

Background

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Raising the Social Security Wage Cap Would Hurt Small Businesses

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Groups such as the American Association of Retired Persons (AARP) have proposed to “fix” Social Security by raising the \$90,000 cap on the amounts of salaries and wages that are subject to the Social Security payroll tax. Even if the 12.4 percent payroll tax rate remains untouched, raising the payroll tax cap would affect millions of small-business owners, slow economic activity, and cost jobs. That is a high price to pay for a proposal that would not even fix Social Security’s finances.¹

Workers now pay Social Security payroll taxes on the first \$90,000 of annual income. This cap on the payroll tax is indexed to the growth of real wages in the economy and changes every year. For example, the payroll tax cap was \$87,000 in 2003 and rose to \$87,900 in 2004 and \$90,000 in 2005. Any income earned over this amount is not subject to the 12.4 percent payroll tax that funds Social Security’s Old-Age and Survivors and Disability Insurance (OASDI) programs.

Direct and Indirect Effects

Proponents of raising the payroll tax cap point out that most workers would not face a tax increase, but that is not to say that raising taxes on others would not affect them. When people pay higher taxes, they have less to spend on goods and services, which translates into fewer jobs and lower wages across the economy. These indirect effects are especially apparent when those paying higher taxes own businesses and employ workers.

Eliminating the Social Security wage cap would directly raise taxes on 3 million small-business own-

Talking Points

- In addition to *not* fixing Social Security’s finances, raising or eliminating the cap on Social Security payroll taxes would directly raise taxes on 3 million small-business owners who account for almost one-third of the wages and nearly one-fourth of the interest expenses paid out by all small businesses.
- Raising or eliminating the payroll tax cap would also affect small-business owners’ families, employees, and customers. The affected small-business owners make up about one-third of the 9 million workers who earn more than Social Security’s wage cap, and their families include more than 4.5 million spouses and children.
- These 3 million small-business owners could face more than \$242 billion in higher taxes over the next five years—money that would not be available to hire workers, purchase equipment, or expand businesses.

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ers by as much as \$242 billion over the next five years.² It is easy to see this direct effect—more of small-business owners' wages would be exposed to the payroll tax. However, what is not so obvious is that their businesses would have \$242 billion less to spend on wages, to invest in new buildings, to purchase new computers, and to expand and grow in general.

Impact on the Economy

The following are a few examples of the impact that raising or eliminating the payroll tax cap would have in 2005.

- **About 3 million business owners would face higher taxes.** About 3 million small-business owners earn more than \$90,000 per year in wages and salaries and would face higher taxes if the tax cap were raised or lifted. These small-business owners make up about one-third of the 9 million workers who earn more than Social Security's wage cap.
- **On a family basis, almost 8 million people would be directly affected.** Many of these 3 million small-business owners do not file as single taxpayers. Accounting for their families, these business owners are collectively responsible for more than 4.5 million people, including spouses and children. Altogether, this means that almost 8 million people would be directly affected by raising the payroll tax cap—and that does not even include small businesses' employees and customers.
- **Owners of small businesses that pay \$129 billion in total wages would be directly affected.** The 3 million small-business owners who would be affected by raising the payroll tax cap account for almost one-third (\$129 bil-

lion) of the wages paid out by all small businesses. Their businesses account for nearly one-fourth (\$30 billion) of all the interest expenses paid by small businesses.

- **Owners of small businesses that are major purchasers of capital equipment would be directly affected.** The 3 million small-business owners who would be affected by raising the payroll tax cap account for about 20 percent of small businesses' capital depreciation, or about \$20 billion per year. Capital depreciation reflects how much capital equipment a business purchases. These same small businesses hold approximately \$300 billion in capital assets, which constitutes a major investment in the U.S. economy.

More Small Businesses Would Be Affected

These figures are conservative in that they do not include all small-business owners who would be directly affected by raising or eliminating the payroll tax cap. The figures include only small-business owners who earn at least \$90,000 in wages, salaries, and self-employment income and report positive net business income to the IRS on the Schedule C form.

These figures do not include small-business owners who report a net loss on their Schedule C forms, even though some earn more than \$90,000 in wage and salaries. This group numbers about 1 million, bringing the total number of the affected small-business owners to about 4 million.³

Vulnerability Index

The composite index presented in this section can be used to gauge which states' small-business

1. See Rea Hederman, Jr., and Tracy Foertsch, "AARP's Social Security Plan Would Raise Taxes for AARP Members Without Fixing Social Security," Heritage Foundation *WebMemo* No. 678, March 7, 2005, at www.heritage.org/Research/SocialSecurity/wm678.cfm.
2. Heritage Foundation analysts project that eliminating the cap will raise \$484 billion (in nominal dollars) over five years. For the methodology, see Appendix A.
3. Critics may argue that including these "loss" firms overstates the number of true business owners and merely includes individuals who use "shell" businesses to offset their income. However, it is not uncommon for "regular" small businesses to incur a loss, and some business owners may own more than one business and report a net loss for all of the companies on a combined Schedule C, even though one or more of the companies earned a profit.

Composite Index Score		
State	Composite Score	Rank
New York	3.96	51
Connecticut	3.95	50
Montana	3.79	49
District of Columbia	3.76	48
Wyoming	3.73	47
Maine	3.68	46
Vermont	3.62	45
North Dakota	3.60	44
Massachusetts	3.55	43
Oklahoma	3.49	42
South Dakota	3.47	41
Idaho	3.44	40
Nebraska	3.43	39
Iowa	3.31	38
Arkansas	3.27	37
Texas	3.27	36
California	3.23	35
Kansas	3.22	34
Colorado	3.18	33
Minnesota	3.17	32
Washington	3.16	31
Kentucky	3.12	30
New Mexico	3.09	29
Maryland	3.09	28
Utah	3.09	27
Hawaii	3.09	26
Georgia	3.09	25
Florida	3.09	24
Oregon	3.08	23
North Carolina	3.07	22
New Hampshire	3.05	21
Missouri	3.01	20
Arizona	2.98	19
New Jersey	2.96	18
Illinois	2.93	17
South Carolina	2.89	16
Indiana	2.87	15
Virginia	2.80	14
Louisiana	2.80	13
Wisconsin	2.79	12
West Virginia	2.73	11
Rhode Island	2.73	10
Michigan	2.64	9
Mississippi	2.64	8
Tennessee	2.60	7
Ohio	2.58	6
Nevada	2.46	5
Alabama	2.41	4
Alaska	2.33	3
Pennsylvania	2.23	2
Delaware	2.08	1

Source: Heritage Foundations calculations.

owners will suffer the most economic hardship if the Social Security wage cap is raised. The principle is straightforward: The higher the index score, the more susceptible that state's small-business owners are to any economic effects caused by higher taxes.

Certain small-business owners will bear the brunt of raising the Social Security wage cap, and the index attempts to identify where those business owners live. Because Social Security taxes are not levied in a vacuum, the index also reflects states' overall tax burden.

New York is the state most vulnerable to this potential tax hike, for two reasons. First, it is above the national average in terms of the number of business owners earning salary and wage incomes greater than the Social Security wage cap. Second, it has the second highest overall tax burden—adding another tax hike on top of that tax burden would only further erode New York's economic competitiveness. The next four most vulnerable states are Connecticut, Montana, the District of Columbia,⁴ and Wyoming.

Delaware, on the other hand, is the least vulnerable to this potential tax hike because it has a low overall tax burden *and* a below average percentage of business owners earning salaries and wages

greater than the Social Security wage cap. The next four least vulnerable states are Pennsylvania, Alaska, Alabama, and Nevada.

Conclusion

Raising the Social Security wage cap would directly increase taxes for 3 million small-business owners by as much as \$242 billion over the next five years, from 2005 to 2009. This means that the small-business sector would have \$242 billion less to hire and pay workers, to purchase equipment, and to expand businesses.

However, raising or eliminating the payroll tax cap would ultimately affect many more people, such as small-business owners' families, employees, and customers. Policymakers should keep this fact in mind when proponents of raising or eliminating the payroll tax cap say that it would just make the rich pay their "fair share" for Social Security. In reality, it would affect far more Americans of all economic classes.

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4. For purposes of this comparison, the District of Columbia is treated as a state.

Appendix A Methodology for Business Statistics

The estimates in this paper were calculated using The Heritage Foundation's microsimulation tax model. To estimate the year-to-year change in federal payroll tax revenue, the model simulates the effect of tax law changes on a representative sample of taxpayers. Data for these taxpayers were extrapolated or "aged" to reflect detailed taxpayer characteristics through 2014. The data were aged so that they were consistent with the August 2004 Congressional Budget Office baseline forecast and extensions of President George W. Bush's tax cuts.⁵ For purposes of this analysis, the microsimulation produced conventional revenue estimates.

The starting point for the estimates was small-business owners that file a Schedule C form with the Internal Revenue Service and report net business incomes greater than zero. Heritage Foundation analysts calculated the percentages of these Schedule C filers' interest expense, depreciation expense, and wage and salaries expense accounted for by Schedule C filers that report salaries, wages, and self-employment income greater than \$90,000. The analysts assumed that the percentages of Schedule C interest, depreciation, and employee costs accounted for by this group of tax filers were similar to the corresponding proportions for other small-business entities. As a result, the overall category of "small-business owners" includes all taxpayers that file a Schedule C, Schedule E, or Schedule F with a net positive income.

Payroll tax revenue includes the employee and employer portions of the FICA⁶ tax on salaries and wages as well as the SECA⁷ tax on self-employment income (Schedule C).

Additional Details

For the taxpayers that file Schedule Cs and report net business incomes greater than zero, the microsimulation model was used to project interest expense, depreciation expense, and wage and salaries expense. For each category, the analysts then calculated the percentage of the totals that were attributed to the "above the cap" tax returns. These ratios were used to estimate the corresponding percentages for small-business owners that organize as S corporations and partnerships (and therefore file Schedule E or Schedule F).⁸

Analysts applied the percentages calculated for "above the cap" Schedule C filers to projections of aggregate totals based on 2001 S corporation and 2001 partnership data. The economic assumptions used to derive revenue projections for 2005 S corporation and partnership aggregates were based on a macroeconomic analysis of President Bush's 2005 fiscal year budget proposals. Analysts used Global Insight's U.S. Macroeconomic Model⁹ to forecast the economic effects of the tax cut extensions. The growth rates were applied as follows: The projected GNP growth rate was used for wage expense and interest expense, and the projected corporate investment growth rate was used for depreciation expense and net capital assets.

For all entities, "net capital assets" is defined as "depreciable assets" less "accumulated depreciation." To derive net capital assets for Schedule C filers, analysts applied the ratio of "net capital assets to depreciation expense" as reported in the 2001 Statistics of Income (SOI) data for S corporations. For S corporations, wages are defined as

5. For specifics on the forecasted tax cut extensions, see William W. Beach, Ralph A. Rector, Rea S. Hederman, Alfredo B. Goyburu, and Tim Kane, "The Candidates' Tax Plans: Comparing the Economic and Fiscal Effects of the Bush and Kerry Tax Proposals," Heritage Foundation *Center for Data Analysis Report* No. 04-09, September 20, 2004, at www.heritage.org/Research/Taxes/cda04-09.cfm.

6. Federal Insurance Contributions Act.

7. Self-Employment Contributions Act.

8. The estimates do not include any farms that do not file both a Schedule E and a Schedule F.

9. See Beach *et al.*, "The Candidates' Tax Plans."

“compensation of officers,” which includes salaries, wages, stock bonuses, bonds, and other forms of compensation. For S corporations’

wages, analysts did not include the item “other deductions,” which includes salaries and wages that are not listed separately.

Appendix B Methodology for Vulnerability Index

The composite index ranks states on a scale of one to five, with five representing the worst projected tax situation in 2005. Each state's composite index score is the mean of the two components: the wage cap component and the tax burden component. The wage cap component reflects the projected percentage of a state's small-business owners whose salary and wage incomes are greater than the Social Security wage cap.¹⁰ The second component uses the Tax Foundation's estimated state-by-state total tax burden as a percent of income.¹¹

Each of the components is calculated beginning with the national mean. For each state, the squared difference from the mean is calculated. The squared differences are then summed and divided into five equal increments. Each state is then assigned a ranking based on where it fits in these increments. The mean of a state's two component indices is the state's composite index score.

Wage Cap Component

The wage cap component is the number of business owners with salary and wage incomes greater than \$90,000 divided by the number of taxpayers within the state. National estimates for both the business owners (individuals who reported income

on Schedule C, Schedule E, or Schedule F) and total taxpayers were estimated with The Heritage Foundation's microsimulation model.¹²

State-by-state allocations for Schedule C and Schedule F filers are made using data from the IRS master tax file as published in the spring editions of the *Statistics of Income Bulletin*. Projections for the state-by-state allocations to 2005 are based on a trendline estimate using historical data from 1991–2002.¹³

State-by-state allocations for Schedule E filers are imputed using the national ratio of Schedule E filers to Schedule C filers. Projections for the Schedule E filer ratio to 2005 is based on a trendline estimate using historical data from 1993–2002.

Tax Burden Component

The tax burden component was created using 2005 estimates generated by the Tax Foundation for its annual Tax Freedom Day report. The data reflect projections of net national product and all taxes paid on the federal, state, and local levels as defined by the National Income and Product Accounts from the Bureau of Economic Analysis.

10. In 2005, the wage cap is \$90,000. Any income earned over this amount is not subject to the 12.4 percent OASDI payroll tax. The tax rate includes the employee and employer portion and also applies to those individuals who are self-employed.

11. See Curtis S. Dubay, Sumeet Sagoo, and Scott A. Hodge, "America Celebrates Tax Freedom Day," Tax Foundation *Special Report* No. 134, April 2005, at www.taxfoundation.org/sr134.pdf (April 12, 2005).

12. See Appendix A.

13. Internal Revenue Service, *Statistics of Income Bulletin*, various years, Table 2 in "Selected Historical and Other Data" section.

Component Index Scores				
State	Wage Cap Component	Tax Burden Component	Composite Score	Rank
Alabama	3.19	1.62	2.41	4
Alaska	3.27	1.38	2.33	3
Arizona	2.97	2.99	2.98	19
Arkansas	3.61	2.93	3.27	37
California	3.23	3.23	3.23	35
Colorado	3.31	3.05	3.18	33
Connecticut	2.90	5.00	3.95	50
Delaware	1.31	2.86	2.08	1
District of Columbia	2.51	5.00	3.76	48
Florida	3.18	2.99	3.09	24
Georgia	3.19	2.98	3.09	25
Hawaii	3.19	2.99	3.09	26
Idaho	4.38	2.50	3.44	40
Illinois	2.84	3.01	2.93	17
Indiana	2.77	2.97	2.87	15
Iowa	3.97	2.64	3.31	38
Kansas	3.47	2.98	3.22	34
Kentucky	3.36	2.89	3.12	30
Louisiana	3.17	2.42	2.80	13
Maine	3.77	3.59	3.68	46
Maryland	3.15	3.03	3.09	28
Massachusetts	3.12	3.99	3.55	43
Michigan	2.29	2.99	2.64	9
Minnesota	3.20	3.13	3.17	32
Mississippi	3.19	2.08	2.64	8
Missouri	3.20	2.82	3.01	20
Montana	5.00	2.57	3.79	49
Nebraska	3.87	2.99	3.43	39
Nevada	1.84	3.07	2.46	5
New Hampshire	3.19	2.91	3.05	21
New Jersey	1.67	4.24	2.96	18
New Mexico	3.19	2.99	3.09	29
New York	3.19	4.72	3.96	51
North Carolina	3.19	2.96	3.07	22
North Dakota	4.99	2.21	3.60	44
Ohio	2.16	2.99	2.58	6
Oklahoma	4.64	2.33	3.49	42
Oregon	3.21	2.94	3.08	23
Pennsylvania	1.49	2.97	2.23	2
Rhode Island	2.01	3.44	2.73	10
South Carolina	3.08	2.71	2.89	16
South Dakota	5.00	1.94	3.47	41
Tennessee	3.41	1.79	2.60	7
Texas	3.54	2.99	3.27	36
Utah	3.19	2.99	3.09	27
Vermont	4.14	3.10	3.62	45
Virginia	2.61	3.00	2.80	14
Washington	3.02	3.30	3.16	31
West Virginia	2.70	2.77	2.73	11
Wisconsin	2.41	3.18	2.79	12
Wyoming	3.69	3.78	3.73	47

Source: Heritage Foundations calculations.