

THROUGH THE DOUGHNUT HOLE: REIMAGINING THE SOCIAL SECURITY CONTRIBUTION AND BENEFIT BASE LIMIT

PATRICIA E. DILLEY*

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* Professor of Law, University of Florida Levin College of Law. I am grateful to the University of Florida Levin College of Law for summer-research-grant support for this project. I thank my able research assistants, all students in the University of Florida Levin College of Law Graduate Tax Program—Elizabeth Faist, Josh Kendrick, Marla DaVee, Jay Riffkin, and Martina Nethery.

INTRODUCTION

One of the most peculiar popular reactions during the health care reform debate of 2009 was the repeated assertion from many senior citizens that they did not want “government-provided health care,” accompanied in virtually the same breath by a vociferous warning to politicians to “keep your hands off my Medicare.”¹ The perception that Medicare is something other than government-provided health care indicates the political strength of the earnings-based entitlement and contributory payroll tax financing for Medicare and Social Security. These beneficiaries clearly feel that Medicare coverage belongs to them—is something they worked for, is something they have some sort of ownership interest in, and is not really provided by the government.² This public sense of individual ownership does not attach to other government programs, whether it be national defense or the interstate highway system, despite the fact that all are supported by taxes paid by Americans in one setting or another.

This singular view of Social Security and Medicare might seem bizarre to tax analysts who consider the Social Security payroll tax, or Federal Insurance Contributions Act (FICA) tax, to be not just one source of overall government revenue but also an inequitable, or at least unwise, one, primarily because it applies the same tax rate to all levels of earnings, and to a lesser extent because it taxes only the lower part of those earnings—up to the contribution and benefit base (limited to \$106,800 in earnings for 2010).³ Given the uneven economic impact of the tax system supporting

1. See, e.g., Carolyn Lochhead, *Overhaul Must Be Fully Funded, Not Worsen Deficits, Obama Says*, S.F. CHRON., July 25, 2009, at A1 (“Obama shot back against complaints that he is leading the nation to ‘government-run health care,’ calling such complaints part of an ‘ancient ideological battle’ that ignores the fact that 60 percent of Americans already receive government-provided health care under Medicare, Medicaid and veterans’ benefits.”); Bob Moos, *Medicare Changes Coming into Focus as Health Care Overhaul Moves Forward*, DALLASNEWS.COM, Oct. 18, 2009, <http://www.dallasnews.com/sharedcontent/news/healthscience/stories/101809dnbusmedicare.4472819.html> (“Ender said she was flabbergasted this summer when she heard seniors and others vehemently oppose any ‘public option’ insurance plan, but at the same time demand that lawmakers keep their hands off Medicare. ‘Don’t they realize that the traditional Medicare program is public insurance?’ she said.”).

2. See, e.g., Posting of Bob Cesca to The Huffington Post, http://www.huffingtonpost.com/bob-cesca/get-your-goddamn-governme_b_252326.html (Aug. 5, 2009, 06:45 EST) (“Another argument I’ve heard, by the way, is that seniors and veterans have *earned* their socialist health care. To which I usually respond: *I see. So socialized health care is a reward for a job well done? Can I quote you?*”).

3. See, e.g., THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., INCREASING THE SOCIAL SECURITY PAYROLL TAX BASE: OPTIONS AND EFFECTS ON TAX BURDENS (2009); MELISSA M. FAVREAU & GORDON B. T. MERMIN, URBAN INST., ARE THERE OPPORTUNITIES TO INCREASE SOCIAL SECURITY PROGRESSIVITY DESPITE UNDERFUNDING? (2008); Thomas L. Hungerford, *How Increasing the Payroll Tax Base Affects*

these programs, it may seem odd that the public has not developed the same phobia toward the payroll tax that it seems to have toward the income tax, much the fairer tax by most standards. Most “non-expert” taxpayers have little complaint about the FICA tax rate being essentially a flat tax (although most would of course prefer it to be a lower rate); however, the wage base limit or “tax cap” is widely excoriated by taxpayers as extremely unfair. In their eyes, it is plainly unjust that the wealthiest taxpayers pay no more in FICA taxes than someone earning just at the wage base.⁴

This sense of unfairness has likely been exacerbated over the last two decades of stagnant real-wage growth, coupled with increasing income and wage inequality.⁵ Each year, the FICA contribution and benefit base reflects a decreasing percentage of wages in the national economy, despite the automatic indexing provision that raises the base limit each year according to increases in average wages. The goal of indexing is to keep about 90% of wages in the economy within the limit and therefore part of the base for benefit accrual and FICA taxation, but the current provision has proved unequal to the challenge.⁶

The most recent worldwide economic crisis has created a new context for an old argument, as shrinking payrolls from higher unemployment are temporarily reducing near-term Social Security surpluses. Tax analysts, political commentators, and some members of Congress have variously called for payroll tax holidays to stimulate the economy, for different ways to finance Social Security that would lessen the tax pressure on employment, and ultimately, for wholesale reductions in program benefits

Tax Burdens, 115 TAX NOTES 643, 644–46 (2007); Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 1025–26 (2004).

4. Recent polling data indicates that 83% of Americans support elimination of the Social Security tax cap “so that workers earning more than [\$106,800] would pay Social Security tax on their entire salary just like everyone else.” VIRGINIA P. RENO & JONI LAVERY, NAT’L ACAD. OF SOC. INS., ECONOMIC CRISIS FUELS SUPPORT FOR SOCIAL SECURITY: AMERICANS’ VIEWS ON SOCIAL SECURITY 13 (2009), http://www.nasi.org/sites/default/files/research/Economic_Crisis_Fuels_Support_for_Social_Security.pdf.

5. See, e.g., Kyle Mudry & Justin Bryan, *Individual Income Tax Rates and Shares, 2006*, STAT. INCOME BULL., Winter 2009, at 5, 12, available at <http://www.irs.gov/pub/irs-soi/09winbulinincome.pdf> (stating that despite three years of tax rate increases, the rate paid by the top 1% decreased); Justin Bryan, *Individual Income Tax Returns, 2006*, STAT. INCOME BULL., Fall 2008, at 5, 10, available at <http://www.irs.gov/pub/irs-soi/08fallbulintax.pdf> (discussing that “[f]or 2006, average tax rates increased for each income category as incomes went up to AGI of \$5 million or less,” but that the average tax rate for income categories above \$5 million decreased); Scott Hollenbeck & Maureen Keenan Kahr, *Ninety Years of Individual Income & Tax Statistics, 1916–2005*, STAT. INCOME BULL., Winter 2008, at 136, 144 tbl.1, available at <http://www.irs.gov/pub/irssoi/16-05intax.pdf>.

6. See *infra* notes 80–85.

to reduce long-term costs of Social Security.⁷ Even before the depth and breadth of the financial crisis was fully realized, however, the issue of Social Security's possible long-term financing shortfall, and the use of wage-base-limit increases to address it, was raised during the presidential campaign of 2008.

As a candidate, President Obama suggested resolving at least part of the possible long-term financing problems for Social Security by raising the contribution and benefit base limit for some taxpayers.⁸ Details are a bit fuzzy, but generally the idea was to raise or eliminate the base only for workers with earnings in excess of \$250,000, thus creating a gap—a “doughnut hole,” so to speak—of no additional FICA tax liability for workers with earnings above the current-indexed base—set at \$106,800 for 2010—but below \$250,000.⁹ The political attraction of this proposal is

7. See, e.g., Hendrik Hertzberg, *Not Insane*, NEW YORKER, Mar. 23, 2009, at 23–24, available at http://www.newyorker.com/talk/comment/2009/03/23/090323taco_talk_hertzberg (noting that pundit David Frum and Senate Minority Leader Mitch McConnell support a payroll-tax holiday); Kimberly Palmer, *David Walker Explains Social Security's Future*, U.S.NEWS.COM, June 16, 2009, <http://www.usnews.com/money/personal-finance/articles/2009/06/16/david-walker-explains-social-securitys-future.html> (quoting the former U.S. Comptroller General suggesting, “We should consider adding on top [of Social Security] a supplement—an automatic individual savings account.”).

8. See Jason Furman & Austan Goolsbee, Op-Ed., *The Obama Tax Plan*, WALL ST. J., Aug. 14, 2008, at A13, available at <http://online.wsj.com/article/SB121867201724238901.html> (noting that Obama was considering plans that would ask individuals making over \$250,000 to pay more in total payroll taxes); Senator Barack Obama, Remarks at the AARP Life@50+ National Expo (Sept. 6, 2008), http://www.barackobama.com/2008/09/06/remarks_of_senator_barack_obam_70.php [hereinafter Obama Remarks] (proposing to cut and eliminate taxes for working families and seniors); Foon Rhee, *Candidates Offer Social Security Plans*, BOSTON GLOBE, June 14, 2008, at A5, available at http://www.boston.com/news/nation/articles/2008/06/14/candidates_offer_social_security_plans/. The proposal was modified in mid-August of 2008 to take effect much later, in 2017, which matches the point at which Social Security expenditures are estimated to begin exceeding total yearly revenues. BD. OF TRUSTEES, FED. OLD-AGE AND SURVIVORS INS. AND FED. DISABILITY INS. TRUST FUNDS, THE 2008 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND FEDERAL DISABILITY INSURANCE TRUST FUNDS 18 (2008), <http://www.ssa.gov/OACT/TR/TR08/tr08.pdf> [hereinafter 2008 BD. OF TRUSTEES REPORT]. The 2009 Trustees Report now indicates that expenses will exceed revenue beginning in 2016. BD. OF TRUSTEES, FED. OLD-AGE AND SURVIVORS INS. AND FED. DISABILITY INS. TRUST FUNDS, THE 2009 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND FEDERAL DISABILITY INSURANCE TRUST FUNDS (2009), <http://www.ssa.gov/OACT/TR/2009/tr09.pdf> [hereinafter 2009 BD. OF TRUSTEES REPORT].

9. See Soc. Sec. Admin., Contribution and Benefit Base, <http://www.ssa.gov/OACT/COLA/cbb.html> (last visited Apr. 26, 2010). Interestingly, it appears that the “doughnut hole” feature originated with the campaign of John Edwards

fairly obvious—it addresses the aforementioned popular notion of the unfairness of the FICA “wage cap” and also fulfills the President’s campaign promise to not raise taxes on anyone making less than \$250,000 per year. Little has been heard about the proposal since the election, and it is unclear whether it will see the light of day in any future Obama Administration proposals for Social Security. Nonetheless, the suggestion provides an opening for examination of the contribution and benefit base with fresh eyes.

Arguments about the general concept of a tax base have most often focused on the notion of a “comprehensive tax base” and, more recently, on whether we should tax consumption as a base, rather than income.¹⁰ Whatever the criteria for the “best” tax system are—efficiency, social welfare, distribution of tax burden, etc.—the debates frequently center on the question of the appropriate definition of the tax base: what exactly should be taxed, no matter what kind of rate is assessed? If income is to be taxed, the inevitable next inquiry is what constitutes income and how comprehensive that definition should be.¹¹ If consumption is to be taxed, the first inquiry, before addressing the appropriate rate level, is likely to be what kinds of consumption should be exempt in order to prevent the tax from imposing too onerous a burden on the most vulnerable segments of society.¹²

Much less attention has been paid in tax theory debates to the Social

when he was still in the race for the Democratic nomination. Teddy Davis, *Obama Floats Social Security Tax Hike*, ABCNEWS.COM, Sept. 22, 2007, <http://abcnews.go.com/Politics/Story?id=3638710&page=1> (quoting Edwards as saying, “I do think we need to have a bubble above \$97,000, probably up to about \$200,000, so we don’t raise taxes on middle-class families. . . . But, above the \$200,000, these millionaires on Wall Street ought to be paying their Social Security taxes”).

10. See, e.g., Deborah A. Geier, *The Taxation of Income Available for Discretionary Use*, 25 VA. TAX REV. 765, 767 (2006) (“The signature tax policy tension of the last two decades (at least) has been whether the federal tax base ought to reach ‘income’ or only ‘consumption’”); Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 920–38 (2005) (arguing for a progressive postpaid consumption tax as a way to implement a fair timing of taxation); Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745, 746–47 (2007) (“In the last ten or so years, [the tax policy debate] has increasingly come to denote instead replacing the income tax with a consumption tax.”).

11. For a more recent discussion on the comprehensive tax base, see David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955 (2004). As those authors note, several seminal works on the topic include Boris I. Bittker, *A “Comprehensive Tax Base” as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (1967); and Joseph A. Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63 (1967).

12. See McCaffery, *supra* note 10, at 812 (suggesting that a postpaid consumption tax is the “fairest and least arbitrary” tax system because it “burdens some but not all uses of capital and its yield, and for normatively attractive reasons”).

Security contribution and benefit base, even though many American workers pay more in payroll taxes than income taxes each year.¹³ True, economists and tax analysts have repeatedly criticized the FICA tax for its regressivity, but the range of analysis is limited mainly to the economic impact of a tax on wages, with less consideration of what the base itself should look like from any other policy perspective.¹⁴ What is different about the Social Security payroll contributions and earnings-based benefit system that leads analysts to marginalize it in the bigger picture of tax analysis?

Three elements of the FICA contribution and benefit base in particular differentiate it from other tax bases: (1) the inclusion of only wages, not other sorts of income, in the base;¹⁵ (2) the dollar limit that results in inclusion of less than 100% of all wages in the base; and (3) the use of the same base for both benefits earned and contributions paid. Perhaps the last element is the major reason the Social Security contribution and benefit base has remained essentially unchanged in structure for seventy years: it is part of a closed system that both requires revenues from a special levy to be dedicated to a single spending purpose and ties those expenditures to earnings recorded under the same limited tax system.¹⁶ The FICA structure's purpose is not simply to raise revenue but also to provide a method of financing that echoes the values underlying the system for old-age income benefits: those who work for a lifetime are the ones who earn entitlement to benefits.

Payroll-tax financing has made Social Security's revenue flow less susceptible to political manipulation precisely because it is part of this closed system, which includes an internal savings mechanism in the form of

13. See ANDREW CHAMBERLAIN & GERALD PRANTE, TAX FOUND., WHICH TAXES WEIGH MOST HEAVILY ON AMERICANS WITH DIFFERENT INCOMES?, (2007), <http://www.taxfoundation.org/files/ff80.pdf> (“On average, federal payroll taxes per household actually outweighed personal income taxes in 2004—\$7,069 per household compared to \$7,062.”).

14. See, e.g., CITIZENS FOR TAX JUSTICE, AN ANALYSIS OF ELIMINATING THE CAP ON EARNINGS SUBJECT TO THE SOCIAL SECURITY TAX & RELATED ISSUES 3–4 (2006), <http://www.ctj.org/pdf/socialsecuritytaxearningscapnov2006.pdf> (suggesting expanding the Social Security tax base to adjusted gross income).

15. Of course, most dedicated taxes are applied to a specific kind of income and expenditure—for example, the Highway Trust Fund is financed by federal gasoline taxes. 26 U.S.C. § 9503 (2006).

16. See, e.g., Charles Krauthammer, Op-Ed., *Forget 2042—The Real Crisis for Social Security Comes in 13 Years*, PITTSBURGH POST-GAZETTE, Feb. 19, 2005, at A-10 (stressing that the Social Security system is “pay-as-you-go”); Robert Novak, Op-Ed., *McCain Could Score Big with Payroll Tax Cut*, CHI. SUN-TIMES, Mar. 27, 2008, at 19 (“[T]he heavy payroll tax revenues not only provide enough money for Social Security but fund other programs, as well.”).

yearly surpluses retained and held as dedicated government bonds to be used to pay benefits whenever yearly revenues may fall short.¹⁷ The flip side of this stability, however, is that the entire system becomes the target of political attacks in any year payroll-tax revenues are projected to fall short of projected yearly benefit payments, even when trust-fund reserves are adequate for decades to bridge any financing gaps.¹⁸ In addition, the unified contribution and benefit structure seems to restrict, and possibly distort, thinking on options for changing the system's financing to meet changing economic circumstances.¹⁹

Current calls for "reform" of Social Security have little to do with any generally perceived need for change in the way the program delivers benefits. Rather, the limitations of payroll tax financing and the current wage base have created an opening for budget hawks and longtime opponents of Social Security to argue that the program must be targeted for reductions to address the federal deficit.²⁰ I suggest that the limits of the current base and payroll-tax system do not mean that the very necessary benefit system is too expensive but rather that we should examine other ways to increase dedicated revenues to fully fund the system if the current system's revenues fall short at some point. The problem is not that benefits

17. See, e.g., 42 U.S.C. § 401(a) (2006) (establishing a Federal Old-Age and Survivors Insurance Trust Fund); 42 U.S.C. § 1395i(a) (2006) (creating a Federal Hospital Insurance Trust Fund); 2009 BD. OF TRUSTEES REPORT, *supra* note 8, at 2 (reporting that the trust funds to support Social Security are adequately financed for the next twenty-five years, but that the combined funds are projected to become exhausted in 2037).

18. See Lori Montgomery, *Lawmakers Seeking Consensus on Social Security Overhaul*, WASH. POST, May 6, 2009, at A14 (describing potential negotiations between both political parties regarding major changes to Social Security).

19. See AARP PUB. POLICY INST., REFORM OPTIONS FOR SOCIAL SECURITY 6–7 (2008), http://assets.aarp.org/rgcenter/econ/i3_reform.pdf (discussing that trust-fund asset returns could be increased by investing in nongovernment securities.) See also Letter from David M. Walker, Comptroller General of the U.S., to Rep. Bill Thomas, Chairman, Comm. on Ways and Means, U.S. House of Representatives (May 6, 2005), <http://www.gao.gov/new.items/d05649r.pdf> (outlining options for social security reform, including tapping different revenue streams and increasing investment returns through broader investing and individual accounts).

20. The recent creation of the National Commission on Fiscal Responsibility and Reform by President Obama is seen by many as a result of pressure by long-time "deficit hawks" to focus on cuts in Social Security and Medicare as a primary way to address the national debt. See, e.g., Posting of James Ridgeway to Mother Jones, <http://motherjones.com/mojo/2010/02/obamas-stealth-entitlement-commission> (Feb. 19, 2010, 00:33 PST); see also Posting of John D. McKinnon to Washington Wire, <http://blogs.wsj.com/washwire/2010/02/18/left-and-right-take-aim-at-alan-simpson/> (Feb. 18, 2010, 18:20 EST) (discussing former Sen. Alan Simpson, named co-chair of the commission, and his history of supporting dramatic cuts in Social Security); Posting of Dean Baker to TPMCafé, http://tpmcafe.talkingpointsmemo.com/2010/02/17/alan_simpson_a_man_who_intensely_wants_to_cut_soci/ (Feb. 17, 2010, 04:41 EST).

are too generous—far from it—but rather that revenues are falling short of system needs.²¹ In contrast to the problems of Medicare and the health system generally, the costs of the Social Security cash-benefit system have not exceeded expectations (the number of baby boomers reaching retirement age beginning in 2005 was essentially known from the time of their births, after all), but payroll-tax income has not kept pace with expenditures.²²

If we are to think creatively about how to resolve any future financing issues for Social Security, it is critical to bear in mind that while the right to benefits is earned individually, benefits are paid for on a social basis. The amount of payroll taxes collected from or on behalf of any individual worker has nothing to do with her eventual benefit entitlement.²³ The payroll tax is a group-financing mechanism, not an individual investment or payment for individual benefits, and in fact is not the sole source of revenue for the program.²⁴ It is often overlooked in debates over Social Security's future financial path that the original designers did not contemplate a payroll tax as the primary financing mechanism at all, and certainly not once the program reached maturity. Indeed, substantial revenues from nonpayroll-tax sources have long been part of the total financing of the system.²⁵

For example, the Social Security trust funds receive general income tax

21. For a clear demonstration of how low Social Security benefits are, see PATRICIA E. DILLEY, NAT'L ACAD. OF SOC. INS., RESTORING OLD AGE INCOME SECURITY FOR LOW-WAGE SINGLE WORKERS, (2009), http://www.nasi.org/sites/default/files/research/Patricia_Dilley_January_2009_Rockefeller.pdf.

22. The average Social Security benefit payable to retired workers in January 2009 was \$1,153 per month. See Soc. Sec. Admin., Find an Answer to Your Question, http://ssa-custhelp.ssa.gov/cgi-bin/ssa.cfg/php/enduser/std_adp.php?p_faqid=310 (last visited May 8, 2010). For a discussion of the system's financing arc in the future, see 2009 BD. OF TRUSTEES REPORT, *supra* note 8, at 2 (predicting that the annual cost of Social Security will begin to exceed tax income in 2016 and that the system will become insolvent in 2037).

23. See 42 U.S.C. § 402(a) (2006) (stating that every fully insured individual who has attained age 62 and filed an application for benefits "shall be entitled to an old-age insurance benefit for each month" beginning with the first month in which that individual has reached retirement age and ending with the month preceding the month of his death); *id.* § 414(a) (defining the term *fully insured individual* as anyone with the required number of quarters of coverage, normally forty, by the time of application for benefits); *id.* § 413 (defining *quarter of coverage* for years before 1978 as a calendar quarter in which the individual was paid \$50 or more in wages, and for years after 1977, "each portion of the total of the wages paid and self-employment income credited" that equals the amount required for a quarter of coverage that year).

24. SOC. SEC. ADMIN., SOCIAL SECURITY: UNDERSTANDING THE BENEFITS 6–9 (2010), available at <http://www.ssa.gov/pubs/10024.pdf> (explaining the breakdown of paying into the system and receiving benefits out of the system). See 2009 BD. OF TRUSTEES REPORT, *supra* note 817, at 37 (noting that financial securities produce another stream of revenue).

25. 2009 BD. OF TRUSTEES REPORT, *supra* note 8, at 37.

revenues representing the federal government's employer share of payroll taxes for federal employees covered by Social Security as well as the revenues realized from taxation of Social Security benefits received by higher income beneficiaries.²⁶ Both of these revenue sources represent a further socialization of the costs of Social Security over all taxpayers, unassociated with any individual taxpayer's benefit accrual. This is not to say the contributory principle is unimportant, but focusing on the difference between earning benefits individually and paying for them as a society may yield some fresh insights on how the concept of the contribution and benefit base might be productively redesigned.

The heart of the matter is the very nature and basis for entitlement to Social Security benefits—the prevailing assumption that workers become entitled to benefits because they pay for that coverage through payroll taxes is simply wrong, both as a matter of philosophical principle and of law. Entitlement to Social Security benefits is attained by working, not by paying taxes, in keeping with the program's fundamental premise that all those who work for most or all of their lives are entitled to at least basic income security in their old age. The distinction is not mere semantics: separating entitlement based on effort from financing needs is a critical step to developing more flexible and equitable solutions to future financing problems, beginning with a fresh look at the contribution and benefit base limit.

The President's wage-base proposal has created an opportunity for a wholesale reimagining of the base limit. Beyond any specific merits or drawbacks this proposal might have, it serves as a convenient starting point for an exploration of the notion of the contribution and benefit base primarily from a Social Security programmatic perspective. The President has recently reiterated his support for increases in the contribution and benefit base to resolve, in whole or in part, any long-term or short-term financing issues for Social Security, but there may be equally compelling reasons to raise the base or change its calculations whether or not Social Security ultimately requires additional financing.²⁷

26. See 26 U.S.C. § 86(a)–(b) (2006) (providing for taxation of Social Security benefits for beneficiaries in designated higher income brackets); Social Security Act Amendments of 1983, Pub. L. No. 98-21, § 121(e), 97 Stat. 65, 83–84 (requiring that the amount of revenues equivalent to the “aggregate increase in tax liabilities” attributable to taxation of Social Security benefits be appropriated at least quarterly to the Social Security trust funds).

27. See SOC. SEC. ADMIN., UPDATE 2010 (2010), <http://www.socialsecurity.gov/pubs/10003.pdf> (showing that the 2010 wage base has not been stepped up from that of 2009). For the President's continued support for increasing the wage base to address long-term Social Security financing, see President Barack Obama, Townhall in Henderson, Nevada (Feb. 19, 2010), in REALCLEARPOLITICS.COM, http://www.realclearpolitics.com/articles/2010/02/19/obamas_townhall_in_henderson_n

Part I of this Article explores the original design of the Social Security contribution and benefit base as part of its benefit and financing system in an attempt to understand why a wage tax was chosen as the financing mechanism, why a limit was placed on the wages and earnings that would count, and why both benefits and taxes are tied to the same base. One reason for the muddled discussion of raising the wage base is perhaps the lack of understanding of its origins and function in Social Security; the frequent appeals for fidelity to “original principles” are too often based on either extremely sketchy knowledge of or thinly disguised hostility to the actual basic principles of social insurance generally and of the U.S. Social Security system in particular.

Part II discusses the current configuration of the contribution and benefit base, which is widely perceived as unfair by the people whose wages are entirely covered by it, in the context of Social Security program principles as well as of tax policy. The contribution and benefit base limit has been increased on an ad hoc basis many times throughout the history of the program—most recently by a schedule of increases enacted as part of the 1977 Social Security Amendments, the last of which occurred in 1992 (the schedule was accelerated in the 1983 Social Security Amendments).²⁸ Currently, the dollar limit of the base is indexed to the increase in average wages each year, so the question is whether there is any programmatic basis for increasing the dollar amount further, increasing it only for workers with earnings greater than a certain level, or eliminating the limit altogether. The importance of the contributory principle to the Social Security program is undeniable, but it is unclear that the present level of the base for both benefits and taxes is completely consistent with program goals or with at least some definitions of tax fairness.

Part III uses the doughnut hole proposal as a starting point for examination of possible alternatives to simply raising the contribution and benefit base beyond the indexed increases already provided under current

evada_104485.html. In response to a question on Social Security, the President suggests,

So what we've said is, well, . . . doesn't it make sense to maybe have that payroll tax [base] cut off at a higher level, or have people—maybe you hold people harmless till they make \$250,000 a year, but between \$250,000 and a million or something, they start paying payroll tax again—just to make sure that the fund overall is solvent. . . .

That's not the only way of fixing it, but if you made a slight adjustment like that, then Social Security would be there well into the future and it would be fine.

Id. A brief disclaimer: I will not be discussing the Medicare program, although I will address, for comparison's sake, the Medicare portion of the FICA tax (since 1984, 1.45% of the 7.65% total) and the elimination in 1993 of the wage base for that portion.

28. See Social Security Amendments of 1977, Pub. L. No. 95-216, § 101, 91 Stat. 1509, 1510–12 (increasing the tax rates to offset deficit); § 331, 91 Stat. at 1541–42 (reducing benefit increases); Social Security Amendments of 1983, Pub. L. No. 98-21, § 101, 97 Stat. 65, 67–70 (changing coverage for newly hired federal employees).

law. A host of enforcement and tax-equity issues are obviously raised by the idea of increasing or eliminating the wage base only for high-wage workers, but I focus mainly on the question of whether there is a coherent basis in Social Security program theory for anything like a doughnut hole wage-base configuration. Even if the proposal is never revived by the Obama Administration, examination of the reactions to it is useful in revealing both the political agendas and the lack of understanding of Social Security on the part of many of its critics. Ultimately, the primary objection to a doughnut hole structure may be practical rather than theoretical: Congress may have learned some hard lessons from the reactions to the legislated coverage gap in the Medicare prescription-drug plan about being careful when creating gaps in either tax or benefit structures that may have unintended consequences leading to uncertainty, anger, and gamesmanship behavior in taxpayers.²⁹ The distributional and political results may not be worth the accompanying static.

While the doughnut hole proposal might create as many problems as it would solve, it does suggest that the time may be right to redesign the concept of the wage base to raise additional revenue for Social Security and achieve the desired distributional results without invoking the notion of a gap in taxation at all. These solutions will require reexamination of actual, as opposed to politically distorted, fundamental principles of Social Security. This is not simply a question of efficient and fair tax policy: it is essential to consider how changing or eliminating the limit on the base, or decoupling the contribution base from the benefit base after a certain wage or income level, would affect the function and political viability of Social Security and the payroll tax. Payroll-tax financing, both the fixed rate and the automatically indexed wage base, provides political strength and certainty to Social Security but also imposes rigidity and lack of flexibility in the face of changing economic conditions.

Part IV analyzes some possibilities for reimagining and reformulating the current contribution and benefit base, mainly focusing on the notion of decoupling the tax base for financing purposes from the earnings base for benefit-accrual purposes while still retaining the contributory principle that has traditionally been the foundation of Social Security's widespread public support across income and class lines. While the contributory financing

29. See, e.g., Robert Pear, *Medicare Beneficiaries Confused and Angry over Gap in Drug Coverage*, N.Y. TIMES, July 30, 2006, at A14, available at http://www.nytimes.com/2006/07/30/washington/30medicare.html?_r=1&ex=1154404800&en=584f50d7ee778a42&ei=5087%0A (“The gap, the notorious ‘doughnut hole,’ is upsetting many beneficiaries, and it has become a potent symbol as politicians debate the merits of the new program.”).

system, as discussed below in Part I, is an integral element of the political economy of Social Security, there may be no compelling rationale for continuing to largely restrict the program's financing to payroll tax revenues.

Some critics of proposals to raise the base for contributions but not for benefit calculations have charged that such a separation would violate a fundamental principle of the earned entitlement of social insurance.³⁰ The same objection is also frequently raised against suggestions for partial financing of Social Security from non-FICA, general-tax-revenue sources, despite the fact that it already receives substantial nonpayroll-tax revenues. For reasons I discuss below, I think these criticisms are overstated and frequently based on a misunderstanding of the role of the contribution and benefit base in the Social Security program. The more serious objections to any separation of the base for benefits from the base for taxes are political, having to do with public support for the program, which may or may not be grounded in an accurate understanding of program principles. There are valid political as well as substantive policy points against increasing the wage base without increasing the benefit base, but it is not an open-and-shut case.

Much of the resistance to the idea of expanding partial general-tax-revenue financing is connected to the fear of the political consequences of loosening the bonds between contributory financing and the earned right to a benefit. The erroneous notion, exploited by conservative opponents of the program, that Social Security benefits are an individual investment rather than an earned right to a portion of the future productivity of society as a whole has hampered creative approaches to financing that would equalize the tax burden by requiring more from the upper-income taxpayers who benefit disproportionately from the economic and social stability that Social Security underwrites.

There is a strong case for leaving the wage base essentially unchanged for the time being, a decision President Obama appears to have reached during the campaign when he suggested a 2019 effective date for his base increase proposal.³¹ The larger issue that hangs over any discussion of changes to the Social Security base for policymakers, if not for tax theorists, is whether or when the system will need additional payroll-tax revenue to

30. See, e.g., Mickey Kaus, *Obama's "Mission Accomplished": What His New Faux-Presidential Seal Symbolizes*, SLATE, June 21, 2008, <http://www.slate.com/id/2193674/#bigdonut> (describing reactions to proposed Social Security reforms).

31. See Larry Kudlow, *One-on-One with Austan Goolsbee, Obama's Econ Man*, CNBC.COM, Aug. 28, 2008, <http://www.cnbc.com/id/26441455> (noting that the marginal rate would increase to 39.6% in "2019 at the earliest"); see also Furman & Goolsbee, *supra* note 8 (detailing Obama's suggestions for changing Social Security).

fully finance benefits as required by current law.³² The flurry of interest at the 2009 White House Fiscal Responsibility Summit in “fixing Social Security” demonstrates the tenacity of the belief in the need to overfinance current Social Security benefits in order to secure the program’s financial future thirty years from now.³³ However, depending on how one views the possibility that future congresses or presidential administrations would fail to honor the Treasury’s obligations to redeem Social Security bonds and provide the cash necessary to fully pay benefits, there is a strong argument that there is no need to talk about increasing the contribution and benefit base or any other aspect of the payroll taxes right now, or at least to have any such increase go into effect any time soon.³⁴

At the heart of continuing discussion of raising revenue now or years or even decades before the system actually needs any additional cash to pay benefits is the chimera of advance funding, a goal that runs counter to the fundamental “pay as you go” financing structure of the program.³⁵ The suggestion that Social Security needs more immediate revenue is a political question, not a programmatic or even tax-policy question, and the fact that Social Security financing is being discussed at all right now represents a victory of propaganda over analysis and a fundamental misunderstanding of Social Security itself.

32. For a discussion of the possible effects of the current economic crisis on Social Security’s financial stability, see Robert Greenstein, President, Ctr. on Budget & Policy Priorities, Remarks at the Fiscal Responsibility Summit (Feb. 23, 2009), http://www.whitehouse.gov/assets/blog/Fiscal_Responsibility_Summit_Report.pdf; see also *The Economic Outlook and Budget Challenges: Hearings Before the H. Comm. on the Budget*, 111th Cong. 44–49 (2009) (statement of Alice M. Rivlin, Ph.D, Senior Fellow, Brookings Institution).

33. See Joe Conason, *Reform Healthcare—and Leave Social Security Alone*, SALON, Feb. 23, 2009, http://www.salon.com/opinion/conason/2009/02/23/fiscal_responsibility_summit/ (arguing that the Administration should leave entitlement programs alone as Social Security will “be solvent on its own for decades to come”).

34. See generally 2009 BD. OF TRUSTEES REPORT, *supra* note 8.

35. For example, at a presidential campaign event in July 2008, John McCain attacked “pay-as-you-go” claiming that “Americans have got to understand that we are paying present-day retirees with the taxes paid by young workers in America today. And that’s a disgrace. It’s an absolute disgrace, and it’s got to be fixed.” Larry Rohter, *The Candidates Speak Off the Cuff, and Trouble Quickly Follows*, N.Y. TIMES, July 11, 2008, at A15. Of course, it is clear that pay-as-you-go financing is not a new phenomenon but rather was the intention since the program’s inception. As the Committee on Economic Security noted, “Expressed differently, the plan we advocate amounts to having each generation pay for the support of the people then living who are old.” COMM. ON ECON. SEC., REPORT OF THE COMMITTEE ON ECONOMIC SECURITY (1935), reprinted in *Economic Security Act: Hearing on H.R. 4120 Before the H. Comm. on Ways and Means*, 74th Cong. 45 (1935), <http://www.ssa.gov/history/reports/ces5.html> [hereinafter CES REPORT].

I. ORIGIN AND PURPOSE OF THE WAGE BASE LIMIT

The Social Security program—in the very limited original form of the Old Age Insurance—was initially enacted in 1935 as a response to the widespread financial crisis caused by the collapse of the international financial system, which severely shook both stock markets and financial institutions. The general economic effects of the crash and of the Great Depression in the 1930s affected almost all Americans, but the impact on the elderly was concentrated and devastating: their savings were lost when banks crashed, their pensions, for the lucky few who had any, were likely to have dried up, and their children, hit hard with lost employment, were much less able to help fill in economic gaps or even provide them a place to live.³⁶ It was impossible to claim that poverty and economic desperation were a result of individual shiftless or spendthrift behavior when economic collapse left at least a quarter of working-age men unemployed and essentially penniless.³⁷ A social response to a societal economic collapse was required.

Social Security was thus born out of economic necessity, but not as an instrument of immediate poor relief, which was the purpose of a different program altogether.³⁸ The primary objective of Social Security, particularly in the form that finally took effect after the 1939 fundamental

36. The Depression's impact, declared economist Paul H. Douglas in 1936, "increasingly convinced the majority of the American people that individuals could not by themselves provide adequately for their old age and that some form of greater security should be provide by society." PAUL H. DOUGLAS, *SOCIAL SECURITY IN AMERICA* 6–7 (1936). "The Depression deprived millions of older workers of jobs; it seemed unlikely that they would ever reenter the labor force." W. ANDREW ACHENBAUM, *SOCIAL SECURITY: VISIONS AND REVISIONS* 16 (1986). "A Massachusetts Census for Unemployment (1934) indicated an overall unemployment rate of 25.2%; the percentages for those aged sixty to sixty-four and sixty-five to sixty-nine were 27.2% and 29.8%, respectively." *Id.* at 201 n.21 (citing INDUSTRIAL RESEARCH DEP'T, UNIV. OF PA. WHARTON SCH. OF FIN. AND COMMERCE, *UNEMPLOYMENT IN PHILADELPHIA FAMILIES*, APRIL, 1931, at 20 (spec. rep. no. 1–8, 1931) and Herman B. Byer, *Employment Conditions and Unemployment Relief*, 43 MONTHLY LAB. REV. 1150, 1157–61 (1936)). Firms were unable to honor pension obligations and savings were lost. *See id.* at 16–17. "By 1934, over half of the elderly in America were impoverished. . . . Records of almshouses in 121 urban areas revealed that between 1929 and the end of 1933, the populations in those institutions jumped by almost 75 percent." NANCY J. ALTMAN, *THE BATTLE FOR SOCIAL SECURITY: FROM FDR'S VISION TO BUSH'S GAMBLE* 23 (2005).

37. *See* ACHENBAUM, *supra* note 36, at 16 (noting that the Depression posed a threat to everyone's futures and therefore the public became "more responsive to the problems of those growing older").

38. The Social Security Act of 1935 instituted the "Grants to States for Old-Age Assistance" program, which granted funds to each state, subject to certain requirements, to provide financial assistance for the elderly poor. *See* Social Security Act of 1935, Pub. L. No. 74-271, 49 Stat. 620, 620–22.

revisions, was to prevent future poverty in old age for workers who had spent a lifetime working, as well as for their spouses or surviving spouses.³⁹ It is important to keep this focus in mind when examining the financing mechanism of the payroll tax and the limitations of the wage base.

When the Roosevelt Administration sent Congress the original set of proposals that became the Social Security Act of 1935, the Old Age Insurance program was proposed to be financed through mandatory contributions from employees and an equivalent excise tax that employers would pay on employee earned wages, but there was no specific limit on the wages subject to the levy.⁴⁰ However, while manual laborers would be covered regardless of their level of earnings, workers earning more than \$3,000 per year in nonmanual labor were exempt from coverage under the system.⁴¹ The House Ways and Means Committee included the concept of the contribution and benefit base in its version of the legislation, expanding the number of workers covered to reach all workers in industrial or service work but limiting the “contribution and benefit base” to \$3,000 per year. Thus, workers making more than that base figure would have essentially partial Social Security benefit accrual and taxation, as is the case today.⁴²

39. See generally H.R. DOC. NO. 76-110, at 1-2 (1939), available at <http://www.ssa.gov/history/fdrstmts.html#1939b>.

40. Roosevelt’s advisors and many of the original designers of the program considered using general income-tax revenues rather than a dedicated wage tax to pay for Social Security. However, the income tax would have had to be greatly expanded to working people if it was not to be funded solely by the upper class, which then paid almost all income taxes. This was not a viable option at a time when only the wealthy were foreseen to ever pay income taxes and in addition would not have had Roosevelt’s desired political effect of creating an “earned entitlement” that could never be taken away from workers. See Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 BUFF. L. REV. 685, 689-91 (1988-89).

41. See JANEMARIE MULVEY & DEBRA B. WHITMAN, CONG. RESEARCH SERV., SOCIAL SECURITY: RAISING OR ELIMINATING THE TAXABLE EARNINGS BASE 1 (2008), <http://aging.senate.gov/crs/ss9.pdf> (noting that only very rarely would a manual laborer exceed \$3,000 in yearly earnings at that time).

42. “The term ‘wages’ does not necessarily apply to the total remuneration received from the employer by the employee; the term includes only the first \$3,000 of wages received by an employee from his employer with respect to employment during the calendar year.” H.R. REP. NO. 74-615, pt. II, at 21 (1935), available at <http://www.ssa.gov/history/reports/35housereport.html>. Thus, the Committee on Economic Security report, CES REPORT, *supra* note 35, focused on covering workers in low paying jobs, as very few manual laborers would have had more than \$3,000 in wages at that time, while the House bill, which ended up being essentially what was finally enacted, focused on covering all workers, but only wages of those workers up to a certain point. It is interesting that the House bill was essentially more economically democratic than the Administration’s approach; covering workers who are in low-wage jobs presupposes more or less fixed employment at that level, whereas covering all workers (or at least all workers in industrial employment) but only earnings up to a fixed level allows for both mobility and fluctuation in earnings levels from year to year.

The original 1935 benefit formula was tied to the \$3,000 per year base but was to be applied to all cumulative covered earnings over the worker's career, not counting more than \$3,000 per year.⁴³ This version of Social Security never actually took effect as no benefits were paid prior to the enactment of the 1939 Amendments and the benefit structure was modified in those amendments to be based on average, rather than cumulative, wages up to the base⁴⁴ and to be substantially more progressive as well.⁴⁵ The payroll contribution made by employees and the excise tax paid by employers was also limited by the \$3,000 base and collected through wage withholding, an innovation made necessary by the widespread coverage of workers who for the first time were subject to a federal obligation.⁴⁶

Prior to the enactment of Social Security, the federal income tax affected a small minority of U.S workers, almost solely those at the top end of the

43. Benefits were to be calculated at 1/2 of 1% of the first \$3,000 earned plus 1/12 of 1% of the next \$42,000 earned plus 1/24 of 1% of the amount earned exceeding \$45,000. See Social Security Act of 1935 § 202, 49 Stat. at 623.

44. The change from cumulative to average covered earnings as a base to which the formula was applied was done deliberately to achieve somewhat higher ultimate benefits for lower wage workers. See ACHENBAUM, *supra* note 36, at 32. In a 1938 report, the Advisory Council on Social Security stated the following:

In addition, the Council believes that careful study should be given to the substitution of an *average* wage formula for the *accumulated* wage formula incorporated in the present Act. An average wage formula would more readily permit an increase in the early benefit payments and enable eventual costs to be kept within the limits prescribed under Recommendation II. Furthermore, in Recommendation VI the Council is on record as approving the average wage formula for computing survivorship benefits. By basing all benefits under Title II upon average wages, simplicity of understanding and administration is achieved as well as a consistent and related pattern of benefit payments.

ADVISORY COUNCIL ON SOC. SEC., REPORT OF THE 1938 ADVISORY COUNCIL ON SOCIAL SECURITY TO THE SOCIAL SECURITY BOARD AND THE SENATE FINANCE COMMITTEE (1938), <http://www.socialsecurity.gov/history/reports/38advise.html>.

45. The formula applied to the average monthly wage (AMW) was 40% of the first \$50 plus 10% of the next \$200, with the total result increased by 1% for each year with at least \$200 of creditable wages. The result of applying that benefit formula to the AMW was the "primary insurance amount," or PIA, and all other Social Security benefits to be paid on the worker's account (spousal benefits, for example) were (and still are) calculated as a percentage of PIA. See GEOFFREY KOLLMANN, CONG. RESEARCH SERV., SOCIAL SECURITY: SUMMARY OF MAJOR CHANGES IN THE CASH BENEFIT PROGRAM: 1935-1996, at 2-3 <http://www.ssa.gov/history/pdf/crs9436.pdf>.

46. For a discussion of the innovation of wage withholding, see Joseph J. Thorndike, *Historical Perspective—The Price of Reorganization: Fewer Audits and Tax Forgiveness*, Sept. 2, 2002, TAXHISTORY.ORG, <http://www.taxhistory.org/thp/readings.nsf/ArtWeb/9A29924C03AB9E1E85256DFE005981F9?OpenDocument> ("World War II brought two major changes to the federal tax system. First, it dramatically expanded the individual income tax, boosting the number of taxpayers sevenfold in just six years. Second, it introduced wage withholding to help new taxpayers meet their obligations.").

income scale.⁴⁷ The insistence of the designers of Social Security on direct employee contributions to the system required a more expansive payment mechanism than the income-tax model could provide. In addition, it seemed important to distinguish Social Security contributions—under FICA—from taxes and to keep the whole system as far from the IRS as possible.⁴⁸

Therefore, employers were enlisted in the cause of enforcement and collection of FICA contributions: charged with withholding the employee contributions and then forwarding both employee contributions and employer shares to the Bureau of Old Age Benefits for processing.⁴⁹ This collection system had a number of effects all by itself, not least making this contribution extremely visible to both workers and employers, and inspiring in workers contributing to the system a sense of connection to their future Social Security benefits.⁵⁰ The early information given to workers and the public generally about Social Security deliberately characterized the employee share of FICA as a contribution rather than a tax to emphasize each individual's relationship to the system and to his eventual entitlement to benefits.⁵¹

While the general point of the first Social Security Act in its entirety was to alleviate economic hardship for working people fallen on hard times, the original \$3,000 figure for the contribution and benefit base for the Old Age Insurance portion of the Act was high enough to cover most American wages even though large categories of workers were initially left out of the system altogether.⁵² Less than 10% of salaries exceeded \$3,000 per year at

47. See Jones, *supra* note 40, at 689 (stating that only about 3.7% of the total population paid federal income taxes under FDR).

48. See ACHENBAUM, *supra* note 36, at 28 (explaining that social security officials released a campaign to assure American workers that “the taxes they were paying were like insurance premiums”).

49. See W. ELLIOT BROWNLEE, *FUNDING THE MODERN AMERICAN STATE, 1941–1995: THE RISE AND FALL OF THE ERA OF EASY FINANCE* 92 (1996).

50. Nancy J. Altman, *Social Security and the Low-Income Worker*, 56 AM. U. L. REV. 1139, 1152–53 (2007) (“Nevertheless, to the extent that people have made specific monetary payments to ensure receipt of their own benefit, the moral obligation of government to honor the promises made is much stronger than it would be otherwise. Americans appropriately have a sense of contributing toward their own retirement and feel good about receiving those benefits. This sense of entitlement contributes to the program’s success.”).

51. ALTMAN, *supra* note 36, at 33–34 (discussing FDR’s intent that the social security program be conceived of as an insurance program).

52. Farm workers and minority workers were especially affected. See generally Dorothy A. Brown, *Race and Class Matters in Tax Policy*, 107 COLUM. L. REV. 790 (2007). “Policymakers expected that all workers would someday participate in the old-age insurance plan, but practical administrative and constitutional considerations persuaded them to limit coverage at first. Roughly 9.4 million workers (including farmers, domestic servants, and government employees) were excluded from the new program.” ACHENBAUM, *supra* note 36,

the time, and only 9% of the population made more than \$2,500 a year in 1939, so the administration's 1935 proposal effectively covered the entire wage of all manual laborers in industrial jobs, few of whom would make as much as \$3,000 per year, as well as most nonmanual workers in industrial work.⁵³ The focus was on getting people benefit coverage and only to a lesser extent on how to pay for those benefits.⁵⁴

The drafters of the 1935 House bill that set the contribution and benefit base at \$3,000, however, made an explicit decision to tie the base for earnings covered by Social Security for benefit purposes to the base for tax purposes.⁵⁵ When that original, very limited Social Security program was rewritten from the ground up in the 1939 Social Security Act Amendments and expanded into a true social insurance program, the contribution and benefit base was one of the few elements to carry over essentially unchanged.⁵⁶

A critical point is that neither the 1935 program nor the 1939 amended program, which essentially established the basic program that is in operation today, contained any direct relationship between benefits paid out and amount of taxes paid in. It is true that the original legislation was based on a contributory annuity model, similar to private annuities

at 23. "That most of the poorest workers—such as Southern blacks—were excluded from coverage suggests that policymakers were willing to make politically expedient compromises." *Id.*

53. REPORT OF THE SOCIAL SECURITY BOARD, H.R. DOC. NO. 76-110, at 8–9 (1939), available at <http://www.ssa.gov/history/reports/38ssbadvise.html>. The 1939 Census showed that only 9% of the population made more than \$2,500 per year, so clearly almost all of the wages of those workers covered by the program were included in the contribution and benefit base. Many categories of workers were left out of the original Act, for example, farm laborers, so that far fewer than 90% of all workers were actually covered by the original bill. See BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, POPULATION—SPECIAL REPORTS: EDUCATIONAL ATTAINMENT BY WAGE OR SALARY INCOME: 1940 (1946), <http://www.census.gov/population/socdemo/education/p46-5/p46-5.pdf>. Coverage was greatly expanded in the 1939 Act and later legislation.

54. "In 1935, the designers of Social Security, President Franklin Roosevelt's Committee on Economic Security, did not recommend a maximum level of taxable earnings in its plan, and the draft bill that President Roosevelt sent to the Hill did not include one. The bill emphasized who was to be covered by the system, not how much wages should be taxed. Being in the midst of the Depression, the Administration's attention was on the large number of aged people living in poverty." See MULVEY & WHITMAN, *supra* note 41, at 1.

55. See generally H.R. REP. NO. 74-615, pt. 2, at 19–22, 29–33 (1935) (establishing a system where the old-age benefits are paid directly from the federal Treasury, which is authorized to collect taxes on wages not exceeding \$3,000).

56. See Social Security Act Amendments of 1939, Pub. L. No. 76-379, § 209, 53 Stat. 1360, 1373–78. The 1939 amendments added two new categories of benefits: dependent's benefits and survivor's benefits. In addition, the amendments "increased benefit amounts and accelerated the start of monthly benefit payments." See Soc. Sec. Admin., History: 1939 Amendments, <http://www.ssa.gov/history/1939amends.html> (last visited April 27, 2010).

purchased through insurance companies today, although with guaranteed benefits based on a benefit formula applied to cumulative earnings under the system.⁵⁷ However, that model was essentially abandoned only two years after contributions began to be collected and before any benefits were paid. The 1939 Amendments remade the 1935 Old Age Insurance program, which would have provided proportional benefits only for workers, into Old Age and Survivors Insurance (OASI), a true social-insurance program with a weighted benefit formula and spousal and survivor benefits.⁵⁸

The common element, from 1935 up to the present, is that benefits are calculated based on earnings covered by Social Security, while taxes withheld are an entirely separate system, with no connection to benefits paid out.⁵⁹ Critics of Social Security are fond of comparing it to individual annuities or investment plans, but a more accurate private system comparison, albeit not precisely similar in all respects, is the employer-sponsored defined-benefit pension plan, in which benefits are accrued based on years of employment and financed by employer contributions to a trust, based on estimates of future financing needs.⁶⁰ The question that should be asked is why was payroll-tax financing a feature of the program at all given the partition of benefit accrual from system financing?

After the major revisions of the 1939 Social Security Amendments, the benefit calculation became more weighted toward low-wage workers, and survivor benefits were added, making the relationship between contributions paid in and benefits paid out even more remote and the system more of a true “social insurance” program.⁶¹ Nonetheless, it is also

57. See CES REPORT, *supra* note 35, at 43–44 (recommending that contributions be based upon cumulative earnings to be phased in “1 percent in the first 5 years; 2 percent in the second 5 years; 3 percent in the third 5 years; 4 percent in the fourth 5 years and 5 percent thereafter”).

58. Social Security Act Amendments of 1939 § 201, 53 Stat. at 1362–67.

59. H.R. REP. NO. 74-615, pt. 1, at 5–7.

60. For an exhaustive discussion of plan funding methods and elements, see DAN M. MCGILLET AL., *FUNDAMENTALS OF PRIVATE PENSIONS* 201–333 (7th ed. 1996).

61. The Director of Old-Age and Survivors Insurance circulated a January 1940 memorandum reflecting the view and purpose of the 1939 amendments. See Memorandum from John J. Corson, Dir., Bureau of Old-Age and Survivors Ins., to Regional Representatives and Field Office Personnel, Old-Age and Survivors Insurance (Jan. 10, 1940), <http://www.ssa.gov/history/reports/1939no3.html> [hereinafter Corson Memorandum]. This memorandum explained that through a form of social insurance “we are endeavoring to protect society against the contingency that it will be called upon to support a large proportion of the people over sixty-five who can no longer support themselves.” *Id.* The form of social insurance was meant to “replace a part of that wage income that made for the individual’s own security and makes simultaneously for the protection of society against the neces[sity] of his support.” *Id.*

The revision of the benefit formula reflects the change in the emphasis of the

clear from the legislative history that both the Roosevelt Administration and the Congress at the time viewed contributions by individual workers, as part of the financing of Social Security, to be an essential element of social insurance.⁶²

Roosevelt's own insistence that workers who would ultimately benefit from the system should contribute to its costs is well known, as is his view that making direct payments into the system would create an unassailable "earned right" to retirement income that would not be subject to means testing.⁶³ The 1935 Committee on Economic Security (CES) Report to the

program. The original provisions offered primarily a plan for systematic savings for old age. The amendments, on the other hand, are designed to provide a minimum subsistence income for the retired worker and his dependents or for certain of his survivors, relating the amount of the benefit to his family responsibilities and, roughly, to the level of his former earnings as well as to the extent of his participation in the system. The primary monthly benefit, payable to a qualified worker at 65 or after, is based on his average monthly wage (as defined subsequently) according to the following formula: (1) a basic amount of 40 percent of the first \$50 of the average monthly wage, plus 10 percent of the amount by which that average exceeds \$50 and does not exceed \$250, and (2) 1 percent of the amount calculated under (1) multiplied by the number of years in which the worker has received \$200 or more in wages from covered employment. The minimum primary benefit is set at \$10.

Lyle L. Schmitter & Betti C. Goldwasser, *The Revised Benefit Schedule Under Federal Old-Age Insurance*, SOC. SECURITY BULL., Sept. 1939, at 3, available at <http://www.ssa.gov/history/reports/1939no2.html>. "The average-wage formula in the amendments relates benefits not only to presumptive need, as indicated by the level of customary earnings, but also to the relative amount of time spent in covered employment." *Id.* at 7; see also Social Security Act Amendments of 1939 § 202(a); Social Security Act, 42 U.S.C. § 402 (2006) (describing the current benefit formula).

62. *An Act to Amend the Social Security Act of 1939 and for Other Purposes: Hearing on H.R. 6635 Before the S. Comm. on Finance.*, 76th Cong. 3, 5, 7-8, 16 (1939) (highlighting that contributions by individual workers were viewed as part of the financing).

63. Senator Moynihan (D-N.Y.) describes President Roosevelt's feelings as follows:

We know one thing in particular: President Roosevelt was absolutely determined that the payments made into this system would be credited to the individual who had paid them. Each individual would have an account recording every nickle [sic] he and his employer put in, and a passbook in the form of a Social Security card with his or her name on it. In 1941, Luther Gulick, a very distinguished professor at Columbia University, and one of the founders of the profession of public administration in our country, was working temporarily in Washington. He went in to see President Roosevelt, who was not then surrounded by staff. . . . Professor Gulick suggested that perhaps the time had come to stop levying payroll taxes separately from income taxes. Gulick said that it is all really one set of finances. Should we not just have one rate and collect it at one time? It would be efficient. Why have two sets of books, two sets of rates of contribution, when one would do? Gulick went back and wrote a memorandum of the conversation. The President replied. He said: I guess you are right on the economics, but those taxes were never a problem of economics. *We put those payroll contributions in so as to give the contributors a legal, moral, and political right to collect their pension and their unemployment benefits with those taxes in there. No damned politician can ever scrap my Social Security Program.* Roosevelt

President echoed this conviction:

Contributory annuities are unquestionably preferable to noncontributory pensions. They come to the workers as a right, whereas the noncontributory pensions must be conditioned upon a “means” test. Annuities, moreover, can be ample for a comfortable existence, bearing some relation to customary wage standards, while gratuitous pensions can provide only a decent subsistence.⁶⁴

However, by the time the major expansion of Social Security took place four years later, the link between contributions and benefits was already being described in more ambiguous terms:

The present old-age insurance system, while maintaining a reasonable relationship between past earnings and future benefits, provides proportionately greater protection for the low-wage earner and the short-time wage earner than for those more favorably situated. In other words, it recognizes *presumptive* need as an essential consideration in any socially adequate old-age insurance system. . . .

But every worker, regardless of his level of earnings or of the length of time during which he has contributed, will receive more by way of protection than he could have purchased elsewhere at a cost equal to his own contributions. In other words, the system recognizes the principle of individual equity, as well as the principle of social adequacy.⁶⁵

By 1939, it appears the redesigners of the original program viewed contributions as more of a political mechanism for assuring rights to adequate benefits in old age rather than as actual payment for a future retirement annuity or an investment yielding a return in the form of the retirement benefits. The expansion of the program to meet the needs of elderly spouses and survivors of covered workers and the acceleration of payment of benefits to meet more current needs, along with other changes that expanded the role of Social Security to resemble what it is today, required a recognition that worker contributions constituted partial, not complete, financing for the system as a whole, not direct payment for the benefits they would eventually receive.

In the original estimates for Social Security’s financing, even in 1935, and to a greater extent in the 1939 revamping of the system, worker and employee contributions via the payroll tax were not seen as the sole, long-term source of financing.⁶⁶ General tax revenues were projected to begin

wanted that money to be identified with the individuals who had contributed it. And that system worked very well indeed.

101 CONG. REC. 28,086 (1990) (emphasis added).

64. CES REPORT, *supra* note 35, at 39.

65. REPORT OF THE SOCIAL SECURITY BOARD, H.R. DOC. NO. 76-110, at 5 (1939), available at <http://www.ssa.gov/history/reports/38ssbadvise.html>.

66. “There can be no escape from the costs of old age; and since these costs must be

partially financing benefits at least by the 1960s on the assumption that contribution rates would not rise above 5%.⁶⁷ As will be discussed below, partial nonpayroll-tax financing is completely consistent with the social insurance model and belies any notion that Social Security benefits are tied in any direct way to their source of financing.⁶⁸

So what conclusions can be drawn from examination of the fundamental principles associated with the Social Security contribution and benefit base that should guide any future changes? First, clearly the level of covered wages has traditionally been aimed at covering most wages in the national economy, but the highest wage earners have always had the top part of their salaries exempted from Social Security taxes and omitted from their earnings records for benefit computation purposes. It is not clear, however, that this design feature is necessarily an inviolable basic principle of social insurance generally or of the U.S. Social Security system in particular.

Second, the causative relationship between contributions and benefits that so many commentators, as well as members of the public, seem to perceive as a fundamental principle of Social Security simply does not exist, at least not in the sense of benefits resulting from or depending on taxes paid. Benefits are based on earnings recorded in the Social Security system, not on taxes paid, similar to the way workers covered by an employer-sponsored defined-benefit pension plan accrue benefits over a

met, an orderly system under which employers, employees, and the Government will all contribute appears to be the dignified and intelligent solution of the problem.” CES REPORT, *supra* note 35, at 46. “Since the nation as a whole, independent of the beneficiaries of the system, will derive a benefit from the old-age security program, it is appropriate that there be Federal financial participation in the old-age insurance system by means of revenues derived from sources other than pay-roll taxes.” ADVISORY COUNCIL ON SOC. SEC., FINAL REPORT, S. DOC. NO. 76-4, at 6 (1938), *available at* <http://www.ssa.gov/history/reports/38advise.html>. The Social Security Board, while differing in many respects from the Advisory Council’s report, echoed this sentiment:

The Board is of the opinion that it would be sound public policy to pay part of the eventual cost of the benefits proposed out of taxes other than pay-roll taxes, preferably taxes such as income and inheritance taxes levied according to ability to pay.

The portion of the total costs to be met by taxes other than pay-roll taxes should depend upon the proportion of the general population covered by the insurance system. The wider the coverage, the more extensive this contribution from other tax sources might properly be.

REPORT OF THE SOCIAL SECURITY BOARD, H.R. DOC. NO. 76-110, at 12 (1939), *available at* <http://www.ssa.gov/history/reports/38sbadvise.html>.

67. See CES REPORT, *supra* note 35, at 45 (“Benefit payments will be light in the early years but will increase steadily until, by 1965, they will exceed the annual receipts. It is at this stage that the Federal Government would begin to make contributions to the annuity system . . .”).

68. See *infra* text accompanying notes 70–71.

career with that employer.⁶⁹ There has never been any connection between the amount of FICA taxes paid by a worker and her employers on her behalf and her ultimate level of benefits.⁷⁰

Of course, as a political matter, it may not matter that the tax–benefit connection does not exist if the public at large believes that it does, but that is likely a question of ignorance and a generational unfamiliarity with the principles of accrual of benefits under any kind of defined benefit pension plan, something with which today’s workers have very little experience.⁷¹ As a policy question, however, it is time to set aside popular mythology based on a misunderstanding of the actual fundamental principles of Social Security financing and benefits, one that clearly distorts both policy analysis and public understanding of the program.

Finally, the wage-base limit is really a by-product of the original limits on coverage for benefit purposes and in some ways is a relic of the original 1935 legislation that envisioned Social Security as a type of contributory

69. See 42 U.S.C. § 415 (2006) (describing the computational methods for primary insurance amounts). I previously described the Social Security system as follows:

Payroll taxes are merely a method of financing the system, not the basis for benefits earned and paid out. Benefit calculations are made based on *earnings* recorded in the Social Security system, which is done as a record-keeping matter through withholding tax records filed with the Federal Reserve and forwarded to the Social Security Administration. But benefit calculations do not take into account the amount of *taxes* paid, and benefits cannot be reduced in the event of a failure to pay such taxes by the employer who is responsible for withholding FICA taxes from workers’ paychecks. The system could as easily be financed through income tax revenues, like other government expenditures, without any impact on the earnings-based benefit structure.

Patricia E. Dilley, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*, 41 B.C. L. REV. 975, 1000 (2000); see also Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1, 35 (2002).

70. See Dilley, *supra* note 69, at 1000.

71. Professor Stephen F. Befort chronicled this significant shift as follows:

Through the 1970s, traditional defined benefit plans predominated. In 1975, for example, 87% of all workers covered by a pension plan participated in a defined benefit plan. Since 1980, however, there has been a significant shift toward defined contribution plans. While the number of employees covered by a defined benefit plan fell 25% between 1980 and 2000, the number participating in a defined contribution plan jumped 250%. As of 2005, twice as many American workers were covered by defined contribution plans as compared to defined benefit plans. Of those with pension coverage, only 19% of U.S. households are currently covered by a defined benefit plan, while 58% are covered solely by a defined contribution plan, and 23% participate in both types of plans.

Stephen F. Befort, *The Perfect Storm of Retirement Insecurity: Fixing the Three-Legged Stool of Social Security, Pensions, and Personal Savings*, 91 MINN. L. REV. 938, 948 (2007); see also Henry H. Drummonds, *The Aging of the Boomers and the Coming Crisis in America’s Changing Retirement and Elder Care Systems*, 11 LEWIS & CLARK L. REV. 267, 281 (2007) (“In summary, the defined benefit traditional pension system suffers from a marked decline in its coverage of American workers and a funding crisis in sectors heretofore thought to be its strength.”).

annuity to provide for a future limited floor of retirement security.⁷² That version of Social Security was replaced, before it ever really took effect, by the more expansive social insurance model of the 1939 Amendments.⁷³ Social insurance has a much broader mission—protecting society by caring for individuals:

Social insurance is one of the ways in which we endeavor to make society secure. . . . The basic purpose of all forms of social insurance is to replace a sufficient part of that wage income when it is lost as a result of any of these hazards—unemployment, accident, old age, or death of the wage earner—to insure not only that the individual may look forward to protection, but that society as well may be protected against the hazards which it faces.⁷⁴

Clearly, Social Security was explicitly intended, and successfully functions, as a social stabilizer, protecting society from unrest by giving workers generally the promise of protection against destitution in old age.⁷⁵ From that perspective, high-wage workers are “purchasing” more with their Social Security contributions than just their future benefit entitlement, and the indirect economic benefit of social and economic stability for society generally, particularly for those most likely to reap the biggest economic benefit from society and a stable capitalist economy, was an intentional result.⁷⁶

72. MULVEY & WHITMAN, *supra* note 41, at 1.

73. *See generally* Social Security Act Amendments of 1939, Pub. L. No. 76-379, 53 Stat. 1360.

74. Corson Memorandum, *supra* note 61. After passage of the 1939 Amendments, John Corson traveled around the country to explain the new law to employees of the agency. A Director’s Bulletin put Corson’s remarks into the written form from which this quotation is taken. These remarks, I believe, reflect the contemporary and later understanding of social insurance of most of the original designers of the 1939 bill.

75. President Roosevelt made this point explicitly in his statement to Congress even before the formulation of the Social Security Act:

Among our objectives I place the security of the men, women and children of the Nation first. This security for the individual and for the family concerns itself primarily with three factors. People want decent homes to live in; they want to locate them where they can engage in productive work; and they want some safeguard against misfortunes which cannot be wholly eliminated in this man-made world of ours. . . . The third factor relates to security against the hazards and vicissitudes of life. Fear and worry based on unknown danger contribute to social unrest and economic demoralization. If, as our Constitution tells us, our Federal Government was established among other things, “to promote the general welfare,” it is our plain duty to provide for that security upon which welfare depends.

President Franklin Delano Roosevelt, Message to Congress Reviewing the Broad Objectives and Accomplishments of the Administration (June 8, 1934), <http://www.ssa.gov/history/fdrstmts.html#1939b>.

76. This result, of course, is quite similar to one premise of progressive income taxation discussed below: higher income taxpayers benefit more from the institutions and protections of government and therefore should pay higher taxes. *See generally* Joseph M. Dodge, *Theories*

No fundamental principle of Social Security is necessarily at stake, therefore, in consideration of a wide range of proposals to raise, redesign, eliminate, or add to the base for tax purposes, benefit purposes, or both, or for adding other sources of financing for Social Security benefits. Even in 1939, the program's designers anticipated that the program's possible broader financing needs in the future would need to be met either by continuing increases in the tax base or infusions of general tax revenues.⁷⁷ Any discussion of financing changes that are "true to original principles of Social Security" clearly should include a broader menu of options than just increases in the base or rates of the current payroll-tax financing system. It is particularly appropriate to begin with an examination of the wage-base limit, as expansion of the base can serve two purposes: increased financial viability and increased fairness in the eyes of the taxpayers.

II. RAISING THE BASE TO TRADITIONAL TARGET LEVEL

The main purpose of the doughnut hole proposal is to increase payroll-tax contributions to Social Security only from higher wage workers in order to shore up the long-term financing of the system.⁷⁸ Setting aside for the moment the question of whether long-term financing needs to be addressed at all right now, the first issue should be the appropriate level for the wage base from a Social Security program perspective. Apart from political considerations, the base's two separate roles need to be reimagined from the perspective of the Social Security program's mission itself and not simply from a tax policy or political salability perspective.

Social Security was designed and has developed over several decades as a way to deal with certain problems that still exist: insuring working people and their families against the chance of destitution when they are no longer able to work (whether because of old age, disability, or death) and, as a result, promoting social stability throughout the life cycle.⁷⁹ The central

of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles, 58 TAX L. REV. 399 (2005).

77. See *An Act to Amend the Social Security Act and for Other Purposes: Hearing on H.R. 6635 Before the S. Finance Comm.*, 76th Cong. 81, 83, 86, 92–93, 101, 250 (1939) (highlighting that increases in taxes as well as increased contribution rates were considered).

78. See *supra* notes 8–9 and accompanying text.

79. Frances Perkins, the "mother of Social Security" and a member of the original Committee on Economic Security that developed the proposal for the first Social Security legislation in 1935, described the origins of Social Security in a speech to Social Security Administration employees on the twenty-fifth anniversary of the program as follows:

We were not yet out of the woods of the Great Depression and, of course, it was the Great Depression which we must never forget in this country, which was the proximate cause of this movement which was launched at that time—this movement to write under the lives of the American people a basis of security which came to

criterion to be applied to proposed modifications of the base (for benefits, contributions, or both) is whether the changes improve or detract from the program's ability to continue to meet that central purpose. This is not to ignore the impact of the dedicated payroll-tax base as part of the overall federal tax structure. Nonetheless, the programmatic purposes of the wage base should be balanced against the overall economic impact of base increases on Social Security taxpayers and beneficiaries.

One clear rationale for another round of ad hoc contribution and benefit base increases can be found in a comparison of wages covered by the FICA wage base at the onset of the program and now. In 1937, the \$3,000 contribution and benefit base covered 92% of all wages in the national economy, but over the next fifty years, as the economy expanded in the post-World War II period, the percentage of wages covered declined, requiring periodic legislation to increase the base.⁸⁰ At several points during the history of the program, the disparity between wages actually covered and the traditional 90% standard was quite wide—for example, in 1965, only 71% of all wages were covered—and eight ad hoc increases in the wage base were put in place between 1939 and 1972.⁸¹ Indexing the base to increases in average wages in 1972, combined with the last set of ad hoc increases that were eventually completed in 1992, was intended to eliminate the need for ad hoc increases.⁸²

However, indexing the base to increases in average wages, rather than to some more comprehensive gauge, such as aggregate U.S. earnings, means that growing income and earnings inequality allows more compensation at the top of the earnings scale to escape the base. While the earnings of about 94% of all U.S. workers are completely covered by the 2010 base of

them out of the orderly, substantial, and regular contributions to their future and to the future hazards.

Frances Perkins, Remarks at the Social Security Twenty-Fifth Anniversary Ceremonies (Aug. 15, 1960), <http://www.ssa.gov/history/25annoasis.html>.

80. See generally Patricia P. Martin & David A. Weaver, *Social Security: A Program and Policy History*, 66 SOC. SECURITY BULL. 1, 1 (2005), available at <http://www.ssa.gov/policy/docs/ssb/v66n1/v66n1p1.pdf>.

81. See, e.g., MULVEY & WHITMAN, *supra* note 41, at 4.

82. In 1973, Commissioner of Social Security Robert M. Ball explained that major social security legislation enacted in July 1972 included

[an increase] from \$9,000 in 1972 to \$10,800 in 1973 and to \$12,000 in 1974 the maximum amount of a worker's annual earnings that may be counted in figuring his and his family's social security benefits (and on which he pays social security contributions) and provided in addition for keeping the amount up to date automatically in the future as average wages rise; and a revised contribution rate schedule

Robert M. Ball, *Social Security Amendments of 1972: Summary and Legislative History*, SOC. SECURITY BULL., March 1973, at 3, 3, available at <http://www.ssa.gov/history/1972amend.html>.

\$106,800, the share of total wages subject to the payroll tax has been steadily falling—from about 90% in 1982, at the time of the last big Social Security financing bill, to 85% in 2005—mainly because of the great disparity between average wage increases and compensation increases for the highest wage earners.⁸³ If no additional changes are made to the wage base, it is projected to cover only 83% of wages by 2014.⁸⁴ However, increasing the base to cover 90% of wages in the national economy would not be a trivial change. For example, in 2005, meeting that goal would have required a jump from that year's base limit of \$90,000 to \$150,000.⁸⁵

Even so, no matter what measure is used, increasing the contribution and benefit base at least back up to the 90% level seems to be the easiest case to make from the perspective of fidelity to the basic design and purpose of Social Security, for several reasons. From a simple financing perspective, it could be argued that coverage of almost all, if not 100% of, wages earned is one way to insure adequate financing of current benefits without having to increase the FICA rate to levels that would be extremely burdensome for lower and middle wage workers. Nonetheless, there is more to the base than financing concerns, which may make raising it a programmatic necessity regardless of financing concerns. It makes sense, then, to unpack the base into contribution purposes and benefit purposes and to examine the rationales for each type of limit independently.

A. Benefit Base

The traditional goal of including at least 90% of wages for both benefit and tax purposes satisfies important political and philosophical objectives of social insurance—if almost all workers and most of their wages are covered, they have a commitment to the program for themselves as well as for society in general. However, the importance of universal benefit coverage—both of workers and of their wages—goes deeper than creation of stakeholders.

Coverage of most earnings for benefit purposes is the underpinning of social insurance's role of encouraging social stability—tying together economic interests of working, middle, and upper economic classes. It is not surprising that the designers of Social Security thought it important to cover at least earnings up to the top 10% of wage earners, given the dramatic downturn of economic fortunes during the Great Depression that saw those even at or near the top lose assets and the capacity to earn

83. KATHLEEN ROMIG & JANEMARIE MULVEY, CONG. RESEARCH SERV., *SOCIAL SECURITY: RAISING OR ELIMINATING THE TAXABLE EARNINGS BASE 1* (2009).

84. *Id.*

85. *Id.*

through no fault of their own.⁸⁶ Melding the interests of top and bottom earners served not only as political glue but as a stabilizer of economic expectations for society generally—wage earners covered by Social Security might fall down the economic ladder, but in old age they would not need to appeal for government aid to the poor.⁸⁷

While some workers manage to earn at or above the base for their entire careers, many more have earnings histories that fluctuate, sometimes dramatically, over thirty-five to forty years of work.⁸⁸ If the benefit base is compressed and fails to capture earnings near the top, benefits could be dramatically affected for workers who have some good years accompanied by many average or below average ones. The whole point of providing an entitlement in the future to benefits based on past earnings is to allow for the possibility of misfortune along the way to old age, to provide income

86. See generally DAVID M. KENNEDY, FREEDOM FROM FEAR: THE AMERICAN PEOPLE IN DEPRESSION AND WAR, 1929–1945, at 58–59 (1999) (providing examples of the poor economic climate during the Depression, such as the 26,355 business failures by the end of 1930).

87. See *supra* notes 63–67 and accompanying text.

88. The University of Michigan Retirement Research Center studied this phenomenon and concluded,

In practice, when we compare the hypothetical profiles with actual earnings, we find that the scaled profiles do not compare well to actual earnings paths. One reason for this divergence is that the assumption of steady work does not track the experience of actual Health and Retirement Study (HRS) workers. Well over one-third of all men and women in our sample did not have covered earnings in their 20s, and many women had zero earning years after that. All the hypothetical profiles are higher and flatter than the typical HRS workers in our sample. We also find that the Average Wage Index, intended to reflect a weighted average of actual earnings at any given time, does not match the average earnings of any given cohort. In addition, the AWI exceeds average actual earnings during working cohorts' early years, and, using measures unaffected by high outlier earners, it is still higher than HRS actual cohort earnings in all years. Further, median HRS actual earnings were more similar to the low versus the medium scaled profile. Even after restricting the HRS sample to respondents with substantial work histories, the medium scaled profile is 28% above HRS actual median earnings, implying a lifetime difference of more than \$150,000.

Andrew Au, Olivia S. Mitchell & John W.R. Phillips, *Modeling Lifetime Earnings Paths: Hypothetical Versus Actual Workers* 19 (Univ. Mich. Ret. Research Ctr., Working Paper No. 2004-074, 2004), <http://www.mrrc.isr.umich.edu/publications/papers/pdf/wp074.pdf>. In addition, the Center for Retirement Research Center at Boston College found,

Few workers have level career earnings, so the traditional approach to policy simulation represents a serious distortion of actual labor market experience. Moreover, differences in the pattern of career earnings can produce wide disparities in pension entitlements, even for workers with the same average earnings, under individual account and other retirement plans.

Barry Bosworth, Gary Burtless & C. Eugene Steuerle, *Lifetime Earnings Patterns, the Distribution of Future Social Security Benefits, and the Impact of Pension Reform* (Ctr. for Ret. Research at Boston Coll., Working Paper No. 1999-06, 2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=252052.

assurance in advance and without proof of need at the time benefits are paid.

Correcting the benefit base to cover at least 90% of wages (not just workers) is thus completely consistent with fundamental principles of Social Security and indeed is necessary to fulfill program benefit goals of adequate benefit replacement and program participation. Raising the base higher than the traditional 90% coverage standard raises additional questions, however. One rationale that has always been given for limiting benefit coverage to earnings up to, but not above, the benefit base is that replacement of any part of wages above the base is unnecessary in a public-benefit program.⁸⁹ Given the increasing concentration of wealth and earnings levels at the top end of American incomes and the growing inequality of those incomes, it might be appropriate to raise the benefit base above 90%, but there is no clear line indicating how high is too high.

B. Contribution Base

The programmatic connection between the base and benefits is clear—the base serves as a limit to the amount of earnings that can be used to calculate the ultimate benefit entitlement, and the level of the base is important in capturing a complete picture of a worker's earnings history. The connection between the base and wages subject to FICA, however, is less clearly connected to Social Security program goals beyond simply raising sufficient funds to pay benefits. The wage aspects of the base, therefore, unlike the benefit aspects, implicate both Social Security programmatic principles and general tax justice and policy issues.

1. The Contribution Base from a Programmatic Perspective

As described earlier, the original base was set at \$250 per month, or \$3,000 per year for benefit-accrual reasons, but it is not clear that the House drafters of the 1935 Act had anything more in mind than simple symmetry when they used the same limit for FICA purposes.⁹⁰ This symmetry is consistent with the original vision of the program as a compulsory, federally sponsored annuity program.⁹¹ This original design

89. See ROMIG & MULVEY, *supra* note 83, at 1 (explaining that the Social Security program was originally intended only to “provide a ‘core’ benefit as a floor of protection against poverty”).

90. See *supra* note 43 (describing how the Social Security Administration calculated benefits in 1935).

91. From the descriptions in the 1935 CES Report and other documents, the original design resembled an employer-provided pension plan more than social insurance:

Pensions sufficient for a decent subsistence for all of the aged who are dependent

explains the insistence in the original bill on categorizing payments into the system as “contributions” rather than taxes—employees were described as making contributions to social insurance, while employers were said to be paying an “excise tax” on their employees’ wages.⁹²

However, while workers clearly felt they were contributing to their own future retirement through the FICA tax withheld from their wages, it is not clear that policymakers viewed those withheld amounts as anything other than taxes, albeit taxes dedicated to the financing of those future benefits. The 1938 Advisory Council’s report to the President on the upcoming rewrite of the Social Security Act describes both the employee and employer shares of FICA as a tax and further recommends requiring employers to show employees the amount of taxes deducted from their wages under the old-age insurance system.⁹³ The expansion of Social Security in the 1939 Amendments into a true, broad-based social insurance program protecting workers and families from future need in retirement or because of early death made it harder than ever to view the program as an individual annuity system.⁹⁴ The public entitlement required public financing, even if most of the needed funds came through the dedicated payroll tax.

As discussed earlier, it is important for the benefit base to cover at least 90% of earnings in the U.S. economy if the Social Security program is to meet its goal of paying benefits that provide adequate, but not excessive, earnings replacement for workers whose earnings may greatly fluctuate throughout their working lifetime.⁹⁵ The question is whether there is a

upon the public for support are approved by the overwhelming majority of the people of this country. In order to reduce the pension costs and also to more adequately provide for the needs of those not yet old but who will become old in time, we recommend a contributory annuity system on a compulsory basis, to be conducted by the Federal Government.

CES REPORT, *supra* note 35, at 42.

92. *Id.* at 22.

93. ADVISORY COUNCIL ON SOC. SEC., FINAL REPORT, H.R. DOC. NO. 76-4, at 6–7 (1938), available at <http://www.ssa.gov/history/reports/38advise.html>.

94. GEOFFREY KOLLMANN, CONG. RESEARCH SERV., SOCIAL SECURITY: SUMMARY OF MAJOR CHANGES IN THE CASH BENEFIT PROGRAM: 1935–1996, at 2 (1996), available at <http://www.ssa.gov/history/pdf/crs9436.pdf>.

95. This concern was expressed very early in the switch from cumulative to average earnings as the basis for calculating the primary insurance amount (PIA):

The Board recommends that benefits be calculated upon the basis of average wages, rather than, as at present, upon total accumulated wages. This change would make it possible to increase early benefits and to relate benefits more closely to the previous normal wage income of the individual. It would also eliminate, as the years go by, the large bonus which present provisions would afford those who have had only a brief period of participation prior to the date of retirement. . . .

While the Board believes that benefits should be related to the average wage, it

similar programmatic imperative for setting the wage base at 90% or more of average earnings. The contributory function of the payroll tax is its most direct connection to Social Security program objectives, as it was envisioned originally as a way to establish an unbreakable political entitlement to eventual benefit receipt.⁹⁶ It is not clear, however, that the absolute level of contribution is particularly significant in the creation of that entitlement.

For one thing, as discussed above, there is no—and never has been any—statutory connection between entitlement to benefit payments and payroll taxes paid. Benefits are required to be paid to each worker who has satisfied the basic requirements for coverage—based on earnings reported or demonstrated to have been earned for the requisite number of quarters—whether or not her employer actually withheld the proper amounts or paid over to the Treasury amounts owed.⁹⁷ Moreover, in a public program governed by statutes that can be amended at any time by Congress, the entitlement of any worker to any particular benefit is theoretically subject to change any time Congress is in session, regardless of any contributions made over her working lifetime.

In reality, in the entire history of Social Security, no Congress has ever acted to reduce the current benefits of workers already receiving them, and only once has Congress reduced a scheduled increase in benefits for beneficiaries already in pay status: the 1983 Social Security Amendments delayed the annual cost-of-living increase from June to December on a permanent basis, beginning with the 1983 Cost-of-Living Adjustments (COLA).⁹⁸ This action was only taken during an extreme financial crisis in

recognizes that benefits should also be related to the number of years the individual has been in covered employment and has made contributions. The Board therefore recommends that an insured individual, upon retirement, receive a basic benefit related to his average wages; and that, for every year he has earned more than some small specified amount of wages in covered employment, his basic monthly benefit be increased by a specified percentage. Conversely it recommends that for every year a person does not earn this specified amount of wages, the basic monthly benefit be reduced by the same percentage.

REPORT OF THE SOCIAL SECURITY BOARD, H.R. DOC. NO. 76-110, at 6–7 (1939), <http://www.ssa.gov/history/reports/38ssbadvise.html>. The latter part of this recommendation, to increase or reduce benefits based on years of earnings above or below a set limit, was not included in the final 1939 legislation. However, other aspects of the benefit formula, such as dropping out the lowest five years of earnings before calculating the average indexed monthly earnings (AIME), may be said to be addressing some of the same concerns.

96. See MULVEY & WHITMAN, *supra* note 41, at 1.

97. See *supra* note 23 and accompanying text; see also Social Security Act of 1935, Pub. L. No. 74-271, § 202, 49 Stat. 620, 623; Social Security Amendments of 1939, Pub. L. No. 76-379, § 202(a), 53 Stat. 1360, 1363–67.

98. See Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65.

which the system's reserves were scheduled to be exhausted in the middle of 1983, making it impossible to pay the full amount of benefits due out of either current or accumulated payroll taxes, a situation not currently predicted to occur again until around 2040.⁹⁹

The same cannot be said for benefits scheduled to be paid but not yet in payment status. Congress has acted several times to amend the program to reduce or eliminate benefits promised to future beneficiaries. One major example of such a cutback occurred in 1977 when Congress corrected an error in calculating automatic wage indexing of initial benefits, enacted in 1972, which had been discovered to be increasing initial benefits at roughly twice the intended rate.¹⁰⁰ The correction was made for beneficiaries first entitled to benefits on January 1, 1979, and the ensuing furor over the "notch" between benefits for those becoming entitled in 1978 and earlier and those becoming entitled in 1979 and later made Congress wary of such abrupt changes in benefits even for future beneficiaries.¹⁰¹ The 1983 Amendments included possibly the largest cutback ever enacted in benefits for future beneficiaries in the form of the "increase in the retirement age."¹⁰² This change is still in the process of phasing in over a twenty-year period (Congress having learned its lesson with the "notch baby" furor), but when completely in effect, it will raise the age for full benefits from 65 (in 1983) to 67 by 2022—a change that is not really an increase in the retirement age, but rather is a benefit decrease of up to 30% for those taking benefits before age 67 in 2022 and later.¹⁰³

Critics of Social Security point to these kinds of reductions in future benefits and the ability of Congress to reduce or eliminate any benefits at any point as proof that there is no such thing as real entitlement to Social Security benefits regardless of the contributory FICA structure.¹⁰⁴ But it is

99. See *id.*; see also H.R. REP. NO. 98-25, pt. 1, at 1-2 (1983), reprinted in 1983 U.S.C.C.A.N. 143, 219-20 (describing the economic situation that made the Amendments necessary); 129 CONG. REC. 7392-94 (1983), reprinted in 1983 U.S.C.C.A.N. 143, 498-99; 2008 BD. OF TRUSTEES REPORT, *supra* note 8, at 10 (projecting the years in which Social Security trust funds will be exhausted).

100. See Social Security Amendments of 1977, Pub. L. No. 95-216, § 201, 91 Stat. 1509, 1514; see also Soc. Sec. Admin., History of SSA-Related Legislation, <http://www.ssa.gov/legislation/history/95.htm>.

101. For a brief summary of the controversy, see Op-Ed, *The Greed of the Notch Babies*, N.Y. TIMES, Jan. 13, 1998, at A22, available at <http://www.nytimes.com/1988/01/13/opinion/the-greed-of-the-notch-babies.html>.

102. See Social Security Act Amendments of 1983, § 201(a), 97 Stat. 107 (amending 42 U.S.C. § 416).

103. *Id.*

104. For an extended discussion of why the Social Security benefit entitlement is just as secure, and perhaps more secure, than private entitlement in savings and investments, see Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating*

naïve to think any sort of private entitlement or ownership right to future income, whether in private pension plans or investment accounts designed to produce old-age income, is any more secure than the Social Security entitlement.¹⁰⁵ Private investment accounts are of course subject to the vagaries of investment markets, not to mention other sorts of losses both in value and sometimes in title to which private property is also subjected (bank failures and eminent domain exercise are two examples).¹⁰⁶ As for employer-sponsored private pensions, over the past fifty years, long after the economic catastrophe of the Great Depression revealed the weaknesses of pension funding and despite the funding requirements put in place by ERISA in 1974 and later, employers have frequently underfunded the trusts financing those plans and subsequently gone bankrupt, leaving the plan without sufficient funds to pay benefits.¹⁰⁷

Private Pensions and Social Security, 30 LOY. L.A. L. REV. 1063 (1996–1997).

105. For a discussion of the public–private determination of property rights, see Amnon Lehavi, *The Property Puzzle*, 96 GEO. L.J. 1987 (2008).

106. For a report on the losses to 401(k) account balances from the last two years of market downturns, see, for example, Jack VanDerhei, *The Impact of the Recent Financial Crisis on 401(k) Account Balances*, EMP. BENEFIT RES. INST. ISSUE BRIEF, Feb. 2009, at 1, 10, http://www.ebri.org/pdf/briefspdf/EBRI_IB_2-2009_Crisis-Impct.pdf (charting the time needed to recover from 401(k) losses based on certain equity and non-equity return assumptions at figures 6 and 7). The collapse of banks is far from a historic footnote, and their takeover by the FDIC is now a weekly occurrence. One of the first and most extensive examples was the collapse of IndyMac Bank in California, which was taken over by the FDIC on July 11, 2008, and resulted in deposit losses in excess of the \$100,000 insured limit for thousands of depositors. See, e.g., William Heisel, *IndyMac's Shuffle Ran Over Depositors*, L.A. TIMES, Feb. 28, 2009, at C1 (stating that an estimated 10,000 IndyMac depositors lost \$270 million in deposits); Damian Paletta, Lingling Wei & Ruth Simon, *IndyMac Reopens, Halts Foreclosures on Its Loans*, WALL ST. J., July 15, 2008, at C1 (stating that while the FDIC normally insures up to \$100,000 per depositor, nearly \$1 billion of IndyMac's deposits were uninsured). At this writing, there are large numbers of banks on the brink of similar collapses, thanks largely to the home-mortgage-loan and ensuing foreclosure debacle of the last several years. See Damian Paletta & David Enrich, *Banks on Sick List Top 400: Industry's Health Slides as Bad Loans Pile Up; Deposit-Insurance Fund Shrinks*, WALL ST. J., Aug. 28, 2009, at A1 (stating that 416 banks were on the FDIC's "problem list"); Press Release, FDIC, Statement by FDIC Chairman Sheila Bair at the Quarterly Banking Profile Press Conference (Aug. 27, 2009), http://www.fdic.gov/news/news/press/2009/pr09_qbp.html (stating that the number of "problem" institutions is at a fifteen-year high).

107. For example, an employer's or plan administrator's failure to fiscally respond to the fluctuation of interest rates can lead (and has led) to the underfunding and termination of employer-sponsored pension plans. In particular, when interest rates fall, employers sponsoring private pension plans assume a lower rate of return on the money invested in the plan. Consequently, the employer must invest more money into the plan to make up for lower expected returns. Without doing so, it is unlikely that a plan will meet its prescribed level of expected future funding. However, many employers have failed to conform their investments with the potential losses attributable to lowered interest rates, resulting in failing or underfunded pensions. To protect against the risk of underfunded or failed pension plans, the Employment Retirement Income Security Act (ERISA) provides a government-

Social Security, on the other hand, is backed by the power to tax as well as by the political will of American workers and retirees who have insisted, through the political process, on Congress respecting their basic entitlement to benefits, even in the face of the dire financial emergency of 1983 and the strong efforts of the second President Bush in 2005.¹⁰⁸ There are also two additional critical differences between the public and private entitlements. First, Social Security guarantees a level of income in old age, whereas private investment assets can guarantee only equity ownership, not actual income in retirement—it is the value and liquidity of the asset when income is needed that matters, not the security of one’s right to the asset.¹⁰⁹ Employer-sponsored defined-benefit plans also guarantee a level of income, but only if they are adequately funded, which is far from a sure thing.¹¹⁰ In any event, defined-benefit pension plans have been slowly dying over the last thirty years so that few American workers will be able to count on them

run insurance scheme—the Pension Benefit Guaranty Corporation (PBGC)—which insures nonforfeitable retirement pension benefits for single-employer, defined pension plans. Nevertheless, the amount of coverage that PBGC can guarantee is limited under ERISA § 4022. The principle limitation involves a cap on the maximum benefits that PBGC will pay. Under § 4022, benefits payable to a participant under a plan are guaranteed only to the extent that they do not exceed the statutory maximum. Under the single-employer program, the limit is adjusted annually based on changes in the Social Security contribution and benefit base. In addition, PBGC does not guarantee benefit payments that exceed the amount of a participant’s accrued plan benefit payable at normal retirement age. *See* Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1322 (2006). For an analysis of the current probability of pension-fund failures from a practitioner’s perspective, see Alex D. Moglia, *Underfunded Pension Funds: A Ticking Time Bomb for Companies and Taxpayers*, AM. BANKR. INST. J., Oct. 2009, at 46.

108. In a poll conducted in May 1999 by Princeton Survey Research Associates, [fifty-eight] percent of Americans favored a system that would include private accounts. The idea was opposed by 33 percent. But the results were almost precisely the opposite when the same survey asked workers to choose between a program that guaranteed a monthly benefit based on lifetime earnings, as under the current system, and a program that would allow individual investment in the market without a guarantee. Given that choice, 59 percent favored the guaranteed payment, while 33 percent backed private investment.

Richard W. Stevenson, *Bush to Advocate Private Accounts in Social Security*, N.Y. TIMES, May 1, 2000, at A1, available at <http://www.nytimes.com/2000/05/01/us/2000-campaign-issues-bush-advocate-private-accounts-social-security.html?pagewanted=all>. An Associated Press/Ipsos poll on Social Security showed consistent near 60% disapproval of President Bush’s handling of Social Security, and a CNN/Opinion Research Corporation poll showed that by October 2008, there was over 60% disapproval of private investment of Social Security taxes. *See* PollingReport.com, Social Security, <http://www.pollingreport.com/social.htm> (last visited Apr. 20, 2010).

109. I have discussed this point thoroughly in my previous work. *See* Dilley, *supra* note 104; *see also* Befort, *supra* note 71, at 963–65.

110. *See* Befort, *supra* note 71, at 950–51 (stating that “[a]n increasing number of defined benefit plan sponsors fail to fulfill their pension promises”).

in the future.¹¹¹ Second, the costs of the public-entitlement promise are spread across the entire working population and guaranteed to be collected through the public taxing power, while the private-entitlement promise depends on the economic solvency and well-being of individual workers, of their employers, or on the market's valuation of assets at the time of the worker's retirement, none of which are either guaranteed or predictable.¹¹²

Thus, the individual worker's contribution to Social Security, which most Americans today appear to understand goes to pay for current benefits rather than being saved for their future retirement, establishes a politically formidable, if not a legally unchangeable, entitlement to benefits. The function of the payroll tax in forging a strong connection between workers and the system is therefore, as Roosevelt predicted, an essential element of the program.¹¹³ The extent to which the dedicated FICA tax contribution cements worker support for Social Security is hard to measure, but most polls of taxpayers over the past several decades have shown that the best tolerated tax has always been the payroll tax.¹¹⁴ The assumption may be that workers feel they know what they pay the Social Security tax for, unlike the income tax which funds the more amorphous

111. For a discussion of the declining importance of defined benefit plans, see JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, *PENSION AND EMPLOYEE BENEFIT LAW* 58 (4th ed. 2006).

112. Yale economist Robert Shiller continues to be the leading and most correct analyst of both housing prices and stock market cycles. See, e.g., STANDARD & POOR'S, S&P/CASE-SHILLER HOME PRICE INDICES 2008, A YEAR IN REVIEW, http://www2.standardandpoors.com/spf/pdf/index/Case-Shiller_Housing_Whitepaper_YearinReview.pdf (offering an analytical description of the housing market recession); see also Robert Shiller, Online Data, <http://www.econ.yale.edu/~shiller/data.htm> (last visited Apr. 20, 2010) (describing available data sets on consumer price indices from 1871 to the present).

113. This is not to say that the payroll tax must be the only source of financing—that question is outside the scope of this Article, but a future article currently in progress entitled *Dedicated to the Ones We Love* will explore the broader question of the payroll tax principle in general.

114. For instance, when asked about their income taxes in a USA TODAY/CNN/Gallup poll taken September 10–14, 1999, “68% of respondents said their income taxes are too high, compared with 29% who said they are about right or too low. When asked about their Social Security taxes, 43% said they are too high, while 49% said they are about right or too low.” Owen Ullmann, *Payroll Tax Relief Isn't High Priority*, USA TODAY, Sept. 24, 1999, <http://www.usatoday.com/money/wealth/saving/msw126.htm>. Similarly, according to the Tax Foundation's 2006 Annual Survey, only 14% of those surveyed (15% in 2005) found the Social Security payroll tax to be the least fair, while 25% (26% in 2005) found the federal income tax to be least fair and 31% (30% in 2005) found the federal estate tax to be least fair. See TAX FOUND., 2006 ANNUAL SURVEY OF U.S. ATTITUDES ON TAX AND WEALTH (2006), http://www.taxfoundation.org/files/survey_topline-20060405.pdf (similarly demonstrating that Americans view federal income taxes as less fair than Social Security taxes).

“government.”

However, even if the idea of contributing payments based on wages is a fundamental element of Social Security, the contribution principle alone still provides little guidance on the appropriate level of the wage base—programmatic imperatives essentially grounded in benefit-coverage goals do not necessarily dictate the flat taxation of exactly 90% of all wages in the economy. Instead, an examination of tax justice and tax policy principles may provide some adequate guidelines to help properly assess where to draw the line between appropriate and excess wage-base levels.

2. *Contribution Base from a Tax Perspective*

Discussion of Social Security financing has generally been relegated to the province of economists, who apply almost exclusively efficiency-based critiques to tax systems and who have mainly analyzed the payroll tax in the context of its possible wage-depression effects as well as its perceived inability to assure the long-term financing of Social Security benefits, with a view to building support for privatizing the system.¹¹⁵ In contrast, my focus in this Article is the optimal level for the contribution and benefit base from the perspective of the Social Security benefit program, as well as from the perspective of the tax system, leaving the comparatively simple questions about adequate financing for Social Security until the end. Disregarding for the moment the question of whether the payroll tax itself is the best financing option for Social Security at all, we can begin a tax policy analysis of the FICA wage-base limit by examining a couple of issues that frequently crop up in economists' discussions of the payroll tax—distributional effects (i.e., the regressive nature of the tax and the base) and the somewhat amorphous notion of “tax fairness.”

a. *Distributional Considerations*

The payroll tax is commonly criticized as the most regressive aspect of the U.S. tax system because it taxes all workers at the same rate—6.2% of wages for the Old-Age, Survivors, and Disability Insurance (OASDI) program and 1.45% of wages for Health Insurance, the Medicare portion—regardless of their level of earnings and, for the OASDI portion, only up

115. See Lewis D. Solomon & Geoffrey A. Barrow, *Privatization of Social Security: A Legal and Policy Analysis*, 5 KAN. J.L. & PUB. POL'Y 9, 13–15 (1995); Martin Feldstein, *The Missing Piece in Policy Analysis: Social Security Reform* 24–29 (Nat'l Bureau of Econ. Research, Working Paper No. 5413, 1996); see also PETER J. FERRARA, SOCIAL SECURITY: THE INHERENT CONTRADICTION 311 (1980); Martin Feldstein, *Toward a Reform of Social Security*, 40 PUB. INT. 75 (1975) (serving as one of the earliest salvos); Sylvester J. Schieber & John B. Shoven, *Social Security Reform: Around the World in 80 Ways*, 86 AM. ECON. REV. 373, 376 (1996).

to the wage base limit.¹¹⁶ This “flat tax” contrasts with the progressive income tax which taxes higher income taxpayers at a higher rate on their top marginal income.¹¹⁷ As a result, while workers making \$50,000 per year and \$150,000 per year, respectively, will pay the same nominal payroll tax rate, their income tax rates will vary considerably, with the first worker paying a top marginal rate of 25% on the last \$16,050 of her income, while the second will pay a top marginal rate of 28% on the last bracket of income.¹¹⁸ Under progressive rate theory, the FICA tax result is perverse—the \$50,000 a year worker, with fewer dollars remaining after paying for necessities than the \$150,000 a year worker, ends up paying the same nominal rate on those excess dollars.¹¹⁹

As one would expect, the base and rate intersect to aggressively increase the regressivity of the tax. Since the rate on wages above the base is zero, the higher the wages, the lower the effective payroll tax rate on the taxpayer’s entire earnings.¹²⁰ As a result, for example, someone reporting \$300,000 per year in wages is paying an effective OASDI payroll-tax rate of just over 2% on all her wages, while someone earning \$106,800 (the base for 2010) or less, is paying the statutory—and effective—rate of 6.2%. This is clearly no longer a flat tax rate; it is a pyramid, the complete inverse of the progressive income tax in that the more someone earns, the less payroll tax he pays.

Of course, earnings above the wage base are not counted for benefit purposes, so the regressive effect of the base could be rationalized as being essentially irrelevant from a Social Security perspective. It might be argued that those wages above the base are outside the closed-contribution and benefit system, and that including them for purposes of calculating an effective payroll tax rate distorts the contribution–benefit relationship. Moreover, because the benefit structure is mildly progressive in that lower wage workers receive benefits that are higher than a strictly proportional

116. See Soc. Sec. Admin., Trust Fund Data, Social Security & Medicare Tax Rates, <http://www.socialsecurity.gov/OACT/ProgData/taxRates.html> (last visited Apr. 20, 2010).

117. See I.R.C. § 1 (2006) (detailing the different tax brackets under the progressive income tax); Rev. Proc. 08-66, 2008-45 I.R.B. 1107 (providing the 2009 cost-of-living adjustments for the progressive tax).

118. Rev. Proc. 08-66, 2008-45 I.R.B. 1110, tbl.3. This rate example, of course, does not include the effects of the rate differential between ordinary income and capital gains rates.

119. See, e.g., Jason Bordoff & Jason Furman, *Progressive Tax Reform in the Era of Globalization: Building Consensus for More Broadly Shared Prosperity*, 2 HARV. L. & POL’Y REV. 327, 331–41 (2008); Geier, *supra* note 10, at 821; Vada W. Lindsey, *The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 FLA. TAX REV. 1, 13–14 (2001).

120. See generally Deborah A. Geier, *The Payroll Tax Liabilities of Low- and Middle-Income Taxpayers*, 106 TAX NOTES 711 (2005) (discussing the burden of payroll taxes on low-income taxpayers).

benefit formula would produce, it can be argued that the progressively structured benefits are a trade-off for a regressive tax structure.¹²¹

One problem with the progressive benefit–regressive contribution trade-off rationale, however, is that it relies on viewing the payroll tax as not simply a premium-paying mechanism but as an actual payment for benefits. The trade-off rationale posits that while low-wage workers pay a higher percentage of their wages than do workers with wages above the wage base, they get more for those tax payments in the form of disproportionately higher benefits.¹²² However, as previously discussed, the amount of payroll taxes paid by or on behalf of any worker has no connection to the benefits she eventually receives; benefit entitlement is earned, not purchased with taxes.¹²³ While contributory financing is a fundamental principle of social insurance in the United States, contributions to cement basic entitlement to ultimate benefits on the one hand and payments as a quid pro quo for specific benefits on the other are not the same thing. If benefits are not functionally related to taxes, then the progressive benefit structure must be—and is—justified on Social Security program grounds, while the tax system has to be viewed as a financing mechanism, one of many possible ones, whose distributional effects should be critiqued based on consistent tax principles as well as Social Security program needs.

b. Tax Fairness—Who Benefits? Who Pays?

From a distributional perspective, the FICA wage base would be most equitable if it covered all wages, resulting in an effective wage tax identical to the statutory payroll-tax rates. Would this be a fair outcome, though, from a theoretical tax perspective? Standard theories of tax justice have seldom been discussed in connection with payroll taxes generally, or the wage base specifically, except as an example of a somewhat crude version of the “benefit” theory of tax equity:

The prevailing modern view is that the quasi-exchange version of the benefit principle should be cabined off to government activities that involve citizen use of government property, facilities, and services. . . . Arguably,

121. See, e.g., Posting of the Economist to Free Exchange, http://www.economist.com/blogs/freeexchange/2009/04/are_payroll_taxes_regressive (Apr. 14, 2009, 18:00 EST) (discussing whether social security taxes are regressive or progressive); 2009 BD. OF TRUSTEES REPORT, *supra* note 8; see also *Investing in the Private Market: Hearing Before the Subcomm. on Social Security of the H. Comm. on Ways and Means*, 106th Cong. 95 (1999) (statement of John Mueller, Senior Vice President and Chief Economist, Lehman Bell Mueller Cannon, Inc.).

122. See Posting of the Economist to Free Exchange, *supra* note 121.

123. See 42 U.S.C. §§ 402(a), 413(a)(2)(A), 414(a) (2006).

government insurance, such as Social Security, Medicare, workers' compensation, and unemployment compensation, also might be included within the benefit principle to the extent that beneficiaries are limited to those who (directly or indirectly) pay appropriate amounts of "premiums" into the system relative to anticipated benefits. On the other hand, these programs are mandatory (and therefore operate to override preferences to self-insure and avoid risks) and often entail redistribution because of the premium and/or benefit structure.¹²⁴

This view of Social Security taxes as a direct quid pro quo for Social Security benefit payments when (and if) they are eventually received by the individual taxpayer is the basis for much of the modern conservative "money's worth" critique of Social Security.¹²⁵ Raising the wage base to mitigate the harsh regressive distributional effects of the payroll tax would only exacerbate the perceived inequity of high-wage workers paying FICA taxes "in exchange" for future benefits that might be less than the equivalent amount that investments would have earned for them in the private markets.¹²⁶

However, there are broader articulations of the benefit theory of taxation that provide an alternate view of Social Security taxes—a view that is certainly more consistent with Social Security's founding principles and provides some support for the current tax and benefit structure. While the "new benefit theory," as Professor Dodge has labeled it,¹²⁷ does not provide specific, measured results in terms of benefits for individual taxpayers, the lack of a direct quid pro quo may be the whole point, as others have suggested:

To me, the bottom-line question is: *How should the costs of maintaining a regulated capitalist economy, with its laws of supply and demand that create wealth, be allocated among the members of the population?*² In my view, essentially all tax revenue goes toward paying the costs of maintaining a regulated capitalist economy Therefore, the costs of paying for that system should be allocated across the population at least in proportion to the money benefits extracted under that

124. Dodge, *supra* note 76, at 405–06.

125. For a succinct statement of Feldstein's view that Social Security is a bad investment, see MARTIN FELDSTEIN, CATO INST., PRIVATIZING SOCIAL SECURITY: THE \$10 TRILLION OPPORTUNITY (1997), <http://www.cato.org/pubs/ssps/ssp7.html>.

126. See generally *id.* I have previously criticized this "rate of return" argument, which of course has not stopped anyone from making it. See Dilley, *supra* note 69.

127. Professor Dodge described the "new benefit theory" as follows:

The new and expanded version of the benefit principle purports to be a norm of tax fairness that avoids the measurement problem inherent in the quasi-exchange version of the benefit principle by postulating that the measure of a person's benefit from government is none other than his or her financial (as opposed to psychic) well-being. Dodge, *supra* note 76, at 406 (footnote omitted).

system. The person earning \$500,000 per year is able to do so *only because* he or she lives in a regulated capitalist system and can exploit the market to sell products or services.¹²⁸

Professor Geier's version of the benefit theory of taxation echoes the mission statement, as it were, of Social Security as restructured in the 1939 Amendments, which was, as discussed above, to provide a benefit for society as a whole, not simply to pay benefits to ensure that individual workers were spared an indigent old age.¹²⁹ The case for raising the wage base to cover some or all of the top 10% of earnings is more persuasive if those earners are seen as paying their FICA taxes not just for their individual benefits but also for prevention of the social disintegration that would very possibly flow from allowing a generation of elderly people to slide even further into poverty than is already the case.¹³⁰ The "money's

128. Deborah A. Geier, *Incremental Versus Fundamental Tax Reform and the Top One Percent*, 56 SMU L. REV. 99, 119–20 (2003) (footnotes omitted). Geier points out, in another setting, that

[f]our commonly invoked "tax justice" fairness norms are: (1) the equal-sacrifice principle; (2) the principle that persons should sacrifice to government according to the benefits received from government; (3) the principle that persons should sacrifice to government according to their standard of living or well-being (what economists call 'utility'); and (4) the principle that persons should sacrifice to government according to their respective abilities to pay (meaning material wealth).

....

In short, current tax policy "fairness" debates typically involve only arguments concerning whether the "standard-of-living" norm or the "ability-to-pay" norm is more persuasive. The "benefit" norm is typically viewed as a relic of a simpler time.

....

It seems to me that the mere exploitation of our economic system to earn income (including foreign income, which can be earned only because of the U.S. legal and economic environment that allows and supports foreign direct and indirect investment)—whether investment income or active business income—is sufficient under a reconstituted benefit theory to justify (in general) income taxation.

Deborah A. Geier, *Time to Bring Back the 'Benefit' Norm?*, 102 TAX NOTES 1155, 1155, 1157 (2004) (internal quotation marks omitted) (footnote omitted). The same assessment seems to me to clearly apply to the Social Security tax as well.

129. See *supra* Part II.B.

130. According to the standard U.S. poverty level measures, the U.S. elderly as a group are at about the same level of poverty as the population at large; however, this measure has been criticized as being out of date, ignoring the much higher costs of medicine and medical care that the elderly disproportionately face. Recently, New York City Mayor Bloomberg's staff developed an alternative measure under which about one-third of New York's elderly would be considered to be living in poverty. See Cara Buckley, *City Refines Formula to Measure Poverty Rate*, N.Y. TIMES, July 14, 2008, at B2, available at <http://www.nytimes.com/2008/07/14/nyregion/14poverty.html>; see also CARMEN

worth” argument, from this perspective, becomes largely irrelevant in determining the appropriate level of Social Security taxes, including the wage base.

c. Optimal Base Level

What then would be the optimal level for the wage base, given that neither program principles nor tax policy principles provide any specific guidance? As long as the contribution and benefit base is unified, clearly the minimum level should be the traditional 90% of wages in the national economy. The current indexation mechanism is not effectively maintaining that level, as pointed out above, because the increasing disparity between high-income earners and everyone else has increased dramatically over the last two decades.¹³¹

Raising the contribution and benefit base for both tax and benefit calculation purposes to \$150,000, which in 2006 would have covered 90% of all earnings, would at that point have eliminated about 40% of the long-term revenue shortfall for the system.¹³² An ad hoc increase of this nature, however, would mean an immediate tax increase for what might be called middle-upper income wage earners and would undoubtedly be wildly unpopular with that group of likely voters, making any such proposal difficult to enact in the absence of an immediate financing crisis along the lines of the 1983 financing situation.¹³³

DENAVAS-WALT, BERNADETTE D. PROCTOR & JESSICA C. SMITH, U.S. DEP'T OF COMMERCE, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2008, at 2, 18 (2009), <http://www.census.gov/prod/2009pubs/p60-236.pdf> (noting that in 2007 the number of poor elderly would be 13 million higher if social security payments were excluded from income, more than quadrupling the number of poor elderly, and that the elderly represent 12.6% of the total U.S. population and 9.2% of the poor population).

131. See MULVEY & WHITMAN, *supra* note 41, at 1.

132. *Id.* at 13. The authors put forth a few options for raising or eliminating the taxable earnings base. For example,

[o]ne proposal would slowly raise the taxable wage base for both employers and employees to cover 90% of all earnings and credit these taxes to allow individuals to receive correspondingly higher benefits. In 2006, it was estimated that a cap of \$171,600 would roughly cover 90% of wages. Under this option, benefits at retirement for high earners would also rise. These changes would have a net positive impact on the Social Security Trust Funds. . . . Raising the wage base to 90% would eliminate 43% of the long-range financial shortfall—extending the Trust Funds' exhaustion date to 2044. To achieve solvency for the full 75-year projection period under this option, the total payroll tax rate would have to be raised by an additional 1.09 percentage points (from 12.40% to 13.49%) or other policy changes would have to be made to cover the shortfall.

Id. (footnotes omitted).

133. *Id.* For a discussion of the importance of the 1983 Social Security financial crisis to

One widely circulated proposal for gradually raising the base to the 90% target level was made by the late Robert Ball, former Commissioner of Social Security and a widely respected voice in social insurance analysis for fifty years.¹³⁴ The Ball proposal was designed to resolve any long-term financing shortfalls in Social Security revenues by addressing the wage-base issue as well as adding additional dedicated financing sources to the current mix of payroll taxes and income tax revenues from taxation of Social Security benefits. Ball proposed a 2% per year increase in the base limit, in addition to already-scheduled automatic-indexing increases over several years, to eventually reach 90% of covered payroll.¹³⁵ This is an example of one possible way to gradually phase in an increase while minimizing the immediate effect on workers who now have at least some wages above the current base limit, a clear political advantage. By itself, this change would do very little to address any near-term financing concerns, but the base would eventually be brought up to its traditional target level with only a very small yearly impact in increased taxes for each worker.

However, even with such an ad hoc increase, whether all at once or over a long period of time, the base would still be playing catch-up in the future, as the current measure for automatic increases in the wage base, which uses average earnings to develop the index figure, misses wages at the top.¹³⁶ A further suggestion, therefore, has been made to change the base for the index calculation from average wages to aggregate earnings, which would stabilize the 90% level, preventing further leakage resulting from increasing earnings disparity.¹³⁷ Such a technical change in the definition of the wage base would clearly be a correction within the scope and intent of current law, although the 90% of aggregate earnings target would have to be reached by one or more ad hoc increases in the current base before any new indexing measure would be effective. The effect such a change would have on Social Security financing would depend on how quickly the new measure was phased in, but modifying the base calculation to use a more expansive measure would directly address at least some fairness issues of the current base by making future automatic increases more likely to capture wages at the top. Such a change would clearly improve the function of the contribution and benefit base in capturing most earnings for both benefit

the enactment of rescue legislation, see ALTMAN, *supra* note 36.

134. See Century Found., Social Security Reform Check List #1: The Robert M. Ball Plan (1999), http://www.socsec.org/facts/Check_Lists/checklist1.pdf.

135. *Id.*

136. Soc. Sec. Admin., National Average Wage Index, <http://www.ssa.gov/OACT/COLA/AWL.html> (last visited Apr. 20, 2010).

137. See MULVEY & WHITMAN, *supra* note 41, at 8.

and tax purposes. Still, however, from the perspective of the ordinary taxpayer, any limit on earnings subject to FICA is likely to seem unfair.

III. THROUGH THE DOUGHNUT HOLE?

Since 1935, the concept of the contribution and benefit base has remained essentially unchanged except for regular increases in amount. Changing the measure of contribution and benefit base increases from average to aggregate wages could be viewed as one way to redesign the base, but it would essentially be a correction in the measure used in the current indexing system, not a fundamental redesign. The innovative aspect of the doughnut hole suggestion is that it would actually redesign the base by leaving the current indexed base as it is and instituting a second-tier base applicable to workers with yearly earnings at or above \$250,000 (presumably indexed), thus creating a gap in which earnings above \$106,800 (the limit for 2010) but below \$250,000 would not be subject to FICA at all.¹³⁸

President Obama's economic advisors said during the 2008 campaign that the \$250,000 level for his wage-base proposal is not necessarily set, and that the increase in the wage base on which FICA taxes are assessed might or might not be linked to an increase in benefit base on which benefits are calculated.¹³⁹ Obviously, more net revenue would be raised if the wage base were raised while the benefit base remained set and increased only as average wages increase. Even if additional benefits were to be paid as a result of this redesigned wage base, however, the proposal would resolve a substantial part of the currently projected long-range deficit for the OASDI part of Social Security.¹⁴⁰

138. See *supra* note 9 and accompanying text for discussion of the doughnut proposal.

139. The formula for determining the "contribution and benefit base" is determined each year by applying a formula set forth in § 430. 42 U.S.C. § 430 (2006). For 2008, the contribution base was \$102,000 with a tax rate of 6.2%. In 2009, the contribution base was \$106,800. Obama's advisors have also suggested that the tax rate above the doughnut hole would not be the full FICA rate, but rather a 3–4% tax. See *supra* notes 8–9 and accompanying text. This kind of "surtax" model is discussed below.

140. As specialists in this area have discussed,

Raising or eliminating the cap on wages that are subject to taxes could reduce the long-range deficit in the Social Security Trust Funds. For example, if the maximum taxable earnings amount had been raised in 2005 from \$90,000 to \$150,000—roughly the level needed to cover 90% of all earnings—it would have eliminated roughly 40% of the long-range shortfall in Social Security. If all earnings were subject to the payroll tax, but the base was retained for benefit calculations, the Social Security Trust Funds would remain solvent for the next 75 years. However, having different bases for contributions and benefits would weaken the traditional link between the taxes workers pay into the system and the benefits they receive.

MULVEY & WHITMAN, *supra* note 41. In effect, a decoupling of the wage base from the

The key feature of this proposal, the gap in imposition of the payroll tax for those making over the current base but less than \$250,000 per year, bears a strong resemblance to what is popularly known as the doughnut hole in the Medicare prescription-drug program, a gap in coverage that was built into the reimbursement structure in the legislation that created the program in 2004. The Medicare drug program covers drug expenses up to \$2,810 a year and then does not cover drug expenses above that until the individual's expenses for the year reach \$4,550 (these are the limits for 2010), after which reimbursement begins again.¹⁴¹ While this doughnut hole, as it came to be known, may be effective in limiting program costs while still providing additional coverage for those with very high drug expenses, it has proven to be confusing and worrying for elderly Medicare beneficiaries.¹⁴² A tax doughnut hole is unlikely to create that level of anxiety, but other problems might make it equally unpalatable.

Clearly the main reason for the proposed Social Security base gap is political palatability, as it would exempt a large group of upper-middle-class voters (or at least a large number of people who think of themselves as middle class) from a tax increase.¹⁴³ It is unclear whether there is any real rationale for the doughnut hole beyond the politics of distributional effect. But if we take this proposal seriously from a policy perspective, despite its many flaws, perhaps there are elements that could be incorporated into

benefit base was accomplished for the Medicare program in 1993 when the wage base was eliminated for the Health Insurance (HI) portion of FICA but not for the cash benefit retirement, survivor, and disability programs. The base elimination in Medicare raised few programmatic concerns because Medicare benefits are in the form of payment of medical expenses and are not connected to preentitlement earnings or taxes paid.

141. See Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173, 117 Stat. 2066 (codified in scattered sections of 42 U.S.C. (2006)); see also CTRS. FOR MEDICAID AND MEDICARE SERVS., CMS LEGISLATIVE SUMMARY: MEDICARE PRESCRIPTION DRUG, IMPROVEMENT, AND MODERNIZATION ACT OF 2003, PUB. L. NO. 108-173 (2004), <http://www.cms.hhs.gov/MMAUpdate/downloads/PL108-173summary.pdf>; David Pratt, *The New Medicare Part D Prescription Drug Benefit*, 17 ALB. L.J. SCI. & TECH. 337 (2007). For long-range estimates of the plan, see 2009 BD. OF TRUSTEES REPORT, *supra* note 8. "Under the intermediate assumptions, the annual balance is positive for eight years (through 2016) and is negative thereafter. This annual deficit rises rapidly, reaching 2 percent of taxable payroll by 2024, and continues rising generally thereafter, to a level of 3.87 percent of taxable payroll for 2083." *Id.*

142. See Posting of Victoria E. Knight to Wall Street Journal Health Blog, <http://blogs.wsj.com/health/2008/11/18/seniors-still-mystified-by-medicare-doughnut-hole/tab/article/> (Nov. 18, 2008, 16:39 EST).

143. See, e.g., Posting of David Leonhardt to Economix, <http://economix.blogs.nytimes.com/2009/08/21/what-about-the-upper-middle-class> (Aug. 21, 2009, 11:55 EST) (discussing views on the effect Obama's Social Security proposal would have on the upper-middle class); GERALD PRANTE, TAX FOUND., NEW CENSUS DATA ON INCOME GIVES A WELCOME DOSE OF FACT CHECKING TO "MIDDLE-CLASS" RHETORIC, Sept. 11, 2007, <http://www.taxfoundation.org/files/ff102.pdf>.

other possible redesigns for the base that achieve some of the goals of the doughnut hole without creating the same problems. The common thread of much of the substantive critique of the proposal, however, is the transformation it would produce in the character of the payroll-tax system, making it in many ways, mostly unfortunate, more similar to the income tax.

Sadly, many commentators criticizing the proposal appear to have little understanding of Social Security's actual underlying principles. Therefore, it is necessary on the one hand to analyze and critique the doughnut hole idea from a genuine Social Security and tax policy perspective, while on the other to debunk at least some of the commentary that cynically or mistakenly uses distorted descriptions of Social Security core principles to score political or ideological points. Much of the rhetoric in this commentary amounts to thinly disguised attacks on Social Security itself, taking advantage of the doughnut hole proposal to renew a decades-old challenge to the concept of social insurance.¹⁴⁴

A. Substantive Critique

The principal purpose of the doughnut hole proposal is to increase Social Security revenues while making the payroll tax less regressive in impact, all in a politically palatable manner. As discussed above, raising the wage base to cover at least 90% of wages in the economy is not only consistent with program purposes, it is probably a necessity given the great disparity in wages and income in the American economy that has caused the wage base to lag behind that target.¹⁴⁵ But the Obama proposal would import distributional equity into the payroll tax to an unprecedented extent while still holding harmless a large segment of politically influential wage earners.¹⁴⁶

The underlying problem is, of course, that the payroll tax is essentially a flat tax imposing a proportional tax burden up to the wage base, with a regressive effect resulting from the lack of taxes on wages above the base. All other factors being even (same base, same definition of wages, etc.), a

144. See *infra* notes 160–75 and accompanying text.

145. For an analysis of the growing gap in income between rich and poor, see ARLOC SHERMAN, CTR. ON BUDGET & POLICY PRIORITIES, INCOME GAPS HIT RECORD LEVELS IN 2006, NEW DATA SHOW: RICH-POOR GAP TRIPLED BETWEEN 1979 AND 2006 (2009), <http://www.cbpp.org/cms/index.cfm?fa=view&id=2789>.

146. See, e.g., Posting of Glenn Kessler to Trail, http://blog.washingtonpost.com/44/2008/06/13/obama_clarifies_social_security.html?hpid=topnews (June 13, 2008, 11:14 EST) (noting that Obama asserted that his plan “can extend the promise of Social Security without shifting the burden on to seniors’ while leaving ‘absolutely no change’ in taxes for 97 percent of Americans”).

flat-rate payroll tax simply cannot produce a progressive-rate tax result, even though raising the base would mitigate the regressive effect of the current tax. The doughnut hole proposal is an attempt to go a step further by essentially imposing a new tax on earnings above \$250,000 with no additional limit; however, while it would increase the overall progressivity of the payroll tax, it would also create somewhat perverse effects and incentives for earnings below \$250,000.¹⁴⁷

First, the open question of whether the proposal would apply to the base for benefits as well as for taxes has no good or obvious answer. The overall issue of splitting the two bases as a general proposition will be discussed below, but in looking at the question strictly in the context of the doughnut hole proposal, obvious equity issues would arise if earnings above \$250,000 were counted for benefit purposes but those between the current base and \$250,000 were not. For one thing, including those top earnings in the benefit calculation would fly in the face of one principal rationale for the limit on the benefit base—that workers at the very top of the earnings scale should not get additional benefits based on those earnings from a publicly funded social insurance program.¹⁴⁸ That objection might be overcome by the programmatic purpose discussed earlier, that the wage base should be as inclusive as possible in order to properly reflect the ups and downs of a worker's record who might be at the top for a few years and near the bottom for others.¹⁴⁹

However, there is no real answer for the complaints of those with earnings in the gap about getting less in the way of benefit accrual than those with much higher earnings. This result, while probably not increasing significantly the overall replacement rates for the highest earners, would be difficult to explain and very likely would be perceived as inequitable by those with earnings in the gap and probably by those with earnings below the gap as well. The political power of the earnings-based benefit principle would certainly be diminished by a benefit-accrual structure that to most people would appear as capricious and unfair as the current Medicare prescription-drug coverage gap does.¹⁵⁰

Second, the gap would complicate the payroll tax for both workers and employers, negating one great advantage of any flat tax—simplicity and

147. See discussion *supra* Part II.B.2.

148. See *supra* note 89 and accompanying text (noting that the benefits base reflects the concept of limiting upper-income benefits out of public necessity).

149. It might also be possible to amend the benefit formula, currently a three-bracket structure, to add a fourth tier to provide 10% or 5% of AIME above a certain level, instead of the 15% provided currently, so as to minimize the effect of the highest earnings on the ultimate benefit.

150. See Pear, *supra* note 29 (describing disdain toward the current Medicare doughnut hole policy).

ease of collection. Since the payroll tax is essentially administered and collected by employers, the employers would bear most of the burden of determining when workers would hit the first contribution base limit so as to stop withholding at that point, only to have to begin withholding again later in the year after the \$250,000 floor for the next tier of the base was reached.¹⁵¹ From the employee side, the complication would be more a matter of understanding and acceptance of a more complex structure that would be difficult to explain. Again, the example of the Medicare prescription is instructive—regardless of the desirability of the distributional consequences of the program’s coverage gap, it is very difficult to explain, let alone justify, to those directly affected.

Granted, the elderly population affected by the drug plan may be less able to absorb the nuances of the changes in Medicare than workers who are younger and who have less immediately at stake than eighty-five-year-old widows terrified of being unable to pay for their medications. Nonetheless, complexity is one of the most widely perceived negatives of the income-tax system in contrast to the simplicity and relative ease of the payroll tax, and the more the latter is modified to look more like the former, the more resistance to any change in the payroll tax is likely to be created among taxpayers generally.¹⁵²

Third, a gap in the wage base would in all likelihood exacerbate already-existing perverse incentives to game the payroll-tax system by keeping compensation out of the payroll-tax box. The current contribution and benefit base limit for the OASDI portion of FICA generally limits its effects to employees who have few opportunities to change the way they are compensated in order to avoid the payroll tax.¹⁵³ However, when the wage

151. The task would be made even more difficult by gaming opportunities, which are discussed below. *See infra* notes 153–57 and accompanying text.

152. “The complexity of our tax code breeds a perception of unfairness and creates opportunities for manipulation of the rules to reduce tax. The profound lack of transparency means that individuals and businesses cannot easily understand their own tax obligations or be confident that others are paying their fair share.” PRESIDENT’S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR & PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 1 (2005), http://www.taxfoundation.org/UserFiles/Image/Blog/Executive_Summary.pdf. *See generally* Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673 (1969) (discussing the structural complexity of the income-tax collection procedure).

153. Most employees do not control the timing of their wages and are governed by their employer’s decisions on how often to pay them (weekly, bi-weekly, monthly, etc.) for services performed. In many states, in fact, it is illegal for employers to agree to defer wages or salaries for any period. *See, e.g.*, *Stanton v. Lighthouse Fin. Servs., Inc.*, 621 F. Supp. 2d 5, 14–16 (D. Mass. 2009) (ruling that an agreement to defer the payment of salary violated the Massachusetts Weekly Wages Act and was therefore void). Executives signing contracts for deferral of a portion of future compensation under nonqualified arrangements are not

base was eliminated for Medicare's hospital-insurance portion of the tax in 1993, highly compensated executives and professionals suddenly faced an additional 1.45% tax on all their earnings over the regular base.¹⁵⁴ This relatively sudden tax increase on upper level wage compensation was likely a factor encouraging the development of a plethora of deferred compensation and equity compensation techniques that allow highly paid employees to defer (and sometimes permanently evade) income and payroll taxation on substantial portions of their income from work.¹⁵⁵

Even though Congress has acted recently to try to rein in the most egregious of abusive deferred-compensation techniques,¹⁵⁶ the ability of highly paid executives to structure their compensation arrangements seems not to have been substantially limited.¹⁵⁷ These techniques would therefore be available for evasive possibilities for these taxpayers in the event of any large increase in the payroll tax. The introduction of a gap in the earnings to which an additional 6.2% of payroll taxes would apply adds more wrinkles to the possibilities and also increases the universe of workers with more incentive to distort the character of their compensation. While workers making less than \$250,000 generally have less control over their compensation than executives and professionals at higher compensation levels, compliant employers, anxious to avoid the employer share of the FICA tax, might well be helpful in keeping compensation characterized as wages under the \$250,000 limit. This kind of gaming strategy is more akin to the kind of manipulations that have long plagued the income tax and might cost the Social Security system much of the limited acceptance the payroll tax has enjoyed over the years.

affected by such statutes. For a discussion of the wage realities for lower paid Americans, see HEATHER BOUSHEY ET AL., CTR. FOR ECON. POLICY & RESEARCH, UNDERSTANDING LOW-WAGE WORK IN THE UNITED STATES (2007), <http://www.inclusionist.org/files/lowwagework.pdf>.

154. See MULVEY & WHITMAN, *supra* note 41, at 2–3 (discussing the outcome of the Medicare wage-base elimination).

155. The general topic of the ability of highly compensated employees to manipulate the payroll tax system will be the subject of another article. See Patricia E. Dille, *Are [Payroll] Taxes Really Just for the Little People* (forthcoming).

156. See I.R.C. § 409A (2006) (enacted by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885, 118 Stat. 1418, 1634–41 (2004)). *But see* Michael Doran, *Time to Start Over on Deferred Compensation*, 28 VA. TAX REV. 223 (2008) (arguing that § 409A of the Internal Revenue Code and the ensuing regulations implementing it did little to restrain game playing with executive compensation arrangements).

157. See, e.g., Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008) (analyzing private equity funds employing the partnership form to provide a profit interest to manager partners, thereby transforming services income into investment income taxed at the capital gains rate, currently 15%, as opposed to ordinary income, which is taxed at a top rate of 35%).

In sum, the doughnut hole proposal might achieve marginally better distributional results in tax burdens than the current FICA wage base does, but at the high cost of importing to the Social Security tax system some of the most unpopular characteristics of the income tax—seeming capriciousness, unreasonable complexity, and increased incentives to distort economic realities in order to avoid a tax liability.¹⁵⁸ The only real advantage of the gap from a tax fairness perspective is that only taxpayers at the highest income levels would have increased tax liability, so that those taxpayers would finally be bearing what many workers who never have earnings in excess of the wage base would consider a more equitable tax burden.

Indeed, much of the criticism of the proposal simply points out (with considerable horror, it must be said) the new, higher marginal tax rates to which the highest earning taxpayers would be subjected once FICA applies to wages above \$250,000.¹⁵⁹ But those increased rates would be the product of almost any proposal to increase revenues for Social Security, with or without the doughnut hole. The question is whether the increase in what many would consider “tax fairness” is worth the considerable negatives that accompany the gap, and whether it might not be worth taking the political heat and simply raising the wage base without a gap.

B. The Illusory Critiques

Clearly the doughnut hole proposal has a number of serious problems when examined from a Social Security program as well as a tax equity and administration perspective. However, the proposal has also been attacked by a number of commentators claiming to base their opposition to the proposal on its betrayal of what they portray as fundamental principles of the Social Security system. On closer examination, though, many of the most ferocious critiques are grounded in a complete misunderstanding or misrepresentation of basic principles of Social Security. The end result,

158. Some of the unpleasant characteristics of the income-tax system have been described as follows:

Substantively, the income tax is a mess. Taxpayers at every income level confront extraordinary complexity. . . . Many feel like “chumps” if they pay the taxes they legally owe. Young people, especially, admit that they feel no compunction about filling out their tax forms dishonestly. And the Internet has facilitated growth of the “tax deniers” movement—people who spread their rejection of the legitimacy of any income tax requirements, including the requirement for employers to withhold taxes on their employees’ wages.

Michael J. Graetz, *Taxes that Work: A Simple American Plan*, 58 FLA. L. REV. 1043, 1045–46 (2006).

159. See, e.g., Andrew G. Biggs, *Barack Obama’s Social Security Donut Hole*, AEI.org, March 2008, at 1, <http://www.aei.org/issue/27704>.

whether intentional or accidental, is the promotion of notions not only antithetical to a real understanding of Social Security, but also designed to paint a false picture about the program's financial future and the relationship between benefits and financing alternatives.

For example, one commentator, in discussing the President's wage-base proposal, has said that the link between the benefit base and contribution base means Social Security was modeled on a "Contributory Model," under which "you pay in part of your paycheck until you've paid enough to 'cover' your benefits, then (if you keep earning) you don't have to contribute any more."¹⁶⁰ It is unclear what this commentator had in mind, but this description bears little resemblance to either the original Social Security plan of 1935 or the revamped version of social insurance enacted in the Social Security Amendments of 1939 or, indeed, even to any private pension model in existence either in the 1930s or later.¹⁶¹ Some employer-sponsored defined-benefit pension plans can be described as "contributory" in that they allow or require employees as well as employers to make contributions.¹⁶² However, such plans were highly unlikely to have served as a model for planners in the 1930s as they were quite rare until after the enactment of Social Security, and even under such plans (they are still to be found in state and local government plans), the employee's contribution does not limit the amount of benefits paid.¹⁶³

A persistent element of many of these critical assessments is the charge that a gap in the base would fundamentally change Social Security or somehow be in complete contradiction to basic principles of the program.

160. Posting of Mickey Kaus to Slate, <http://www.slate.com/id/2193674/#bigdonut> (June 17, 2008, 12:47 EST).

161. See *supra* notes 38–45 (discussing the original Social Security Act of 1935 and the Amendments of 1939).

162. STAFF OF J. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EMPLOYER-SPONSORED DEFINED BENEFIT PENSION PLANS AND THE PENSION BENEFIT GUARANTY CORP. ("PBCG") 13 (Comm. Print 2005), available at <http://www.house.gov/jct/x-3-05.pdf> (discussing the present rules regarding qualified retirement plans).

163. Three-quarters of the pension plans established between 1874 and 1929 were wholly employer financed. The other quarter of plans either required employee contributions or, less commonly, allowed voluntary employee contributions to supplement employer-provided sums. The reverberating economic effects of the Great Depression of the 1930s, coupled with the United States government's creation of Social Security, led employers to begin largely trending toward implementation of contributory pension plans in place of defined benefit plans. See Patrick W. Seburn, *Evolution of Employer-Provided Defined Benefit Plans*, MONTHLY LAB. REV., Dec. 1991, at 16, 19, available at <http://www.bls.gov/opub/mlr/1991/12/art3full.pdf>. It is not really clear what Kaus means by "contributory" pension plan—he might well be thinking of a defined contribution plan along the likes of a § 401(k) plan, which did not exist until the late 1970s, making it unlikely as a model for Social Security. See Posting of Mickey Kaus, *supra* note 160.

“Social Security is structured so that the more you pay in, the more you get back. That’s what supposedly makes it a compact among the generations and not a welfare program. Actually, what it does is make it an inefficient, disguised welfare program.”¹⁶⁴ In his comment, Ramesh Ponnuru seems to be assuming that the gap proposal would apply to the wage base alone, which is probably reasonable given the difficulties discussed earlier with omitting a large range of earnings records from benefit calculations. Nonetheless, that feature is not yet actually a part of the proposal according to Obama’s advisors.¹⁶⁵

Ponnuru also completely misstates and oversimplifies the structure of Social Security benefit accrual, which is, as described earlier, based on earnings, not on taxes paid, and of the Social Security benefit structure, which provides redistributive benefits based on the weighted-benefit formula but not paid based on proof of need, which is the essence of welfare.¹⁶⁶ The critique itself, however, reveals the commentator’s essential hostility to the notion of redistribution, something that is hardly a direct product of the gap but is rather essential to the mission of social insurance.

Another commentator, Nicholas Kaster, echoes the same theme:

Moreover, under current rules, Social Security caps both benefits and earnings. Thus, unless Obama also favors paying more Social Security benefits to the wealthier earners—highly unlikely—then his plan undermines Social Security’s historic role as a basic social safety net rather than a program that redistributes income. This realization has triggered criticism even from Democrats, including Henry Aaron of the liberal Brookings Institution and former Rep. Charles Stenholm of Texas. When you say you’re going to begin means-testing the program,” Stenholm noted, “you begin to convert Social Security from an insurance program to a welfare program.”¹⁶⁷

Kaster is of course mistaken about Social Security’s historic role—Social Security has always functioned as the baseline of income support in old age, part of the “safety net,” but it has done so by redistributing income, through the progressive-benefit formula, with benefits financed by all

164. Posting of Ramesh Ponnuru to National Review Online, <http://corner.nationalreview.com/post/?q=ZjYxMTIwZTIxMTBkYTlhNzhjZDFjNjgwMWNiZWZzZDc=> (June 13, 2008, 17:17 EST).

165. See Furman & Goolsbee, *supra* note 8; Obama Remarks, *supra* note 8; Rhee, *supra* note 8.

166. See 42 U.S.C. § 415 (2006) (requiring that an individual’s basic Social Security benefit be calculated based on percentages of the individual’s average indexed monthly earnings). For a discussion of the nature of welfare, see FRANCES FOX PIVEN & RICHARD A. CLOWARD, *REGULATING THE POOR: THE FUNCTIONS OF PUBLIC WELFARE* (1971).

167. Posting of Nicholas J. Kaster to American Thinker Blog, http://www.americanthinker.com/blog/2008/06/obamas_latest_proposal_to_incr.html (June 19, 2008, 11:01 EST).

workers regardless of their chances of ultimately collecting benefits, in a manner similar to private-insurance risk sharing.¹⁶⁸

It is hard to imagine, moreover, how a public program could function as a safety net without some degree of redistribution. As discussed earlier, the decision to pay higher than strictly proportional benefits to the lowest earners was made right from the start of Social Security and is certainly not a product of President Obama's proposal.¹⁶⁹ It is true that means testing Social Security benefits would fundamentally change the program's character, but that is not what the wage-base-gap proposal would do.¹⁷⁰ It is a substantial and unsupported leap from a proposal to tax higher wage workers, with or without allowing them to accrue additional benefits on their highest wages, to "means testing," which requires actual "testing" of "means," i.e., proof of inadequate income and assets, and demonstration of current need.¹⁷¹ The core principle of social insurance¹⁷² is the right to a stream of income in old age or disability based on presumed rather than demonstrated need, providing future security while avoiding disincentives to accumulate and save income and resources.¹⁷² This is the diametric opposite of the welfare-program dynamic, the essence of which is to support those who are in current (and in the U.S. program design, dire) need.¹⁷³

The common characteristic of these critiques of the gap proposal is their

168. Private insurance program distribution methods have been described as follows: The characteristic of risk distribution sets insurance contracts apart from other kinds of contracts. It can be said, then, that a contract of insurance is an agreement in which one party (the insurer), in exchange for a consideration provided by the other party (the insured), assumes the other party's risk and distributes it across a group of similarly situated persons, each of whose risk has been assumed in a similar transaction.

ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW 14 (4th ed. 2007) (emphasis removed).

169. See *supra* notes 36–76 and accompanying text (exploring the origins of Social Security as a redistributive system).

170. See Posting of Nicholas J. Kaster, *supra* note 167 (arguing that "unless Obama also favors paying more Social Security benefits to the wealthier earner . . . his plan undermines Social Security's historic role as a basic social safety net").

171. See generally PIVEN & CLOWARD, *supra* note 166 (discussing the welfare program dynamic).

172.

Although the definition of social insurance can vary considerably in its particulars, its basic features are: the insurance principle under which a group of persons are 'insured' in some way against a defined risk, and a social element which usually means that the program is shaped in part by broader social objectives, rather than being shaped solely by the self-interest of the individual participants.

Soc. Sec. Admin., Historical Background and Development of Social Security, <http://www.socialsecurity.gov/history/briefhistory3.html> (last visited May 13, 2010) (discussing the general principles of social insurance).

173. See generally PIVEN & CLOWARD, *supra* note 166.

mischaracterization of Social Security's basic principles, a distortion that mainly seems to stem from an underlying opposition to income redistribution, which is an actual basic principle of social insurance but not something peculiarly characteristic of the gap proposal itself. The notion that redistribution from higher wage workers to lower wage workers would somehow abrogate the "compact between generations" or taint the earnings-based foundation of the benefit structure ignores the fact that redistribution from higher income to lower income is at the heart of not just Social Security, but public financing of government functions generally.¹⁷⁴

These kinds of criticisms of the doughnut hole proposal should therefore be seen less as actual critiques of the gap and more as rhetorical tactics aimed at contributing to an overall misapprehension of Social Security—part of the continuing conservative resistance to Social Security's redistributive income security, a campaign that has persisted through the entire seventy-five-year history of the program.¹⁷⁵ This strategy essentially creates a "straw man" Social Security, one based on individual equity and return on tax payments that ignores the reality of the actual program of redistributive social insurance. This falsely reconfigured "Social Security" is then used to oppose suggested changes that might actually be consistent

174. See *supra* notes 125–30 and accompanying text (discussing Social Security as a function of redistribution within the larger ambit of the social safety net).

175. Conservative Senator Barry Goldwater published *Conscience of a Conservative*, a work criticizing both Democrats and Republicans in 1960; Nancy J. Altman describes his argument as maintaining that

Social Security and welfare should be provided by the private sector or, if government involvement was absolutely necessary, by state and local governments, but under no circumstances by the federal government. Rather, Social Security and programs like it inevitably, according to Goldwater, lead to "unlimited political and economic power . . . as absolute . . . as any oriental despot." The recipient of these programs, according to Goldwater, is transformed by them "into a dependent animal creature."

ALTMAN, *supra* note 36, at 199. Republican President Ronald Reagan proposed a Social Security reform package that included a recommendation to reduce early retirement benefits among other cuts:

The Reagan proposal would have reduced the benefits for people who retired early more than the actuarial reduction warranted. Specifically, the law provides that people who retire at age 62 receive the actuarially equivalent 80 percent of the monthly amount received by people who retire at age 65. The administration proposed to reduce the percentage to 55 percent of the age 65 benefit.

Id. at 231. Ultimately, President Reagan dropped the most controversial aspects of his plan but formed the bipartisan National Commission on Social Security Reform to make recommendations regarding the Social Security System. *Id.* at 234, 237. The recommendations of the Commission are reflected in the Social Security Amendments of 1983. *Id.* at 253. The next attack on Social Security came from Republican President George W. Bush, who established a presidential commission to study Social Security and stipulated "that the commission's recommendations 'must include individually controlled voluntary personal accounts.'" *Id.* at 265. President Bush continued his campaign to privatize social security throughout his two terms. *Id.* at 272.

with the principles and purposes of the real Social Security program, ultimately driving the debate into a discussion of false choices about the program's financial future and benefit structure.

C. Other Options Within the Current Base Paradigm

The doughnut hole proposal is not the only option for revamping the current wage-base limit with a view to increasing future program revenues. There are a variety of possible redesigns, which include eliminating the limit altogether, restructuring the base into a series of progressive brackets, and expanding the definition of wages to include items such as certain types of deferred compensation when earned rather than when received and compensation for services currently characterized as return on equity. A brief survey of other options for using the base to raise additional revenue gives an indication of why it is critical at this point to rethink the distinction between earning benefits and paying for them.

1. Eliminating the Limit on the Contribution and Benefit Base

The rationale for limiting the base at any particular point below 100% of earnings and wages is somewhat fuzzy and may well be more easily defended for benefits than for taxes. Rather than raising or redesigning the base, eliminating it altogether might resolve several issues at once, especially in spreading the impact of the FICA tax more equitably across income lines and in raising considerable revenue that would go a long way toward resolving the possible future financing difficulties of Social Security.¹⁷⁶ Of course, additional questions would be raised from the absence of a limit specific to FICA, particularly in connection with the additional benefits that would accrue to very highly paid workers. The fundamental question, however, is whether the limited wage base is really an essential element of either the Social Security benefit or tax structure.

The benefit base serves as a limit on yearly benefit accruals under Social Security, a somewhat different approach from the benefit-accrual systems permitted for use in private defined-benefit pension systems. In private defined-benefit systems, benefits accrue over the working career, usually ratably for each year of service, and the final benefit is usually based on the average of several of the highest years of wages under the plan—highest five or highest three, for example—multiplied by a percentage formula and the numbers of years of service under the plan.¹⁷⁷ There is no real

176. See MULVEY & WHITMAN, *supra* note 41, at 17–18 (examining the potential impact of eliminating the wage base).

177. See generally MCGILL ET AL., *supra* note 60.

counterpart to the Social Security benefit-base limit in private plans, whose benefits to highly paid participants are now limited primarily by the tax nondiscrimination rules which require (theoretically, if not always in practice) roughly comparable benefits to be paid to highly compensated and non-highly-compensated employees.¹⁷⁸

The primary difference between benefit accrual under private systems and under Social Security is that the distributional goals of private plans are generally the mirror opposite of the public social insurance program. Private plans generally strive to place as much of the total benefits as possible into the hands of the most highly paid participants, and inclusion of the highest levels of compensation in benefit calculations helps to serve that end.¹⁷⁹ The Social Security benefit structure, in contrast, has a function peculiar to an earnings-based social insurance system in that it is designed to provide proportionally higher benefits, as a percentage of lifetime earnings, to lower earners.¹⁸⁰ The benefit formula determines the level of income replacement for beneficiaries with earnings records at all levels, but the base limit implicitly sets the target for the highest income level we are willing to insure with public funds, since earnings above the base are excluded from the earnings record to which the benefit formula is applied.

The issue of limiting the public subsidy for high-income beneficiaries is important, particularly since one of the only areas of publicly perceived unfairness in the Social Security benefit structure itself is the receipt of benefits by people who apparently do not need them.¹⁸¹ Yet there is no

178. *Id.*

179. *Id.*; see also Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851, 876 (1987) (“The revenue loss attributable to private pensions has been estimated to benefit high-income workers disproportionately, and the distribution of benefits from private pension plans is skewed in the same direction.”).

180. The decreasing percentage applied to increasing levels of wages in the benefit formula produces this result. See Social Security Act, 42 U.S.C. § 402 (2006) (stating the current benefit formula).

181. See, e.g., Posting of Casey B. Mulligan to Economix, <http://economix.blogs.nytimes.com/2010/02/24/are-we-overpaying-grandpa/> (Feb. 24, 2010, 6:00 EST). For a response to this suggestion, see Posting of Dean Baker to Beat the Press, http://www.prospect.org/csnc/blogs/beat_the_press_archive?month=02&year=2010&base_name=the_government_pays_more_money (Feb 25, 2010; 05:10 EST) (“Of course, it would be foolish to compare the money that rich investment bankers get in interest payments on money they have lent to the government with the pure transfer payments that the government makes to ensure that poor children have a decent chance in life. But, it is also foolish to compare the retirement benefits that seniors have largely paid for during their working life, through Social Security and Medicare taxes, with the pure transfer payments that the government makes to ensure that poor children have a decent chance in life.”). For a discussion of what means testing of benefits might mean for the program, see AMER. ACAD. OF ACTUARIES, MEANS TESTING FOR SOCIAL SECURITY (2004),

persuasive programmatic reason (as opposed to political) why the benefit formula could not achieve most of the benefit-limitation goals without any limit on earnings recorded for benefit accrual. As a mechanical question, it would be quite feasible to amend the benefit formula to reduce the benefit accrual on those wages by adding gradually smaller brackets for higher levels—for example, adding decreasing accrual rates on top of the current top 15% rate, to be applied to wages above the current base at brackets designed to produce minimal increments in ultimate benefit amounts. If the objection to inclusion of all earnings in the base is the prospect of excessive publicly funded benefits, a revised benefit formula could insure diminishing replacement rates for wages at the top level and minimize the resulting increase in benefits.

Moreover, there is a reasonable argument for including even earnings at very high levels over a worker's thirty-five or forty-year working career. As discussed earlier, few workers consistently earn at an extremely high level throughout their careers, and it could be argued that the ultimate benefit amount for an earner with a volatile earnings record would more fairly reflect her lifetime average record if the years with very high earnings were included in benefit calculations.¹⁸² Nonetheless, the question remains whether allowing the benefit structure to reflect lifetime earnings for all workers, regardless of earnings levels, is consistent with the targeted earnings-replacement rates on which the benefit structure is based and with the principles of social insurance. As discussed above, the limit on the amount of wages subject to FICA taxes was essentially a by-product of the program designers' determination to cover industrial employees for benefit purposes and has been maintained largely as a matter of symmetry with the benefit base.¹⁸³ From a programmatic perspective, then, there appears to be no real reason to exclude any wages from the wage base if all earnings are included (at least to some extent) in the benefit base. From a tax perspective, elimination of the base would essentially result in an increase of the top marginal tax rates on wage income alone, which would exacerbate an already-existing issue—the problem of top levels of compensation escaping FICA taxes altogether.

Wages would appear to be a less malleable base for taxation than income—they are recorded and reported by a third party, the employer, and for the most part the amount and timing of an employee's wages are not under the recipient's control. But highly compensated workers whose wages now largely escape the OASDI portion of FICA because they are

http://www.actuary.org/pdf/socialsecurity/means_0104.pdf.

182. See *supra* note 95 and accompanying text (noting that earnings often fluctuate over the course of a worker's career).

183. See *generally supra* notes 41–42.

above the wage base are far more likely to control the form and conditions of their compensation than the vast majority of salaried or hourly workers. Highly paid executives are better able to recharacterize compensation as non-wage income or to delay receipt in order to manipulate the timing and amount of tax liability.¹⁸⁴ As discussed earlier, these mechanisms became more popular and important to highly compensated executives when the limit on the base for purposes of the Medicare hospital-insurance portion (1.45%) of the FICA tax was eliminated in 1993.¹⁸⁵ Any attempt to impose an additional 6.2% OASDI tax on top of earnings will inevitably encourage even more strategies to avoid compensation in the form of wages. In the absence of measures to capture compensation in disguise, eliminating the limit on the wage base for tax purposes may result in far less revenue than might be anticipated.

2. *Making the Base Progressive*

Simply raising or eliminating the current base limit is not the only option for making the base more fair and effective in financing and calculating benefits. So long as most wages of most workers are included in the main contribution and benefit base, a tiered approach for wages above the currently applicable base might be explored. This would be similar to the doughnut hole proposal in some ways, except that instead of a gap where no tax is imposed followed by full taxation above the gap, intermediate base levels and taxes could be added to the current base. For example, half the current tax rate could apply to wages between the current base and \$250,000, and then a quarter to 30% of the rate to wages above that, with proportionately smaller benefit accruals at each level.¹⁸⁶ There are many possible variations on the theme of a progressive wage base, but the essential goal is a compromise, allowing the benefit-accrual system to partially reflect earnings above the current base level while imposing the wage tax on all earned income.

Such a tiered system would clearly be the inverse of a progressive rate

184. See *supra* notes 153–58 and accompanying text (discussing the ability of higher paid persons to engage in gaming of the Social Security benefit system).

185. See MULVEY & WHITMAN, *supra* note 41, at 8 (noting the elimination of the Medicare wage base and discussing potential effects of elimination of the Social Security wage base in comparison).

186. This tiered approach is similar to legislation introduced in the 109th Congress by Representative Wexler. His bill, H.R. 2472, would impose an additional Social Security contribution of 3% of wages above the current wage base on workers and employers. In his bill, however, earnings above the base would not be included in the benefit computation base. See Social Security Forever Act of 2005, H.R. 2472, 109th Cong. (2005), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_bills&docid=f:h2472ih.txt.pdf.

structure, and would import some of the complexity of the tiered income-tax design into the payroll tax. On the other hand, it would reduce some of the incentives for gamesmanship at the top wage levels because the tax rate would be less than the full 6.2%, which would provide some benefit accrual even at the very top of the earnings scale. Most importantly, perhaps, such a base structure would restore some fairness to the payroll tax in the mind of most taxpayers by imposing at least some FICA tax on all wages. It is unclear, however, that the complexity resulting from mirroring the progressivity of the income tax (limited as it is) in the payroll-tax base is worth the effort, particularly when there is a more direct, simpler, and ultimately more flexible way to accomplish the same goal. That solution, however, requires some fundamental rethinking of the basis of entitlement to Social Security benefits.

IV. RETHINKING THE BASE LIMIT PREMISE

While the doughnut hole proposal may lack credibility and substance as a serious policy proposal at this point, even suggesting such a change opens the debate about FICA taxes to a new level of questions about what other design changes might be considered that would improve the future finances of Social Security while also promoting its programmatic goals. What is necessary is a simple but fundamental shift in thinking, albeit one grounded in the program's original and enduring premise that work itself creates the right to security and that could lead to more creative approaches to future financing shortfalls in Social Security, based on decoupling the base for earning benefits from the base for payroll taxes. Such an approach would make it easier to consider alternative revenue options, to add to the current nonpayroll-tax sources of financing Social Security, that would achieve greater parity in tax burdens and additional revenue (if and when that is necessary) without violating any real basic principles of social insurance.

This reframing is essentially focused on the legal basis of entitlement under Social Security: both Medicare and Social Security cash benefits are earned through working, not through paying payroll taxes, and benefits are financed through many sources, not just payroll taxes.¹⁸⁷ Payroll taxes finance not the individual benefits of the taxpayer but the overall Social Security system and the furtherance of its goals, ultimately social stability and individual financial security.¹⁸⁸ The failure to recognize and structure public policy around the distinction between taxes paid and benefits earned has made the payroll tax into a straightjacket on analysis and development

187. *See supra* notes 121–30 and accompanying text (discussing the erroneous notion of Social Security as a system that returns benefits based on the amount of tax contributed).

188. *Id.*

of financing options. Once the distinction is recognized, however, reimagining the contribution and benefit base (and in particular the limit) becomes a real possibility and more than an academic exercise.

The traditional defined-benefit pension model, particularly the concepts of benefit accrual combined with program-funding requirements, provides an analogy that may make this distinction easier to recognize. Employer-sponsored pension plans base the ultimate benefit of participants in the plan on, in part, a method of accruing benefits over the participant's years of service with the employer, similar to the years of earnings credits tracked by the Social Security Administration for each worker covered by the program.¹⁸⁹ Financing of private pension benefits, on the other hand, is a completely separate issue, with funding requirements based on funding needs for whatever benefits have been promised under the terms of the plan.¹⁹⁰ While there are many dissimilarities between Social Security and employer-provided pensions, in this respect the comparison is an apt one—workers earn their private pension benefits, and plan sponsors, normally employers, fund the trust that eventually pays those benefits. In the same way, it is work that creates the entitlement to Social Security benefits, and those benefits are funded by the “plan sponsor,” the taxpayers themselves, with the federal government as the manager of the plan and its trust.

If we separate the tax function of the base from the benefit-accrual function, immediately the policy options for increasing revenues to the Social Security system are freed from the inherent regressivity and possible employment impact of payroll-tax increases. The possibilities for additional financing range from a dedicated income surtax on taxpayers with more than \$250,000 in earned income in a year, which would mimic the Obama payroll-tax proposal, to simply supplementing payroll-tax revenues with general tax revenues in any year in which the trust fund reserves are inadequate to fully fund benefit payments. Even the President's doughnut hole proposal might be more feasible if it produced additional revenues from the highest wage workers with no additional benefit entitlement, although all the aforementioned problems with tax avoidance would still be a formidable obstacle.

If additional revenues are the only goal, it might be more consistent with Social Security principles to simply impose a surtax on income—not wages—above a certain adjusted gross income level, whether \$250,000 or \$200,000, and earmark the results for financing Social Security. This approach would have many signal advantages—the tax rate and affected

189. *See supra* note 177 and accompanying text (explaining how benefits accrue during an employee's working career).

190. *See id.* (discussing financing of private pension benefits).

income level could be adjusted simply based on financing needs rather than on juggling issues of benefit accrual and wage definitions. A surtax could also be readily justified based on the last two decades of changes in the nature of compensation from wages to other types of compensation which escape the wage base, as well as the skewing of the American income structure to an imbalanced share of national income and wealth at the top.¹⁹¹ Such a tax could also be said to make up for the dramatic loss of employer-provided pensions over the last twenty years at the expense of working people's retirement security while the highest corporate earners steered a higher and higher proportion of company earnings into their own compensation packages.¹⁹²

The major objection to these approaches would of course be that it is somehow a breach of principle to look to extra-payroll-tax revenue since the system has always been financed by contributions out of the wages of those accruing benefits on those same earnings. Yet, as discussed earlier, one of the longest standing, yet almost totally ignored, principles of Social Security is the assumption of the drafters that general revenues would of course be part of the long-term financing of the program.¹⁹³ In many ways, that is the case already, given that income taxes imposed by the 1983 Amendments on Social Security benefits received by higher income beneficiaries are earmarked for the Social Security trust funds to be used for financing the program into the future.¹⁹⁴

More importantly, most objections to using general revenues for Social Security financing are based on a misapprehension that Social Security benefits are tied to taxes or contributions so that infusing general revenues into the program's financing would be some sort of violation of a "more you pay, more you get" principle. On the contrary, as stated earlier, benefit accrual under Social Security is based on the individual earnings history, while payroll taxes are a financing source unconnected to benefits actually paid.¹⁹⁵ The contributory principle is important and is more than simply a symbol—it helps to create a direct commitment, a participatory connection between worker and program in a way that a completely general revenue financing system could not. If additional financing is needed, however, it does not seem unreasonable to require additional

191. See generally McMahon, *supra* note 3 (discussing the increasing concentration of income and wealth in the top 1% of the American population).

192. *Id.*

193. See *supra* notes 66–68 and accompanying text (showing the presumption by the original drafters that general revenues would be needed).

194. Social Security Amendments of 1983, Pub. L. No. 98-21, § 121, 97 Stat. 65, 80–84.

195. See *supra* notes 121–30 and accompanying text (discussing the erroneous notion of Social Security as a system that returns benefits based on the amount of tax contributed).

contributions from those at the top income levels who now reap a significantly higher portion of the benefits of a relatively stable social system for an aging population based largely on Social Security.

A more serious problem with decoupling the base for accrual of benefits from the base for taxes is whether the contributory principle would be so degraded that public support for Social Security—and tolerance of FICA taxes—would substantially erode. Currently the public is largely unaware of the degree to which general tax revenues already finance Social Security and Medicare, and the strong feeling of ownership toward both programs, exhibited as recently as in the protests against health care reform that declared hostility to government-provided health care while at the same time demanding protection for Medicare, may well be grounded primarily in the belief that payroll taxes are the source of entitlement.

Of course, decoupling the tax base from the benefit-accrual base in no way implies a change in the earnings basis of entitlement, and additional financing from nonpayroll-tax sources would simply be an extension of current nonpayroll-tax financing. The deeper issue is public perception, which usually trumps reality and fact. If public support for Social Security rests on the perception that each worker is contributing to her own individual savings account that is drawn on in retirement, it might be difficult to persuade the public that adding other revenues to payroll-tax financing is consistent with an earnings-based entitlement. On the other hand, there is very strong public support for increasing the wage-base limit to address any revenue shortfall the system might experience,¹⁹⁶ indicating that American workers generally think higher income taxpayers are not contributing their fair share to support Social Security.

Political considerations aside, a compelling argument can be made for increasing the contributions of higher wage workers without commensurate increases in benefits, and for either a wage tax or an income tax from the perspective of the same fundamental notions of fairness and social benefit that underlie the justification for progressive income taxation. It can be argued that it is fair to tax higher income taxpayers at a higher marginal rate on their top brackets of income, in part because they benefit to a greater degree from social and economic structures and institutions. For example, a surgeon earning \$1 million in a year is able to make and keep those earnings because of a host of public goods: police and fire protection, courts to enforce property rights, public infrastructure, the military, and not least, the Medicare program which makes it possible for many of her patients to pay for her services. Because of her higher level of benefit from

196. *See supra* note 4 and accompanying text (providing polling data on citizen support for an elimination of the tax cap).

those public goods, it is argued that it is not unreasonable for our surgeon to pay a higher marginal rate on the top part of her income as recognition of her greater degree of benefit from the protection of society.

This reasoning applies equally well to the benefits of Social Security which extend far beyond individual benefits—Social Security’s role in stabilizing society and the economy by insuring a steady stream of income at all income levels, maintaining demand, and providing retirees a stable set of income expectations cannot be overstated. The “money’s worth” argument frequently used by critics of the program to attack its value to high-wage workers ignores the value to the upper class of the enormous social good of economic and social stability through the life cycle that Social Security provides. It is therefore not unreasonable to ask them to pay what might be thought of as a “stability premium” in the form of higher payroll or income taxes to be used to insure Social Security’s benefit payments.

Ultimately, the issue of separating the benefit base from the tax base is a question of philosophy rather than economics or tax theory. Americans are unaccustomed to the notion that is widely accepted in most industrialized countries: that people have a fundamental right, based not on work or taxes or fees but on existence in the nation’s jurisdiction, to basic welfare in the form of at least minimal income support and access to health care. Most Americans recognize the civic rights laid out in the Constitution to free speech, voting, etc. as being inalienable for American citizens, but economic and social welfare rights have always in the American system had to be earned, paid for, or both. Social Security is based on that very American notion that economic security in old age must be earned and cannot be a “gift” from the government.

The conflation of the benefit and tax base limits, however, has allowed that “earned right” to be portrayed, particularly in recent years, as not so much earned as “paid for”—paving the way for the last few decades of red herring arguments about the “return on investment” that compared payroll taxes paid in to benefits received. Correcting that erroneous framing to restore the “earned” part of the earned-right principle is an enormous task. Americans have become inured to having every public issue framed as a question of narrow cost–benefit analysis and to looking at all public goods, including the general welfare provided by government programs like Social Security, as a question of narrow self-interest. When the issue of Social Security financing is framed this way, it becomes extremely difficult to increase the payroll-tax base limit without invoking cries of protest that higher wage workers will get less than they ought to in benefits in exchange for their tax payments. When the system is looked at correctly, however, as a system in which benefits are earned, and the system as a whole is paid for

with direct contributions from workers and with other tax revenues as well, the question of raising additional revenue immediately has multiple answers, of which raising the taxable-wage-base limit is only one.

CONCLUSION

Tax policy analysts and commentators are reluctant to follow President Obama through the new doughnut hole he has proposed for the Social Security wage base for a variety of reasons both legitimate (tax avoidance and gaming possibilities) and misplaced (violation of some basic Social Security principle). I suggest in this Article that a clear analysis of the proposal and alternatives should be grounded in a different way of looking at the base and at the fundamentals of entitlement to benefits that are in fact, rather than in fantasy, consistent with Social Security's core principles. If we reframe the entitlement notion itself as one of earnings and work, rather than payments and taxes, the entire question of Social Security financing becomes infinitely more open to multiple answers, ranging from changes in the tax base limit without changes in the benefit base to income-tax surtaxes on higher income taxpayers.

Of course, there is no immediate need to do anything about Social Security financing at all; on a trust fund reserve basis, it will most likely be unnecessary to raise revenue for the OASDI cash-benefit system beyond what is currently projected for at least two decades and possibly longer.¹⁹⁷ A detailed discussion of financing projections and the relationship between dedicated tax financing and the trust-fund concept must wait for a follow-up article, but clearly it makes little sense to increase the dedicated tax base limit now to raise payroll-tax revenues that are not yet needed to pay for current payments. That approach has been tried before—the 1983 Social Security legislation put in place benefit reductions (including the increase in the age for receipt of full benefits) and base and FICA tax rate changes that were purposely designed to build up a large reserve through the 1990s and the first decade of the 21st century, to be drawn on if and when yearly revenues became insufficient to pay yearly benefits in the second quarter of the new century.¹⁹⁸ Now that we may be approaching the point of drawing on those reserves by 2018 or earlier to make up yearly revenue shortfalls, the trust-fund reserves are characterized by critics of Social Security as “imaginary” and alarming cries that the system is “insolvent” pervade the public commentary.

Despite a concerted campaign from conservative political and economic analysts to assert that the trust fund does not exist, however, it is undeniably

197. See generally 2009 Bd. OF TRUSTEES REPORT, *supra* note 8.

198. See generally Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65.

true that American workers paid higher payroll taxes than necessary over the last fifteen years in order to fund in advance the retirement of the baby boom and later generations.¹⁹⁹ Because the trust funds are held as special-issue obligations of the U.S. Treasury, however, the practical effect of surplus payroll-tax revenues over this period has been to finance the general revenue deficit with regressive payroll-tax collections. Once the trust-fund-bond reserves begin to be called upon to make up for yearly revenue shortfalls, clearly income and other tax revenues will be under more pressure to meet other government obligations. Nonetheless, the political-economic obligation to pay Social Security benefits that are earned over a working lifetime, regardless of the source of revenue, remains in place, and the political reality of the trust-fund reserves made up of those excess tax payments largely from baby-boom workers cannot be wished away by those who would rather reduce benefit levels than increase income taxes to repay general fund obligations to the Social Security trust funds.

The real utility of discussing changes to the wage-base limit now, including the President's doughnut hole notion, is to begin to reframe public and policymaker understanding of the real basis for Social Security entitlement as I have laid out in this Article. By reimagining the Social Security contribution and benefit base limit, we can free the analysis and the policymakers from the straightjacket of regressive taxation as well as from irrelevant arguments about rates of return on tax payments into the system. This is not really either an economic or tax policy issue per se—it is rather a question of properly understanding the peculiarly American premise that those who work are entitled to dignified and meaningful economic security. That premise has provided a sound, if not generous, basis for economic and social stability: The future stability of the Social Security benefit entitlement and of the revenue stream that funds those benefits must rest on an accurate understanding and application of that premise so that earned benefits can continue to be paid for by whatever means necessary.

199. See, e.g., COMM. ON WAYS AND MEANS, 98TH CONG., ACTUARIAL COST ESTIMATES OF THE EFFECTS OF PUBLIC LAW 98-21 ON THE OLD-AGE, SURVIVORS AND DISABILITY INSURANCE AND HOSPITAL PROGRAMS 22–23 (Comm. Print 1983) (showing the buildup in trust-fund reserves because of the excess of payroll taxes collected over benefits being paid out from the mid-1980s through 2020, with the corresponding decline in reserves thereafter).