Order Code 97-116 EPW
Updated January 17, 2002

CRS Report for Congress
Received through the CRS Web

Social Security: Raising or Eliminating the Taxable Earnings Base

David Koitz and Geoffrey Kollmann
Specialists in Social Legislation
Domestic Social Policy Division

Summary

Social Security taxes are levied on earnings up to a maximum level set each year. In 2002, this maximum — or what is referred to as the taxable earnings base — is $84,900. There is no similar 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 taxing earnings only up to a certain level creates a 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 level — estimated at about $90 billion in 2002 if all earnings were taxed — 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 (since benefits are based on one's earnings record), weaken pensions and other forms of private savings, and ultimately 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

maximum taxable amount was set at the Social Security level.[1] 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.

The base has been raised 35 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 wages have risen. An increase in the base from $80,400 in 2001 to $84,900 in 2002 was derived from an increase in average wages from 1999 to 2000.

Origin of the Base

Year 2002 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	$84,900
Hospital Insurance	no maximum
Percent of covered earnings above the base (not taxed):	
Social Security **	16%
Hospital Insurance	(all earnings are taxed)

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

***Represents estimate for 1999; from 2000 Social Security Annual Statistical Supplement.*

People often ask why is there is a maximum amount of earnings subject to the tax — 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 and created 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 more a month from coverage (which

[1] 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.

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.[2] 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 later years, with a higher base preferred by those seeking a progressive tax system, there was little if 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 and lead 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 erode over time (thereby preserving their support for the system). Critics argued that this would increase benefits 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's ailing financial condition. In 1990, as part of a 5-year plan to reduce the federal budget deficits – i.e., the Omnibus Budget Reconciliation Act of 1990 – a higher base was enacted for HI ($125,000, effective in 1991). The HI base rose automatically to $135,000 over the next two years, at which point President Clinton proposed that it be eliminated altogether. He offered this as part of his 1993 plan to reduce budget deficits. His proposal was enacted as part of the Omnibus Budget Reconciliation Act of 1993 and took effect in 1994 (raising an estimated $29 billion in revenues over the FY1994-98 period).

Arguments For and Against Raising or Eliminating the Base

In recent years 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 made a similar proposal in a 1997 speech. In the 105th Congress Senator Moynihan proposed hiking the base to $97,500 by 2003 (or by $15,600 above what it would otherwise rise to) as part of a package of changes to restore Social Security's long-range solvency (S. 1792). He again included a base hike in a solvency package he introduced in the 106th Congress (S. 21). Similar base hikes were contained in other solvency bills introduced by Senators Gregg and Breaux, et.al. (S.1383

---

[2] 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.

and S.2774) and by Representative Nadler (H.R. 1043). In the 107th Congress, H.R. 2771 introduced by Representatives Kolbe and Stenholm would hold the base at 86% of total payroll. 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. In 2002, 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). However, because the tax is levied on only the first $84,900 in earnings, someone earning $200,000 a year pays $5,263.80, or only 2.6% of his or her earnings. Critics point out that only 6% of workers have earnings above the base, and, since 1991, the amount of their earnings that escapes taxation has risen from 12 % to 16%, and is projected to continue to rise. They therefore contend that the current tax structure favors a small group of the most well-off workers in society.

They also point out that the overall employee tax rate rose from 6.13% in 1980 to 7.65% in 1990 (counting the Medicare portion) — or by 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.

Thus, critics argue that raising or eliminating the base not only would be more fair, but also that either the tax rate could be reduced without causing a loss of revenue to the system, or, alternatively, that Social Security's projected long-range financing problems could be substantially alleviated. It is estimated that about $90 billion in new Social Security taxes would be generated annually by taxing all earnings, and if such revenues were not used to lower the tax rate, they would reduce the government's outstanding debt and Social Security's long-range deficit. This deficit currently is projected to be about 14% of the program's income. Proponents of a base hike argue that, while eventually it would cause higher benefits to be paid to some workers (because the additional "taxed" earnings would be added to the workers' Social Security earnings records), overall there would be a net revenue gain to the system. The actuaries of the Social Security Administration have estimated that if the base were eliminated, $3 in revenue would result for every $1 in additional benefits (on average over their 75-year valuation period). This could eliminate about 2/3rds of the long-range Social Security deficit.[3]

Arguments Against. Those who support keeping the base as is 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 perceived regressivity is offset by the progressive nature of Social Security benefits, i.e., its benefit formula favors low-wage earners by replacing a greater proportion of their earnings than it does for higher wage earners. They further maintain that while on its face the tax appears regressive, its critics fail to take into account the effect of the earned income tax credit (EITC). They point out that mitigating the

---

[3] In the 2001 trustees' report, the average deficit was reported to be 1.86% 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%.

Social Security tax bite was part of the motivation for creating the EITC, which provides an income tax credit on earnings up to $34,180 in 2002 for workers with two or more children (up to $12,065 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.

Supporters 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.

From another perspective, some — who might otherwise espouse progressive taxation — support raising the base but not eliminating it. They believe eliminating it 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 that high earners would receive would represent a poor return for the higher taxes they would pay. 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 are 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 Security[a]	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
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

Year	Tax rates: Social Security[a]	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
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	87.2
1994	6.200	1.45	15.3	60,600 (HI-no limit)	94.6	87.1
1995	6.200	1.45	15.3	61,200 (HI-no limit)	94.2 est.	85.9 est.
1996	6.200	1.45	15.3	62,700 (HI-no limit)	93.9 est.	85.5 est.
1997	6.200	1.45	15.3	65,400 (HI-no limit)	93.7 est.	84.8 est.
1998	6.200	1.45	15.3	68,400 (HI-no limit)	Not yet known	84.5 est.
1999	6.200	1.45	15.3	72,600 (HI-no limit)	Not yet known	84.4 est.
2000	6.200	1.45	15.3	76,200 (HI-no limit)	Not yet known	Not yet known
2001	6.200	1.45	15.3	80,400 (HI-no limit)	Not yet known	Not yet known
2002	6.200	1.45	15.3	84,900 (HI-no limit)	Not yet known	Not yet known

Source: *Social Security Bulletin, Annual Statistical Supplement, 2000.*

[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.