

# Would Lifting the Taxable Earnings Cap Make Social Security Solvent?

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*The annual Social Security Trustees report was quietly released in June, but it looked bleak. The Social Security program (including retirement benefits, Disability and Supplemental Security Income) is facing an \$11.4 trillion unfunded liability over the next 75 years. The liability increases to \$32 trillion into the indefinite future.*



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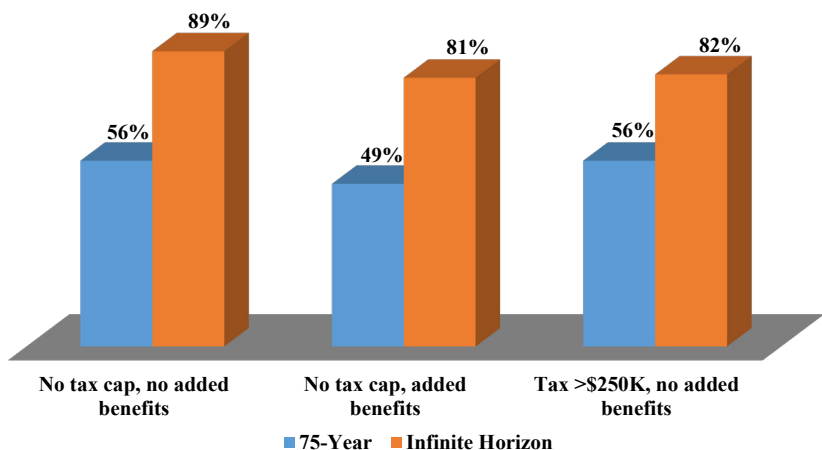
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**What Is an Unfunded Liability?** The unfunded liability is the difference between the benefits that have been promised to current and future retirees and what will be collected in dedicated taxes. So far, Social Security's revenue has exceeded its costs, but that will change in 2019, when the Treasury must begin drawing from the Social Security Trust Fund to pay some benefits. The \$2.8 trillion Trust Fund is the excess of payroll tax revenues over benefit payments. But no money has been actually set aside and invested. The excess money is spent on other programs and replaced with government promises to pay from general revenues. After these IOUs are redeemed by the U.S. Treasury, the Trust Fund will be depleted by 2034. At that point, Social Security will become insolvent.

The payroll tax rate for Social Security and Disability Insurance (OASDI) is 12.4 percent, split evenly between employees and employers. According to the 2016 Trustees Report, the funding shortfall is equivalent to 2.5 percentage points of taxable payroll from 2016 to 2090. Solvency would require an immediate payroll tax increase of 2.5 percentage points, possibly more. To extend solvency into the infinite horizon would require an immediate and permanent payroll tax hike of 4 percentage points.

**Percentage of the Funding Gap Closed Under Three Proposed Changes in the Taxable Maximum Wage**



Source: "Provisions Affecting Payroll Taxes," Social Security Administration.

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**The Taxable Maximum Wage.** Currently, only wages up to \$118,500 are subject to the Social Security portion of the payroll tax. In 2017, the taxable maximum salary cap will increase to \$127,200. A number of policymakers and politicians have raised the idea of eliminating the taxable maximum. In 2008, President Obama proposed taxing earnings above \$250,000. Presidential candidate Hillary Clinton also proposed this idea and floated the possibility of taxing other income not currently subject to the payroll tax, such as capital gains.

What would happen if the taxable earnings cap were lifted entirely? The Social Security Trustees calculated different “solvency provisions” and how they would affect the funding gap. Three are discussed below and shown in the figure.

**Scenario One: Eliminate the taxable earnings cap entirely, but do not provide benefit credits above the current-law taxable maximum.** According to the Trustees:

- Over one-half (56 percent) of the shortfall would be eliminated after 75 years. In the long-run (infinite horizon), the additional taxes would cover 89 percent of the shortfall.
- Social Security would remain solvent through 2082.

This is probably the least popular reform due to the fact that additional taxed earnings would be decoupled from retirement benefits, creating less of an earned benefit and more of a “welfare program.” This was not the original intention for Social Security.

**Scenario Two: Eliminate the taxable earnings cap entirely and provide benefit credits above the current-law taxable maximum.** As a result:

- Almost one-half (49 percent) of the funding shortfall would be eliminated after 75 years. In the long run (infinite horizon), the additional taxes would cover 81 percent of the shortfall.
- Social Security would remain solvent through 2067.

**Scenario Three: Tax all wages above \$250,000 at the 12.4 percent rate, but do not provide benefit credits for the additional taxes paid.** This scenario is similar to President Obama’s 2008 proposal. Earnings between \$118,500 (the current-law taxable maximum) and \$250,000 would not be taxed, but the payroll tax would apply to wages above \$250,000. As a result:

- More than half (56 percent) of the shortfall would be eliminated after 75 years. In the long run (infinite horizon), the additional taxes would cover 82 percent of the shortfall.

- Social Security would remain solvent through 2072.

### Is Raising Taxes on Workers a Good Idea?

Proponents of lifting the taxable earnings cap make these solutions sound fairly innocuous, but they all increase the marginal tax rate on work, potentially discouraging additional labor. In 2006, Jeffrey Liebman of Harvard University and Emmanuel Saez of the University of California - Berkeley examined the effects of eliminating the taxable earnings maximum. Based on longitudinal uncapped earnings records from 1981 to 1999 and previous empirical studies, they analyzed the effect of different wage elasticities — the change in gross earnings in response to an increase in taxes. They also assumed the employer’s share of the payroll tax is borne by the worker in the form of lower wages. They found:

- At an elasticity of zero, meaning no behavioral response, taxing 100 percent of wages would result in a 15 percent per earner increase in payroll tax revenue, but slight reductions in federal and state income tax revenue.
- At an elasticity of 0.2, taxing all wage income would result in a slight reduction in average earnings and 13 percent less in payroll tax revenue per earner compared to the zero elasticity scenario. Federal and state income tax revenue would also fall.
- At an elasticity of 0.5 there would be a further reduction in average earnings and a fall in payroll tax revenue of about 25 percent per earner compared to the zero elasticity scenario, with further reductions in federal and state income tax revenue.

Assuming a 0.5 percent elasticity, the net effect on total tax revenue would be zero. The additional payroll tax revenue gained would equal the income tax revenue lost at both the federal and state level.

**Conclusion.** Lifting the tax cap on earnings sounds like a simple fix for Social Security’s funding gap. The scenarios considered in the Trustees Report would extend the date of insolvency, but none would close the gap. If any were adopted, they could discourage work by the most productive workers, resulting in less payroll tax revenue than anticipated. Moreover, they would further weaken the link between earnings and benefits. Other solutions should be considered first.

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