AARP Public Policy Institute

Perspectives

REFORMING SOCIAL SECURITY

Option: Increase the Payroll Tax Cap

The Social Security payroll tax currently applies to annual earnings up to $110,100. Any wages earned above $110,100 go untaxed for Social Security. This cap generally increases every year as the national average wage increases. Today, the cap covers about 84 percent of total earnings in the nation. Raising the cap to cover a higher percent of total earnings would help close Social Security's funding gap. How much depends on how high the cap is set and how quickly the cap would be raised to reach that level. One commonly mentioned goal would raise the cap to cover 90 percent of all earnings, which in 2012 would have meant a cap of about $215,000. This would mean any employee earning more than the current tax cap of $110,100 (as well as his or her employer) would have to pay more payroll taxes, up to about $6,500 per year for those earning $215,000 a year or more. Raising the cap to 90 percent is estimated to fill 36 percent of the funding gap.

Argument for:

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Argument against:

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Lifting the cap on earnings subject to Social Security taxes to cover 90 percent would complete the job that Congress started in 1977 when it set the cap to include 90 percent of the earnings of all covered workers. Congress also provided for adjusting the cap automatically to keep pace with average wage growth so that it would continue to cover 90 percent of earnings. But because of growing inequality since then, with today's top earners enjoying much bigger gains than everyone else, the cap now covers only about 84 percent of all earnings.

Lifting the cap to 90 percent is sensible and fair. Only 6 percent of workers earn more than the current cap of $110,100. These top 6 percent get a boost in their take-home pay when they reach the cap and stop paying into Social Security for the year. (Their employers stop paying in then, too.) For example, someone earning about $120,000 this year would hit the cap and stop paying into Social Security in late November, while someone making $2.5 million would stop paying in mid-January.

If phased in over five years, restoring the cap to include 90 percent of all earnings (or about $215,000 a year) and counting those earnings toward the worker's future benefits would—

- Restore the intent of Congress;
- Make Social Security financing more fair by requiring top earners to pay somewhat more into Social Security; and
- Eliminate more than a third (36 percent) of Social Security's projected financing gap over the long term.

David John

The bad news about this idea is that it would cause a hefty tax increase that will hit middle-income taxpayers while not affecting the rich. It would especially hurt the self-employed and certain smaller business owners. And such a move only delays Social Security's financial problems. It does not fix them.

The proposal would mean that people would pay Social Security payroll taxes on their first $215,000 of income instead of today's $110,100 level. If accepted, this move would hit employees with up to $5,500 in new taxes each year. What is worse, the self-employed and certain small business owners would see up to an $11,000 annual tax increase.

In general, increasing taxes is a bad idea. For one thing, it reduces the amount that Americans have to spend on their own and their family's food, housing clothes, education, and so on. Additional taxes that seem like a trivial amount to people in Washington may cause real problems to normal Americans.

Second, taking the approach that all Social Security needs is a tax increase keeps us from reviewing the program and seeing what works and what could be improved. Today's Social Security does many things right, but its treatment of women and lower-income Americans could be improved.

Finally, tax increases tend to look like they improve Social Security's finances more than they actually do because of the program's complex accounting methods. Social Security's experts say that requiring people to pay taxes on all of their earnings up to a maximum of about $215,000 would allow the program to be fully financed from its payroll tax from 2013 through 2019.

Starting in 2019, Social Security would again be forced to depend on its trust fund. Instead of running out in 2036 as it is now expected to do, the tax increase would keep the trust fund solvent until 2044. However, then everyone receiving Social Security benefits would see his or her benefits cut substantially.

This tax increase delays Social Security's problems by only eight years while hurting middle-class Americans. It does not fix the problems.

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NOTE: The estimated solvency effects in this Perspectives report are based on the intermediate assumptions in the *2011 Social Security Trustees Report*.

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