SOCIAL SECURITY'S FINANCES

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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SOCIAL SECURITY'S FINANCES

THURSDAY, JUNE 23, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
JOINT WITH
SUBCOMMITTEE ON SOCIAL SECURITY,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:04 p.m., in Room B–318, Rayburn House Office Building, the Honorable Sam Johnson (Chairman of the Subcommittee) presiding.

[The advisory of the hearing follows:]

HEARING ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

Chairman Johnson Announces Hearing on Social Security's Finances

June 23, 2011

U.S. Congressman Sam Johnson (R–TX), Chairman of the House Committee on Ways and Means Subcommittee on Social Security announced today that the Subcommittee will hold a hearing on Social Security's current revenue streams, proposed changes to those structures and the impact they would have on the program, beneficiaries, workers and the economy. **The hearing will take place on Thursday, June 23, 2011 in B–318 Rayburn House Office Building, beginning at 1:30 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

The 2011 Annual Report of the Social Security Board of Trustees again highlighted the financing challenges facing the Old Age and Survivors Insurance (OASI) and the Disability Insurance (DI) programs. The trustees project permanent and growing cash flow deficits, and by 2036 the combined OASI and DI Trust Funds are projected to become exhausted and unable to pay scheduled benefits. The DI Trust Fund is projected to become exhausted in 2018. The Public Trustees expressed the need for action soon in order to be able to protect vulnerable populations and those at or near retirement age.

Social Security benefits are financed primarily by payroll taxes on covered wages. The Federal Insurance Contributions Act ("FICA") imposes a tax on covered wages up to the taxable wage base of $106,800 in 2011, divided between employers (6.2%) and employees (6.2%). Self-employed taxpayers are subject to payroll tax under the Self-Employed Contributions Act ("SECA") on the same wage base with a rate equal to 12.4 percent (the total combined employer-employee rate). The wage base is adjusted annually based on average wage growth, if a Social Security cost-of-living adjustment is payable.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reduced the OASDI payroll tax paid by the worker by 2 percentage points in calendar year 2011. The law also required the Secretary of the Treasury to make general revenue transfers to replace revenues temporarily diverted from the trust funds.

According to the Social Security Administration, about 94 percent of workers in paid employment and self-employment are covered under the OASDI program. The majority of non-covered workers are in State, local, or the Federal Government.

In addition to Social Security payroll taxes, certain Social Security beneficiaries must include a portion of Social Security benefits in taxable income for the Federal income tax, and the Social Security program receives part of those taxes.

According to the 2011 Annual Report of the Social Security Trustees, in calendar year 2010, Social Security non-interest income was $637.3 billion from payroll taxes and $22.7 billion from the taxation of benefits. Social Security tax income as a percent of taxable payroll will grow from 12.52 in 2011 to 13.31 in 2086, due to growth in income from the taxation of benefits.

The Social Security actuaries have estimated a number of revenue generating proposals, including those proposed by the President's Fiscal Commission which would require all newly hired state and local workers to participate in Social Security and increase the amount of earnings subject to Social Security payroll taxes by increasing the taxable wage base.

In announcing the hearing, Chairman Sam Johnson (R–TX) stated, "When Social Security first began, the payroll tax was only 2 percent—evenly split between employers and employees—on the first $3,000 in wages. Today the payroll tax is 12.4% on the first $106,800 in wages. Yet despite the tax increases, Social Security is in trouble. Clearly tax hikes have not been a panacea. This hearing will provide an opportunity to learn more about Social Security revenues, options for change and their impacts."

FOCUS OF THE HEARING:

The hearing will focus on the sources of Social Security's revenues, how those sources have changed over time, options for change and their impacts.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by the close of business on Thursday, July 14, 2011. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721 or (202) 225–3625.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://www.waysandmeans.house.gov/*.

Chairman JOHNSON. Thank you all for being here. I want to apologize to our witnesses and audience for the delay due to the vote, and I thank you for your patience. This meeting will come to order.

I want to thank you all for your testimony ahead of time. As we heard from the public trustees at our June the 3rd hearing, Social Security revenues will cover only 77 percent of the benefits by 2036. Congress needs to act, and the sooner we do so, the sooner we can protect those who are most vulnerable, along with current retirees and those nearing retirement. And for younger workers and families we have a responsibility to provide certainty about the future of their Social Security.

To that end, I was heartened to learn of the deliberations of AARP's volunteer board, and welcome their acknowledgment that Social Security will be unable to pay benefits promised in the future, and how the program needs to be strengthened for generations to come.

Today we will learn more about Social Security's current revenue sources, proposed changes to those sources, and their impact on Social Security workers, beneficiaries, and economic growth.

Since its beginning, Social Security has been a program primarily financed by workers for workers. Workers' hard-earned payroll taxes fund the majority of the benefits Social Security pays out each year. It is important to point out, as well, that the number of workers paying into Social Security has been steadily declining over the years. In 1950, for instance, there were 16½ workers for each beneficiary. Today, just 2.9 workers, and in 14 years, 2.3 workers per beneficiary.

You are shaking your head; you agree.

[Laughter.]

Chairman JOHNSON. In 1935, the tax rate for employers and employees each was just 1 percent on earnings, up to $3,000 a year. How far we have come. Congress has raised the payroll tax 14 times since then. Today the tax rate is 6.2 percent for employees and employers, for a combined 12.4 percent.

The amount of earnings subject to payroll tax, however, known as the taxable wage base, has also grown over time. In 1935 the taxable wage base was $3,000. Over the life time of the program, the taxable wage base has been statutorily increased by Congress 10 times. In 1972, Congress passed legislation that increased the base automatically to reflect the growth in average wages. However, soon afterwards, Congress increased the wage base even further over a number of years.

Annual tax increases have generally been in autopilot since 1982. Since then, the wage base has increased 26 times from $32,400 to its current level of $106,800. Probably go up again this year, too, you all think?

But despite these tax increases, Social Security is still in trouble. Not enough young workers are paying this tax to sustain the Baby Boomer wave of retirees leaving the workforce and drawing benefits at the rate of 10,000 a day for the next 19 years. Clearly, we can't tax our way to sustainable solvency.

And, as we consider the program's financial state, we can't lose sight of the fact that throughout the history of the program, Congress has also increased benefits beyond the ability of the program to pay for them in the long run.

The challenge Congress now faces goes beyond just rebalancing Social Security's finances. With chronic unemployment, falling incomes, and so many young workers unable to start their careers, nothing we do should make it harder for Americans to find good-paying jobs.

I am sure, if you ask any ordinary citizen, what is vitally important to them, you will likely hear, "good paying jobs." They worry America is falling behind, and that their children's futures will be dictated by foreign predators. Americans want and expect a balance between creating a new and better economy for their children and caring for their elders.

That is why, as we look ahead, Social Security must be what its founders intended: a program that lives within its means. Americans want, need, and deserve nothing less. We must do this for the American people. And I am confident that, by working together, we will.

Mr. Becerra, would you care to make a statement?

Mr. BECERRA. Yes, Mr. Chairman, I would. Mr. Chairman, thank you very much. Thank you for holding this hearing today.

I would like to begin, first, by acknowledging something the chairman said, that we are looking at somewhere around 2036 before Social Security will face a situation where it doesn't go broke, it won't go bankrupt, but it will have a challenge in providing the benefits that Americans today expect to receive when they retire in that year of 2036.

I think that is an important acknowledgment, Mr. Chairman, because too often the conversation—or should I say the debate—on Social Security is one where some would discount the money that Americans, on a daily basis, are contributing to Social Security through a tax, the FICA tax, that they contribute to the Social Security system and the trust fund.

The more we acknowledge that today Social Security is paying benefits on time and in full, and has always done that for more than 75 years, and that it will continue to do so for another good 20-some-odd years, it becomes very important. Because, unlike the rest of the Federal Government, which is in fiscal crisis, Social Security today goes forward.

Remember, as well, that, at the same time that Social Security has never missed a payment, most Americans a couple of years ago were afraid to look at their 401(k) or IRA statements, because they saw what was happening to their private savings and their pension funds. It becomes very important for us to have a conversation about Social Security that talks about the facts on the ground.

And, Mr. Chairman, I think many people will have to acknowledge that the facts are very stubborn things. They don't lie. And the reality is that today we have a system that has never failed the American public. And I don't believe anyone in this chamber would like to see Social Security fail. And that is why I do believe, Mr.

Chairman, like you, that there is a chance for some bipartisan cooperation in dealing with the future challenges that Social Security will face, much because of the Baby Boom generation, but many of them simply because of the fact that America, like every other country, continues to change.

The challenge has nothing to do with any sneaky numbers or broken magic on the part of Social Security to pay benefits. It is a very straightforward system. You put something in, and we've been able to guarantee that we put something out to pay you.

I actually disagree with you on one point, Mr. Chairman. Social Security is not overly generous. Social Security hasn't gotten too big when it comes to what it provides to Americans. The benefits today are very modest. And most seniors have very limited incomes. The average benefit for a senior today is somewhere around $14,000 a year. Among senior households, the median income is only about $24,000. So when you are talking about a household that may have more than one senior, you are still only looking at about $24,000.

One out of every three beneficiaries under Social Security depends on that Social Security paycheck to provide virtually all of their income. And less than half of seniors in America have a pension or a savings plan from their work. Only the wealthiest one-fifth of seniors in this country have any significant income from assets.

Keep in mind, as I said before, that were it not for Social Security, in 2008 all those folks who are ready to retire in this country probably were looking at a collapse of their IRA and their 401(k). At least a third of the value of those privately held assets had disappeared.

And that is why, Mr. Chairman, it does disturb me that some of the proposals we see from my Republican colleagues call for nothing but cuts to the benefits in Social Security, whether it is the privatization plan presented by Mr. Sessions, a member of the leadership in the House Republican Conference, or whether it is the plan of the chairman of the Budget Committee, Mr. Ryan, who has had plans in the past to privatize the system, and whose budget calls for a fast-tracking on future cuts of Social Security, or whether it was the recent proposal by Senator Hutchinson to reduce the COLA by one percent at a time when seniors haven't received a COLA increase in two years, these are all cuts.

And at a time when all Americans are suffering through difficult economic times, I don't believe we want to see our seniors go back to the 1930s when, what was it, some 3 out of every 4 that would retire retired into poverty.

And so this is a fabulous program that has worked well. But demographics will make it more challenging in about a quarter of a century. And rather than wait a quarter of a century, we should tackle it now. And that is why, Mr. Chairman, I look forward to working with you and all of our colleagues on this committee to try to present to our colleagues and the rest of the House a proposal in the future that can really take us a long ways in making sure that Social Security will once again be there for all Americans, as it has for more than 75 years.

I yield back.

Chairman JOHNSON. Thank you. Just know that you and I disagree on how the money is being counted, and there are a lot——

Mr. BECERRA. I think you have made that very clear, Mr. Chairman.

Chairman JOHNSON. There are a lot of IOUs out there in the Social Security trust fund that have to be paid from the general revenue.

Mr. BECERRA. China, Japan, and every major corporation in America knows the same thing, and they are waiting to be paid, as well.

Chairman JOHNSON. I know. Before we move on to our testimony today, I want to remind our witnesses to limit your oral statements to five minutes, if you can.

Without objection, all the written testimony will be made part of the permanent record.

We have one panel today, and our witnesses who are seated at the table are Tom Barthold, Chief of Staff, Joint Committee on Taxation; Stephen Goss, Chief Actuary, Office of the Chief Actuary, Social Security Administration; Tim Lee, Texas Retired Teachers Association, on behalf of the Coalition to Preserve Retirement Security—we have had some arguments over that one, too—Alex Brill, research fellow, American Enterprise Institute; Mark Warshawsky, Ph.D., former Assistant Secretary for Economic Policy, U.S. Department of the Treasury; and Andrew G. Biggs, Ph.D., resident scholar, American Enterprise Institute.

I thank all of you for being here today.

And, Mr. Barthold, you are recognized for five minutes.

STATEMENT OF THOMAS A. BARTHOLD, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Mr. BARTHOLD. Well, thank you, Chairman Johnson and Mr. Becerra. Your subcommittee staff had asked if my staff and I could prepare background discussion of the Social Security tax base, and that is what was provided to you and your staff in our publication JCX–36–11. I will take my couple of minutes here to summarize the high points, many of which you actually introduced in your opening remark.

The Social Security and Medicare trust funds are primarily financed by payroll taxes on covered wages. The payroll taxes include the FICA tax, Federal Insurance Contribution Act, and the SECA tax, the Self-Employed Contributions Act. There is also, for the Medicare trust fund, an additional hospital insurance tax. And, in addition, funds are contributed to both the Medicare and Social Security trust funds from an income tax on certain included Social Security benefits.

I will discuss first, in brief, the payroll taxes. FICA imposes taxes on both employers and employees, based on an amount of wages paid to the employee during the year. It is composed of two parts. The OASDI tax equals 6.2 percent of covered wages, up to the maximum wage base, $106,800 for this year, as noted by the chairman. And there is an HI tax equal to 1.45 percent of covered wages. The employee's tax is generally equal to the amount of tax imposed on the employer.

Likewise, the SECA tax has two components, and the rate of the SECA tax is set to equal the combined rates of the employee and the employer under the FICA tax. So, under the OASDI component, the current rate of tax is 12.4 percent on self-employment income, up to the Social Security wage base of $106,800. And under the HI component, the tax rate is 2.9 percent on all self-employed employment income.

Now, I should note that, for the current year, there is a two percentage point reduction in the OASDI rate to 4.2 percent, both for the employee portion of FICA, as well as for SECA. This was enacted as a provision in late 2010.

The present law—as noted by the chairman, the present law wage base is indexed each year, based on growth in average wages in the national economy. Now, under these taxes the law provides certain exceptions from the wage base for certain types of employment and certain types of remuneration.

One type of employment exempted from Social Security tax is based on categories of workers who are covered under alternative retirement systems. These include certain state and local government employees, employees of the Federal Government, and workers whose compensation is subject to the Railroad Retirement tax system.

A second type of exempted employee involves workers with religious beliefs whose beliefs preclude participation in the Social Security system.

A third type of exempted employment is wages to students. There has been a recent—I will note that there is a recent dispute resolved by the Supreme Court in the so-called Mayo case. The Supreme Court in that case upheld an IRS regulation providing that medical residents are not students, and, therefore, are subject to Social Security taxes, where wages paid to other students are exempt.

Now, even when a worker's type of employment is covered by the Social Security, certain types of remuneration paid to the worker are not subject to that tax. This generally follows income tax exclusions. Examples of such exempted compensation include employer-provided retirement benefits and employer-provided health benefits. There are similar elective contributions for health benefits through health FSAs, which are also excluded from both the income and Social Security taxes.

In general, the FICA taxes apply to workers who are employees. The SECA taxes apply to workers who are self-employed or independent contractors. One ongoing issue regarding payroll tax liability is the determination of whether a worker is properly treated as an employee or as an independent contractor. If a person is an employee, the responsibility for reporting and withholding FICA rests with the employer. If you are an independent contractor, then reporting and withholding rests with the worker. This determination shifts the burden of compliance, not the underlying liability.

I also noted another component of funding for the trust funds is the income tax. Individuals with incomes above certain thresholds must pay income tax on a portion of their Social Security benefits, and the revenue raised from the Social Security benefits finance—

from the taxation of Social Security benefits, excuse me—finances both the Social Security and the Medicare trust funds.

And, with that, I will conclude my brief summary, and be happy to answer any questions that the Members might have.

[The prepared statement of Mr. Barthold follows:]

DESCRIPTION OF THE SOCIAL SECURITY TAX BASE

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SOCIAL SECURITY
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on June 23, 2011

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

June 21, 2011
JCX-36-11

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INTRODUCTION

The Subcommittee on Social Security of the House Committee on Ways and Means has scheduled a public hearing for June 23, 2011, on Social Security's finances. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a brief overview and legislative history followed by a brief description of the present-law tax base of the Social Security system.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Social Security Tax Base* (JCX-36-11), June 21, 2011. This document may also be found on our website at www.jct.gov.

I. OVERVIEW AND BRIEF LEGISLATIVE BACKGROUND

In general

Social Security benefits and certain Medicare benefits are financed primarily by payroll taxes on covered wages.[2] Payroll taxes include the Federal Insurance Contributions Act ("FICA"), the Self-Employed Contributions Act ("SECA"), and the additional hospital insurance tax on certain high-income individuals.

FICA.—FICA imposes taxes on both employers and their employees based on the amount of wages paid to an employee during the year.[3] As discussed in greater detail below, the employer tax is comprised of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($106,800 in 2011); and (2) the Medicare hospital insurance ("HI") tax amount equal to 1.45 percent of covered wages. The employee tax is equal to the amount of tax imposed on the employer.[4] The employee tax generally must be withheld and remitted to the Federal government by the employer.[5]

SECA.—Self-employed taxpayers are subject to tax on their self-employment income under SECA. Like the FICA tax, the SECA tax has two components. Under the OASDI component, the rate of tax is 12.40 percent (10.4 percent in 2011 only) on self-employment income up to the Social Security wage base ($106,800 for 2011).[6] Under the HI component, the rate is 2.90 percent of all self-employment income (without regard to the Social Security wage base).[7]

The wage base for the FICA and SECA taxes is indexed each year automatically according to a statutory formula. As a result, an increase in average wages in the economy increases the wage base for purposes of the FICA and SECA taxes.[8]

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[2] Revenues from the income taxation of Social Security benefits and interest earnings on trust fund reserves are other sources of funding.

[3] Sec. 3111. Unless otherwise stated all section references are to the Internal Revenue Code of 1986, as amended.

[4] For 2011 only, the employee tax is 4.2 percent.

[5] The OASDI and HI payroll tax is generally collected as a single tax with portions of it allocated by statute among separate trust funds: the Federal Old-Age and Survivors Insurance Trust Fund, the Federal Disability Insurance Trust Fund, the Federal Hospital Insurance Trust Fund and the Supplementary Medical Insurance Trust Fund. 42 U.S.C. secs. 401, 1395i.

[6] Sec. 1401(a). In calculating the SECA tax for OASDI, the Social Security wage base taken into account is reduced by FICA wages paid to the individual during the taxable year.

[7] Sec. 1401(b)(1).

[8] The earnings base can only increase in a year in which there was an increase in benefits under the cost-of-living adjustment (COLA) formula. If there was no increase in benefits, the earnings base is prohibited from

Additional hospital insurance tax on certain high-income individuals.—For remuneration received in taxable years beginning after December 31, 2012, the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages[9] received in excess of the threshold amount.[10] However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

Income taxation of Social Security benefits.—Individuals with income above certain thresholds must pay income tax on the Social Security benefits they receive. The revenue raised from taxation of Social Security benefits also finances Social Security and Medicare. Revenues generated under the first tier of tax (those generated from the taxation of up to 50 percent of benefits) are dedicated to the Federal Old-Age and Survivors Insurance Trust Fund and Federal Disability Insurance Trust Fund, and any additional taxes from the second tier (those generated from the taxation of benefits beyond the initial 50 percent of benefits and up to 85 percent of benefits) are dedicated to the Federal Hospital Insurance Trust Fund and Supplementary Medical Insurance Trust Fund.

Persons covered by OASDI.—In 2010, approximately 156 million people worked jobs covered under the OASDI program. Approximately 93 percent of the U.S. workforce is covered by OASDI. Workers excluded from coverage include: (1) Civilian federal employees hired before January 1, 1984; (2) Railroad workers (who are covered under the railroad retirement system, which is coordinated with Social Security); (3) Certain employees of State and local governments who are covered under their employers' retirement systems; (4) Domestic workers and farm workers whose earnings do not meet certain minimum requirements (workers in industry and commerce are covered regardless of the amount of earnings); and (5) Persons with very low net earnings from self-employment, generally under $400 annually.[11] Currently, earnings of about 25 percent of State and local government employees are not covered under the OASDI program. This represents about four percent of the total U.S. workforce.

Legislative Background of FICA, SECA, and the Income Taxation of Social Security benefits

FICA and SECA as of 1975. —In 1975, the FICA tax on employers was comprised of the OASDI tax, at that time equal to 5.85 percent of covered wages up to the taxable wage base of $14,100, and the HI tax, equal to 0.9 percent of covered wages. Then, as now, each employee is

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increasing. Sec. 230(a) of the Social Security Act. Since there was no increase in benefits from 2009 through 2011, the earnings base remained constant from 2009 through 2011. When indexing restarts, the wage base will reflect wage growth from 2009 under the normal indexing rule.

[9] Sec. 3121(a).

[10] Patient Protection and Affordable Care Act ("PPACA"), Pub. L. No. 111-148.

[11] Social Security Administration, *Annual Statistical Supplement to the Social Security Bulletin, 2010* (Feb. 2011).

subject to FICA taxes equal to the amount of tax imposed on the employer. The SECA tax in 1975 was imposed on the same wage base as FICA and was composed of the same OASDI and HI components, but the rate was equal to 7.9 percent of the wage base (7 percent OASDI, 0.9 percent HI). While the taxable wage base since 1975 has generally been determined under a statutory formula, Congress provided for different taxable wage bases for taxable years 1979-1981.[12]

FICA payroll taxes were modified by the Social Security Amendments of 1983 (the "1983 Act").[13] Under the 1983 Act, coverage was extended on a compulsory basis to Federal employees,[14] members of Congress, the President and Vice-President, Federal judges, and employees of non-profit organizations. In addition, the 1983 Act also accelerated a previously enacted increase in the tax rate and made other changes.

The 1983 Act also raised SECA payroll taxes. Prior to the 1983 Act, SECA taxes had been deliberately set lower than FICA taxes. The 1983 Act sought to erase this discrepancy starting in 1984 with the goal of achieving parity between SECA and FICA by 1990. Therefore, effective in 1990, only 92.35 percent of self-employment income is taxable as "net earnings from self-employment"[15] and the self-employed taxpayer receives a deduction for 50 percent of SECA taxes paid.[16]

Also, as a result of the Omnibus Budget Reconciliation Act of 1990[17] the HI base was raised to $125,000 in 1992 and $135,000 in 1993.

As part of the Omnibus Budget Reconciliation Act of 1993,[18] the earnings base for the HI portion of the tax was removed, making all earnings taxable for HI purposes, effective in 1994.

Beginning in 1990, the OASDI tax rate has been 6.2 percent and the HI rate 1.45 percent for employee and employer, while for SECA taxes the OASDI rate has been 12.4 percent and the HI rate 2.9 percent.

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[12] Pub. L. No. 95-216.

[13] Pub. L. No. 98-2. High unemployment rates throughout the 70s as well as a decrease in real wages led to fears that the system would be vastly underfunded and a need to generate revenue quickly. The National Commission on Social Security Reform was created to address the issue, and its final report formed the basis for many of the 1983 amendments.

[14] If hired after December 31, 1983.

[15] This adjustment is made to reflect the fact that employees do not pay FICA taxes on the employer's portion of the FICA tax. Thus, the base is reduced by 7.65 percent, the employer's share of FICA taxes.

[16] This deduction mirrors the treatment for employees, who do not pay income tax on the employer's portion of the FICA tax.

[17] Pub. L. No. 101-518.

[18] Pub. L. No. 103-66.

Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, for 2011 only the employee OASDI rate was lowered two percentage points to 4.2 percent and the SECA rate was lowered by two percentage points to 10.4 percent.[19]

Income taxation of Social Security Benefits.—The 1983 Act made OASDI benefits subject to income tax. Under the 1983 Act, up to half of OASDI benefits were made includable in taxable income for taxpayers with incomes above certain base amounts. As part of the Omnibus Budget Reconciliation Act of 1993, the maximum portion of Social Security benefits includable in taxable income was raised from up to half, to up to 85 percent.

[19] The revenue loss to the Social Security Trust Funds from the provision was replaced by a general revenue transfer.

II. SOCIAL SECURITY AND MEDICARE TAXES

A. Federal Insurance Contributions Act

In general

FICA imposes a tax on employers and employees based on the amount of wages paid to the employee during the year.[20] The tax imposed is comprised of two components: OASDI and HI.

Under the OASDI component, the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[21] The tax is imposed on covered wages up to the taxable wage base ($106,800 in 2011).[22]

Under the HI component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not limited by the amount of the taxable wage base.

Generally, covered wages means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Exceptions from this general rule apply under present law.[23]

The employee portion of FICA usually must be withheld and remitted to the Federal government by the employer.[24] The employer is liable for the amount of this tax whether or not the employer withholds the amount from the employee's wages.[25] In the event that the employer fails to withhold FICA from an employee's wages, the employee generally is not liable to the IRS for the amount of the tax. If, however, the employer pays its liability for the amount of the tax not withheld, the employer has a right to collect that amount from the employee. If the employer deducts and pays the tax, the employer is indemnified against claims and demands of any person for the amount of any payment of the tax.[26]

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[20] Sec. 3111.

[21] Sec. 3101. A special rule for 2011 temporarily reduces the employee tax rate for OASDI from 6.2 percent to 4.2 percent. Pub. L. No. 111-312.

[22] The taxable wage base can only increase in a year in which there was an increase in benefits under the cost-of-living adjustment ("COLA") formula. If there was no increase in benefits, the earnings base is prohibited from increasing. Sec. 230(a) of the Social Security Act. Since there was no increase in benefits from 2009 through 2011, the earnings base remained constant from 2009 through 2011 too. When indexing restarts, the wage base will reflect wage growth from 2009 under the normal indexing rule.

[23] These rules are described in detail below.

[24] Sec. 3102(a) and Treas. Reg. sec. 31.3121(a)-2.

[25] Sec. 3102(b).

[26] *Ibid.*

Additional tax on high income individuals

For taxable years beginning after December 31, 2012, the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages received in excess of $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, or $200,00 in any other case.[27]

As is the case for wages paid prior to 2013, the employer is required to withhold the additional HI tax on wages and is liable for the tax if it is not withheld from wages. However, in determining the employer's requirement to withhold and its liability for the tax, only wages that the employee receives from the employer in excess of $200,000 for a year are taken into account and the employer must disregard the amount of wages received by the employee's spouse. Thus, the employer is only required to withhold on wages in excess of $200,000 for the year, even though the tax may apply to a portion of the employee's wages at or below $200,000 (for example, if the employee's spouse also has wages for the year, they are filing a joint return, and their total combined wages for the year exceed $250,000). The employee is liable for the additional tax to the extent that it is not withheld by the employer.

Definition of wages

FICA applies to wages paid to an employee by an employer during the year. Wages subject to FICA generally include all pay, whether made in cash or in other forms, given to an employee for services performed.[28] Wages include salaries, vacation allowances, bonuses, deferred compensation, commissions, and fringe benefits. Amounts an employer pays as a bonus for signing or ratifying a contract in connection with the establishment of an employer-employee relationship and an amount paid to an employee for cancellation of an employment contract and relinquishment of contract rights are wages subject to FICA.

The Code, however, provides for numerous exceptions to the definition of wages that are subject to FICA. Several of the most prevalent exceptions are discussed below.

Payments not subject to FICA

Cafeteria plans

A section 125 cafeteria plan is a written plan that allows employees to choose between receiving cash or taxable benefits instead of certain qualified benefits which are excludable from wages (and thus not subject to FICA).

Generally, a cafeteria plan may not include any plan that offers a benefit that defers pay. A cafeteria plan may, however, include a qualified 401(k) plan and certain life insurance plans maintained by educational institutions despite the fact that they defer compensation. Cafeteria plans may include adoption assistance, dependent care assistance, group-term life insurance

[27] Sec. 3101 as added by PPACA, Pub. L. No. 111-148.

[28] Sec. 3121(a).

coverage, flexible spending arrangements, and health savings accounts among other qualified benefits.

FICA does not apply to any payment made to, or on behalf of, an employee or his or her beneficiary under a cafeteria plan if: (1) the payment would not be treated as wages without regard to the plan, and (2) it is reasonable to believe that (if the cafeteria plan rules would apply for purposes of the definition of the term wages) Code Sec. 125 would not treat any wages as constructively received.[29]

Special rules apply to S corporation shareholders and cafeteria plans that favor highly compensated or key employees.

Fringe benefits

Generally, fringe benefits, such as employer-provided automobiles, vacations, discounts, and tickets to entertainment or sporting events, are considered wages and are subject to FICA. Subject to certain special valuation rules, the amount that must be included in wages is the amount by which the fair market value of the benefits exceeds the sum of what the employee paid for the benefit.

Some fringe benefits, however, are excluded from gross income if certain conditions are met.[30] There is a parallel exclusion from FICA if, at the time the benefit is provided, it is reasonable for the employer to believe that the benefit is excludable from gross income. Examples of nontaxable fringe benefits include no additional cost services, qualified employee discounts, working condition fringe benefits,[31] minimal value (de minimis) fringe benefits,[32] qualified transportation fringe benefits, qualified moving expense reimbursements, on-premises athletic facilities, and qualified tuition reduction by educational institutions. Nondiscrimination rules may apply to certain fringe benefits in order for them to be excluded from wages.[33]

[29] Sec. 3121(5)(G).

[30] Sec. 132.

[31] Working condition fringe benefits are property and services provided by an employer to its employees so that the employee can perform his or her job. Examples include an employee's use of the company car for business, and job-related education provided to an employee.

[32] De minimis fringe benefits are property and services provided by an employer to its employee whose value is so small that accounting for it is unreasonable of administratively impracticable. Examples include occasional typing of personal letters by a company secretary, local telephone calls, and occasional picnics for employees.

[33] Sec. 132(j).

Accident and health benefits

Employer contributions towards accident and health insurance for employees, their spouses, and dependents, are not considered wages and are not subject to FICA. Generally, this exclusion also applies for qualified long-term care insurance.

Employee achievement awards

Awards that are tangible personal property (excluding, for this purpose, cash, gift certificates, and securities), given to an employee for length of service or safety achievement, awarded as part of a meaningful presentation, and under circumstances that do not indicate that the payment is disguised compensation, are excluded from wages and are not subject to FICA to the extent that at the time provided it is reasonable to believe the award is not included in the employee's gross income.

In general, a maximum of $400 per year can be excluded for the cost of all employee achievement awards given to the same employee. There is a higher limit of $1,600 for awards that are given pursuant to a written plan that does not discriminate in favor of highly compensated employees ("qualified plan awards"). An award cannot be treated as a qualified plan award if the average cost per recipient of all awards under all qualified plans exceeds $400.

Moving expenses

Moving expenses that are paid under a qualified plan, and that would otherwise be deductible by the employee, are not considered wages unless the employer has knowledge that the employee deducted the expenses in a prior year.

Meals and lodging

The value of meals that are provided for the employer's convenience and on the employer's premises generally is not treated as wages and is not subject to FICA. Similarly, the value of lodging is not considered wages if the lodging is furnished for the employer's convenience, on the employer's premises, and as a condition of employment. Whether meals or lodging are provided for the convenience of the employer is determined based on the totality of the facts and circumstances.

Differential wage payments

Differential wage payments are payments made by an employer to an employee for a period during which the employee is performing services in the uniformed services of the United States while on active duty for a period of more than 30 days.[34] The payments represent all or part of the wages the individual would have received from the employer if the individual were continuing to perform services for the employer. While differential wage payments are wages for purposes of income tax withholding, they are not considered wages for purposes of FICA.

[34] Sec. 162(a)(1).

Employee business expense reimbursements

An expense reimbursement arrangement is a system pursuant to which employers pay the advances, reimbursements, and charges for employees' ordinary and necessary business expenses.[35] Reimbursements and allowances paid under an "accountable plan" are not wages and are, therefore, not subject to withholding and employment taxes. In order to be an "accountable plan" an arrangement must meet the following requirements: (1) individuals must have paid or incurred the expenses while performing services in their capacity as employees, (2) the amount must have been paid for the expense and must not be an amount the individual would have otherwise paid; (3) the employee must substantiate expenses to the employer within a reasonable time frame; and (4) the employee must return any amount in excess of the substantiated expenses within a reasonable time frame. If expenses are not substantiated, or if amounts in excess of the substantiated expenses are not returned, they are treated as having been paid under a nonaccountable plan. Payments made under a nonaccountable plan are considered to be wages and are subject to withholding and payment of payroll taxes for the first payroll period following the end of a reasonable period of time.[36]

Relocating for temporary work assignments

If an employee is given a temporary work assignment away from his or her regular place of work, certain travel expenses reimbursed or paid directly by the employer under an accountable plan may be excluded from wages. Generally, a temporary work assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less. In addition, the new work location must be outside the city or general area of the employee's regular work place or post of duty, the travel expenses must otherwise qualify as deductible by the employee, and the expenses must be for the period during which the employee is at the temporary work location.

Health Savings Accounts ("HSAs") and Archer Medical Savings Accounts ("Archer MSAs")

Employer contributions towards HSAs and Archer MSAs are not subject to FICA if it is reasonable to believe at the time of the contribution that they will be excludable from the employee's income (i.e., that they will be used to pay for qualified medical expenses as defined in Code section 213(d)). To the extent it is not reasonable to believe the contributions will be excludible the amount will be included in wages and subject to FICA.

Employee contributions to an HSA made pursuant to a salary reduction arrangement under a Code section 125 cafeteria plan are not considered wages and are not subject to

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[35] Ordinary and necessary business expenses are those that would otherwise qualify for a deduction by the employee. See Treas. Regs. secs. 1.62-2 and 31.3121(a)-3.

[36] Whether a period of time is "reasonable" is determined under the individual facts and circumstances, although certain safe harbors exist. See Internal Revenue Service, Publication 15: (Circular E), Employer's Tax Guide (2011).

employment taxes. Other employee contributions to their HSAs and Archer MSAs made through payroll reduction, however, are included in wages.

Medical care reimbursement

Generally, medical care reimbursements paid by an employer for an employee under an employer's self-insured medical reimbursement plan are not wages and thus are not subject to FICA.[37]

Per diem and other fixed allowances

Employees may be reimbursed for travel days, miles, and certain other fixed expenses. In these cases, the expenses are considered to have been adequately accounted to the employer (and thus, not considered wages) if the reimbursement does not exceed rates established by the Federal government. For example, the standard mileage rate for 2011 is 51 cents per mile. If the per diem or allowance exceeds the Federal amounts, the excess amounts are treated as wages and are subject to withholding and payment of employment taxes.

Retirement and pension plans

Employer contributions to a qualified retirement or pension plan are excluded from wages for purposes of withholding and employment taxes. Employer contributions to individual retirement accounts under a simplified employee pension plan ("SEP") are also excluded from wages, except for amounts that are contributed under a salary reduction agreement ("SAR-SEP"). An employer's nonelective or matching contributions are exempt from FICA. Distributions from qualified retirement and pension plans and section 403(b) annuities are also exempt from FICA.

Elective contributions to a 401(k) plan, however, are subject to FICA.[38]

Scholarship and fellowship payments

Amounts paid by an employer as part of a qualified scholarship to a candidate for a degree may be excluded from the recipient's wages. A qualified scholarship is any amount granted as a scholarship or fellowship that is used for tuition and fees required to enroll in, or to attend, an educational institution, or fees, books, supplies, and equipment that are required for courses at the educational institution.

The exclusion does not apply to the portion of any amount received that represents payment for teaching, research, or other services required as a condition of receiving the scholarship.[39]

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[37] There are special rules for certain highly compensated employees. See sec. 105(h).

[38] "Elective contributions" are employer contributions made to a plan pursuant to an election under a cash or deferred arrangement. See Treas. Reg. sec. 1.401(k)(6).

Sick pay

In general, sick pay is any amount paid by an employer to an employee who is unable to provide services due to sickness or injury. Sick pay is generally subject to FICA. There is, however, certain sick pay that is excluded from FICA, including: (1) payments made after an employee's death, disability, or retirement if the payments would not otherwise have been made; (2) payments made after the calendar year of the employee's death; (3) payments made to an employee entitled to disability insurance benefits; (4) payments made after the end of the sixth calendar month after the calendar month the employee last worked for the employer; (5) payments attributable to employee contributions.

Wages paid in kind

Wages paid in a medium other than cash or a readily negotiable instrument are said to be paid "in kind." Payments in kind may take the form of lodging, food, clothing, or other services. Generally, the fair market value of the in kind payments, determined at the time the payments are provided, are considered wages and are subject to FICA.

In an exception to the general rule, noncash payments for household work, agricultural labor, and services not in the employer's trade or business may be exempt from FICA.[40]

Other special rules

In addition to specific examples discussed above, there are special rules for various types of services and payments that may exclude such services and payments from FICA. These special rules encompass, among others, the following circumstances: (1) payments to general or limited partners of a partnership; (2) certain supplemental unemployment compensation plan benefits; (3) tips if the combined total is less than $20 in a month; (4) worker's compensation; (5) domestic service in private homes if payments of less than $1,700 were made during the calendar year or if performed by an individual under age 18 and whose principal occupation is not as a household employee; (6) certain income derived from Indian fishing rights; (7) remuneration received from the exercise of certain statutory stock options; and (8) certain outplacement services provided to employees to help them find new employment (e.g., career counseling, resume assistance, and skills assessment).

Definition of employment

For purposes of FICA, employment generally means any service performed by an employee for an employer if the service is either performed within the United States, performed in connection with an American vessel or aircraft, performed outside the United States by an

[39] Special rules apply to scholarships received through the National Health Services Corps Scholarship Program and the Armed Forces Health Professions Scholarship and Financial Assistance Program.

[40] Noncash payments for agricultural labor, such as commodity wages, are treated as cash payments subject to FICA if the substance of the transaction is a cash payment. See, IRS Publication 15 (Cat. No. 10000W).

American citizen or resident for an American employer, or is covered under an agreement governed by section 233 of the Social Security Act.[41]

Employment not subject to FICA

Certain types of employment are specifically excluded from FICA coverage.[42] Common exceptions are described below.

All services performed by an individual during a pay period for the same employer are treated alike, either entirely subject to FICA or entirely exempt.[43] If one-half or more of an individual's services in a particular pay period are subject to FICA, all services are subject to the tax for that period. If, however, less than half of the services are subject to FICA, then none of the individual's services are subject to the tax for that period.[44] A pay period is a period of not more than 31 consecutive days for which a payment of remuneration is ordinarily made to the employee by the employer.

Foreign agricultural employees

Services performed by certain foreign agricultural workers lawfully admitted to the United States for the purpose of performing agricultural labor on a temporary basis are not considered employment for purposes of FICA. Agricultural labor includes, among other services, cultivating the soil and raising livestock, and the operation, management, and maintenance of farm tools and equipment.[45]

Student employees

Services performed in the employ of a school, college, or university (or an auxiliary nonprofit organization operated and controlled by a school, college, or university) are exempt

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[41] Section 233 of the Social Security Act, 42 U.S.C. sec. 433, authorizes the President to enter into a totalization agreement with a foreign country to coordinate the collection of payroll taxes and the payment of benefits under each country's social security system for individuals who divide their careers between multiple countries.

[42] Sec. 3161(b). Note, however, that exemption from FICA does not necessarily indicate exemption from SECA as well. We do not discuss exceptions from FICA covered employment that are no longer of practical import, such as, for example, certain exceptions for employees continuously employed by a non-profit organizations since 1984, and employees of certain communist organizations required to register with the Subversive Activities Control Board (which is defunct as of 1968). See, for example, sec. 2601(e)(1) of Public Law. No. 98-369 and Code sec. 3121(b)(17).

[43] Sec. 3121(c).

[44] Treas. Reg. sec. 31.3121(c)-1(d). This rule does not apply if the periods for which the employer compensates its employees vary to the extent that there is no "ordinary" pay period or if the pay period ordinarily exceeds 31 days. Treas. Reg. sec. 31.3121(c)-1(g). The rule also does not apply to service excluded because it is covered under the Railroad Retirement Tax Act or domestic services performed in the private home of an employer by an individual under the age of 18 whose principal occupation is not the performance of domestic services.

[45] Treas. Reg. sec. 31.3121(g).

from FICA if the service is performed by a student who is regularly attending classes at such educational institution.[46] The student FICA exception is based on the idea that the student's primary relationship with the educational institution is that of a student rather than that of an employee.[47]

Excepted student employment includes domestic services performed for a local college club or local chapter of a college fraternity or sorority by a student who is enrolled in and regularly attending classes at an educational institution. Student employees of Federal hospitals, other than medical and dental interns, are excepted from FICA, as are student nurses performing part-time services in a hospital for nominal earnings and as an incidental part of their training.

Government employees

Federal employees

Employees of the United States or any of its instrumentalities are generally subject to FICA for services performed after 1983. Certain service is excluded from coverage, however, if it was exempt prior to 1984.[48] Service prior to 1984 was generally exempt if it was covered by another retirement system established under Federal law or by a Federal instrumentality. Certain other Federal employees' service is also excluded, but only if the employee has been continually performing such service[49] since December 31, 1983 or is receiving an annuity under a retirement system established by the Federal government. Service performed by employees of the legislative branch may be exempt from FICA if the employee was subject to the Civil Services Retirement System, or certain other Federal retirement systems, on December 31, 1983.[50] All serving Members of Congress are covered by Social Security.

Services performed by inmates of a federal penitentiary, by student nurses and student employees (other than medical or dental interns or residents) for a Federal hospital, and by individuals serving on a temporary basis as a result of fire, storm, earthquake, or similar emergency, continue to be exempt from FICA.

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[46] Medical residents are not students for purposes of this exception, and thus stipends paid to medical residents after April 1, 2005 are subject to FICA. See, *Mayo Foundation v. U.S.* (S. Ct. No. 09-837, 2011). The IRS, however, has made an administrative determination to treat medical residents as students for purposes of FICA for periods ending before April 1, 2005 (the date Treasury Regulation 31.3121(b)(1)-2 became effective). See, IRS News Release IR-2010-25 (March 2, 2010).

[47] Treas. Reg. sec. 31.3121(b)(10)-2.

[48] Such service is generally, however, exempt only with respect to OASDI, and is still subject to the HI tax. Sec. 3121(u).

[49] Continuous service includes any period following a separation from service that is less than 366 consecutive days, and certain service during an individual's detail or transfer to an international organization or as a member of a uniformed service of the United States. See sec. 3121(b)(5).

[50] Sec. 3121(b)(5)(G)(i).

State and local government employees

Employees of State and local governments, or instrumentalities that are wholly owned by one or more State or political subdivision, (other than employees of the District of Columbia, Guam, and American Samoa) are generally subject to FICA for services performed after July 1, 1991. There is an exception for certain individuals who participate in a retirement program maintained by a State or local government, and whose benefits under that plan are comparable to the benefits they would have received under social security,[51] although such employees are still subject to the HI tax if their employment began (or restarted) after March 31, 1986.

Services performed by individuals who are employed by a State or local government (1) in order to relieve such individual from unemployment, (2) in a hospital or home as a patient or inmate, (3) on a temporary basis dues to a disaster, (4) as an election worker receiving less than $1,200 during the year, or (5) who are compensated on a fee basis, are not subject to FICA.

Subject to exceptions for certain elected officials and patients or inmates of hospitals and penitentiaries, services performed while in the employ of Guam or American Samoa (including their subdivisions and instrumentalities) are subject to FICA.

Service performed in the employ of the District of Columbia is generally subject to FICA unless it is covered by a retirement program established under Federal law.[52] Exceptions apply, however, for services performed: (1) in a hospital or penal institution by a patient or inmate, (2) by a student employee (other than a medical or dental resident or intern) in a D.C. hospital, (3) on a temporary basis as a result of a disaster, or (4) by a member of a board, committee, or council of the District paid on a per diem, meeting, or similar basis.[53]

Special rules apply to services performed in connection with the operation of public transit systems.[54]

Employees of foreign governments

Services performed by an employee of a foreign government (and, in some cases, foreign instrumentalities) are generally exempt from FICA, regardless of whether the foreign government grants similar exemptions with respect to services performed in the foreign country by a U.S. citizen.[55] This exception applies to ambassadors, ministers, diplomatic officers and employees, consular officers, and non-diplomatic representatives.

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[51] Treas. Reg. sec. 31.3121(b)(7)-2.

[52] Sec. 3121(b)(7)(C). Such service may be subject to the HI tax with respect to employees hired, or rehired, after March 31, 1986. See sec. 3121(u).

[53] *Ibid.*

[54] Sec. 3121(j).

[55] Sec. 3121(b)(11) and (12).

Employees of international organizations

Services performed by an individual employed by an international organization are generally exempt from FICA.[56] Special rules apply, however, to Federal employees who are temporarily transferred to an international organization after 1994.[57]

International organizations are public organizations entitled to the privileges, exemptions, and immunities available to international organizations under the International Organization Immunities Act. Examples of international organizations include the United Nations, the World Health Organization, and the World Bank.

Nonimmigrant aliens

Aliens admitted to the United States on certain student visas are exempt from FICA,[58] as are certain residents of the Philippines working in Guam.[59]

Family employees

Several exceptions to FICA exist for employees who are members of the same family as their employers. Service performed by a child less than 18 years of age in the employ of his or her parent is excluded from FICA. Service not in the regular course of the employer's trade or business or domestic service in a private home of the employer, performed by an individual under age 21 in the employ of his or her parent, or performed by an individual in the employ of his or her spouse or child, is also generally excepted from FICA.[60]

Religious service

Services performed by an ordained, commissioned, or licensed minister in the exercise of his or her ministry, or by a member of a religious order in performing duties required by the order, are generally exempt from FICA.[61] Churches and certain church-controlled organizations may elect to have services performed for them excluded from FICA if the employer is opposed to the payment of social security taxes due to religious reasons. Such election does not apply to services performed for the church or organization in an unrelated trade or business.

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[56] Sec. 3121(b)(15).

[57] Sec. 3121(y).

[58] Sec. 3121(b)(9).

[59] Sec. 3121(b)(18).

[60] Sec. 3121(b)(3).

[61] Sec. 3121(b)(8).

Members of religious sects

Employees who are members of religious sects that are conscientiously opposed to the acceptance of public and private insurance benefits, for example, the Old Order Amish,[62] may apply for exemption from FICA, provided the employer has also applied for and received a similar exemption.[63]

Railroad employees

Service performed by an employee or employee representative whose compensation is subject to the Railroad Retirement Act[64] is exempt from FICA.[65]

Newspaper distributors

Delivering and distributing newspapers or shopping news (i.e., handbills and similar advertising material) is exempt from FICA if the employee performing the services is less than 18 years old and the material is distributed to the ultimate consumer.[66] The sale of newspapers and magazines is exempt from FICA, regardless of the seller's age, if the merchandise is sold at a fixed price and the seller's compensation is based on his or her keeping the excess of the fixed price charged to consumers over the amount that the seller paid for the merchandise.[67]

Fishing Crews

Services performed by an employee on a boat engaged in catching aquatic forms of animal life are exempt from FICA if: (1) the employee's remuneration must be entirely based on the amount of aquatic life caught, and (2) the operating crew of the boat (or each boat on which the individual works, if there are multiple vessels involved) is normally made up of less than ten people.[68] If the individual receives cash payments in addition to his or her share of the vessel's catch, the exemption does not apply unless the payment does not exceed $100 per trip, the payment is contingent on a minimum catch, and the payment is paid solely for additional duties (for example, as an engineer or cook) for which additional payment is customary.

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[62] See T.C. Memo 1990-32, 58 CCH TCM 1242.

[63] Sec. 3127.

[64] Secs. 3201 through 3233.

[65] Sec. 3121(b)(9).

[66] Sec. 3121(b)(14)(A).

[67] Sec. 3121(b)(14)(B). This exception applies only to sales to the ultimate consumer, thus, for example, sales to a regional distributor of a newspaper are not included in the rule.

[68] Sec. 3121(b)(20).

Real estate agents and direct sellers

Services performed by certain qualified real estate agents and direct sellers are exempt from FICA.[69] A "qualified real estate agent" is a licensed agent whose remuneration is substantially related to sales or other output (including appraisals) rather than the number of hours worked. The services of the agent must be performed in connection with a written contract between the agent and the person for whom the services are being performed specifying that the agent will not be treated as an employee. A "direct seller" includes any person engaged in the trade or business of selling, or soliciting the sale of, consumer products to the ultimate consumer or for resale to a buyer on a buy-sell basis, a deposit-commission basis, or any similar basis, provided the sale does not occur in a permanent retail establishment. As with real estate agents, substantially all of the remuneration received by the seller must be directly related to sales or other output rather than the number of hours worked, and the service must be performed pursuant to a written agreement stating that the seller is not an employee.

Elected coverage

Under certain circumstances employers may enter into an agreement with the Federal government to extend social security coverage to service that would otherwise be exempt from FICA. An American employer may enter into such an agreement with the IRS for certain services that are performed outside the United States by citizens or residents of the United States who are employees of a foreign affiliate of the American employer.[70] By entering into such an agreement the American employer becomes liable for the employee and employer portions of FICA, including amounts equivalent to interest, additions to taxes, and applicable penalties, as if the employee's services were otherwise subject to FICA. The employer is under no obligation, however, to deduct, or cause to be deducted, from the employee's pay any part of the amount due from the employer.

In addition to employees of foreign affiliates, most exempt employees of State and local governments are brought into the social security system through voluntary coverage agreements between their employer and the Commissioner of Social Security.[71] All 50 States, Puerto Rico, and the U.S. Virgin Islands are eligible to enter into coverage agreements. The District of Columbia, Guam, and American Samoa, however, may not enter into such agreements.[72] Each governmental employer divides its employees into coverage groups and then decides which groups will be covered under the agreements.[73] Under certain circumstances, employees must

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[69] Sec. 3508(a). They are, however, subject to SECA. Rev. Rul. 85-63.

[70] Sec. 3121(l). No agreement under 3121(l) may be terminated on or after June 15, 1989.

[71] 42 U.S.C. sec. 418(a)(1).

[72] 42 U.S.C. sec. 418(c)(1).

[73] It is worth noting that not all types of employees may be included in a coverage group, e.g., employees who are hired solely to provide relief from unemployment, services performed in a hospital, home, or other institution by a patient or inmate. See 42 U.S.C. sec. 418(c)(6).

also vote to be covered in order for the agreement to take effect.[74] After April 19, 1983, agreements extending social security coverage to State and local employees cannot be terminated either by the employer or the Social Security Administration.[75]

A religious order whose members are required to take a vow of poverty (or an autonomous subdivision of such order) may elect to have social security coverage extended to service performed by its members in the exercise of duties required by such order.[76] Such an election must specify that (1) it is irrevocable, (2) it applies to all current and future members, (3) all services performed in the exercise of the member's required duties are deemed to have been performed as an employee of the order, and (4) the order will pay the employer and employee portion of FICA with respect to the wages of each active member, including the fair market value (but not less than $100 per month) of any board, lodging, clothing, and other perquisites furnished to a member by the order.

[74] 42 U.S.C. sec. 418(d)(6).

[75] 42 U.S.C. sec. 418(g).

[76] Sec. 3121(b)(8)(A) and (r)(1).

B. Self-Employment Contributions Act

In general

Generally, tax under SECA is imposed on the self-employment income of an individual. SECA tax has two components. Under the OASDI tax component, the rate of tax is 12.40[77] percent on self-employment income up to the Social Security wage base ($106,800 for 2011).[78] Under the HI tax component, the rate is 2.90 percent of all self-employment income (without regard to the Social Security wage base).[79]

Self-employment income subject to the SECA tax is determined as the net earnings from self-employment. An individual may use one of three methods to calculate net earnings from self-employment.[80] Under the generally applicable rule, net earnings from self-employment means gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the SECA tax rules. Alternatively, an individual may elect to use one of two optional methods for calculating net earnings from self-employment. These methods are: (1) the farm optional method; and (2) the nonfarm optional method. The farm optional method allows individuals to pay SECA taxes (and secure Social Security benefit coverage) when they have low net income or losses from farming. The nonfarm optional method is similar to the farm optional method.

Additional HI for self-employed individuals

For remuneration received in taxable years beginning after December 31, 2012, an HI tax applies to the HI portion of SECA tax on self-employment income in excess of the threshold amount. Thus, an additional tax of 0.9 percent is imposed on every self-employed individual on self-employment income in excess of the threshold amount. [81]

The threshold amount for the additional SECA HI tax is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. The threshold amount is reduced (but not below zero) by the amount of wages taken into account in determining the FICA tax with respect to the taxpayer. No deduction is allowed under section 164(f) for the additional SECA tax, and the deduction

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[77] A special rule for 2011 temporarily reduces the SECA for OASDI from 12.4 percent to 10.4 percent. See section 601 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312. This reduction is not taken into account for purposes of the deduction under section 1402(a)(12).

[78] Sec.1401(a). In calculating the SECA tax for OASDI, the Social Security wage base taken into account is reduced by FICA wages paid to the individual during the taxable year.

[79] Sec. 1401(b)(1).

[80] Sec. 1402(a).

[81] Sec. 1401(b)(2).

under 1402(a)(12) (generally for one-half of the sums of the rates for OASDI and HI) is determined without regard to the additional SECA tax rate.

Net earnings from self employment

General rule

Net earnings from self-employment is the gross income derived by an individual from any trade or business less allowed deductions which are attributable to the trade or business and allowed under the SECA rules. Certain passive income and related deductions are not taken into account in determining net earnings from self employment, including rentals from real estate unless received in the course of income as a real estate dealer,[82] dividends and interest unless such dividend and interest are received in the course of a trade or business as a dealer in stocks or securities,[83] and sales or exchange of capital assets and certain other property unless the property is stock in trade which would properly be included in inventory or held primarily for sale to customers in the ordinary course of the trade or business.[84]

For purposes of computing net earnings from self employment, taxpayers are permitted a deduction equal to the product of the taxpayer's net self employment income (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings.[85] This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas the self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes. This is generally referred as the "regular method" of determining net earnings from self employment, and in forms and publications is expressed as multiplying total self employment net income by 92.35 percent.

Treatment of Conservation Reserve Program payments

The Conservation Reserve program ("CRP")[86] is a voluntary program under which the United States Department of Agriculture ("USDA") through the Commodities Credit Corporation makes annual payments to participants. Participants include farm owners and operators who agree to place environmentally sensitive cropland in conserving uses for 10 to 15 years. Participants receive an annual "rental" payment (including incentive payments) and cost sharing assistance to establish and maintain approved groundcover, and participants agree to plant grasses, trees, and other conserving cover crops, restore wetlands and establish buffers.

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[82] Sec. 1402(a)(1).

[83] Sec. 1402(a)(2).

[84] Sec. 1402(a)(3).

[85] Sec. 1402(a)(12). For the purpose of determining this deduction in 2011, the two percentage point reduction in the SECA tax rate is disregarded.

[86] 16 U.S.C. secs. 3801, 3831-3836.

Generally, a participant is eligible to enroll land in CRP if the participant has owned or operated the land for at least twelve months prior to the close of the CRP sign up period. Land is eligible for placement in CRP if it is cropland or marginal pasture land. Generally, CRP rental payments are self employment income.[87] However, in the case of individuals receiving Social Security retirement or disability benefits, CRP payments are excluded from self employment income for purposes of SECA taxes.[88]

Optional methods of determining self employment income

Farm optional method

If an individual is engaged in a farming trade or business, either as a sole proprietor or as a partner, the individual may elect to use the farm optional method in one of two situations. The first situation is an individual engaged in a farming business who has gross farm income of not greater than 150 percent of a specified dollar amount (the specified dollar amount is $4,480 for 2011).[89] In this situation, the individual may elect to report two-thirds of gross farm income as net earnings from self-employment. In the second situation, an individual engaged in a farming business may elect the farm optional method even though gross farm income exceeds this limit (150 percent of $4,480, or $6,720 for 2011) but only if the net farm income is less than $4,851 for 2011.[90] In this second instance, the individual may elect to report the dollar amount ($4,480 for 2011) as net earnings from self-employment for the taxable year and be entitled to four quarters of coverage for the year. In all other situations (i.e., more than $6,720 of gross farm income for 2011 and net farm income of at least $4,851 for 2011) a person engaged in a farming business must compute net earnings from self-employment under the generally applicable rule. There is no limit on the number of years that an individual may elect the farm optional method during such individual's lifetime.

Nonfarm optional method

The nonfarm optional method is available only to individuals who have been self-employed for at least two of the three years before the year in which they seek to elect the nonfarm optional method and who meet certain other requirements. Specifically, an individual may elect the nonfarm optional method if the individual's: (1) net nonfarm income for the taxable year is less than $4,851; and (2) net nonfarm income for the taxable year is less than 72.189 percent of gross nonfarm income. If a qualified individual engaged in a nonfarming business that elects the nonfarm optional method has gross nonfarm income of $6,720 (for 2011) or less for the taxable year, then the individual may elect to report two-thirds of gross nonfarm

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[87] *Wuebker v. Commissioner*, 205 F.3d 897 (6th Cir. 2000).

[88] Sec. 1401(a)(1)

[89] The specified dollar amount is the amount of wages or self-employment income required under section 213(d) of the Social Security Act to earn four quarters for the year ($4,480 for 2011)

[90] Net income for this purpose is determined before the deduction of 7.65 percent of net earnings allowed under section 1402(a)(12) (generally for one-half of the sums of the rates for OASDI and HI) .

income as net earnings from self-employment. If the electing individual engaged in a nonfarming business has gross nonfarm income of at least $4,851 for 2011, then the individual may elect to report $4,480 as net earnings from self-employment for the taxable year. In all other instances, a person engaged in a nonfarming business must compute net earnings from self-employment under the generally applicable rule. An individual may elect to use the nonfarm optional method for no more than five years in the course of the individual's lifetime

SECA for employee ministers

If an individual is a minister of a church, the individual's earnings for the services performed as a minister are subject to SECA tax, even if the individual performs these services as an employee of a church. Ministers are individuals who are duly ordained, commissioned, or licensed by a religious body constituting a church or church denomination. They are given the authority to conduct religious worship, perform sacerdotal functions, and administer ordinances or sacraments according to the prescribed tenets and practices of a church or denomination. If a church or denomination ordains some ministers and licenses or commissions others, anyone licensed or commissioned must be able to perform substantially all the religious functions of an ordained minister to be treated as a minister for Social Security purposes.

In calculating net earnings from self-employment, a minister generally includes the following in gross income: salaries and fees for ministerial services, offerings received for marriages, baptisms, funerals, masses, etc., the value of meals and lodging provided to the minister, and the minister's spouse, and dependents for the minister's employer's convenience, and the fair rental value of a parsonage provided to the minister (including the cost of utilities that are furnished) and the rental allowance (including an amount for payment of utilities) paid to the minister.

C. Unearned Income Medicare Contribution

Medicare contribution tax on unearned income

For taxable years beginning after December 31, 2012, a new Code provision, section 1411, enacted as part of the Health Care and Education Reconciliation Act of 2010,[91] provides a Medicare contribution tax on unearned income. The tax is applicable to an individual, estate, or trust. No provision is made for the transfer of the tax from the General Fund of the United States Treasury to any Trust Fund.

In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment income or the excess of adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins. The tax does not apply to a non-resident alien or to a trust all the unexpired interests in which are devoted to charitable purposes. The tax also does not apply to a trust that is exempt from tax under section 501 or a charitable remainder trust exempt from tax under section 664.

The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

Net investment income

Net investment income is investment income reduced by the deductions properly allocable to such income. Investment income is the sum of (1) gross income from interest, dividends, annuities, royalties, and rents (other than income derived in the ordinary course of any trade or business to which the tax does not apply), (2) other gross income derived from any trade or business to which the tax applies, and (3) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply.[92] Investment income does not include distributions from a qualified retirement plan or amounts subject to SECA tax.

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[91] Pub. L. No. 111-152, sec. 1402.

[92] Gross income does not include items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence, which are excluded from gross income under the income tax.

Application to trade or business income

In the case of a trade or business, the tax applies if the trade or business is a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities (as defined in section 475(e)(2)). The tax does not apply to other trades or businesses. Income, gain, or loss on working capital is not treated as derived from a trade or business.

Application to disposition of partnership and S corporation stock

In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account.[93]

[93] For this purpose, a business of trading financial instruments or commodities is not treated as an active trade or business.

III. SPECIAL CASES

A. Worker Classification for Employment Tax Liability

In general

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a facts and circumstances test under common law that seeks to determine whether the worker is subject to the control of the service recipient, not only as to the nature of the work performed, but also as to the circumstances under which it is performed.[94] However, under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though, applying the common-law test, the facts and circumstances indicate that the worker is properly classified as an employee. This safe harbor applies if the service recipient has a reasonable basis for treating the worker as an independent contractor (including certain specified safe harbors) and certain other requirements are met. In some cases, the treatment of a worker as an employee or independent contractor is specified by statute.

Common-law test

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test that has been incorporated into specific provisions of the Code or that is required to be used pursuant to Treasury regulations or case law. For example, section 3121(d)(2) (which defines terms for purposes of the Social Security taxes that apply to wages paid to an employee) generally defines the term "employee" to include any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. By contrast, section 3401 (which defines terms for purposes of an employer's Federal income tax withholding obligation with respect to wages paid to an employee) does not define the term "employee." However, regulations issued under section 3401 incorporate the common-law test.

The regulations under section 3401 provide that an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished. In other words, an employer-employee relationship generally exists if the person providing the services "is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[95] Under the regulations, it is not necessary that the employer actually exercises control over the manner in which the services are performed, rather, it is sufficient that the employer has

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[94] Generally the determination of whether a worker is an employee or independent contractor is referred to as worker classification. Because a service recipient is required to withhold income tax and FICA from an employee's wages, and is liable for payment of the employer portion of FICA, during a calendar year, and thus generally must take a position as to the worker's classification before the worker files an income tax return, the first classification of a worker is generally made by the service recipient.

[95] Treas. Reg. sec. 31.3401(c)-(1)(b).

a right to such control.[96] Whether the requisite control exists is determined based on all the relevant facts and circumstances.[97] Over the years, courts have identified on a case-by-case basis various facts or factors that are relevant in determining whether an employer-employee relationship exists.

The origin of the common-law test is the master and servant employment relationship as described in the Restatement (Second) of Agency. Under the Restatement, classification of a worker as a servant (that is, employee) rather than an independent contractor is based on a facts and circumstances determination. The facts are generally evaluated to determine the extent of the service recipient control. The principal difference between a servant and an independent contractor is the extent of control. In the case of a servant, by agreement, the master may exercise control over the details of the work, both with respect to the result the worker is to accomplish and the means by which such result is accomplished.[98] Over the years, courts have identified on a case-by-case basis various facts or factors that are relevant in determining whether a master-servant (that is, employer-employee) relationship exists.

In 1987, based on an examination of cases and rulings, the IRS developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists.[99] The degree of importance of each factor varies depending on the occupation and the

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[96] *Ibid.* See also, *Gierek v. Commissioner,* 66 T.C.M. 1866 (1993) (involving the classification of a stockbroker and stating that the key inquiry is whether the brokerage firm had a right to control the worker regardless of the extent to which such control was actually exercised). See also, Internal Revenue Service Publication 1779: Independent Contractor or Employee (Rev. 1-2005).

[97] Restatement of Agency 2nd , sec. 220 (1958), *Nationwide Mutual Insurance Co. v. Darden,* 503 U.S. 318, and Alden J. Bianchi, "Employee Benefits for the Contingent Workforce," Tax Management Portfolio 399, page A-9.

[98] Restatement of Agency 2nd, sec. 220 (1958), *Nationwide Mutual Insurance Co. v. Darden,* 503 U.S. 318, and Alden J. Bianchi, "Employee Benefits for the Contingent Workforce," Tax Management Portfolio 399, p. A-9.

[99] Rev. Rul. 87-41, 1987-1 C.B. 296 (providing guidance with respect to section 530 of the Revenue Act of 1978). The 20 factors identified by the IRS are: (1) instructions (compliance with instructions required indicates employee status); (2) training (the provision of training by service recipient indicates employee status): (3) integration (integration of the worker's services into the business operations of service recipient indicates employee status); (4) services must be rendered personally (indication of employee status); (5) hiring, supervision, and paying assistants (if service recipient hires, supervises or pays assistants, it indicates employee status, but if the worker hires and supervises others under a contract pursuant to which the worker agrees to provide material and labor and is only responsible for the result, this indicates independent contractor status); (6) continuing relationship (indicates employee status); (7) set hours of work (indicates employee status); (8) full time services required (indicates employee status); (9) work done on employer's premises (indicates employee status if work could be done elsewhere); (10) order or sequence test (indicates employee status if a worker must perform services in the order or sequence set by service recipient); (11) oral or written reports required (indicates employee status); (12) payment by the hour, week, or month (indicates employee status); (13) payment of business and/or traveling expenses (indicates employee status): (14) furnishing tools and materials by service recipient (indicates employee status); (15) significant investment by worker (indicates independent contractor status); (16) realization of profit or loss by worker (indicates independent contractor status); (17) working for more than one firm at a time (indicates independent contractor status); (18) making services available to the general public (indicates independent

factual context in which the services are performed; factors other than the listed 20 factors may also be relevant.

More recently, the IRS has identified three categories of evidence that may be relevant in determining whether the requisite control exists under the common-law test and has grouped illustrative factors under these three categories: (1) behavioral control; (2) financial control; and (3) relationship of the parties.[100] The IRS emphasizes that factors in addition to the 20 factors identified in 1987 may be relevant, that the weight of the factors may vary based on the circumstances, that relevant factors may change over time, and that all facts must be examined.[101]

Section 530 of the Revenue Act of 1978

Section 530 of the Revenue Act of 1978 ("section 530") generally allows a taxpayer who is a service recipient to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the worker's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment or otherwise fails to meet certain requirements.[102] Section 530 only applies to the service recipient and only applies for purposes of employment taxes. Under section 530, a reasonable basis for treating a worker as an independent contractor is deemed to exist if the taxpayer reasonably relied on: (1) past IRS audit practice with respect to the taxpayer, (2) published rulings, technical advice with respect to the taxpayer, or judicial precedent, or (3) long-standing recognized practice of a significant segment of the industry in which the taxpayer is a member. With respect to the industry practices safe harbor, section 530 specifically provides that the significant segment requirement does not require practice by more than 25 percent of the industry (determined without taking the taxpayer into account). The "long-standing" requirement does not require the practice to have continued for more than 10 years and the practice does not fail to be long standing merely because it began after 1978. In addition, a taxpayer can rely on any "other reasonable basis" for treating a worker as an independent contractor.

The relief under section 530 is available with respect to a worker only if certain additional requirements are satisfied. The taxpayer must not have treated the worker as an

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contractor status); (19) service recipient has right to discharge (indicates employee status); (20) worker has right to terminate relationship (indicates employee status).

[100] Internal Revenue Service, *Independent Contractor or Employee? Training Materials*, Training 3320-102 (10-96) TPDS 84238I, pp. 2-7. This document is publicly available through the IRS website.

[101] *Ibid.* p. 2-3 through p. 2-7.

[102] The relief provided to an employer under section 530 was initially a temporary measure (scheduled to terminate at the end of 1979) to give Congress time to resolve the many complex issues regarding worker classification. Section 530 was permanently extended in 1982 and later revised. Section 530 was extended through the end of 1980 by Pub. L. No. 96-167 and through June 30, 1982, by Pub. L. No. 96-541. It was permanently extended by the Tax Equity and Fiscal Responsibility Act of 1982. A number of changes to section 530 were made by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, and the Pension Protection Act of 2006.

employee for any period, and for periods after 1978 all Federal tax returns, including information returns, must have been filed on a basis consistent with treating such worker as an independent contractor. Further, the taxpayer (or a predecessor) must not have treated any worker holding a substantially similar position to the worker as an employee for purposes of employment taxes for any period beginning after 1977 (the "similar worker consistency requirement").[103]

Section 530 does not apply in the case of a worker who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.[104] Thus, the determination of whether such workers are employees or independent contractors for purposes of employment taxes is made in accordance with the common-law test.

Section 530 also prohibits Treasury and the IRS from publishing regulations and revenue rulings with respect to the employment status of any individual for purposes of employment taxes.[105] However, in response to a taxpayer request, the IRS may issue a written determination regarding the status of a particular worker as an employee or independent contractor for purposes of Federal employment taxes and income tax withholding.[106]

Statutory employees or independent contractors

The Code contains various provisions that prescribe treatment of a specific category or type of worker as an employee or an independent contractor. Some of these provisions apply for Federal tax purposes generally; for example, certain real estate agents and direct sellers are treated for all tax purposes as not being employees.[107] Others apply only for specific purposes; for example, full-time life insurance salesmen are treated as employees for Social Security tax

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[103] Under section 864 of the Pension Protection Act of 2006 (Pub. L. No.109-280, the similar worker consistency requirement does not apply with respect to services performed after December 31, 2006, by an individual who provides services as a test proctor or room supervisor by assisting in the administration of college entrance or placement examinations. This exception only applies if the service recipient is an organization that is described in section 501(c) and the service provider is not otherwise treated as an employee of the organization for employment tax purposes

[104] Section 1706 of the Tax Reform Act of 1986.

[105] Rev. Rul. 87-41 (described above) provides guidance with respect to section 530 of the Revenue Act of 1978.

[106] IRS Form SS-8 (Rev. 11-2006). A written determination with regard to prior employment status may be issued by the IRS. The IRS will not issue a written determination with respect to prospective employment status. Rev. Proc. 2007-3, 2007-1 I.R.B. 108.

[107] Sec. 3508.

and employee benefit purposes,[108] and certain salesmen are treated as employees for Social Security tax purposes.[109]

[108] Sec. 3121(d)(3)(B) and 7701(a)(20).

[109] Sec. 3121(d)(3)(D).

B. Employment Tax and Self-Employment Tax Treatment of S Corporation Shareholders and Partners

S corporation shareholders

An S corporation is treated as a passthrough entity for Federal income tax purposes. Each shareholder takes into account and is subject to Federal income tax on the shareholder's pro rata share of the S corporation's income.[110]

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages from the S corporation.

A shareholder of an S corporation generally is not subject to FICA tax on amounts that are not wages, such as the shareholder's share of the S corporation's income. Nevertheless, an S corporation employee is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized by the taxpayer as other than wages. Case law has addressed the issue of whether amounts paid to shareholders of S corporations constitute reasonable compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.[111]

In cases addressing whether payments to an S corporation shareholder were wages for services or were corporate distributions, courts have recharacterized a portion of corporate distributions as wages if the shareholder performing services did not include any amount as wages.[112] In cases involving whether reasonable compensation was paid (not exclusively in the S corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms.[113] The Seventh Circuit, however, has adopted an "independent investor" analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was

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[110] Sec. 1366.

[111] See the discussion of case law in, e.g., Richard Winchester, *The Gap in the Employment Tax Gap*, 20 Stanford Law and Policy Review 127, 2009; James Parker and Claire Y. Nash, *Anticipate Close Inspection of Closely Held Company Pay Practices - Part I*, 80 Practical Tax Strategies 215, April 2008; *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, at 280.

[112] *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, e.g., *Joseph M. Grey Public Accountant, P.C., v. U.S.*, 119 T.C. 121 (2002), aff'd, 93 Fed. Appx. 473, 3d Cir., April 7, 2004, and *Nu-Look Design, Inc. v. Commissioner*, 356 F.3d 290 (3d Cir. 2004), cert. denied, 543 U.S. 821 (2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to employment tax.

[113] See, e.g., *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).

compensated.[114] The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.[115]

Partners

A partnership is treated as a passthrough entity for Federal income tax purposes. Each partner includes in income its distributive share of partnership items of income, gain and loss.[116]

A partner's distributive share of partnership items is not treated as wages for FICA tax purposes.

A partner who is an individual is subject to the SECA tax on his or her distributive share of trade or business income of the partnership. The net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as rent, dividends, interest, and capital gains and losses, as described above[117]). This general rule applies to partners who are individuals and who are not limited partners to whom the exception (described below) applies. Thus, this general rule applies to individuals who are general partners.

An exclusion from SECA applies for limited partners of a partnership.[118] Specifically, in determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.[119]

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[114] *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

[115] In *Metro Leasing and Dev. Corp. v. Commissioner*, 376 F.3d 1015 (9th Cir. 2004) at 10-11, the Ninth Circuit noted that it is helpful to consider the perspective of an independent investor, and pointed to other Circuits that apply the multi-factor test through the lens of the independent investor test, citing *RAPCO Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996). In determining whether compensation is reasonable, the U.S. Tax Court has applied the multi-factor test viewed through the lens of an independent investor where a case is appealable to a U.S. Court of Appeals which has neither adopted nor rejected the independent investor test. See *Chickie's and Pete's, Inc. v. Commissioner*, T.C. Memo. 2005-243, 90 T.C.M. 399 (2005), at footnote 9; *Miller & Sons Drywall, Inc. v. Commissioner*, T.C. Memo. 2005-114, 89 T.C.M. 1279 (2005).

[116] Secs. 701, 702.

[117] Sec. 1402(a).

[118] Sec. 1402(a)(13).

[119] In 1997, the Treasury Department issued proposed regulations defining a limited partner for purposes of the self-employment tax rules. Prop. Treas. Reg. sec. 1.1402(a)-2 (January 13, 1997). These regulations provided, among other things, that an individual is not a limited partner if the individual participates in the partnership business for more than 500 hours during the taxable year. However, in the Taxpayer Relief Act of 1997, the Congress imposed a moratorium on regulations regarding employment taxes of limited partners. The moratorium provided that any regulations relating to the definition of a limited partner for self-employment tax purposes could not be issued or effective before July 1, 1998. No regulations have been issued to date.

The owners of a limited liability company that is classified as a partnership for Federal tax purposes are treated as partners for Federal tax purposes. However, under State law, limited liability company owners are not defined as either general partners or limited partners.[120] The rule imposing SECA tax on individuals who are partners in a partnership, and the exclusion from SECA for limited partners, have not been modified to address the treatment of limited liability company members who are treated as partners for Federal tax purposes.

[120] In *Renkemeyer, Campbell & Weaver, LLP, v. Commissioner*, 136 T.C. 7 (February 9, 2011), the Tax Court held that partners in a law firm that is a limited liability partnership (LLP) (not a limited liability company) under applicable State law are subject to self-employment tax. Thus, the exception for limited partners under section 1402(a)(13) did not apply in *Renkemeyer*. The Tax Court noted that "[i]n essence, an L.L.P. is a general partnership that affords a form of limited liability protection for all its partners by filing a statement of qualification with the appropriate state authorities," and concluded after a review of the legislative history of section 1402(a)(13), "[t]he insight provided reveals that the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage." 136 T.C. 7, pages 7 and 9.

IV. INCOME TAXATION OF SOCIAL SECURITY BENEFITS

Under present law, Social Security benefits are taxed under a two-tier system. Taxpayers receiving Social Security benefits are not required to include any portion of such benefits in gross income if their provisional income does not exceed a first-tier threshold, which is $25,000, in the case of unmarried individuals, or $32,000, in the case of married individuals filing jointly.[121] For purposes of these computations, a taxpayer's provisional income is defined as adjusted gross income plus: (1) tax-exempt interest; (2) excludable interest on educational savings bonds; (3) adoption assistance payments; (4) certain deductible student loan interest; (5) certain excludable foreign-source earned income; (6) certain U.S. possession income; and (7) one-half of the taxpayer's Social Security benefits. A second-tier threshold for provisional income is $34,000, in the case of unmarried individuals, or $44,000, in the case of married individuals filing joint returns.[122] The thresholds are not indexed for inflation.

If the taxpayer's provisional income exceeds the first-tier threshold but does not exceed the second-tier threshold, then the amount required to be included in income is the lesser of (1) 50 percent of the taxpayer's Social Security benefits, or (2) 50 percent of the excess of the taxpayer's provisional income over the first-tier threshold.

If the amount of provisional income exceeds the second-tier threshold, then the amount required to be included in income is the lesser of: (1) 85 percent of the taxpayer's Social Security benefits; or (2) the sum of (a) 85 percent of the excess of the taxpayer's provisional income over the second-tier threshold, plus (b) the smaller of (i) the amount of benefits that would have been included in income if the 50 percent inclusion rule (described in the previous paragraph) were applied, or (ii) one-half of the difference between the taxpayer's second-tier threshold and first-tier threshold.[123]

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[121] In the case of a married individual who files a separate return, the first-tier threshold is generally zero. However, if the individual lives apart from his or her spouse for the entire year, the first-tier threshold is $25,000.

[122] In the case of a married individual who files a separate return, the second-tier threshold is generally zero. However, if the individual lives apart from his or her spouse for the entire year, the second-tier threshold is $34,000.

[123] Special rules apply in some cases under present law. Tier I Railroad Retirement benefits are similar to Social Security benefits and are taxed in the same manner as Social Security benefits. In the case of nonresident individuals who are not U.S. citizens, 85 percent of Social Security benefits are includible in gross income and subject to the 30-percent withholding tax (sec. 871(a)(3)). The taxation of Social Security benefits may also be specified in income tax treaties between the United States and other countries.

<table>
<tr><th colspan="5">Summary of the Phase-out of Social Security Benefits for Unmarried Taxpayers</th></tr>
<tr><td>Provisional income level</td><td colspan="4">Amount included in taxable income</td></tr>
<tr><td>$24,999 and below[124]</td><td colspan="4">0%</td></tr>
<tr><td rowspan="2">$25,000 to $33,999[125]</td><td colspan="4">First-tier inclusion is the lesser of...</td></tr>
<tr><td colspan="2">(1) 50% of Social Security benefit</td><td colspan="2">(2) 50% of provisional income exceeding $25,000[126]</td></tr>
<tr><td rowspan="3">$34,000 and above[127]</td><td colspan="4">Second-tier inclusion is the lesser of...</td></tr>
<tr><td rowspan="2">(1) 85% of Social Security benefit</td><td colspan="3">(2) 85% of the amount of provisional income exceeding $34,000[128] plus the lesser of...</td></tr>
<tr><td colspan="2">(2a) $4,500[129]</td><td>(2b) amount of Social Security benefit that would have been included if the 50% rule applied</td></tr>
</table>

Revenues from the first-tier inclusion of Social Security benefits are dedicated to the Social Security Trust Funds (i.e., the Federal Old-Age and Survivors Insurance Trust Fund and Federal Disability Insurance Trust Fund). Revenues from the second-tier inclusion are dedicated to the Medicare Trust Funds (i.e., the Federal Hospital Insurance Trust Fund and Supplementary Medical Insurance Trust Fund).

[124] $31,999 and below for taxpayers who are married filing jointly.

[125] $32,000 to $43,999 for taxpayers who are married filing jointly.

[126] $32,000 for taxpayers who are married filing jointly.

[127] $44,000 and above for taxpayers who are married filing jointly.

[128] $44,000 for taxpayers who are married filing jointly.

[129] $6,000 for taxpayers who are married filing jointly.

APPENDIX
Social Insurance Taxable Wage Base and Rates of Tax

Year	Maximum Taxable Earnings	Contribution Rate for Both Employers and Employees (Percent of Covered Earnings)			Contribution Rate for Self-Employed Persons		
		Total	OASDI	HI	Total	OASDI	HI
1975	$14,100	5.85	4.95	0.9	7.9	7.0	0.9
1976	$15,300	5.85	4.95	0.9	7.9	7.0	0.9
1977	$16,500	5.85	4.95	0.9	7.9	7.0	0.9
1978	$17,700	6.05	5.05	1.00	8.1	7.1	1.0
1979	$22,900	6.13	5.08	1.05	8.1	7.05	1.05
1980	$25,900	6.13	5.08	1.05	8.1	7.05	1.05
1981	$29,700	6.65	5.35	1.3	9.3	8.0	1.3
1982	$32,400	6.7	5.4	1.3	9.35	8.05	1.3
1983	$35,700	6.7	5.4	1.3	9.35	8.05	1.3
1984[1]	$37,800	7.0	5.7	1.3	14.00	11.4	2.6
1985	$39,600	7.05	5.7	1.35	14.10	11.4	2.7
1986	$42,000	7.15	5.7	1.45	14.30	11.4	2.9
1987	$43,800	7.15	5.7	1.45	14.30	11.4	2.9
1988	$45,000	7.51	6.06	1.45	15.02	12.12	2.9
1989	$48,000	7.51	6.06	1.45	15.02	12.12	2.9
1990	$51,300	7.65	6.2	1.45	15.3	12.4	2.9
1991[3]	$53,400	7.65	6.2	1.45	15.3	12.4	2.9
1992	$55,500	7.65	6.2	1.45	15.3	12.4	2.9
1993	$57,600	7.65	6.2	1.45	15.3	12.4	2.9
1994	$60,600	7.65	6.2	1.45	15.3	12.4	2.9
1995	$61,200	7.65	6.2	1.45	15.3	12.4	2.9
1996	$62,700	7.65	6.2	1.45	15.3	12.4	2.9
1997	$65,400	7.65	6.2	1.45	15.3	12.4	2.9
1998	$68,400	7.65	6.2	1.45	15.3	12.4	2.9
1999	$72,600	7.65	6.2	1.45	15.3	12.4	2.9
2000	$76,200	7.65	6.2	1.45	15.3	12.4	2.9
2001	$80,400	7.65	6.2	1.45	15.3	12.4	2.9
2002	$84,900	7.65	6.2	1.45	15.3	12.4	2.9
2003	$87,900	7.65	6.2	1.45	15.3	12.4	2.9
2004	$87,900	7.65	6.2	1.45	15.3	12.4	2.9
2005	$90,000	7.65	6.2	1.45	15.3	12.4	2.9
2006	$94,200	7.65	6.2	1.45	15.3	12.4	2.9
2007	$97,500	7.65	6.2	1.45	15.3	12.4	2.9
2008	$102,000	7.65	6.2	1.45	15.3	12.4	2.9
2009	$106,800	7.65	6.2	1.45	15.3	12.4	2.9
2010	$106,800	7.65	6.2	1.45	15.3	12.4	2.9
2011	$106,800	[2]	[2]	1.45	13.3	10.4	2.9

[1] For 1984 only, employees were allowed a credit of 0.3 percent of taxable wages against their FICA tax liability, reducing the effective rate to 6.7 percent.

[2] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reduced the FICA tax rate for employees by two percentage points for 2011. Specifically, the employer OASDI rate remains at 6.2 while the employee rate is reduced to 4.2.

[3] The maximum taxable earnings for HI purposes was raised beginning in 1991. The maximum taxable earnings for HI was $125,000 in 1991, $130,000 in 1992, $135,000 in 1993, and unlimited since 1994.

Chairman JOHNSON. Thank you, I appreciate that. I want to welcome our newest member, Mr. Kenny Marchant, from the great state of Texas, as a member of this committee. Glad to have you aboard.

Mr. MARCHANT. Glad to be here.

Chairman JOHNSON. Stephen Goss, chief actuary, Office of the Chief Actuary, Social Security Administration. You are recognized for five minutes, sir.

STATEMENT OF STEPHEN C. GOSS, CHIEF ACTUARY, OFFICE OF THE CHIEF ACTUARY, SOCIAL SECURITY ADMINISTRATION

Mr. GOSS. Thank you very much, Chairman Johnson, Ranking Member Becerra, Members of the Subcommittee. It is really a pleasure to be here, and thank you for the invitation.

I would like to take these couple of minutes to sum up the written testimony that I submitted, but also to put in perspective the history and the expectations for the future of what the costs of Social Security are going to be, and what they mean for us, to make sure that the system is set up properly for the future.

Chairman Johnson, you quite rightly pointed out some of the very interesting facts of Social Security, about the incredibly fundamental ratio of numbers of workers for every beneficiary that we have to support the system.

And we should keep in mind about Social Security, that when the first monthly benefits were paid in 1940, we had somewhat over 40 workers for every beneficiary. And the reason for that was clear; we were taxing virtually all the workers, starting right off the bat, but the only people in 1940 who could get monthly benefits were people who had worked for at least 2 years in the years 1937, 1938, or 1939. Not many very, very old people had worked for two years in that period.

So, it was a long time, not until about 1975, until the system actually matured, and we reached the point where we reached a rather stable level of 3.3 workers per beneficiary. We stayed at that level from 1975 until about 2008.

As you mentioned, Chairman Johnson, after 2008, starting around 2010, the recession has gotten a head start on moving in the direction of having a drop in the number of workers per beneficiary.

It is important to understand why that is happening. It is happening in part because of the Baby Boomers moving over from the ages which have been working ages over the next 25 years, into the ages in which they will be retirees. But, actually we wouldn't even call them the Baby Boom bulge if, in fact, they had all had 3.3 kids themselves as people in 1946 through 1965 did.

Historically, birth rates have been at about 3 children per woman, especially if you look at the number of children surviving to age 10. Between the end of the Baby Boom period and the mid-1970s, we actually had a drop in the birth rate in this country from an average of 3 kids down to an average of 2 children. If we are going to support elders in our country, and they all had three kids in the past, and now in the future they are all going to have two kids, that really is a fundamental shift.

The point is that this isn't just a matter of people living longer. There is some of that. The fundamental change over the next 25 years, in the cost of the system relative to GDP, relative to payroll, and in the number of workers per beneficiary, is really due to the drop in the birth rate. It is not that we are going to do anything about this change, but it is important for understanding how we got there.

The implication of this drop in the birth rate is really quite striking. As both the chairman and the ranking member mentioned, we are in a situation where we are going to have a drop in the number of workers per beneficiary, and this is going to cause the cost of Social Security, of the benefits that are scheduled now, to change from about 4.3 percent of GDP—which it has been for decades—to rise up to about 6 percent of GDP.

The fundamental question before you all, as our elected representatives is, "Where do we want to go? What do the American people want to do? Do they want to have the kind of benefits that are scheduled in current law, and raise the revenue up from the 4.5 percent of GDP that is scheduled in current law now up to 6 percent? Or, do they want to keep revenue at 4.5 percent of GDP and lower benefits?" There is really a fundamental choice between raising revenue by a third, reducing the scheduled benefits by a fourth, or some combination of those two.

In my position—I am sure also for Tom Barthold and probably most of us—we are not in a position to tell you what really makes the most sense. But these are the choices that are before you on behalf of your and all of our constituents.

Let me speak a little bit about the very near term situation for Social Security. There has been a lot of talk about the year 2010, in which we had the first year—for quite a while, since 1972—in which we had more cost for the system than we had taxes coming in. Now, the trust fund is still growing, because interest more than exceeded the amount of shortfall we had in taxes, and that will continue until 2023. But we did have of taxes in the year 2010, and this is what a recession looks like; we have more people coming and getting benefits, fewer people working.

We are projecting now for the years 2012, 2013, and 2014, that we will have cash flow deficits—that is, cost exceeding the taxes in the system, by a little less than 20 billion a year, where in the prior trustee's report, in 2010, we were projecting a little bit less than a $10 billion-per-year surplus.

That kind of a swing is significant. But for a $700 billion per year cost program and a federal budget where we are running deficits on the order of $1 trillion per year, that kind of swing was probably not all that traumatic.

So, we are facing a situation over the next 25 years in which we are going to have this dramatic shift. We are going to be having increasing cost, we are going to have to find a way to get there. The trust funds do stand as the cushion to give us the authority to be able to augment the taxes that we have coming in to be able to pay scheduled benefits, as you both mentioned, until 2036.

But the fundamental question that is before us is, "What do we do thereafter?" Are we going to raise taxes? Are we going to lower benefits? One thought that I would really want to leave you with is that we should not analyze a change in taxes or a change in benefits from just one perspective.

For example, if we decided that, in order to continue paying the full benefits, even through 2036, we want to raise taxes during that period to have more money coming into the trust funds, what that will mean is that we will dip into the trust funds less. If we raise taxes and have more revenue coming to pay benefits during that period, that means that we will have less spending down of the trust funds and——

Chairman JOHNSON. Can you close it down? Your time has expired.

Mr. GOSS. Okay, sorry. If we have more taxes, we will have less borrowing from the public. Both of those have economic implications. We should not look at an increase in taxes, just as the implication of taxes, but also what that means in terms of borrowing less from the public.

I have submitted a number of individual provisions that have been considered. I am hoping in the questions we might be able to get into some of those.

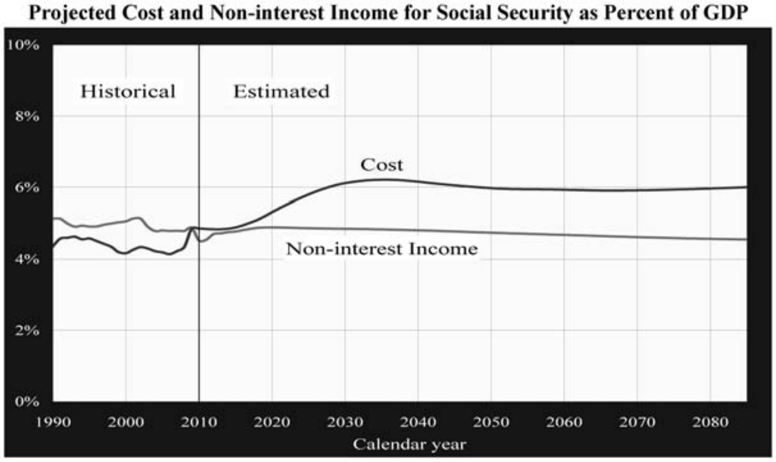
[The prepared statement of Mr. Goss follows:]

Testimony by Stephen C. Goss, Chief Actuary, Social Security Administration
To the House Committee on Ways and Means Subcommittee on Social Security
June 23, 2011 1:30PM
B-318 Rayburn House Office Building

Hearing on Social Security's Finances

At its most fundamental level, the future financial status of the Social Security program is straightforward. The financing for the program provides income exclusive of interest on trust fund assets that is about 4.5 percent of GDP. The cost of providing benefits scheduled in the law has been less for over two decades, through 2009, resulting in a substantial accumulation of assets in the Trust Funds. However, due to the aging of the population of the United States the cost will be rising to a level of about 6 percent of GDP by 2035 and will stay at essentially that level through 2085.

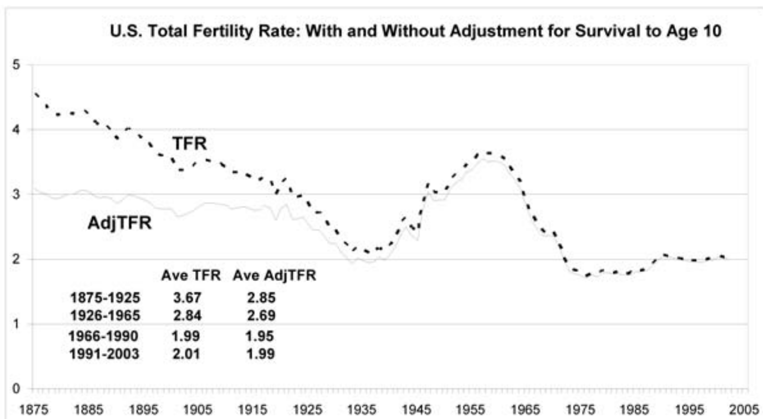
Projected Cost and Non-interest Income for Social Security as Percent of GDP



The question confronting Congress and the American people is fairly simple. The permanently higher level of program cost as a share of GDP, which is reached over the next 25 years, could be met by an increase in scheduled revenue of about one third, or decrease in scheduled benefits of about one fourth, or any combination of these adjustments. The gap of 1.5 percent of GDP will need to be closed one way or another. Neither an immediate increase in payroll taxes nor an immediate reduction in benefits seems well advised given the current state of our economy. However, we will need to make changes over the next two decades. We can all agree that even if changes in scheduled taxes and scheduled benefits are not implemented immediately, we would be wise to enact necessary changes soon in order to provide time for future workers and beneficiaries to plan for and adapt to these changes.

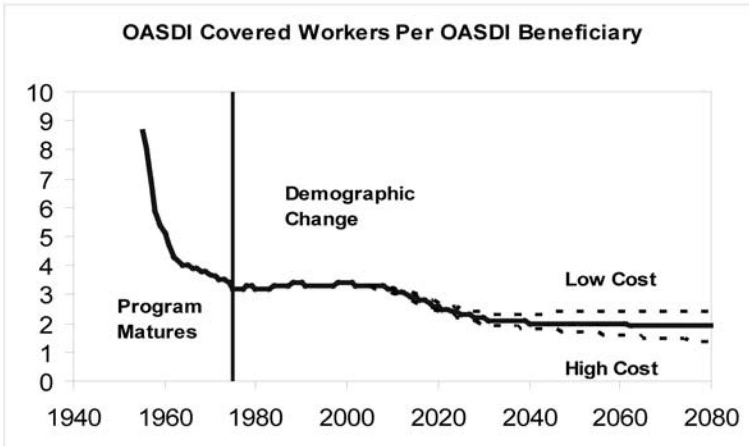
Why is the Cost of Social Security going up over the Next 25 Years?

Apart from the near-term effects of the recent economic downturn, the real reason for the rising cost of Social Security over the next 25 years is the aging of the population, not principally because we are living longer or because of the post-World War II baby boom, but because of the drop in birth rates since the baby boom. Birth rates averaged 3.3 children per woman from 1946 through 1965, and were generally at around 3 children per woman for many decades before that time. Adjusting for the percent of births that survived to age 10 in the past, the effective birth rate was remarkably flat until 1965. This is especially true if we average out the low-birth years of the great depression with the high years post World War II.



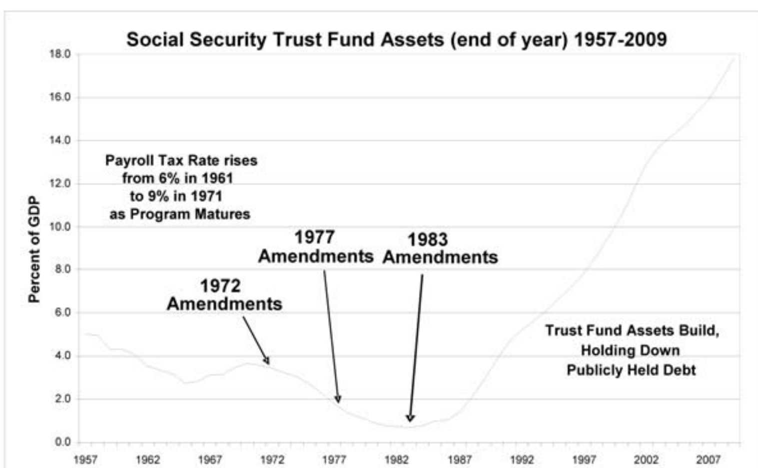
The fact that overall birth rates dropped from 3 to 2 children per woman in the United States has led directly to the change in the age distribution of our population that presents a financial challenge not only to Social Security and Medicare in the future, but also to every aspect of our economy. The change from a world where elders had on average 3 children in the workforce behind them to a new world with only 2 children will as sure as the sun rises in the east increase in numbers of elders and beneficiaries compared to the numbers of working age persons in our country.

This shift can bee seen readily in the projected numbers of workers per Social Security beneficiary. As the Social Security program gradually matured, finally offering the full opportunity to receive retirement, survivors and disability benefits to individuals at all ages around, the ratio of beneficiaries to workers settled in at 3.3 and stayed there through 2008. Between 2008 and 2035, however this ratio will drop to about 2 workers per beneficiary reflecting the drop in family size chosen by the baby boomers and subsequent generations.



In essence then, we have a choice between asking the relatively smaller numbers of children in the future to pay higher tax rates or work longer, or for the elders of the future to accept lower benefits or retire later. In all likelihood, the solution will be some combination of changes.

Social Security Trust Fund Assets



Social Security Trust Fund holdings were 5 percent of GDP in 1957, and were used over the next 25 years to augment current taxes for the payment of benefits. In that time, the Congress enacted major reform legislation three times, in 1972, 1977, and 1983. The reserves in the Trust Funds allowed Congress the time make judicious choices and to provide advance notice to those who would be affected.

While opinions about the significance of the Trust Funds vary, certain facts are indisputable. The Trust funds have allowed the Social Security program to spend more than current tax income for some periods. However, the Trust Funds cannot allow the program to go into debt. Unlike most other Federal programs, Social Security has no borrowing authority and must always maintain a position of having collected more in taxes from workers, their employers, and beneficiaries, than it has expended since it's inception. The following facts provide a solidity to the commitment to make these assets available for program expenditures as has always occurred in the past:

(1) trust fund assets can by law be expended only for benefits and administrative expenses of the program,
(2) all assets must be invested in interest bearing securities backed by the full faith and credit of the United States Government, and
(3) the Contract with America Act of 1996 requires that all revenues for the system be credited expeditiously to the trust funds.

Perhaps the strongest evidence of the importance of the trust funds is constraint they provide on program financing. History clearly shows that Congress is moved, even forced into action anytime a trust fund approaches exhaustion.

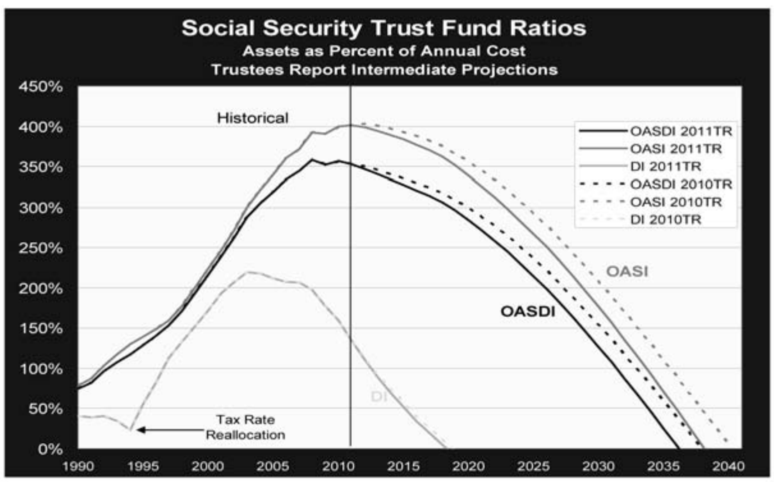
Thus, while Social Security has run a cumulative surplus of $2.6 trillion since it started collecting taxes in 1937, the rest of government has run up a debt now over $14 trillion and rising. The fact that the Social Security reserves are a part of this total Federal debt is of no small consequence. Total Federal debt subject to limit is the sum of publicly held debt and the "public debt" held by the trust funds on behalf of the public. If the trust Funds had not loaned $2.6 trillion to the Treasury then the publicly held debt might simply be that much more today. While some argue that the Trust Fund accumulations in fact encouraged the rest of government to spend beyond its means, this theory does not explain the nearly $12 trillion in excess spending that is currently reflected in our borrowing directly from the public.

With trust reserves of $2.6 trillion, or roughly 18 percent of GDP, Social security financing might appear to be on solid ground. However, the impending demographic shift due to the drop in birth rates in the 1960's requires adjustments to the program. The current substantial trust fund reserves represent a cushion allowing us time to phase in needed changes gradually.

Potential Adjustments to Social Security Revenue and Benefits

The Consequence of Inaction

If we do nothing, the Disability Insurance Trust Fund is expected to become exhausted in 2018, at which point continuing tax revenue would permit payment of only 86 percent of scheduled benefits on a timely basis. The change would be abrupt and devastating. This will of course not happen. Even if we only reallocate a part of the OASI payroll tax rate to the DI program, for no net increases in taxes, as we did in 1994, then both the OASI and DI trust funds would be extended to exhaustion in 2036, at which time 77 percent of scheduled benefits would be payable. These would be real consequences. The inability of the OASDI program to borrow would make this a reality in the absence of any Congressional action between now and 2018, or any substantial action between now and 2036.



Possibilities for Change

Clearly, the Congress will make substantial changes in Social Security scheduled revenue, in Social Security scheduled benefits, or both well before 2036.

Increasing Revenue

The primary focus of this hearing is on the possibilities and consequences of increasing revenue to help close the projected financing gap for Social Security. That gap is projected to rise gradually over the next 25 years to about 1.5 percent of GDP.

One possibility for increasing revenue for financing Social Security benefits is to increase the maximum amount of annual earnings that is subject to the 12.4-percent payroll tax. Back in 1982 and 1983, 90 percent of all earnings covered under Social Security were subject to the payroll tax. That percentage declined to about 83 percent in 2008 as the distribution of earnings became much more dispersed, that is the proportion of earnings for the very highest earners increased. We project that after the economy has fully recovered from the recent recession the percentage of earnings subject to the payroll tax will reach about 82.5 percent. The recent Fiscal Commission chaired by Erskine Bowles and Alan Simpson recommended gradually increasing, over 38 years, the taxable maximum to again tax 90 percent of covered earnings. This change would eliminate about 25 percent of the financing gap over the next 75 years, and even more if phased-in more rapidly.

Another possible source of increased revenue for Social Security would be to subject premiums for employer sponsored group health insurance to the payroll tax. This change, recommended by the Bipartisan Policy Center task force chaired by Alice Rivlin and Pete Domenici would close about 40 percent of the 75-year financial gap for Social Security. The share of all employee compensation---wages plus fringe benefits---subject to the payroll tax has declined over the years principally as health care costs have risen and more employee compensation has been directed to tax-favored employee sponsored group health insurance. Removing this tax-favored status would improve Social Security financial status and in addition potentially contribute to s slowing in the increase in health care costs in general.

A proposal that would have a smaller increase in revenue, covering a little over 10 percent of the 75-year Social Security financing gap would be to subject employee compensation in the form of cafeteria Section 125 plan contributions to the payroll tax. Currently this tax-favored status is used primarily for employee payments toward the premiums of employer sponsored group health insurance.

Some have considered applying a payroll tax to all earnings above the current taxable maximum amount, either the full 12.4 percent or some smaller rate. Applying the 12.4-percent tax rate to all earnings above the current taxable maximum amount could completely eliminate the projected 75-year shortfall for Social Security, as indicated in estimates for Representative Deutch that we provided in October 2010. Applying a lesser tax rate to all earnings above the current limit would provide a partial solution to the financing gap.

In May 2010, we provided estimates to Representatives Johnson, Brady, and Ryan for an array of potential proposals to apply a payroll tax rate of 2, 3, or 4 percent to all OASDI covered earnings above $200,000, 300,000, or 400,000 starting in 2017. The potential revenue gains from these provisions ranged up to about 25 percent of the 75-year financing gap for Social Security.

The Consequence of Action

We know that if we fail to act in a substantial way between now and 2036, the current trust fund assets will be gradually redeemed and eventually exhausted. The process of redeeming the assets in the fund involves a reduction in the Federal debt owed to the trust funds while at the same time increasing the amount of federal debt owed directly to the public. The consequence of this shift in Federal debt from that owed to the trust funds, and thus indirectly to the public, to debt owed directly to the public is unclear. The total debt subject to limit is not affected.

What is affected by trading debt to the trust funds for publicly held debt is there is a greater amount of debt actually auctioned by the Treasury. The consequence of this shift over time is unclear. It is the job of financial markets to anticipate changes that will occur in the future and to incorporate expected changes into current pricing of financial securities today. The existence of the $2.6 trillion of Federal debt owed to the OASDI trust Funds is not a secret and it would be unreasonable that the sophisticated financial markets are not well aware to the projections for increased debt subject to auction as trust fund securities are redeemed.

To the degree that redemption of substantial amounts of trust fund assets and issuance of additional publicly held debt may be disruptive to the markets and the economy, this should be contrasted with the implications of raising additional revenue through taxes in order to limit the amount of current trust fund assets that will be redeemed by 2036. Both increases in taxes and increases in publicly held debt will have consequences for the economy and the markets. Which would have greater consequence is not clear and is debatable. Additional borrowing in the private markets arguably absorbs potential savings that might otherwise have been invested wholly in growing the economy. Additional taxes would presumably result in some combination of reduced savings and investment, and reduced consumption. Both would have consequence.

The alternative to increasing revenue is of course reduction in scheduled benefits for Social Security. This will happen automatically under current law once all trust fund assets are exhausted, assuming that taxes are then insufficient to pay full scheduled benefits. The consequence of precipitous reduction in benefits would be devastating to beneficiaries at a level far beyond the consequence for the economy as a whole. More gradual reduction in scheduled benefits, or changes that would slow the rate of increase in benefits in the future, would have less drastic consequence because the effects would occur gradually. Reduced benefit levels for future generations would mean less consumption, faster draw down of savings, and less passed on to their heirs. The effects on overall consumption, investment, and savings in the economy would be significant and may or may not be greatly different from the levels if currently scheduled benefits are maintained through increased taxes or increased borrowing from the public. The one clear consequence would be a relatively lower standard of living for most of the elderly and disabled population.

Conclusion

The projected Social Security financial shortfall is essentially the consequence of the drop in birth rates from an average of about 3 surviving children per woman for the long term past to a level of about 2 children per woman over a lifetime of child bearing since 1970 and for the indefinite future. This fundamental shift is now in the process of manifesting itself in the changing age distribution of our population as the last generations born of higher birth rates, the "baby-boom" generation, passes from working age to retirement age, and is replaced by workers born of lower birth-rate periods. This transition will be essentially complete by 2035, and the cost of Social Security will be elevated as a result from the level of less than 4.5 percent of GDP experienced over the last 20 years, to 6 percent of GDP for 2035 and thereafter.

This change in the fundamental age distribution of the population is inevitable now and will also affect Medicare and all other plans, public and private, that depend on investment or serve retirees. As a nation, we will need to adapt to having a higher proportion of the population at old age due to the drop in birth rates. Continuing increases in life expectancy will add to this change but only very gradually over the long-term future. We must adapt by either working longer, retiring later, increasing taxes on workers, reducing benefits and income generally to the elderly and disabled, or some of each.

The array of possible changes for closing the financial gap for Social Security, including revenue increases and benefit reductions reflect the entire range of possible adaptations. I know I speak for all members of the Office of the Chief Actuary at the Social Security Administration in saying that we look forward to continued work with members of the Congress and staff in the development of this range of options. We hope to contribute to a common knowledge and understanding of the implications of the potential changes so that you, our elected representatives can make the best possible choices on behalf of all of the American people.

Attached are brief lists of selected options for increasing revenue of reducing scheduled benefits for Social Security and the percent of the 75-year financial shortfall that each individually would eliminate. Note that the effect of several proposals on a combined basis is generally less than the sum of their individual effects due to interactions among provisions.

Selected Options for Increasing Revenue for Social Security

Provision	Estimated Percent of the 75-Year Shortfall Eliminated
1. Increase the OASDI taxable maximum amount gradually, from 2012 to 2049, to tax 90 percent of covered earnings. Include additional earnings for benefit credit.	27%
2. Phase out the payroll tax exclusion for employer sponsored group health insurance premiums between 2018 and 2028.	42%
3. Tax all voluntary salary reduction plan contributions (125 plans) like 401k plans for OASDI payroll tax.	10%
4. Eliminate the OASDI taxable maximum amount between 2011 and 2017, with no additional benefit credit.	100%
5a. Apply a 4 percent payroll tax to all earnings over $200,000 in 2017, wage indexing the threshold thereafter. Provide proportional benefit credit for additional earnings.	18%
5b. Apply a 4 percent payroll tax to all earnings over $200,000 in 2017, wage indexing the threshold thereafter. Provide no benefit credit for additional earnings.	22%
6. Cover all State and local government employees hired in 2020 and later.	7%
7. Gradually invest 15 percent of OASDI Trust Fund assets in a broad indexed fund of equities and maintain this percent.	11%

Note that combining several provisions will generally result in a change less than the sum of the individual changes due to interaction among provisions.

Source: Office of the Chief Actuary, Social Security Administration
June 23, 2011
http://www.ssa.gov/OACT/solvency/provisions/index.html

Selected Options for Reducing Scheduled Beneits for Social Security

Provision	Estimated Percent of the 75-Year Shortfall Eliminated
1. Beginning in 2023, reduce benefit levels for new retirees and survivors each year by the increase in life expectancy at 67.	22%
2. Starting 2023, index the normal retirement age to increase beyond 67 to maintain a constant ratio of expected retirement years to potential work years. Increase the earliest eligibility age above 62 to keep it 5 years below the NRA.	42%
For those with at least 25 years of earning 4 quarters of coverage, omit these changes if average earnings less than 250% of poverty, and limit change if below 400% of poverty.	15%
3. Starting with the December 2012 COLA, base the increase on increase in the chain-weighted Consumer Price Index (C-CPI-U)	23%
4. Price index initial benefits across generations beginning 2017. Reduce all PIA factors (90, 32, 15) by the real growth in average earnings.	113%
5a. Progressive price indexing so that steady maximum earners have price indexed benefits across generations, with lesser reductions for lower earners---no change for lowest 50% of earners.	42%
5b. Progressive price indexing so that steady maximum earners have price indexed benefits across generations, with lesser reductions for lower earners---no change for lowest 30% of earners.	64%

Note that combining several provisions will generally result in a change less than the sum of the individual changes due to interaction among provisions.

Source: Office of the Chief Actuary, Social Security Administration
June 23, 2011
http://www.ssa.gov/OACT/solvency/provisions/index.html

Chairman JOHNSON. Thank you, sir.

Mr. GOSS. Thank you very much.

Chairman JOHNSON. Tim Lee, Texas Retired Teachers Association, on behalf of the Coalition to Preserve Retirement Security. You are recognized for five minutes.

Mr. LEE. Thank you very much.

Chairman JOHNSON. Are you from Texas?

Mr. LEE. Yes, sir.

Chairman JOHNSON. Where do you live?

Mr. LEE. I live in Austin.

Chairman JOHNSON. Okay.

Mr. LEE. Yes, sir.

STATEMENT OF TIM LEE, TEXAS RETIRED TEACHERS ASSOCIATION, ON BEHALF OF COALITION TO PRESERVE RETIREMENT SECURITY

Mr. LEE. Chairman Johnson, Ranking Member Becerra, and distinguished Members of the Subcommittee, my name is Tim Lee, and I am the executive director of the Texas Retired Teachers Association. I am testifying today in my capacity as a board member of the Coalition to Preserve Retirement Security, specifically here to talk about the issue of mandating Social Security coverage with public workers.

Over the years some have recommended bringing all public workers into the Social Security program. However, mandating that all newly hired public workers must participate in the Social Security system would create significant new cost pressures for the affected state and local government jurisdictions, while providing only minimal benefit to the program.

These jurisdictions, with their own long-standing defined benefit retirement plans, would have to make difficult choices. Adding an additional 6.2 percent payroll tax per worker to the benefit cost of public employers would almost certainly result in cut-backs to their existing defined benefit plans, cuts in government services and/or increases in taxes or fees to absorb the added costs. The disruption that would likely occur for these public jurisdictions and their workers seems a high price to pay for adding an estimated two years of solvency to the Social Security program.

It is estimated that mandatory Social Security coverage would cost the affected states and localities $44 billion over 5 years. The additional financial burden, which will impact all 50 states to one degree or another, could be an insurmountable budgetary hurdle, particularly during these very difficult days of huge revenue shortfalls hitting virtually every state.

In Texas, for example, our state legislature has finished its regular session and is now in special session. The regular session was particularly difficult, as we all struggled with a budget reduction for the biennium that exceeded $15 billion. The state budget reduction has hit public sector—particularly our public schools—very hard. Tens of thousands of public school employees, including classroom educators and support personnel, have been sent reduction in force notices, and are not anticipating being rehired in the coming school year.

To the issue of added cost, due to the mandating Social Security, the impact would be devastating to 95 percent of Texas school districts. These school employers and employees already make a contribution equal to 6.4 percent of their salary to the Texas teacher retirement system. The state legislature is bound by the Texas constitution to make a contribution, a minimum of six percent of the aggregate active teacher payroll.

I think it is speculative, at best, to assume that any of these contributions to the teacher retirement system in Texas will remain in the event that Congress mandates Social Security coverage for all public employees.

School districts and employees would be hard-pressed to make an additional contribution to the Social Security trust fund, as well as maintaining contributions to the TRS pension fund. Our Texas TRS fund is presently valued at around $110 billion. It is about 82.3 percent funded. Redirecting contributions away from this fund to cover a new federal mandate for Social Security coverage would quickly destabilize the fund, and jeopardize the long-term financial security of 1.3 million Texans. To break that number down even further, 1 out of every 20 Texans depends on the TRS Texas as their primary source of their retirement or future retirement security.

Texas has taken bold steps to maintain the health of the public retirement system, and projections suggest that TRS Texas is able to meet current and future obligations through the year 2114. Mandating Social Security coverage would have a profound negative impact on that funding status, and leads us in the wrong direction, and jeopardizes the long-term funding of the retirement system.

Some suggest that current retirees may be held harmless by mandating Social Security coverage for only newly hired active employees, contending this would make it less onerous for public employers. But nothing could be further from the truth. Public sector-defined benefit plans rely on constant reliable revenue stream in order to meet actual real goals and provide a retirement benefit for plan participants at affordable contribution levels. Proponents of this solution fail to understand that the normal cost of the existing retirement plan will increase as percentage of payroll as younger members are eliminated from the plan.

Thus, employers and new workers will not only have to add additional 6.2 percent of the new payroll tax, but employers may also have to increase contributions to the existing plan, or cut benefits. When states and localities are under extreme fiscal stress, as they are currently, this added expense will create enormous burdens with negligible, if any, positive outcomes.

Those positive outcomes are significantly less positive than one may realize. A study by the General Accountability Office concluded that a new hire would only add two years, at most, to the Social Security solvency. The same report stated that moving to mandatory coverage would be very costly to the states involved. As a result, mandatory coverage provides no long-term solution to the Social Security issue, but it creates a huge, unfunded mandate on state and local governments. Destabilizing state designed, state-funded public pension plans would have grave repercussions across a public and private spectrum alike.

Considering this, the—consider this. The teacher retirement system pension fund pays about 6.6 billion annually in benefits to over 300,000 current TRS Texas retirees. These benefit payments have a substantial impact on the Texas economy, including $640 million in state taxes paid, 260 million in local government revenues, and helps create more than 91,500 permanent jobs in Texas.

And I will skip to the end, Mr. Chairman. Mandating Social Security coverage for all public sector workers would only create an enormous unfunded federal mandate on state and local taxpayers, and major costs and burdens for public employers, without contributing significantly to the solvency of the Social Security program. Millions of public employees have placed their faith and their future in the pension plans, and have planned for their retirement accordingly. It is absolutely critical to maintain the stability and confidence, the security of those public pension plans for their employees. And we will work to continue to do so.

Thank you for the opportunity to testify, and thank you for your staff's work in helping me be here today.

I appreciate it.

[The prepared statement of Mr. Lee follows:]

House Committee on Ways and Means

Statement of Tim Lee, Board Member
Coalition to Preserve Retirement Security, Alexandria, Virginia

Testimony Before the Subcommittee on Social Security
of the House Committee on Ways and Means

June 23, 2011

Chairman Johnson, Ranking Member Becerra and distinguished members of the subcommittee, my name is Tim Lee and I am the Executive Director of the Texas Retired Teachers Association. I am testifying today in my capacity as a Board member of the Coalition to Preserve Retirement Security. On behalf of the Coalition, I thank you for the opportunity to appear before the subcommittee to discuss Social Security's finances. Specifically, I am here to discuss the issue of mandating Social Security coverage for public sector workers.

The Coalition to Preserve Retirement Security (CPRS) is a non-profit organization composed of members representing state and local governments, public employee unions, retiree associations, and public pension systems throughout the United States. The purpose of our organization is to assure the retirement security of millions of public employees by protecting the financial integrity of their public employee retirement systems.

Our members are found in Alaska, California, Colorado, Connecticut, Florida, Illinois, Kentucky, Louisiana, Massachusetts, Missouri, Nevada, Ohio, and Texas and represent more than 4 million public employees and retirees.

In addition, our national associations and public pension unions represent more than 15 million public workers, about one-third of whom are outside of Social Security.

The Problem

Over the years, some have recommended bringing all public workers into the Social Security program. However, mandating that all newly hired public workers must participate in the Social Security system would create significant new cost pressures for the affected state and local government jurisdictions while providing only minimal benefit to the program.

These jurisdictions, with their own long-standing defined benefit retirement plans, would have to make difficult choices. Adding an additional 6.2 percent payroll tax per worker to the benefit costs of public employers would almost certainly result in cutbacks to their existing defined benefit plans, cuts in government services, and/or increases in taxes or fees to absorb the added costs. The disruption that would likely occur for these public jurisdictions and their workers seems a high price to pay for adding an estimated two years of solvency to the Social Security program. It is estimated that mandatory Social Security coverage would cost the affected states and localities $44 billion over 5 years. This additional financial burden —which will impact all 50 states to one degree or another – could be an insurmountable budgetary hurdle particularly during these very difficult days of huge revenue shortfalls hitting virtually every state.

Background

When the Social Security system was created in 1935, state and local government employees were not allowed to participate in the system. As a consequence, state and local governments – many of which had preexisting pension programs – designed their own retirement plans in reliance on that exclusion. Beginning in the 1950s, state and local government employers could elect to have their employees covered by the Social Security program and were allowed to opt-in or -out of the system.

In 1983, there was a major revision of the Social Security and Medicare laws, triggered primarily by a concern about the long-term solvency of these two trust funds. Once again, Congress decided not to require state and local employees who were outside the system to be covered, but did end the opt-out for public employees who had chosen to be covered.

In 1986, as part of the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), Congress required universal participation in the Medicare system on a "new hires" basis, but chose to leave public employee retirement plans in place, and did not change the law with respect to Social Security.

In 1990, Congress enacted a law requiring that all public employees, not covered by a state or local retirement plan meeting specified standards, must be covered by Social Security. That law, adopted as part of the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act"), ensures that all public employees will be covered either under Social Security or under a public retirement plan that provides comparable benefits. Today, about one-third of all state and local government employees, over six million public employees, are outside the Social Security system because they are covered by their employer's public retirement plan. In addition, millions of current retirees from non-Social Security public pension plans, including the 74,000 members of the Texas Retired Teachers Association, depend on those plans for a significant share of their retirement income.

In 2001, the President's Commission to Strengthen Social Security made history by being the first commission to not recommend mandatory Social Security coverage in its proposals for Social Security reform. This is particularly remarkable, since the late New York Senator Daniel Patrick Moynihan, a vociferous proponent of forced coverage, co-chaired the Commission.

Most recently, the Bowles-Simpson Deficit Commission and the Domenici-Rivlin Task Force plan both propose to require that all newly-hired employees of state and local governments after 2020 be covered under Social Security.

The Deficit Commission concluded that excluding some public employees from Social Security and instead maintaining separate retirement systems "has become riskier for both government sponsors and for program participants and a potential future bailout risk for the federal government." Further, they argue that mandatory coverage "will ensure that all workers, regardless of employer, will retire with a secure and predictable benefit check." Our coalition strongly disagrees with both points.

Forcing newly hired state and local public workers outside of the Social Security program to participate is seen by some as an attractive way of generating additional revenues for the program in the short term. This position is flawed and should not be included in any Social Security or debt reduction package.

On June 19, 1998, then Congressman, now Speaker John Boehner wrote, "Mandatory coverage is a short-term fix for a long-term problem." For the reasons discussed below, we agreed with Mr. Boehner in 1998 and we continue to agree today.

The Myth of Covering Just New-Hires: Covering Only New-Hires is Still Harmful

Proponents of mandatory coverage contend that applying the mandate only to newly-hired workers would make it less onerous for public employers – nothing could be further from the truth. Public sector defined benefit plans rely on a constant and reliable revenue stream in order to meet actuarial goals and provide a retirement benefit for plan participants at affordable contribution levels.

Proponents of this solution fail to understand that the normal cost of the existing retirement plan will increase as a percentage of payroll as younger members are eliminated from the plan. Thus, employers and new workers will not only have to add an additional 6.2 percent for the new payroll tax, but employers may also have to increase contributions to the existing plan or cut benefits. When states and localities are under extreme fiscal stress as they are currently, this added expense will create enormous burdens with negligible, if any, positive outcomes.

Non-covered systems depend heavily on investment income to provide retirement benefits and ancillary services such as healthcare. National studies show that on average, investment income provides approximately 70% of retiree benefits. The loss of contributions from employees and employers that would be diverted to Social Security, together with the loss of income on those funds, would not only be catastrophic over time but would also result in an unfunded Federal mandate on state and local plans that by and large are securely funded. State and local pension plans would have no choice but to reduce benefits not only for new hires but possibly for current members and retirees as well.

Mandatory Social Security Coverage Will Only Extend Social Security's Solvency by Two Years, But Could Destabilize Public Pension Systems Nationwide

A study by the Government Accountability Office (GAO) concluded that adding new hires would only add two years at the most to Social Security solvency. The same report stated that moving to mandatory coverage would be very costly to the states involved. As a result, mandatory coverage provides no long-term solution to Social Security, but it creates a huge unfunded mandate on state and local governments.

According to a 2005 study by The Segal Company (which is currently being updated), mandatory Social Security coverage could cause a reduction in employee and employer contributions to existing defined benefit plans, "which are an essential part of their actuarial funding. This could destabilize the existing plans on which current workers and retirees depend." The report continued, "Lower funding would not only have an impact on retirement benefits, but could affect disability and survivor benefits as well," which are often more generous than those offered by Social Security.

State and Local Public Pension Plans Are Not In Crisis

Contrary to the premise upon which the most recent Debt Commission based its recommendation, most state and local government employee retirement systems have substantial assets to weather the recent economic crisis; those that are underfunded are taking steps to strengthen funding. As you know, pensions are funded and paid out over decades. More state and local governments enacted significant modifications to improve the long-term sustainability of their retirement plans in 2010 than in any year in recent history. According to a study produced by the National Conference of State Legislatures, in the past few years, nearly two-thirds of states have made changes to benefit levels, contribution rate structures, or both; many local governments have made similar fixes.

Perhaps most importantly, since 1985 – a period that has included three economic recessions and four years of negative median public fund investment returns – actual public pension investment returns have exceeded assumptions. For the 25-year period ended 12/31/09, the median public pension investment return was 9.25%. Moreover, for the year ended 6/30/10, this return was 12.8%.

The Costs of Mandatory Coverage Greatly Outweigh the Benefits

As noted above, mandatory coverage would only add two years of solvency to the 75-year projection for the Social Security program. But, it would cost public employees, their employers and ultimately taxpayers nationwide more than $44 billion over the first five years, according to the Segal report. Mandatory Social Security would be felt in all 50 states and over time would add new beneficiaries to the program who would draw down benefits like other Social Security recipients, increasing financial pressures on the system. It's estimated that 75% of all public safety officers (police, fire, and corrections personnel) and 40% of all public school teachers are exempt from Social Security.

The chart below illustrates how mandatory coverage would affect the home state of each member of the Ways and Means Social Security Subcommittee.

Member of Congress	Home State	Employees Affected	5-Year Cost to Employees, Employers and Taxpayers
Sam Johnson, Chairman	Texas	836,000	$5,277,097,497
Kevin Brady	Texas	836,000	$5,277,097,497
Pat Tiberi	Ohio	820,000	$4,350,432,245
Aaron Schock	Illinois	489,000	$4,237,608,792
Rick Berg	North Dakota	10,000	$65,396,921
Adrian Smith	Nebraska	17,000	$113,827,468
Kenny Marchant	Texas	836,000	$5,277,097,497
Xavier Becerra, Ranking Member	California	1,468,000	$8,205,239,780
Lloyd Doggett	Texas	836,000	$5,277,097,497
Shelley Berkley	Nevada	100,000	$831,165,283
Fortney Pete Stark	California	1,468,000	$8,205,239,780
Subcommittee Totals		3,740,000	$23,080,767,986
National Totals		6,617,000	$44,242,669,672

Source: "State-by-State Cost Analysis of Mandatory Social Security," The Segal Company, 2005

Mandatory Coverage: Tough Choices for States and Localities

If all newly hired state and local employees are forced to participate in the Social Security program, their employers – state and local government entities – and policy makers will have to make difficult decisions on how to offset these new taxes.

According to the Segal report, these taxes would likely be absorbed through "tax increases, cuts in existing benefits and/or reductions in workforce and services," none of which are particularly popular and all of which would be met with strong resistance by the affected constituencies. Many states and localities are already facing large financial challenges. Mandating Social Security coverage would only exacerbate already troubled financial landscapes for jurisdictions across the country.

Hidden Impacts

Mandatory coverage could also undermine other benefits of public pension plans. These plans, in addition to offering sound and secure retirement benefits for public workers also provide valuable benefits that reduce pressure on federal government programs. These benefits are overlooked by mandatory coverage proponents.

For instance, certain classes of public sector workers have special needs that would not be met by the Social Security program. Safety workers, like police and fire, because of working conditions and job qualifications, retire earlier than other workers, often before age 62, the earliest age at which one can collect Social Security. Consequently, if these workers no longer had their traditional defined benefit public retirement, they could be forced to retire from their public safety jobs but have little or no retirement benefits until reaching 62.

Public retirement plans also offer partial disability benefits, unlike Social Security. These disability benefits go a long way toward providing an income stream so partially disabled workers do not have to depend on public assistance programs.

Most plans provide pre-retirement survivor benefits. For children, Social Security's survivor benefits end at age 18. Many public plans provide benefits after that age has been reached if the child is a full-time student.

Early retirement, partial disability and survivor benefits are among the benefits specifically tailored to meet the needs of public workers that would be threatened by mandatory coverage.

Conclusion

Mandating Social Security coverage for all public sector workers would only create an enormous unfunded Federal mandate on state and local taxpayers and major costs and burdens for public employers without contributing significantly to the solvency of the Social Security program.

Millions of public employees in non-covered systems have placed their faith and their future in the pension plans, and have planned their retirement accordingly. It is absolutely critical to maintain the stability, confidence, security, and trust of those public employees who have served so well.

Chairman JOHNSON. Thank you, sir.

Mr. LEE. Thank you.

Chairman JOHNSON. Thank you for being here. And you know, I don’t think there are very many of us that want to impose a tax on any state. And, as you know, the state of Texas, along with a lot of others, some of their associations, fireman and police, opted out of Social Security for a private retirement fund. And that is what America is all about, in my view.

Alex Brill, a research fellow, American Enterprise Institute, you are recognized for five minutes.

STATEMENT OF ALEX BRILL, RESEARCH FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. BRILL. Thank you very much, Chairman Johnson, Ranking Member Becerra, other Members of the Subcommittee, for the opportunity to appear before you this afternoon to testify on this important topic.

To establish Social Security as a sustainable, solvent program, changes are certainly necessary. Absent structural reforms, scheduled benefits will exceed income by roughly 30 percent in 25 years. 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 through tax increases. But these two options have different economic effects, particularly the effect on labor supply. Advocates of reform proposals that offer a combination of both revenue increases and benefit reductions sometimes argue that a solution involving both sides of the ledger is a "balanced approach." However, once one considers the economic impact of different changes, that balance may shift considerably.

This hearing is about the revenue matters with regard to Social Security. And so, in my testimony I will focus briefly on the economic consequences of tax changes.

First and foremost, I would like to stress that in evaluating 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 alter their behavior in response to tax changes. And this behavioral response is not without consequence. It gives rise to what economists call an excess burden. The greater the taxpayers' response to avoid the tax, the greater the excess burden. This behavioral response, that may result from an increase in the payroll tax rate, includes fewer hours worked and a shift from taxable wage income to non-taxed fringe benefits.

Described earlier, the payroll tax is a tax on wages, not total worker compensation. And, therefore, it generally creates a distortion between wage compensation and non-wage compensation, such as health benefits and many other non-taxed fringe benefits. When an employer pays a worker wages, the employer deducts that cost from his own taxes, while the worker reports the wages as taxable income. However, when an employer compensates a worker with a non-taxable fringe benefit, it too, is deducted from the employer's income, but excluded from the worker's income.

As a result of this distortion, there has been a decrease of wages as a share of total employee compensation. Today, approximately one out of every five dollars of compensation is non-wage, almost all of which is excluded from taxable income—income tax and payroll taxes. The shift from wage to non-taxed fringe benefits has eroded the payroll tax base over time. And while many Social Security reform proposals subject a greater share of payroll to the payroll tax, few have focused on more broadly taxing compensation income.

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 also note that the 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 increase. It has also been documented that high marginal tax rates also discourage entrepreneurship, and reduce the business activity of sole proprietorships.

Tax rate increases will generate more income for the Social Security trust funds, but that additional revenue comes at a cost. Higher marginal rates will discourage labor supply and, through other means of shifting, reduce taxable income. In addition to less economic output, such a change will lead to a significant decline in both federal and state income taxes.

The least bad of the various tax options would be a broadening of the tax base by taxing fringe benefits. This would at least eliminate some of the existing distortions 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 benefit formula, and the consumer price index methodology for calculating cost of living adjustments before considering tax increases.

I will conclude by reiterating that raising tax rates to prevent insolvency is likely to discourage work, and thus, long-term economic growth.

I would also like to express to the committee my view that Congress need not wait until a full reform that actuaries estimate will return the trust funds to long-run solvency can be agreed to. Many incremental reforms can and should be considered now. The sooner Congress adopts pro-solvency measures, the less consequential they need to be. Thank you, and I look forward to answering your questions.

[The prepared statement of Mr. Brill follows:]

American Enterprise Institute for Public Policy Research

Statement before the House Committee on Ways and Means
Subcommittee on Social Security

Hearing on Social Security's Finances

Alex M. Brill

Research Fellow

American Enterprise Institute

June 23, 2011

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

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

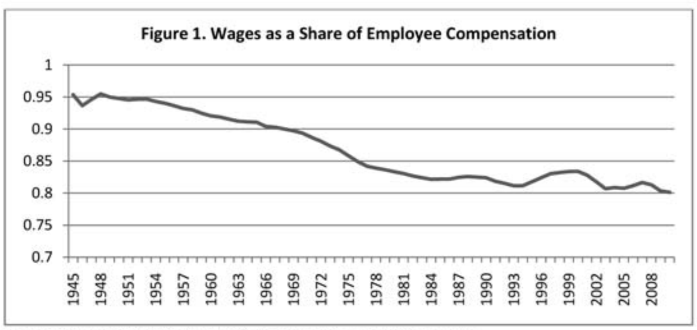
[4] *The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*.
[5] Martin Feldstein, "The $110,000 Question," *Wall Street Journal*, September 1, 2004.
[6] Ibid. Feldstein assumes a taxable income elasticity of 0.5. Alan 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.

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[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.

Chairman JOHNSON. Thank you, sir. I appreciate your remarks.

Dr. Warshawsky, a former assistant secretary for economic policy, U.S. Department of the Treasury, you are recognized, sir.

STATEMENT OF MARK J. WARSHAWSKY, PH.D., FORMER ASSISTANT SECRETARY FOR ECONOMIC POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. WARSHAWSKY. Thank you very much, Chairman Johnson, Ranking Member Becerra, and Members of the Subcommittee on Social Security. I appreciate the opportunity to be here. I would like to congratulate you for holding this hearing discussing the revenue options for Social Security reform.

As the recent Social Security trustees report shows, the program's financial status has worsened both in the short and long term. Social Security is now running large and soon to be rapidly growing cash flow deficits, adding to the federal debt outstanding held by the public and the budget deficits of the Federal Government. The day is steadily growing closer when benefits by law will have to be cut. Indeed, for disabled beneficiaries and their families, this is projected to occur in seven years.

It is good that we are now discussing more actively options to strengthen Social Security, and it is promising that many groups and individuals and legislators have put forward specific proposals. At the same time, not all provisions and all reform plans are good policy.

For example, there are proposals coming from the deficit reduction commissions and elsewhere to increase Social Security payroll taxes substantially by increasing the contribution and benefit base. In particular, the commissions propose to increase the Social Security contribution and benefit base—also called the taxable maximum—by an additional two percent each year, starting in 2012, until 90 percent of total earnings of the labor force are taxed.

If the increase were to happen in one step in 2012, the taxable maximum would be about $215,000, up from $106,800 today. This is a very large tax increase on about 10 million of our most productive workers. Almost 99 percent of workers would then be subject to Social Security taxation on all of their earnings, up from about 94.5 percent today.

This proposed provision is a bad idea for at least four reasons, in addition to the general ill effects of tax increases.

It unfairly targets a specific segment of the population that has not seen particularly large gains in earnings. It is an extra burden, in addition to the new taxes imposed on this and other groups to finance Medicare and in the recent health care legislation. It will cut pre-retirement savings. And it represents an unnecessary expansion of Social Security. Let me explain briefly each.

Those who advocate an increase in the taxable maximum have indicated that their goal is to have 90 percent of total earnings in the labor force subject to Social Security taxation. This taxable coverage ratio has fluctuated over the history of the program, from as little as 71 percent in 1965 to a high of 90 percent in 1983. And most recently, in 2009, it was 85.7 percent. The use of this ratio for policy design seems very arbitrary. But I think what the advocates are getting at is a deeper concern about the distribution of income and earnings, more broadly. And they claim, based on some research, that there has been an increase in inequality.

But then consider another study that focuses on the wages of private sector workers, ages 25 to 60, over a long period of time. It finds that the increase in equality has slowed since the late 1980s, and that the vast majority of the increase for the top 20 percent of workers, the first group since 1980 is due to those above the 1 percent, the top percentile, the second group that is, those earning more than $215,000. And this is confirmed also looking at estimates from Social Security wage data.

So, the first group, which is the larger group, has had wage increases much more modest than the upper group. Punishing the first group with a much bigger tax increase than the second group would be very unfair.

The second reason why an increase in the taxable maximum is a bad policy is that workers in this segment—and also those with higher earnings, in the upper earnings distribution—are already bearing significant increases in payroll taxes, and are scheduled for further increases soon.

In 1991 the earnings cap for Medicare health insurance was increased, and in 1994 it was lifted entirely. So these workers already have seen a significant payroll tax increase of 2.9 percent of earnings. Under the new health care law, an additional payroll tax, HI payroll tax of .9 percent will be levied from workers earning above $200,000 for singles, $250,000 for joint filers. Because these thresholds are not indexed, many of the same workers would be hit by this tax increase as the increase that was proposed by lifting the Social Security taxable maximum.

The third reason for opposition to this increase is that it will reduce private retirement savings. We have done work using a comprehensive retirement planning model for some illustrative household situations, and a colleague and I have found that those individuals earning above $106,000 that would be hit by this tax increase would reduce their retirement savings by about 4 percent.

When you translate that across 10 million workers, that is a significantly lower amount of domestic sources of investment capital.

Finally, an increase in the wage contribution of benefit base is an unnecessary expansion of the program. An increase is unnecessary, because there are fairer and better ways to bring Social Security to permanent solvency with no payroll tax increase, which would involve changes in several aspects of the program affecting different groups that, together, add up to sustainability. Thank you.

[The prepared statement of Mr. Warshawsky follows:]

STATEMENT OF THE HONORABLE MARK J. WARSHAWSKY TO THE HOUSE WAYS AND MEANS SUBCOMMITTEE ON SOCIAL SECURITY, HEARING ON SOCIAL SECURITY'S FINANCES, JUNE 23, 2011

Chairman Johnson and Ranking Member Becerra and Members of the Subcommittee on Social Security, my name is Mark Warshawsky. I am a Member of the Social Security Advisory Board and formerly was Assistant Secretary for Economic Policy at the Treasury Department where I had oversight responsibility for the preparation of the Trustees Reports and analysis of Social Security reform proposals. Today I am not speaking on behalf of the Advisory Board or any other organization. Rather, my statement today is based on my research and insights gained from years of analysis of Social Security and public finance.

I would like to congratulate you for holding this hearing discussing the revenue options for Social Security reform. As the recent Trustee Report shows, the program's financial status has worsened, both in the short- and long-term. Social Security is now running large and soon-to-be rapidly growing cash flow deficits, adding to the federal debt outstanding held by the public and to the budget deficit of the federal government. The day is steadily drawing closer when benefits, by law, will have to be cut – indeed for disabled beneficiaries and their families, this is projected to occur in seven years. I believe that doing nothing to solve the program's financial problems also has negative consequences for the economy right now. When consumers, investors, and other economic decision-makers see that we as a body politic cannot make progress on well-known, long-standing and large fiscal problems, it creates uncertainty and saps the confidence needed for both small and large businesses to create jobs and make productivity-enhancing investments.

It is good that we are now discussing more actively options to strengthen Social Security and it is promising that many groups and individuals and legislators have put forward specific proposals. At the same time, not all provisions in all reform proposals are good policy. For example, there are proposals coming from the deficit reduction commissions and elsewhere to increase Social Security payroll taxes substantially by increasing the contribution and benefit base. In particular, the commissions propose to increase the Social Security contribution and benefit base (taxable maximum) by an additional 2 percent each year, starting in 2012, until 90 percent of total earnings of the labor force are taxable. The actuary has indicated that these increases are expected for 38 years, that is, through 2049. If the increase to reach 90 percent of total earnings taxed were done in one step in 2012, the taxable maximum would be about $215,000, up from $106,800 today. This is a very large tax increase on about 10 million of our most productive workers. Almost 99 percent of workers would then be subject to Social Security taxation on all of their earnings, up from about 94.5 percent today.

This proposed provision is a bad idea for at least four reasons in addition to the general ill effects of tax increases: it unfairly targets a specific segment of the population that has not seen particularly large gains in earnings, it is an extra burden in addition to the new taxes imposed on this and other groups to finance Medicare and in the recent health care legislation to finance health insurance coverage for poor and middle-income households, it will cut private retirement savings, and it represents an unnecessary expansion of the Social Security program. Let me explain each reason, in turn, in more detail.

Those who advocate an increase in the taxable maximum have stated that their goal is to have 90 percent of total earnings of the labor force subject to Social Security taxation. This "taxable coverage" ratio has fluctuated over the history of the program, from a low of 71.3 percent in 1965 to a high of 90.0 percent in 1983; most recently, in 2009, it was 85.7 percent. The use of this ratio for policy design seems arbitrary. It may actually be, however, a manifestation of a deeper concern by advocates arising from the widely discussed research claim that a shift has occurred over the last four or more decades in the distribution of income and earnings toward higher-paid workers and tax units and households, that is, that the share of earnings going to the top percentiles of workers and household units has increased.[1] Therefore advocates want to use tax and other government policies to change the impact of what they view as less social equity. Some analysts have questioned the relevance of the statistics of this research claim has been made, because it ignores the shift in resources toward the poor and middle-class that has come in the form of increased spending on employer- and government-provided health insurance coverage, and for many other methodological issues.[2] Nonetheless let's take the claim as true and relevant for the sake of argument.

But then consider another study that focuses on the wages of most private sector workers ages 25 to 60 over time – it finds that the increase in inequality has slowed since the late 1980s and that the vast majority of the increase for the top 20 percent of workers since 1980 is due to the surge in earnings within the top percentile, that is, the 1 percent of workers now earning more than $215,000.[3] Indeed, looking at wage statistics from the Social Security Administration, I estimate that the group of workers in about the same segment of the earnings distribution equivalent to those earning from $106,800 to $215,000 in 2009 has experienced a smaller gain in their relative share of total earnings since 1990 than those earning above $215,000. And, of course, the first, more modestly paid, group is much larger in number than the second, very high-paid, group, so the rate of wage increases for the first group is lower than for the second group. Using SSA statistics, for example, I estimate that workers and self-employed individuals earning at the 95th percentile saw their earnings increase about 30 percent from 1999 to 2006, but those earning at the 99.95th percentile saw their earnings increase over 35 percent. Punishing the first group with a much bigger tax increase than the second group would be quite unfair.[4]

Many of the workers earning above $106,800 are in their early 50s at the peak of their earnings profiles, after years of hard work at lower wages, supporting growing children and perhaps a low-earning or non-working spouse. These workers have also been hit hard in recent years by rapidly rising health care and

[1] See Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," *Quarterly Journal of Economics*, February 2003, pp. 1 – 39, with updates through 2007 on Professor Saez' website.
[2] See Richard V. Burkhauser and Kosali I. Simon, "Measuring the Impact of Health Insurance on Levels and Trends in Inequality," NBER Working Paper No. 15811, March 2010.
[3] See Wojciech Kopczuk, Emmanuel Saez, and Jae Song, "Earnings Inequality and Mobility in the United States: Evidence from Social Security Data Since 1937," *Quarterly Journal of Economics*, February 2010, pp. 91 – 128.
[4] Even under current law, the asymmetric pattern of earnings growth leads to an unfairness -- the increase in earnings at the very top of the distribution is included in the average wage index which increases the taxable maximum automatically, but workers with earnings just around and above the maximum have gotten lower wage increases than those at the very top. This unfairness could be fixed by relating the average wage index just to the earnings of those in the lower percentiles below the 94.5th of the earnings distribution.

education costs, without the assistance and relief given to lower-paid workers and retirees in the recent health law and other legislation.

The second reason why an increase in the taxable maximum is bad policy is that workers in this segment and above of the earnings distribution are already bearing significant increases in payroll taxes and are scheduled for further increases soon. In 1991, the earnings cap for Medicare Health Insurance (HI) payroll taxes was increased, and in 1994, it was lifted entirely. So these workers already have seen a significant payroll tax increase of 2.9 percent of earnings. Moreover, under the new health care law, an additional HI payroll tax of 0.9 percent will be collected from workers with earnings over $200,000 for single filers and $250,000 for joint filers, effective for taxable years after December 31, 2012. These earnings thresholds are not indexed and hence many of the workers to be hit by this HI tax rate increase will be the same individuals to be hit by the proposed increase in the Social Security taxable maximum. In addition, there is a new tax of 3.8 percent on unearned income of individuals with modified adjusted gross income above $250,000 (in the case of a joint return) or $200,000 (in the case of a single filer return). On top, of course, a progressive income tax structure exists at the federal level and in most states and localities.

The third reason for opposition to the proposal to increase in the taxable maximum is that will reduce private retirement savings. Using a comprehensive retirement planning model for some illustrative household situations, a colleague and I have found that an individual now earning just above $106,800 would reduce her optimal retirement savings by about 4 percent.[5] Of course, upper-income households contribute more than proportionately to aggregate household savings for the nation and therefore this decline in savings, when added up across 10 million workers, will mean much less in domestic sources of investment capital. The reason for the decline is quite simple – the higher payroll tax provision takes an increasingly large share of earnings for these workers over time and their standard of living declines. As a result, they have fewer resources with which to save for their retirement.

Finally, an increase in the Social Security contribution and benefit base represents an unnecessary expansion of the Social Security program, in at least three senses. First, it is unnecessary because upper-income workers have many other methods of saving for their retirement, whether through employer plans or individual savings vehicles, and do not need or want Social Security beyond a base retirement benefit related to their earnings. Second, Social Security is already a progressively designed program, and making it more of a welfare program will reduce its political support. In the third sense, an increase in the taxable maximum is unnecessary because there are fairer and better ways of bringing Social Security to permanent solvency, with no payroll tax increase, which involve changes in several aspects of the program affecting different groups that together add up to sustainability.[6]

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[5] See Gaobo Pang and Mark Warshawsky, "Implications of Some Deficit Reduction Proposals for Retirement Savings," *Benefits Quarterly*, forthcoming.

[6] In 2008, I put forward such a proposal, scored by the Social Security actuary as sustainably solvent; see http://www.ssa.gov/OACT/solvency/Warshawsky_20080917.pdf. Since then, I have worked with Congressional staff to update and refine a proposal based on these ideas and would be glad to continue to do so.

In summary, strengthening Social Security is necessary now, not in future years. Increasing the taxable maximum as part of an overall reform package, however, would be unfair, burdensome, inefficient and unnecessary.

Chairman JOHNSON. Thank you, sir. I agree with your last statement, wholeheartedly.

Andrew Biggs, doctor—is it Andy?

Mr. BIGGS. It is.

Chairman JOHNSON. Yes, that's what I thought. Resident scholar, American Enterprise Institute, you are recognized for five minutes.

STATEMENT OF ANDREW G. BIGGS, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. BIGGS. Thank you very much. Mr. Chairman, Ranking Member Becerra, Members of the Subcommittee. Thank you for offering me the opportunity to testify today with regard to Social Security's finances.

The American population is aging, which means that smaller numbers of workers must support larger populations of retirees. To help them do so, public policy should encourage individuals to do three things: work more, meaning more hours of the week and more weeks of the year; save more, meaning greater contributions to retirement plans and other savings vehicles; and retire later, meaning delaying retirement past 62, the most common age of claiming Social Security benefits.

If we improve the incentives for Americans with regard to work, saving, and retirement ages, we can boost the economy and increase our capacity to finance rising entitlement costs. How would fixing Social Security through tax increases affect these efforts?

Put broadly, increased taxes generally mean that individuals will work less, because the reward for working has been reduced; save less, because they have less after-tax income with which to save, and less reason to save, as entitlement programs would be more generous; and retire earlier, because Social Security benefits would appear more generous, relative to their after-tax pre-retirement earnings. In other words, higher taxes work opposite to economic-level goals that most analysts would accept.

We may disagree regarding how large the effects of raising taxes would be. We might also conclude that some policy goals are so important that the negative economic effects of tax increases are a price worth paying. But we should not dispute that raising taxes imposes a cost on the economy's ability to support growing populations of retirees.

The most common proposal for raising Social Security taxes is lifting or eliminating the maximum taxable wage. With regard to raising the so-called tax max, I would make four points.

First, the current payroll tax ceiling is not unusually low, by historical standards. As of 2009, 85 percent of total wages were subject to the payroll tax. From 1937 through 2009, the average was 84 percent. And from 1950 through 1970, only 78 percent of total earnings were subject to taxes.

Second, Social Security's payroll tax ceiling also is not unusually low, relative to other developed countries. Across 22 OECD countries, pension taxes were, on average, applied up to 2.1 times the average wage. In the U.S., the Social Security payroll tax is applied up to around 2.9 times the average wage, a significantly higher tax cap than in the UK, Germany, Canada, or other competing countries.

Third, eliminating the payroll tax ceiling could lead to very high marginal tax rates. Based on the tax rates proposed by the administration, eliminating the tax max would raise the top all-in marginal tax rate to an average of 63 percent, and higher than that in some states. And these taxes would be before we had done much of anything to fix Medicare and Medicaid.

Fourth, roughly one-quarter of the revenue gains from eliminating the tax max would be offset by lower tax receipts in other areas. This result does not depend on assuming that individuals change their work behavior. Rather, employers would reduce workers' wages to compensate for their own higher payroll tax liabilities. These reduced worker wages would lower receipts from federal income taxes, Medicare payroll taxes, and state income taxes.

If individuals made even modest behavioral responses to higher taxes, then about half the gross revenues from eliminating the payroll tax ceiling would be lost, according to a study by Professors Jeffrey Liebman of Harvard University, and Emmanuel Saez of the University of California, Berkeley.

Lawmakers face a choice: policies that encourage work and saving, or retaining the safety net for the poor, versus policies that discourage work and saving. Our ability to care for those in need springs from the goods and services produced in the economy. If we penalize workers who produce those goods and services, the goals of Social Security and other federal programs will be more difficult to achieve. Thank you very much.

[The prepared statement of Mr. Biggs follows:]

American Enterprise Institute for Public Policy Research

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

Andrew G. Biggs, Ph.D.

Resident Scholar

American Enterprise Institute

June 23, 2011

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Chairman Johnson, Ranking Member Becerra and Members of the Committee. Thank you for offering me the opportunity to testify with regard to Social Security's finances. My name is Andrew Biggs and I am a resident scholar at the American Enterprise Institute. The views I express today are my own and do not represent those of AEI or any other institution.

Elected officials and the American people face a daunting challenge. As the Congressional Budget Office has confirmed, over the next several decades the largest fiscal challenge facing the federal government is the aging of the population, which will drive up costs for Social Security, Medicare and Medicaid.[1] In an aging society, smaller numbers of working-age individuals must be sufficiently productive to support ever-increasing numbers of retirees. If society can sufficiently increase economic output it is possible to support larger populations of retirees without reducing the standard of living of working age Americans. In short, a strong and growing economy is the only way in which entitlement reform can avoid being a zero-sum game between young and old.

When smaller numbers of workers must support larger numbers of retirees, public policy should encourage individuals to do three things:

- First, work more, meaning more hours of the week and more weeks of the year;
- Second, save more, meaning higher participation in an employer-sponsored retirement plan and increased contribution levels; and
- Third, retire later, meaning putting off retirement from 62, when most Americans currently claim Social Security benefits, until a later age.

If we improve the incentives for Americans with regard to work, saving and retirement ages, we can boost the economy and increase our capacity to finance the Social Security program, alongside the even more daunting challenges of Medicare and Medicaid. This context should inform our view of whether to address Social Security's financing challenges through increased taxes or reduced benefits.

But let me begin with one area that is not in dispute: we should *not* reduce benefits for low earners who cannot save sufficient amounts for retirement on their own and who otherwise would fall into poverty in old age. Social Security's most important task is to prevent Americans from falling into poverty. A recent proposal for Social Security reform I authored as part of a Peterson Foundation initiative would guarantee a poverty-level income for all beneficiaries, regardless of earnings or labor force participation, increasing benefits for around one-third of all beneficiaries.[2]

In effect, the main policy disagreement is whether to raise taxes on middle and high earners in order to pay higher benefits to middle and high earners. I will argue that it is generally preferable to maintain current tax rates as much as possible, while achieving long-range solvency principally by extending work lives and slowing the growth of benefits for middle and higher earners.

A recent study by the RAND Corporation confirmed what economic theory and evidence already suggest: most individuals would react to lower Social Security benefits by saving more and/or delaying retirement.[3] Forty-seven percent of respondents told RAND they would definitely extend their work lives, with another 44 percent saying maybe. Likewise, 41 percent said they would save more prior to retirement with another 50 percent saying maybe. In both cases, around 1 in 10 said they would react to lower scheduled benefits by doing nothing and simply swallowing the benefit cut. These survey results correspond with research findings that Social Security tends to reduce private saving[4] and encourages earlier retirement.[5]

While we expect individuals to react to lower benefits by increasing their work and saving, how can we expect them to react to higher taxes? Put broadly, increased taxes generally mean that individuals will

- Work less, because the reward for working has been reduced;
- Save less, because they have less after-tax income with which to save and, through provision of more generous entitlement benefits, less reason to save; and
- Retire earlier, because the effective replacement rate paid by Social Security – that is, Social Security benefits relative to after-tax pre-retirement earnings – will rise.

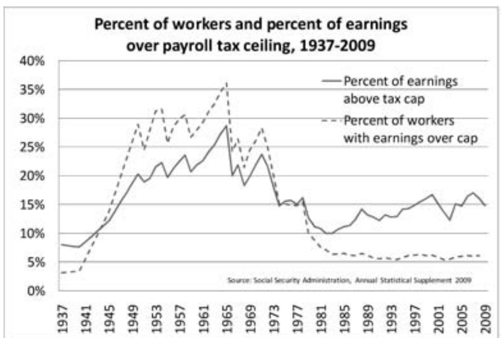
In other words, higher taxes work opposite to macro-level goals that a broad spectrum of analysts and policymakers generally would recognize. We may disagree regarding how large the effects of raising taxes might be and whether some policy goals are sufficiently important that the negative economic effects are a price worth paying. But we should not dispute the fact that increasing taxes to support entitlement programs imposes a cost on the economy's ability to support growing populations of retirees.

Since very few leaders on either side in Congress have discussed raising the payroll tax rate, I will focus on the most common proposal for raising Social Security taxes: lifting or eliminating the maximum taxable wage. Currently, individuals pay taxes and accrue benefits only on the first $106,800 in earnings. Many have proposed increasing this cap. Indeed, the Social Security Actuaries project that if the payroll tax ceiling were eliminated it would be sufficient to restore the program to solvency over 75 years, albeit not to the more exacting standard of "sustainable solvency."

It pays to begin with some history. In June 1934, President Franklin Roosevelt appointed the Committee on Economic Security to put flesh on the bones of Roosevelt's ideas for old age pensions. The Committee conferred and issued a report, which was the basis upon which Congress began work in formulating the Social Security program.[6] In that report, the Committee recommended that individuals with earnings above $3,000 (around three times the average wage) be *exempt* from Social Security taxes and not even participate in the program.[7] That is, the Committee recommended that Social Security contain *no* overt redistribution from high to low earners. The $3,000 figure also was not chosen to match any particular percentage of total earnings. Rather, it reflected an "esthetic logic," in the words of one Committee staffer, that "looked very good. It was $250 per month."[8]

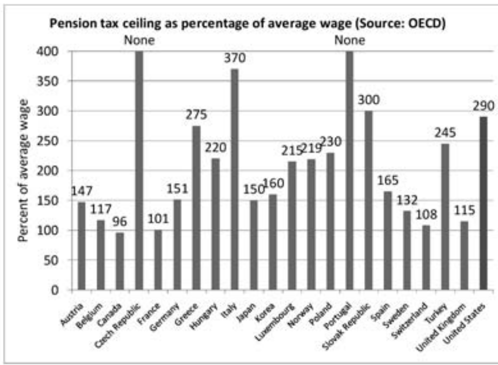
While the Committee's recommendation to exempt high earners was not adopted in the end, the eventual decision to base both taxes and benefits on earnings up to a given maximum reflected Roosevelt's intent that Social Security more closely resemble a mandatory individual saving program, with a modest supplement to low earners, than a welfare program transferring resources wholesale from rich to poor. Roosevelt went to great pains to distinguish Social Security from what was then called "relief" and is today termed "welfare."

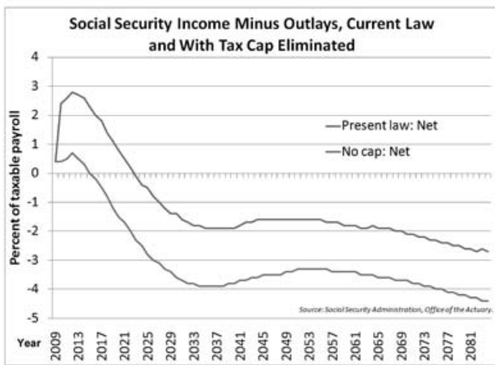
Over the years, the maximum taxable wage was increased many times. In the early years of the program such increases were often portrayed as being in the interests of middle and high wage workers, who would pay more and then receive more in retirement. This is more plausible than it may seem, as the implicit rate of return paid by Social Security in early decades was high. However, increases in the maximum taxable wage also often corresponded with general benefit increases to all beneficiaries, indicating that the need for additional revenue to expand the program was a motivating factor. More recently, the argument for an increased payroll tax ceiling has again been framed in terms of fairness, but in this case the question is how to distribute the burdens of higher taxes.



In that context, it is worth noting that the current payroll tax ceiling is not unusually low by historical standards. Through much of Social Security's history, a significantly greater share of total earnings escaped taxation and more workers had earnings above the payroll tax ceiling than today. As of 2009, 85.2 percent of total wages were subject to the payroll tax, leaving around 15 percent above the tax ceiling. From 1950 through 1970, however, an average of 22 percent of total earnings lay above the tax cap. Likewise, around 6 percent of current workers have earnings above the payroll tax ceiling, while from 1950-70 around 29 percent of workers had at least some earnings above the maximum taxable wage. The current payroll tax ceiling is not out of character with how Social Security has been financed over the last seven decades.

Social Security's payroll tax ceiling also is not unusually low relative to other developed countries. Across 22 OECD countries, pension taxes were on average applied up to 2.1 times the average wage. In the United States, the Social Security payroll tax is applied up to around 2.9 times the average wage, a significantly higher tax cap than in the U.K., Germany, Canada and other competing countries. On the benefit side, Social Security is also more progressive than the typical OECD program. Only a small number of countries, most of Anglo origin, have more progressive pension benefit structures than the U.S.[9] Broadly speaking, the U.S. Social Security program is smaller but more targeted than pension programs in other developed countries.





Lifting or eliminating the cap on taxable earnings could significantly increase revenues to Social Security, raising taxes by around $1.5 trillion over the first 10 years, according to data from the SSA Office of the Chief Actuary.[10] But to this policymakers should ask two important questions:

First, would those additional revenues be saved? Eliminating the payroll tax ceiling would reduce the rising cost burden on future taxpayers only if the near-term surpluses it generated were saved to cover benefits once the program went into deficit. By saved, I mean not simply credited to the Social Security trust fund, but saved in a sense that reduced overall budget deficits and added to national saving. If near-term surpluses were effectively spent, either through increased outlays or lower non-Social Security taxes, then on a straight cash basis eliminating the payroll tax ceiling fills only around 40 percent of annual Social Security deficits once they occur.

A trio of studies by well-respected economists concludes that Social Security surpluses since the 1980s have *not* translated into improved budget balances or reduced publicly-held government debt. The basic analytical technique is to ask how changes in the Social Security balance correlated with changes to the overall budget balance, after controlling for other factors. Professor Kent Smetters of the Wharton School, who wrote the first such study, concludes:

> There is no empirical evidence supporting the claim that trust fund assets have reduced the level of debt held by the public. In fact, the evidence suggests just the opposite: trust fund assets have probably increased the level of debt held by the public.[11]

Barry Bosworth and Gary Burtless of the Brookings Institution reached similar conclusions: for OECD countries, "Between 60 and 100 percent of the saving within pension funds is offset by reductions in government saving elsewhere in the public budget."[12] Likewise, research by John Shoven of Stanford and Sita Nataraj of Occidental College on all U.S. federal trust funds "suggest[s] a dollar-for-dollar offset of trust fund surplus with spending increases or tax cuts; the authors are able to reject the hypothesis that the full dollar of trust fund surplus is saved by the government."[13]

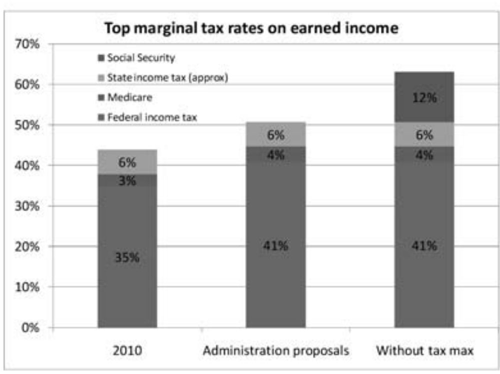
The Congressional Budget Office appears to have accepted these views, recently stating that

> trust fund balances convey little information about the extent to which the federal government has prepared for future financial burdens, and therefore ... trust funds have important legal meaning but little economic meaning.[14]

It would be ironic if Congress approved a strategy to fix Social Security that relied on trust funds that both economic research and the Congressional Budget Office have concluded don't effectively pre-fund future benefits.

This leads to a second question: how would higher tax rates affect work, the economy, and tax revenues? Higher Social Security taxes should be seen in the context of other tax increases that are already in the works. Currently, the top federal income tax rate is 35 percent. Adding in the 2.9 percent Medicare tax and a typical state income tax rate of around 6 percent, the all-in top marginal tax rate on earned income is around 44 percent. In some high-tax states it could be as high as 49 percent.

Under the Obama administration's plans, the top income tax rate will rise to 40.8 percent, due to an increase in the top rate to 39 percent and the restoration of the Pease provision phasing out itemized deductions for high earners. The Medicare tax rate on high earners is scheduled to rise to 3.8 percent as of 2013 as part of the recent health reform legislation.[15] Assuming, perhaps optimistically, that state income tax rates remain constant, the top marginal tax rate will rise under current plans to 51 percent, with a maximum in states such as Hawaii and Oregon of around 56 percent.



Now imagine that we eliminate the Social Security payroll tax ceiling. While only around 6 percent of earners have earnings above the tax max in a given year, about 24 percent of households would be affected by higher taxes over their lifetimes.[16] In years in which earnings exceeded the current taxable maximum, these individuals would pay an additional 12.4 percent tax on their wages. The total maximum marginal tax rate on earned income could reach 63 percent and even higher in certain states.[17] These tax increases, which would leave high earners essentially tapped out in terms of revenues, would be before we've addressed Medicare and Medicaid's multi-trillion dollar funding shortfalls.

Even if individuals did not alter their work behavior, increasing the Social Security maximum taxable wage would cause non-Social Security taxes to shrink. SSA's Office of the Chief Actuary projects that eliminating the payroll tax ceiling would reduce earnings subject to those increased taxes by around 6 percent, as employers lower wages to cover their own increased tax obligations.[18] These lost wages would no longer be subject to federal income taxes, Medicare taxes, or state income taxes. I estimate that the federal budget would lose slightly over 20 cents in non-Social Security revenues for each dollar of new Social Security taxes, a figure that appears consistent with Joint Tax Committee practices.[19] In addition, state governments would lose income tax revenues based on the reduced tax base.[20]

Many respected economists would go even further. Edward Prescott, the 2004 winner of the Nobel Prize in economics, points out that Americans on average work around 50 percent more hours than do working-age French, Italians or Germans. What drives this difference? Prescott explains: "It turns out the answer is not related to cultural differences or institutional factors like unemployment benefits; rather, marginal tax rates explain virtually all of this difference."[21] Back when Europeans were subject to around the same tax rates as Americans, they worked around the same number of hours. But, as my AEI colleague Alan Meltzer has pointed out, "From the 1970s to the 1990s, the effective tax rate on work increased by an average of 28 percent in Germany, France and Italy. Over that same period, work hours fell by an average of 22 percent in those three countries."[22]

Revenue losses increase quickly if taxable income falls in response to the new tax. For instance, if individuals reduced earnings above the ceiling by 5 percent in response to higher marginal tax rates, then non-Social Security revenue losses would rise from around 20 percent to about 38 percent of new Social Security revenues, which would themselves decline versus static projections.

This example may not overstate the case. Using relatively conservative assumptions regarding the responsiveness of taxable income to tax rates, Professors Jeffrey Liebman of Harvard University and Emmanuel Saez of the University of California, Berkeley estimated that 46 percent of the static increase in revenues due to eliminating the Social Security payroll tax ceiling would be offset due to employer changes in wages, offsets against other federal and state taxes and changes in labor force participation.[23] Using more aggressive behavioral assumptions, which nevertheless have some support in the tax literature, the net revenue gain would be zero.

In a future economy when smaller numbers of workers must support larger numbers of retirees, these are not outcomes policymakers should be comfortable with. Leaving aside the moral issue of taxing away over 60 percent of an additional dollar earned, countries such as Germany, France, Holland and Sweden – which have no such qualms about high taxes – have judged that as a matter of economic stewardship such high rates are counterproductive. We should bear the same factors in mind.

Lawmakers face a choice: policies that encourage more work and more saving, while retaining the safety net for the poor, versus policies that discourage work and saving. Our ability to care for those in need springs from the goods and services produced in the economy. If we punish workers who produce those goods and services, the goals of Social Security and other important federal programs will be more difficult to achieve.

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[1] Congressional Budget Office. "Long Term Budget Outlook, 2010."

[2] Antos, Joseph, Andrew Biggs, Alex Brill, and Alan D. Viard. "Fiscal Solutions: A Balanced Plan for Fiscal Stability and Economic Growth." Peter G. Peterson Foundation. May 25, 2011.

[3] Delavande, Adeline and Rohwedder, Susann. "Individuals' Responses to Social Security Reform." (September 29, 2008). Michigan Retirement Research Center Research Paper No. WP 2008-182.

[4] For a review of the literature see Congressional Budget Office. "Social Security and Private Saving: A Review of the Empirical Evidence." July 1998.

[5] For instance, Burtless and Moffitt point out that large numbers of individuals retiring at age 62 did not occur prior to the availability of early Social Security benefits at that age. Burtless, Gary, and Robert A. Moffitt. 1984. "The Effect of Social Security Benefits on the Labor Supply of the Aged." In *Retirement and Economic Behavior*, ed. Henry J. Aaron and Gary Burtless, 135–71. Washington, DC: Brookings Institution.

[6] The Committee's report is available at http://www.ssa.gov/history/reports/ces/cesbasic.html. It is worth noting that the CES report, and the Social Security Act, contained many elements beside what we consider today to be "Social Security." These included unemployment benefits, need-based benefits for the elderly to be distributed by the states, and other policies.

[7] The Social Security program would be compulsory for individuals earning less than $3,000 per year (average earnings in 1935 were roughly $980). By comparison, the current average wage for Social Security purposes is slightly over $43,000 while the maximum taxable wage is $106,800. For individuals earning above $3,000, as well as for the self-employed, the Committee recommended the establishment of voluntary government-provided annuities.

[8] See Schieber, Sylvester J. and John B. Shoven. *The Real Deal: The History and Future of Social Security*. Yale University Press. 1999. P. 151.

[9] Source: OECD. *Pensions at a Glance* 2007.

[10] See http://www.ssa.gov/OACT/solvency/provisions/tables/table_run191.html. Following budgetary convention, 10-year tax revenues are in nominal dollars.

[11] Kent Smetters, "Is the Social Security Trust Fund Worth Anything." NBER Working Paper No. W9845, July 2003.

[12] Barry Bosworth and Gary Burtless. "Pension Reform and Saving." The Brookings Institution. January 5, 2004.

[13] Sita Nataraj, John B. Shoven. "Has the Unified Budget Undermined the Federal Government Trust Funds?" NBER Working Paper No. 10953. December 2004.

[14] Congressional Budget Office. "Effects of the Patient Protection and Affordable Care Act on the Federal Budget and the Balance in the Hospital Insurance Trust Fund." December 23, 2009.

[15] Alan Viard. "The Myth of a Return to Clinton-era Taxes." *The American*. September 15, 2010.

[16] Based on calculations for the 1990 birth cohort conducted using the Policy Simulation Group Social Security and pension models. For details on these models, see www.polsim.com.

[17] If policymakers opted to pay additional benefits based upon higher Social Security taxes, the additional tax rate net of new benefits would be around 6.6 percent of earnings, raising the top marginal rate to 57 percent. Under this option, eliminating the taxable maximum would not be sufficient to restore 75-year solvency because of the increased benefit costs.

[18] Author's calculations, based on Alice H. Wade and Chris Chaplain. "Estimated Long-Range OASDI Financial Effects of Eliminating the OASDI Contribution and Benefit Base." Memorandum. Social Security Administration, Office of the Chief Actuary. October 20, 2003.

[19] It is unclear how the CBO would score such a change, but it appears that the Joint Economic Committee would assume a 20 percent revenue offset for a change in the employer portion of the payroll tax. See Congressional Budget Office. "The Role of the 25 Percent Revenue Offset in Estimating the Budgetary Effects of Legislation."

January 13, 2009. Staff of the Joint Committee on Taxation. "Overview of Revenue Estimating Procedures and Methodologies Used by the Staff of the Joint Committee on Taxation." February 2, 2005.

[20] This would have a minor positive effect on the federal budget, as state income tax payments are deductible from individual federal tax returns.

[21] Edward C. Prescott. "The Elasticity of Labor Supply and the Consequences for Tax Policy," Federal Reserve Bank of Minneapolis. February 2005.

[22] George P. Shultz, Michael J. Boskin, John F. Cogan, Allan Meltzer and John B. Taylor. "Principles for Economic Revival." *Wall Street Journal*. September 16, 2010.

[23] Liebman, Jeffrey and Emmanuel Saez. "Earnings Responses to Increases in Payroll Taxes." U-C Berkley Working Paper. September 2006

Chairman JOHNSON. Thank you, sir. I appreciate all of your testimony. I don't think any of us up here—on this side, anyway—want to raise taxes. But we will have to see what falls out.

Mr. Goss, in 2010 the maximum amount of earnings subject to the 12.4 percent payroll tax was 106,800, same as this year. And 84.2 percent of covered earnings were subject to the tax. What would the maximum amount be this year if 90 percent of covered earnings were subject to the payroll tax?

Mr. GOSS. Dr. Warshawsky addressed that point already, and it would be somewhat in excess of 200,000. We estimate that by the time we get to 2020, if we were to go to a 90 percent taxable instead of the roughly 82.5 percent taxable that we expect to have at that time, it would be a little bit over double the taxable maximum amount that we would have, otherwise.

Chairman JOHNSON. Yes. Are you in favor of that?

Mr. GOSS. We are in favor of solvency and strengthening Social Security——

Chairman JOHNSON. Okay.

Mr. GOSS [continuing]. Absolutely, by whatever means you all determine.

Chairman JOHNSON. Okay, 202,500 is what it would be today.

Dr. Biggs and Mr. Brill, the Congressional Budget Office produced a policy option publication for Congress last July. In it they stated, "Like all taxes on earnings, Social Security taxes reduce the award from work, which tends to decrease how much people work."

The Joint Committee on Taxation recently completed a revenue analysis for me, and the analysis says that 2.8 trillion in self-employment income, and 13.4 trillion in wage income, would be subject to payroll taxes over the next decade if the wage base were eliminated. If the taxable wage base were lifted to cover 90 percent of earnings, those numbers would be 500 billion and 4.4 trillion, respectively.

Given these facts from CBO and Joint Tax, do you think that raising the wage base would keep this country from creating new jobs in this country that we desperately need? Either one of you.

Mr. BIGGS. Well, as I noted in my testimony, I believe that we need to concentrate on economy-level goals of work, saving, investment, the things that will strengthen the economy and allow us to support larger populations of retirees.

With regard to the effects of taxation, I think I would raise three points. One is that the negative economic effects of a tax increase depend, first, on the size of the tax increase. A 12.4 percent increase in the marginal tax rate is large, by itself.

Second, it depends on the tax it's already stacked on top of. If people are already paying high marginal tax rates, and then you add more to it, the economic effects are more significant than if you were stacking that tax increase on a low tax rate.

Third, higher-income individuals tend to be the most sensitive to marginal tax rates. So, essentially, you are applying this tax increase in the place where you are going to have the most negative economic effects from it. So I think it is just not, in my mind, a particularly productive way of going about this problem.

Chairman JOHNSON. Do you agree with that?

Mr. BRILL. I do agree. I agree with Mr. Biggs's points. And I would just add that the response that we could anticipate—your question focused on labor and job creation—a number of the small business and medium businesses are pass-through entities, taxed through the ordinary individual income tax, not the corporate tax system. Roughly half of small business income is taxed by individuals at relatively high income rates. Raising the cap, whether it be to 90 percent—in other words, to $200,000—or taking the cap off all together, would raise the marginal rates significantly on those small businesses.

Chairman JOHNSON. Yes, and small businesses—our studies indicate that is where most of the jobs are created. Is that true?

[No response.]

Chairman JOHNSON. Dr. Biggs and Mr. Brill, from an economic viewpoint, how do you think small business owners would react if Congress raised their marginal payroll tax 12.4 percent? What would be the business response, particularly during these times?

Mr. BRILL. Research by Doug Holtz-Eakin and Bob Carroll and others have noted that the response from sole proprietorships to increases in tax rates can be significant. So a reduced amount of business activity from these small employers. It could be on the order of magnitude to a five to seven percent reduction in activity.

In addition, there is a shift in the amount of taxable income that is reported, different than a shift in the economic activity. But both of these are important consequences. So there is both an effect to federal revenues on the income tax side, as well as a real effect on the economy.

Chairman JOHNSON. Thank you.

Mr. BIGGS. I believe the effects would be larger on the small business end than they would be for individuals working for other employers. Small businesses have more capacity to shift the way compensation is paid out, where individual employees have less. So I think the negative effects we are talking about would be larger on the small business end than they would be in the rest of the workforce.

Chairman JOHNSON. Yes, it is negative overall, in my view, too. Mr. Becerra, you are recognized for five minutes.

Mr. BECERRA. Thank you, Mr. Chairman, and thank you all for your testimony and for having taken the time to shed some light on the issues of Social Security.

Interesting, Mr. Brill, I take a couple of things from your testimony that I think are very important that we have to really consider. Non-wage compensation does not get taxed, for payroll purposes, to provide the funds for Social Security.

So we find ourselves in a situation where, if you are a worker in America who relies principally on your paycheck, and your income is anywhere between, you know, 0 to $106,800, you are subject to the full level of the Social Security payroll tax contribution to the system. But if you rely on a paycheck for part of your income, but the lion's share of your income comes from other non-payroll sources—and obviously, an extreme example would be a Bill Gates or perhaps a Wall Street executive, there is a good chance that the vast majority of their income doesn't get taxed for payroll purposes.

So there are a whole bunch of Americans who are making vast sums of income who, because they don't get it through a paycheck, don't have to contribute to the Social Security system beyond whatever they get as a paycheck for a directly-compensated wage. That is an excellent area of examination. Because I think you talked about how you have to figure out how you broaden the base in a fair way. And I think we should try to explore that a bit more.

Mr. Biggs, you pointed out something that I think most Americans don't often think about, and may have to swallow kind of hard to recognize or accept, and that is—you said you have to work more, save more, and retire later. I think in America, the goal of most Americans is to be able to retire earlier—save more, and retire earlier, rather than have to work more, have to save more, and retire later.

And I think the way you tried to explain it, though, it makes it clear you are not telling folks, "Hey, this is a new day in America, where we are going to work longer and get less," what we are simply saying is, "Be smart about the way you save, understand what it means to have to work hard, and be prepared to know what it will take for you to live out the rest of your years, if you are going to retire, whether you retire early or not."

And I think, too often, Americans don't really plan for what it will take to live out their retirement in dignity. And then that is where I think Social Security has become a tremendous asset in this recent heavy recession, and I think makes it very clear why so many seniors have become so protective of Social Security benefits.

I want to ask a quick question. Are any of you familiar with Mr. Sessions's—Pete Sessions—legislation that he recently introduced, H.R. 2109?

[No response.]

Mr. BECERRA. I referenced it in my opening remarks. It is legislation which essentially privatizes Social Security, because it allows workers today to not contribute into the system, and instead, create their own private accounts.

And unlike previous privatization proposals, in this case, in the Sessions legislation, there would be no backfilling of the lost revenues by having today's workers no longer put money into the system, and instead, only put money into a private account. Most of the previous privatization proposals at least recognized that Americans who are retired today because they were working and contributing to the system yesterday should not be expected to take the massive loss of benefits, as a result of having today's workers no longer contributing to the system.

Mr. Goss, I have tried to explain an aspect of the Sessions legislation. Obviously, it goes well beyond that into other areas, as well. But what would happen if you had a system where you created a system—I would no longer call it Social Security, because it would become a privatized system, where no longer would American workers contribute, starting today, into the Social Security system and the trust fund? What would happen to today's retirees?

Mr. GOSS. Very good question. We have not been asked to do a formal estimate of the plan, but we are familiar with it. My understanding of the plan is that workers today who are not yet retired and not receiving benefits would have the option to start paying one half of the taxes, and after 15 years not to pay any of the taxes themselves, and by their employers.

People who are over 40—especially over 50—probably wouldn't want to do this, because they have a substantial investment in Social Security already. For people who are under 40, they may well decide that the amount of money that they could put into an account would be sufficient that they would be willing to walk away from the Social Security benefits that have been scheduled for them.

What this would mean, though, to the extent that people did this, is that the amount of revenue coming into Social Security would be dramatically reduced. Already, as many on the panel have pointed out, we do not have enough taxes coming in over the future to be able to pay for scheduled benefits, as it is. Taxes would be reduced—essentially, immediately—by a substantial degree, and we would not have any offsetting reduction in benefits until people who are under 40 now got to the point of receiving benefits.

So, for Social Security—the ability to pay benefits to people who are currently receiving or are now approaching the time of receipt of benefits would be severely compromised. Trust fund exhaustion would certainly come much sooner than 2036. And the extent to which we have cash flow shortfalls, and the speed with which we would be spending down our trust fund assets, would be much, much faster.

Mr. BECERRA. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you. Mr. Smith, you are recognized.

Mr. SMITH. Thank you, Mr. Chairman. And thank you to our witnesses, for sharing your expertise and your time.

We have heard various characterizations of Social Security, that everything is just fine and so forth. And I am trying to grapple with various points of information and perspectives.

But Mr. Goss, would you describe Social Security as actuarially sound?

Mr. GOSS. Thank you very much for the question. Clearly, we do not project that Social Security is solvent over the next 75 years. We will reach the point in 2036, if nothing is done—and we trust something will be done—that the trust funds will become exhausted and won't be able to pay full benefits. As Chairman Johnson indicated, at that point in time, 77 percent of scheduled benefits would be payable.

So, changes clearly need to be made. We need to either increase revenue or, to reduce the scheduled benefits to match the revenue already being put on the table under current law.

Mr. SMITH. But is there even a mechanism to reduce those benefits, should nothing be done?

Mr. GOSS. Well, actually, there is. Social Security OASI, DI, and the Medicare Hospital Insurance funds are special in the Federal Government. Most programs in the Federal Government, as we know too well, can run deficits for a long time, and actually build up a lot of debt. We have over $14 trillion of total federal debt now. Social Security does not have any debt. In fact, it cannot have debt, by statute. It is not allowed to have debt.

From the point of its inception, it has to always have taken in more money than it has paid out. So there is a natural breaking force spending, there is a scrutiny that is applied to the trust fund programs. If we reach the point where the trust funds run out, and there is no action by Congress, we will have no choice but to pay out only then what the trust funds have available, which will be $.77 on a dollar.

That would be—I don't know if catastrophic is too strong a word, but that would be a terrible situation. You cannot—anybody would not want to have our beneficiaries, from one day to the next, drop by 23 percent in the amount that they receive. So we have absolute confidence that the Congress will act between now and that time, and hopefully sooner.

Mr. SMITH. Okay, thank you. Dr. Biggs, in your testimony you note that while only six percent of workers reach the taxable maximum in a given year, almost a quarter of workers would be affected by such an increase over their lifetimes. Could you expand on this?

Mr. BIGGS. Sure. In an given year, around six percent of employees have earnings above the taxable maximum of around $107,000. We had periods in the past—I think from 1950 to 1970 that actually were around 20 or 22 percent of workers were above that tax cap in any given year.

Today it is only six percent, but it is not the same six percent year after year. Some people have good years, some people have bad years. If you look at the course of individuals' full working lifetimes, somewhere—my number is around 24 percent—would have had some earnings above that cap at some point in their career. And so, if you lift or eliminate the cap, would have been subject to that higher tax rate.

Mr. SMITH. Mr. Brill, certainly the six percent sounds like a small number. But if these are entrepreneurs and job creators, how does that impact our economy and our effort to reverse this recession?

Mr. BRILL. I think, actually, the more important number is the larger number that you referenced, the 24 or 25 percent, because what is important to keep in mind is it is not only those taxpayers who are facing the higher tax rate currently, but those that would risk facing it if they were successful.

So, research on the economic consequences of entrepreneurship have confirmed this, that if an individual who is making $100,000 is considering a new venture, a risky venture that, if things work out well, his income or her income would jump to $200,000, knowing that their tax rate would increase substantially at the same time may discourage some of that activity.

So, it is important to focus not just on those who are actually affected at the moment, but those who are at risk of facing the higher tax, as well.

Mr. SMITH. Okay. Dr. Warshawsky, would you care to comment?

Mr. WARSHAWSKY. I agree with the statistics that have been put forward. But I think it is also very helpful to give some characterization of who these workers are. The typical earnings profile of many workers is that they reach their peak in their early fifties, when they have their highest earnings potential. This is after years of education, hard work, supporting growing children. And these people have been hit pretty hard by high education costs, high health care costs.

So, I think it is important to sort of get a sense of the character of these workers.

Mr. SMITH. Okay. Thank you. Thank you, Mr. Chairman. I yield back.

Chairman JOHNSON. Thank you, Mr. Smith. Mr. Berg, you are recognized.

Mr. BERG. Well, thank you, Mr. Chairman. I wanted to explore a little bit the question that comes up always that there is income that people receive that they are not paying, you know, FICA or SECA on. What is an example of what people use for that? There is some specific revenue that you hear a lot? Please.

Mr. GOSS. We have on page nine of the written testimony identified a couple proposals that could generate revenue that have been put forth by the bipartisan policy center workgroup, and one of them actually by Paul Ryan, in his roadmap plan, that would not increase the taxable maximum amount. These are plans, instead, that would look at employee compensation that is now not taxed, but would become taxed.

One of these items that would cover about 42 percent of our 75-year shortfall would be to tax the employer-sponsored group health insurance premiums, whether those are paid for by employees or by employers. Currently, they are generally not subject to the FICA tax. If those were subject to the FICA tax over a gradual period of time, phased in as this particular proposal would suggest, we could cover almost half of the 75-year shortfall.

Another smaller approach toward covering a portion of this would be to cover certain Section 125 cafeteria plans by which employees can pay for a portion of some fringe benefits that they receive. These are also tax exempt currently. Most of this, as we have learned from our friends at Joint Committee on Taxation, is the employee share of employer-sponsored group health insurance. If we were to make that no longer FICA tax-exempt, that would cover about 10 percent of the long-term shortfall for Social Security.

So, there are options, other than just raising taxes.

Mr. BERG. And I was just curious, because I hear people talking about that, and now I know that what they are talking about is simply taxing health care benefits, or employer-provided health care benefits.

The other question I had—and again, we had a reduction in 2010 where we went from 6.2 to 4.2, and I guess I was just wondering if any of the panelists here have—do we have any results from that, that we can say, "Hey, that was a good decision," or a poor decision, or—what was the impact of that? Anyone wish to address that? Or is it too early to tell?

Mr. GOSS. Well, I would just——

Mr. BERG. Do you get paid extra? Are you getting paid by the—no.

Mr. GOSS. Okay.

Mr. BERG. No, no.

Mr. GOSS. A portion of that legislation suggests that the trust funds, per se, would not be affected. The revenue coming into the trust funds has been maintained exactly as though the tax rate were not reduced.

So, effectively, one might suggest that it was a mechanism by which the amount that employees and self-employed had to pay to the Federal Government was reduced by 2 percent of their pay, up to the $106,800. Trust funds are not affected, and the long-term solvency is not affected.

Mr. BERG. I can't understand that. Why is the trust fund not affected, or the long-term? Are we taking dollars and putting it in there to offset that two percent?

Mr. GOSS. We——

Mr. BERG. Okay.

Mr. GOSS. The trust fund continued to be credited, not by money that was coming in in payroll taxes, but money from the general fund to the treasury.

Mr. BERG. Right, right, okay.

Mr. GOSS. And this is a special——

Mr. BERG. I follow you, I follow you.

Mr. GOSS [continuing]. A special one-year thing in 2011.

Mr. BERG. So now, what is the benefit, then?

Mr. GOSS. Well, the benefit—I think some of our economists could probably speak better——

Mr. BERG. I see some smiles, though.

Mr. GOSS [continuing]. To this than I.

Mr. BERG. Whoever has the biggest smile starts.

Mr. WARSHAWSKY. I am anxious to hear what Steve will say. [Laughter.]

Mr. GOSS. But we have heard much discussion about the impact on economic growth and desire to work by having taxes increase. This effectively was a one-year decrease in taxes for employees and for self-employed. The intent, presumably, was to encourage more work and more employment during that period. I am not sure that anybody can really measure what the impact is.

Mr. BRILL. I would just comment that if we are thinking about changing the tax rates as a tool to create jobs, we need to distinguish between temporary tax policies and permanent policies. This policy, which was a temporary one, while technically it may be too early to do the analysis, and it is always hard to know the but-for case, but certainly the labor market is not improving while this policy is in place.

Mr. WARSHAWSKY. I would just comment again. I have not seen any studies in it. I would imagine it is premature. But I think the American public sees that Social Security has financial troubles, and that the Federal Government has financial troubles, and with this sort of temporary tax cut, people, you know, are uncertain. They don't know. Does that mean taxes will increase in the future?

Mr. BERG. I just—let me—it is clear to me. I, of course, just come from little old North Dakota. And it seems that out here everything is pretty temporary, and a cloud of uncertainty over business and over everything. A cloud of uncertainty is over Social Security. People need to know what is going to happen.

And again, just to add to that, I think we need long-term solutions for solvency, whether it is our country's cash flow, whether it is our country's regulatory environment, whether it is our country's tax environment, simply having a path that people can look down the road and have confidence that it is going to be there is really what is critical.

So, just one final question. What is the cost? Does anyone know what the cost of the two percent is, then, to the general fund? Do we have a number on what that is?

Mr. GOSS. So for 2010 and some of the cost for 2011 slipping into 2012, it is about $110 billion in total.

Mr. BERG. And that is set to expire in December of 2011, or——

Mr. GOSS. Or the beginning of 2012. Work in 2012 will no longer be subject to the 2 percent reduction.

Mr. BERG. Okay.

Mr. GOSS. In payroll tax.

Mr. BERG. Thank you. I yield back.

Chairman JOHNSON. Thank you, Mr. Berg. Mr. Marchant, you are recognized.

Mr. MARCHANT. Thank you, Mr. Johnson. Mr. Brill, the President is proposing that we cut the employer's payroll taxes to create jobs. Other Members of Congress—the Democratic Members of Congress—are proposing that we raise payroll taxes in order to make the Social Security fund solvent.

Which of those two policies would create more jobs, or make the fund become more solvent? Which one of those policies should we select?

Mr. BRILL. Are there any other choices?

[Laughter.]

Mr. MARCHANT. I won't select either one of those, but those are the proposals——

Mr. BRILL. I would just note again, as I remarked to Congressman Berg, the important distinction between those two, in addition to the fact that one is going up and the other one is going down, is that one is temporary and the other one is permanent. The evidence of temporary tax policies on permanent job creation is shaky, at best.

And as we were just noting, a recent experience may be too soon to analyze, but it seems unlikely that we would get a large benefit from a temporary payroll tax, whether it be on the employee side or the employer side. Of course, there have been a number of attempts at temporary policies in the last few years, none of which seem to have been particularly effective.

On the other side, raising the cap is a permanent policy, and employers and employees experiencing long-term, higher marginal rates are less likely to engage in work.

Mr. MARCHANT. As someone that is a small employer, as well as a Member of Congress, and my brother as well, we have had this discussion in the last week about what happens in January, when all of a sudden the two percent goes away, and all of a sudden the same exact check to one of our—the foreman in this case, $68, will—the foreman will be paid exactly the same amount, but there will be $68 less in his paycheck.

Is there any of you on the panel that have any opinion about how—what effect that is going to have on employment, if Congress or the administration is not able to extend that deduction? Dr. Biggs, how about you?

Mr. BIGGS. I think I would agree with some of the others, that I suspect the effects on employment of temporary payroll tax cuts will be small. And so, if we didn't see a lot of job gains through the payroll tax cut—and I suspect we didn't—then probably we won't see a lot of job losses when the payroll tax goes back to its original level. That is my gut on this.

It may be possible to do some research in further years and figure it out, but if you are looking to hire somebody, particularly if you are looking to hire somebody for a quality job, you know, what we call a "good job," it is somebody you want to have them stick around for a while, you know, a permanent employee, a two percent cut in your labor cost in one year is not really enough to say, you know, "I am going to go out and add a whole load of new people." It is just—the temporary nature of it just—I don't think will have that big an effect.

So, I tend to think the positive effects were small, and the negative effects, when it goes away, also will be small.

Mr. MARCHANT. And, Mr. Chairman, if I could ask a question that I promised a gentleman last week—when he found out that I was going to be on the Social Security Subcommittee, he asked me to ask this as a question.

What is—and I will ask this to Mr. Goss—what is the definition of a gap baby? Notch baby, I am sorry.

Mr. GOSS. Notch.

Mr. MARCHANT. Because this gentleman obviously is a notch baby.

Mr. GOSS. Okay.

Mr. MARCHANT. And he calls often.

[Laughter.]

Mr. GOSS. We apologize for that. There was a certain period of time during which births reached retirement age in a period when, as a result of the 1977 Social Security amendments, because the benefit levels were rising at, really, an unsustainable rate, these so-called replacement ratios, benefits relative to wage levels, were growing out of control. And the 1977 Social Security amendments came along and corrected that.

But the Congress at that time decided that the benefits had risen to a level that was about six percent higher than they thought made sense. So they actually, over a period of five or six years worth of retirees, pulled the benefit levels down. As a result of having the benefit levels pulled down over that period, we ended up with a situation which really defines what a notch is: people retiring this year, say at 62, actually getting less when they retire at 62 than a person who is now 63, had the same job, and retired a year ago.

And so, if a person retiring now is getting less than a person who retired a year ago from the same job, then that is defined as a notch that is something which, when we design proposals—everybody who is sitting behind you knows well—this is something we strive to avoid, having notches in the future so you won't have any more cards and letters.

Mr. MARCHANT. Okay. Thank you, Mr. Chairman.

Chairman JOHNSON. Try not to ask that question any more.

[Laughter.]

Chairman JOHNSON. Let's see, Mr. Tiberi.

Mr. TIBERI. Thank you, Mr. Chairman. Thanks for having this hearing.

Mr. Goss, remind us up here. When Social Security was created, my understanding is that President Roosevelt stressed that this would not be a welfare system, that this would be a system that the benefits, the taxes that you paid, would equal the benefits that you incurred. And, therefore, if you were making $100,000, and paying tax on the $100,000, your benefit will be higher over a period of time if your average wage over time was $50,000, and thus you paid $50,000 into—or taxes based on the $50,000. Is that correct? Is that how it works?

Mr. GOSS. That is absolutely correct. People who earn more, and therefore pay higher taxes, do get higher benefits. But it is not in direct proportion.

Mr. TIBERI. Right.

Mr. GOSS. If you have somebody who makes $50,000 versus $100,000, the $100,000 will pay twice as much in the way of taxes. But because of the way the benefit formula has been put together, they will not get twice as much in the way of benefits.

Mr. TIBERI. But they will get a percentage higher, because they put a percentage more in.

Mr. GOSS. They definitely will get more benefits.

Mr. TIBERI. If we lift the cap—the proposals to lift the cap haven't corresponded to the theory that President Roosevelt has proposed, is that correct? My understanding is those who want to lift the cap want to also cap the benefit and then use the remainder to fund the system. Is that correct, or am I wrong?

Mr. GOSS. Well, we have a variety of proposals. One that has been discussed much here is to gradually raise the taxable maximum up, so that we will again be taxing 90 percent.

Actually, the fiscal commission and the bipartisan policy center commission came up with slightly different flavors of that. Generally speaking, if we do raise the taxable maximum, extra earnings that people have above the current taxable maximum might be confronted in our benefit formula with getting only a 15 percent return, as compared to about the average 48 percent return that earnings tend to get.

The fiscal commission actually suggested that the extra earnings should get not a 15, but a 5 percent return. So they were trying to achieve actually more solvency kick out of raising the taxable maximum than the bipartisan policy center is.

Other proposals have been put forth that would say that for the extra taxes paid in for higher earnings, there will be no extra benefit gains. So there is a great variety of possibilities that you might consider.

Chairman JOHNSON. Dr. Biggs, would we lose public support, in your opinion, if we raise the tax? And we have heard from you and Mr. Brill about the negatives of raising the tax. But put that aside for now. Would we lose public support of the system, in your opinion, if we took the cap off and retirement benefits would be less than they are today for those earners, based upon the tax paid and the benefits received, whether it is 48 percent versus 15 or 48 percent versus 5 for the added amount?

Mr. BIGGS. Well, I think that that is an important issue, sort of a political economy issue, of how people view the program, and how that affects their support for it.

Historically, that issue is very, very important for President Roosevelt. He appointed a commission to develop sort of the skeleton of the Social Security program.

The interesting thing of what the committee on economic security came up with is they originally set this wage cap of $3,000, and they argue that anybody above that wage cap shouldn't even participate in the program, that they should just go save on their own. So, under their structure, you wouldn't have had any redistribution from these high earners to low earners. It was really seen as a universal insurance program, where everybody paid in, everybody got out.

The compromise they came to was a cap where you pay in taxes based up to $100,000 in earnings, and your benefits are based on those same taxes. So there was always this interchange between the two. If you made it too progressive, the argument was, it would be come to be seen was what Roosevelt called relief—the phrase we use today is "welfare."

Now, the question is how far can you push that. You can say we are going to eliminate the cap, and you are going to get an extra penny of earnings, or an extra penny of benefits. People say, "Okay, clearly, that is sort of a—that makes kind of a joke of the situation." So the question is, how far can you push it before you get the lack of political support, which, really, people have counted on for the program? If people don't feel a program is fair, then the political support does tend to fall apart.

Chairman JOHNSON. Thank you. Mr. Brill, you commented about the concern that, in raising Social Security revenue, there would be a detrimental impact on overall federal revenue. Can you expand upon that, why you believe that?

Mr. BRILL. Sure. I think this is an important consequence to appreciate when looking at raising the cap or raising the payroll tax rate. It depends, in part, on exactly the sensitivity of the workers, to what degree they respond to this higher tax rate. And there is a debate among academics to that response.

But there is absolutely shifting that will occur, and it would be reflected in any analysis that Tom and his team would undertake, or any work done by the CBO on this issue.

One paper that many have noted on this area is a working paper by Jeffrey Liebman and Emmanuel Saez. In that paper, they estimate the impact on a per-worker basis of raising the payroll cap. In one example, a more conservative example, raising the cap to 90 percent from where it is now would result in $155 more in payroll taxes, but $67 less in other taxes being paid, as the workers shift their behavior and either work less or report less taxable wages. And so, in that sense, there is a decreasing amount of general fund revenues in exchange for increasing amounts of Social Security revenues.

Chairman JOHNSON. Thank you. You know, you guys didn't talk about raising the age limit at all. I am surprised.

And, Mr. Lee, you didn't push your teachers out there, I am sorry to hear. Tell them hi when you get back, will you?

Mr. LEE. I will, thank you.

Chairman JOHNSON. I thank you all for being here today. This subcommittee will continue to monitor progress to make sure that Social Security is done right, within its means.

With that, the committee stands adjourned. Thank you all for being here.

[Whereupon, at 3:28 p.m., the subcommittee was adjourned.]

[Submissions for the Record follow:]

112TH CONGRESS, 1ST SESSION

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SEP 27 2011

Honorable Sam Johnson
Chairman
U.S. House of Representatives
Committee on Ways and Means
Subcommittee on Social Security
B317 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Johnson:

The following is in response to your letter of September 12 regarding my testimony on June 23, 2011, before the Subcommittee on Social Security regarding Social Security's finances. My answers follow your numbered questions. It should be noted that because all of SECA is attributable to the employee, those questions that refer to the "employee" portion of SECA reflect the entire SECA amount.

1. What is the percent of those receiving Social Security whose benefits are under the individual income tax?

   We estimate that 39.5 million income tax returns will have a total of $667.8 billion in Social Security benefits reflected in tax year 2011. Roughly 44 percent of those income tax returns will have $192.7 billion in taxable Social Security benefits included in adjusted gross income ("AGI") in 2011 (approximately 29 percent of the income). We forecast that these percentages will be increasing over the budget window, with roughly 66 percent of returns with Social Security benefit income having roughly 46 percent of their Social Security benefit income included in AGI in 2021.

2. What percent of taxpayers pay more in the employee share of FICA tax than income taxes? What percent pay more in the employee share of the OASDI tax portion of the FICA tax than in income tax?

   We estimate that 65.9 million returns (40 percent) pay more in the employee share of FICA than income taxes in tax year 2011. We forecast that this percentage will be declining over the budget window, with 63.5 million returns (35 percent) paying more in the employee share of FICA than income taxes in 2021. In tax year 2011, 59.3 (36 percent) million returns will pay more in the employee share of OASDI than in income taxes. By tax year 2021, we estimate that 58.3 (32 percent) million returns will pay more in the employee share of OASDI than in income taxes.

Congress of the United States
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Washington, DC 20515–6453

Honorable Sam Johnson
U.S. House of Representatives

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3. What percentages of taxpayers pay only the employee share of payroll taxes (FICA) and no other income tax?

   In tax year 2011, we estimate that 44.9 million returns (27 percent) will pay only the employee share of FICA and have no Federal income tax liability. In tax year 2021, we estimate that 41.9 million returns (23 percent) will pay only the employee share of FICA and have no Federal income tax liability.

   For those taxpayers who pay only payroll taxes, what percent of those have the employee share of OASDI portion of the FICA tax fully offset by the earned income tax credit ("EITC")?

   In 2011, 20.6 million filers (76 percent of EITC recipients) will be eligible for an EITC equal to or larger than their combined income tax liability and employee share of payroll tax liability (including SECA).

   What percentage of these taxpayers actually receives a refund from the EITC?

   By definition, all 20.6 million filers described above receive an income tax refund; otherwise, their EITC would not be larger than their combined income tax liability and payroll tax liability. Overall, about 23.4 million filers receive the EITC as an outlay (87 percent of recipients).
   To go along with my earlier response of 20.6 million filers having EITC exceeding their income plus employee payroll and SECA tax liability, following is the breakdown by number of children and filing status, per the request (in millions of returns):

	Single	Married	Head of Household	Total
0 children…………..	2.6	0.4	0.0	3.0
1 child……………...	1.2	1.4	5.2	7.9
2 children…………..	0.7	1.8	5.0	7.4
3+ children………...	0.1	1.3	0.9	2.3
Total……………….	4.5	4.8	11.2	20.6

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U.S. House of Representatives

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4. For the child credit piece (item 4), 16.4 million filers have a child tax credit that exceeds their income plus employee payroll and SECA tax liabilities. This is approximately 44 percent of child tax credit recipients. Again, by definition, all of these filers receive a refund from the child credit. Here is the breakdown by number of children and filing status:

	Single	Married	Head of Household	Total
1 child…………….	1.0	1.4	4.9	7.3
2 children…………	0.5	1.7	4.0	6.2
3+ children………..	0.2	1.6	1.1	3.0
Total………………	1.8	4.7	10.0	16.4

5. What percent of taxpayers pay more in the employee share of SECA tax than income taxes? What percent pay more in the employee share of the OASDI tax portion of the SECA tax than in income tax?

   We estimate that 11.8 million returns (7 percent) pay more in the SECA taxes than income taxes in tax year 2011. We forecast that this percentage will be declining over the budget window, with 10.9 million returns (6 percent) paying more in SECA taxes than income taxes in 2021. In tax year 2011, 11.5 (7 percent) million returns will pay more in the employee share of OASDI than in income taxes. By tax year 2021, we estimate that 10.6 (6 percent) million returns will pay more in the employee share of OASDI than in income taxes.

6. What percentages of taxpayers pay only the employee share of payroll taxes (SECA) and no other income tax?

   In tax year 2011, we estimate that 0.9 million returns (6 percent) will pay only SECA taxes and have no income tax liability. In tax year 2021, we estimate that 0.9 million returns (5 percent) will pay only SECA taxes and have no income tax liability.

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U.S. House of Representatives

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I hope this information answers your questions. If we can be of further assistance in this matter, please let me know.

Sincerely,

Thomas A. Barthold

Thomas A. Barthold

SOCIAL SECURITY
Office of the Chief Actuary

August 31, 2011

The Honorable Sam Johnson
Chairman, Subcommittee on Social Security
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

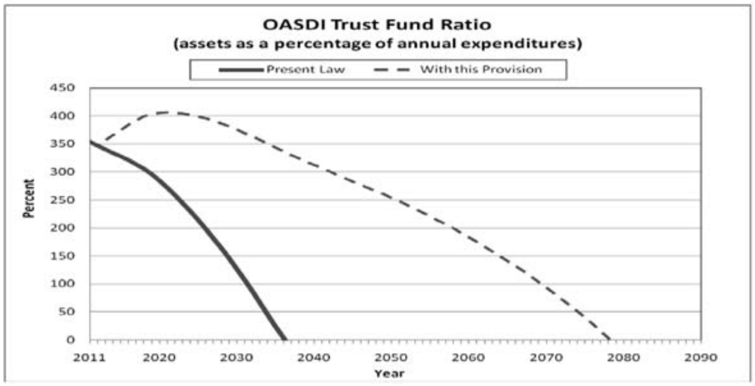
Dear Mr. Johnson:

Thank you again for the opportunity to testify before the Committee on Ways and Means, Subcommittee on Social Security during the June 23, 2011 hearing on Social Security's finances. I hope the information that I and others provided regarding the implications of increasing revenue for the OASI and DI Trust Funds will prove to be helpful. Below I have restated the two questions you sent to me on August 22, 2011, and have provided answers.

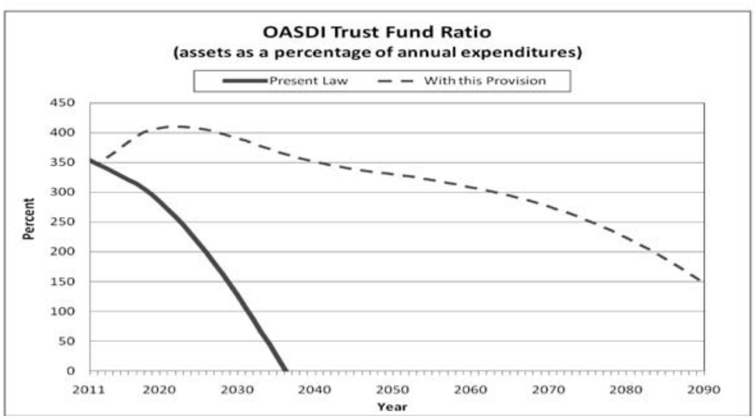
1. **Even if all covered earnings were taxed, similar to the Hospital Insurance payroll tax, and assuming all earnings subject to the payroll tax would be used in determining benefits, would sustainable solvency be achieved? Would sustainable solvency be achieved if the additional earnings subject to the payroll tax were not used in determining benefits?**

Answer: In 1983, 90 percent of all earnings for OASDI covered workers were under the taxable maximum. Over time, that percentage diminished because of a gradual increase in the concentration of earnings among the very highest earners. By 2008, about 83 percent of covered earnings were below the taxable maximum. While this percentage rose temporarily during the recent recession, we project that it will return to about 82.5 percent of covered earnings below the taxable maximum for 2020 and beyond.

If we were to eliminate the taxable maximum starting for all earnings in 2012 and include the additional taxable earnings in workers' earnings records for benefit credit, we project that the actuarial deficit of 2.22 percent of payroll under current law would be reduced to 0.32 percent of payroll for the 75-year period, 2011 through 2085. We further project that the exhaustion year for the combined OASI and DI Trust Funds would extend from 2036 under current law to 2078. While this would be a very substantial improvement in the actuarial status of the OASDI program, enacting this provision alone would not be sufficient to achieve sustainable solvency for the program. Sustainable solvency requires that trust fund assets be positive through the next 75 years, and that assets be stable or rising as a percent of annual cost at the end of the 75-year period. The graph below shows the effect that enactment of this provision alone would have on the path of trust fund assets expressed as a percentage of annual program cost.



Alternatively, if we were to eliminate the taxable maximum starting for all earnings in 2012 and provide no additional benefit credit, we project that the actuarial deficit of 2.22 percent of payroll under current law would be eliminated, and we would have a positive actuarial balance of 0.11 percent of payroll. The combined OASI and DI Trust Fund assets would be positive throughout the next 75 years and assets would be at 180 percent of annual program cost at the end of the period. However, because the size of assets as a percent of annual program cost would be declining gradually at the end of the 75-year period, enactment of this provision alone would not meet the conditions for sustainable solvency. The graph below shows the projected path of trust fund assets expressed as a percent of annual cost under present law and assuming enactment of this provision alone.



It is important to note that any comprehensive proposal to restore sustainable solvency for Social Security will likely include several provisions: some that increase revenue, as this provision would, and others that lower cost. Either of the proposals described above would provide a substantial base for developing a comprehensive reform plan for OASDI, but additional provisions would be needed to meet the objective of sustainable solvency.

2. How does the tax on benefits add to the trust fund finances over time?

Answer: The 1983 Social Security Amendments made a portion of monthly OASDI benefits subject to personal income tax for 1984 and later. The law specified that the personal income tax revenue derived from taxing up to one-half of benefits would be transferred to the OASI and DI Trust Funds. The amount of benefits actually includable for personal income tax depends on the beneficiary's modified adjusted gross income (MAGI), which is equal to adjusted gross income (AGI) excluding any portion of benefits that is taxable, plus any non-taxable interest income. When MAGI plus one-half of actual OASDI benefits exceeds certain thresholds ($25,000 for single taxpayers, $32,000 for married couples filing jointly, but zero for married couples filing separately), one-half of the excess, but not more than one-half of the benefit itself, is declared taxable under personal income tax and is included in AGI.

For 2011, we estimate that the revenue from taxing Social Security benefits that is allocated to the combined OASI and DI Trust Funds is about 0.41 percent of payroll, or about 3.3 percent of total OASDI non-interest income for the year. However, because the thresholds described above have not been indexed or increased since 1983, the percent of beneficiaries subject to taxation of benefits has gone up and will continue to go up over time. By 2085, we project that this revenue will rise to 0.94 percent of taxable payroll, or 7.1 percent of total OASDI non-interest income. Thus, revenue from the taxation of OASDI benefits makes a significant and growing contribution toward the financing of these benefits.

Also, note that legislation enacted in 1994 expanded taxation of benefits by making up to 85 percent of OASDI benefits subject to personal income tax. However, the additional revenue due to this expansion is allocated not to the OASI and DI Trust Funds, but to the Medicare Hospital Insurance Trust Fund.

Again, I hope this further information will be helpful. If you have any further questions or need assistance in any way please let me know.

Sincerely,

Stephen C. Goss

Stephen C. Goss
Chief Actuary

cc:
Kim Hildred

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August 22, 2011

Stephen C. Goss
Chief Actuary
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6401 Security Blvd.
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Baltimore, MD 21235

Dear Mr. Goss:

Thank you for your testimony before the Committee on Ways and Means, Subcommittee on Social Security during the June 23, 2011 hearing on Social Security's finances. In order to complete our hearing record, we would appreciate your response to the following questions:

1. Even if all covered earnings were taxed, similar to the Hospital Insurance payroll tax, and assuming all earnings subject to the payroll tax would be used in determining benefits, would sustainable solvency be achieved? Would sustainable solvency be achieved if the additional earnings subject to the payroll tax were not used in determining benefits?
2. How does the tax on benefits add to the trust fund finances over time?

We would appreciate your responses to these questions by September 5, 2011. Please send your response to the attention of Kim Hildred, Staff Director, Subcommittee on Social Security, Committee on Ways and Means, U.S. House of Representatives, B-317 Rayburn House Office Building, Washington, D.C. 20515. In addition to a hard copy, please submit an electronic copy of your response in WordPerfect or Microsoft Word format to jessica.cameron@mail.house.gov.

Thank you for taking the time to answer these questions for the record. If you have any questions concerning this request, you may reach Kim at (202) 225-9263.

Sincerely,

Sam

SAM JOHNSON
Chairman

Texas Retired Teachers Association
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August 25, 2011

Thank you for the opportunity to respond to these important questions. I appreciate the help of the Coalition to Preserve Retirement Security in researching these answers. Please know that I am available to answer any additional questions you may have.

Tim Lee

Answers to Question from June 23 Ways and Means Committee Hearing

1. Please explain why State and local workers were excluded from Social Security in the first place?

   The legislative history on this point is ambiguous, but it appears from the congressional archives that Congress and the Roosevelt Administration were concerned about the states sovereignty. In pressing their case for mandatory participation by private sector employers, lawmakers anticipated Constitutional challenges to the law. (In fact, private sector employees sued to overturn the law. However, the Supreme Court found the Social Security Act constitutional. See *Steward Machine Co. v. Davis*, 301 U.S. 548 (1937), *Helvering v. Davis*, 301 U.S. 619 (1937).) Lawmakers appeared less confident in the constitutionality of taxing employees of sovereign States. In addition, Congress appeared to believe that many states already had traditional pension plans for state and local government workers and worried that allowing them to participate in Social Security could result in "double dipping."

2. Would you explain how public workers would be able to obtain coverage under Social Security today?

   Social Security coverage is extended to state and local government employees through "Section 218 Agreements" between a state and the Social Security Administration (SSA). Coverage under Section 218 Agreements differs greatly from state to state. For example, within a state, teachers in one county may be covered under Social Security, whereas teachers in the neighboring county may not be covered. The State Social Security Administrator is the main resource for information about Social Security and Medicare coverage and reporting issues for state and local government employers and employees. Section 218 Agreements cover positions, not individuals. If the government position is covered by Social Security and Medicare under a Section 218 Agreement, then any employee (current or future) filling that position is subject to Social Security and Medicare payroll taxes. (See CRS Report, Social Security: Mandatory Coverage of New State and Local Government Employees)

Opening Statement of Rep. Xavier Becerra (D-CA)
Ranking Member, Committee on Ways & Means

Subcommittee on Social Security

HEARING ON SOCIAL SECURITY'S FINANCES

June 23, 2011

In any discussion of the successes and challenges for Social Security, the $2.6 trillion American workers have built up in the Social Security Trust Fund to date cannot be ignored. I'm concerned that in describing Social Security's finances, the Majority today has disregarded the true value and the $117.5 billion in interest earned by the U.S. Treasury bonds in Social Security's Trust Fund in 2010 alone.

This is part of a disturbing pattern my colleagues on the other side have established in which they seem to dismiss the tax contributions hard working Americans have deposited into the Trust Fund. Over the last 75 years, Americans have contributed and earned interest totaling $14.6 trillion for Social Security, and Social Security has paid out a total of $12 trillion in benefits and administrative costs. Americans have built up a $2.6 trillion dollar surplus in their Trust Fund. American workers know that their Social Security contributions are real – they see the amount deducted from their paycheck every week. My friend from Texas calls these Treasury Bonds, which were purchased with worker contributions, "pieces of paper." I call them "the safest investment money can buy."

The Treasury bonds held by the Trust Fund are real and just like all the other bonds Treasury has issued over the years. All are backed by the full faith and credit of the United States. U.S. Treasury bonds are the safest and most sought-after bonds in the world.

I'm concerned with the impact that the benefit cuts to Social Security that Republican leaders have proposed will have on seniors and beneficiaries. Social Security benefits are very modest, and most seniors have limited incomes. The average benefit for a retiree is $14,000 a year. Among senior households, the median income is only about $24,000 a year. One out of every three beneficiaries depends on Social Security to provide virtually all of their income. Less than half of seniors have a pension or savings plan from work. Only the wealthiest fifth of seniors have any significant income from assets. Keep in mind that during the 2008 financial collapse, IRAs and 401(k)s lost 32 percent of their value.

The benefit cuts Republicans have put on the table this year would have devastating consequences for today's seniors and for the 155 million future beneficiaries who are paying in to Social Security today.

Last week, Senator Kay Bailey Hutchison introduced a bill that would wipe out the COLA this year – the third year that seniors would receive no increase in their checks – and cut it by more than a third in all future years. Her bill would also cut benefits for future retirees by raising the retirement age – an annual benefit cut of $2,000-$2,700 for a middle-income worker.

Rep. Pete Sessions, together with some of his colleagues in the House Republican leadership, recently introduced a bill that would drain money from the Social Security Trust Fund by diverting money into private accounts. This privatization bill creates a real risk that too much money will be diverted from the Trust Fund, preventing current Social Security beneficiaries from receiving the benefits they earned. It also eliminates benefits for younger workers with accounts, and bars them from receiving any disability or survivor benefits.

The Chairman of the House Budget Committee has a plan to privatize Social Security, raise the retirement age, and cut benefits for the middle class, and House Republicans recently voted to create a special "fast-track" process for Social Security cuts.

Mr. Chairman, I am ready and willing to have a comprehensive discussion on all of the options available to us to strengthen Social Security. However, we cannot forget that for so many seniors across our country, whether they live in rural, urban or suburban America, Social Security is essential to a life of dignity. We owe it to them and to our children, to have an open and thoughtful conversation about the future of their Social Security.

Written Testimony
Presented by Speaker William G Batchelder, Ohio House of Representatives
Presented to the House Committee on Ways and Means
Congressman Dave Camp, Chairman
Subcommittee on Social Security
Congressman Sam Johnson, Chairman
Hearing on Social Security Finances
June 23, 2011

Mr. Chairman and Members of the Subcommittee on Social Security:

When The Social Security act of 1935 was first passed, it excluded state and local workers from participation in its benefits. As a consequence, state and local governments-many of which had pension plans already in place (including Ohio)-designed, or re-designed, their own retirement plans with a reliance on that exclusion.

In the 1950's Congress passed legislation that amended the Social Security Act to allow states to elect voluntary coverage for their employees, should they so choose. Ohio, along with many other states, chose not to join as they felt their plans provided secure retirement, as well as survivor and disability benefits that had been tailored to the needs of their employees.

The question of imposing mandatory coverage in Social Security has been raised from time-to- time over the years and in 1990 the Congress did mandate Social Security coverage for state and local workers who had no other retirement plan options. However, even then the Congress maintained its long standing position of not extending mandatory coverage to non-covered public employees who were already participating in pension plans like those in Ohio and many other states, which were still self-reliant.

While it is true that many states are non-covered states, it is important to note that there are exempt plans in all 50 states. This is due primarily to the fact that nearly 75% of police and fire pension plans are outside of Social Security.

In recent years proponents of mandatory coverage have used a new strategy to try and implement their goals. Rather than calling for extending mandatory coverage for all non-covered workers, they have shifted to the idea of extending coverage to new hires only with the belief that there would be little or no costs to the states and little impact on benefits for current employees or retirees. They are mistaken on both counts.

The reality is quite the opposite; an independent study by the Segal Company in 2005 showed that the costs to the states over a five year period would be in excess of $ 44 billion. The cost to Ohio alone would be nearly $5 billion. It is without questions that that number would be much higher in 2011; I have been informed that a new study will be available soon which will show that costs have increased 60% from the first study in 1999.

It is no secret that Ohio and most other states are facing enormous fiscal challenges. It is also true that many states, including Ohio, are engaging in important reforms of their public pension plans. We are making the changes necessary to insure not only the financial stability of our plans, but also to reflect changing demographics and to insure that promised benefits will be delivered well into the future.

What would be extraordinarily detrimental to that effort would be a $5 billion dollar mandatory Social Security cost shift from the Congress on top of the financial pressures already being felt within Ohio. I believe that this would cause unnecessary strain on the other states as well. It is also my firm belief that federal intrusion in state pension plans is unnecessary and unwarranted at this time. These plans are the responsibility of the states, and it is our duty to ensure their fiscal health.

The reason that federal intrusion into state pension plans will cause such a large fiscal burden is that pension systems like those in Ohio and other states depend primarily on investment income to pay for benefit. Investment income also primarily pays for healthcare in those states, such as Ohio, that provide such services.

Mandatory coverage would significantly divert both employer and employee contributions to Social Security; as a result our pension plans would have far less money to invest, hence, returns would be reduced, and the results would be catastrophic over time. In Ohio, on average, investment income provides the funds for 70% of retiree benefits. At the same time the number of people retiring continues to grow each year. Also, the ability to provide health care would be impacted almost immediately in many plans, as that is likely the first area to be cut. Most state and local pension plans would have to cut benefits for new hires and eventually would have to consider reducing benefits for current members and retirees as well.

As was stated previously, we are moving forward on pension reforms, and will be able to do it in a way that reflects what is best for both the state and the systems. Mandatory coverage would not only destabilize our pension plans, but it would essentially destroy the pension reforms that are currently underway.

Reflecting on the history of the Ohio Congressional delegation over the years, I can tell you that they have always maintained unanimous bipartisan opposition to mandatory coverage. I hope that other states will continue to join us in that effort.

Thank you for your time and for allowing me to submit this testimony before the House Committee on Ways and Means.

Sincerely,

William G. Batchelder, Speaker
Ohio House of Representatives
77 S. High St.
Columbus, OH 43215
614-466-8140

Comments for the Record

House Ways and Means Committee

Subcommittee on Social Security

Hearing on Social Security's Finances
Thursday, June 23, 2011

by Michael Bindner

The Center for Fiscal Equity

Chairman Johnson and Ranking Member Becerra, thank you for the opportunity to submit my comments on this topic.

The sources of Social Security's revenues

We will leave it to the government's witnesses to explain how Social Security was initially funded with payroll taxes, to the extent that revenues were used by the general fund until original participants retired or the general agreement on increasing tax rates with time in order to build up revenue streams to so that the program would be self funding.

We will add, however, that Social Security was part of a new social compact which, along with very high marginal tax rates and partnership with organized labor, built the middle class while keeping corporate capitalism in place. In a very real way, these programs were a reaction to not only the Great Depression, but a preventative to a very real movement toward more direct employee control and ownership of the workplace by the union movement. The passage of *Taft-Hartley Act* restrictions on concentrated ownership of the workplace were set in place as much to protect management from being swept away as they were a desire to diversify pension assets to protect workers.

This social context is important to understanding options for the future of Social Security.

How those sources have changed over time

As the advisory for this hearing stated, payroll taxes began at the 2% level for employers and employees, with increasing rates and income caps over time to accommodate the growth of the number of covered retirees from zero to entire generations.

In the early 1980s, Social Security was close to having to draw from the General Fund. Ronald Reagan's conservatism was ascendant, with recently passed income tax cuts being phased in over a three year period and a beginning of the end of the bargain with the union movement to maintain labor peace in exchange for not pushing for a larger ownership share. Indeed, for all practical purposes, labor had become de-radicalized over time. It had moved to seeking to preserve benefit levels rather than advancing the interests of workers into the management suite.

In this context, a new grand bargain was created to save Social Security. Payroll taxes were increased to build up a Trust Fund for the retirement of the Baby Boom generation. The building of this allowed the government to use these revenues to finance current operations, allowing the President and his allies in Congress to honor their commitment to preserving the last increment of his signature tax cut, where the only other realistic option at the time was to abandon some or all of them, which was politically unacceptable given Republican control of the White House and the Senate.

Options for change and their impacts

Actions should be taken as soon as possible, especially when they must be phased in, as it is a truism that a little action early will have a larger impact later.

This trust fund is now coming due, with the expectation that shortfalls in Social Security payroll taxes will be covered by both income from interest income from the Social Security trust fund and eventually revenue from the general fund. The cash flow problem currently experienced by the Trust Fund is not the Trust Fund's problem, but a problem for the Treasury to address, either through further borrowing – which will require a quick resolution to the debt limit extension or through higher taxes on those who received the lion's share of the benefit's from the tax cuts of 1981, 1986, 2001, 2003 and 2010. At some point, Congress must ignore the interests of its major donors (to both parties) and honor the bargain it made to shore up the trust fund. This is entirely appropriate, given the fact that much of the Trust Fund was built up in order to preserve the income tax cuts of 1981.

As luck would have it, adequate personal income tax increases to finance repaying the Trust Fund will occur automatically on January 1, 2013. This revenue profile, not current tax rates, must be considered the baseline on which any new bargain is formed.

The complication, and there are always complications, is that low tax rates enacted on capital gains, income and dividends during the Clinton and Bush administrations have created two asset based recessions, the first in the technology sector and the second in housing.

The recent recession is more accurately described as a Depression, since the financing of the real estate bubble has still not been resolved, even while economic growth numbers have begun to rebound. This new has both temporary and permanent effects on the trust fund's cash flow. The temporary effect is a decline in revenue caused by a slower economy and the temporary cut in payroll tax rates to provide stimulus.

The permanent effect is the early retirement of many who had planned to work longer, but because of the recent recession and slow recovery, this cohort has decided to leave the labor force for good when their extended unemployment ran out. This cohort is the older 99ers who need some kind of income now. The combination of age discrimination and the ability to retire has led them to the decision to retire before they had planned to do so, which impacts the cash flow of the trust fund, but not the overall payout (as lower benefit levels offset the impact of the decision to retire early on their total retirement cost to the system).

At the very least, the constraints on borrowing to fund the conversion of Social Security trust fund assets to debt held by the public must be dealt with by enacting a clean debt limit extension, or at the very least, automatically allowing the debt limit to increase to facilitate this conversion. The only alternative to this is immediately increasing income taxes before they go up automatically in 2013. While Social Security may not be a legal obligation to retirees, the funds which back it are under the 14th Amendment, so it would be unconstitutional to not give their repayment first priority.

Let us be clear that August 4th is not the real deadline which is of concern, but December 31, 2012. The only leverage against automatic tax increases is a deal in advance of their expiration and the only leverage for such a deal is the debt limit extension.

It would be entirely inappropriate to renege on promises to the baby boomers to fund further income tax cuts by further extending the retirement age, cutting promised Medicare benefits or by enacting an across the board increase to the OASI payroll tax as a way to subsidize current spending or tax cuts. The current fiscal crisis should not be an excuse to use regressive Old Age and Survivors Insurance payroll taxes to subsidize continued tax cuts on the top 20% of wage earners who pay the majority of income taxes. Retirement on Social Security for those at the lowest levels is still inadequate. Any change to the program should, in time, allow a more comfortable standard of living in retirement.

The ultimate cause of the trust fund's long term difficulties is not financial but demographic. Thus, the solution must also be demographic – both in terms of population size and income distribution. The largest demographic problem facing Social Security and the health care entitlements, Medicare and Medicaid, is the aging of the population. In the long term, the only solution for that aging is to provide a decent income for every family through more generous tax benefits.

The free market will not provide this support without such assistance, preferring instead to hire employees as cheaply as possible. Only an explicit subsidy for family size overcomes this market failure, leading to a reverse of the aging crisis.

The recommendations for raising net income are within the context of comprehensive tax reform, where the first 25-28 percent of personal income tax rates, the corporate income tax, unemployment insurance taxes, the Hospital Insurance payroll tax, the Disability Insurance payroll tax and the portion of the Survivors Insurance payroll tax funding survivors under the age of 60 have been subsumed by a Value Added Tax (VAT) and a Net Business Receipts Tax (where the net includes all value added, including wages and salaries).

Net income would be adjusted upward by the amount of the VAT percentage and an increased child tax credit of $500 per child per month. This credit would replace the earned income tax credit, the exemption for children, the current child tax credit, the mortgage interest deduction and the property tax deduction. This will lead employers to decrease base wages generally so that the average family with children and at an average income level would see no change in wage, while wages would go up for lower income families with more children and down for high income earners without children.

Gross income would be adjusted by the amount of tax withholding transferred from the employee to the employer, after first adjusting net income to reflect the amount of tax benefits lost due to the end of the home mortgage and property tax deductions.

This shift in tax benefits is entirely paid for and it would not decrease the support provided in the tax code to the housing sector – although it would change the mix of support provided because the need for larger housing is the largest expense faced by growing families. Indeed, this reform will likely increase support for the housing sector, as there is some doubt in the community of tax analysts as to whether the home mortgage deduction impacted the purchase of housing, including second homes, by wealthier taxpayers.

Within twenty years, a larger number of children born translates into more workers, who in another decade will attain levels of productivity large enough to reverse the demographic time bomb faced by Social Security in the long term.

Such an approach is superior to proposals to enact personal savings accounts as an addition to Social Security, as such accounts implicitly rely on profits from overseas labor to fund the dividends required to fill the hole caused by the aging crisis. This approach cannot succeed, however, as newly industrialized workers always develop into consumers who demand more income, leaving less for dividends to finance American retirements. The answer must come from solving the demographic problem at home, rather than relying on development abroad.

This proposal will also reduce the need for poor families to resort to abortion services in the event of an unplanned pregnancy. Indeed, if state governments were to follow suit in increasing child tax benefits as part of coordinated tax reform, most family planning activities would be to increase, rather than prevent, pregnancy. It is my hope that this fact is not lost on the Pro-Life Community, who should score support for this plan as an essential vote in maintaining a perfect pro-life voter rating.

Obviously, this proposal would remove both the mortgage interest deduction and the property tax deduction from the mix of proposals for decreasing tax rates while reducing the deficit. This effectively ends the notion that deficit finance can be attained in the short and medium term through tax reforms where the base is broadened and rates are reduced. The only alternatives left are a generalized tax increase (which is probably necessary to finance future health care needs) and allowing tax rates for high income individuals to return to the levels already programmed in the law as of January 1, 2013. In this regard, gridlock is the friend of deficit reduction. Should the President show a willingness to let all rates rise to these levels, there is literally no way to force him to accept anything other than higher rates for the wealthy.

This is not to say that there is no room for reform in the Social Security program. Indeed, comprehensive tax reform at the very least requires calculating a new tax rate for the Old Age and Survivors Insurance program. My projection is that a 6.5% rate on net income for employees and employers (or 13% total) will collect about the same revenue as currently collected for these purposes, excluding sums paid through the proposed enhanced child tax credit. This calculation is, of course, subject to revision.

While these taxes could be merged into the net business income/revenue tax, VAT or the Fair Tax as others suggest, doing so makes it more complicated to enact personal retirement accounts. My proposal for such accounts differs from the plan offered in by either the Cato Institute or the Bush Commission (aka the President's Commission to Save Social Security).

As I wrote in the January 2003 issue of Labor and Corporate Governance, I would equalize the employer contribution based on average income rather than personal income. I would also increase or eliminate the cap on contributions. The higher the income cap is raised, the more likely it is that personal retirement accounts are necessary.

A major strength of Social Security is its income redistribution function. I suspect that much of the support for personal accounts is to subvert that function – so any proposal for such accounts must move redistribution to account accumulation by equalizing the employer contribution.

I propose directing personal account investments to employer voting stock, rather than an index funds or any fund managed by outside brokers. There are no Index Fund billionaires (except those who operate them). People become rich by owning and controlling their own companies. Additionally, keeping funds in-house is the cheapest option administratively. I suspect it is even cheaper than the Social Security system – which operates at a much lower administrative cost than any defined contribution plan in existence.

Safety is, of course, a concern with personal accounts. Rather than diversifying through investment, however, I propose diversifying through insurance. A portion of the employer stock purchased would be traded to an insurance fund holding shares from all such employers. Additionally, any personal retirement accounts shifted from employee payroll taxes or from payroll taxes from non-corporate employers would go to this fund.

The insurance fund will save as a safeguard against bad management. If a third of shares were held by the insurance fund than dissident employees holding 25.1% of the employee-held shares (16.7% of the total) could combine with the insurance fund held shares to fire management if the insurance fund agreed there was cause to do so. Such a fund would make sure no one loses money should their employer fail and would serve as a sword of Damocles' to keep management in line. This is in contrast to the Cato/ PCSSS approach, which would continue the trend of management accountable to no one. The other part of my proposal that does so is representative voting by occupation on corporate boards, with either professional or union personnel providing such representation.

The suggestions made here are much less complicated than the current mix of proposals to change bend points and make OASI more of a needs based program. If the personal account provisions are adopted, there is no need to address the question of the retirement age. Workers will retire when their dividend income is adequate to meet their retirement income needs, with or even without a separate Social Security program.

No other proposal for personal retirement accounts is appropriate. Personal accounts should not be used to develop a new income stream for investment advisors and stock traders. It should certainly not result in more "trust fund socialism" with management that is accountable to no cause but short term gain. Such management often ignores the long-term interests of American workers and leaves CEOs both over-paid and unaccountable to anyone but themselves.

Progressives should not run away from proposals to enact personal accounts. If the proposals above are used as conditions for enactment, I suspect that they won't have to. The investment sector will run away from them instead and will mobilize their constituency against them. Let us hope that by then workers become invested in the possibilities of reform.

Indeed, real reform is only possible if workers become more radicalized to the possibilities of workplace ownership and democracy. The purpose of this testimony is to remind workers of the bargain struck in the Roosevelt era, which I mentioned at the outset, to allow capitalism to exist in exchange for moving workers into the middle class. As that bargain has been abandoned on one side, there is no reason for workers not to pick up old demands for workplace democracy. Indeed, it is essential that they do so in order to quit losing ground.

All of the changes proposed here work more effectively if started sooner. The sooner that the income cap on contributions is increased or eliminated, the higher the stock accumulation for individuals at the higher end of the age cohort to be covered by these changes – although conceivably a firm could be allowed to opt out of FICA taxes altogether provided they made all former workers and retirees whole with the equity they would have otherwise received if they had started their careers under a reformed system. I suspect, though, that most will continue to pay contributions, with a slower phase in – especially if a slower phase in leaves current management in place.

Thank you for this opportunity to share these ideas with the subcommittee.

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Clients:

The Center for Fiscal Equity has received no outside funding of any kind to support this testimony. It is not representing any interests for pay.

INTERNATIONAL ASSOCIATION OF FIRE FIGHTERS

Statement of
Harold A. Schaitberger
General President
International Association of Fire Fighters

Hearing on Social Security's Finances
Before the
The House Ways and Means
Subcommittee on Social Security

June 23, 2011

I would like to thank Chairman Johnson, Ranking Member Becerra, and the members of this distinguished subcommittee for the opportunity to present the views of the nation's professional fire fighters and emergency medical personnel on the vitally important issue of Social Security's finances. My name is Harold Schaitberger and I have the honor of serving as General President of the International Association of Fire Fighters (IAFF). I speak today on behalf of the nearly 300,000 men and women who risk their lives to provide fire rescue and emergency medical services protection to over 85 percent of our nation's population.

Every day in America, fire fighters place their lives on the line to protect their neighbors, and all too often they pay the ultimate price. We were once again reminded of the dangers of our profession just two weeks ago when we lost our brothers Vincent Perez and Tony Valerio as they battled a house fire in San Francisco. Their memory, bravery and dedication will live on with their brothers and sisters at Engine Company 26 and throughout the IAFF.

Every fire fighter knows that the next alarm may be our last, but we do not flinch and we do not waiver. We fulfill our duty because that's who we are. We ask for neither fame nor fortune, but we do ask that fire fighters who spend their career serving their communities are able to retire with dignity. And we especially ask that our brothers and sisters who suffer career-ending injuries and the survivors of those who make the ultimate sacrifice are provided for.

That is why I urge this committee to reject proposals that would undermine the pension, disability and survivor benefits we have worked so hard to develop. Unfortunately, forcing all fire fighters into the Social Security system would do exactly that. Especially in the current budgetary environment, municipalities would be unable to afford to contribute to both Social Security and fire fighter retirement systems. Forcing jurisdictions to pay into Social Security would lead to the collapse of pension systems that that have provided retirement, disability and survivor benefits to generations of public safety officers.

Consider the city of Memphis, Tennessee, which currently contributes 5% of employees' pay into a retirement system that includes retirement, disability and survivor benefits. If Memphis employees were brought into Social Security, the city would be required to pay more for a retirement plan that delivers far less in benefits. It is simply wishful thinking to suggest that the city could pay both the 6.2% Social Security payroll tax and still contribute 5% into their own city plan. The inevitable result would be that Memphis, like hundreds of other jurisdictions facing similar circumstances, would simply abolish their current pension system.

When the Social Security system was created in 1935, government employees were expressly excluded. Even when state and local governments were given the option to join the system in the 1950s, many fire departments were still legally barred from electing Social Security coverage until 1994. Because of this long exclusion from the Social Security system, local governments created pension systems that addressed the unique needs of fire fighters without Social Security.

Today, an estimated 70 percent of all fire fighters are covered by pension plans that are independent of Social Security. Instead, they participate in specialized fire fighter pension plans that have been designed to reflect the unique circumstances of their profession, including early retirement ages and high rates of disability.

Historically, public safety agencies have sought to ensure a younger, physically fit workforce by promoting earlier retirement ages for fire fighters and law enforcement officers than other occupations. Many local jurisdictions, as well as the federal government, have mandatory retirement ages which require a fire fighter to leave their job at a certain age. Our pension plans reflect this reality and typically allow fire fighters to retire in their 50s.

As you know, the earliest age when beneficiaries can withdraw Social Security payments is 62, and doing so would result in reduced payments. Retiring at age 62 or at the normal retirement age of 67 for beneficiaries born in 1960 or later would undermine the policy goal of having a younger, more physically fit, public safety workforce. We do not believe it is wise public policy to force a fire fighter to remain on the job after they are no longer capable of performing their duties, just so they can begin to collect their partial or full Social Security benefits.

Our defined benefit pension plans also offer greater protection than Social Security in the event of an injury. The Social Security definition of "disabled" is far more stringent than the definition contained in fire fighter pension systems. The vast majority of fire fighters who suffer career-ending injuries would not be eligible to receive Social Security disability benefits, and they could be left with little means of support. Similarly, Social Security survivor benefits pale in comparison to the benefits fire service pensions pay to the widows and dependent children of those fire fighters who fall in the line of duty.

In short, dismantling fire fighter retirement systems in favor of Social Security would be cruelest to our most vulnerable.

In addition to the harm that would come to fire fighters if their retirement systems are dismantled, mandatory Social Security coverage would also impose a heavy payroll tax on middle-income workers. Most fire fighters contribute toward their retirement, but their annual payment is often less than the 6.2% Social Security payroll tax. As a result, public safety officers would be forced to pay thousands of additional dollars in taxes each year. Like other middle-income wage earners, fire fighters are struggling in the current economy and imposing this hefty tax increase would take a significant toll on family budgets.

And what, exactly, would be the benefit to the federal government of this wholesale disruption of fire fighter retirement systems and the heavy tax increase imposed on them? Very little indeed. A GAO report found that including newly hired public employees in Social Security would extend the solvency of the Social Security Trust Fund by only two years. Jeopardizing fire fighter retirement security is too heavy a price to pay for such a small contribution to Social Security's fiscal challenges.

While it cannot be questioned that Social Security's finances must be addressed, fire fighters and other State and local government employees should not be forced into the system as a way to simply generate revenue. Doing so would ignore the repercussions that would ensue, damaging State and local governments and the public servants who eschew careers in the private sector for the privilege of serving the public.

At tragic times, this dedication to community and country leads to the greatest sacrifice, such as our heroic brothers Lt. Vincent Perez and Tony Valerio. I urge this subcommittee to honor their sacrifices and look to other ways to shore up the Social Security program.

Social Security Subcommittee
Ways and Means Committee

Re: Concern/Suggestion on possible Social Security benefit cuts

To whom it may concern:

As a recent retiree (2008) of working for over 40 years and contributing to the Social Security system during that time and reading/hearing recent discussions about possible cuts in SS benefits as a result of the current stalemate in the talks on deficit cuts, I would like to air my thoughts to those of you that are deeply involved in this very important issue.

I do not understand the need to pay benefits to those who have chosen not to contribute to the Social Security program by deciding not to work or to work a reduced period of time. As you know, based on the spousal benefit clause the program automatically will pay ½ of the working spouse's benefits to the non-working spouse at retirement age regardless of their contribution to the program, therefore taking away funds from those that have chosen to contribute to their own retirement benefits by paying into the SS program.

Example:
My wife chose to take 10 years out of her career to be with our children during their early years. She went back to work to provide additional income for our family as well as contributing to her own retirement via IRA, 401K, and Social Security contributions. Her recent SS statement shows that if she chooses to begin receiving benefits at age 62 she would receive $1,041/mo.

I have many friends with non-working spouses that have paid the maximum SS tax on a yearly basis and when they choose to retire, the non-working (or minimally working) spouse will get ½ of the maximum SS payment in addition to the payment made to the working spouse. This will be within striking distance of the amount paid to my wife who chose to go back to work and contribute to SS for the past 20 years.

There are probably thousands of current SS benefit recipients and countless others that will be in line to be paid out of the SS funding that have chosen not to work as well as those who have chosen to work minimal hours with no contribution or very small contributions to SS. This was a choice made for various reasons and as much as I respect the right to do so, I do not believe that there should be benefits from SS that reflect a larger payment than the benefit they should receive based on their individual contribution. By making the current level of payments, we (I consider myself as a shareholder in the SS program) are paying out way more than we have taken in from those of us that have contributed, thus eroding the funds available.

Consideration to help reduce future deficits (small part of the total required)
Instead of an across the board reduction (if it comes to that) in benefits to all recipients, consider cutting/reducing benefits to those who have not contributed – recalculating of benefits based on the amount they have contributed during the time they chose to work rather than automatically giving them ½ of their working spouse's benefits.

Thank you for your efforts in helping to retain the integrity/intent of the SS program,

Jim Miller
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[redacted]

Statement for the Record by Max Richtman, Executive Vice President and Acting CEO
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10 G Street, N.E. Suite 600
Washington, DC 20002

House Committee on Ways and Means
Subcommittee on Social Security

Hearing on Social Security's Finances

June 23, 2011

As Executive Vice President and Acting Chief Executive Officer of the National Committee to Preserve Social Security and Medicare, I appreciate the opportunity to submit this statement for the record. With millions of members and supporters across America, the National Committee is a grassroots advocacy and education organization devoted to the retirement security of all citizens.

Chairman Johnson, Ranking Member Becerra and members of the Subcommittee on Social Security, the National Committee appreciates your holding this hearing to examine Social Security's current revenue streams, proposed changes to those structures and the impact they would have on the program, beneficiaries, workers and the economy.

As you know, 54 million Americans receive Social Security benefits each month. The benefits they receive from this program constitute a vital lifeline that is critical to their economic well-being. More than ever, today's retirees are heavily dependent on these benefits. Without this critical safety-net program, over half of all older Americans would fall into poverty. Approximately one-third of seniors have no income other than Social Security, and two-thirds rely on Social Security for more than one-half of their retirement income. Moreover, these benefits are quite modest with the average Social Security beneficiary receiving only about $14,000 per year; less than minimum wage.

While we are certainly concerned about the future solvency challenges facing Social Security, we remain alarmed at the various proposals currently under consideration that would dramatically cut benefits for current and future beneficiaries. The cuts most commonly being considered include raising the retirement age, reducing the annual cost of living increase, and revising the benefit formula through means testing or price indexing.

The argument for such cuts has been based on the deficits in the federal budget. This is a false argument. Put plainly, Social Security is not the driver of long-term deficits. According to the 2011 Social Security Trustees Report, Social Security has a dedicated stream of financing that keeps it fully funded until 2036. This means that there is little reason to be cutting benefits in this program in the foreseeable future. This fact is buttressed by the sentiment of the American people. Overwhelmingly, the polling data shows that a large majority of Americans— across all demographics and political affiliations— regard Social Security as a core benefit that should not be on the table as policymakers consider ways to reduce the deficit. In short, proposals to cut Social Security in the near future effectively take away benefits for which workers have already paid through their taxes.

The National Committee is mindful that the Subcommittee must weigh the various revenue options and their costs against one another and against the necessity of closing Social Security's long-term funding gap. However, we urge Congress to find the means to address Social Security solvency without cutting benefits for current or future retirees. What follows are descriptions of some of the proposals that have been advanced recently as options for cutting benefits and the concerns we have about the effects of these proposals on America's seniors.

Proposals to Cut the Cost-of-Living Adjustment (COLA)

Among the numerous options for cutting Social Security benefits, the notion of reducing the COLA is a perennial favorite, especially among those who want to reduce Social Security benefits to balance the budget. Although most policymakers have pledged to limit the impact of Social Security changes to younger workers who have time to plan for any changes before retirement, this option would cut benefits for all Americans, **including those who are already retired**.

Social Security is one of the few retirement programs that provide an automatic annual COLA to beneficiaries. The annual COLA is intended to ensure that Social Security benefits for retirees, survivors and the disabled maintain their purchasing power by keeping pace with inflation.

For the millions of seniors who rely on Social Security as their only source of income, and millions more who rely on it for at least half of their income, a cost of living adjustment is not a luxury, it's a necessity. Social Security's COLA is designed to help beneficiaries keep up with the constantly rising cost of living during retirement. The current CPI index, known as the CPI-W, while helpful, does not come close to staying in line with the skyrocketing cost of health care, which eats up a significant portion of every retiree's benefit.

The CPI-W understates inflation experienced by older people because it does not reflect the greater portion of seniors' incomes that are spent on healthcare, the cost of which is increasing at a faster pace that general inflation. About 27 percent of today's Social Security benefit, on average, is spent on Medicare Part B and D out-of-pocket costs alone, and this percentage is expected to continue rising over time.

Yet, despite the deficiencies of the current index, some in Congress are proposing cutting the COLA even further beginning as soon as January 2012 by moving to a chained-CPI formula. Switching to a chained-CPI will permanently cut COLAs for generations of retirees and the disabled, making it harder and harder for them to make ends meet. Recent analysis released by Representative Xavier Becerra has quantified the amount of the reduction associated with this change. According to this analysis, over time, the annual benefit cut will total almost $1,400.

The National Committee agrees that it is critical that the COLA be calculated based on an accurate formula. But if accuracy is the goal, Congress should change the COLA formula to factor in the large health care expenses most seniors face.

As a result of the recession, the past two years have yielded a zero COLA for the first time since the enactment of provisions that established automatic benefit adjustments for inflation. Although the Trustees are predicting a small COLA for 2012, for most beneficiaries the additional money will almost entirely go to cover the increase in their Medicare premiums.

The National Committee agrees that the current CPI-W needs to be replaced, but we believe that the chained-CPI index is the wrong way to go. Rather than producing an inflation adjustment that more accurately reflects the spending patterns of the elderly, the chained CPI moves in the opposite direction. Instead, the Congress should enact legislation that calculates the COLA by using the CPI-E, an index that more accurately reflects retirees' spending priorities that has been undergoing testing by the Bureau of Labor Statistics for decades.

Raising the Retirement Age

Another frequently discussed change to Social Security is to increase the age at which a retiree receives full benefits. Supporters of this proposal suggest that raising the age of eligibility for full retirement benefits to 70 or higher will reduce the deficit and increase Social Security's solvency. Any proposal to increase the retirement age is first and foremost a cut in benefits. For example, SSA's Chief Actuary estimates the proposal to raise the retirement age, included in the recommendations of the National Commission on Fiscal Responsibility and Reform, would reduce benefits by about 15 percent by 2080. Furthermore, it is important to note that the retirement age for full Social Security benefits has already been increased from 65 to 67 for anyone born in 1960 or later. This increase was enacted in 1983 as part of comprehensive legislation to strengthen Social Security's financing at a time when the program was facing an imminent financial crisis.

Proposals to increase the retirement age rest on the premise that, because people are living longer, they can continue working for more years. Although it is true that people, on average, are living longer, these longer life expectancies are by no means across-the board. Over the last quarter-century, the life expectancy of lower-income men increased by one year compared to 5 years for upper-income men. This is not surprising considering higher income workers are less likely to have physically demanding jobs and more likely to work in jobs with high-quality health coverage. Lower-income women have actually experienced a decline in longevity during that period. Yet the increases in retirement age apply to all workers, whether or not they are living longer.

In addition, increasing the retirement age would have a severe impact on workers who are not healthy enough to continue to work, even though they would prefer to do so, especially those who have physically demanding jobs. If the retirement age is increased, older workers will have no choice but to continue to try to work, unless they are able to qualify for disability benefits.

Finally, while many older workers may be healthy enough to work, jobs for them may simply not exist. Although studies have shown the many contributions older workers bring to their employers, most companies remain focused on the bottom line, which, due to higher health care costs, translates into a competitive disadvantage for older workers. Unless there is a dramatic change in employer attitudes or in the structure of our workforce, most workers will continue to retire well below their full retirement age. Any increase in the retirement age will only add to the difficulties older Americans will face in the years to come.

The National Committee is opposed to any effort to increase the retirement age. Workers who have paid into the Social Security system all their lives are entitled to a safe secure retirement. Increasing the retirement age will not further this goal.

Means Testing Social Security Benefits

Another option offered by those who want to cut Social Security benefits for the purpose of balancing the budget is to eliminate or otherwise limit the amount of benefits for higher-income individuals. In other words, they propose to means test Social Security. Changes of this nature assume many guises, ranging from benefit formula changes that make the amount of the benefit contingent on lifetime earnings to explicit means testing, where an individual's income determines the amount that is payable.

Changes of this nature fly in the face of the history of the program. It was created and has always been an earned right whose benefits upon retirement are determined by the contributions made during a person's working career. The relationship between earnings and benefits is a fundamental feature of the program, and one that distinguishes it from welfare programs and other non-earned entitlements. Means-testing Social Security would break this historic relationship and convert the program into a welfare program.

Those who would means-test Social Security argue that eliminating Social Security benefits for extremely wealthy Americans is an appropriate option for reducing the program's costs. Of course wealthy Americans can go without Social Security, and in fact there is no law that forces anyone to claim benefits. However, the wealthy make up only an extremely small portion of the American population. Disqualifying them from receiving Social Security will have little appreciable impact either on Social Security's solvency or the deficit. It will also take away a benefit that workers have paid for and earned during their working lives.

To make a significant change in Social Security's financing, benefits would have to be reduced for workers earning $60,000 to $70,000 annually—hardly wealthy people in anyone's book. In fact, a means-test included in the recommendations of the National Commission Fiscal Responsibility and Reform would reduce Social Security benefits for people with average lifetime earnings of only $43,000.

Americans understand that Social Security is their money, not the government's, and they hold that view irrespective of their financial situation at retirement. The National Committee believes that means-testing Social Security is an undesirable policy option that would break faith with American workers, would be unfair, and would undermine public support for the program.

Conclusion

Despite the impression left by some, the average Social Security retirement benefit today is modest— only $14,000 per year overall, with an average benefit for women of only $12,000. Any reduction in these benefits, whether from cutting the COLA, raising the retirement age, or instituting some sort of means test, will result in **real** cuts in benefit levels over time for both those retiring in the future and current beneficiaries. Cutting benefits should not be the first or even the last place Congress looks for budget savings or for strengthening the long-range financing of the Social Security program.

Sincerely,

Max Richtman

Max Richtman
Executive Vice President
and Acting CEO

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