Keep the Cap
Why a Tax Increase Will Not Save Social Security
by Michael Tanner

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Some opponents of allowing younger workers to privately invest a portion of their Social Security taxes through individual accounts have suggested that most or all of Social Security’s financial problems can be solved if the current cap on income subject to the Social Security payroll tax is raised or removed altogether. Indeed, public opinion polls show widespread public support for the idea. Even President Bush appears open to the idea, although only in the context of larger reforms that would also include the creation of personal accounts.

However, removing the cap would create the largest tax increase in U.S. history: $1.3 trillion over the first 10 years. Even increasing the cap to cover the first $150,000 of wages would amount to $384 billion in new taxes. It would give the United States one of the highest marginal tax rates in the industrialized world, with the potential for severely disrupting economic growth.

Yet in exchange for this massive tax increase, Social Security would gain only an additional seven years of cash-flow solvency. In the end, proposals for changing the taxable wage cap are all pain and no gain. With a viable alternative—creating personal accounts—Congress should not go down this road.

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Introduction

Some opponents of allowing younger workers to privately invest a portion of their Social Security taxes through individual accounts have suggested that most or all of Social Security’s financial problems can be solved if the current cap on income subject to the Social Security payroll tax is raised or removed altogether. Indeed, public opinion polls show widespread public support for the idea.¹ Even President Bush appears open to the idea, although only in the context of larger reforms that would also include the creation of personal accounts.² However, a closer look shows that this proposal, which would create the largest tax increase in U.S. history, would actually do very little to improve Social Security’s finances.

When Franklin Roosevelt first proposed Social Security in 1935, there was no explicit cap on the wages subject to the tax. However, because the law was primarily designed to provide retirement benefits for low-income workers, nonmanual laborers with incomes of more than $3,000 were exempted from the program. The final legislation, however, in an attempt to make the program more universal, eliminated the exemption for nonmanual laborers, while formally capping taxable wages at $3,000.³ That $3,000 cap remained in place until 1951 when Congress, faced with a need for additional Social Security revenue, increased it for the first time to $3,600. Between then and 1974, Congress voted seven more times to raise the cap, until it reached $13,200 in 1974. At that point, Congress established an automatic mechanism to increase the cap annually by a percentage equal to the growth in average wages. Congress overrode those automatic provisions in 1977 to increase the wage base above the scheduled level for the years 1979–81. Thereafter, the increase in the wage cap returned to the automatic formula established in 1974 (Table 1).⁴

Currently, workers pay Social Security taxes on the first $90,000 of wage income. Income above that level is exempt from Social Security taxes (though not Medicare payroll taxes).⁵ Approximately 84 percent of all wage income earned in the United States falls under that cap and is subject to the tax.

Advocates of raising or eliminating the cap on payroll taxes often suggest that the current level of covered wages is significantly below the rate of roughly 90 percent of covered earnings subject to the tax in 1983, at the time of the Greenspan Commission’s reform. What they fail to note, however, is that the 1983 rate was unnaturally high. In fact, as Figure 1 shows, from 1945 to 1965 the proportion of wages covered by the payroll tax declined steadily, from 88 percent to roughly 71 percent. However, beginning in 1965, as the cap was gradually increased, it reached a high of 90 percent in 1983. Since that time, it has again begun to decline but remains above the post–World War II average of 82.9 percent.⁶ For advocates of changing the cap, there are two main policy questions. First, should the cap be removed altogether or simply raised? Although some groups, such as the Economic Policy Institute, the 2030 Center, and the National Council of Women’s Organizations, have suggested the cap should be completely eliminated, most have argued in favor of increasing it, generally to a level that would cover 90 percent of wage payroll.⁷ That would be approximately $150,000 today.

Second, should the increased taxes count toward increased benefits? Today, workers theoretically earn some benefits in return for every dollar paid into the system.⁸ Therefore, raising or eliminating the cap to subject more wages to taxation would, under current formulas, mean that the worker would receive more benefits. It would not be a dollar-for-dollar increase, because Social Security’s progressive benefit formula provides workers with only 15 cents on the dollar for taxes paid on wages above $3,779 per month. Still, the provision of increased benefits in exchange for increased taxes would somewhat reduce the revenue gains and could ultimately result in Social Security paying Bill Gates millions of dollars in retirement income.
Table 1
History of Wage Cap

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
<th>Year</th>
<th>Amount</th>
</tr>
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<tbody>
<tr>
<td>1937–50</td>
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<td>1972</td>
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<td>$57,600</td>
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<tr>
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<td>1994</td>
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<td>1995</td>
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<tr>
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<td>1996</td>
<td>$62,700</td>
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<td>$16,500</td>
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</tr>
<tr>
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<td>1998</td>
<td>$68,400</td>
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<tr>
<td>1979</td>
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<td>1999</td>
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<td>1982</td>
<td>$32,400</td>
<td>2002</td>
<td>$84,900</td>
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<tr>
<td>1983</td>
<td>$35,700</td>
<td>2003</td>
<td>$87,000</td>
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<tr>
<td>1984</td>
<td>$37,800</td>
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</tr>
<tr>
<td>1985</td>
<td>$39,600</td>
<td>2005</td>
<td>$90,000</td>
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</table>

Source: Social Security Administration.

Figure 1
Percent of Covered Wages Subject to the OASI Payroll Tax

The other alternative would be to increase the tax cap without allowing workers to accrue any additional benefits, turning Social Security into even more of a welfare program than it is today. As a result, even some supporters of traditional Social Security have been reluctant to embrace lifting the cap, fearing that to do so would undermine the program’s image as a broad-based, contributory social insurance program. Bill Clinton warned against this approach at a 1998 forum hosted by the Concord Coalition and AARP, pointing out that this change would make Social Security “an actuarially negative investment for the people involved, where you’re just taxing people’s payroll far more than they’ll ever get back, and they’re just subsidizing the system.”

**The Consequences of Raising the Cap**

Elimination of the payroll tax cap would be the largest tax increase in U.S. history—more than $472 billion in the first five years alone. Even raising the cap to $150,000 per year would amount to an overall tax hike of $106 billion over the first five years. Over 10 years, the cost of raising the cap would be $384 billion and the cost of eliminating it would be an astounding $1.3 trillion in new taxes. To put this in perspective, Figure 2 compares the proposed tax hike to the last three major tax hikes: the 1982 increase in Social Security tax rates, the 1990 Omnibus Budget Reconciliation Act (wherein President George H. W. Bush broke his “read my lips” pledge), and the 1993 Omnibus Reconciliation Act of 1993 (the Clinton tax hike of 1993).

As bad as that would be in the aggregate, it would be even worse for individual workers. A worker earning $100,000 per year would directly or indirectly pay $1,240 more in taxes each year.

Moreover, as the above example shows, raising the tax cap would not just impact the super rich, as is often portrayed, but would fall most heavily on the upper middle class. Indeed, some 9.2 million Americans would see their taxes increased. Roughly three-quarters of those are managers or other professionals such as doctors, lawyers, and engineers. But roughly 16 percent work in sales or office occupations, and the remainder includes teachers, nurses, truck drivers, farmers, police officers, and others. Nearly 60 percent of those workers are between the ages of 35 and 55, and 20 percent are over 55 and nearing

**Figure 2**

Five-Year Cost of Tax Increases

<table>
<thead>
<tr>
<th>Year</th>
<th>Billions of Dollars (2005)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982 Social Security Tax Increase</td>
<td>329</td>
</tr>
<tr>
<td>1990 Omnibus</td>
<td>215</td>
</tr>
<tr>
<td>1993 Omnibus</td>
<td>292</td>
</tr>
<tr>
<td>Eliminating Cap</td>
<td>472</td>
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</table>

Source: Cato Institute calculations; Tax Foundation; Heritage Foundation.
For all these working men and women, raising the cap would immediately increase their marginal tax rate—the amount of taxes paid on each additional dollar of income earned—by roughly 10 percentage points (less than the full 12.4 percent because the employer’s half is tax-deductible). Most of the affected workers are already paying federal income taxes at the top rate of 35 percent. Moreover, as Cato senior fellow Alan Reynolds has pointed out, the effective marginal tax rate for those workers is actually 2 to 3 percentage points higher than the 35 percent rate, because itemized deductions begin to be phased out if income tops $142,700 and personal exemptions are phased out above $214,050. Therefore these workers are already paying marginal tax rates in the range of 42 percent. And that doesn’t count state income taxes, which can add approximately 5 percentage points to marginal tax rates. Throw in the 2.9 percent Medicare tax, which is not capped, and upper-income workers are already facing marginal tax rates of over 45 percent. That is, nearly half of every additional dollar earned is taken in taxes.13

Adding 10 more percentage points by eliminating the cap on Social Security taxes would increase this to 55 percent. That would give the United States one of the highest marginal tax rates in the world, exceeding even such notoriously high-tax countries as Germany (47 percent), and roughly equal to that of Sweden (56 percent).14

Small businesses would be particularly hard hit. In fact, about one-third of the workers affected by raising the cap would be small business owners. Gene Steuerle of the Urban Institute believes that an increase in the payroll tax cap would have a disproportionate impact on small businesses, because of the difficulty in differentiating between earnings from work and earnings from investment in their businesses.15

Although there has been relatively little analysis of the economic consequences of raising or eliminating the payroll tax cap, it seems fair to assume that they would be considerable. For example, Edward Prescott, winner of the 2004 Nobel Prize in economics, has compared high-tax societies in Europe with the United States and found that workers respond to the incentives supplied by marginal tax rates. The higher marginal tax rates in Europe clearly discourage labor. In fact, Europeans work a full 50 percent less than Americans. That is a change from the early 1970s, when individual Europeans worked nearly 50 percent harder than Americans.16

Raising the tax cap is also likely to reduce national savings, since the upper-income households that would be subject to the increased taxes are also those that do much of the nation’s saving. More than 84 percent of those in the top 10 percent of incomes report saving during the previous year, whereas fewer than a third of those in the lowest 10 percent do.17

The Heritage Foundation estimates that removing the cap would reduce the rate of U.S. economic growth by 2–3 percent. Over the next 10 years, it would cost the U.S. economy nearly $136 billion in lost growth. In addition, roughly 1.1 million jobs would be lost over the next 10 years.18

Yet, in exchange for this massive tax increase and its attendant costs, Social Security would gain very little.

The Effect on Solvency

Advocates of removing the cap often make grand claims about its impact on Social Security solvency. For example, the Economic Policy Institute suggests that elimination of the cap would reduce Social Security’s 75-year funding shortfall by as much as 90 percent.19 However, those claims are based on a fundamental fallacy: the assumption that Social Security surpluses accumulated today can be saved through the Social Security Trust Fund.

Social Security payroll taxes are currently bringing in more revenue than the program pays out in benefits, a surplus that is projected to continue until approximately 2017. Thereafter, the situation will reverse, with
Social Security paying out more in benefits than it brings in through taxes. The surplus is used to purchase special issue Treasury bonds. When the bonds are purchased, the Social Security surplus becomes general revenue and is spent on the government’s annual general operating expenses. What remains behind in the Trust Fund are the bonds, plus an interest payment attributed to the bonds (also paid in bonds, rather than cash). Government bonds are, in essence, a form of IOU. They are a promise against future tax revenue. When the bonds become due, the government will have to repay them out of the general revenue.

Perhaps the clearest explanation appeared in the Clinton administration’s FY 2000 budget:

These [Trust Fund] balances are available to finance future benefit payments . . . but only in a bookkeeping sense . . . . They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large trust fund balances, therefore, does not by itself have any impact on the government’s ability to pay benefits.²⁰

Adding more money to the Trust Fund now would simply increase the number of bonds. The money from purchase of those bonds would revert to general revenue and be spent. It is an endless cycle that does nothing to change Social Security’s actual solvency.

A far better measure of Social Security’s finances and the impact of changes such as raising the tax cap is the annual cash-flow surplus or deficit, that is, the yearly gap between Social Security’s revenue and expenditures. This is a measure of the amount of additional revenue Congress will have to find—through taxes, borrowing, or reductions in other spending—if benefits are to be paid.

Figure 3 shows the current financial condition of Social Security. The program is running a surplus today, but by 2017 it will begin to run a deficit.²¹ Those deficits continue to increase, reaching 5.75 percent of payroll at
the end of the 75-year actuarial period, and continuing to grow outside thereafter. Overall, Social Security's unfunded obligations total $5.7 trillion over the actuarial period and $12.8 trillion over an infinite horizon.\textsuperscript{22}

How would changing the tax cap affect the fiscal balance? Figure 4 shows what would happen if the tax cap were raised to $150,000, approximately 90 percent of wages, while allowing workers to continue accruing benefits. There is almost no effect on Social Security's finances. The program begins to run cash-flow deficits in 2021, just four years later. At the end of the 75-year actuarial window, Social Security's deficits are just over one-half percent of payroll less than they would have been without raising the cap.\textsuperscript{23}

Moreover, this may actually overstate the gain to Social Security's finances. By dramatically increasing marginal tax rates on incomes above $90,000 per year, raising the cap would create a strong incentive for workers to shift assets from wages to income that is taxed at a lower rate, such as capital gains or dividends. While the Social Security Administration's actuarial estimates attempt to adjust for such income shifting, many observers believe that the impact could be larger than assumed by SSA's actuaries.\textsuperscript{24} For instance, Harvard economist Martin Feldstein estimates that this would cut income reported by about 7 percent as a result of reduced effort and increased tax avoidance.\textsuperscript{25}

Eliminating the cap obviously brings in more revenue than simply raising it, but far less than many believe. As Figure 5 shows, the date Social Security begins running deficits would move to 2024, a gain of just 7 years, while the shortfall in 2080 would be reduced from 5.75 percent of payroll to 4 percent.\textsuperscript{26} In other words, even after the largest tax increase in U.S. history, the program would still require a tax hike equal to a one-third increase in the payroll tax in order to pay promised benefits.

The most extreme proposal would be to eliminate the cap and not provide any additional credit toward benefits (Figure 6). The program would continue running surpluses until 2025, eight years longer than current projections, but would still fall into deficit thereafter. This move would cut the shortfall in 2080 by a little less than half, but it would still exceed 3 percent of payroll.\textsuperscript{27}

Thus, even the most drastic option does

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**Figure 5**
Social Security’s Payroll Tax Surplus or Deficit (eliminate cap, credit for additional benefits)

Source: Social Security Administration.

**Figure 6**
Social Security’s Payroll Tax Surplus or Deficit (eliminate cap, no additional benefits)

Source: Social Security Administration.
not come close to restoring Social Security to long-term solvency. Even more important, under every one of these options, at the end of the 75-year actuarial period the trend line is down, indicating that Social Security’s solvency will continue to deteriorate in the future. Quite simply, we can’t tax our way out of Social Security’s problems.

The Real Issues of Social Security Reform

It is also important to realize that Social Security’s problems are not just a matter of financing. While restoring Social Security to permanent sustainable solvency is an important goal of any reform, it should not be the only goal. Rather, Social Security reform should be seen as an opportunity to fix many of the underlying problems with the system.

The first of these is ownership. Under the current Social Security system, Americans have no ownership rights to their benefits. In 1960 the Supreme Court of the United States ruled in Flemming v. Nestor that Social Security was just another tax-and-spend program, no more special than corporate welfare or farm subsidies. Social Security “contributions” are a tax, the Court ruled, “benefits” just another spending program, and taxpayers have no legally enforceable claim to the payment of such benefits.28

This lack of ownership leads directly to another problem with the current Social Security system: a lack of inheritability. Although the current Social Security system does provide survivors’ benefits for children under age 18, millions of workers who die prematurely are unable to pass along a legacy to their loved ones. Social Security as it is structured today is, essentially, a 100 percent death tax. This is of particular importance to African Americans, the poor, and others with shorter life expectancies.

And, finally, it is important to realize that Social Security taxes are already so high compared with benefits that the program has become an increasingly bad deal for younger workers, providing a low, below-market rate of return. Indeed, on average, younger workers can expect a return on their taxes of less than 2 percent. For the upper-income workers likely to be affected by raising or eliminating the cap, the expected rate of return from Social Security is likely to be less than one-half of 1 percent.29

Raising taxes will do nothing to resolve these problems. It will not give workers ownership and control over their money. It will not allow low- and middle-income workers to accumulate a nest egg of real, inheritable wealth. It will not improve Social Security’s rate of return for younger workers. In fact, for those upper-income workers subject to the tax increase, it will make their already dismal rate of return even worse. In many cases, it would make that return negative.

A Better Alternative

Rather than increasing taxes, we should allow younger workers to privately invest a portion of their Social Security taxes through personal accounts.

And, although personal accounts would not by themselves solve all of Social Security’s financial problems, combined with other measures they could do far more to restore the program to solvency than could increasing the payroll tax cap.

For example, compare the most radical proposal, complete elimination of the cap and no additional benefits, with legislation introduced by Reps. Sam Johnson (R-TX) and Jeff Flake (R-AZ), which was based on the Cato Institute’s “6.2 Percent Solution” (Figure 7).30 The Johnson-Flake bill (HR 530) would allow workers under age 55 to save their half of the Social Security payroll tax (6.2 percent of wages) through individual accounts and would change the Social Security benefit formula from a wage index to a price index.

The Johnson-Flake bill restores Social Security to permanent sustainable solvency.31 Eliminating the cap does not. In fact, at the end of the 75-year actuarial period, Social Security without a cap on taxable earnings would still...
be facing a shortfall equal to 3 percent of payroll, whereas the Johnson-Flake bill would be running a surplus equal to 3 percent of payroll. Given that the Johnson-Flake bill also deals with Social Security’s other problems—it would give workers ownership and control over their retirement funds; allow workers to build a nest egg of real, inheritable wealth; and provide higher benefits than Social Security can currently pay—it clearly represents a better approach to Social Security reform. Other proposals for personal accounts would also be a significant improvement over proposals to raise or eliminate the cap.\textsuperscript{32}

\section*{Conclusion}

Social Security is insolvent. The troubled retirement program will begin running deficits in just 12 years and is facing unfunded obligations of roughly $12.8 trillion. The options for reform are limited. As then president Bill Clinton pointed out, the only choices are to raise taxes, cut benefits, or invest privately.\textsuperscript{33} That has led some observers to propose raising or even eliminating the cap on the amount of wages subject to the Social Security payroll tax.

Such a massive tax hike—the largest in U.S. history—would have serious consequences for both taxpayers and the U.S. economy. However, it would do relatively little for Social Security’s solvency.
nest egg of real, inheritable wealth. It would not improve Social Security's rate-of-return for younger workers.

At the same time, proposals for personal accounts would give workers ownership and control over their retirement funds. And, combined with measures to restrain benefit growth, they can do far more for Social Security's solvency than would eliminating the cap.

In the end, proposals for changing the taxable wage cap are all pain and no gain. With a viable alternative—creating personal accounts—Congress should not go down this road.

Notes
1. For example, a USA Today/CNN/Gallup poll showed that roughly two-thirds of voters supported removing the cap. Susan Page, “Poll: Tap Wealthy on Social Security,” USA Today, February 8, 2005.


5. Medicare payroll taxes were originally subject to the same cap as Social Security taxes. However, in 1990, Congress raised the wage base for Medicare taxes to $120,000, and in 1993 removed it entirely.


8. This is only a theoretical linkage. The Supreme Court ruled in the case of Flemming v. Nestor that there is no direct link between contributions and benefits. However, the current AIME/PIA benefit formula calculates benefits based on all wage income subject to the payroll tax.


12. Ibid.


14. Ibid.


Federal Old-Age and Survivors and Disability Insurance Trust Funds,” March 2005.

22. Estimates include the $1.7 trillion cost of redeeming the Trust Fund.


27. Ibid.


