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RSC Policy Brief:
The Consequences of Repealing the Social Security Wage Cap

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"We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions and their unemployment benefits."

-President Franklin D. Roosevelt

"You and your employer will each pay three cents on each dollar you earn, up to $3,000 a year. That is the most you will ever have to pay…"

-Early Social Security Pamphlet[1]

Background: According to the Social Security Trustees, the Social Security Trust Fund has unfunded liabilities over the next 75 years of $4.3 trillion. In the nearer term, Social Security spending is projected to increase from 4.3% of GDP in 2007 to 6.1% of GDP in 2035. The Social Security program is funded by a 12.4% payroll tax, 6.2% on the employee and 6.2% on the employer. In 2008, the Social Security payroll tax applies to the first $102,000 of an employee's income. This $102,000 threshold, beyond which wages are not subject to the Social Security payroll tax, is the Social Security wage cap. Some Democrats, as a means to address Social Security's financial troubles, advocate raising or completely eliminating the Social Security wage cap. The purpose of this policy brief is to analyze these proposals.

History of the Social Security Wage Cap: The cap on earnings subject to the Social Security tax was included in the Social Security Act of 1935. During the first thirteen years of Social Security's existence (1937-1949), a 2 percent tax (1% on employer, 1% on employee) applied to the first $3,000 of income. From the 1950s to the early 1970s, the cap was increased by statute on an irregular basis. In 1972, President Nixon signed into law legislation that increased Social Security benefits, provided an annual COLA, and indexed the Social Security wage cap to wage growth. In 1977, the cap was increased by another $7,500. In every year since 1982, the cap has increased in line with wage growth, and under current law, it will continue to do so.

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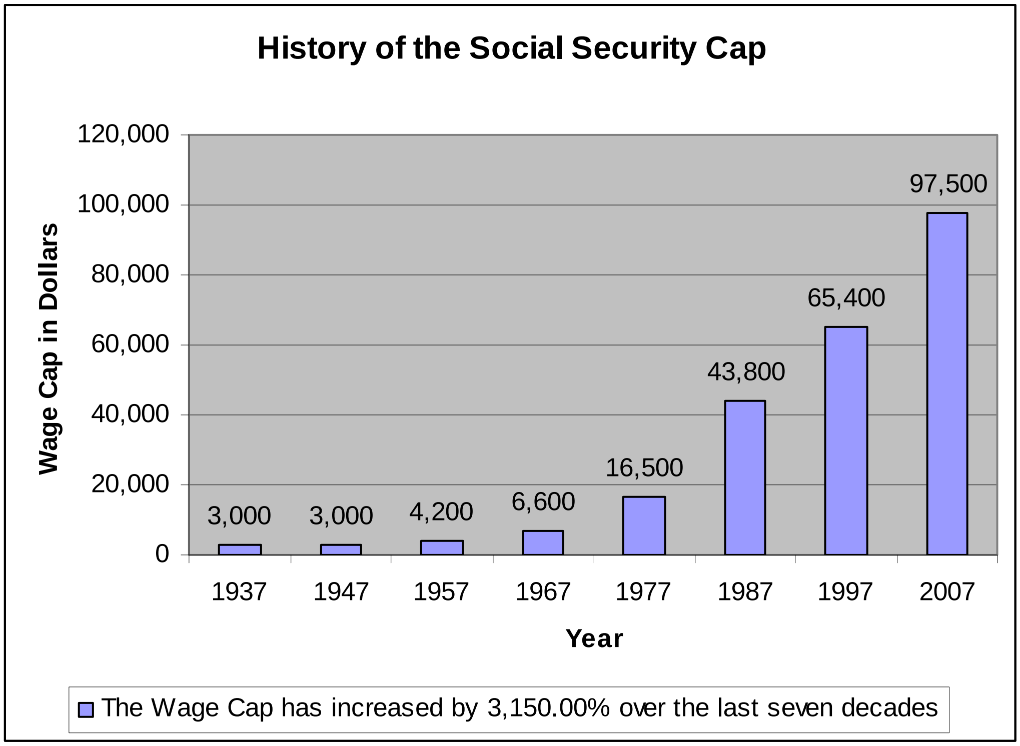
[1] Amity Shlaes, "Fixing Social Security the FDR Way," *Washington Post* November 26, 2007, available online at http://www.washingtonpost.com/wp-dyn/content/article/2007/11/25/AR2007112501545.html (accessed June 30, 2008).

As shown by the chart below, in the seven decades since 1937, the cap on wages subject to the Social Security tax has increased by 3,150.0%, increasing from $3,000 in 1937 to $97,500 in 2007.

Figure 1: Social Security Wage Cap by Decade



It is worth noting that many provisions in the tax code, which limit tax liability, do not increase automatically with wage growth. For example, income tax brackets do not increase in line with wage growth, but instead with inflation, which is usually lower than wage growth. Other provisions in the tax code that limit tax liability (such as the AMT exemption and the child tax credit) are only adjusted by an act of Congress. Even as currently constructed, the automatic adjustment of the wage cap to wage growth will cause the federal tax burden to increase.

Proponents of increasing or eliminating the cap on wages subject to the Social Security tax note that the percentage of wages subject to this tax has fallen from 90% in 1982, to 85% in 2005, to a projected 83% in 2014. However, this reflects a substantially larger earnings base than any other period since the creation of Social Security. For example, in every year between 1950 and 1974, the wage cap caused earnings subject to the Social Security tax to fall within a range of 71.3% and 81.8%.

<u>Rationale for the Social Security Wage Cap:</u> The Social Security wage cap has always been a feature of the Social Security system for two reasons. First, the Social Security program is intended to have some correlation between what an individual pays into the system and the value of the benefit that the individual receives. As CRS notes:

> "[H]aving different bases for contributions and benefits would weaken the traditional link between the taxes workers pay into the system and the benefits they receive."

Eliminating the cap (assuming no proportionate increase in benefits) would repeal the link between taxes paid into the system and benefits received for the projected 21% of Americans that, according to CRS, will have wages in excess of the current wage cap at some point in their careers. This would cause Social Security to come closer to resembling a redistributive welfare program instead of an earned entitlement program.

This is in contrast to some conservative reform proposals such as the Growing Real Ownership for Workers Act of 2005 (H.R. 3308 from the 109th Congress), which would have dedicated the Social Security surplus to voluntary, personal accounts. Personal accounts, by their very nature, have the effect of strengthening the relationship between tax contributions and benefits received.

Second, the only way to raise or eliminate the cap on Social Security taxes, while still maintaining the link between taxes paid and benefits received, is to pay much higher benefits to higher-income individuals. According to CRS, under such a policy, someone who has lifetime earnings of $1,000,000 a year would receive $162,000 a year in Social Security benefits. Such a policy would create the perverse result of giving wealthier seniors Social Security benefits that would in some cases be more than ten times larger than the current average benefit, and this extra money would come from a Social Security Trust Fund that—even with the new revenue—would still have structural financial problems.

The U.S. is not alone in having a wage cap on taxes that fund public pensions. In fact, Andrew Briggs of AEI points out that the U.S. wage cap is 2.9 times the average U.S. wage, while the average OECD country sets its comparable limit at 1.9 times the average wage.

Proposals to Raise Social Security Wage Cap in the 110th Congress:

Social Security Forever Act: Representative Robert Wexler (D-FL) has introduced legislation, H.R. 5779, to create a new 6% Social Security tax on earnings above $102,000 (3% on the employee, 3% on the employer). The self-employed would be responsible for paying the full additional 6% tax. This new tax would *not* come with higher benefits for those required to pay it.

The "Donut Hole" Option: Senator Barack Obama has proposed a plan to tax wages at the normal 12.4% rate up to $102,000, and then 0% from $102,000 to $250,000, and then 12.4% on wages higher than $250,000. It is unclear whether Senator Obama's plan would include higher benefits, and it is hard to imagine such a "donut hole" being unfilled for long.

Eliminate the Wage Cap: A final option would be to eliminate the tax cap altogether, which would impose the 12.4% Social Security tax on all earnings, including all earnings above $102,000.

The Federal Tax Burden and Social Security Taxes: In 2007, federal revenue was 18.8 percent of GDP, above the 18.2 percent of GDP average of the previous forty years. Federal revenue grew by 14.5 percent in 2005, 11.8 percent in 2006, and 6.7 percent in 2007. Federal tax collections have increased by $688 billion or 37 percent since the end of 2004. Under current law, CBO projects federal revenues will increase by another $1.89 trillion or 71% over the next ten years.

In addition, CBO notes, "Without future adjustments, a host of characteristics of the current tax system will continue to interact with economic conditions and cause receipts, on net, to grow faster than GDP." This occurs because the income tax is not indexed for wage growth, the value of some deductions in the tax code are not indexed for inflation at all, the large projected increase in the number of taxpayers hit by the AMT, significant future tax payments have been deferred such as with IRAs, and finally because under current law the 2001 and 2003 tax cuts expire. In short, if federal tax policy is simply left on auto-pilot, even with no other action by Congress to increase taxes, the federal tax burden measured as a percentage of GDP will increase to levels never before seen in American history.

Figure 2: Federal Revenue as a Percentage of GDP by Year

	Historical Average	2007	2018	2050
Federal Revenue	18.2	18.8	20.3	23.5

Source: *January 2008 CBO Budget Outlook and December 2007 CBO Long-Term Budget Outlook*

To date, the highest figure for federal revenue as a percentage of GDP is 20.9 percent in 1944, at the height of World War II, and then again in 2000, during the stock market bubble. Raising or eliminating the wage cap would cause the federal tax burden to increase even further.

The Top Marginal Tax Rate and the Social Security Wage Cap: Repealing the Social Security wage cap would increase the top federal marginal tax rate from 37.9 percent to 50.3 percent. If this tax increase was also done in conjunction with allowing the income tax rate reductions in the 2001 and 2003 tax cuts to expire, the top marginal tax rate would increase from 37.9% today to 54.9%. As Paul Krugman notes:

> Barack Obama's new Social Security proposal, love it or hate it, is huge news; it would push tax rates on some high-income Americans back to the levels of the 1970s.

According to the Tax Foundation, the U.S. marginal tax rate was the 10th lowest of the 30 OECD countries in 2006. Repealing the wage cap and allowing the 2001 and 2003 tax cuts to expire would cause the U.S. to have the fourth highest marginal tax rate in the OECD after 2010, behind only France, Sweden, and Denmark.

Conclusion: Proposals to raise or eliminate the wage cap would have at least two very important consequences. First, eliminating the wage cap would change the nature of the Social Security program by repealing the link between the amount of taxes an individual pays into the system and what an individual receives upon retirement in Social Security benefits.

Second, in terms of tax policy, eliminating Social Security's wage cap would be a very large increase to the top U.S. marginal tax rate. As even some liberal economists (such as Paul Krugman) have noted, repealing the Social Security wage cap would cause the top marginal tax rate to increase to levels not seen in the U.S. since the Carter Administration—eliminating much of the success conservatives have had in reducing marginal tax rates since 1981.

Additional Reading: For further information on this issue see:

- *CRS: Social Security: Raising or Eliminating the Taxable Earnings Base*
- *Andrew Biggs, AEI paper: Barack Obama's Social Security Donut Hole*
- *Tax Foundation: In OECD Comparison of Wage Taxes, U.S. Ranking Would Slip Badly if 2001 Tax Cuts Expire*
- *Heritage Foundation: Keep the Social Security Wage Cap: Nearly a Million Jobs Hang in the Balance*
- *Amity Shlaes, Washington Post: Fixing Social Security the FDR Way*

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