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Social Security Taxes: Regressivity and Subsidies

By Robert J. Myers

Considerable discussion is occurring currently about the alleged regressivity of the Social Security taxes and the corresponding need for partial or entire financing of the Social Security program from general revenues, so as to eliminate this regressivity and effectuate more progressive taxation financing.[1] Closely allied with this movement is the pressure for such general-fund payments to help finance the Social Security system so that its benefit protection can be greatly expanded, to what the advocates thereof believe is a "more adequate" level.

Such additional source of financing seems by far the most feasible approach to expansion of the program because of the growing complaints of covered workers about the increasingly high direct payroll taxes, which are so apparent. The expansionists are eager to support any approach that will "justify" and make possible government subsidies to Social Security, which they prefer to call by the more appealing phrase "government contribution."

Before getting into the direct discussion of the topics of regressivity of Social Security taxes and government subsidies to the Social Security program, there will first be considered briefly the question, who pays Social Security taxes?

Who Pays the Social Security Taxes? Over the years, economists have considered the very interesting topic of who really pays the Social Security taxes. To the man on the street, this matter seems simple—the law clearly states that the employee pays a certain tax and that the employer matches it.

But to economists, life is not that simple. Great intellectual exercise can be obtained from speculating on the real incidence of taxes. All sorts of answers can be derived in theory. Moreover, the use of statistics (possibly with elegant simulation exercises on electronic data processing machines) can make the matter even more challenging and add the appearance of scientific precision.

Insofar as the employer tax is concerned, is it passed along to the consumer in the form of higher prices? Or is it really paid by the employee through lower wages? Or does it result in lower profits? Or is it paid partially by the Federal government (and thus by the general taxpayer, who is largely in the employee category), because employer Social Security taxes are counted as a business expense and thus result in lower employer income taxes?

This Issue in Brief

Public awareness of the bite of the Social Security tax and what the program is costing is the very reason for retaining the present financing method, says the author.

He contends the insurance concept in Social Security is "no myth" and that beneficiaries should expect to pay for it in the same way that they pay for other services or even food, without government subsidy to provide a price based on income.

Social Security taxes are not regressive when the benefits, heavily weighted in favor of the low-income worker, are considered, he concludes.

[1] For an eloquent presentation of this belief, see John A. Brittain, "The Payroll Tax for Social Security", The Brookings Institution, July 1972.

Then, as to the employee tax, does the worker really pay all himself? Or does the employer pay it as a result of wage demands being higher due to such tax deductions? Many employees are consciously or unconsciously economics-minded, and really consider not their gross pay, but rather take-home pay.

As to how to allocate the employer and worker Social Security taxes, note how they are treated by the U.S. Department of Commerce in the national income accounts. Such employee taxes are *not* considered as part of personal income (also the case for such employer taxes), while Social Security benefits are considered as part of personal income. (Rather anomalously, the exact reverse procedure is followed for private pension plans.) This treatment of Social Security taxes would seem to imply that the employee tax is paid by the employer, since it is not considered part of his income, even though all other taxes are so considered.

Still other authorities take a different approach in allocating the employer tax. Herriott and Miller allocate it on a 50-50 basis between employees and prices.[2] They also point out that others use quite different allocation bases, as follows:

(1) Council of Economic Advisers — all on employees.

(2) Tax Foundation — all on prices.

(3) Gillespie — 50-50, employees and prices.

Nonetheless, many economists currently feel the employee taxes are really part of the total compensation of employees and that therefore the employer Social Security taxes are paid by employees as a group. I question, on grounds of general reasoning, whether this can actually be proven.

[2] See Roger A. Herriott and Herman P. Miller, "Tax Changes Among Income Groups — 1962-68", *Business Horizons*, February 1972.

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In the field of mathematics, it is not possible to accomplish a solution for every problem posed. In fact, it can be shown in some cases that solutions are impossible—e.g., squaring the circle. The same situation can also prevail in the field of economics.

The incidence of taxation—although a fascinating subject and problem—is not susceptible to precise solution, because the initiation of a tax will often, if not generally, change the situation completely. For example, with the high personal income tax rates that we now have on upper incomes, salary increases for executives are made relatively large so as to produce a given net result after taxes. Similarly, self-employed professional people in establishing their fees consider not the gross amount to be asked, but rather their net return. Such results may not be produced by fully conscious thought by the individuals involved, nor will they follow on a one-for-one basis when taxes are changed, but over the long run this will very likely be so.

Employer Doesn't Pay Same for Each Worker

But even going along with the conclusion of many economists that Social Security taxes are, in the long run, borne by employees in the aggregate, we cannot logically or reasonably jump from that conclusion to the one that each employee is himself really paying the employer tax levied on his earnings. Some economists do take that jump in the dark, because they do not give adequate consideration to the mechanics of fringe benefits generally—both social-insurance and private-sector benefits.

In private employee benefit plans, the employer cost is usually expressed as an average percentage of payroll, but this does not by any means indicate that the employer is paying the same relative amount for each employee. In actual practice, it is usually the case that much more proportionately is paid by the employer for older employees, especially under pension plans and group life insurance plans, although the reverse can occasionally be so (e.g., maternity benefits). Similarly, the employer cost, although stated as an average for all his employees, may differ widely as between various branches of his business, and yet it is not customary to allocate such costs on an experience basis.

In the same way under the Social Security program, if it is assumed that, in the aggregate for the country as a whole, the employer taxes are really part of the remuneration of the employees and are therefore borne by them, then no reason exists to declare that the employer tax is allocated to each employee directly and individually. Instead, it seems more reasonable and logical to assert that the high-cost employee (the older one, or the low-paid one, or the one with dependents) receives a much higher portion of the employer tax than his own tax. And since this is a nationwide system with universal pooling, such allocation can occur beyond the walls of the particular employer, so that his employees might really have allocable employer contributions from other firms. Or, conversely, the employees of a particular employer might, on this risk-allocation basis, have assigned to them in the aggregate less than the amount of the taxes paid by their employer.

The foregoing discussion has referred only to the incidence of the employer tax and how it should logically be allocated to employees on a risk basis, rather than directly and individually proportionately. We may assume that the employee tax is paid entirely by each employee individually, although even this assumption is not necessarily and absolutely so. In fact, legally it has no foundation.

Similarly, the self-employed can logically be considered as a combination of worker and employer. Any excess that they pay over what the employee tax would have been on their earnings can be presumed to be employer taxes which are pooled for the benefit of the system as a whole.

How Progressive Should Taxes Be? Americans generally agree that taxation for overall governmental purposes should be of a progressive nature—i.e., higher-income persons should pay a higher tax rate than low-income ones. This seems fair and reasonable, but the question should be raised as to just how far such progressive taxation should go. After all, the extreme of progressive taxation is to have everybody with the same net income after taxes. And this would hardly be desirable on either philosophic or economic grounds as destroying incentives.

In actual practice—as is often the case with any type of governmental controls—the institution of a progressive tax or the making of any tax "more progressive" will often be counterbalanced by subsequent individual economic actions. Thus, for example, salaries of higher-paid workers and the fee and profit levels of the self-employed will usually be adjusted upward to reflect what the after-tax result will be, certainly over the long run, if not at once. In the same manner, too, organized labor has well in the back of its mind not merely what the gross pay is, but also the take-home pay.

Are Social Security Taxes Regressive? Critics of the payroll taxes that are used to finance the Social Security program are quick to point out that they are regressive (and therefore presumably evil, so that this financing basis should be changed). Their argument points out, correctly, that the tax rate is a constant percentage up to the maximum earnings base (currently $10,800 per year). The same tax rate is paid by all persons earning under the base, whereas those earning above it pay an *average* rate that is lower. Specifically, in 1973 the employee rate is 5.85 percent for earnings up to $10,800, so that the average rate for a man earning, say, $108,000 per year is .585 percent. Obviously, say the critics, this is an extreme situation of regressive taxes!

But when both sides of the coin are considered—both benefits and taxes—Social Security is definitely *not* regressive. Looking merely at the tax side is playing ostrich. The benefits are heavily weighted in favor of the low-paid workers. Thus, for example, the primary benefit (payable to a retired worker aged 65 at time of retirement or to a disabled worker) is 64.4 percent of average monthly wage (as defined in the Social Security Act) for a $300 per month worker, but only 40.4 percent for the $1,000 individual. Moreover, no significance can be attached to the fact that the average tax rate for those earning above the base is lower than for those at or below it, because no benefit rights are created on earnings above the base.

Benefits Are Service Bought by Individual

Social Security benefits can properly be considered as just another type of service and commodity that individuals are purchasing. The fact that the law compels them to make this purchase seems no more important than that they are compelled by a law of nature to consume food (which they must purchase). It seems democratic that the prices of goods and services should be the same for everybody, so that people are not subject to the stigma of being second-class citizens to whom government-required lower prices are applicable.

Those who argue that the Social Security payroll taxes are regressive have several solutions to offer. One is to increase the maximum taxable earnings base to a much higher level. In this way, the alleged regressivity would be reduced, although not eliminated. Such an approach seems undesirable, because it would expand the scope of Social Security benefits for the highest paid and thus diminish private-sector activities in the economic security field.

Another approach that is suggested by the critics of the payroll tax is to give special exemptions to lower-income workers so that all or part of the payroll taxes that they paid will subsequently be refunded to them through the income tax return. For example, the taxes on the first $600 might be refunded for everybody, so that the *average* net tax rate paid would have a decreasing trend as wages increase. But looking at the situation from the standpoint that Social Security is a type of financial service that individuals purchase, why should they not maintain their dignity and feeling of personal pride and self-reliance by paying the same for it (as a percentage of their income) as does the next man?

The prices of other goods and services could be considered to be equally (or more so) regressive as the payroll tax when measured against income. For example, the poor pay the same price for the same loaf of bread as do the rich, and yet their price expressed as a percentage of their income is much higher. Would it be advocated that, in order to eliminate regressivity of prices, all individuals should receive a card from the government showing their relative income status, and then the prices paid in stores would not be in dollars as at present, but rather in units according to income?

The crux of the problem is that those who favor so-called tax relief from the payroll tax for the poor do not recognize that the problem is on the income side and should be attempted to be solved directly and forthrightly—not merely by acting upon only one of the expenditure items.

Dangers of Government Subsidy to Social Security Program. Some claim the Social Security payroll tax is regressive, considering only the employee tax, and therefore relief should be provided by having partial financing from general revenues. Others go further and believe that the situation is doubly bad because the employee, in reality, pays the employer tax. The latter group suggest solving the problem by eliminating the payroll tax and substituting general-revenue financing, preferably obtained by raising income tax rates. They assert that what they consider to be the myth of the "insurance" concept in the Social Security program is what is really thwarting their efforts and that, if they can only destroy it, all will be well. Actually, the insurance concept is no myth and is, in fact, one of the real underlying strengths of the program. To destroy the insurance concept would very likely be to destroy the program and change it over to merely a needs-test public assistance program, with all the inherent weaknesses of such an approach.

Some persons who favor significant expansion of the Social Security program so as to have much higher benefit levels strongly oppose the views of those economists who attempt to deny its insurance principle and seek to eliminate or greatly weaken the payroll-tax financing basis. Nonetheless, such Social Security expansionists do favor the infusion of some government subsidy into the finances of the program, hoping that a little such subsidy (proportionately) will not weaken the insurance principle. Their reason for such a compromise suggestion is that the general level of the payroll tax is now considered a financial squeeze, and covered workers are beginning to complain more and more about the high level of the tax rate, so that any further benefit increases beyond those necessary to keep the benefits up to date with cost of living will be difficult to accomplish.

It is for this very reason that no government subsidy should be introduced into the payroll-tax-supported Social Security program on a permanent ongoing basis. If the system is continued on a completely self-supporting basis in the future, as it has been in the past, the covered workers and their employers will be fully cognizant of the costs involved as a result of the observable direct impact of the payroll taxes. They can then decide, on an informed basis, just how much further expansion of the governmental program they desire. Thus, full financing through the payroll tax makes the cost of the Social Security program readily apparent and therefore serves as a highly desirable cost control.

Some advocates of a government subsidy to Social Security assert this is nothing new and, in fact, is already being done. They point out that payments from general revenues are currently being made with respect to the cost of (1) gratuitous wage credits for certain military service, (2) hospital insurance benefits for certain uninsured aged persons initially blanketed-in at the start of the Medicare program, (3) uniform cash benefits for certain persons aged 72 and over who attained such age before 1972, and (4) the matching amounts with respect to the premiums paid for persons covered by Supplementary Medical Insurance.

None of these instances are really a precedent for a government subsidy on a permanent, ongoing basis to the portions of the Social Security program that are supported by payroll taxes. The military service wage credits merely involve the government as the employer. The two blanketing-in benefit provisions for benefits for persons already aged when the new protection was added relate to special transitory groups that will be phased out over a period of years. Finally, the matching of the SMI premium rates is essential in order to have a *voluntary* insurance program with uniform rates that is a good buy for all persons eligible.

In summary, then, it seems a completely different matter to inject general revenues into a payroll-tax-financed program as a permanent matter. To do so confuses the economic picture as to what the program really costs and who is paying for it. It is pure deception if workers—and employers too— are convinced by the expansionists that a government subsidy will come out of somebody else's pocket, and not their own, in the long run.