The Financial Status of Social Security, Part 3
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14 Jun 2014

Having reviewed the false and hypocritical notion of a viable Social Security Trust Fund, we turn now to a historical review of how the program has been funded since it was established in 1935. It is not administered, as has been shown, as a traditional Ponzi scheme. The Social Security system has always been funded as a regressive payroll tax. That is, it is financed entirely by a straight percentage of income, no deductions, no exclusions, and no exemptions. It is regressive in the sense that the poor and the middle class pay the same fraction of their income, meaning that the burden upon the poor is greater in relative terms than the burden on the middle class. A tax rate of say 5% represents a different number of dollars per paycheck to the poor and the middle class. Suppose a working poor person earns $20,000 per year (about $385 per week), and a middle class person earns $50,000 per year (about $960 per week). If the tax rate on both is 5%, the poor person pays about $20.00 per week in Social Security taxes, whereas the middle class person pays about $48.00. So, the middle class person pays a lot more; but, the $20.00 paid by the poor is more important to him insofar as providing necessities for his family than the $48.00 paid by the middle class person. Thus the economists say that this type of tax is regressive upon the poor.

Figure 1 provides a historical view of the tax rates and maximum income to which the tax applied, in then-year dollars. The black lines (tax rates) are read from the left scale, red line (income) on the right. The tax rates are broken out into two sections: Old Age Survivors (OAS), which is for retirement benefits, and Disability Insurance (DI). The DI tax and benefit was not created until 1956.

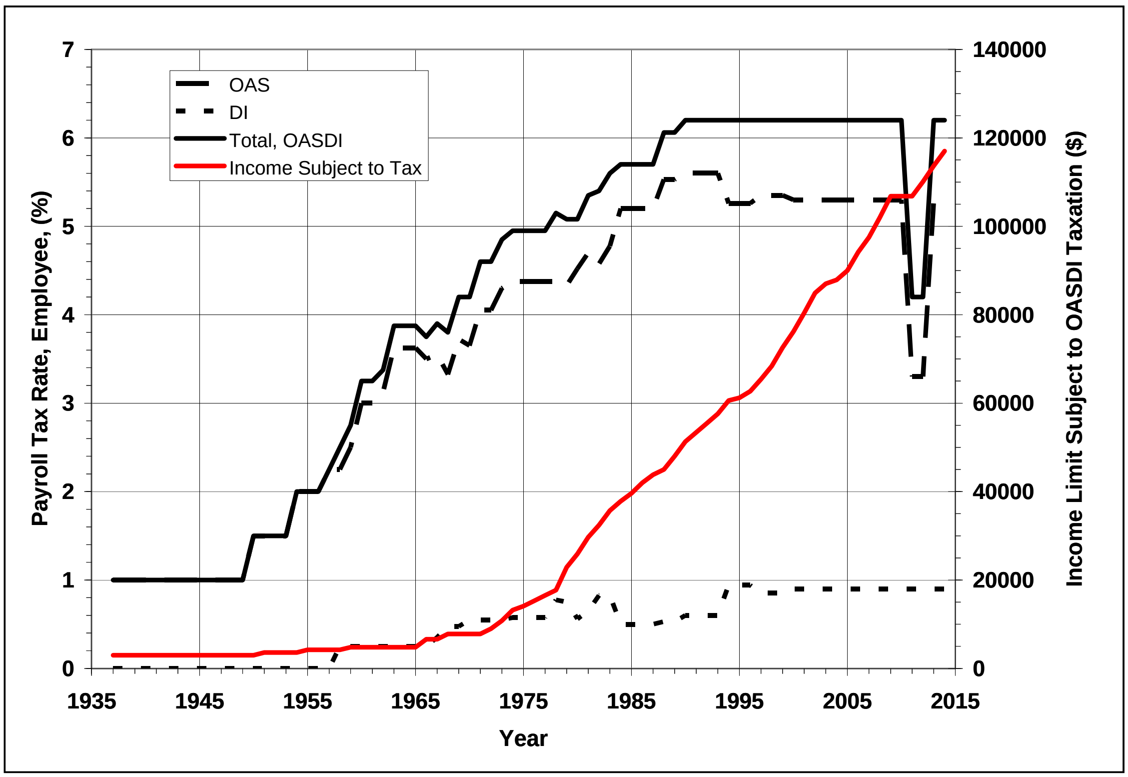

Figure 1: Tax Rates and Income Subject to Social Security Taxation, 1937-2014

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There is one important point to make about the left scale of Figure 1: this scale is labeled "Tax Rate, Employees". But an equal tax rate is additionally paid by the employers. That means the total tax rate on incomes is double the tax rates shown on the left scale. In 2014, the total tax rate for OASDI is 12.4%. There is nothing on Figure 1 that should be surprising to even the casual observer. You can see the typical progression of tax rates as well as the increasing maximum income level to which Social Security taxes are levied. The increase in the tax rate is due to the general expansion of the program; first to help the elderly poor, then to help the elderly middle class, and now as a general middle-class generic benefit. It is always the same with government programs: the goal is to expand it until everyone believes they are benefiting from it. Then it becomes politically impossible to curtail it, as people will believe they are being short-changed if the program is reduced. But there is another tangible benefit to the government from programs like Social Security: if everyone depends on it during their retirement, the government controls their lives. People tend to do what the government tells them if their income depends on the government. You can see a dip in the tax rates for 2011 and 2012. This was done as a temporary measure to put more money in people's pockets, in hope that it would help the economy come out of the 2008 recession. It didn't work, as evidenced by the fact we are still in a recession in 2014.

Note that I have omitted thus far any discussion about what is paid by the wealthy. That is because Social Security was envisioned as a program for the poor, then it became a program for the middle class. Therefore, since the poor and the middle class are the main beneficiaries, it was thought prudent (probably correctly), that taxes should be levied only on incomes up through the upper middle class levels; incomes above a certain amount are exempt because the maximum benefit paid corresponds only to incomes up to the middle class levels. So, there has never been a Social Security tax that was levied on all income. Besides, the wealthy have the means and contacts to make sure their tax burden is reduced to the maximum extent politically possible. Normally that comes in the form of special deductions and allowances, but in the case of a payroll tax, it comes in the form of a limit on the income subject to the tax.

Some have exaggerated the growth in the income subject to taxation, claiming that the tax was miniscule compared to modern times. But in fact the growth in the level of income subject to taxation is an artifact of the high inflation rates we have had since the Federal Reserve gained power. In 1937, (the first year of taxation), the maximum amount subject to taxation was only $3000; but keep in mind that $3000 then went a lot further than the same amount now. In order to see a more accurate picture of the growth in taxable income levels, it is necessary to account for the effect of inflation. That can be done by normalizing the income levels to given year as a baseline by adjusting per the annual inflation rate. We chose to do so by normalizing the buying power of $1.00 to the value of a 2014 dollar, as shown on Figure 2, by applying the cumulative inflation rates for each year [1]. The periods of high inflation (1939 - 1949, 1967 - 1980) and low inflation (1957 - 1965, 1983 - 2014) are also indicated. For example, one dollar in 1988 had the same buying power as $2.00 in 2014; a dollar in 1949 would buy what $10.00 would buy today; and a dollar in 1939 would buy what $17.00 would buy today.

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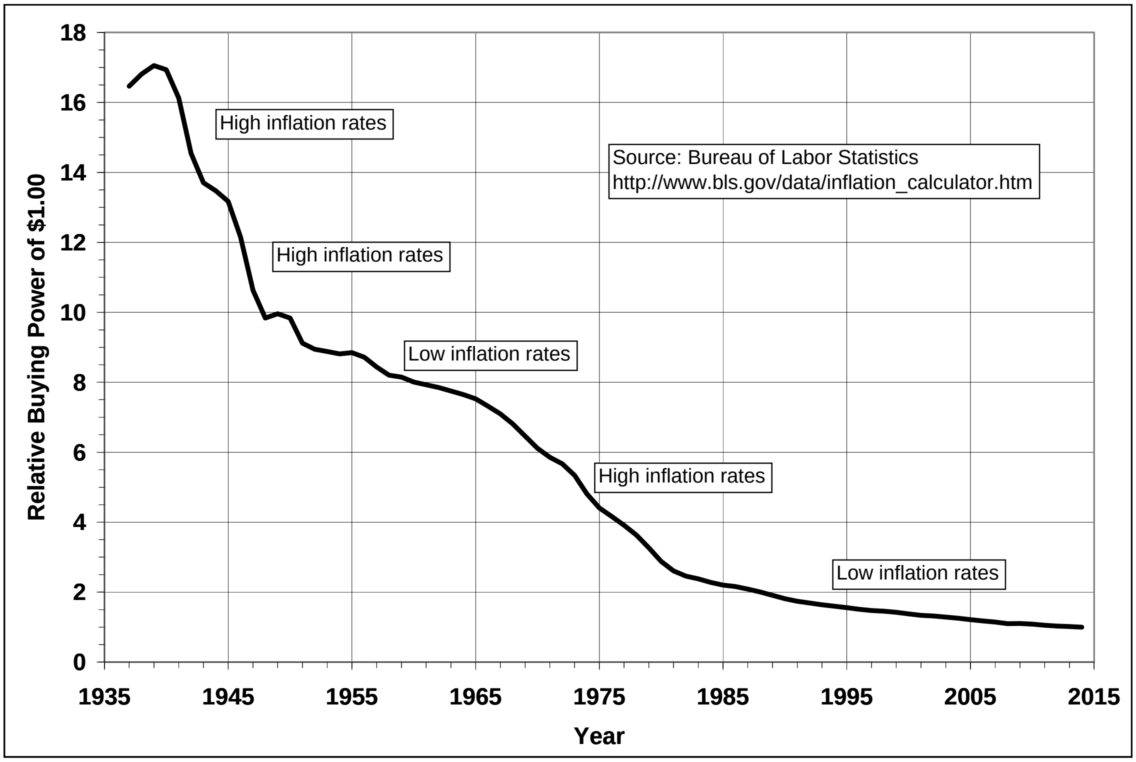

Figure 2: Relative Buying Power of $1.00 Since 1937

The next step is to compare the actual median income levels with the amounts subject to taxation [2]. Only data back to 1967 is available, and is shown on Figure 3. The red curve shows again the amount of income that is subject to Social Security taxation; the black curve is the median household income. It is easy to see that the levels subject to taxation were once approximately correlated with median income (assuming the trend from the 1930's was about the same as in the early 1960's), but is now in excess of twice the median income. Taxes have been going up steadily since the mid-1970's, measured in both the tax rate and the amount of income subject to the tax. No surprises there. Next we will consider the return obtained in the form of benefits for each generation of workers.

There is a third important point about the tax rates shown back on Figure 1. Financial advisors routinely explain that it is necessary for a worker to save and invest about 15% of his income throughout his working years, in order to have enough for retirement. Recalling that the true tax rate is double what is shown on the left of Figure 1, it is easy to see that many people are already paying 12.4% into Social Security. But how many believe they can retire on Social Security benefits alone?

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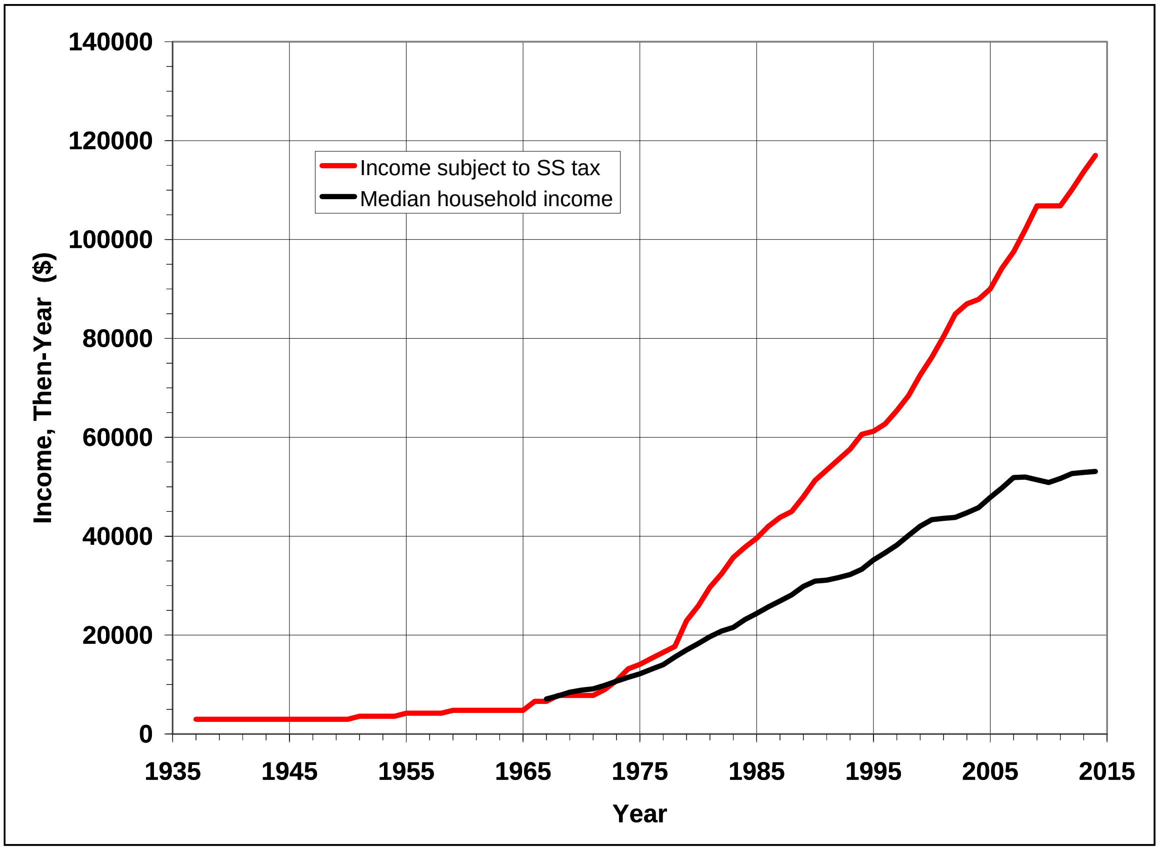

Figure 3: Comparison of Median Income and Income Subject to Social Security Taxation

References

[1] Bureau of Labor Statistics CPI Inflation calculator, http://www.bls.gov/data/inflation_calculator.htm
[2] United States Census Bureau, https://www.census.gov/hhes/www/income/data/historical/household/2012/H06AR_2012.xls

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