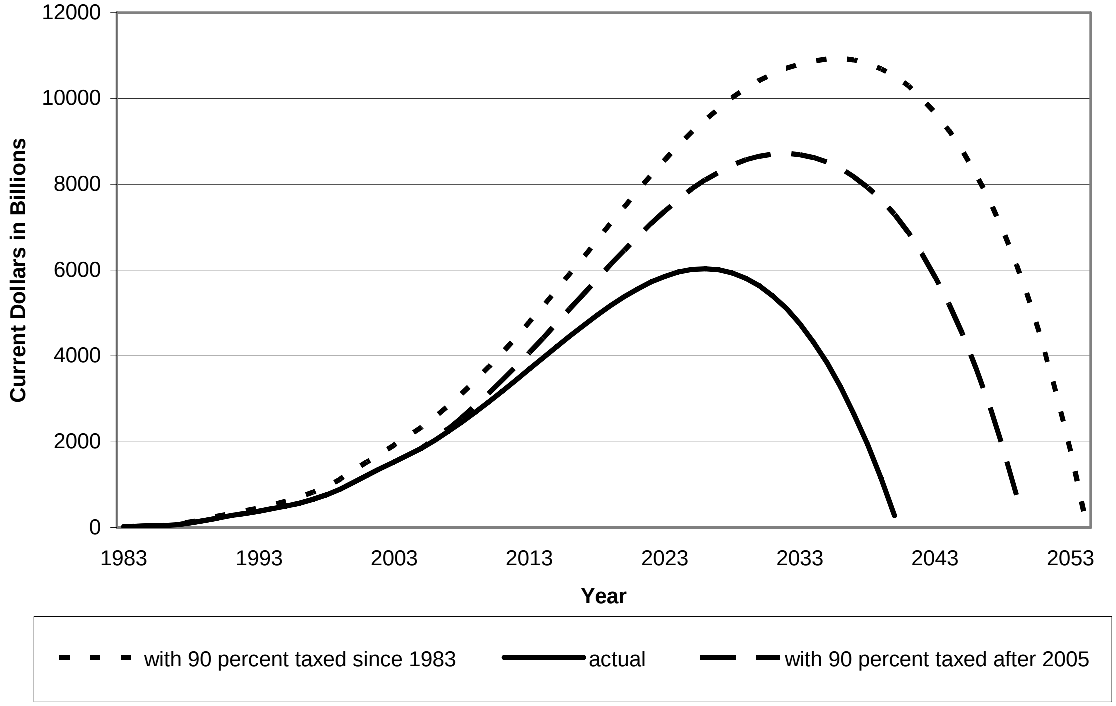


Source: SSA (2005b) and author's calculations

The policy solutions to address the shrinking ratio of wages and salaries subject to the payroll tax should be to raise or eliminate the cap. As a starting point, the cap could be restored to the same level of salaries and wages that was taxed in 1983. Consider what would have happened to Social Security's finances if 90 percent of wages and salaries were continuously subject to taxation. Although some of this money would go immediately to pay higher benefits,[2] Social Security would receive more income and face an exhaustion date in 2054. If this policy is put in place in 2006, the trust would be solvent until 2049 (figure 5). Moreover, after the trust funds are exhausted, Social Security would still receive more income to pay benefits than is currently the case.

[2] It is assumed that 15 percent of the additional income is used to pay for higher benefits since this is the actual replacement rate for the dollar amounts at or above the cap. This likely overstates the actual increase in benefit payments since some time will pass before additional earnings translate into additional benefits.

Figure 5: Trust Fund Balances, with Different Shares of Covered Earnings Taxed



Sources: SSA (2005) and author's calculations.

The impact of raising the cap on Social Security's finances is substantial. If 90 percent of salary and wages had been taxed since 1983 and if this continued into the future, Social Security would see a reduction in its expected shortfall for the next 75 years of 47.7 percent (table 1). If this policy is enacted in 2006, Social Security's shortfall will be reduced by 35.4 percent. In the same vein, if the share had been raised to 95 percent since 1983, the expected shortfall would be reduced by 91.2 percent. For the period after 2005, this would reduce the shortfall by 65.3 percent.

By eliminating the cap, every wage and salary earner would contribute his or her fair share for Social Security's future, and the expected shortfall for the next 75 years would essentially vanish. If the cap were eliminated after 2005, the projected shortfall would shrink by 93.8 percent – practically erasing the shortfall over the 75-year horizon.[3] That is, Social Security would become solvent for the next 75 years if all wages and salaries were subject to Social Security taxation in the future, as is already the case for Medicare.

[3] The tax plan proposed by the Center for American Progress proposes to eliminate the cap, but it also proposes to reduce the combined payroll tax rate by half (CAP, 2005).

Table 1
Reductions in Expected Social Security Shortfalls with Different Shares of Covered Earnings Subject to Social Security Taxation

Share of covered earnings subject to tax	In place since 1983	In place after 2005
90 percent	47.6%	35.4%
95 percent	91.2%	65.3%
100 percent	100.0%	93.8%

Sources: SSA (2004, 2005) and author's calculations.

It is occasionally argued that many people making more than $90,000 per year are really middle-class wage earners and that restoring the cap would unduly burden many middle-class families. While many people making more than $90,000 per year are facing financial obstacles due to high costs for homes, cars, health care, education and so on, there cannot be any doubt that they earn well above what one would consider typical middle-class incomes. In 2003, the median earnings for a worker – meaning 50 percent earned less than that – was $26,911. Not surprisingly, in the past few years, less than 6 percent of wage earners and the self-employed had earnings above Social Security's cap (SSA, 2005b). In fact, the share of workers earning wages and salaries above the cap has declined from more than 6.5 percent in the 1980s to 5.4 percent in 2002 – the last year for which data are available.

The other argument brought forth in opposition to restoring the cap is that it would hurt employment and growth by supposedly reducing the incentive to save. According to estimates by the conservative Heritage Foundation (Hederman et al., 2005), a complete removal of the cap would have a cumulative employment effect of 0.7 percent fewer jobs and 0.6 percent less gross domestic product (GDP) after 10 years.

Notwithstanding that these already small figures would be much smaller if the cap was restored to its previous levels and not eliminated, this research has little to stand on. For one, it assumes that the tax increases are spread out across all taxpayers and not just over the 5.4 percent of individuals earning more than $90,000. Because the effect would be limited to a small share of taxpayers, the employment effects would likely be much smaller than estimated.

Second, the argument assumes that high-income earners will react in the same way as everybody else in terms of saving less when the cap is increased. However, higher income earners have more flexibility in their discretionary income and would be less likely to reduce their savings than the population at large. Consequently, there would be a smaller reduction and fewer economic effects than asserted by this research.

Finally, this research vastly understates the offsetting effects from substantially lower budget deficits. The government would immediately see its deficits turn into surpluses. This change would mean a reduction in the deficit by 3.8 percentage points relative to GDP in the first year after the cap has been eliminated. According to estimates from the Federal Reserve, this should lower long-term interest rates by 0.9 percentage points (Laubach, 2003). Instead, the model shows a much smaller reduction of the interest rate, 0.1 percentage points. However, substantially lower interest rates would foster faster growth and more employment. That is, the already small economic effects shown by this research could easily turn into positive economic and employment gains.

Conclusion

Part of Social Security's long-term financial shortfall stems from the fact that not all wages and salaries are subject to Social Security taxation. As a consequence, an ever growing share of high-income earnings has moved beyond the cap. Thus, policymakers should focus on restoring fiscal fairness, which would also improve Social Security's long-term solvency. Either the cap should be raised, such that at least 90 percent of wages and salaries are again subject to Social Security taxation, as was the case at the time of the last Social Security reform in 1983, or the cap should be eliminated to completely erase Social Security's projected shortfall for the coming 75 years. Either policy solution would mean that those taxpayers who are in the best position to help Social Security's finances would pay their fair share for this important program's long-term future.

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