



## Only 1% of Taxpayers Would Be Affected by Obama’s Proposal to Increase the Social Security Payroll Tax for the Rich

Presidential candidate Senator Barack Obama has proposed increasing the Social Security payroll tax on wealthy Americans to enhance the program’s solvency for years to come. While several commentators and politicians have suggested that this would burden the middle-class, only around 1 percent of taxpayers would actually be affected by this proposal.

Social Security is funded by a payroll tax of 12.4 percent on the first \$102,000 of each workers’s earnings. (This cap is increased each year to adjust for the growth in wages.) Half of this tax is nominally paid by the worker and the other half by the employer, but economists and analysts believe that the worker effectively pays the employer portion as well in the form of lower wages or benefits. The self-employed pay both portions directly.

In the past, some experts and lawmakers have suggested raising the cap or eliminating it altogether. Senator Obama’s idea differs in that he would only increase the Social Security tax for those whose earnings are above \$250,000. In other words, under Obama’s proposal any earnings above \$102,000 but below \$250,000 would continue to not be taxed as is the case today, but earnings above \$250,000 would be newly subject to the tax. This would create a “donut hole” in the portion of the federal payroll tax that funds Social Security.

If Senator Obama’s Social Security proposal had been in effect in 2007, only 1.1 percent of taxpayers would have been affected by it. As the table at the right illustrates, over 90 percent of the taxpayers affected belong to the richest one percent, while virtually no one in the poorest 95 percent is affected.

<b>Effects of Extending the 12.4% Social Security Payroll &amp; Self-Employment Tax to Earnings Above \$250,000 Per Earner (2007 levels)</b>						
Income group	Number with tax hike	% in group with tax hike	Total tax hike (\$-bill.)	Average tax hikes		
				On those affected	On all in group	% of total tax hike
Bottom 95%	—	—	\$ —	\$ —	\$ —	—
Next 4%	718,590	12.9%	5.2	7,197	931	9.5%
Top 1%	760,010	54.8%	49.1	64,608	35,388	90.5%
<b>ALL</b>	<b>1,478,600</b>	<b>1.1%</b>	<b>\$ 54.3</b>	<b>\$ 36,706</b>	<b>\$ 386</b>	<b>100.0%</b>
<b>Note:</b> The effective rate of the tax is less than 12.4% due to (a) pretax wages are expected to fall to reflect the employer share of the increased payroll tax; (b) the fact that only 92.65% of self-employment earnings are subject to tax; and (c) the fact that half of the self-employment tax is deductible in computing adjusted gross income. These factors lower the effective tax rate on affected earnings to 11.2%.						
<b>Source: ITEP Tax Model, July 2, 2008</b>						

Several points about these figures are striking:

- The payroll tax applies to individuals, not households. These figures assume that Obama does not alter this concept of the payroll tax, so that the \$250,000 threshold applies to each worker rather than each “tax unit” or tax-paying household. This means that two married workers can earn up to a combined \$500,000 before they are affected by the proposed payroll tax increase.
- Many high-income families would be unaffected by the payroll tax increase. This is because much of their income does not take the form of wages and salaries, but consists of capital gains, dividends, interest or other forms of investment income that are not subject to the payroll tax. Even among the richest one percent, almost half the families would avoid being affected by this increase in the payroll tax.
- In fact, only a fifth of all income of the richest one percent would be subject to the proposed payroll tax increase.
- The fact that so much income is not subject to the payroll tax for the richest 1 percent suggests that there could be a more efficient approach to raising revenue. For example, a tax could be implemented that covers a broader base (that affects more forms of income than just earnings) and could raise the same amount of revenue even with a lower rate. For an analysis of such a proposal, see CTJ’s previous report on this topic.<sup>1</sup>

### **Would Obama’s Social Security Tax Plan Go Even Further?**

Some commentators have suggested that Senator Obama may actually change the way Social Security is financed more fundamentally by applying a tax increase to total household income rather than individual earnings.<sup>2</sup> This would mean that the \$250,000 threshold would apply to all household income rather than individual earnings. Two married working people would be affected if their *combined* earnings exceeded \$250,000, or if the combination of their combined earnings and investment income exceeded that amount.

**Even among the richest one percent, almost half the families would avoid being affected by the proposed increase in the payroll tax.**

We estimate that in 2008, only 2.1 percent of taxpayers will have adjusted gross income (which includes forms of income that are potentially taxable) above \$250,000. **This means that even under this more expansive interpretation of Senator Obama’s Social Security plan, about 98 percent of taxpayers would not be affected.**

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<sup>1</sup>An Analysis of Eliminating the Cap on Earnings Subject to Social Security Payroll Taxes & Related Issues," Citizens for Tax Justice, November 30, 2006. <http://www.ctj.org/pdf/socialsecuritytaxearningscapnov2006.pdf>.

<sup>2</sup>“Obama’s Social Security Fine Print,” Donald L. Luskin, *Wall Street Journal*, June 25, 2008. <http://online.wsj.com/article/SB121435112024101581.html>

## **Thinking Through the Consequences of Changing the Payroll Tax**

Whether or not Congress and the next President alter the way Social Security is financed, it is worth thinking through the long-term consequences of such a change. One factor to consider is whether or not people perceive the program and the way it is financed to be fair.

Some believe that the reason Social Security enjoys widespread support today is that it is perceived to be a pension program rather than a “welfare” program. It is structured as a pension program, with benefits paid out related to the contributions paid in. But the relationship between benefits and contributions is attenuated by a feature of the program that makes it progressive. At retirement, low- and middle-income workers receive much higher annual Social Security retirement benefits relative to the taxes they paid than do better-off workers.<sup>3</sup> Social Security is therefore highly progressive, but it is probably still perceived as an earned benefit.

Legislation that increases contributions from the wealthy into Social Security could include increased benefits to the wealthy, but that would reduce the revenue and solvency gain obtained from the proposal. Some fear that increasing the taxes paid by the wealthy without increasing their benefits would further weaken the linkage between Social Security taxes paid and Social Security benefits received. Many argue that by doing so, the widespread public and political support for Social Security as an earned benefit could be endangered.

On the other hand, many perceive the current cap on wages covered by Social Security to be unfair. Senator Obama has made much of the fact that someone earning ten million dollars this year will not pay more towards Social Security than someone earning \$102,000 this year. The reality, of course, is that benefits are limited for people with very high incomes since they are based on contributions paid in, which are themselves limited. In other words, benefits are capped for the rich, just as contributions into the program are capped.

Making Social Security more progressive by increasing contributions into the program by wealthy Americans may be a worthy goal. But it is important to remember that the program is already both fair and progressive, providing an earned benefit but favoring those who most need a foundation for a secure retirement as well as insurance against disability or the loss of a family’s breadwinner. The debate over whether to change Social Security should be informed by facts. Claims that the Obama payroll tax proposal will directly harm the “middle-class” are inaccurate and do not help inform this debate.

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<sup>3</sup>Roughly speaking, for someone who retires this year, annual Social Security benefits equal 90% of the first \$7,300 in average annual taxable earnings over his or her career (adjusted for wage growth), 32% of the next \$36,900 and 15% of any taxable earnings above \$44,300. That translates into a wage replacement rate of 66% for low-income workers, 49% for average workers, and only 34% for those who paid the maximum tax throughout their working careers.