NATIONAL COMMISSION ON SOCIAL SECURITY REFORM
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WASHINGTON, D.C. 20503

September 7, 1982

MEMORANDUM NO. 50

TO: Members of the National Commission on Social Security Reform

FROM: Robert J. Myers
Executive Director

SUBJECT: Adjusting the Payroll Tax Rate to Compensate for the Erosion of the Tax Base Due to the Growth of Fringes

During the past 30 years, a progressively smaller portion of total compensation (cash wages + taxable fringes + non-taxable fringes) has been subject to the OASDI payroll tax. As tax-exempt fringe benefits have grown relative to total compensation, earnings subject to the payroll tax have been shrinking relatively. Whereas about 95% of total compensation was subject to the payroll tax in 1951, today only about 84% of total compensation is so taxable.

Continuation of this trend over the next 75 years -- as is assumed in the intermediate Alternative II-B cost estimates in the 1982 Trustees Report -- would erode the tax base, so that by 2056 only 62% of total compensation would be subject to the payroll tax. Under these projections, about one-third of the projected long-term deficit, averaging about 1.8% of taxable payroll, can be attributed to the erosion of the payroll-tax base assumed to result from the relative growth of non-taxable fringes.1/

To illustrate the importance to the program of such an eroding tax base, this memorandum describes a means of adjusting the payroll tax rate so as to offset the erosion of the payroll-tax base. As the "cash earnings plus taxable fringe benefits" portion of total compensation nationwide shrinks, the payroll tax rate would increase. While maintaining payroll-tax and income-tax exemption for fringes, this change would result in a payroll tax which taxes total compensation at a constant percentage rate. on average!

1/ See Chen, Yung-Ping, "The Growth of Fringe Benefits: Implications for Social Security," Monthly Labor Review, November 1981.

Note: This memorandum was prepared by Eric Kingson, a member of the staff.

Table 1 shows the tax rates that would result for employers and employees under each set of assumptions used in the 1982 Trustees Report, if -- beginning in 1991 -- payroll tax rates were adjusted so as to maintain a constant tax rate relative to total compensation, comparable with the situation in 1990. (Similar changes would be made in the tax rates of the self-employed.) The year 1990 -- when the final increase in the OASDI payroll tax rate is scheduled under present law -- is used as the base year for this procedure.

The advantages of this procedure are as follows:

(1) It compensates the Social Security system for the erosion of the taxable-payroll base without increasing the real tax burden relative to total compensation. In any given year, the total OASDI tax receipts would be the same proportion of total compensation as in 1990, when the scheduled tax rate goes into effect.

(2) It prevents significant losses of revenue that would result if the taxable-payroll base were allowed to erode. Consequently, it reduces the projected long-term deficit. For example, using Alternative II-B assumptions, this adjustment procedure would prevent the loss of revenue of 1.61% of taxable payroll on the average over the 75-year period.2/ Further, most of the increased tax revenue would occur during the period of the largest projected deficits (see Table 2).

(3) It stabilizes the cost estimates, which are sensitive to assumptions about changes in the proportion of total compensation that is taxable. Consequently, this procedure eliminates an important source of unpredictable variation in the OASDI cost estimates.

The disadvantages of this procedure are as follows:

(1) The methodology used to create the data base on yearly changes in the proportion of total compensation that is taxable may

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2/ There is a discrepancy between this figure and the figure used in the Chen article (which was about 0.6% of taxable payroll). Chen finds that, if there is no growth of fringes relative to total compensation, about one-third of the long-term financing problem is eliminated. Under the Chen assumption, workers pay larger amounts of payroll taxes because their cash wages are higher, but they also receive somewhat larger OASDI benefits, which partially offsets the savings resulting from the larger payroll-tax base. Under the tax-adjustment concept, the tax rate (rather than the taxable-payroll base) is larger. Thus, when one assumes a relative decline in taxable compensation relative to total compensation of 0.4% a year (as Alternative II-B assumes) --the only savings which result are those arising from increasing the tax rate to offset the declines in the taxable-payroll base.

have errors of precision and accuracy, and it could become subject to political manipulation if this indexing procedure were adopted. (It should, however, be pointed out that the agencies involved in the collection of these data have a long history of doing so in an impartial manner).

(2) The distributive implications of increasing the payroll-tax rates to compensate for erosion of the payroll-tax base due to the growth of fringes would place the greatest tax burden on the "least fringed" elements of the workforce. (This is an important criticism, but the same distributive problems exist for any payroll-tax rate increase.)

(3) Because the payroll tax is levied only on taxable compensation, the proposal increases the present incentives for the growth of non-taxable fringes.

(4) The proposal is complex.

In summary, this memorandum presents one procedure -- namely, adjusting the tax rates -- to compensate for erosion of the taxable-payroll base due to the growth of non-taxable fringes, as a means of protecting the Social Security system from automatic and erratic revenue losses.

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