American Enterprise Institute for Public Policy Research

March 2008

On the Issues

Barack Obama's Social Security Donut Hole

By Andrew G. Biggs

Until recently, Senator Barack Obama (D-Ill.) was surprisingly responsible regarding Social Security, noting the urgency of reform and saying all options should be on the table. But having cornered himself with Democratic activists whose attitudes toward Social Security reform range from demagoguery to denial, his solution to the system's problems has veered leftward. He now plans to fix Social Security exclusively with higher taxes. The new Obama plan would not only fail to resolve the system's long-term problems, but would also impose significant costs on the economy as a whole.

Through much of the presidential campaign, Obama was the most engaged and responsible of the Democratic presidential aspirants when it came to Social Security reform. On a number of occasions, he has noted the need to reform the program, which faces deficits beginning in roughly ten years and insolvency in the 2040s. Obama said that all options for reform should be on the table for consideration. His Social Security adviser, Harvard economist Jeffrey Liebman, is among the brightest and most fair-minded analysts in the field.

This seeming moderation on Social Security prompted a backlash from the liberal blogosphere and opponents in the Democratic presidential primary, and today the senator is reverting to old-line liberal remedies. "Once people are making over $200,000 to $250,000," Obama says, "they can afford to pay a little more in payroll tax." He makes no mention of shared sacrifice or outreach to moderates or conservatives. As this statement indicates, Obama proposes eliminating the $100,000 ceiling upon which Social Security's 12.4 percent payroll tax is levied, while creating a "donut hole" exempting earnings between $100,000 and $200,000. There is a big problem with this proposal: this donut is sure to become a Danish. Obama's plan fixes less than half of Social Security's long-term deficit, making further tax increases to fill the gap inevitable.

Andrew G. Biggs is a resident scholar at AEI. A version of this article appeared in the *Wall Street Journal* on March 12, 2008.

Social Security Financing

The Social Security program is currently running a surplus of approximately 1 percent of taxable payroll. The program's trustees project that these surpluses will turn to deficits in 2017 and that Social Security's trust fund will be exhausted around 2040. Over the next seventy-five years, Social Security faces a shortfall of 1.95 percent of payroll. This can be interpreted as meaning that an immediate and permanent increase in payroll taxes of 1.95 percentage points—from the current 12.4 percent to 14.35 percent—or an equivalent immediate and permanent reduction in benefits would be sufficient to keep the trust fund solvent for the next seventy-five years. To achieve "sustainable solvency" extending beyond seventy-five years—a goal for reform proposals since the 1994–96 Advisory Council on Social Security appointed by President Bill Clinton—would require significantly larger changes.

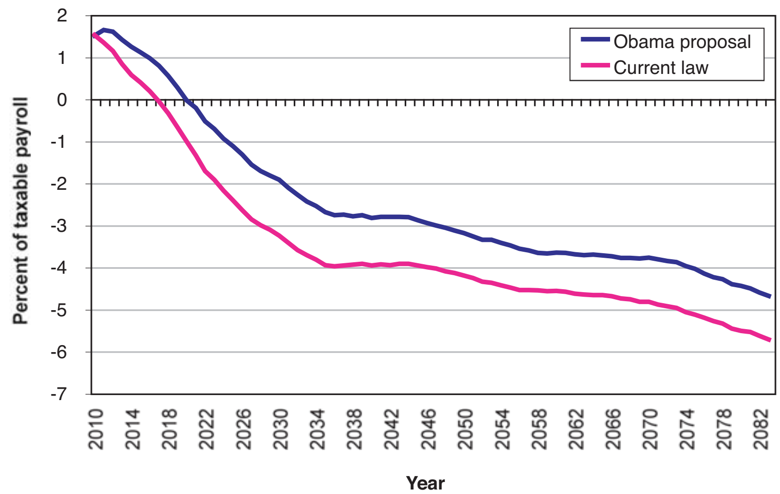
I estimate the effects of Obama's proposal using the Policy Simulation Group's GEMINI model, a microsimulation of the U.S. population and

Social Security finances that is used by the Government Accountability Office in its Social Security analyses.[1]

Obama's campaign has stated that the proposal would be phased in over time. I have assumed that beginning in 2010, the maximum taxable wage would be increased by increments of $100,000, and in 2021, the earnings cap would be eliminated entirely. An exclusion from taxes would be established beginning at the current law taxable maximum of $102,000 and extending up to $204,000; these boundaries are increased each year with average wages in the economy.

Given the scale of the tax rate increases—a 12.4 percentage point increase in tax rates for the highest earners—it is striking how little Obama's plan would accomplish. The GEMINI model estimates that Obama's plan eliminates only around 43 percent of Social Security's seventy-five-year shortfall. Even after the plan's implementation, Social Security would face a seventy-five-year shortfall of around 1.12 percent of payroll.[2]

FIGURE 1
SOCIAL SECURITY NET CASH FLOW, 2010–2080



SOURCE: Author's calculations, GEMINI model.

> There is a big problem with this proposal: this donut is sure to become a Danish. Obama's plan fixes less than half of Social Security's long-term deficit, making further tax increases to fill the gap inevitable.

Moreover, even this improvement assumes that Congress saves the increased taxes—almost $600 billion over ten years—rather than using them to cover deficits elsewhere in the budget. A number of econometric studies have concluded that surpluses in Social Security tend to encourage deficits elsewhere in the budget, instead of reducing net borrowing and adding to national saving.[3] If this is the case, then the Obama proposal, which would increase the trust fund balance in the short term, would tend to subsidize other government spending rather than provide a broader budgetary or economic foundation for Social Security financing.

By a more rigorous measure of Social Security's financing—the program's annual cash surpluses or deficits—the Obama plan also fails to address long-term problems. When fully phased in, Obama's proposal makes annual cash flows about 1 percent of payroll better than current law. By the 2030s, Social Security would still run annual deficits exceeding $150 billion (in 2008 dollars).

The annual cash deficit at the close of the scoring period, a rule of thumb used by Social Security's actuaries to gauge progress toward sustainable solvency, would be reduced by only around one-fifth—from around 5.5 percent of payroll to around 4.5 percent. Obama's plan would come nowhere close to restoring Social Security to sustainable solvency.

This is not to gainsay the improvements to Social Security financing that Obama's proposal would accomplish. Solving half of a very large problem is better than solving none of it, which is where some of Obama's presidential competitors currently reside. Nevertheless, Obama cites the donut hole plan as evidence that we need not consider other policies, such as reducing the growth of future benefits or increasing the Social Security retirement age. In truth, such policies would be needed *in addition* to the plan Obama has proposed.

Other Shortcomings with Obama's Plan

The Obama plan's modest improvements to Social Security's financing come at a steep cost: top marginal federal tax rates inclusive of federal income, Social Security, and Medicare taxes would increase from 37.9 percent to 50.3 percent.[4] Put another way, the Obama proposal is equivalent to repealing the Bush administration's reductions in top income tax rates from 39.6 percent to 35 percent almost three times over.

In addition, the average top state income tax rate is 6.4 percent, and Obama's pledge to formally rescind the Bush tax cuts would add 4.6 percentage points to top tax rates on earned income. Thus, in an Obama administration, tax rates on earned income exceeding 60 percent are easily possible, putting the United States among the highest rates in the Organisation for Economic Co-operation and Development (OECD).

The Obama proposal is equivalent to repealing the Bush administration's reductions in top income tax rates from 39.6 percent to 35 percent almost three times over.

The estimates using the GEMINI model are based on static projections, assuming no changes to individual behavior. There are several reasons, however, to believe that even the modest improvements to system financing shown above may be overstated.

First, if employers reduce wages to cover their increased payroll tax liabilities, as economic theory indicates they would, these reduced wages would no longer be subject to state or federal income taxes or Medicare taxes. A 2006 study by Liebman and Emmanuel Saez concluded that roughly 20 percent of revenue increases would be offset by declining non-Social Security taxes.[5]

Second, individuals may respond to higher marginal tax rates by reducing their work effort. Assuming modest negative behavioral responses, Liebman and Saez projected an additional 30 percent reduction in net revenues, leaving barely half the original revenue intact.

Third, Obama's plan would dramatically raise incentives for tax evasion, potentially further degrading revenue gains. Many high-earning individuals evade the 2.9 percent Medicare payroll tax by creating subchapter S corporations, paying themselves in untaxed dividends rather than taxable wages. Former senator John Edwards (D-N.C.) avoided $590,000 in Medicare taxes this way in the 1990s. Had Obama's plan been in place, Edwards's tax savings would have exceeded $3 million.

Obama's plan shows the limits of solving the fiscal gap exclusively on the backs of the affluent. Top earners would effectively be tapped out, with taxes as high as economically and politically feasible, yet most of Social Security's deficit and the much larger shortfalls in Medicare would be untouched.

Another problem with the Obama plan is the effect it would have on future generations' earnings and taxes. To analyze the effects of the Obama proposal on the distribution of taxes and benefits within Social Security, I use the GEMINI microsimulation model to simulate the donut hole plan on the 1990 birth cohort. These individuals are entering the workforce today and would work most of their lives with the higher payroll tax ceiling.

About 9.3 percent of the 1990 birth cohort would pay higher taxes over their lifetimes under the Obama proposal. While a very small percentage of individuals earn over $200,000 in any given year, it is not the same individuals each year. For those affected by the provision, total lifetime earnings would be reduced by 8.8 percent. These individuals would pay, on average, 2.27 times more in taxes over their lifetimes than they would receive in benefits.

Social Security as a "Welfare Program"

The United States already collects far more Social Security taxes from high earners than other countries do. While payroll tax rates are often higher in other developed countries, the level of wages to which these rates apply is generally lower.

The current U.S. wage cap equals around 2.9 times average earnings, far above the 1.9 times average among OECD countries. In Canada and France, payroll taxes are levied only up to the average wage; in the UK, to 1.15 times the average wage; and in Germany and Japan, to 1.5 times.[6] Social Security is already more progressive than the typical OECD country's pension program, and Obama's plan would make it more so.

This aspect of Obama's proposal presents perhaps the greatest potential cost: the effect on the character of the program itself. Unlike traditional welfare programs, Social Security has never been strongly progressive. In fact, as originally conceived by Franklin Roosevelt's Committee on Economic Security, high earners would have been exempt from the program, meaning there would have been *no* redistribution from these individuals to lower earners. Social Security currently has a modest tilt toward low earners, but not enough to impose a stigma on the poor or a work disincentive on the affluent. Many believe the system's relatively low progressivity has helped retain the program's political support over time. In the aphorism of Social Security's founders, "a program for the poor is a poor program."

While Social Security benefits are progressive up to the wage ceiling, the cap prevents Social Security from imposing a confiscatory burden on high earners. As of 2005, roughly 84 percent of total wages are subject to Social Security taxes. While down from around 90 percent in the early 1980s, this level is slightly above the program's historical average of 83.3 percent.[7]

President Clinton considered lifting the wage ceiling modestly but was skeptical of plans that would, in his terms, "soak" high earners with taxes many times what they could expect to receive in benefits. Eliminating the wage cap outright, Clinton said in 1998 at an event promoting Social Security reform, would "tremendously change the whole Social Security system. . . . We should be very careful before we get out of the idea that this is something that we do together as a nation, and there is at least some correlation between what we put in and what we get out," Clinton said. "You can say, 'well, they owe it to society.' But these people also pay higher income taxes, and the rates are still pretty progressive for people in very high rates."[8]

A Shared Burden

Social Security's shortfalls are attributable to society-wide trends of lower birth rates and longer life spans. An argument can be made for increased progressivity to target Social Security's limited resources more effectively, but Obama's proposal to raise tax rates massively on high earners will have significant costs for the economy and for Social Security's political support. To retain the shared character that distinguishes Social Security from traditional welfare programs, the burdens of reform should be shared proportionately. Obama should drop his exclusive focus on raising taxes and return to his previous view: that Social Security faces significant problems requiring prompt attention, and all options for reform should be considered. These positions show both insight and political courage and present hope for fixing this important program.

Notes

1. For more details on the GEMINI model, see www.polsim.com.

2. This 1.12 percent actuarial deficit under the Obama plan is calculated relative to a payroll base that is 9 percent larger under current law. The payroll tax increase applied to the *current* wage base to achieve seventy-five-year solvency would also be larger, at approximately 1.22 percent, versus 1.95 percent under current law. Thus, part of the measured improvement in the Obama plan is simply the creation of a larger payroll base upon which *additional* tax increases could be applied.

3. See Kent Smetters, "Solvency and Reform of Social Security: Is the Social Security Trust Fund a Store of Value?" *American Economic Review* 94, no. 2 (May 2004); Barry Bosworth and Gary Burtless, "Pension Reform and Saving" (paper presented at the International Forum of the Collaboration Projects, Tokyo, February 17–19, 2003, revised January 5, 2004), available at www.brookings.edu/~/media/Files/rc/papers/2004/0105useconomics_bosworth/200401bosworthburtless.pdf (accessed March 17, 2008); and Sita Nataraj and John B. Shoven, "Has the Unified Budget Undermined the Federal Government Trust Funds?" (Working Paper 10953, National Bureau of Economic Research, December 2004), available through www.nber.org/papers/w10953 (accessed March 17, 2008).

4. This makes the conventional assumption that the full payroll tax burden—2.9 percent for Medicare and 12.4 percent for Social Security—is born by the employee.

5. Jeffrey Liebman and Emmanuel Saez, "Earnings Responses to Increases in Payroll Taxes" (paper, National Bureau of Economic Research, September 2006), available at www.nber.org/programs/ag/rrc/04-06LiebmanSaez%20Final1.pdf (accessed March 24, 2008).

6. Organisation For Economic Co-Operation and Development, *Pensions at a Glance: Public Policies across OECD Countries*, June 2007, available through www.oecd.org/document/35/0,3343,en_2649_34757_38717411_1_1_1_1,00.html (accessed March 24, 2008).

7. See U.S. Social Security Administration (SSA), Office of Policy, Office of Research, Evaluation, and Statistics, *Annual Statistical Supplement to the Social Security Bulletin, 2006* (Washington, DC: SSA, June 2007), 4.12–4.13, table 4.B1.

8. Bill Clinton, "The Great Social Security Debate" (speech, Kansas City, MO, April 7, 1998), available at www.concordcoalition.org/images/event-transcript/98-greatdebate/kcss0498.html (accessed March 17, 2008).