An Analysis of Eliminating the Cap on Earnings Subject to the Social Security Tax & Related Issues

Recently, there has been renewed interest in the idea of raising or eliminating the cap on earnings subject to the Social Security payroll tax and self-employment tax. This paper evaluates the effects of such a change and examines some of the issues it raises.

1. Current Law

Under current law, wages and other earnings are subject to a 12.4 percent tax, which is used to finance Social Security. This tax applies only to the first $97,500 in earnings (in 2007), a "cap" that is adjusted every year for the growth in average wages.[1] The Social Security tax on wages is nominally paid half by workers and half by employers. But the burden of the full tax is generally considered to fall on workers. For consistency, self-employed people must pay both the worker and employer sides of the tax.

Many have asked why we fund such a substantial part of our government's outlays with a tax that people stop paying once their earnings exceed $97,500. Indeed, looking at the Social Security tax in isolation, it does appear to be very regressive. As a share of workers' total income (including not only earnings, but other kinds of income), Social Security taxes are about 11 percent of income for those up to the earnings cap. But the tax falls off dramatically as a share of income above the cap — to 1 percent or less at the highest income levels.

Social Security Taxes As % of Total Income

Income	%
$0-10K	11.1%
$10-20K	10.8%
$20-30K	11.0%
$30-40K	11.2%
$40-50K	11.2%
$50-75K	11.3%
$75-100K	11.2%
$100-150K	10.3%
$150-200K	8.5%
$200-300K	6.4%
$300-400K	4.1%
$400-500K	3.3%
$500-750K	2.5%
$750K-1mill	1.9%
$1-2mill	1.2%
$2-5mill	0.6%
$5-10mill	0.3%
$10-20mill	0.1%
$20mill+	0.0%

For non-elderly couples and singles with taxable earnings.

Is this as unfair as it looks at first blush? The designers of the Social Security system, led by President Franklin D. Roosevelt, certainly didn't think so. Of course, in 1937, when Social Security was first established, things were quite different. Back then, most people paid no personal income tax at all, while the top income tax rate on the extremely wealthy was a whopping 78 percent. Meanwhile, the Social Security tax rate was only 2 percent (1 percent each on workers and employers). Such a small tax, in the context of very high income tax rates on the wealthy, did not significantly reduce the overall progressivity of the federal tax system.

More important and still relevant today is that Social Security was purposely conceived not as just another government spending program funded by general tax revenues, but as a national pension plan. People pay their taxes — or "contributions" as they're officially called — into the Social Security system during their working years, and when they retire, their benefits are based on the amount they put in. To be sure, this linkage is hardly exact. At retirement, low- and middle-income workers receive much higher annual Social Security

[1] A separate 2.9 percent earnings tax is used to finance the Medicare system. This tax used to be capped at the same earnings level as the Social Security tax, but since 1993 the Medicare tax has applied to all earnings.

retirement benefits relative to the taxes they paid than do better-off workers.[2] So, looked at as a pension plan, Social Security isn't regressive at all. Instead, it's highly progressive.

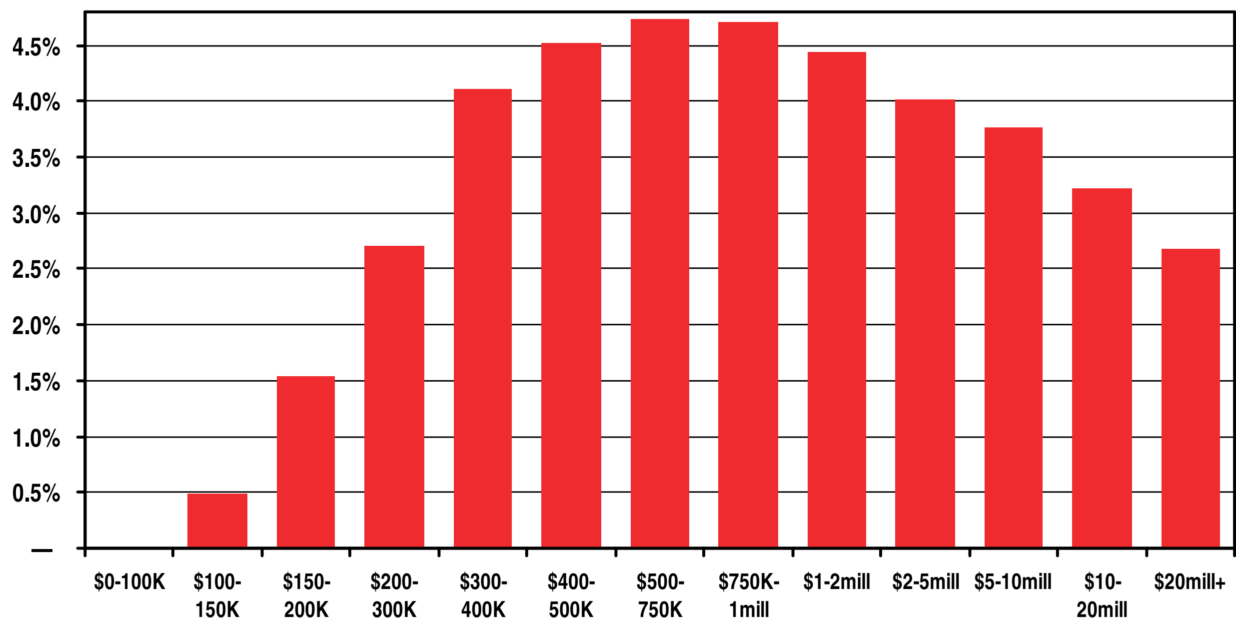
2. Proposals for Change

It is occasionally suggested that the earnings cap on the Social Security tax be increased or eliminated, as a way to address Social Security's long-term financial problems. For example, eliminating the cap entirely would increase Social Security revenues by $124 billion a year (at 2007 levels) — 19 percent above current Social Security tax receipts. That would be enough to keep Social Security solvent (on paper) into the far distant future.

3. Distributional effects of Eliminating the Earnings Cap

As noted above, the Social Security tax already fully applies to earnings up to roughly $100,000 a year per worker. (A two-earner married couple can owe Social Security tax on almost $200,000 in earnings.) As a result, raising or eliminating the earnings cap would increase taxes on only 6.5 percent of couples and individuals, virtually all of whom make more than $100,000 a year.

The following chart shows the effects of eliminating the earnings cap as shares of total income for individuals and couples in various income groups. For the 86 percent making less than $100,000 there would be no tax increase. The effects of eliminating the earnings cap then rise gradually, peaking at 4.7 percent of total income for those making between $500,000 and $1 million. At very high income levels, the tax hike declines as a share of



[2]Roughly speaking, for someone who retires this year, annual Social Security benefits equal 90% of the first $7,100 in average annual taxable earnings over his or her career (adjusted for wage growth), 32% of the next $35,700 and 15% of any taxable earnings above $42,800. 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.

income, because so much of the income of the wealthy — such as interest, dividends and capital gains — is not subject to the earnings tax.

Even so, more than a third of the total tax increase from eliminating the earnings cap would be paid by the 0.3 percent who make more than $1 million a year, and more than half of it would be paid by the 0.8 percent who make more than $500,000 a year.

4. Issues in Raising or Eliminating the Earnings Cap

a. Effects on Social Security benefits. If the earnings cap on the Social Security tax were raised or eliminated, one would have to address the effects, if any, on future Social Security retirement benefits for those paying the higher taxes.

- One possibility would be to maintain the current benefit formula. This approach would increase annual retirement benefits for those paying the higher tax (by about 15 percent of average annual earnings above the old cap). The cost of these higher benefits would reduce the net long-term gain to the Social Security trust fund. But because the existing benefit formula is so progressive, the trust fund would still end up well ahead of its current situation.
- Another possibility would be to deny any increase in benefits to those paying higher Social Security taxes, despite their higher "contributions" to the system.
- Or there could be a middle ground, that increases benefits for those paying higher taxes, but by a lesser amount than the current formula.

One potentially big problem with any of these approaches is that they 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.

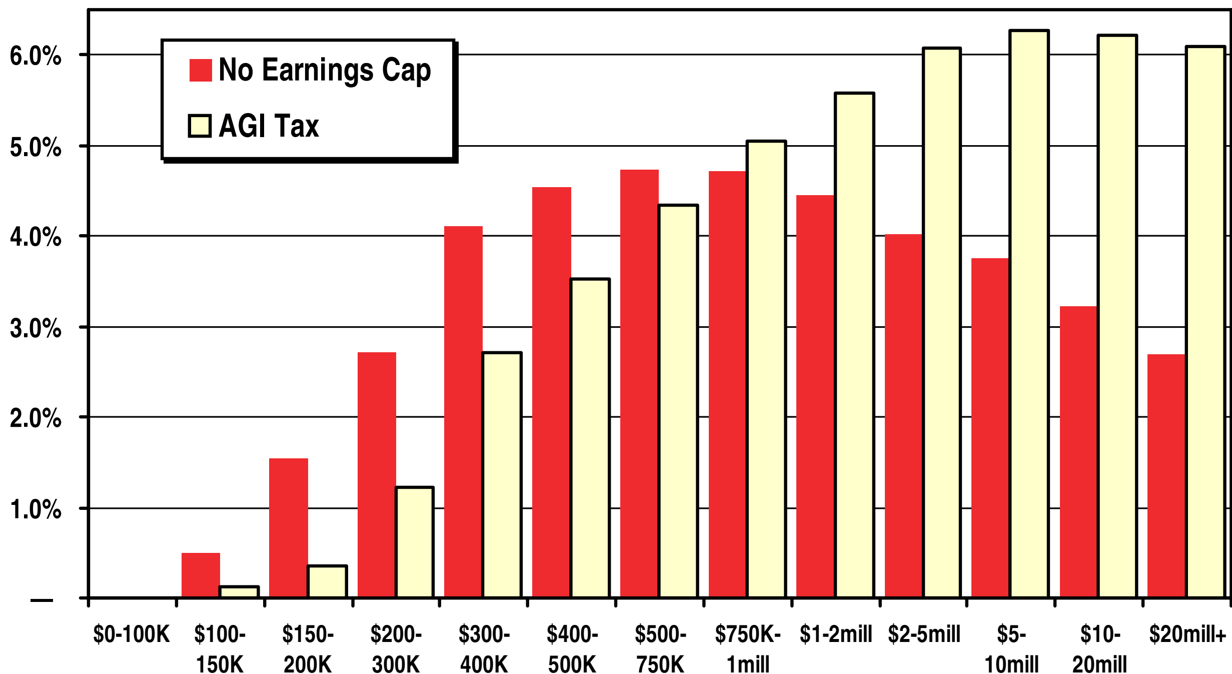
b. Better options? If the goal of increasing or eliminating the Social Security earnings cap is to deal with Social Security's long-term financial problems in a progressive way, then one might ask why the tax increase should be limited solely to earnings. If instead, the tax base were expanded to include other forms of income besides earnings, then the tax rate could be considerably lower. Moreover, such an approach would avoid the pitfall of further expanding the already wide gap between (relatively high) taxes on earnings and (relatively low) taxes on investment income.

One possible broader tax base would be adjusted gross income (AGI) reported on tax returns. We calculate that an 8.2 percent tax on AGI above $100,000 ($200,000 for couples) would raise the same amount as eliminating the Social Security earnings cap.[3] Under such an approach:

- The 8.2 percent tax rate on AGI would be a third lower than the 12.4 percent Social Security tax rate on earnings only.

[3]This "AGI tax" would apply only to amounts in excess of the starting points (which would go up each year like the earnings cap). Thus, an individual with AGI of $101,000 would be taxed on $1,000, and the 8.2% tax would be $82.

- Such an AGI tax would be paid by only 4.3 percent of all couples and individuals (because of the higher starting point for couples), compared to the 6.5 percent who would pay higher taxes from eliminating the Social Security earnings cap.
- Rather than declining at very high income levels, the AGI tax would remain progressive into the highest income groups.
- The tax increases would be much smaller for most of the people who are affected.
- Three-fifths of the tax hike would be paid by those who make more than $1 million a year, and fourth-fifths by those who make more than $500,000.
- Unlike an earnings-only tax, the AGI tax would fall on high-income retirees as well as workers. One can debate whether this is an advantage or a flaw.



c. Uses of the additional revenues. If Social Security taxes are increased, by whatever means, then a key question remains: How can we assure that the additional revenues will be reserved to pay future Social Security benefits? In this regard, the historical record is not encouraging.

Prior to 1983, Social Security was run on a pay-as-you-go basis, with virtually all the money raised in payroll taxes used to pay current benefits. At that time, the Social Security Trust Fund was insignificant. Phased-in tax increases enacted in 1977 and benefit cuts adopted in 1983, however, changed the system so that taxes would substantially exceed benefit payments for a very long time.[4] The theory was that if the rest of the government behaved itself by balancing its revenues and outlays, then the surpluses in Social Security could be

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[4]The 1977 tax increases, which were fully phased in by 1990, increased Social Security tax revenues by 30 percent. The 1983 benefit reductions will cut retirement benefits by almost as much (these cuts are still being phased in).

used to pay down the national debt. Then, when the baby boomer generation retired, the government would be able to fulfill its obligations to retirees more easily, because it would not be paying large amounts in interest on the debt.

Unfortunately, this promise was immediately broken. President Reagan and the first President Bush both spent every penny of the growing Social Security surpluses on tax cuts and other government programs. Only at the end of the 1990s, under President Clinton, did our government finally begin to save the Social Security surpluses as it had promised. But that achievement was short-lived, as the second President Bush quickly reverted to the policies of his father and President Reagan.

For the past five years, not a penny of the annual surpluses in the Social Security trust fund has been saved to help pay for future benefits. Instead, all of the surpluses have been spent to pay for other government activities such as the war in Iraq and upper-income tax cuts. In other words, we have been funding a substantial portion of our regular government through a capped tax that exempts most of the income of the rich.

To be sure, Social Security is supposed to be walled off from the rest of the federal budget, with its surpluses treated as “off-budget” in the technical lingo. But that supposed wall has been routinely ignored. For example, when President Bush bragged that he had “cut” the fiscal 2006 budget deficit to a mere $248 billion (from the budget surplus he inherited), he failed to mention that he had also borrowed and spent another $186 billion from Social Security. The actual “on-budget” deficit in 2006 was $434 billion.

Is it foolish to think that we can trust our politicians to use the excess of Social Security’s revenues over outlays for its intended purpose? The late Senator Daniel Patrick Moynihan (D-NY), one of the architects of the decision to build up the Social Security Trust Fund, eventually reached that conclusion. In the early 1990s, Moynihan became so frustrated with the failure to live up to the promise to save Social Security’s surpluses for the future that he called for stopping the build-up of the trust fund, cutting payroll taxes and raising progressive income taxes to make up the shortfall in the regular budget. Moynihan argued for returning Social Security to a pay-as-you-go system, with higher taxes assessed only when Social Security actually needs more money to pay benefits.

Moynihan’s idea may or may not be too radical. But continued spending of Social Security’s surpluses rather than saving them to pay future benefits is an even more radical attack on both tax fairness and the future of the Social Security program.

5. Conclusion

Social Security has been such a successful and popular program for so long because it is widely perceived as a universal, contributory national pension plan, albeit one that is far more progressive in its overall effects than any private plan. Policymakers should worry about undermining public support for the program if they move too far away from the pension paradigm, whether by excessively attenuating the linkage between contributions and benefits or by continuing to spend rather than save the Social Security surpluses that are supposed to be reserved to pay future benefits.

Additional Tables

Effects of Eliminating the Social Security Earnings Cap vs. an 8.2% Tax on AGI in excess of $200K ($100K for singles) As Shares of Total Income for All Couples and Individuals					
2007 Income Group	**Social Security Tax Now**	**Change from no Earnings Cap**	**Revised Total Tax**	**Change from AGI Tax**	**Revised Total Tax**
$0-10K	**6.8%**	—	**6.8%**	—	**6.8%**
$10-20K	**6.2%**	—	**6.2%**	—	**6.2%**
$20-30K	**7.8%**	—	**7.8%**	—	**7.8%**
$30-40K	**8.7%**	—	**8.7%**	—	**8.7%**
$40-50K	**9.0%**	—	**9.0%**	—	**9.0%**
$50-75K	**9.4%**	—	**9.4%**	—	**9.4%**
$75-100K	**9.7%**	+0.0%	**9.7%**	—	**9.7%**
$100-150K	**9.1%**	+0.5%	**9.6%**	+0.1%	**9.3%**
$150-200K	**7.6%**	+1.5%	**9.1%**	+0.4%	**7.9%**
$200-300K	**5.6%**	+2.7%	**8.3%**	+1.2%	**6.8%**
$300-400K	**3.6%**	+4.1%	**7.7%**	+2.7%	**6.3%**
$400-500K	**2.8%**	+4.5%	**7.4%**	+3.5%	**6.4%**
$500-750K	**2.2%**	+4.7%	**6.9%**	+4.3%	**6.5%**
$750K-1mill	**1.7%**	+4.7%	**6.4%**	+5.0%	**6.7%**
$1-2mill	**1.0%**	+4.4%	**5.5%**	+5.6%	**6.6%**
$2-5mill	**0.5%**	+4.0%	**4.5%**	+6.1%	**6.6%**
$5-10mill	**0.2%**	+3.8%	**4.0%**	+6.3%	**6.5%**
$10-20mill	**0.1%**	+3.2%	**3.3%**	+6.2%	**6.3%**
$20mill+	**0.0%**	+2.7%	**2.7%**	+6.1%	**6.1%**
ALL	**6.8%**	**+1.3%**	**8.2%**	**+1.3%**	**8.2%**

Note: Unlike the table on page 1, this table includes all couples and individuals, including those who pay no Social Security tax now because they have no taxable earnings.

Shares of the total tax increase by income group in 2007

Income group	**No earnings cap**	**AGI tax**
<$100K	—	—
$100-500K	44%	21%
$500K-$1mill	19%	18%
$1mill+	37%	61%
Total	**100%**	**100%**