SOCIAL SECURITY

MEMORANDUM

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Subject: Computing the Ratio of Social Security Taxable Earnings to Covered Earnings; Implications for
          Provisions to Raise the Contribution and Benefit Base--**INFORMATION**

The ratio of taxable earnings to covered earnings under the Old-Age, Survivors, and Disability
Insurance (OASDI) program is of interest as an indicator of the changing proportion of total
covered earnings that falls below the contribution and benefit base, or taxable maximum. This
proportion changes when the distribution of earnings becomes more or less skewed toward the
highest earners.

Over the past two decades, the proportion of earnings received by the very highest earners has
generally been rising, with the result that the proportion of the total earnings below the taxable
maximum has been falling. As a result, the ratio of taxable to covered earnings, also called the
taxable ratio, has also been declining.

Proposals have been suggested that would raise the taxable maximum from its current level of
$90,000 for 2005 at a rate faster than the growth rate in the average wage index for the U.S.
economy (which is used for the annual automatic adjustment under current law). Some
proposals have suggested raising the taxable maximum at an accelerated pace until a taxable
ratio of 90 percent is achieved. This ratio is the level reported in Table 4.B1 of the Social
Security Bulletin Annual Statistical Supplements for years 1982 and 1983. This level is
significant, as it occurred shortly after the last ad hoc adjustment to the taxable maximum for
earnings in 1981. Thus, these proposals are usually described as an attempt to return the level of
the taxable ratio to about the level that resulted from the last direct Congressional action. These
proposals have also been described as an attempt to restore the intent of the Congress to achieve
approximately this taxable ratio.

The balance of this memorandum describes:
- The customary method used for computing the taxable ratio,
- An alternative, more comprehensive computation of this ratio, and
- Implications for proposals to change the taxable maximum by targeting a particular
  taxable ratio.

Customary Method for Computing the Taxable Ratio

Historically, the OASDI taxable ratio has been computed by dividing the actual earnings taxed for a year by the estimated total earnings in covered employment. However, for years through 1993, a portion of covered earnings was not reported to the Social Security Administration and thus was not included in the denominator of the taxable ratio. The unreported earnings were self-employment earnings of individuals who had, in the same year, wage earnings at or in excess of the taxable maximum. For these individuals, the self-employment earnings resulted in neither additional tax liability nor additional earnings credits toward benefits, so these earnings were not considered to be important. However, exclusion of these unreported self-employment earnings reduced the tabulated total covered earnings, and thus resulted in a slight overstatement in the computed taxable ratio.

This overstatement in the OASDI taxable ratio was essentially unavoidable through the year 1993, and was also not important for analytical purposes as long as the historical series of taxable ratios was computed on a consistent basis. For this reason, we have continued to compute the taxable ratio in this fashion (excluding these excess self-employment earnings) even after total excess self-employment earnings became available for years 1994 and later. Thus, the traditional computed taxable ratio is somewhat overstated, but is overstated on a consistent basis.

Alternative (Comprehensive) Method for Computing the Taxable Ratio

Starting in year 1994, total self-employment earnings for workers with wages at or above the OASDI taxable maximum have been reported. Adding these additional covered earnings to the denominator of the taxable ratio lowers this ratio for 2005 from 83.9 percent (under the customary computation) to 83.6 percent. However, using this same approach for historical years would also lower past computed taxable ratios. For years 1982 and 1983, the taxable ratios under the alternative computation are estimated at about 89.7 percent in each year.

Because the taxable ratios for 1982 and 1983 (the years immediately after the last ad hoc adjustment by the Congress) are lower under the alternative computation, a proposal that seeks to align the taxable ratio for the future with what occurred for 1982 and 1983 would aim lower than a taxable ratio of 90 percent. To be consistent with the taxable ratios of 1982 and 1983, the target taxable ratio for the future on the alternative computation would presumably be about 89.7 percent.
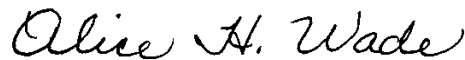
Implications of Changing the Taxable Maximum to Achieve a Specified Taxable Ratio

Under the traditional computation of the taxable ratio, where a 90 percent ratio was reported for 1982 and 1983, a taxable maximum amount for 2006 of about $164,100 would be needed to achieve the desired 90-percent taxable ratio. Phasing into this target taxable ratio over a ten year period (2006-15) would result in an improvement in the OASDI actuarial balance of 0.79 percent of payroll.
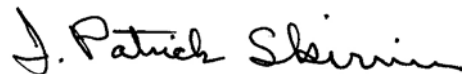
Under the alternative computation of the taxable ratio, where an 89.7 percent ratio is estimated for 1982 and 1983, a taxable maximum amount for 2006 of about $165,000 would be needed to achieve the desired 89.7-percent taxable ratio. Phasing into this target taxable ratio over a ten year period (2006-15) would result in an improvement in the OASDI actuarial balance of 0.80 percent of payroll.

Thus, if the intent of a proposal is to target a return of the taxable ratio achieved shortly after the last direct Congressional action to set the taxable maximum (1981), the resulting taxable ratio for 2006, and the cost implications for the OASDI program, are similar regardless of which computation is used for the taxable ratio.
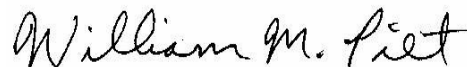
However, if a taxable ratio of 90 percent under the alternative computation is desired for 2006, then a significantly larger increase in the taxable maximum would be needed, i.e., to $171,000. Phasing into this target taxable ratio over a ten year period (2006-15) would result in an improvement in the OASDI actuarial balance of 0.83 percent of payroll. But it must be noted, that this approach is not consistent with realigning the taxable ratio to a level consistent with the result for 1982-3 after the last direct Congressional ad hoc increase in the taxable maximum. This target increase to a taxable ratio of 90 percent on the alternative basis is significantly above the estimated taxable ratio of 89.7 for 1982 and 1983. Moreover, setting the taxable maximum at the same $171,000 for 2006 would result in a taxable ratio under the customary computation of 90.3 percent, well above the historical 90 percent recorded on the same basis for 1982-83.

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