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Social Security: Raising or Eliminating the Taxable Earnings Base

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Summary

Social Security taxes are levied on earnings up to a maximum level set each year. In 1999, this maximum — or what is referred to as the taxable earnings base — is $72,600.[1] There is no taxable earnings base for the Medicare Hospital Insurance (HI) portion of the tax; all earnings are taxable for HI purposes. Elimination of the HI base was proposed by President Clinton and enacted in 1993, effectively beginning in 1994. Recently, others have proposed that the base for Social Security be raised or eliminated as well. They complain that the limit on taxable earnings creates an overall regressive tax. They point out that the 94% of all workers whose earnings fall below this level have a greater proportion of earnings taxed than the 6% whose earnings exceed it. They contend that the revenues generated by raising the limit — estimated at nearly $80 billion in the year 2000 from taxing all earnings — could be used to reduce Social Security taxes for lower wage earners or help reduce the long-range actuarial shortfall in Social Security. Those who support retaining the base in its current form point out that Social Security's benefit formula favors low-wage earners by replacing a greater proportion of their earnings than it does for higher wage earners. They argue that the progressive benefits mitigate the regressive tax. They maintain that eliminating the base completely would cause enormous benefits to be paid to millionaires, weaken pensions and other forms of private savings, and erode public support for the program.

Background

Social Security was enacted in 1935, and the Social Security tax was first levied in 1937. From 1937 through 1949 the tax rate was 1% (on employee and employer, each) on earnings up to $3,000 a year. From then on, the rate and taxable maximum were increased numerous times to help meet the financing needs of the program and to keep the taxable maximum up to date with changing earnings levels. Medicare was enacted in 1965, and the HI portion of the program also was financed with payroll taxes. The HI tax was first levied in 1966 at a rate of 0.35% (on employee and employer, each) and the

[1] Social Security refers to the Old-Age, Survivors, and Disability Insurance (OASDI) programs authorized by Title II of the Social Security Act.

maximum taxable amount was set at the Social Security level.[2] The HI rate was subsequently raised from time to time (reaching its current level of 1.45% in 1986) to meet the financing needs of the program, but its base was tied to whatever it was for Social Security through 1990. In 1991, as a result of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-518), the HI base was raised to $125,000 (in lieu of the $53,400 level set for Social Security by the operation of prior law), and in 1994, as a result of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), it was eliminated.

All told, the base has been raised 33 times for Social Security and 24 times for HI. Since 1982, the Social Security base has risen at the same rate as wages in the economy. By law the Commissioner of Social Security is required to raise the base whenever an automatic benefit increase — cost of living adjustment (COLA) — is granted to Social Security recipients, assuming average wages have risen. An increase in the base from $68,400 in 1998 to $72,600 in 1999 was derived from an increase in average wages from 1996 to 1997.

Origin of the Base

People often ask why there is a maximum amount of earnings taxed each year — why aren't all earnings taxed?

In 1935, the designers of Social Security — President Franklin Roosevelt's Committee on Economic Security — actually did not recommend a maximum level of taxable earnings in its plan, and the draft bill that President Roosevelt sent to the Hill did not include one. The bill emphasized who was to be covered by the system, not how much wages should be taxed. Being in the midst of the Depression, the Administration's attention was on the large number of aged people living in poverty. Its goal in proposing a Social Security program was to complement public assistance measures (Old-Age Assistance) in its plan. The plan offered immediate cash aid to the aged poor plus an annuity system intended to lessen the need for welfare benefits in the long run. It was recognized that the annuity system would not provide a full retirement income, but would provide a "core" benefit as a floor of protection against poverty. Not concerned about high-income retirees, the Administration's proposal exempted non-manual workers earning $250 or

1999 Social Security and Medicare Tax Rates and Maximum Taxable Earnings

Social Security tax rate*	6.20%
Hospital Insurance tax rate*	1.45%
Maximum taxable earnings:	
Social Security	$72,600
Hospital Insurance	no maximum
Percent of covered earnings above the base (not taxed):	
Social Security **	14%
Hospital Insurance	None (all earnings are taxed)

**Employee and employer each; double for self-employed, but certain adjustments and income tax deductions apply.*

***Represents estimate for 1997; from 1998 Social Security Annual Statistical Supplement.*

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[2] The same maximum taxable amount was set for the self-employed when they were covered in 1951 and for the Disability Insurance (DI) portion of the tax when it was first levied in 1957.

more a month from coverage (which equated to $3,000 annually). Manual workers were to be covered regardless of their earnings, but few had earnings above this level.

It was the Social Security bill reported by the House Ways and Means Committee that clearly established a maximum taxable amount, which it set at $3,000 per year.[3] In addition, the committee dropped the exemption for non-manual workers with high earnings. The committee's report and floor statements made at the time give no clear record as to the reasoning for the taxable limit, but concerns about tax equity and attaining as much program coverage of the workforce as possible were suggested as factors for rejecting the high-earner exemption. Not covering them meant that they would not pay the tax where lower wage earners would, and coverage would be erratic for workers whose earnings fluctuated above and below the $250 monthly threshold.

Although tax policy concerns were raised in the years to follow — with a higher base preferred by those seeking a progressive tax system — there was never any serious attention given to eliminating the base entirely. In the late 1940s and early 1950s and to a lesser extent later on, the major arguments were over the base's size and how it affected the development of Social Security. A larger base meant that more earnings would be credited to a person's Social Security record, leading eventually to higher benefits (since benefits are based on a worker's earnings). Proponents argued that the base needed to be raised to reflect wage or price growth so that the benefits of moderate and well-to-do recipients would not diminish over time (thereby preserving their support for the system). Critics argued that this would increase benefits unnecessarily for people who could save on their own while making saving by private means more difficult. In 1972, procedures were enacted automatically increasing the base to reflect wage growth as a means of financing COLAs for Social Security recipients. In 1977, the base was raised beyond what resulted from the automatic provisions (by $7,500 over 3 years) as a means of raising revenue to help shore up the program. In 1990, as part of a 5-year plan to reduce the federal budget deficits, a higher base was set for HI ($125,000, effective in 1991). This two-tiered base system (one for Social Security and another for HI) was in place through 1993 when the HI base had reached $135,000. Then, in 1993, as part of his plan to reduce federal budget deficits, President Clinton proposed that the HI base be eliminated. It was enacted and took effect in 1994. It was estimated to generate $29 billion in new revenues cumulatively over the FY1994-FY1998 period.

Arguments For and Against Raising or Eliminating the Base

Recently new proposals to raise or eliminate the base have been made. Former Presidential candidate Michael Dukakis suggested taxing all earnings and lowering the Social Security tax rate. Senator Kennedy suggested a similar idea in a 1997 speech. In the 105th Congress Senator Moynihan proposed hiking the base to $97,500 by 2003 (or $15,600 higher than it otherwise is estimated to be) as part of a package of changes to restore long-range solvency to Social Security (S. 1792). Former Commissioner of Social Security Robert Ball recently made a similar proposal as did Brookings Institution

[3] The maximum for a worker was to be $3,000 per year *per employer*, so that, under the original legislation enacted in 1935, someone could have paid tax on more than $3,000 in earnings per year (and received benefits from all such wages) if they worked for more than one employer.

economists Henry Aaron and Robert Reischauer. Some general arguments for and against these ideas follow.

Arguments For. The major complaint about the Social Security base is that it creates a regressive tax structure. Critics point out that workers whose earnings fall below it have a greater proportion of earnings taxed than workers whose earnings exceed it. Someone with annual earnings of $30,000 pays $1,860 in Social Security taxes, or 6.2% of his or her earnings (ignoring the HI portion and the employer share of the tax). Since the tax is levied on only the first $72,600 in earnings (in 1999), someone earning $200,000 a year pays $4,501.20, or only 2.3% of his or her earnings. Critics argue that only 6% of workers have earnings above the base, and, therefore, contend that the current tax structure favors a small group of the most well off workers in society.

They point out that the overall employee tax rate rose from 6.13% in 1980 to 7.65% in 1990 (counting the Medicare portion) — or 25% — and complain that this increase is one of the main reasons for a disproportionate rise in the aggregate federal tax burden on lower and middle-income people over that decade. They further maintain that for most workers, Social Security and Medicare taxes (counting the employer share, which they view as a foregone wage) are now greater than their income taxes. They argue that, in the aggregate, 14% of earnings in covered employment escapes taxation because of the Social Security base, and that if the base were raised or eliminated, the tax rate that all workers pay could be reduced without causing a revenue loss to the system.

They point out that an estimated $400 billion or more in new Social Security taxes would be generated over the 2000-2004 period by taxing all earnings (averaging $80 billion annually), and if such revenues were not used to lower the overall tax rate, they would help reduce the government's outstanding debt as well as Social Security's long-range actuarial deficit.[4] The long-range deficit is currently projected to be about 16% of the program's income. Proponents of a base hike argue that, while it would cause a higher amount of benefits to be paid by the system (the additional "taxed" earnings would be added to the workers' Social Security earnings records), overall the system would experience a net revenue gain from the change. The actuaries of the Social Security Administration have estimated that if the base were eliminated, on average, over their 75-year valuation period $3 in revenue would result for every $1 in additional benefits. This could eliminate nearly 60% of the long-range Social Security deficit.[5]

Arguments Against. Those who support keeping the base in its current form argue that its critics often view the issue as only a tax policy matter — that they see only a regressive tax. They contend that this ignores the progressive nature of Social Security benefits — i.e., its benefit formula favors low-wage earners by replacing a greater proportion of earnings when such workers come onto the rolls than it does for higher

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[4] Estimates provided by the Office of the Actuary, SSA, based on the intermediate assumptions of 1998 OASDI trustees' report ($78 billion in CY 2000, $82.3 billion in 2001, $86.5 billion in 2002, $91.7 billion in 2003, and $97.5 billion in 2004). These are "static" estimates that assume no changes in employee compensation arrangements result from eliminating the base.

[5] In the 1998 trustees' report, the average deficit was reported to be 2.19% of taxable payroll. The SSA actuaries estimate that eliminating the base would generate revenue equal to 2% of payroll on average, while benefit costs would rise by 0.7%.

wage earners.[6] They argue that the progressive benefit package offsets any regressivity in the tax. They also point out that those who would raise the base in order to lower the rate often ignore the long-run costs of such a change. Although such a proposal would achieve revenue neutrality in the short run, it would increase the system's long-range expenditures (because more earnings would be credited to the work records of those effected and used to calculate their benefits), which already are a matter of some concern because of the large number of post-World War II baby boomers who will begin to enter their retirement years 10 years from now. This, they argue, is different from the elimination of the HI base, which carried no added benefit costs.

They further maintain that, while on its face the tax appears regressive, its critics fail to take into account the impact of the earned income tax credit (EITC). They point out that mitigating the Social Security tax bite was part of the motivation for the EITC, which provides an income tax credit on earnings up to $30,580 in 1999 for workers with two or more children (up to $10,200 for workers without children.) They also point out that overall a greater share of the income of low-income families is comprised of government transfer payments that are not subject to Social Security taxes. They argue that the combination of these factors mitigates the flat-rate nature of the tax at lower earnings levels, and that for most other workers the tax is proportional (because it is flat-rate). It is only at the upper end of the income spectrum that it takes on a regressive appearance.

From yet another perspective, some — who might otherwise espouse progressive taxation — support raising the base but not eliminating it because they believe doing so would weaken the principle that Social Security gives people something for their taxes. Having a cap makes Social Security seem less like general purpose taxation. They argue that the system needs support from people of all earnings levels, and that the larger benefits high earners would receive would represent a poor return for the higher taxes they paid. This, they contend, would add fuel to complaints that the system is not a good deal. Moreover, regardless of the money's worth issue, some question the wisdom of paying large benefits to well-to-do people. They argue that the purpose of the program is to provide a floor of protection for retirement, not large benefits for those who can save on their own. They contend that eliminating the base would cause Social Security to supplant part of the role of private pensions, while raising public cynicism about a publicly financed system that pays enormous benefits to people who already well off.

Table 1. Social Security and Medicare Tax Rates and Taxable Earnings Bases

Year	Tax rates			Maximum taxable earnings for Social Security & HI	% of workers with earnings below Social Security base	% of covered earnings below Social Security base
	Social[a] Security	HI[a]	Self-employed (Social Security & HI combined)			
1937	1.000	—	—	$3,000	96.9	92.0
1950	1.500	—	—	3,000	71.1	79.7
1951	1.500	—	2.25	3,600	75.5	81.1
1952	1.500	—	2.25	3,600	72.1	80.5

[6] Under the benefit formula for people becoming eligible in 1999, a worker's average indexed monthly earnings (AIME) are converted into benefits at a 90% rate on the portion of their AIME up to $505; from $477 to $3,043, the rate is 32%; and for AIME above $3,043, the rate is 15%.

Year	Tax rates: Social[a] Security	Tax rates: HI[a]	Tax rates: Self-employed (Social Security & HI combined)	Maximum taxable earnings for Social Security & HI	% of workers with earnings below Social Security base	% of covered earnings below Social Security base
1953	1.500	—	2.25	3,600	68.8	78.5
1954	2.000	—	3.0	3,600	68.4	77.7
1955	2.000	—	3.0	4,200	74.4	80.3
1956	2.000	—	3.0	4,200	71.6	78.8
1957	2.250	—	3.375	4,200	70.1	77.5
1958	2.250	—	3.375	4,200	69.4	76.4
1959	2.500	—	3.75	4,800	73.3	79.3
1960	3.000	—	4.5	4,800	72.0	78.1
1961	3.000	—	4.5	4,800	70.8	77.4
1962	3.125	—	4.7	4,800	68.8	75.8
1963	3.625	—	5.4	4,800	67.5	74.6
1964	3.625	—	5.4	4,800	65.5	72.8
1965	3.625	—	5.4	4,800	63.9	71.3
1966	3.850	0.35	6.15	6,600	75.8	80.0
1967	3.900	.5	6.4	6,600	73.6	78.1
1968	3.800	.6	6.4	7,800	78.6	81.7
1969	4.200	.6	6.9	7,800	75.5	80.1
1970	4.200	.6	6.9	7,800	74.0	78.2
1971	4.600	.6	7.5	7,800	71.7	76.3
1972	4.600	.6	7.5	9,000	75.0	78.3
1973	4.850	1.0	8.0	10,800	79.7	81.8
1974	4.950	.9	7.9	13,200	84.9	85.3
1975	4.950	.9	7.9	14,100	84.9	84.4
1976	4.950	.9	7.9	15,300	85.1	84.3
1977	4.950	.9	7.9	16,500	85.2	85.0
1978	5.050	1.0	8.1	17,700	84.6	83.8
1979	5.080	1.05	8.1	22,900	90.0	87.3
1980	5.080	1.05	8.1	25,900	91.2	88.9
1981	5.350	1.3	9.3	29,700	92.4	89.2
1982	5.400	1.3	9.35	32,400	92.9	90.0
1983	5.400	1.3	9.35	35,700	93.7	90.0
1984	5.700	1.3	14.0	37,800	93.6	89.3
1985	5.700	1.35	14.1	39,600	93.5	88.9
1986	5.700	1.45	14.3	42,000	93.8	88.6
1987	5.700	1.45	14.3	43,800	93.9	87.6
1988	6.060	1.45	15.02	45,000	93.5	85.8
1989	6.060	1.45	15.02	48,000	93.8	86.8
1990	6.200	1.45	15.3	51,300	94.3	87.2
1991	6.200	1.45	15.3	53,400 (HI-125,000)	94.4	87.8
1992	6.200	1.45	15.3	55,500 (HI-130,200)	94.3	86.8
1993	6.200	1.45	15.3	57,600 (HI-135,000)	94.4 est.	87.4 est.
1994	6.200	1.45	15.3	60,600 (HI-no limit)	94.6 est.	87.8 est.
1995	6.200	1.45	15.3	61,200 (HI-no limit)	94.2 est.	86.8 est.
1996	6.200	1.45	15.3	62,700 (HI-no limit)	Not yet known	86.1 est.
1997	6.200	1.45	15.3	65,400 (HI-no limit)	Not yet known	86.1 est.
1998	6.200	1.45	15.3	68,400 (HI-no limit)	Not yet known	Not yet known
1999	6.200	1.45	15.3	72,600 (HI-no limit)	Not yet known	Not yet known

Source: *Social Security Bulletin, Annual Statistical Supplement, 1998.*

[a] Same for employer except 1984 — employee received 0.3% credit (not reflected above). Various credits also applied to self-employed (not reflected above) for 1984-1989 period.