Parametric Adjustments to Social Security

The United States Social Security system is a dynamic system in many different ways. Certain features of the benefit structure are subject to periodic parametric adjustments that are typically tied to inflation, as measured by changes to consumer prices or national wage levels. Benefits in course of payment are subject to a cost-of-living adjustment (COLA) that is based on the Consumer Price Index; the COLA for 2017 is 0.3 percent. The formula for determining the Primary Insurance Amount (PIA) is based on an individual worker's 35-year average monthly index-adjusted earnings that reflect changes in national wage levels (referred to as AIME). In 2017 the PIA formula is 90 percent of the first $885 of AIME, plus 32 percent of AIME between $885 and $5336, plus 15 percent of AIME over $5336. The PIA is also dynamic in the way the break-points in the formula are subject to periodic adjustments to reflect changes in national wage levels; for 2017, the break-points were increased from $856 to $885, and from $5157 to $5336.

While the benefit structure has several dynamic features, the financing structure is also subject to periodic adjustments to the maximum amount of taxable earnings on which the payroll tax is levied; in 2017 this limit was increased from $118,500 to $127,200. However, the payroll tax rate that is the main source of financing for Social Security, is static not dynamic. The current rate is 6.20 percent of taxable earnings, payable by both employees and employers. This rate was set in 1990 and has remained unchanged since then. The rationale for a fixed payroll tax rate recognizes that changing demographic and economic conditions result in a gradual escalation in the actual costs of the system from year to year. To circumvent an escalating payroll tax, a stable fixed tax rate may be set for a specific projected future period, such as 75 years. This method generates surplus funds in the early years, and generates offsetting deficits in later years. However, this concept is not viable in the long run because the escalation of costs beyond the initial projection period is not accounted for. A fixed payroll tax rate structure gradually erodes the solvency and sustainability of the system over time, resulting in projected long-term deficits, putting at risk the ability of the system to meet scheduled benefits. In reality, demographic and economic changes over time require that the financing method be dynamic and maintain continuous actuarial balance if all scheduled benefits are to be met in full. This may be easily accomplished by introducing a dynamic payroll tax structure that would feature small incremental annual changes to the basic fixed stable tax rate. In fact, the required annual adjustments to the payroll tax rate are remarkably small and affordable. To restore the solvency of the system to 100 percent over the next 75 years, the required payroll tax rate is now 7.45 percent. Achieving 100 percent solvency over the next 25 years requires a rate of 6.62 percent; and over the next 50 years the requisite rate is 7.18 percent. In retrospect, it would have been possible to have maintained full solvency over successive rolling 75-year periods since 1990 by simply adjusting the 6.20 percent fixed payroll tax rate with annual increments of about 0.05 percent.

In addition to being static, the Social Security payroll tax rate is regressive since it applies uniformly to persons at all levels of covered taxable earnings. Other payroll taxes, such as the federal income tax, feature progressive graduated rates that are widely acknowledged to represent an equitable and socially-responsible policy. French economist Thomas Piketty brought attention to the problem of global inequality and is widely credited with causing a shift in the focus of economic policy toward income redistribution. Policies to mitigate the effect of regressive taxation are acknowledged to be effective in reducing inequality. If the Social Security payroll tax rates were to be graduated around a central rate of 7.50 percent, the resulting rate scale could be 5.00 percent on covered earnings up to one-third of the taxable earnings limit, 7.50 percent on covered earnings between one-third and two-thirds of the taxable earnings limit, and 10.00 percent on covered earnings above two-thirds of the taxable earnings limit. This scale would result in maximum effective tax rates of 5.00 percent, 6.25 percent and 7.50 percent, applied to all covered earnings. When compared to the existing payroll tax rate of 6.20 percent, this graduated tax rate system would appear to be both reasonable from a social policy perspective and affordable for persons in the top one-third earnings tier.

The combination of graduated payroll tax rates with a modest incremental annual adjustment system could be readily managed to ensure the continuing solvency and sustainability of the US Social Security system.

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