Growing inequality has shrunk Social Security's revenue. Revitalizing its tax base could help restore solvency without cutting benefits.

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(The author thanks Henry Aaron at Brookings for technical comments.)

As the graying and outsized baby boom generation claims Social Security benefits, Americans increasingly doubt whether the program can pay all that it has promised – or even continue to cut checks at all. In their annual report released June 5, Social Security's Trustees warn that, unless Congress acts to restore the program's long-term solvency, by 2034 it will only have sufficient funds to pay 77 cents of each dollar currently promised. By then, the Social Security trust fund will be empty and the program will lack legal authority to pay out more than it can bring in through earmarked taxes. An adjustment this size in 2018 would drop the average Social Security payment of $16,848 to $12,973. Most older Americans depend on Social Security for all or most of their income.

The longer Congress plays chicken on this issue, the greater the risk that changes such as tax increases or benefit cuts, or a combination, will have major economic impacts on retirees and workers. The trustees' report emphasizes the growing ratio of retirees receiving benefits to workers contributing payroll taxes as a major force impinging on the program's solvency. Underlying factors include the size of the baby boom generation and a lower birth rate. But other forces are at work. Growing wealth and income inequality have significantly eroded Social Security's tax base.

First, wealth inequality: As Americans at the top of the economic spectrum continue to amass equities, bonds, and other assets, the portion of national income from capital investment has increased significantly, pushing down the portion earned through labor. In the United States, labor's share of earnings fell about eight percentage points between 1995 and 2013 (compared to a bit over three percentage points in other Organization for Economic Co-operation and Development countries). Since Social Security relies primarily on a tax on labor for its sustenance, the relative growth of capital income gradually is choking off a source of revenue.

Second, income inequality: As part of its structure to promote fairness between economic classes, Social Security replaces relatively more lifetime income for lower-wage workers than those with higher wages – but also caps wages subject to its payroll tax, in part to increase the net value of Social Security in the eyes of higher earners. The wage cap for 2018 is $128,400. Over the past several decades, wages of lower-income Americans have stagnated, while those at the top have grown significantly. As a result, the trustees note that portion of wage income taxed by Social Security has dropped by about six percentage points (see p. 144). In agency jargon, the "taxable ratio" of payroll fell from 88.6 percent in 1984 to 82.6 percent in 2000, and has fluctuated near the latter level since then. Social Security Administration (SSA) actuaries assume the ratio will remain about 82.5 percent over the next decade. In summary, unless the tax cap on earnings keeps up with the growing prosperity of those at the top, Social Security's tax base shrinks as a portion of national income.

The trustees urge policymakers to restore Social Security's financial stability as soon as possible and refer to a long list of policy options developed by the program's actuaries that could do so in a wide variety of combinations. Although it is impossible to know which ones will be in play when bargaining begins, options that have gained attention in the current political environment include reducing benefits, increasing the earnings ceiling and/or raising the payroll tax rate, upping the retirement age, and trimming the inflation protection. SSA actuaries, for example, estimate that:

- Raising the payroll tax (now 12.4 percent) to 15.4 percent in 2018 would eliminate the entire long-range funding shortfall.
- Leaving the program as is, as noted above, would mean a sudden, very large drop in benefits in about 16 years when ttrust funds are depleted.
- Gradually increasing the normal retirement age to 68 would take care of about 15 percent of the gap.
- Switching to a "chained version" of the consumer price index – thereby reducing the annual inflation adjustment by about a 0.3 percentage point – would cover about 20 percent of the long-range shortfall.

Though yet to be been given serious consideration, the actuaries note that changing the formula for calculating benefits so that initial benefits grow more slowly -- by inflation rather than by the Social Security average wage index (which is higher) -- would also virtually eliminate the long-term shortfall. But this change would also shrink future benefit checks.

Unfortunately, many of these measures – particularly sharp benefit cuts or tax increases – would likely damage the economic welfare of millions of middle-class and lower-income Americans. If Congress delays long enough, rebalancing Social Security could have major and negative macroeconomic repercussions.

There are many ways to balance the books. Congress could restore Social Security's tax base by reestablishing and expanding funding provided by people benefiting from decades of growing wealth and income disparities. Two policy options of this type provided by the actuaries could restore most, if not all, of the program's financial health. Yes, taxpayers at the top of economic heap would bear most of the burden, but none would end driving a smaller car or living in a smaller house as a result. Here are the two illustrative policies:

- **Taxing invested capital**: Beginning in 2019, Congress could begin applying an additional 6.2 percent tax on investment income, which mostly accrues to the wealthiest, gradually extending it from top earners to the middle class; proceeds would go to Social Security's old age and survivors trust fund. Responding to a request from Rep. Peter DeFazio and Sen. Bernie Sanders, *SSA actuaries estimate this policy would close about one third of Social Security's long-run shortfall*.

- **Taxing high-earner income**: Beginning in 2019, Congress could apply the payroll tax to earnings above $400,000, leaving a "donut hole" that would gradually disappear as the current indexed tax cap rises, and provide some benefit credit for newly taxed earnings. *This change could close up to two thirds of the program's long-range shortfall*.

Granted, banking on such strategies to restore solvency would comprise a far-left position in negotiations over what to do with Social Security. Conventional political wisdom would label them as unfair to the wealthy and politically impossible, especially since members of Congress tend to give weight to lobbying from monied interests and are themselves economically advantaged. But the political center could well shift leftward, particularly if the next recession is severe. It should be noted that, in the Affordable Care Act, in order to deal with rising health costs, Congress added extra Medicare taxes for high earners on both income and capital gains, thereby providing possible precedent to do the same for Social Security.

Given the current balance of power, a proposal to restore and expand Social Security's tax base might improve the viability of more centrist positions offering compromises between benefit cuts and increasing the level of payroll taxes, whose impact are likely to fall mostly on people in the middle and lower ranges of the income spectrum.

Brookings scholar Henry Aaron recently presented an elegant and thoughtful compromise proposal from a Progressive perspective at a Capitol Hill meeting alongside Social Security actuaries who discussed the trustees' 2018 report and need for action. Laid out in an American Prospect article, he proposes a policy blend including: raising the tax cap; taxing part of employer provided health benefits; improving benefits for low-income workers; reducing spousal benefits; providing some benefit credit for unpaid time raising children; dedicating estate and gift taxes to Social Security; and raising payroll taxes a relatively small amount in the distant future.

Party leaders are now far apart and uncompromising. Saying that no action is likely given today's political leadership, Aaron describes congressional stasis this way: "The chair and ranking member of the Social Security Subcommittee of the House Committee on Ways and Means have each introduced plans that would restore Social Security to sustainable solvency. But that is where their similarity ends. The plan proposed by Chairman Sam Johnson, a Texas Republican, would close the funding gap by cutting benefits—so much, in fact, that the cuts would allow cuts in the payroll tax. The plan proposed by the ranking Democrat, John Larson of Connecticut, would raise taxes more than enough to close the projected long-term funding gap and pay for benefit increases. Unsurprisingly, congressional leaders have shown no interest in pressing matters. As yet."

No one knows when serious negotiations over Social Security's future will begin. The longer Congress waits, the more difficult and painful the task will be. Americans need to know that Social Security's solvency can be restored -- with no benefit cuts -- by reclaiming and expanding contributions from high-income Americans. This position should be on the bargaining table in spite of cries of class unfairness and “soaking the rich.” We no longer need to be afraid of this political boogie man. After all, didn’t Congress just soak the majority of Americans with a tax bill that disproportionately enriches those at the top while driving up the national debt we all must repay? Wealth and income gaps have widened to the point where political orthodoxy and tiptoeing should no longer confine our options.