

Sixteen for '16 - Number 6: Flat Tax for Social Security

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The FICA payroll tax may be the most regressive tax in the developed world: The least a progressive administration could do would be to remove the taxable maximum.

Who pays for government? Conservatives are fond of pointing out that most income taxes are paid by the rich. Technically speaking, they're right. More than half of all personal income tax is paid by households with incomes of more than \$200,000 a year.<sup>1</sup> Most of the rest is paid by households in the top half of the income distribution.

Conservatives are also fond of pointing out that many households pay no personal income tax at all. Again, technically speaking they're right. In most years, almost half of all households pay no personal income tax, most (but not all) of them relatively poor households.<sup>2</sup> Mitt Romney was right about the bottom 47 percent.

He was right, that is, about income tax. If you don't have income, you don't pay income tax. For the 18 million Americans who want jobs but don't have jobs, not paying income tax is the least of their worries.<sup>3</sup> Ditto retired people getting by on Social Security and single parents caring for young children.

Then there are the people who work but who earn so little that their tax credits outweigh their tax liabilities. On \$7.25 an hour, it's hard to make enough money to have any personal income tax liability. The earned income tax credit is, in effect, a federal program that subsidizes low-wage employment through the tax system.

But nearly everyone who works for a living pays taxes. They're just not called income taxes. They're called payroll taxes, or FICA (Federal Insurance Contributions Act) taxes.

There are two FICA taxes. The main FICA tax is a 12.4 percent tax on wage income up to \$117,000 a year. This is known as the Old Age, Survivors and Disability Insurance (OASDI) tax or Social Security tax. Half of the Social Security tax is paid directly by the employee and the other half is paid by the employer on the employee's behalf.

The maximum amount of wages that are subject to taxes - \$117,000 in 2014 - is known as the wage base or taxable maximum. Wages over the taxable maximum are not subject to Social Security tax. The taxable maximum rises slowly over time according to a formula based on average wages.

The second FICA tax is a 2.9 percent tax on all wage income. This is known as the Hospital Insurance (HI) or Medicare tax. Like the Social Security tax, the Medicare tax is split 50-50 between employees and employers. Unlike the Social Security tax, the Medicare tax is paid on all wages.<sup>4</sup>

Taking both Security and Medicare taxes into account, the total combined FICA payroll tax load is 15.3 percent of wage income on all wages up to \$117,000, dropping to 2.9 percent of all wage income over \$117,000. There are no deductions and no exemptions. Everyone pays.<sup>5</sup>

But unlike with personal income taxes, with FICA taxes, the more you make, the less you pay. A person who makes \$117,000, pays \$17,901 in FICA taxes. A person who earns twice as much - \$234,000 - pays \$21,294. That lucky high-wage person has twice the income, but pays just 19 percent more in taxes.

If that seems unfair, spare a tear for the two-earner family. A married couple in which each partner earns \$117,000 pays a total of \$35,802 in FICA taxes (\$17,901 each), while a single person who earns \$234,000 all alone pays \$21,294 in FICA taxes. The married couple pays 68 percent more than the single person. The FICA tax system has a built-in marriage penalty.

The FICA tax system shatters Mitt Romney's suggestion that nearly half of all Americans are spongers and scroungers. All working Americans pay substantial taxes, and when it comes to FICA taxes, the poorest pay the most. The only people who don't pay FICA taxes don't pay them for the simple reason that they don't have jobs.

The FICA payroll tax is perhaps the most regressive tax in the developed world. The richest 1% of American households pay an average FICA tax rate of just 2.2 percent.<sup>6</sup> Their average FICA tax is even lower than the 2.9 percent minimum because much of their income comes from investments, which are not subject to FICA taxes.

How important are FICA taxes? All told, FICA taxes bring in more than \$1 trillion a year and account for more than one-third of all federal government revenue.<sup>7</sup> That's almost as much as the personal income tax and about three times as much as the corporate income tax. The federal government could not operate without the income it receives from FICA taxes.

Because the two FICA taxes are called the Social Security tax and the Medicare tax, people tend to think of them as funding these two programs. In a sense they do. But the connection between FICA and these programs is grounded in legislative history, not in economic reality.

In economic reality, caring for the elderly and disabled is a primary function of government. We spend more than \$800 billion on Social Security and \$500 billion a year on Medicare, far more than on defense (\$620 billion) and diplomacy (\$50 billion) combined.<sup>8</sup>

In economic reality, FICA taxes are just like any other taxes. Contrary to popular belief, their proceeds are not set aside and ring fenced for Social Security and Medicare. The so-called Social Security and Medicare trust funds are little more than accounting devices.

It is true that the original FICA Social Security tax was created by the same 1935 legislation that created Social Security. That's unfortunate. The legacy historical tie between FICA and Social Security gave us a wage tax system that is fundamentally flawed and profoundly unfair.

The fundamental flaw crept in when the Social Security Act of 1935 (of which FICA is part) was making its way through Congress.

The Roosevelt administration proposed a system of old-age insurance that would cover all blue-collar manual workers and some white-collar office workers - those who made less than \$3,000 a year (equivalent to slightly more than \$50,000 today).<sup>9</sup> The system was intended to cover all bone fide working-class workers but to exclude managers and executives, who could be expected to plan for their own retirements.

Congress mangled the \$3,000 limit contained in the Roosevelt plan. Instead of legislating that only working-class workers would receive Social Security benefits while excluding white-collar employees earning more than \$3,000 a year, Congress extended Social Security benefits to everyone who earned a paycheck, no matter how large. All workers are covered by Social Security old-age insurance.

The \$3,000 eligibility test that Roosevelt had proposed to separate working-class office workers from managers and executives was sidestepped but not forgotten. Instead, Congress used \$3,000 as a limit on the amount of income that would be subject to Social Security taxes. This limit, which has risen to \$117,000 in 2014, is now known as the taxable maximum.

As a result, Roosevelt's system for providing old-age support to ordinary bona fide workers funded by a flat tax on the wages of ordinary bona fide workers was turned into a Congressional system for providing old-age support to all workers funded by a regressive tax on the wages of all workers.

The regressive nature of Social Security taxes makes them profoundly unfair. Important taxes that support core government services should be based on taxpayers' ability to pay. The personal income tax is highest on high incomes. The corporate income tax focuses on profitable companies, not loss-making companies. The FICA payroll taxes are the only major taxes that systematically decline as ability to pay increases.

Until 1994, both FICA taxes were completely regressive, with high-earners paying nothing on their wages over the taxable maximums. Then, as part of President Bill Clinton's first-term Deficit Reduction Act, the taxable maximum was removed for the smaller FICA tax that is nominally earmarked for Medicare.

As a result, all wages at all levels are now subject to the 2.9 percent Medicare tax, while only wages under \$117,000 are subject to the larger 12.4 percent Social Security tax.

It's too bad that Clinton wasn't able to remove the taxable maximum from all FICA taxes back in 1994. Estimates are that removing the \$117,000 taxable maximum would generate an additional \$100 billion a year in federal revenue, all of it from high-income taxpayers.<sup>10</sup>

If we want to reduce the federal deficit from its recent record levels, surely it would be fairer to do so by extending the same FICA taxes to everyone than by cutting food stamps or laying off federal workers. Better to flatten FICA than to flatten future benefits for people who depend on Social Security.

A progressive FICA tax (in which low earners paid lower tax rates) would be even fairer. The progressive political agenda doesn't always have to be about higher taxes. A flat FICA payroll tax system would not dramatically alter the federal government's budget position. An extra \$100 billion would be very welcome, but in a \$3.5 trillion budget, it would not be decisive.

The progressive political agenda does always have to be about fairness. The current regressive FICA system is a poke in the eye of all working Americans who aren't lucky enough to make six-figure incomes. It is a poke in two eyes for dual-earner families.

Congress made a mistake in 1935 when it legislated the original taxable maximum for Social Security. That mistake has stood for 80 years. No one who voted on it is alive today. We should not forever be prisoners to the politics of the past.

A flat tax for Social Security would be a fair tax for Social Security. What Bill Clinton did for the Medicare tax in 1993, the next president can do for the Social Security tax in 2017. Who knows - maybe the next president could go one step farther. A progressive payroll tax would be even more ... progressive? Either way, a flat FICA would be a good place to start.

#### NOTES:

1 Calculations based on IRS SOI Tax Stats - Individual Statistical Tables by Size of Adjusted Gross Income, Individual Complete Report (Publication 1304), Table 1.1, 2011.

2 Tax Policy Center (2011), Tax Units with Zero or Negative Tax Liability, Current Law, 2004-2011.

3 Calculations based on Employment Situation Summary Table A. Household Data, 2013.

4 The 2010 Affordable Care Act created additional taxes that also are called Medicare taxes, but they are not part of the FICA wage tax system discussed here.

5 A small number of state and municipal employees are exempt from FICA for technical historical reasons.

6 CBO (2013), The Distribution of Household Income and Federal Taxes, 2010, Table 2.

7 OMB Historical Table 2.1: Receipts by Source, 1934-2019 and Historical Table 2.2: Percentage Composition of Receipts by Source, 1934-2019.

8 OMB Historical Table 3.1: Outlays by Superfunction and Function, 1940-2019.

9 Under the administration's proposal all manual workers would be covered no matter what their wages, but white collar workers would be covered only if they made less than \$250 per month (\$3,000 per year), the implication being that low-wage secretaries and typists would be covered but not high-wage managers and executives; see Francis Perkins et al (1935), Report of the Committee on Economic Security, Social Security Administration archives.

10 Estimate based on figures from Janemarie Mulvey (2010), Social Security: Raising or Eliminating the Taxable Earnings Base, Congressional Research Service report RL32896.