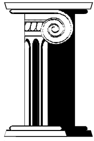

INSTITUTE BRIEF

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Eliminating the Cap is Unwarranted, Unfair, and Ineffective

by Brad Cook

Despite the President's best efforts, many Americans are, for some reason, still skeptical of implementing voluntary Personal Retirement Accounts. One differing proposal that seems to have garnered much attention across America is eliminating the $90,000 cap on wages subject to the Social Security payroll tax. Sixty-five percent of Iowans interviewed in a recent poll published by *The Des Moines Register* "favored making all wages subject to the payroll tax rather than exempting wages above the first $90,000."[1] Not only is the current $90,000 cap on payroll taxes above historical levels, but eliminating the cap would also be detrimental to our economy as the largest tax increase in history, with little effect on the solvency of Social Security.

Despite what many proponents of eliminating the payroll tax cap may say, it is not at a historically low level. When Social Security was originally passed in 1939, Congress set the cap on payroll taxes at $3,000. If the cap was never nominally raised, instead raised regularly by the rate of inflation, the original cap would have been $40,586 in 2004 dollars — less than half the current cap. Proponents are also quick to point out that the proportion of wages subject to the payroll tax has declined from the historical high of 90 percent following the 1983 payroll tax increase. However, they neglect to mention that the current level of 86 percent is still greater than the post World War II average of 84.4 percent.[2]

If Congress and the President were to eliminate the payroll tax cap, they would be responsible for the largest tax increase in American history — "amounting to over $600 billion between FY 2006 and FY 2010 and over $1.4 trillion from FY 2006 and FY 2015."[3] Eliminating the cap would have a direct effect on almost 10 million workers, and would increase the top marginal tax rate on wage income to almost 50 percent, the highest rate since President Kennedy's income tax cuts.

Those most hurt by the tax increase would be small business owners who are above the current cap. An estimated 3 million small business owners and their 4.5 million family members would be affected by eliminating the payroll cap, subjecting them to a $242 billion tax increase over the next five years. These 3 million small business owners pay $129 billion in total wages (accounting for almost a third of all small businesses) and account for nearly $30 billion (one-fourth) of all interest expenses paid by small business.[4] If these small business owners become subject to the $242 billion dollar tax increase, they will have less money to hire and pay employees, invest in capital, purchase equipment, or purchase any number of other services. Not only would these small business owners be hurt, but so too would their paid employees, as well as the individuals and businesses that purchase their goods or supply them with goods.

The tax increase would also have a much broader effect on the economy as a whole. According to a recent econometric study, if the cap was to be removed, the rate of economic growth would decrease,

gross domestic product would be $100 billion lower than the baseline forecast by FY 2015, and there would be about 1 million fewer Americans working by the end of FY 2015, resulting in an unemployment rate increase of 0.3 percentage points. As a result of the slowdown in the economy, real disposable income for a family of four would fall $2,248 by the end of FY 2015, with consumer spending dropping about $1,500 for a family of four. Because of the loss in disposable personal income, the average family of four would be able to save almost $700 less (adjusted for inflation), lowering the already low savings rate 0.4 percentage points.[5]

Even if the cap is eliminated, it would have a negligible effect in resolving Social Security solvency. As projected by the Social Security Administration, under the current system Social Security will begin to pay out more in promised benefits than it collects in taxes by 2017. By redeeming trust fund assets, Social Security could continue to pay out full promised benefits until 2041, at which point the trust fund becomes exhausted. After 2041 Social Security will only be able to pay out 74 percent of promised benefits and then only 68 percent after 2079.[6] Eliminating the cap only prolongs this heartache eight years, to where Social Security would begin to pay out more in benefits than it receives in taxes by 2025.[7]

Though eliminating the cap on taxable wages may be seen as a reasonable reform because it is a tax increase targeted toward upper-income workers, Congress and the President would be ill-advised to pass such a reform. Since its adoption in 1939, the Social Security payroll tax rate has been increased more than 20 times and when adjusted for inflation, the current cap is more than double the original cap of $3,000. Despite these multiple tax increases, Social Security still faces inevitable bankruptcy. It is time for Congress and the American people to begin to accept alternatives to the current system, where the only reform possibilities are to cut benefits or hike up taxes.

(Endnotes)

1 Jane Norman, "Poll: Iowans against private Social Security accounts," *The Des Moines Register,* April 24, 2005, <http://www.desmoinesregister.com/apps/pbcs.dll/article?AID=/20050424/NEWS09/504240351/1001/NEWS> (5/2/05).
2 Rea S. Hederman, Jr., Tracy L. Foertsch, Ph.D., and Kirk A. Johnson, Ph.D., "Keep Social Security Wage Cap: Nearly a Million Jobs Hang in the Balance," *The Heritage Foundation,* April 20, 2005, pp. 4-5.
3 Ibid., p. 6.
4 Norbert J. Michel, Ph.D., J. Scott Moody, and Ralph A. Rector, Ph.D., "Raising the Social Security Cap Would Hurt Small Businesses," The Heritage Foundation, *Backgrounder,* No. 1845, April 19, 2005.
5 Hederman, p. 8.
6 Social Security Administration, *The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds,* March 23, 2005, p. 8, <http://www.socialsecurity.gov/OACT/TR/TR05/index.html> (April 28, 2005).
7 Hederman, p. 2.

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