

Earnings Responses to Increases in Payroll Taxes

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Abstract

This paper uses SIPP data matched to longitudinal uncapped earnings records from the Social Security Administration for 1981 to 1999 in order to analyze earnings responses to increases in tax rates and inform discussions about the likely effects of raising the Social Security taxable maximum. The earnings distribution of workers around the current taxable maximum is inconsistent with an annual model in which people are highly responsive to the payroll tax rate, even in the subset of self-employed individuals. Panel data on married men with high earnings display a tremendous increase in earnings over the 1980s and 1990s relative to other groups, with no clear breaks around the key tax reforms. This suggests that other income groups cannot serve as a control group for the high earners. Our analysis does not support the finding of a large behavioral response to taxation by wives of high earners. We actually find a decrease in the labor supply of wives of high earners around both the 1986 and the 1993 tax reforms, which we attribute to an income effect due to the surge in primary earnings at the top. Policy simulations suggest that with an earnings elasticity of 0.5, lost income tax revenue and increased deadweight loss would swamp any benefits from the increase in payroll tax revenue. In contrast, with an elasticity of 0.2, the ratio of the gain in OASDI revenue to lost income tax revenue and deadweight loss would be much greater.

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