

Broadening the Social Security Tax Base: Issues and Options

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In this article, Hungerford reviews the history of the Social Security tax base, documents its erosion, and examines options for broadening it.

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It is well understood that Social Security faces a long-term funding challenge. After 2034, income to Social Security is projected to be less than scheduled benefits. After that time, tax revenue is projected to be sufficient to pay about 79 percent of scheduled benefits.¹ Some have described this situation as a crisis — Social Security is facing bankruptcy. Others view this situation for what it actually is: a challenge of aligning income (tax revenue) and costs (benefit payments).

This article focuses on only one side of this alignment and examines the issues involved in increasing Social Security tax receipts. As we approach the projected trust fund depletion date, it is appropriate to think about Social Security receipts for two reasons. First, in the past Congress has dealt

¹Social Security does not have the authority to borrow funds to pay benefits if the trust funds are depleted and income falls below costs. All projections are based on the intermediate assumptions of the Social Security trustees. See the Social Security Administration, “2015 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds” (2015), available at <https://www.ssa.gov/oact/tr/2015/tr2015.pdf>.

with Social Security financing challenges by trimming outgo and increasing income. There is no reason to believe that Congress will not consider revenue increases as part of any deal to shore up Social Security finances this time around.

Second, benefit reductions will not significantly improve Social Security’s finances in the short term. Most policymakers agree that any benefit reductions should not affect current retirees and those nearing retirement (workers 50 or 55 years or older). Also, benefit reductions tend to be phased in over several years — it is unlikely any appreciable savings could be achieved in the 20 to 30 years after legislation is enacted. Consequently, increasing revenue is almost the only viable short- to medium-term policy option.

Payroll tax revenue is a function of the tax rate and the tax base. Increasing the tax rate is rather straightforward: The Social Security trustees project that a 2.68 percentage point increase in the payroll tax rate would make Social Security solvent for the next 75 years. Consequently, this article focuses on the tax base.

A. Funding for Social Security

Most workers’ understanding of how Social Security is funded begins and often ends with their observation that FICA taxes, which includes payroll taxes for Social Security and Medicare, are withheld from their paychecks. The Social Security payroll tax rate is 6.2 percent and applies to earnings up to \$118,500. (This limit is known as the taxable maximum and is updated annually as average wages increase.) The employer also pays a 6.2 percent tax rate on the employee’s earnings up to the taxable maximum for a combined tax rate of 12.4 percent.² Earnings exceeding the taxable maximum are not subject to the Social Security payroll tax, but they are subject to the Medicare payroll tax.

The 12.4 percent tax rate is split between Social Security’s two trust funds — the Old Age and Survivors Insurance (OASI) trust fund and the Disability Insurance (DI) trust fund. Before the enactment of the Bipartisan Budget Act of 2015 (BBA),³ 10.6 percent was devoted to OASI and 1.8 percent to DI. The BBA temporarily changes the

²Most economists believe the employee bears the entire burden of the 12.4 percent payroll tax in the long-term.

³P.L. 114-74.

allocation to 10.03 percent for OASI and 2.37 percent for DI between 2016 and 2018.

Payroll tax revenue as well as other income is credited to the two trust funds. Social Security benefits are paid from the trust funds. If income to the trust funds is greater than current withdrawals, the excess is invested in “interest-bearing obligations of the United States or obligations guaranteed as to both principal and interest by the United States.”⁴ Conversely, if withdrawals are greater than current income, trust fund assets are liquidated so full benefits can be paid.

Table 1 reports the status of the two Social Security trust funds in 2015 (the latest year for which this information is available). The OASI trust fund is by far the larger of the two, holding almost 99 percent of the combined assets. Over the course of 2015, the OASI trust fund was accumulating assets while the DI trust fund was liquidating assets. Before the enactment of the BBA, the DI trust fund was projected to be depleted in the fourth quarter of 2016 — just in time for the presidential election. The BBA has improved the situation, and the DI trust fund is now projected to be depleted in 2023.

	OASI	DI
Beginning of year assets	\$2,729.2	\$60.2
Total income	\$801.6	\$118.6
Payroll tax receipts	\$679.5	\$115.4
Taxation of benefits	\$30.6	\$1.1
Interest income	\$91.2	\$2.1
Total expenditures	\$750.5	\$146.6
Benefit payments	\$742.9	\$143.4
Administrative expenses	\$3.4	\$2.8
End of year assets	\$2,780.2	\$32.3

Source: Social Security Administration, Office of the Actuary, available at <https://www.ssa.gov/OACT/ProgData/allOps.html>.

Most income to the trust funds is from payroll taxes (about 86 percent). A significant portion comes from interest on the trust fund assets (\$93 billion or 10 percent of the total). Lastly, about 3 percent of the total income to the trust funds is income taxes on Social Security benefits.⁵

B. Social Security Benefits

Table 1 shows that benefit payments are the largest expenditure from the trust funds, account-

ing for almost 99 percent of the total. Administrative expenses account for less than 1 percent of total expenditures.

There are basically three steps in determining the Social Security benefit for a retired worker.⁶ First, the average indexed monthly earnings (AIME) are calculated based on the 35 work years with the highest indexed taxable earnings.⁷ Second, the AIME is plugged into a progressive formula to calculate the primary insurance amount (PIA) — the benefit received if claimed at the full retirement age (FRA).⁸ Third, the PIA is adjusted up or down for workers claiming benefits after or before the FRA.⁹ This actuarial adjustment is designed to keep lifetime benefits about the same regardless of the age at which benefits are claimed. Through this calculation there is a direct link between earnings, contributions, and benefits.

C. Social Security’s Long-Term Fiscal Challenge

1. A tale of two numbers. Almost all observers — the press, policy analysts, policymakers — mostly focus on two numbers from the annual trustees report to describe Social Security’s long-term situation. Those two numbers, however, provide an incomplete view of Social Security’s financial condition.

Possibly the most cited number from the report is the projected exhaustion date of the Social Security trust funds. If Social Security were truly a “pay as you go” program, there would be no appreciable

⁶Social Security also provides disabled worker benefits, spouse benefits, and survivor benefits. To avoid unnecessary complications, I focus on retired worker benefits, which account for about 80 percent of total Social Security benefit payments. Disability benefits are determined in much the same way except there is no third step.

⁷Earnings are indexed by the average wage index. The basic goal is to have the ratio of the indexed earnings to average wage in the base year be approximately the same as the ratio of the earnings in the year earned to the average wage in the same year. The base year is the year two years before benefits are claimed. For example, suppose a 62-year-old worker claimed benefits in 2014; the base year would be 2012, in which the average wage was \$44,321.67. If the worker earned \$7,500 in 1975 (average wage was \$8,630.92), her indexed earnings for 1975 would be \$38,514 ($\$7,500/\$8,630.92 \times \$44,231.67$).

⁸The benefit formula for those claiming benefits in 2016 is 90 percent of the first \$856 of AIME plus 32 percent of the next \$4,301 of AIME plus 15 percent of AIME over \$5,157. The maximum AIME is determined by the taxable maximum in each year throughout the working career. The percentages are known as the bend point factors and the dollar amounts at which the factors change are known as bend points. The first bend point is \$856 and the first bend point factor is 90 percent.

⁹The Social Security retired worker benefit is equal to 75 percent of the PIA if the worker claims benefits at age 62. The benefit is greater than the PIA by 8 percent for each year claiming is delayed past the FRA up to age 70.

⁴42 U.S.C. section 401(d).

⁵Social Security recipients with incomes exceeding \$25,000 (\$32,000 for married couples filing jointly) may have up to 85 percent of their benefit subject to the federal income tax.

reserve in the trust funds, and thus, an exhaustion date would be meaningless.¹⁰ The trustees project that the combined assets of the two trust funds will be depleted (no assets in the trust funds) in 2034 under the intermediate cost assumptions. The projected exhaustion date is often misinterpreted; some mischaracterize (perhaps deliberately) it as the date when Social Security becomes bankrupt. However, if Congress fails to act, after the exhaustion date tax revenue would be sufficient to pay 79 percent of scheduled benefits.¹¹

The second most cited number is the 75-year actuarial deficit, which is expressed as a percentage of taxable payroll. The latest projected actuarial deficit for the combined trust funds is 2.66 percent of taxable payroll. This can roughly be interpreted as the payroll tax increase immediately needed so that all scheduled benefits can be paid for the next 75 years and so that the trust funds would have enough reserves to cover all benefits for the 76th year. The 75-year actuarial deficit, however, provides no information on what happens after 75 years. Also, it considers only the Social Security shortfall related to taxable payroll rather than to a broader measure of economic resources available.

Of course, projections require making assumptions about the unknowable future course of the economy as well as population changes. The trustees also present these numbers under alternative scenarios — the high-cost and low-cost scenarios. Under the high-cost scenario, the trust funds are projected to be depleted in 2029, and the actuarial deficit is 6.3 percent of taxable payroll. Under the low-cost scenario, the trust funds are not projected to be depleted over the next 75 years, and there is an actuarial surplus of 0.22 percent of taxable payroll.¹²

2. Adding another number to the mix. Social Security, for the most part, is a pay-go system. Payroll taxes collected from today's workers are used to pay for the benefits of today's recipients. Perhaps a more appropriate measure of the long-term financial challenge is the unfunded obligation of Social Security. The unfunded obligation is the difference between the present value of future costs

over the valuation period and current trust fund assets plus the present value of future scheduled tax revenue over the valuation period.¹³

The Social Security Administration's Office of the Chief Actuary projects the infinite horizon unfunded obligation to be \$25.8 trillion, which sounds like a very large number (almost 1½ times the current size of our economy).¹⁴ But this amount is not due today — cash flow shortfalls will be covered from available resources when they occur in the future, and legacy debt will be amortized over the infinite horizon. Gross domestic income (GDI) represents an estimate of all incomes generated in production and is equal (approximately) to GDP.¹⁵ The projected infinite horizon present value of GDP is \$1,952.3 trillion. Consequently, Social Security's unfunded obligation is 1.3 percent of future GDP — suggesting that tax revenue for Social Security would need to increase by 1.3 percent of GDP every year to eliminate the infinite horizon unfunded obligation. For comparison, in 2015 total federal revenue amounted to 18.2 percent of GDP.¹⁶

D. Origin of the Social Security Tax Base

In the two decades leading up to the enactment of the Social Security Act of 1935, much was written on the need for social insurance in the United States drawing on the experience of European nations. Social insurance applies the principle of insurance, but as Abraham Epstein noted, "The insurance principle is carried to its logical limit."¹⁷ The key feature of modern day social insurance is compulsion — it extends protections to those who need it

¹³There is a degree of uncertainty associated with projections, and the longer the valuation period, the larger the uncertainty.

¹⁴Jason Schultz and Daniel Nickerson, "Unfunded Obligation and Transition Costs for the OASDI Program," Social Security Administration, Office of the Chief Actuary, Actuarial Note No. 2015.1 (July 2015), available at <https://www.ssa.gov/oact/NOTES/ran1/an2015-1.pdf>.

¹⁵In principle, GDP and GDI are the same measure of economic activity. GDP represents an estimate of expenditures on the goods and services produced in the economy (the expenditure side) and GDI is the income side. The actual measured difference between the two is known as the statistical discrepancy (see Bruce T. Grimm, "The Statistical Discrepancy," Bureau of Economic Analysis, working paper WP2007-01 (Mar. 2, 2007)).

¹⁶Federal, state, and local tax revenue amounts to about 26 percent of GDP. Increasing total tax revenue by 1.3 percent of GDP would still leave the United States with the lowest taxes of all but three OECD countries — Chile, Korea, and Mexico (see <https://data.oecd.org/tax/tax-revenue.htm>).

¹⁷Epstein, *Insecurity: A Challenge to America* 23 (1936). Sir William Beveridge, "Insurance for All and Everything," 6(7) *The Daily News: The New Way Series* 6 (1924), noted that the risks usually insured under social insurance are uncertain to the individual but certain for the community and, therefore, "are of the kind to be met collectively rather than individually."

¹⁰Sen. Daniel Patrick Moynihan introduced a bill (S. 2016) in 1990 to return Social Security to "pay as you go" financing. This would have been accomplished by periodically adjusting the payroll tax rate.

¹¹This number is based on a theory that assumes the two trust funds are combined into a single trust fund from which both OASI and DI benefits are paid. In the 2016 annual report, the trustees projected the OASI trust fund will be exhausted in 2035 and the DI trust fund in 2023.

¹²Stochastic projections are also offered by the trustees to help gauge uncertainty. The 95th percentile confidence interval for the exhaustion date is 2029 to 2046, and for the actuarial deficit it is 1.04 to 4.92 percent of taxable payroll.

and the risk is spread over a large group (most of the working population in the case of Social Security).¹⁸ Compulsion and universal participation reduces problems associated with adverse selection.

Another feature is the wide distribution of costs. Many European countries had developed social insurance systems for old age and disability in the late 1800s and early 1900s. France and Germany both funded their systems through a combination of employee contributions, employer contributions, and a government subsidy. Most observers thought workers should be responsible for contributing for old age and disability insurance in much the same way that the insured pay premiums under private insurance. The staff of the Committee on Economic Security (CES) argued that a payroll tax was appropriate because “income from gainful employment is a fair measure of financial ability to pay as well as a proper determinant of normal benefits needed to maintain a satisfactory existence following retirement.”¹⁹ Epstein argued that “workers’ contributions should be favored on psychological and pragmatic grounds” by protecting their self-respect and essentially giving workers an earned right to their benefit.²⁰ President Franklin D. Roosevelt reportedly said, “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. With those taxes in there, no damn politician can ever scrap my social security program.”²¹

Many advocates of the German social insurance system in the late 1800s, however, thought that the entire cost of insurance was “too heavy a burden to place on the workman alone; the persons whose interest it was to maintain an efficient labor force — the employers — could therefore be properly called on to assist in defraying the cost of the old-age insurance.”²² In proposing the U.S. social insurance system, the CES staff thought the burden of the employer’s payroll contribution would be shifted eventually to the consumer, and possibly to the worker, but “that in time the incidence of the cost of employer contributions would be spread so broadly

over the whole community that no hardship would be imposed upon any particular group.”²³

It is curious that the U.S. Social Security program has had a taxable maximum from the start, while the well-developed European systems did not. Both the German and French systems at the time, however, exempted high-income salaried workers, and the Roosevelt administration’s original legislative draft would have exempted high-income workers (with earnings greater than \$250 per month or \$3,000 annually) from Social Security coverage. Janemarie Mulvey noted the House Ways and Means Committee dropped the exemption of high-income workers but established a taxable maximum of \$3,000 per year without explanation.²⁴ It is possible that the taxable maximum was a compromise between increasing worker coverage by adding high-income workers to the system (while universality is the ideal for a social insurance program, only workers in commerce and industry were originally covered by Social Security — about half of all workers) and little concern over the retirement income prospects of high-income workers who already had favorable retirement income prospects.²⁵

Most observers of social insurance wanted universal Social Security coverage from the beginning. Many, however, recognized the administrative difficulties. Isaac Rubinow offered an earlier reason to exclude the self-employed by noting that “the administrative difficulty of exacting small payments from individuals.”²⁶ Treasury Secretary Henry Morgenthau Jr. argued in a 1935 testimony before the Ways and Means Committee to initially exclude casual laborers, domestic servants, and agricultural workers because they would make an “extremely formidable” administrative task of collecting revenue “insuperable — certainly, at the outset.”²⁷ Epstein made essentially the same point before the Senate Finance Committee in noting, “There is the problem of administration. You are not going to

²³CES (1937), at 206.

²⁴Mulvey, “Social Security: Raising or Eliminating the Taxable Earnings Base,” Congressional Research Service report RL32896 (Sep. 24, 2010).

²⁵The 1979 Social Security Advisory Council offered an ex post justification for the taxable maximum when it argued that eliminating it would be “an undesirable intrusion into areas better left to private saving and pensions.” See Committee on Ways and Means, “Report of the 1979 Advisory Council on Social Security,” Committee Print, 43, 96th Cong., 1st sess. (1980).

²⁶I.M. Rubinow, *Social Insurance* 350 (1916).

²⁷Statement of Hon. Henry Morgenthau Jr., Secretary of the Treasury, Hearings Before the Committee on Ways and Means, House of Representatives, “Economic Security Act,” 902, 74th Cong., 1st sess. (1935).

¹⁸Social Security insures against the risk of loss of earnings due to disability and retirement.

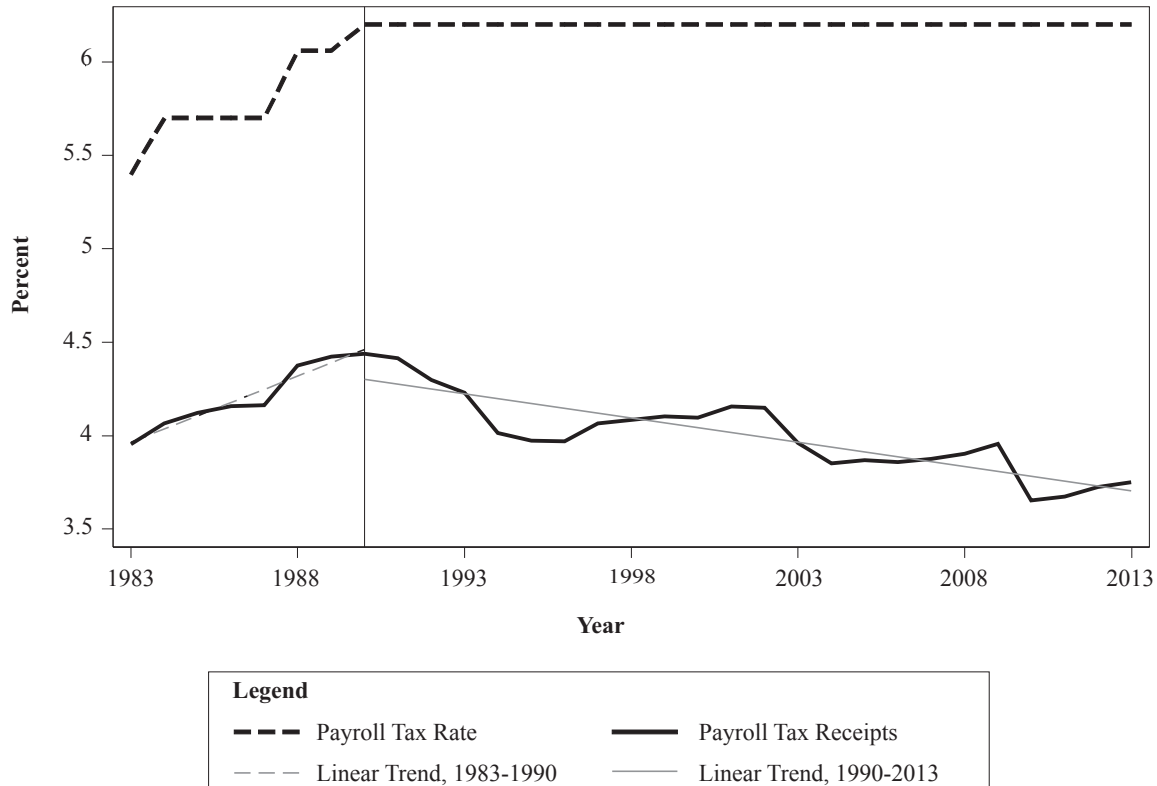
¹⁹Social Security Board for the Committee on Economic Security (CES), “Social Security in America,” at 204 (1937).

²⁰Epstein, *supra* note 17, at 38.

²¹Quoted in Arthur M. Schlesinger Jr., *The Coming of the New Deal* 308-309 (1958). While workers may have a moral and political right to their Social Security benefit, the Supreme Court held in *Fleming v. Nestor*, 63 U.S. 603 (1960), that they do not have a contractual right to their benefit.

²²Department of Commerce and Labor, “Twenty-Fourth Annual Report of the Commissioner of Labor,” at 1384 (1911).

Figure 1. Payroll Tax Rate on Employee (Dashed) and Payroll Tax Receipts as Percentage of GDP (Solid), 1983-2013



collect it. We have no administrative machinery.”²⁸ Both Morgenthau and Epstein expected it would take a few years to build up the administrative capability to handle bringing these workers into the system. These workers were eventually included in Social Security beginning January 1, 1951. Today, almost all workers are covered under Social Security (the primary exception is state and local government workers), but the taxable maximum remains.

E. Social Security Tax Rate and Tax Revenue

The Social Security payroll tax rate has changed many times since it was first enacted in 1935. In 1937 the rate on the worker and employer was 1 percent on the first \$3,000 in wages (the taxable maximum). By 1983 the tax rate had increased to 5.4 percent on the worker and employer. The taxable maximum was increased from time to time on an ad hoc basis until the 1972 Social Security amendments increased the tax maximum and indexed it to wage

growth. The 1977 amendments provided for further ad hoc increases of the taxable maximum in 1979, 1980, and 1981. Since then, the taxable maximum has automatically increased to keep up with average wage levels.

With the tax base essentially set on automatic after 1982, it is instructive to look at the relation between the tax rate and tax revenue. Figure 1 shows the payroll tax rate that is levied on the worker and employer (the top thick dashed line) and payroll tax revenue as a percent of GDP (bottom thick solid line). The tax rate increased in three steps from 5.4 percent in 1983 to 6.2 percent by 1990. The tax rate has remained constant since 1990.²⁹

Payroll tax revenue relative to GDP steadily increased between 1983 and 1990 as the tax rate increased — the linear trend line (thin dashed line) is upward sloping between 1983 and 1990 indicating that revenue as a percent of GDP rose by about 1.2 percent per year. By 1990 payroll tax revenue was equivalent to 4.4 percent of GDP. After 1990, however, payroll tax revenue fell from 4.4 percent of

²⁸Statement of Abraham Epstein, Representing the American Association for Social Security, Hearings Before the Committee on Finance, United States Senate, “Economic Security Act,” 514, 74th Cong., 1st sess. (1935).

²⁹Except for the payroll tax holiday; forgone payroll tax revenue was replaced by transfers from the general fund.

GDP to 3.8 percent of GDP by 2013. The linear trend line (thin solid line) is downward sloping and suggests that payroll tax revenue as a percent of GDP fell by about 0.6 percent per year. The situation after 1990 — a fixed tax rate and indexed taxable maximum but falling tax revenue relative to GDP — strongly suggests a steady erosion of the Social Security payroll tax base with respect to GDP.

F. What’s Happening to the Tax Base?

In 2013 the Social Security tax base — known in jargon as taxable payroll — amounted to \$5.91 trillion or 35.5 percent of GDP (see the first row in Table 2). This tax base (wages and salaries below the taxable maximum) is subject to the 12.4 percent payroll tax. A somewhat broader tax base is what is known as covered payroll, which is all wages and salaries earned in employment covered by Social Security. Covered payroll, by the way, is the tax base for Medicare’s hospital insurance payroll tax.³⁰ It amounted to \$7.15 trillion in 2013 or about 43 percent of GDP (see the second row of Table 2). If covered payroll had been the tax base for Social Security in 2013, a 10.2 percent tax rate would have been sufficient to raise the payroll tax revenue actually collected in that year.

Tax Base	Amount (billions of dollars)	Tax Rate to Achieve 2013 Payroll Tax Contributions
Taxable payroll	\$5,913	12.4%
Covered payroll	\$7,146.8	10.2%
Labor’s share	\$8,844.8	8.3%
AGI	\$8,436.5	8.7%
National income	\$14,458.3	5.1%
GDP	\$16,663.2	4.4%

Taxable payroll was about 83 percent of covered payroll in 2013. The ratio of taxable to covered payroll, however, has been following a generally downward trend over the past three decades. Figure 2 displays this ratio from 1950 to 2013. The trend of this ratio is J-shaped between 1950 and 1983. It reached its high point of 90 percent in 1983 because of legislated changes in the taxable maximum. Since 1983 the ratio has fallen by 0.2 percentage points per year (or 2 percentage points per decade; see Table 3). The primary reason for the downward trend

³⁰Until 1990 the Social Security and Medicare tax bases were the same — all wages and salaries below the taxable maximum. The taxable maximum for Medicare was increased above that for Social Security for 1991, 1992, and 1993. The Omnibus Budget Reconciliation Act of 1993 eliminated the Medicare taxable maximum after 1993.

since 1983 is the rise in wage inequality over the past 30 years — an increasing share of earnings is above the taxable maximum. The share of wage income accruing to the top 5 percent in the earnings distribution, for example, has increased from 18.5 percent in 1983 to about 25 percent in 2011.³¹ The current Social Security tax base is falling further behind covered payroll — a broader tax base — and is likely to continue falling further behind for the near future, with adverse consequences for Social Security’s finances.

	Average Percentage Point Change of Tax Base per Decade Relative to:			
	Covered Payroll	Labor’s Share	National Income	GDP
Taxable payroll	-2	-1.6	-2.2	-1.6
Covered payroll		-0.2	-1.3	-0.8
Labor’s share			-1.7	-0.9
National income				+0.6

Other possible tax bases that are broader than taxable payroll are also listed in Table 2. Labor’s share of income includes all employee compensation, including employer contributions for health insurance, life insurance, pensions, and other fringe benefits.³² In 2013 it amounted to \$10.06 trillion (about 60 percent of GDP). The employer-provided benefits are not subject to the payroll tax, and most are not subject to the income tax (the single largest individual income tax expenditure item is for employer-provided health insurance).³³

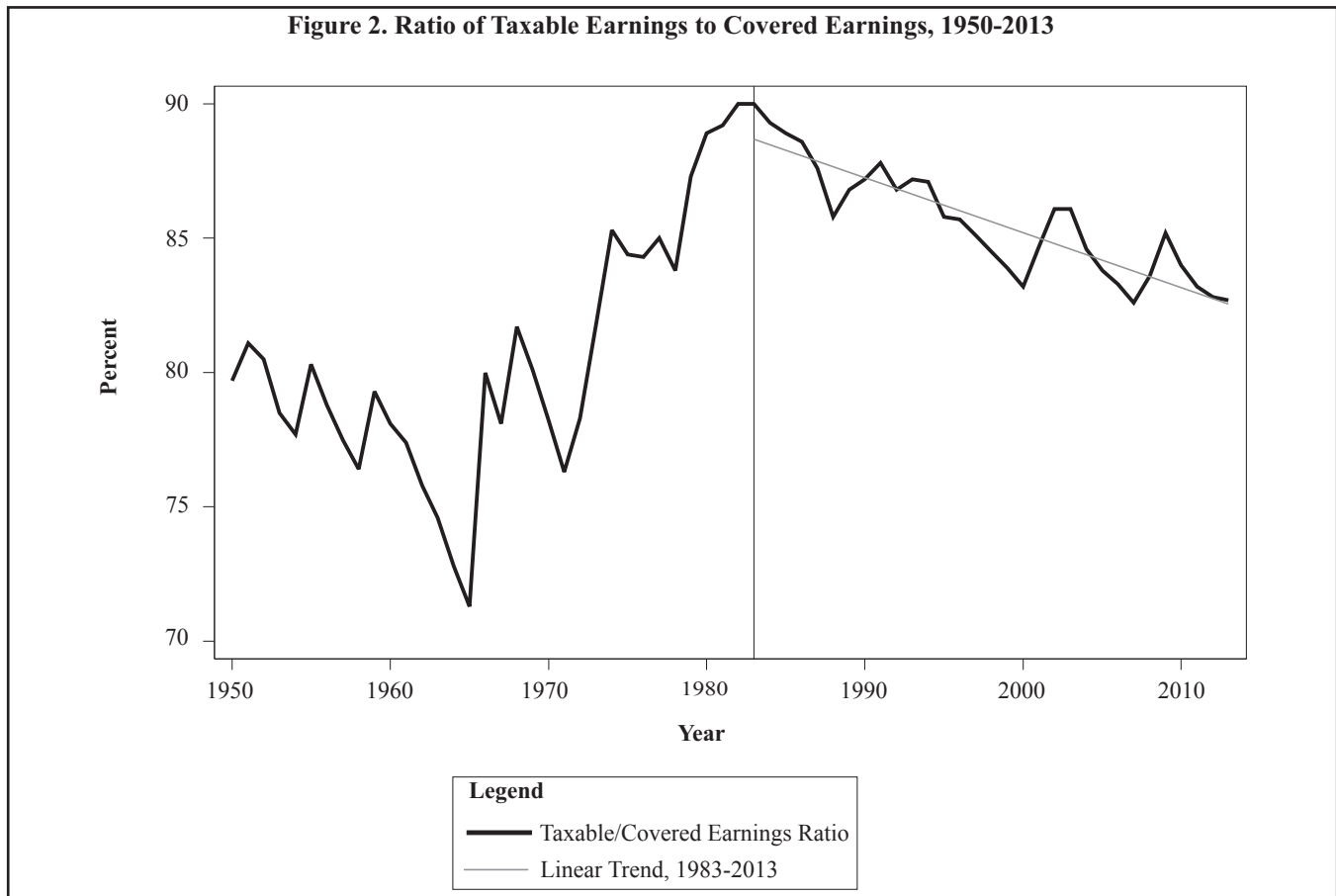
Labor’s share of income is a much broader tax base than either taxable payroll or covered payroll. If it had been the tax base in 2013, the Social Security tax rate could have been 41 percent lower (8.3 percent, or 4.15 percent each on workers and on employers) to raise the payroll tax revenue actually collected. Over the past three decades, both taxable and covered payroll have been falling relative to labor’s share of income (see the third column in Table 3). Also, labor’s share has been falling relative

³¹Emmanuel Saez, “Striking it Richer: The Evolution of Top Incomes in the United States,” 2015, available at <http://eml.berkeley.edu/~saez/TabFig2014prel.xls>. Over this period, the proportion of workers with earnings greater than the taxable maximum has remained steady at 6 percent.

³²Labor’s share includes an estimate of the part of proprietors’ income that is labor compensation.

³³See Joint Committee on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Years 2015-2019,” JCX-141-15 (Dec. 7, 2015).

Figure 2. Ratio of Taxable Earnings to Covered Earnings, 1950-2013



to GDP over the past four decades. Figure 3 displays labor's share as a percent of GDP since 1933. Between 1933 and 1975, the ratio fluctuated around a constant 67 percent (the dashed trend line in the figure is flat).³⁴ The ratio, however, has been on a steady downward trend since 1975. Over the past three decades, labor's share has also been falling relative to national income (see Table 3).

National income is an even broader possible tax base and includes capital income.³⁵ It amounted to \$14.46 trillion in 2013 — almost 2½ times larger than taxable payroll. Taxing capital income is not without precedent: The Medicare net investment income tax, enacted as part of the Affordable Care Act, applies a 3.8 percent tax on specific capital income of high-income taxpayers.³⁶

³⁴Nicholas Kaldor in 1957 noted that labor's share "has shown a remarkable constancy" in the United States since the second half of the 19th century. See Kaldor, "A Model of Economic Growth," 67:268 *Econ. J.* 591-624 (Dec. 1957).

³⁵The main difference between GDP and national income is national income does not include consumption of fixed capital (that is, depreciation).

³⁶The revenue from this tax is not allocated to the Medicare trust fund, however.

A tax base that is not as inclusive as national income, but for the sake of completeness should be mentioned, is adjusted gross income. It includes both labor and capital income (as well as some transfer income). AGI, at \$8.44 trillion in 2013, is almost 1½ times larger than taxable payroll, the current Social Security tax base. However, after various exemptions and deductions, taxable income under the individual income tax is only 5 percent larger than taxable payroll — tax expenditures quickly erode a tax base.

G. Wrinkles in Broadening the Tax Base

Broadening the Social Security tax base is not as straightforward as it sounds; there could be some unanticipated consequences, which will be discussed. The wrinkles associated with base broadening fall into three areas: financial issues or how receipts and expenditures are affected, distributional consequences, and administrative issues.

1. Financial issues. Social Security is set up so there is a direct link between earnings, contributions, and benefits. It is likely that any modification of the tax base would lead to changes in the program so that the additional taxable income would be included in the calculation of the AIME to maintain a direct link between contributions and benefits. Although there

Figure 3. Labor's Share of Income, 1933-2013



are proposals to broaden the tax base without increasing benefits, my guess is such a policy could not pass both houses of Congress and would almost certainly be opposed by those who face the higher taxes. Consequently, increasing tax revenue through base broadening will also lead to an increase in program expenditures.

Clearly, broadening the tax base, other things equal, would improve the financial situation of Social Security. But the resulting benefit increases will worsen the financial situation. The question is, what is the net effect? The Congressional Budget Office estimates that eliminating the taxable maximum would increase payroll tax revenue by 1.1 percent of GDP in 2040 and would increase benefit payments by 0.3 percent of GDP.³⁷ The Social Security Administration's Office of the Chief Actuary estimates that such a policy would eliminate 71 percent of the financial shortfall as measured by the 75-year actuarial balance.³⁸ Broadening the tax base even further to include employee fringe benefits or

capital income is also likely to lead to a net improvement in Social Security's financial situation.

2. Distribution issues. Distributional analyses of broadening the Social Security tax base involve examining who pays higher taxes and who receives higher benefits. The individuals who pay higher taxes are also the same individuals who receive higher benefits. But the higher taxes are paid during the work years and the higher benefits are received during the retirement years — people may be in one part of the income distribution when working and a different part after retirement.

Table 4 displays the distribution of taxable earnings as well as some nontaxable income.³⁹ The first column of numbers shows the share of Social Security taxable earnings (that is, earnings below the taxable maximum) received by the households in

³⁷CBO, "Social Security Policy Options, 2015" (Dec. 2015).

³⁸Social Security Administration, Office of the Chief Actuary, "Summary of Provisions That Would Change the Social Security Program" (Sept. 16, 2015).

³⁹The data for the analysis comes from the Federal Reserve Board's "2013 Survey of Consumer Finances." Only households with a respondent or spouse between the ages of 30 and 61 and report receiving wage income are included in the analysis. Income categories are based on equivalence-adjusted (the square root of household size) total income excluding capital gains.

Table 4. Distribution of Income Sources and Effective Tax Rates by Income Category

	Taxable Earnings		Untaxed Earnings		Employer-Provided Health Insurance		Capital Income	
	Share	Tax Rate	Share	Tax Rate	Share	Tax Rate	Share	Tax Rate
Quintile 1	3.6	9.2	0.0	9.2	5.5	10.8	0.2	9.4
Quintile 2	6.4	8.6	0.0	8.6	11.0	10.3	0.7	9
Quintile 3	11.8	10.0	1.0	10.3	17.8	11.9	1.1	10.5
Quintile 4	23.8	10.3	2.4	10.6	26.7	11.7	2.5	10.8
Quintile 5	54.3	5.7	96.6	8.4	38.9	6.2	95.4	10.3
Top 10 percent	33.1	4.5	92.2	7.8	21.0	4.8	91.9	10.2
Top 5 percent	17.1	3.0	80.9	6.8	10.6	3.2	86	10

Source: Author's analysis of the Federal Reserve Board's 2013 Survey of Consumer Finances.

each income category. As expected, richer households have more taxable earnings — the richest 20 percent of households earn more than half of taxable earnings, while the poorest 20 percent earn less than 4 percent of taxable earnings. The second column shows the effective household payroll tax rate for total household income. The tax rate is approximately proportional up to the 80th percentile and then is highly regressive above the 80th percentile (that is, the effective tax rate declines with increasing income).

The next two columns provide the same information for untaxed earnings or the earnings above the taxable maximum. Untaxed earnings are concentrated at the top of the income distribution — about 92 percent of earnings above the taxable maximum received by households in the top 10 percent of the income distribution. If the taxable maximum were eliminated, households in the bottom two income quintiles would not experience a tax increase, and the effective tax rate would increase slightly for workers in the next two income quintiles (by about 0.3 percentage points). Most households at the top of the income distribution would experience significant increases in the effective tax rate. However, even with all earnings subject to the payroll tax, the payroll tax (for total income) would still be regressive above the 80th percentile.

The sixth and seventh columns of numbers report the same information for employer-provided health insurance.⁴⁰ Employer contributions for health insurance are more evenly distributed than taxable earnings, but they are still unevenly distributed. If these contributions were included in the tax base, households in the bottom 80 percent of the income distribution would experience about a 1.7 percentage point effective tax rate increase, while

⁴⁰The employer's contribution for health insurance premiums was allocated to households based on household size and whether the household has private health insurance coverage. Estimates of the employer contribution from the Kaiser Family Foundation's "2013 Annual Employer Health Benefit Survey."

the richest 20 percent would see a 0.5 percentage point tax rate increase.⁴¹ The effective tax rate would remain approximately proportional until the 80th percentile and highly regressive above the 80th percentile.

The final two columns in Table 4 report information for including capital income (business income, interest, dividends, capital gains, and rent) in the tax base. The distribution of capital income is as highly skewed to the top as untaxed earnings — 95 percent goes to the richest 20 percent and 86 percent goes to the richest 5 percent in the income distribution. Less than 1 percent goes to households in the bottom 40 percent. Broadening the tax base to include capital income would yield an approximately proportional tax across the income distribution with the effective tax rate almost doubling for the richest 20 percent and tripling for the richest 5 percent.

Higher taxable income during the working years will lead to a higher benefit in old age. How much higher the benefit depends on how many years the person has higher taxable income. For example, a worker with an additional \$1 (indexed) in taxable income in a single year will have an AIME that is less than 0.3 cents higher at retirement. But a person with an additional \$1 (indexed) in each year will have an AIME that is 8 cents higher. To the extent that a worker's place in the income distribution in any one work year is closely related to his place in another work year or at retirement, the information in Table 4 suggests that broadening the tax base will lead to higher benefits primarily for the higher income retirees.

However, the ultimate distributional consequences of broadening the tax base must be examined on a lifetime basis rather than focusing on just a single year. The Social Security Administration projects that once the elimination of the taxable

⁴¹Employer contributions for health insurance are excluded from the individual income tax base; Rep. Paul D. Ryan, R-Wis., proposed repealing this exclusion in 2010.

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maximum is fully phased in, almost one-third of the households in the top lifetime income quintile would receive higher benefits compared with about 2 percent in the poorest quintile.⁴² Overall, with the higher taxes and subsequent higher benefits, eliminating the taxable maximum is projected to make the Social Security program more progressive.⁴³

Taxing employer-provided health insurance would increase taxes more broadly throughout the income distribution as well as increasing benefits. Once the policy is fully phased in, it is projected that lifetime taxes would increase more than lifetime benefits.⁴⁴ Furthermore, the difference between the increases in lifetime taxes and benefits would be larger for lower-income beneficiaries than for higher-income beneficiaries. Ultimately, this option may not be as progressive a change to the Social Security program as other changes.

Unfortunately, there are no studies that examine including capital income in the Social Security tax base. That said, some observations can be offered. This method of broadening the tax base would almost exclusively affect individuals in the upper part of the income distribution and likely make the Social Security system more progressive in much the same way as eliminating the taxable maximum. While these workers will also receive higher benefits, the benefit formula is very progressive. In all likelihood, broadening the tax base to include capital income would be a progressive change.

An important caveat to these distributional analyses involves the omission of the income taxation of Social Security benefits. For higher-income beneficiaries, up to 85 percent of the Social Security benefits are subject to the individual income tax, and this taxation makes the system more progressive. If the tax base broadening did lead to higher benefits, most of the additional benefits received by higher-income beneficiaries would be taxed under the individual income tax. Consequently, the reported research results likely understate how progressive these changes actually are.

3. Administrative issues. Changes to Social Security entail obvious administrative issues such as an increased burden on various parties to make timely tax payments and an increased record-processing burden on the Social Security Administration. For

the most part, overcoming these challenges is not insurmountable. Most of the income that could be added to the Social Security tax base is already taxed under the income tax system, so taxpayers already have the necessary records. And administrative computer systems can be updated.

Including employer-provided health insurance in the tax base would present the largest problem. The major challenge is determining the value of the insurance for each worker — the value depends on age, health status, family size and composition, and the cost of medical care in the area.⁴⁵ It is possible that assigning costs based on health status could lead to large imputed income (and consequent high taxes) for those with health problems. Of course, health status could be excluded from the allocation calculation, but some workers (primarily younger and healthier workers) may then deem the allocation as unfair.

Another administrative issue could present a problem for some married couples. Some working couples opt to be covered by the health insurance plan of one spouse even though both are offered coverage by their employers. How should the additional taxed income be credited for purposes of calculating benefits at retirement: credited to one spouse or split between the two?

One possible solution to problems of taxing employer-provided health insurance (and perhaps other fringe benefits such as defined benefit plans) is to tax it at the employer level only, not at both the employer and employee levels. The value of the insurance would not have to be allocated among the individual workers.⁴⁶ Of course, the worker would not receive credit for the increased taxable income and would not receive higher benefits in retirement.

A similar problem crops up with taxing capital income. Among married couples, some assets are individually owned by one spouse, some are jointly owned, and some may be in the name of one spouse but jointly owned. How should the capital income from these assets be credited to the spouses for purposes of calculating benefits for disability or retirement?

An additional problem with taxing capital income is that it would move Social Security from a social insurance system that replaces wage income lost because of disability or retirement. It is possible that such a change could entitle individuals for

⁴²Social Security Administration, Office of Retirement Policy, available at <http://www.socialsecurity.gov/retirementpolicy>.

⁴³Kevin Whitman, "Distributional Effects of Raising the Social Security Taxable Maximum," SSA Policy Brief No. 2009-01 (July 2009).

⁴⁴Kathleen Romig, Dave Shoffner, and Whitman, "Distributional Effects of Taxing Health Insurance Premiums for Social Security," Social Security Administration, Office of Retirement Policy (2016).

⁴⁵See Jane G. Gravelle and Hungerford, "The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening," CRS report R42435 (Mar. 22, 2012), for a discussion of this issue.

⁴⁶Over time, however, it is likely that employers would shift some or all of the tax burden to employees.

benefits who never work and do not experience a loss of an income source in old age. In any single year, about 5 percent of households with one spouse between the ages of 30 and 61 have no wage income but receive capital income.⁴⁷

H. Concluding Observations

The current Social Security tax base — taxable payroll — is a narrow tax base that has been shrinking relative to the economy and to almost all other possible tax bases for the past 30 years. This situation is unlikely to be reversed soon. Increasing wage inequality means that an increasing share of wages will not be subject to the Social Security payroll tax. And various tax expenditures such as the exemption of employer-provided fringe benefits further reduce the potential tax base. The increasing importance of capital income in the economy reduces the amount of national income that could be subject to a payroll tax.

Broadening the Social Security tax base with the concomitant benefit increases would likely be politically difficult to sell, especially during a bitter presidential election and with a polarized Congress. The Republican presidential candidates called for tax reductions on the wealthy, but broadening the tax base would predominantly affect higher-income households.⁴⁸ The future benefit increases could, however, take some of the sting out of the tax increase and reduce political opposition.

The Democratic presidential candidates are advocating for benefit increases for disadvantaged

⁴⁷Author's analysis of "2013 Survey of Consumer Finances," *supra* note 39.

⁴⁸See the Tax Policy Center's interactive feature, "Major Candidate Tax Proposals Election 2016," available at <http://apps.urban.org/features/tpccandidate>.

beneficiaries and lower-income workers.⁴⁹ Increasing taxes on high-income households through base broadening would likely fit the candidates' platforms. But the benefit increases for high-income retirees could be a showstopper.

Two policy alternatives could overcome some of the political opposition to the concentration of benefit increases for those at the top of the income distribution due to base broadening. The basic idea is to spread the gains (beyond the gains from putting Social Security on sounder financial footing) throughout the income distribution. The first possible alternative would spread these gains through the benefit side of Social Security. In the benefit formula, the first bend point factor could be increased from 90 percent to 95 or 100 percent. Every new recipient would benefit from this change — both high- and low-income alike, though it would be proportionally greatest for households at the bottom of the income distribution. Also, a third bend point could be added at the current maximum AIME with a factor of 3 or 5 percent, thus making the formula more progressive.

The second alternative would spread the gains through the tax side of Social Security. Some of the increased tax revenue from base broadening could be used for an across-the-board tax rate reduction.⁵⁰ All taxpayers would gain from the reduced tax rate, though high-income taxpayers would on net pay more in taxes because of the broader tax base.

⁴⁹See The Boston College Center for Retirement Research, "Table, 2016 Presidential Candidates' Proposed Changes to Social Security," available at http://crr.bc.edu/wp-content/uploads/2015/12/Candidates_Positions_Social_Security-7.pdf.

⁵⁰This was proposed by Dalton Conley, "Turning the Tax Tables to Help the Poor," *The New York Times*, Nov. 15, 2004. For an analysis of this proposal, see Hungerford, "How Increasing the Payroll Tax Base Affects Tax Burdens," *Tax Notes*, May 14, 2007, p. 643.



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