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Issue Brief

The Burden of Social Security Taxes and the Burden of Wage Inequality

By Dean Baker[1]

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CENTER FOR ECONOMIC AND POLICY RESEARCH 1611 CONNECTICUT AVE., NW, SUITE 400
WASHINGTON, D.C. 20009 (202) 293-5380 <WWW.CEPR.NET> EMAIL: CEPR@CEPR.NET

[1] Dean Baker is the co-director of the Center for Economic and Policy Research.

Executive Summary

Numerous politicians and commentators have claimed that the prospect of higher Social Security taxes in the future will threaten the living standards of our children and grandchildren. However, the tax increases that the Social Security trustees and the Congressional Budget Office project would be needed to maintain the program's solvency would have far less impact on the living standard of a typical worker than the rise in wage inequality the nation has experienced over the last quarter century.

A typical worker lost an amount equal to 9 percent of their wages due to the increase of wage inequality over the last decade. By contrast, the Social Security trustees and the Congressional Budget Office project the size of the tax increase needed to keep Social Security fully solvent over its 75-year planning period as 1.9 percent and 1.0 percent, respectively.

In fact, the amount of money that typical wage earners have lost in the last year alone, due to the upward redistribution of income, is comparable in size to the tax increases that would be needed to maintain Social Security's solvency for the next seventy-five years. Trends in inequality pose a much greater threat to the living standards of most young workers than the prospect of paying higher Social Security taxes in the future. If wage gains were more or less evenly shared, then future generations of workers would experience large increases in living standards regardless of what happens to the Social Security tax rate.

Since President Bush announced his intention to make overhauling Social Security the top item on his domestic agenda last November, there have been numerous news reports about the burden that Social Security taxes may impose on workers in the future. Many politicians and news reports have referred to a Social Security "crisis." They have also characterized the tax increases that may be needed to finance Social Security in the future as "massive" or claimed that they would impose "crushing" burdens on future generations of workers.

While the selection of an appropriate adjective will inevitably be subjective, comparisons of relative magnitude are not. It is worth comparing the potential impact of future Social Security tax increases with other costs faced by the nation's workers. This discussion compares the impact of prospective Social Security tax increases with the impact of growing wage inequality for a typical worker.

There are very precise measures of the potential impact of higher Social Security taxes on workers. According to the most recent Social Security trustees report, a tax increase of 1.89 percentage points (0.945 percentage points on both the employer and employee) would be necessary to make the program fully solvent over its 75-year planning horizon. The Congressional Budget Office (CBO) projections indicate that a tax increase of 1.0 percentage point (0.5 percentage points on both the employer and employee) would be sufficient to make up this shortfall.

These projections tell us exactly how much impact we can expect Social Security to have on the living standards of workers in the future. The Social Security trustees projections indicate that if their projections prove exactly right, and no other changes are made, workers would have to give up 1.89 percent of their wages to keep the program fully solvent for 75 years. The CBO projections put the income loss at 1.0 percent.

The cost to the typical worker of growing wage inequality can be assessed by comparing wage growth for the typical worker with economy-wide average rate of wage growth. Over the period from 1979 to 2003, the hourly wage for a typical worker rose by 10.2 percent, after adjusting for inflation.[2] By comparison, the average hourly wage increased by 20.7 percent over this period. This gap is due to the fact that so much wage income went to high wage earners like doctors and lawyers. A typical worker (one in the middle of the wage distribution) lost 8.7 percent of their hourly wage as a result of the upward redistribution of wage income over this period.

While wage inequality stopped growing and perhaps even shrank slightly in the late nineties boom, in the last two years, wages for most workers have again begun to stagnate. Data for the wage of the typical worker for 2004 is not yet available, but the

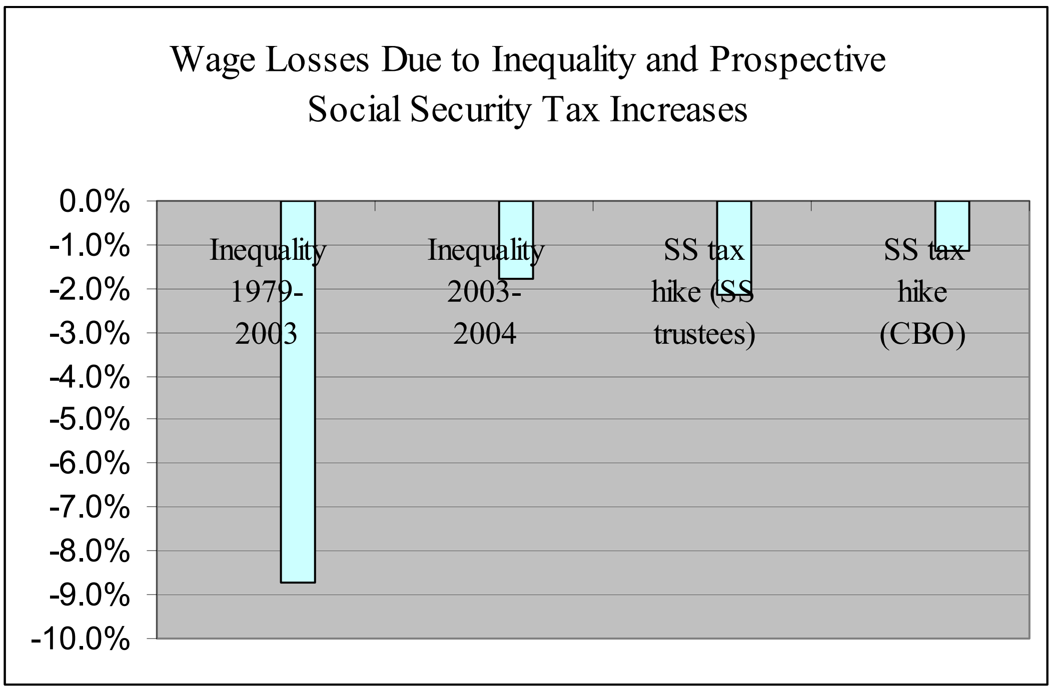
[2] Data for the median hourly wage is taken from Mishel, L., J. Bernstein, and S. Allegretto, 2004. *The State of Working America, 2004-2005*. Washington, D.C.: Economic Policy Institute, table 2.6. The average hourly wage is calculated by taking real hourly compensation from the Bureau of Labor Statistics productivity data. To adjust for the change in the wage share from 1979 to 2003, compensation in each year was multiplied by the ratio of wage income to labor compensation from the Bureau of Economic Analysis, National Income and Product Accounts table 1.12 (line 3 /line2).

average hourly wage for production and non-supervisory workers (which tends to closely follow the median wage) actually fell by 0.5 percent in 2004. Wages typically grow more or less in step with productivity, if there is no change in income distribution.

Productivity growth in 2003 was actually very rapid (4.0 percent) but if we just assume that wages should have grown at the 1.3 percent long-term average rate projected by CBO, then workers lost approximately 1.8 percent of their wages in 2004 due to the growth of wage inequality (a 0.5 percent wage decline compared to the 1.3 percent wage growth they should have seen if there had been no increase in wage inequality).

Figure 1 compares the wage losses due to the increase in wage inequality in the years from 1979 to 2003, and the rise in wage inequality from 2003 to 2004, with the size of the tax increases that the Social Security trustees and CBO project would be necessary to make the program fully solvent over its seventy five year planning period.

Figure 1



Source: Author's calculations, see text.

As can be seen, the wage loss due to the increase in wage inequality has led to a far larger reduction in wage income for the typical worker than the tax increases that might be needed to close the Social Security shortfall. The 8.7 percent decline in the hourly wage for a typical worker is more than 4 times as large as the impact of the tax increase that the trustees project would be needed to make the program fully solvent for its seventy-five year planning period. This loss is almost 8 times the size of the impact of the tax increase that CBO projects is necessary.

Even the wage loss due to the growth in inequality just in 2004 is large relative to the size of the projected Social Security shortfall. The impact of growing inequality in this single year on the wage of the typical worker was 80 percent as large as the prospective tax increase that the trustees project will needed to restore solvency. This single year wage loss was 50 percent *larger* than the tax increase that CBO projects will be needed to restore solvency.

Many politicians, commentators, and reporters have described the size of the tax increases needed to maintain the solvency of Social Security using terms like “crushing,” “enormous” or “huge”. Given the use of such adjectives and the vast amounts of media attention devoted to the issue, it is striking that recent trends in wage inequality – which have a much larger impact on most workers’ welfare – have passed largely unnoticed. If the amount of attention devoted to a topic were proportional to its impact, we would either have to have much more reporting on growing wage inequality, or much less coverage of Social Security.