SO YOU THINK THE SOCIAL SECURITY TAX IS FLAT OR REGRESSIVE; HARDLY!

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ABSTRACT

Federal payroll taxes are frequently referred to as examples of taxes that are proportional or regressive. In fact, the benefits are heavily weighted to those participants at lower income levels. Individuals retiring in 2007 received benefits that are 90 percent of weighted average earnings (indexed) up to $680 per month, but only 32 percent of earnings from $680 to $4,100 and 15 percent for earnings above $4,100. Therefore, it can be argued that the system, considering both the cost and the benefits, is quite progresssive. This study is a first step in research attempting to analyze the extent of this progressiveness.

INTRODUCTION

The federal government imposes two taxes on employment—social security taxes (providing both income and medical benefits) and an unemployment tax. The social security tax under the Federal Insurance Contribution Act (FICA) imposes a tax on both employees and their employers, while the Federal Unemployment Tax Act (FUTA) is paid entirely by the employer. Self-employed individuals are required to pay the entire FICA tax on net earnings from self-employment but do not pay FUTA taxes are not eligible for unemployment benefits. The FUTA tax is not considered in this analysis since it is paid entirely by employers.

If one looks only to the social security tax that provides for old age, survivors, and disability insurance (OASDI), which is proportional at 6.2 percent for the employee, and 6.2 percent for the employer, one may first see a flat tax system. However, because payment stops when a specific amount of eligible earned income is reached ($97,500 in 2007), the average rate goes down as income increases—causing some to apply the regressive label. Another reason is that the tax is only applied to earned income. If one recognizes that higher income individuals are likely to have proportionally more income from capital gains, dividends, and similar items that are *unearned,* the effective percentage drops for them.

The tax that provides for medical insurance (Medicare) is also proportional at 1.45 percent for the employee and another 1.45 percent for the employer, but is assessed on all eligible earned income, without limit. While this is clearly a flat tax, all qualified individuals receive the same benefits under Medicare (regardless of the amount of tax paid). Therefore, since higher income earners pay more for the same benefits, Medicare has avoided the regressive label.

The main purpose of this paper is to illustrate that classifying the social security tax as flat or regressive is not a fair assessment. To begin, although social security tax payments are not set aside for each annuitant and there is no guaranteed benefit, there is a direct relationship between the earnings on which the tax is paid and the benefits anticipated under the current system. However, in the following examples, it is demonstrated that the benefits received by lower income taxpayers are much higher relative to the tax paid than are the benefits received by higher income taxpayers. On a systematic basis, this lower income bias appears to completely overcompensate for any regressivity in the tax rate.

THE PROGRESSIVE ANNUITANT BENEFIT

The monthly old age benefit paid to beneficiaries is the primary feature of the Social Security program. The calculation of these benefits is prescribed in detail by the Social Security Act. Over the years there have been many changes to the formulas. The basic formula now used for determining most new annuitants' monthly primary insurance amount (PIA) is the 1978 Average Indexed Monthly Earnings formula (AIME) [6]. This basic formula uses three rates in the calculation (90%, 32%, and 15%) that are clearly biased in favor of lower income recipients. This effect can be best observed through situations.

For example, Fred and Susan both retire on July 1, 2007, their 67th birthday. The monthly social security benefit check that each will receive depends on the indexed average monthly earnings (the average monthly earned income on which each of them paid social security taxes, indexed for inflation in wages) during their 35 highest earning years. In our example, we find that Fred's annuity is based on adjusted average monthly taxable income of $500; Susan's, on $7,500. Susan has paid 15 times as much social security tax into the system than Fred did. If the distribution system were not a biased, it might be expected that Susan's annuity would be 15 times that for Fred; however, when the formula using the three different rates is applied, the benefits presented in this table illustrate a different result.

	Fred			Susan		
Benefit Brackets	$680	$4,100	Excess	$680	$4,100	Excess
Adjusted Base in Bracket	$500	$ -0-	$ -0-	$680	$3,420	$3,400
Benefit Bracket Percent	0.90	0.32	0.15	0.90	0.32	0.15
Benefit Earned Per Bracket	$450	$ -0-	$ -0-	$612	$1,094	$510
Total Monthly Benefit		$450			$2,216	

The example demonstrates that, while Susan paid 15 times more tax into the social security system, her monthly annuity benefit is only about five times the amount of Fred's. This calculation shows that the social security system is not regressive or even proportional, but quite progressive, redistributing wealth from higher income individuals to lower income individuals.

OTHER CONTRIBUTING FACTORS

Benefits to disabled individuals and the survivors of deceased taxpayers are also calculated using these three different benefit levels based on adjusted average monthly earnings. These features of the social security system also provide benefits that are proportionally greater for lower income earners.

Medicare Surcharge

Starting in 2007, a surcharge to the monthly Medicare premium for higher income individuals is imposed. By 2009, this surcharge is expected to quadruple the monthly premium for individuals with income exceeding $80,000 for single taxpayers and $160,000 for married couples. The surcharge was established by a provision of the *Medicare Prescription Drug Improvement and Modernization Act of*

2003 (Pub. L. 108-173) (signed into law by the President on December 8, 2003) that added a prescription drug benefit to Medicare. Since health benefits appear to be linked more to factors other than wealth, it is possible that lower income individuals use more health care while they pay much less into the system, making the Medicare system clearly progressive instead of flat.

Taxing Social Security Benefits

Social Security annuitants originally paid no income tax on their benefits. That changed in the mid-eighties when up to 50 percent of the benefits were subject to taxation. Then, in 1993, there was an increase where up to 85 percent of benefits could be taxed. The taxable portion is based on what is called modified taxable income (AGI before the social security, municipal bond interest, and one-half of the social security benefit to the extent the total exceeds a base amount). As a result, an increase in some other taxable income or tax-exempt municipal bond interest can cause more of the social security to be taxed. Currently, this phase in stage begins at incomes of $25,000 (single) and $32,000 (married filing jointly). For single annuitants whose income exceeds $34,000 ($44,000 for married filing jointly), 85 percent of the social security benefit is taxable. Clearly, this taxing of social security benefits as the annuitant's income increases is a progressive aspect favoring lower income annuitants.

CONCLUSION

This paper is a first step in research intended to educate people, using simple examples and other tools, that the social security tax "system" is not, as commonly believed, regressive, or even flat. Instead, the social security tax system is progressive and becoming more so. Not withstanding attempts to eliminate the social security system, either entirely or in part, most recent legislation has had the effect of increasing benefits, or at least maintaining the cost of benefits, for lower income individuals, while reducing after-tax benefits and increasing the costs for higher income individuals. Armed with this information, one can make better decisions such as when to *retire*, and for those who have choices, how much to earn each year before retirement (including the effects of low or zero earnings years when one does not work or works for an employer that does not participate in the social security system).

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