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Pay of Top Earners Erodes Social Security

Fund Expected to Be Exhausted in 2037

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The nation's wealth gap is widening amid an uproar about lofty pay packages in the financial world.

Executives and other highly compensated employees now receive more than one-third of all pay in the U.S., according to a Wall Street Journal analysis of Social Security Administration data -- without counting billions of dollars more in pay that remains off federal radar screens that measure wages and salaries.

Highly paid employees received nearly $2.1 trillion of the $6.4 trillion in total U.S. pay in 2007, the latest figures available. The compensation numbers don't include incentive stock options, unexercised stock options, unvested restricted stock units and certain benefits.

The pay of employees who receive more than the Social Security wage base -- now $106,800 -- increased by 78%, or nearly $1 trillion, over the past decade, exceeding the 61% increase for other workers, according to the analysis. In the five years ending in 2007, earnings for American workers rose 24%, half the 48% gain for the top-paid. The result: The top-paid represent 33% of the total, up from 28% in 2002.

The growing portion of pay that exceeds the maximum amount subject to payroll taxes has contributed to the weakening of the Social Security trust fund. In May, the government said the Social Security fund would be exhausted in 2037, four years earlier than was predicted in 2008.

The data suggest that the payroll tax ceiling hasn't kept up with the growth in executive pay. As executive pay has increased, the percentage of wages subject to payroll taxes has shrunk, to 83% from 90% in 1982. Compensation that isn't subject to the portion of payroll tax that funds old-age benefits now represents foregone revenue of $115 billion a year.

The magnitude of executive pay has been difficult to measure, even as policy makers grapple with ways to rein in compensation at companies receiving taxpayer bailouts. Companies aggregate the salaries of all employees in their filings to the Internal Revenue Service and to the Securities and Exchange Commission, and disclose details only for top officers.

But payroll taxes provide an indirect way to calculate amounts executives receive. Only earnings up to a certain ceiling are subject to a U.S. payroll tax of 12.4%, split between employer and employee, which finances Social Security retirement benefits.

The ceiling, which is indexed to the average growth in wages, is $106,800 in 2009, up from $102,000 in 2008 and $97,500 in 2007. (Employers and employees also each pay 1.45% on an individual's total income, with no salary ceiling, to fund

Medicare.)

Social Security data show that 6% of wage earners have pay that exceeds the taxable earnings base, and that their "covered earnings" above the taxable maximum totaled $1.1 trillion in 2007. Adding the portion of their pay below the taxable wage base, $991 billion, totals $2.1 trillion.

The $2.1 trillion figure understates executive pay, however, because it includes just salary and vested deferred compensation, including bonuses. It doesn't include unvested employer contributions and unvested interest credited to deferred-pay accounts. Nor does it include unexercised stock options (options aren't subject to payroll tax until exercised), and unvested restricted stock (which isn't subject to payroll tax until vested; the subsequent appreciation is taxed as a capital gain).

Also not included in the total compensation figures is executive pay never subject to payroll tax. This category includes incentive stock options (which are generally taxed as capital gains), "carried interest" income received by hedge-fund and private-equity fund partners (also taxed as capital gains), and compensation characterized as a benefit (benefits generally aren't subject to any taxes).

Benefits, a category that includes employer-provided health care and contributions employers make to rank-and-file pension plans, totaled nearly $1 trillion in 2007; it isn't possible to tell what portion represents benefits for executives, such as life insurance.

The ability to delay paying payroll taxes on compensation, something that generally is available only to highly paid employees, is in itself an economic benefit that ultimately boosts paychecks.

Lawmakers over the years have introduced bills to raise the taxable wage ceiling, or eliminate it, as was done for the Medicare portion in 1993. During the presidential campaign, Barack Obama proposed extending payroll taxes on households with incomes above $250,000, but the administration isn't pursuing any change as it focuses on proposals for tax increases on wealthy households to help finance a health-care program.

Lifting the earnings ceiling could result in higher Social Security benefits payments to higher-income individuals, since benefits are based on a worker's highest 35 years of earnings. But the additional tax revenue would have decades to earn a return, thus offsetting the cost of the additional payments.

Social Security Administration actuaries estimate removing the earnings ceiling could eliminate the trust fund's deficit altogether for the next 75 years, or nearly eliminate it if credit toward benefits was provided for the additional taxable earnings.

Employers oppose changes that would increase their share of payroll tax. In addition, eliminating the ceiling would prevent employers from using a controversial but common technique, based on payroll taxes, to award additional benefits to executives who participate in rank-and-file pension and 401(k) plans.

For example, health insurer Humana Inc. contributes 4% of pay to employees' retirement accounts on salary up to the taxable-earnings wage base -- and 8% above it. Thanks to the richer contribution, Humana Chief Executive Michael B. McCallister received a total contribution of $22,370 under the plan in 2008. (He also received $314,790 in company contributions to his supplemental executive retirement and savings plan.)

Typically, employers can't discriminate in favor of high-paid employees who participate in taxpayer-subsidized retirement plans. But a "permitted disparity" exception enables them to provide additional benefits on the portion of pay that isn't subject to payroll taxes, ostensibly to replace the Social Security benefits executives won't receive on the portion of their pay that is exempt from payroll taxes.

Humana declined to comment.

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