Social Security and Inequality

BY ARTHUR MACEWAN

Social Security is important. No, it's not the best social insurance program, not what we could and should have. It does, however, make a large positive difference for many people. For example, according to a March 2022 report from the Center on Budget and Policy Priorities:

- Social Security greatly reduces poverty among older adults. In 2020, 9% of older adults lived in poverty, but without Social Security the figure would have been 38%.
- For about half of older adults, Social Security provided at least half of their income in 2020, and for one-quarter of them it provided at least 90% of their income.
- Social Security is especially important for people of color, who enter old age with less wealth and lower alternative sources of income than other groups, and for women, who make up the majority of Social Security recipients in all age groups.

Yet, Social Security has its problems. Foremost among these is that the pensions provided are on average less than half of the recipients' earnings prior to retirement. In several other high-income and some middle-income countries—for example, Italy, France, Austria, Denmark, the Netherlands, and Spain—benefits in government-sponsored retirement programs are over 60% of prior earnings.

And the potential problem with Social Security that is regularly in the news is that, unless changes are made in the operation of Social Security, the system's funds will be inadequate to provide full payments to recipients by about 2035. This potential shortfall has provided fodder for opponents of the system to fearmonger about its viability. Yet, even if nothing is done to alter Social Security's operation, payments will not disappear—though in the do-nothing option those payments could fall by 20%. More important, there are reasonable actions that would alter the system and maintain its full viability.

Social Security's potential shortfall is tied up with economic inequality. Taken together, rising earnings inequality and the falling share of labor in total income account for a large part, if not the entirety, of the approaching Social Security shortfall.

In important ways, Social Security's potential shortfall is tied up with economic inequality. To explain this shortfall-inequality connection and to understand ways the shortfall could averted, a little context is needed.

The Tax Max

Social Security is mostly financed by a dedicated payroll tax, which is currently at a rate of 6.2%. This amount is taken out of workers' salaries, and the same amount is paid by their employers. Additional funds come from taxes on Social Security payments charged to relatively high-income recipients, and interest earned by the Social Security trust fund. The funds in the trust are built up when the money coming in is greater than the benefits that are paid. (On the present course, this trust fund would be empty by about 2035, and the taxes and other sources of funds would then not be able to cover payments.)

The taxes paid by employees and employers are not paid on earnings above a certain annual limit, the so-called "tax max," which is $160,200 in 2023. As a result, the Social Security tax rate effectively declines for high-level earners. For example, a person who obtains a salary of $340,400 (twice the tax max) pays a Social Security tax rate of only 3.1%—that is, 6.2% on $162,200 of those earnings and nothing on the rest. And a person who obtains a $1 million salary would pay a Social Security tax rate of just 1%.

Incomes and Rising Inequality

Moreover, as income inequality—particularly earnings inequality—has become worse, the overall amount of Social Security taxes paid declines relative to overall national income. This is because rising earnings inequality means that a larger and larger share of overall earnings falls above the tax max.

Consider a comparison of two years for which the data are available, 1983 and 2010. In 1983, 90% of earnings were below the tax max. But in 2010, this figure had declined to 86%. As the Social Security Administration publication that provides the data states, "earnings among above-max earners have grown faster than earnings among the rest of the working population"—that is, there has been rising earnings inequality. It seems reasonable, then, to conclude that in 2010 the total Social Security tax would have been 4.65% greater had earnings inequality not increased and everything else had stayed the same. (Ninety is 4.65% greater than 86.) As the decade after 2010 saw a continuing rise in wage inequality, this figure is surely larger in 2023. (The year 2010 is the most recent for which data are available that allow for this calculation.)

It Gets Worse

What's more, the Social Security tax is not applied to income from capital—including capital gains, dividends, interest, and rents. A person whose income is entirely from these sources would pay no Social Security tax. People who obtain a large amount of their income from capital—no surprise—tend to be rich people.

The issue of not applying the Social Security tax to capital has become more significant as capital income has risen relative to labor income in recent decades. Between the 1990s and the most recent decade (2013 to 2022) labor's share in the nonfarm business sector fell by over 7%. These data suggest that had labor's share been the same in this most recent decade as in the 1990s, the Social Security tax would have brought in at least 7% more from 2013–2022.

A Reasonable Conclusion

It seems reasonable to conclude that, taken together, rising earnings inequality and the falling share of labor in total income account for a large part, if not the entirety, of the approaching Social Security shortfall. Raising the tax max and collecting a Social Security tax on income from capital would go a long way in maintaining the full viability of the system. There are other factors that have also contributed to the shortfall. In particular, with baby boomers retiring and people living longer, the share of the population eligible for Social Security payments has risen. (See sidebar.) Yet, the role of rising inequality is an important factor, and the Social Security situation illustrates one more negative consequence of the greater and greater economic inequality that plagues the United States. D&S

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SOURCES: Tax Foundation, "Sources of Personal Income, Tax Year 2019," July 21, 2022 (taxfoundation.org); Center on Budget and Policy Priorities, "Policy Basics: Top Ten Facts about Social Security," March 4,2022 (cbpp.org); Linda Benesch, "Inequality is Weakening Social Security. Here's How to Fix That," Inequality.org, February 23, 2023 (inequality.org); Lawrence Mishel and Jori Kandra, "Wage inequality continued to increase in 2020," Economic Policy Institute, December 13, 2021 (epi.org); St. Louis Federal Reserve Economic Data (FRED), "Nonfarm Business Sector: Labor Share for All Workers," Series PRS85006172 (fred.stlouisfed.org); Kevin Whitman and Dave Shoffner, "The Evolution of Social Security's Taxable Maximum," Social Security Administration Policy Brief No. 2011-02, September 2011 (ssa.gov); "Social Security & Medicare Tax Rates," Social Security Handbook, Section 1405 (ssa.gov).

Life Expectancy, Income Level, and Social Security

Some commentators have suggested that the way to prevent the impending shortfall of Social Security funds would be to raise the age at which people are eligible for Social Security benefits. This proposal is based on the observation that people are living longer than when the original 65 retirement age was established. Baby boomers, who are now retiring, are also living longer.

On average, people are living longer that in the past. However, raising the age of Social Security eligibility would have a disproportionately negative impact on people with low incomes. A study by the Congressional Research Service (CRS) looked at the connection between income levels and life expectancy for people born in 1960. Men at age 50 in the top 20% of the income distribution had a life expectancy of 38.8 years, while men at age 50 in the bottom 20% had a life expectancy of 26.1 years. For women, the difference was slightly larger, 41.9 years for the top group, and 28.3 years for the bottom group.

With the differences in life expectancies between high-income and low-income groups, a shift in the age of Social Security eligibility from 65 to 67 would on average take away 18% of the Social Security income of the low-income men, but only 7.7% for high-income men. For women, the loss on average would be 15% for the low-income group and 7.4% for the high-income group.

This is on top of the fact that there is already a great difference between the lifetime Social Security benefits received by the high-income and low-income groups. The CRS study found that men in the top 20% would have lifetime Social Security benefits of $295,000, while those in the bottom 20% would have $122,000; for women the figures are $235,000 and $91,000. These figures are in 2009 dollars.

SOURCE: Congressional Research Service, "The Growing Gap in Life Expectancy by Income: Recent Evidence and Implications for the Social Security Retirement Age," updated 2021 (crsreports.congress.gov).