

Testimony of

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**Before the United States Senate  
Special Committee on Aging  
Hearing on:**

## **“Social Security: Keeping the Promise in the 21st Century”**

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## **Introduction**

The Social Security system has been the bedrock of retirement security for Americans for over a half century. Over the years, the system has undergone numerous changes, both large and small, in response to changing conditions.

As is well known, under current law, program outlays are expected to outpace revenue so that, in aggregate, the system faces a shortfall over the next 75 years. Some of this shortfall is due to well-known demographic changes, but some is due to policy choices that have let the system continue as is without making adjustments. For example, changes in trend income growth or productivity growth will impact taxable payrolls and thus Social Security revenue and outlays; hence policy changes may be needed if the goal is to restore balance.

## **Restoring balance**

Over the 75-year horizon used by the Social Security actuaries, outlays for benefits will exceed payroll tax revenue by about 2 percent of taxable payroll. Long-run balance within the system can be achieved in one or a combination of three ways: by reducing total benefits, by increasing revenue currently dedicated to Social Security, or by transferring general revenue (or linking new revenue sources) to Social Security.

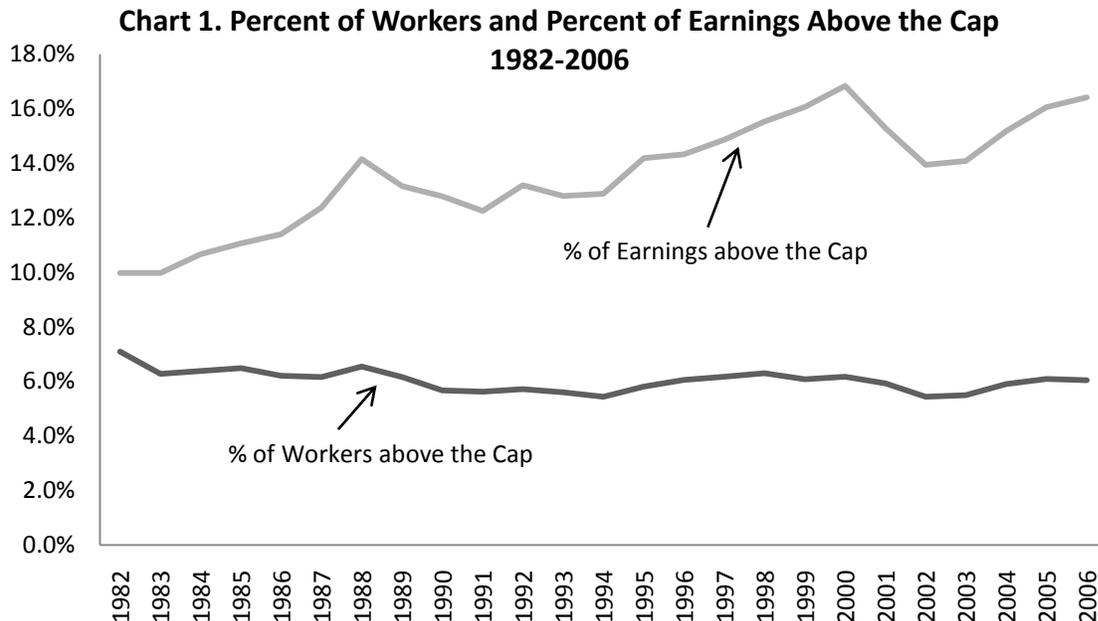
My testimony today will focus on the second of these two options – that is, I will focus on options to increase revenue from the currently existing payroll tax that would bring the overall system closer to long-run balance.

I say “closer to balance” because I do not believe that it is necessary to make changes today to fully close the projected gap. Current projections show a 75-year imbalance, but such estimates are inherently uncertain – and it is not unreasonable to assume that we may do better than the baseline forecast. A system of triggers could be implemented to create automatic adjustments if needed (see, for example, Diamond and Orszag, 2004).

However, having said that, acting sooner rather than later means that the final adjustment will be milder than if we delay. Responsible stewardship of the program would necessitate making feasible adjustments to move us in the right direction whenever warranted. Thus, proposals should not be dismissed just because they do not fully close the gap: incremental progress is still progress.

## **Payroll tax and income distribution: overview**

Social Security taxes are levied on payroll earning up to a maximum level that is adjusted each year to keep pace with average wages. In 2009, this payroll tax cap was set at \$106,800, and roughly 6 percent of the population has earnings above the cap, a share which has remained relatively stable over time (see Chart 1.)



Source: Author's calculations based on data from Social Security Administration, Annual Statistical Supplement, 2008.

The chart also shows that the percent of earnings above the cap has increased. This is a result of growing inequalities in incomes – those with incomes above the cap have seen a faster pace of growth than those with incomes below.

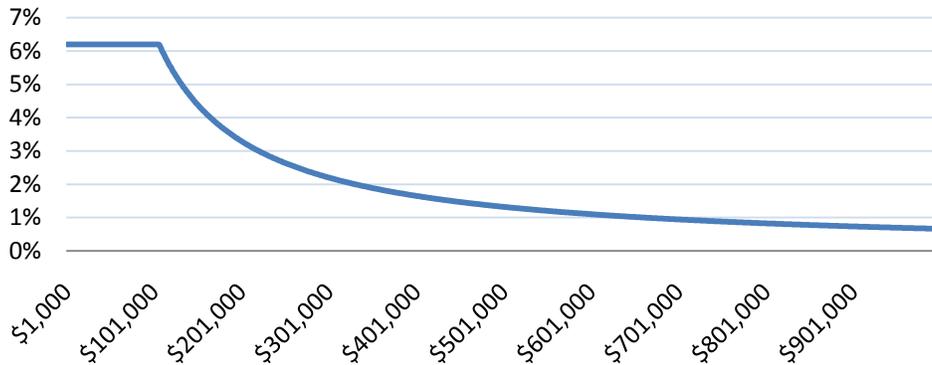
Unlike the income tax, the payroll tax is levied at a flat rate beginning with the first dollar earned and, above the cap, the marginal tax rate is zero. As a result of the design, lower-income taxpayers end up paying a greater percentage of their income when compared to upper-income individuals (see Chart 2). With a flat rate of 6.2 percent paid by employees and employers on their behalf, that means that earners in the second quintile (20-40%) and third quintile (40-60%) pay an average effective payroll taxes (including the Medicare portion) of 10.4 and 10.9 percent, respectively.<sup>1</sup> In contrast, the top 1 and 0.1 percent of earners pay respective average payroll taxes of 1.5 and 0.7 percent. The income tax, by contrast, contains personal exemptions and standard deductions, which lead to lower tax rates on the first dollar earned, and multiple tax brackets that lead higher income taxpayers to pay a greater percentage for higher income levels.

More concretely, workers making \$106,800 or less pay a flat 6.2 percent for Social Security on their earnings, as do their employers. Since the most employees and employers can each owe is \$6,622 (6.2

<sup>1</sup> The effective payroll tax rate includes both the employer and employee share of the tax, as well as the Medicare portion of the payroll tax.

percent x \$106,800), the tax rate for someone earning a million dollars per year and their employer is just 0.66 percent ( $\$6,622/\$1,000,000$ ), roughly one tenth the rate paid by most workers.

**Chart 2. Social Security Tax Paid as a Share of Earnings**



Also, since upper-income individuals receive more of their total income in the form of non-payroll income—such as capital gains—they see a total Social Security liability that can be much lower than average taxpayers. In 2005, those with income in the top 5 percent received 13.2 percent of their income in the form of capital gains. Those in the top 1 percent and 0.1 percent received 17.3 percent and 19.1 percent of their income from capital gains, respectively (Piketty and Saez, 2007). Since this income is not subject to payroll tax and is also subject to a lower federal income tax rate than earned income, many wealthy families owe a lower share of their overall income in taxes than many middle-class families.

Due to growing income inequality, the share of payroll income above the payroll tax cap has risen from 10.0 percent in 1982—after Congress instituted changes to put the system in balance—to approximately 16.4 percent in 2006.<sup>2</sup> This is because incomes have grown strongly at the top—28.5 percent real income growth over the past 20 years for the top quintile—while middle incomes have stagnated.<sup>3</sup>

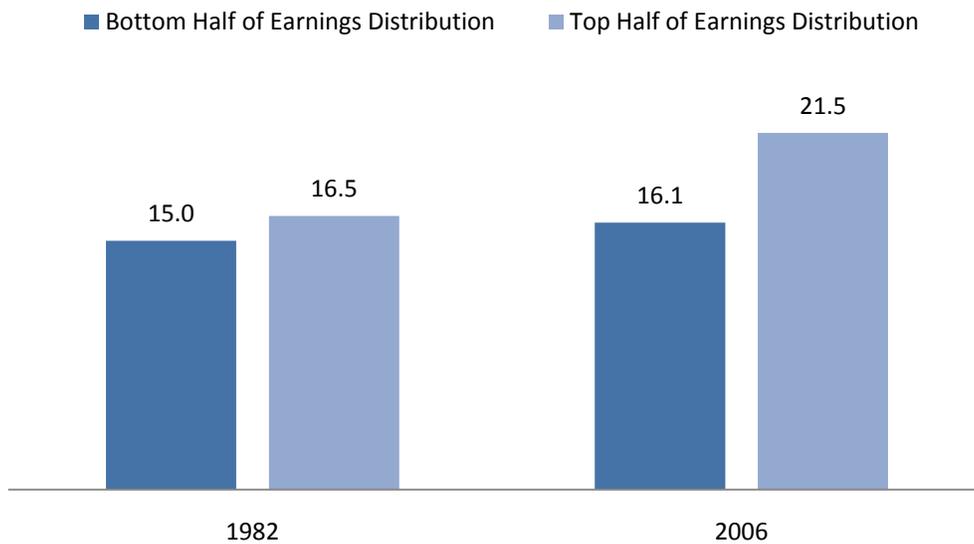
<sup>2</sup> The *total* share of earnings of workers who earn above the cap is almost twice as high (31.6 percent).

<sup>3</sup> In nominal terms, the average pay of workers earnings above the cap grew 281 percent from 1982 to 2006 (from \$51,482 to \$195,928), while the average pay of workers earning below the cap grew only 156 percent (from \$10,671 to \$27,266). If the cap had been eliminated in 1982, this would have had only a modest impact in the growth in after-tax pay for affected workers (pay would still have increased by 270 percent) (author’s calculations based on SSA 2008).

This trend is expected to continue, meaning that a growing share of payroll income will remain outside the tax base. This is happening at a time when federal income taxes have become less progressive as a result of tax cuts passed under the Bush Administration, which exacerbated the increase in income inequality.

Meanwhile, high earners are also capturing a growing share of Social Security retirement *benefits*, as life expectancy in retirement is growing faster among high-income than low-income earners (see Chart 3).

### Chart 3. Male life expectancy at age 65



Source: Waldron, 2007

### Options for additional payroll tax revenue

An increase in revenue would forestall Social Security benefit cuts at a time when other sources of retirement income and savings have eroded due to a shift from traditional pensions to defined contribution plans and a plunge in home and stock prices. Federal Reserve data show that households have lost over \$12 trillion dollars since 2007, and are now below 2004 levels (Federal Reserve, 2009).

There are several options for increasing revenue through the current payroll tax. They include: increasing rates across the board, raising or eliminating the cap on taxable payroll incomes, and expanding the taxable base beyond payrolls to include other forms of income.

An increase in revenue would also allow *expanded* Social Security benefits, as discussed by some of my co-panelists, in response to this unprecedented decline in retirement security.

This committee has no doubt already explored these and other options already. While all these options should be explored in connection with closing the gap and improving benefits, I will suggest that a high priority should be put on changes to the cap on earnings subject to the payroll tax.

According to the Social Security Administration, fully eliminating the cap on taxable earnings would be sufficient to close the projected Social Security shortfall over the next 75 years. This assumes benefits for high earners remain unchanged. If, instead, newly-taxed earnings above the taxable maximum were credited toward benefits, eliminating the cap would reduce the shortfall by 1.8 percent of taxable payroll, slightly less than the long-term shortfall projected by the Social Security trustees.<sup>4</sup>

Short of that, raising and indexing the cap to capture 90 percent of covered earnings, as it did when the system was last in long-term balance, would reduce the shortfall by about 0.8 percent of taxable payroll, or slightly less than half of the projected shortfall according to the Social Security trustees, if earnings above the cap were credited for benefit purposes.<sup>5</sup>

A third option would be to split the difference: eliminate the cap on earnings for employer contributions, and raise the cap to cover 90 percent of earnings for employee contributions. With earnings up to the employee cap credited for benefit purposes, this change would reduce the long-term shortfall by about 1.5 percentage points, or three-fourths of the gap as projected by the Social Security trustees, and more than enough to eliminate the gap as projected by the Congressional Budget Office.

There are several advantages to this last approach. It would eliminate most, and potentially all, of the shortfall, while maintaining a link between higher employee contributions and higher benefits. It would not lead to extremely large benefits for millionaires, which could be a concern if the cap were eliminated altogether and all earnings were credited for benefit calculations. Finally, self-employed taxpayers, who are responsible for both employer and employee contributions, would not face as large an increase in payroll taxes.

Further the tax would have at worst, a modest impact on the standard of living of upper-income taxpayers. The Joint Committee on Taxation estimated that a cap of \$186,000 would have captured 90 percent of covered earnings in 2008 (Roening and Mulvaney 2009). On the employees side of the tax,

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<sup>4</sup> However, the program would still be considered to be in long-term actuarial balance by many experts—more than sufficient, for example, to close the projected shortfall estimated by the Congressional Budget Office, which is less than 1.1 percent of taxable payroll (author's calculations based on Roening and Mulvey 2009, SSA 2009, and CBO 2008).

<sup>5</sup> This would close roughly three-fourths of the gap according to CBO. In 2005, EPI economist Josh Bivens estimated that nearly half of the projected long-term shortfall (0.9 percent of taxable payroll) could be attributed to the growing share of earnings above the cap. That is, he estimated that if the cap had continued to cover 90 percent of earnings from 1983-2005, as it did in 1982, the \$330 billion in additional revenues would cut 0.15 percent of taxable payroll from the 75-year deficit. If the cap was then indexed to cover 90 percent of earnings, this would have cut the deficit further by 0.75 percent of taxable payroll (Bivens 2005).

this would mean an increase in tax payments of, at most, 2.6 percent of income for those impacted. If current income growth for the top 5% of households continues to grow as it has for the past twenty years, and assuming that all 6.2 percent of the tax is passed on to employees, this additional tax obligation will be recouped by these households in less than 4 years.<sup>6</sup>

Even eliminating the cap altogether—as was done for Medicare in 1993—would have a fairly modest impact on affected taxpayers, who are at the very top of the earnings distribution. The Congressional Research Service has projected that fewer than 8 percent of taxpayers would face higher taxes in any given year. A higher share (21 percent) would face higher taxes at some point by 2035, but the median increase in lifetime tax payments would be only 3 percent. The majority (16 percent of beneficiaries, or three-fourths of those affected) would see their lifetime tax payments increase by less than 10 percent. (Roening and Mulvey 2009).<sup>7</sup>

Some will argue that an increase in the cap will create inefficiencies and cost jobs. Indeed, all else equal, I too would prefer to live in a world without taxes, but all else is not equal. If revenue is not generated by lifting the cap, it must be raised from other sources or benefits must be cut to bring the system into balance. The alternative is not “do nothing” but rather a comparison of alternatives. In particular, the revenue generated by lifting the cap is equivalent to increasing revenue by 2.2 percent of taxable payroll.

Affected taxpayers could also recoup some of these higher taxes in the form of higher benefits. Social Security retirement benefits are calculated using a formula based on average indexed monthly earnings (AIME).<sup>8</sup> For example, for someone with career earnings equal to twice the cap, annual benefits would increase from around \$30,000 to around \$45,000. In the aggregate, affected taxpayers would recoup around 17 percent of their higher taxes in the form of higher benefits if earnings above the current cap are included in benefit calculations (author’s calculations based on Roening and Mulvey 2009).

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<sup>6</sup> President Obama has suggested allowing the Bush tax cuts to expire for households earning \$250,000 or more, which along with the repeal of the cap on earnings subject to payroll taxes would increase the tax rate of these households by 10.8%. If current income growth for the top 5% of households continues to grow as it has for the past twenty years, and assuming that all of the tax is passed on to employees, this additional tax obligations will be recouped by these households in just 6.2 years.

<sup>7</sup> The impact on self-employed workers would be larger than the impact on wage and salary workers, because they are responsible for both the employer and employee contribution. This is one argument for retaining the cap (but indexing to cover 90 percent of earnings) for employer contributions. Regardless, most self-employed workers would not be affected, since only 5 percent had earnings above the cap in 2004, slightly lower than the share of wage and salary workers with earnings above the cap (6 percent). All told, just one in ten workers with earnings above the cap was self-employed (Roening and Mulvey 2009).

<sup>8</sup> For every \$100 in AIME above a certain threshold, monthly benefits increase by \$15.

## Conclusion

As policymakers, you have several options to bring the Social Security system into balance. If benefits are not reduced, then you must look at the revenue side of the ledger. While no one likes to raise taxes, raising the cap on the earnings subject to the payroll tax would, in my opinion, be a better option than raising tax rates across the board; thus, any policy to increase overall revenue through the payroll tax should have a higher cap as part of the equation.

In particular, raising the cap to cover 90 percent of all earnings and eliminating the cap on the employer side of the tax would close about 3/4 of the projected 75-year shortfall. This higher cap would impact just 6% of all employees—in contrast, an across the board hike which would impact everyone, with a disproportional impact on low- and moderate-income workers. For most of those that would face a higher rate with a higher cap, the impact would be minimal relative to their incomes, and would likely be more than offset by wage growth in just a few years.

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