Don’t Raise Social Security Taxes: But If It’s Necessary, Here’s How

By Andrew G. Biggs

As the debt-ceiling debate begins, congressional Republicans will demand spending cuts to counter any increase in the debt limit. These spending cuts are likely to include entitlement reforms, with Social Security, particularly, as a prime target. Most congressional Democrats might favor payroll tax increases to make Social Security solvent. But higher taxes discourage work and personal saving and encourage early retirement, with negative consequences for the economy. Although these increases clearly are not the best way to solve America’s overall entitlement problem, they may be necessary to consider if an agreement is to be reached. If so, payroll tax increases should be levied across the board, not merely on high earners, to reduce the economic impact and make all Americans aware of the costs of the benefits they all receive.

Even with the fiscal cliff agreement behind us, we can expect more budget negotiations as we inch closer to the debt ceiling. In exchange for increasing the debt limit, congressional Republicans, who failed to include any significant spending cuts in the deal from January 1, should demand that entitlement reforms be put on the table to stabilize the country’s fiscal path while also honoring its financial obligations. Rising entitlement outlays are the major driver of the long-term fiscal gap, and cuts to future entitlement benefits are more enforceable than other spending cuts, helping address conservative concerns that future Congresses will not follow up the new tax increases with agreed-upon spending cuts.

Of the three major entitlements, Social Security is the most likely to be on the table, as the available policy options are well-understood and House Speaker John Boehner (R-OH) and President Barack Obama already have touched on the program in the early fiscal cliff negotiations. But any Social Security reforms proposed by congressional Democrats will involve tax increases. Republican negotiators should bear in mind the economic effects of raising payroll taxes, which run contrary to common-sense policies in an aging society. If Social Security reform must involve tax increases,

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Key points in this Outlook:

- Reforms to entitlement programs will be a key issue in upcoming congressional budget negotiations, with Social Security the most likely target.
- An immediate increase in the payroll tax rate from 12.4 to 16.3 percent would be necessary to make Social Security permanently sustainable, and such a sharp increase would bring significant economic penalties.
- Although tax increases are not ideal, if they must be on the table, they should be levied across the board to allow all Americans to share the burden.
perhaps the best approach might be the simplest: raise the 12.4 percent Social Security payroll tax rate. At the least, this approach would ensure that everyone receiving benefits would be involved with paying for them.

**Raising the Payroll Tax Is Not the Best Answer**

Social Security levies a flat 12.4 percent payroll tax on earnings below $110,100 and pays a progressive benefit based on the same taxable earnings. The generosity of benefits has changed little over time, with a rising retirement age effectively compensating for longer life spans. The real change has been to taxes: what began as a 2 percent tax in 1935 has evolved into a 12.4 percent tax on earned income. In 1936, the Social Security Administration (SSA) promised that a 6 percent total tax, to be implemented in 1949, would be “the most you will ever pay.” In an ironic sense, SSA’s statement was correct: today, the Social Security tax is the biggest tax that most workers pay.

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Plenty of reasons exist not to raise Social Security payroll taxes. Consider this logic: an aging population requires that a smaller workforce support growing numbers of retirees. The only way for population aging not to devolve into a zero-sum fight between the young and the old is to grow the economy. Simply put, a larger economic pie is the only way to avoid a fight over the size of the slices.

To grow the economy, public policy should encourage Americans to do three things: work more, meaning more hours per day and more days per year; save more, in practice meaning greater participation in 401(k)s and other pension plans; and retire later, meaning extending work lives from today’s common retirement age of 62 to 65 or even 70. Together, these steps could meaningfully increase economic output and ease the financial burden of a graying America.

Now, consider how raising the Social Security payroll tax rate would impact these goals. First, like other taxes, it would discourage work, lowering the net return paid to employees in exchange for their time and effort. For instance, a 2005 study by Wilbert van der Klaauw of the University of North Carolina and Kenneth I. Wolpin of the University of Pennsylvania found that raising the payroll tax from 12.4 to 15.0 percent would reduce annual hours worked by around 6 percent for middle-aged individuals and even more for near-retirees. This would mean lower incomes and tax revenues.

Second, raising the payroll tax would discourage personal saving, because higher taxes would both facilitate higher future Social Security benefits and leave less take-home pay available to save. A literature review by the Congressional Budget Office concluded that one dollar of future Social Security benefits crowds out between zero and 50 cents of private saving. More recent research using better data indicates that, for middle and high earners, roughly two-thirds of Social Security benefits could be offset against private saving. This implies that high earners would mostly compensate for benefit reductions by saving more on their own, while tax increases to raise payable benefits to these groups would result in lower saving. Lower saving would weaken economic output.

And third, higher taxes would encourage early retirement, because the after-tax replacement rate offered by Social Security—that is, retirement benefits as a percentage of after-tax preretirement earnings—would increase. This makes retirement appear more attractive than continued work.

All told, raising Social Security taxes likely means we will have a smaller economic pie to fight over.

**Discouraging Saving in Middle-Income Households**

One could argue that despite all this, Social Security benefits are so important that raising taxes yet again is worthwhile. It is not simply that truly low-income Americans depend highly on Social Security in retirement. Middle- and even higher-income households also derive a significant share of their retirement income from the program. For instance, in a 2008 study for the Social Security Administration, Glenn Springstead and I found that for middle-income retirees Social Security constituted 41 percent of total household income. Even for the top fifth of retiree households, Social Security made up 29 percent of income.

But what many progressives count as a success may fairly be seen as a failure. Although dependence on Social Security by low earners is to be expected and the cost of
that support is accepted by both political parties, middle
and high earners could, should, and would save more on
their own in the absence of generous Social Security
benefits. One study by economists Jagadeesh Gokhale,
John Sabelhaus, and Lawrence Kotlikoff attributes most of
the postwar decline in personal saving to the size and
structure of government entitlement programs.\textsuperscript{5}

As I have noted, research shows that middle and high
earners treat Social Security benefits and personal saving
as substitutes. Social Security currently owes roughly
$22 trillion in accrued benefits, a value that rivals the
nonresidential private capital stock of the United States.\textsuperscript{6}
Had part of that value been in the form of real saving, US
productivity and economic output would have been con-
siderably higher. Real saving raises the capital stock, mak-
ing resources available for investment in factories, tools,
computers, and other assets that make workers and the
economy more productive. While little can be done today
to convert existing Social Security obligations into real
capital, it makes sense to boost saving going forward.

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Finding Ways Forward

The bottom line is that Social Security needs to be fixed.
But if Social Security reform enters the budget negotia-
tions, Democrats will certainly demand tax increases to
fix Social Security. And this set of tax hikes will fall on
the precisely same group targeted in the fiscal cliff deal:
high earners. For most Democrats, the preferred Social
Security reform by far is to increase or eliminate the
$110,000 cap on which payroll taxes are levied. On paper,
eliminating that cap and applying payroll taxes to all
earnings would keep the program funded for almost
75 years, if you take the trust fund to be a real store of
value rather than a mere accounting measure.

But that is true only on paper. A 2006 study by Har-
vard’s Jeffrey Liebman and the University of California’s
Emmanuel Saez—the former a Social Security expert and
high-ranking Obama budget official, the latter the author
of numerous tax studies embraced by the left—concluded
that under conservative assumptions regarding economic
and budgetary feedbacks, eliminating the payroll tax cap
would raise less than 60 percent of the net revenue
projected under static analysis.\textsuperscript{7} This would come at the
price of increasing effective top marginal tax rates by
roughly 10 percentage points.\textsuperscript{8} Using more aggressive,
but still reasonable, assumptions regarding taxes and
economic behavior, such as those generated by Harvard
economists Martin Feldstein and Raj Chetty, net rev-

du  nes likely would not rise at all.\textsuperscript{9} In other words, the
policy alternatives embraced by the left are not much of
an alternative.\textsuperscript{10}

Thus, if increasing Social Security taxes is the only
way to achieve Social Security reform, the most sensible
approach might be to do it the old-fashioned way: by rais-
ing the payroll tax rate. To make the system permanently
sustainable through only tax increases would require an
immediate and permanent increase in the rate from 12.4
percent to 16.3 percent.\textsuperscript{11} As I have noted, raising the
payroll tax rate carries significant economic penalties.
Yet spreading the tax increase among all workers, rather
than simply the top several percent, may lessen, though
obviously not eliminate, the aforementioned negative
economic effects.\textsuperscript{12}

Raising taxes is not a solution to the overall entitle-
ment problem. The tax increases necessary to fund rising
Social Security, Medicare, and Medicaid outlays would
harm the economy. Moreover, Social Security is the enti-
tlement for which tax increases are least appropriate:
while it is difficult for individuals to make up for lower
Medicare and Medicaid benefits through their own
saving, middle and high earners would react to lower
promised Social Security benefits by saving more and
delaying retirement. These steps could ameliorate Social
Security benefit cuts and strengthen the economy’s ability
to support larger numbers of retirees with a relatively
smaller population of workers. But if tax increases for Social Security are to be on the
table, raising the payroll tax rate would force all Ameri-
cans to pay for the entitlement programs that all Ameri-
cans benefit from. Progressives are fond of citing polls
stating that Americans love Social Security and are will-
ing to raise taxes to fund it. But what an individual tells a
pollster may differ from what he or she actually would
support. Congressional Democrats appear to understand
that: most of the reform proposals sponsored by liberals,
such as a recent plan introduced by Senator Mark Begich
(D-AK), involve raising taxes only on high earners, not
across-the-board rate increases.\textsuperscript{13} At least discussing an
overall payroll tax rate increase would put Americans on notice that if they want a growing entitlement state, they must be willing to pay for it.

Notes


8. The employee payroll tax rate is 6.2 percent, which at first glance would imply a smaller increase in marginal taxes. However, the standard assumption is that employers would reduce wages by the amount necessary to pay their own 6.2 percent tax, implying that after-tax wages would nevertheless decline by around 12.4 percentage points. However, assuming that individuals would continue to accrue benefits based on those higher taxable earnings, the new tax rate net of future benefits received would be roughly 10 percent.


10. Feldstein calculates an elasticity of taxable income of around 0.5 for high earners; Liebman and Saez show a range of values including 0.0, 0.2, 0.5, and 0.8. The figures cited in this paragraph for Liebman and Saez assume an elasticity of 0.2.


12. This derives from the rule in public finance that the “deadweight loss” of a tax rises with the square of the tax rate; thus, spreading a given tax increase over a larger number of taxpayers would have smaller negative economic effects than imposing it on a smaller group of taxpayers.