Share of Earnings Subject to OASDI Taxation: Importance, Trends, Mechanisms

Melissa M. Favreault

The Urban Institute

February 2011

What is the Taxable Share?

- Only earnings below the taxable maximum are subject to OASDI payroll taxes
  - Set at $106,800 per year in 2009-11
  - Indexed to account for wage inflation, but not increased in years in which there is no COLA
- Refers to the fraction of total earnings in OASDI-covered jobs subject to payroll tax
  - Currently an outcome of the actuarial model (rather than an assumption)

Urban Institute

The Taxable Share Reflects Earnings / Wage Dispersion

- One composite metric
- Infinite ways to reach the same level
- While we'll focus on the taxable share, other familiar measures are also informative
  - Gini coefficients
  - Percentile ratios: 90/50, 90/10
  - Percentile shares

Urban Institute

Why is the Taxable Share Important?

- Recent wage growth has been concentrated among high earners (Kopczuk et al. 2007)
- If this continues, payroll tax revenues could grow relatively slowly, affecting solvency

Urban Institute

The Benefit Formula's Progressivity Could Compound Effects

- Wage stagnation at the bottom generates relatively large payouts (compared to taxes paid) for low-wage workers
  - Important for DI growth
- The relationship between wage levels and OASDI benefits is complex because of:
  - Placement of the formula brackets
  - Availability of special benefits to spouses and survivors with limited or no work histories
  - 10-year (i.e., the 40 covered quarters) "vesting" rule for retired worker benefits
  - Benefits based on the top 35 years of earnings (rather than all earnings years)
  - Secondary effects on the average wage

Urban Institute

2007 Technical Panel Recommendations

- Additional research to better understand effects of wage dispersion on OASDI financing (O-1)
  - Aim to provide a stronger basis for projections
  - Possible implications of low-end stagnation on incentive to apply for DIs
- Rationale in TR should be more explicit, account for deviations in past (O-2)
- High- and low-cost ratios should provide a realistic range of uncertainty (O-2)

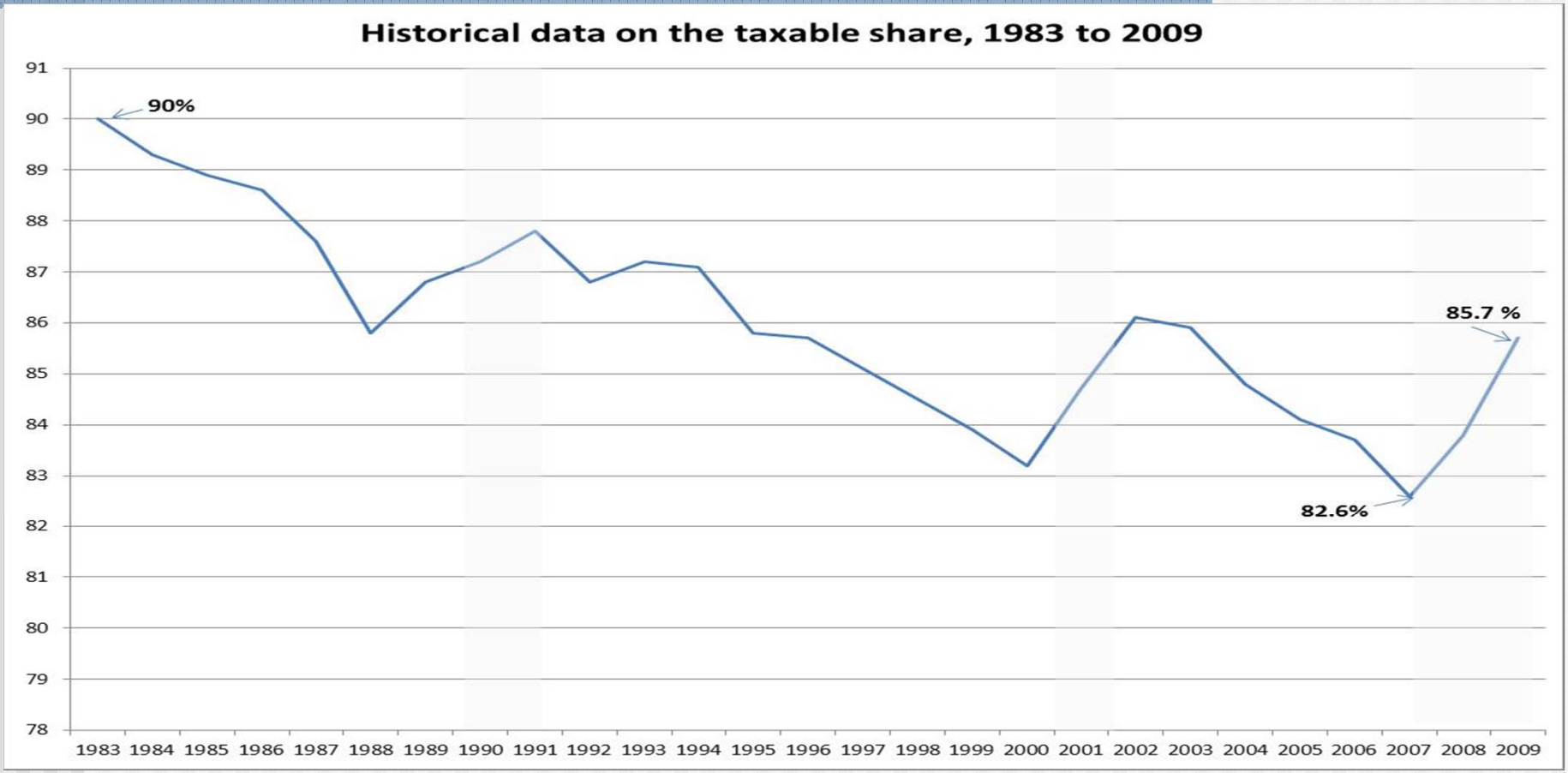
Urban Institute

Social Security Wage Definition

- Payment for services performed for an employer
  - Not just in the form of cash, but also cash value for compensation paid in another form
    - **Bonuses**, commissions, fees, vacation pay, cash tips of $20 or more a month, and severance pay
    - **Profit-sharing, stock bonus plans** under certain conditions
    - Exempts in-kind meals, lodging, gym facilities (but not cash payments in place of these)
- *Social Security Handbook* section 1300

Urban Institute

Share of Total Earnings in OASDI-Covered Employment Subject to OASDI Payroll Tax Declined through 2007, Climbed in Recessions



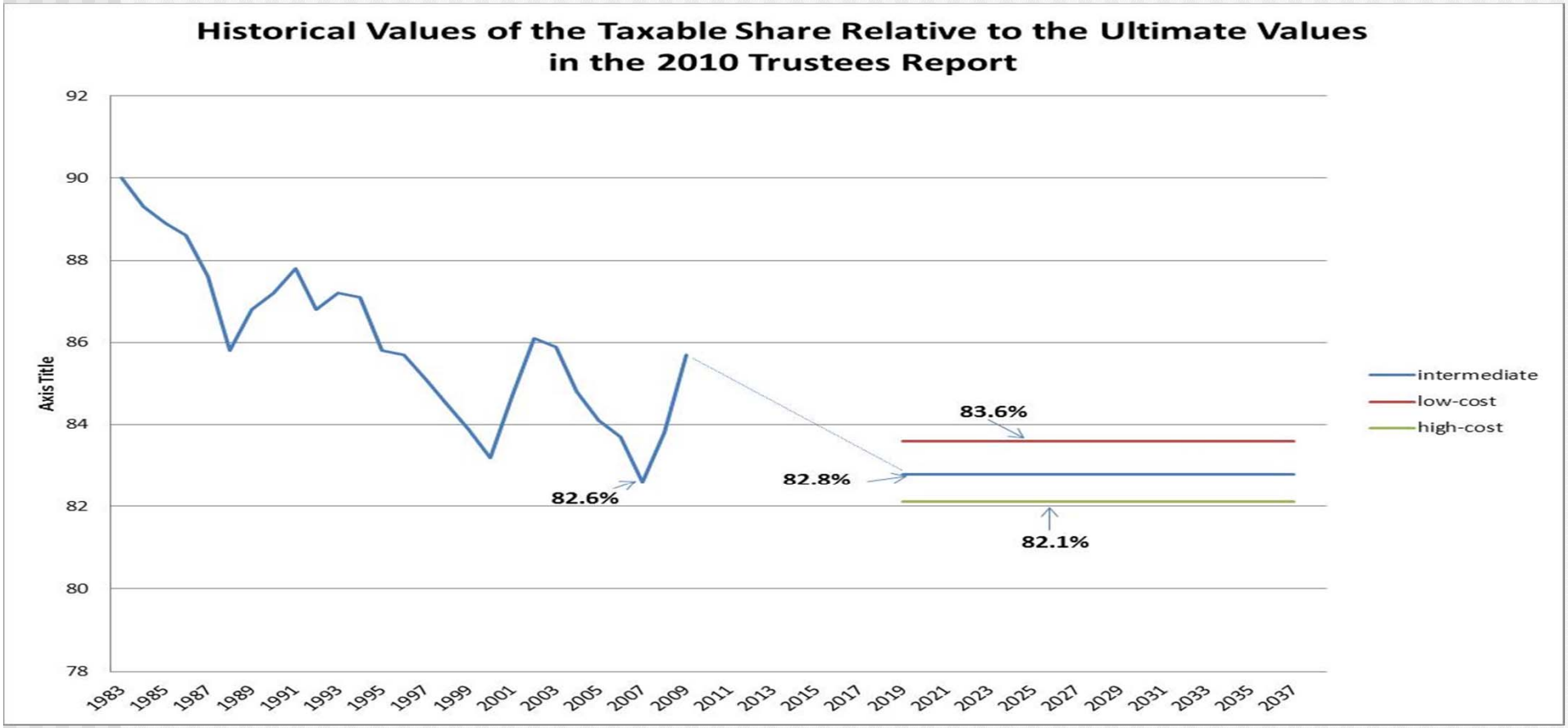
Source: Social Security Administration (2010), Table 4.B1

Notes: Axis does not start at zero, recessions shaded

Urban Institute

OASDI Trustees Project this New Level (near 2007 value) will Be Permanent

(after current recession plays out)

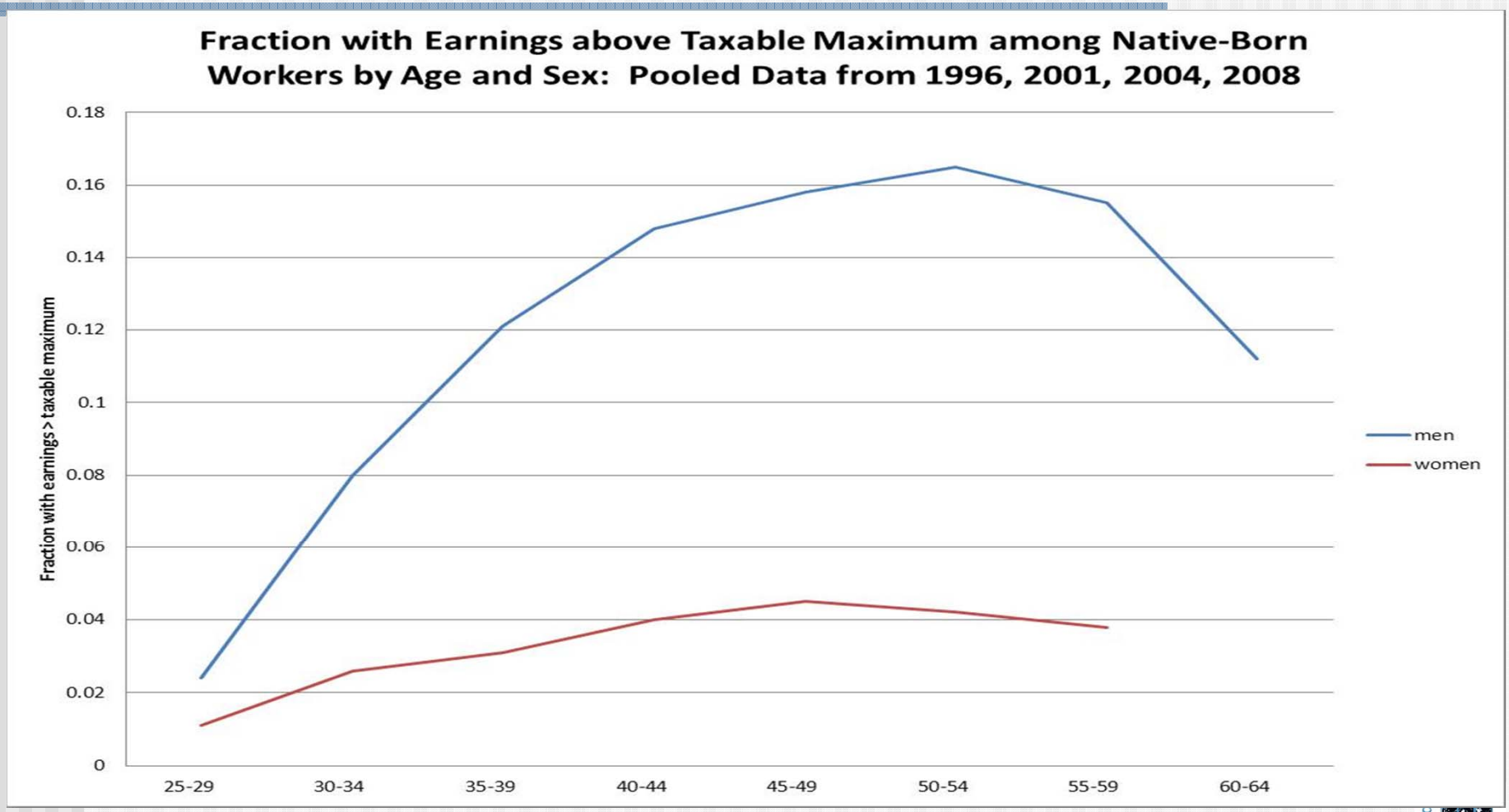


Source: Social Security Administration (2010), Table 4.B1, plus TR10

Note: Axis does not start at zero, interpolation from last historical to ultimate rate is simplified

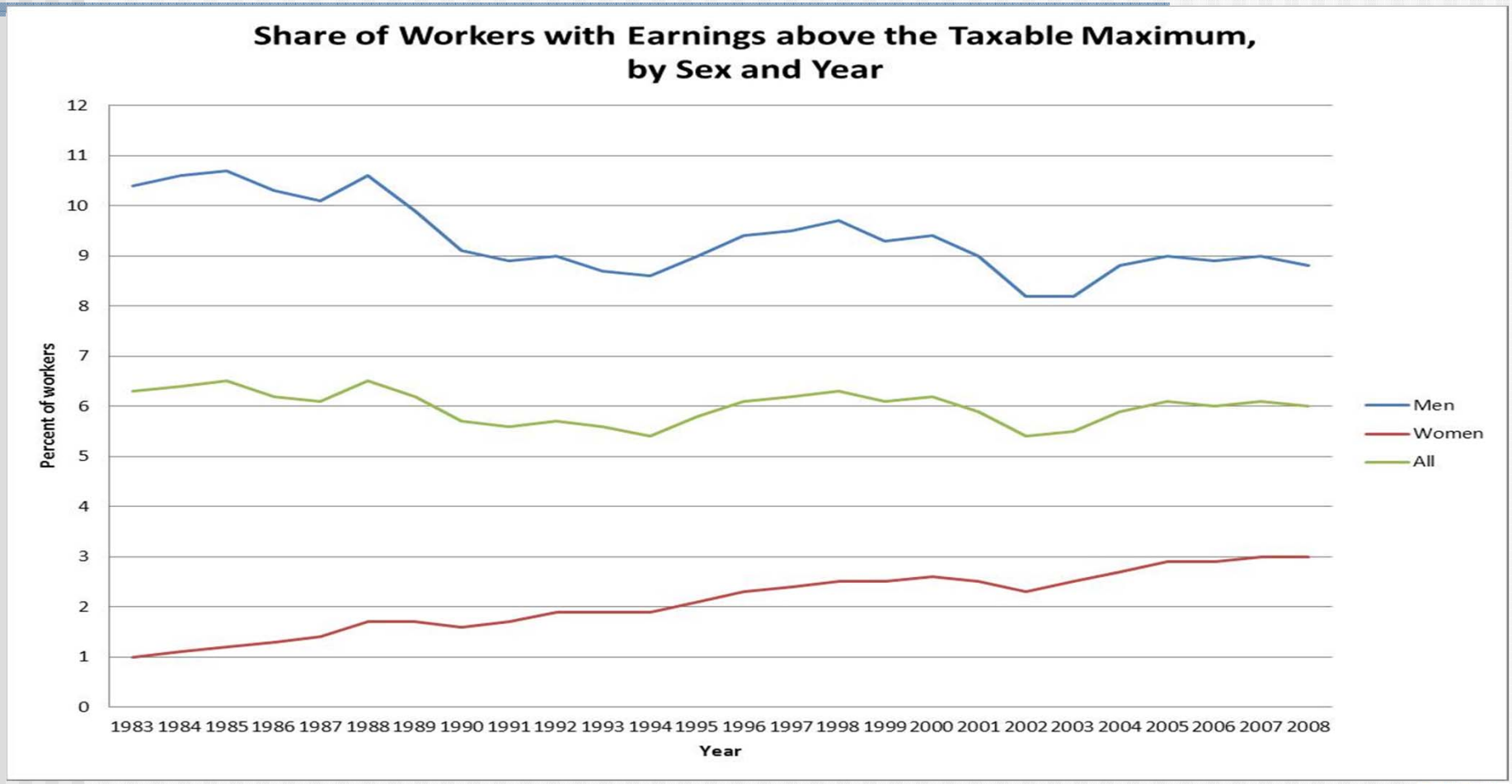
Urban Institute

Shares of Workers with Earnings Above the Cap do Vary Notably by Age and Sex



Source: Author's tabulations from SIPP

Overall Share of Workers with Earnings Above the Cap Remained Relatively Stable Despite Aging (Women's share up, men's down)

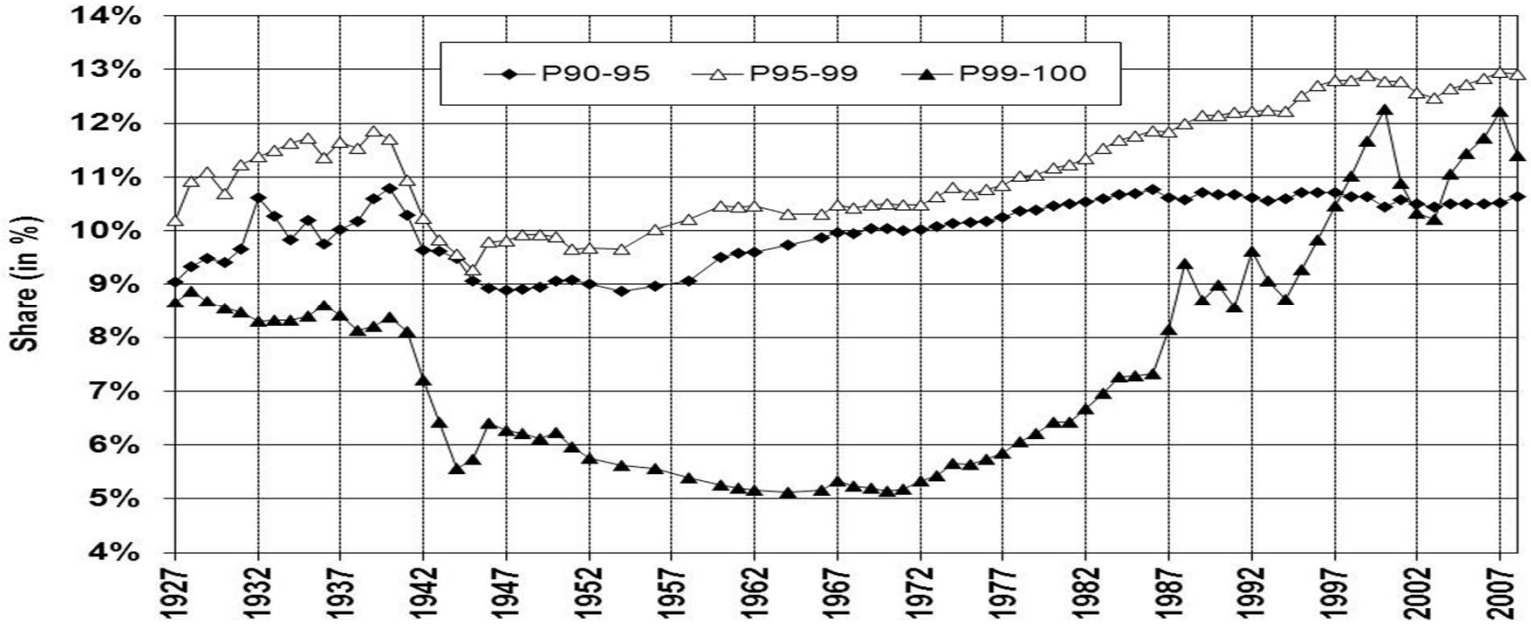


Source: Social Security Administration (2010), Table 4B.4

Urban Institute

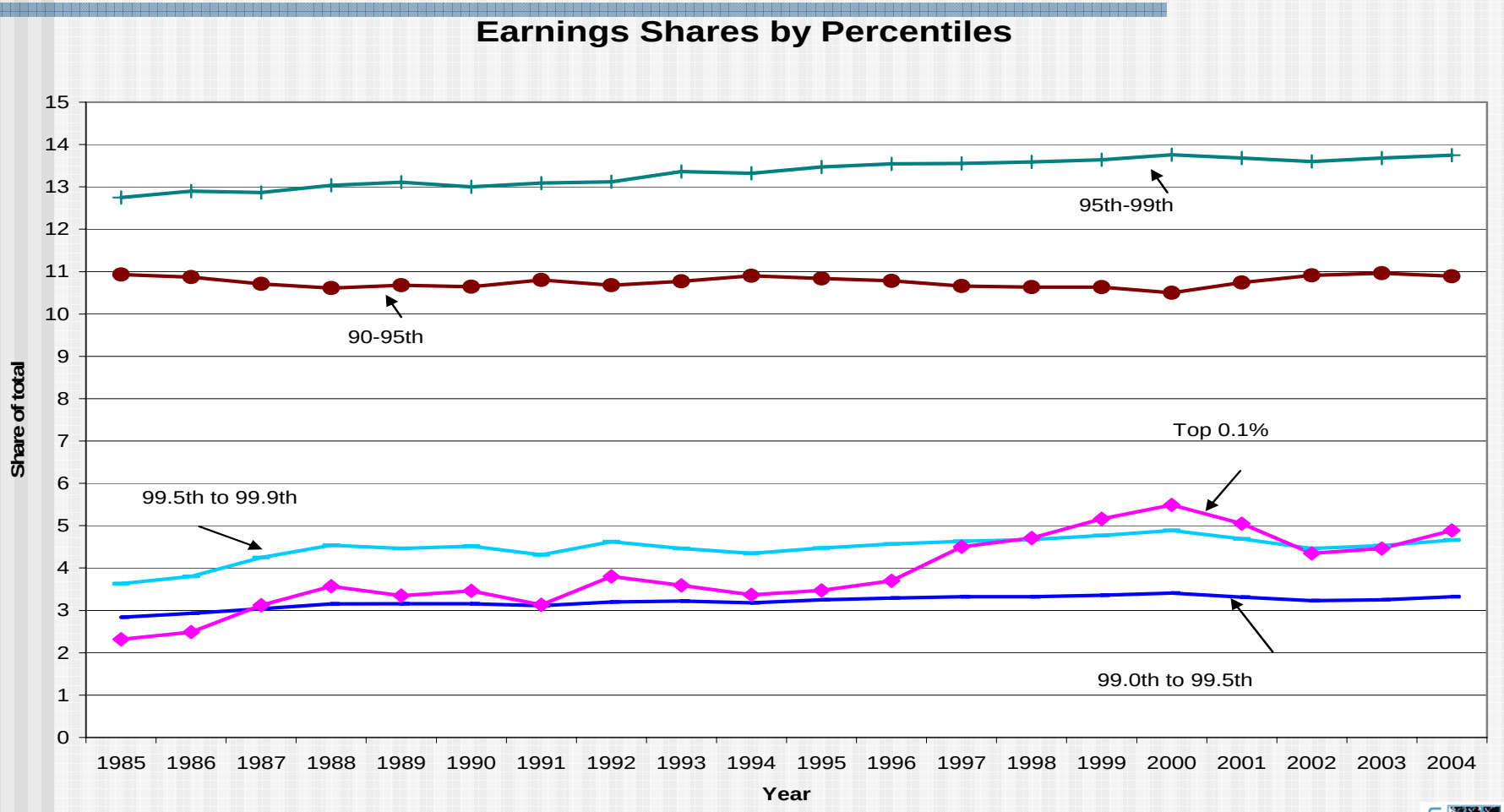
Earnings of the Very Highest Earners Largely Drove These Changes

Wage Income Shares for P90-95, P95-99, and P99-100, 1927-2008



Source: Piketty and Saez (2006, update)

Earnings of the Very Highest Earners Largely Drove These Changes



Source: Kopczuk and Song (2007), Table A.3

What Explains these Patterns?

- Skill-biased technological change (Autor et al. 2006)
  - Informative, but less so for upper tail
- "Superstars"
- CEO pay
- Role of institutions (e.g., Levy & Temin 2007)
  - Unionization/worker negotiating power
  - Policies: Minimum wage, tax policy

Urban Institute

What Explains these Patterns?

- Trade and globalization of labor markets
- Employee benefit costs (e.g. health insurance)
- Compositional change in labor force
  - Education gains slowing
  - Women's share growing (and their education is outpacing men's)
  - Immigration – great heterogeneity in the foreign-born population

Urban Institute

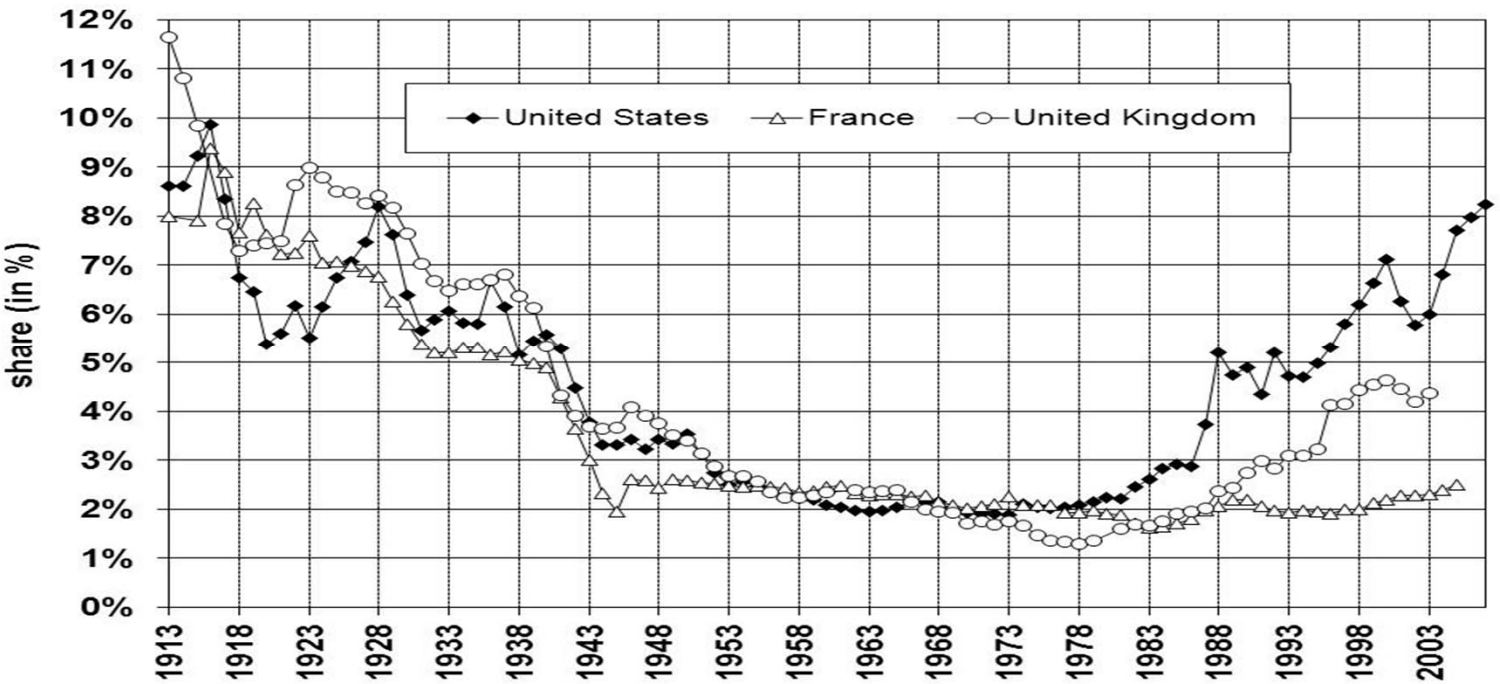
Can International Experience Inform us about Mechanisms?

- Data challenges (comparability, earnings/income)
- Atkinson, Piketty, Saez (2009)
- Over the past 30 years, very top incomes have increased substantially in U.S., other English-speaking countries (Canada, Ireland, UK, Australia, New Zealand), India, China
- Yet NOT in continental Europe, Japan
  - Analysis still missing major countries like Russia and Japan

The U.S. Appears to be Unusual

(Income not Earnings Data)

Top 0.1% **Income** Shares in the U.S., France, and the U.K.,1913-2007



Source: Piketty and Saez (2006, update)

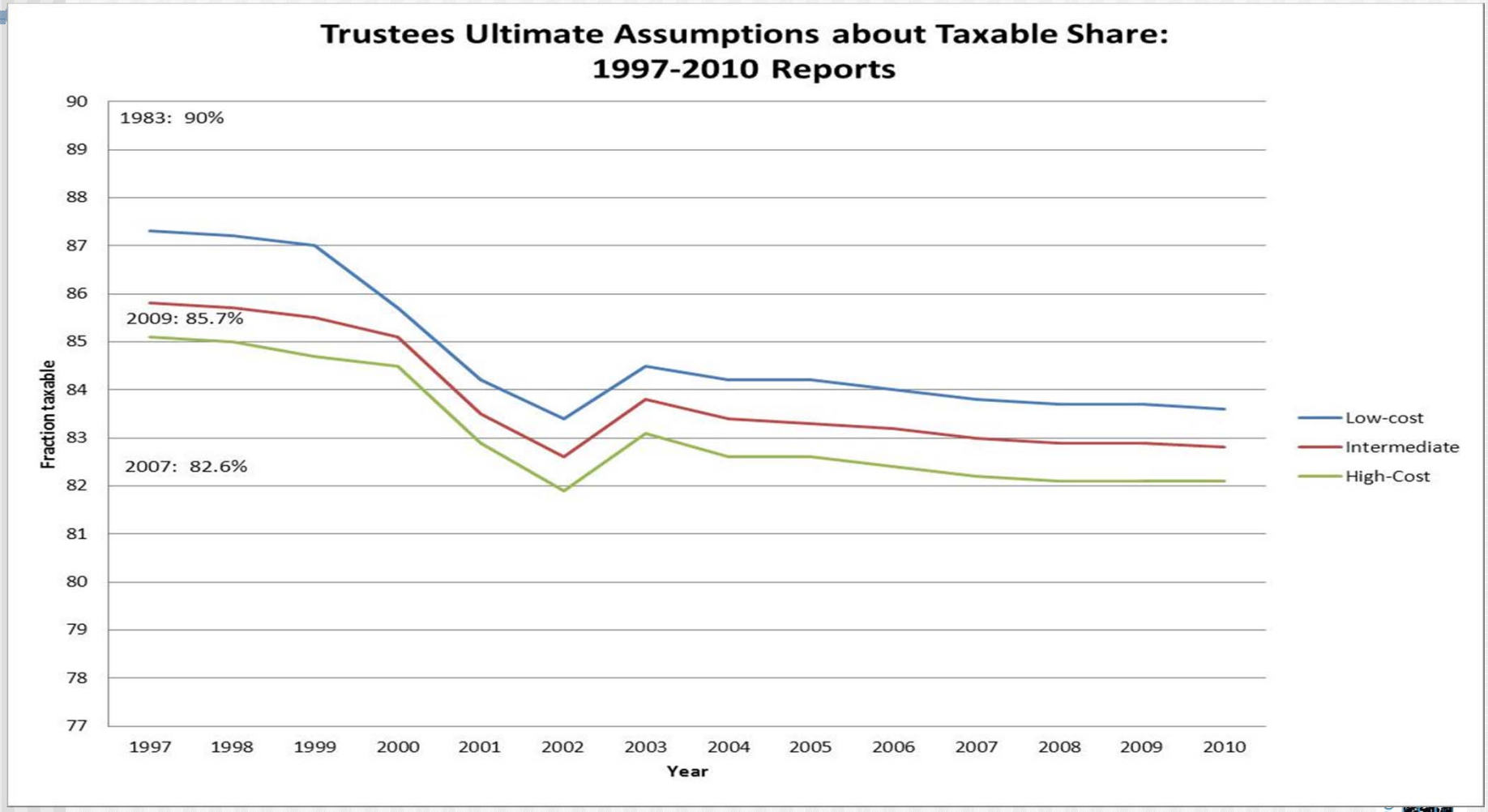
International Experience May Suggest Normative/Policy Component

- If economic forces alone were accounting for this, would patterns be more comparable in countries of similar economic development?
  - Counterargument: similar legal institutions

Urban Institute

High- and Low-Cost Values from Recent Trustees Reports Employ a Narrow Band

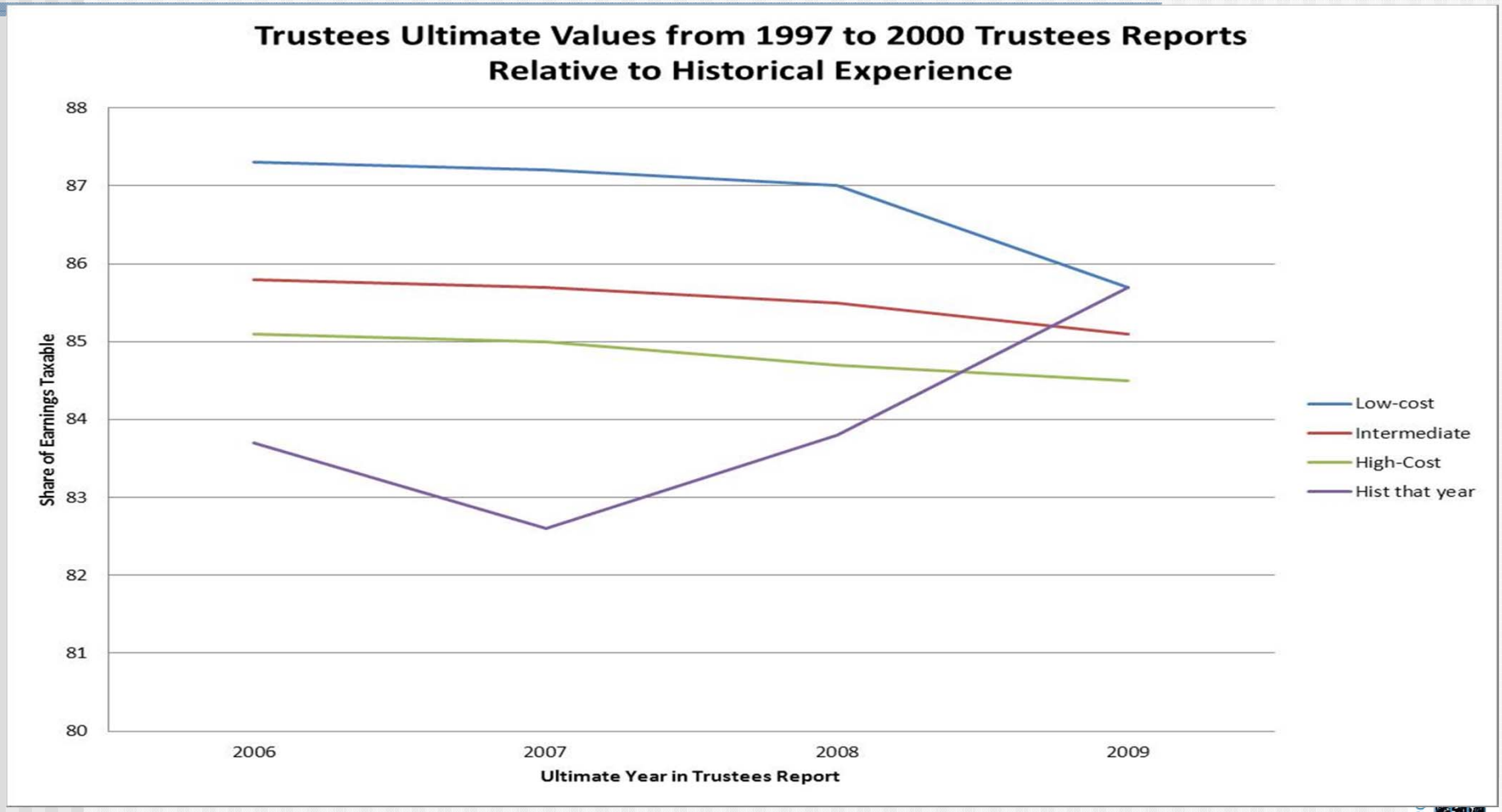
(approx. +/- 0.7 to 0.8 percentage point over the past 10 years)



Source: TRs (may not account for rounding) and historical data

Institute

Except in Recession, Historical Experience did not Fall Within the High and Low Bounds for Ultimate from Trustees Report Projections from 10-14 Years Ago



Source: TRs and historical data from Statistical Supplement

Institute

Preliminary Recommendations: Ultimate Intermediate Level

- Caveat: Still learning and researching, and look forward to discussion today
- Literature and expert judgment mixed
  - Some agree with Trustees' current assessment that we are at or near equilibrium so using the recently observed low from 2007 is reasonable
  - Others argue that the downward trend will continue for some time (after the economy recovers from recession)
    - The trend cannot continue indefinitely
  - Little/no argument for a reversal
- Balance tips modestly towards briefly continuing the trend toward concentration at the top in ultimate

Urban Institute

Preliminary Recommendations: Renewed Call for Research at SSA

- Concern about long-run effects of the recession on the labor market (youth) argues for close monitoring of data in near term
- SSA analysts have access to tremendous data, can continue to inform the research community

Urban Institute

Preliminary Recommendations: High- and Low-Cost Options

- The band seems relatively narrow given historical variability, uncertainty surrounding this outcome, and lack of consensus
- Recommend expanding this range
- Any sense of the sensitivity of cost estimates?

Urban Institute

Disclaimer

The opinions expressed here are my own, and not those of the Urban Institute, its board, or sponsors.