



Statement before the House Committee on Ways and Means
Subcommittee on Social Security
Hearing on Social Security's Finances

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Chairman Johnson, Ranking Member Becerra, and other members of the Subcommittee, thank you for the opportunity to appear before you for this timely hearing on options for ensuring the solvency of Social Security. As the Subcommittee is well aware, the 2011 Social Security Trustees Report was released last month, and it projects that the combined Social Security trust funds will begin to be drawn down in 2023 and will be exhausted in 2036, one year earlier than projected in the 2010 Trustees Report. Increases in both the number and life expectancy of retirees will drive the projected cost from 13.35 percent of taxable payroll in 2011 to 17.56 percent of taxable payroll in 2085. The projected cost in 2085 will exceed projected income levels by 4.24 percent of taxable payroll. The impending insolvency of the Social Security system is not uncertain. According to the Trustees Report, there is a 95 percent probability that the trust funds will be exhausted between 2030 and 2049.¹

To establish Social Security as a sustainable, solvent program, changes are necessary. A wide range of reforms have been proposed in recent years, and many of those proposals include changes both to future benefits and to payroll taxes. One example is the reform proposal of President Obama's National Commission on Fiscal Responsibility and Reform, chaired by former Senator Alan Simpson and Erskine Bowles.² A number of other Social Security reform proposals have sought to establish long-run solvency through benefit changes alone.

From a mechanical accounting perspective, a sustainable Social Security program could be achieved by either a reduction in the rate of growth of future benefits or tax increases. Tax increases can be considered solutions that enlarge the Social Security program to save it, while proposals that affect future benefits to create solvency can be considered solutions that reduce the size of the program in an orderly, predictable, and appropriate fashion. But the economic consequences of these two options are very different. They have different economic effects, particularly on labor supply, even if they appear similar in accounting terms. Proposals to address the shortfall in Social Security often fail to recognize these effects and instead offer a combination of changes, arguing that a solution involving both sides of the ledger is "balanced" and reflects the fair, bipartisan compromise achieved in the 1983 reforms.³

This is a hearing about the tax options to solve the Social Security problem, so my testimony will focus on the economic consequences of tax changes—to workers and employers, the economy, and the Social Security program and beneficiaries. The taxes paid into the Social Security trust funds originate from two sources. First, the vast majority of trust fund income comes from a 6.2 percent employee payroll tax and a 6.2 percent employer payroll tax and the parallel 12.4 percent tax on self-employment earnings. Second, a portion of income taxes

¹ *The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*, May 13, 2011, www.ssa.gov/oact/tr/2011/tr2011.pdf.

² National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, December 2010, www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf. I served as a consultant to the Commission for tax policy matters.

³ Peter A. Diamond and Peter R. Orszag, "Reforming Social Security: A Balanced Plan," Brookings Policy Brief, no. 127 (December 2003), www.brookings.edu/papers/2003/12saving_orszag.aspx.

imposed on certain Social Security benefits are also directed to the Social Security program. The payroll tax is subject to a wage ceiling, currently \$106,800 in 2011. Payroll taxes totaled \$637.3 billion in 2010, and income taxes paid to the trust funds totaled \$23.9 billion.⁴

Economic Consequences of Payroll Tax Changes

To explore the economic impact of the payroll tax, I will focus on three primary characteristics: the combined employer and employee payroll tax rate, the taxable wage base, and the share of compensation that is payroll (wage) income. Policymakers considering tax changes to strengthen the Social Security system could consider raising the payroll tax rate (marginal tax rate increase), raising or eliminating the payroll tax cap (wage base broadening), or taxing total compensation rather than only wages (more fundamental base broadening).

First and foremost, I would like to stress that in evaluating the impact and consequence of any tax increase geared at addressing the solvency of the Social Security system, the burden of the tax is greater than just the tax itself. Taxpayers often alter their behavior in response to a tax, and this response gives rise to an excess burden or deadweight loss. The greater the behavioral response, the greater the excess burden. A host of behavioral responses may result from an increase in the payroll tax rate, including fewer hours worked, a shift from taxable wage income to fringe benefits, and an increase in other forms of tax avoidance. The net combined effect of tax rate changes on the amount of reported taxable income is known as the elasticity of taxable income.

In 2004, Harvard economist Martin Feldstein examined the expected behavioral impact of raising the payroll wage cap from \$87,900 (the taxable maximum in 2004) to \$120,000.⁵ Taking as an example a worker who makes \$110,000, Feldstein found that the jump in the marginal payroll tax rate from 0 to 12.4 percent on each dollar between \$87,900 and \$110,000 would likely lead the worker to reduce reported taxable income by about 7 percent.⁶ In other words, for someone earning \$110,000, increasing the payroll wage cap to \$120,000 would result in reported wages dropping to \$102,000, leading in turn to a reduction in the amount of income and Medicare taxes the worker pays. In Feldstein's analysis, the additional Social Security revenues from raising the wage cap are more than offset by reductions in federal and state income taxes and Medicare taxes.

A more recent study by Jeffrey Liebman and Emmanuel Saez found that under the same assumed behavioral response made by Feldstein, an increase in the payroll tax base from 84

⁴ *The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.*

⁵ Martin Feldstein, "The \$110,000 Question," *Wall Street Journal*, September 1, 2004.

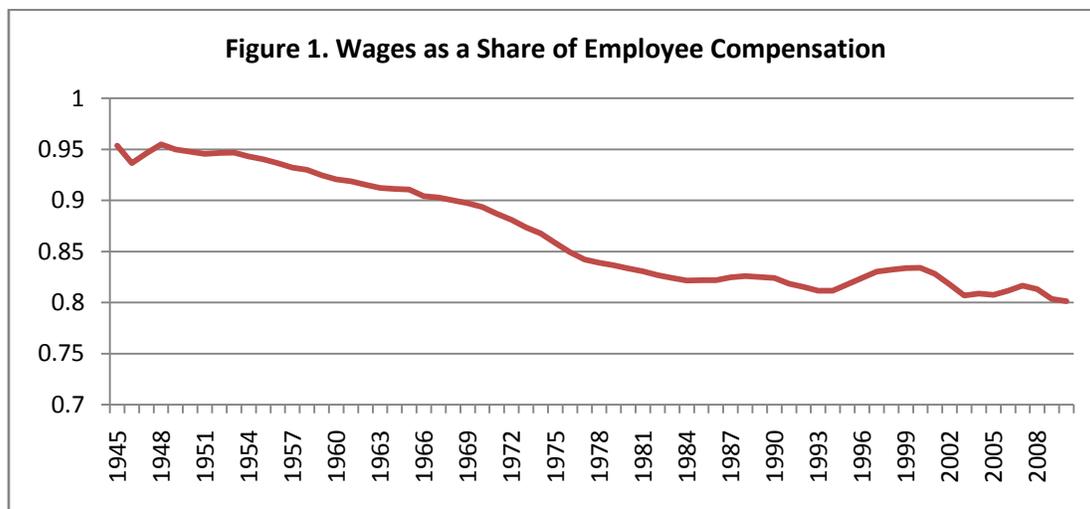
⁶ *Ibid.* Feldstein assumes a taxable income elasticity of 0.5. Alan Viard also assumes a 0.5 elasticity of taxable income in his analysis of a millionaire's surtax (Alan D. Viard, "The Case Against the Millionaire Surtax," *Tax Notes*, December 21, 2009, www.aei.org/article/101464). Viard's work relates to the income tax, not the narrower payroll tax.

percent of taxable wages to 90 percent of taxable wages would result in an average per-worker payroll increase of \$136 but a decline in all other taxes of \$120.⁷ Liebman and Saez note, “This shows that, with an elasticity of 0.5, the current system is close to the Laffer rate maximizing tax revenue for high incomes.”⁸ While Liebman and Saez express the view that the elasticity may likely be less than 0.5, both their research and the work by Feldstein lead to the same conclusion: raising the cap on the payroll tax results in an increase in Social Security taxes but a significant offsetting loss of other taxes and a considerable economic distortion.

A Closer Look at Behavioral Responses

In the examples outlined above, the taxable income elasticity incorporates a range of behavioral responses. Looking more closely at the types of responses yields additional insights.

Wage vs. Non-Wage Compensation. The payroll tax is a tax on wages, not total worker compensation, and therefore creates a distortion between wage compensation and non-wage compensation, such as health benefits and other fringe benefits. When an employer pays a worker wages, the employer deducts that cost from their own taxes, while the worker reports the wages as income. However, when an employer compensates a worker with a non-taxable fringe benefit, it is deducted from the employer’s income and excluded from the worker’s income. As a result of this distortion, there has been a decrease in wages as a share of total employee compensation (see Figure 1).



Source: Bureau of Economic Analysis, National Income and Product Accounts.

The tax bias against wages as a form of compensation betrays a “consumption inefficiency” brought about by the tax code’s making the goods offered as fringe benefits

⁷ Jeffrey Liebman and Emmanuel Saez, “Earnings Responses to Increases in Payroll Taxes,” September 2006, <http://elsa.berkeley.edu/~saez/liebman-saezSSA06.pdf>.

⁸ Ibid. Liebman and Saez also estimate the impact of payroll tax hikes assuming a taxable income elasticity of 0.2 and of 0.8. Even assuming a taxable income elasticity of 0.2, the offsetting revenue loss from other taxes is sizable.

artificially cheap.⁹ For example, the tax-induced shift toward fringe benefits that workers value less than cash leads to consumption of more elaborate fringe benefits, including more “first dollar” health insurance, an insurance design likely to result in excess consumption of health care services.

Tax preferences for fringe benefits also introduce distortions that affect firm behavior. According to economist Robert Turner, “Tax preferences reduce the cost of labor differentially across firms and individuals because tax benefits increase with higher marginal tax rates. This effect may differ across workers, and some firms have cost advantages over others.”¹⁰

As these examples demonstrate, the consequences of the shift in compensation are important. While many Social Security reforms propose subjecting a greater share of payroll to the payroll tax, few have focused on more broadly taxing compensation income. For example, the Simpson-Bowles plan anticipated that the tax reform provisions would yield a broader payroll tax base by subjecting some fringe benefits to tax, but that effect was not included in the actuarial analysis of the Social Security reform proposal contained in the Commission’s report. In addition, the Special Committee on Aging of the U.S. Senate issued a report on Social Security in May 2010 that outlined a host of proposals that would raise payroll tax rates 1–2 percentage points or raise the wage cap from its current level to 90 percent of all wages.¹¹ However, the Aging Committee’s report did not offer a specific proposal regarding taxation of fringe benefits.

Labor Supply. For some workers, higher payroll taxes affect decisions about whether or how much to work. With regard to the impact of higher payroll taxes on labor supply, it is important to note that behavioral responses vary considerably across workers of different types. For example, a number of economists have documented that married female workers are more likely to reduce their labor supply as a result of a marginal tax rate increase. To obtain the aggregate effect of a tax change on labor supply, one need only estimate the weighted average labor supply response. However, given the disparate responses observed among men and women and across income levels, it is valuable to acknowledge that the adverse impact on women is likely greater than the impact on men.

Entrepreneurship. Economists Bill Gentry and Glenn Hubbard have estimated a sizeable effect of progressive tax rates on entrepreneurship.¹² They determined that “the level of the marginal tax rate has a negative effect on entrepreneurial entry, [and] the progressivity of the tax

⁹ Robert Turner, “Fringe Benefits,” in *The Encyclopedia of Taxation and Tax Policy*, 2nd edition, ed. by Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle (Washington, DC: Urban Institute Press, 2005).

¹⁰ Ibid.

¹¹ U.S. Senate Special Committee on Aging, *Social Security Modernization: Options to Address Solvency and Benefit Adequacy*, May 13, 2010, <http://aging.senate.gov/ss/ssreport2010.pdf>.

¹² William M. Gentry and R. Glenn Hubbard, “‘Success Taxes,’ Entrepreneurial Entry, and Innovation,” in *Innovation Policy and the Economy, Volume 5*, ed. by Adam B. Jaffe, Josh Lerner, and Scott Stern (Cambridge, MA: MIT Press, 2005), www.nber.org/chapters/c10808.pdf.

also discourages entrepreneurship.”¹³ This result is important because it illustrates the indirect effects that Social Security can have on the broader economy. For example, lifting the cap on the payroll tax would be a boon for the Social Security trust funds but would likely have negative implications for new firm formation and innovation.

Macroeconomic Consequences. Interesting recent research on the impact of rising health care costs on future tax rates by economists Katherine Baicker and Jonathan Skinner lend insight to the impact of payroll tax hikes on economic growth.¹⁴ Baicker and Skinner’s model analyzes the per-capita GDP effect and the associated excess burden caused by financing the projected rise in federal health care spending through various tax rate increases. While the magnitude of projected health care costs exceeds the estimated shortfall in Social Security by a wide margin, the research demonstrates how even an across-the-board increase in payroll taxes would result in more than \$1 in lost utility for every \$1 in increased taxes paid. Baicker and Skinner find that doubling the payroll tax rate would reduce per-household GDP by 5 percent.

Conclusion

There are dozens of imaginable tax increase proposals that would mitigate the shortfall in the Social Security system, but it is important to recall, as I mentioned earlier, that all the tax proposals can be characterized as rate increases, wage base increases, tax base broadening, or a combination thereof. But I would also reiterate that raising taxes to avert insolvency is likely to discourage work—and thus long-term economic growth.

Marginal tax increases will generate more income for the Social Security trust funds, but that additional revenue comes at a cost. Rate increases borne by taxpayers already facing high marginal tax rates have a far greater distortionary effect than if applied to untaxed activities or taxpayers facing a low marginal tax rate. The least bad of the various tax options would be broadening the base by taxing fringe benefits. This would at least eliminate the existing distortion between wage and non-wage compensation. Such a change, if combined with a reduction in the statutory payroll tax rate, could reduce the excess burden of the payroll tax.

However, there are many other reforms worth adopting before considering tax increases. While those issues are beyond the scope of this hearing, I would encourage the Committee to explore changes to the retirement age, the benefits formula, and the consumer price index methodology for calculating cost-of-living adjustments before considering tax increases. I would also encourage the Committee not to wait until a “full” reform, one that returns the trust funds to long-run solvency, can be agreed to. Many incremental reforms could be considered now. The sooner Congress adopts pro-solvency measures, the less consequential they need to be.

¹³ Ibid.

¹⁴ Katherine Baicker and Jonathan S. Skinner, “Health Care Spending Growth and the Future of U.S. Tax Rates,” National Bureau of Economic Research Working Paper 16772 (February 2011), www.dartmouth.edu/~jskinner/documents/w16772.pdf.