Working Paper
Executive Summary

March 2009, WP# 2009-7

Center for Retirement Research at Boston College

RISING TIDES AND RETIREMENT: THE AGGREGATE AND DISTRIBUTIONAL EFFECTS OF DIFFERENTIAL WAGE GROWTH ON SOCIAL SECURITY

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Recent growth in wage inequality has important implications for Social Security solvency and the distribution of benefits. Because only earnings below the taxable maximum are subject to Social Security payroll taxes, wage growth that is concentrated among very high earners will generate lower tax receipts than wage growth that is more evenly distributed. The progressivity of the Social Security benefit formula increases benefit payouts when the share of workers with low wages grows. This study uses a dynamic microsimulation model to examine the aggregate and distributional consequences of three alternative stylized scenarios about the distribution of future wage growth among workers.

Our stylized analyses suggest that wage growth that is skewed toward the top of the distribution could lead to deterioration in Social Security finances. Wage growth that is more directed at the bottom and lower-middle could, in contrast, shore up the system's finances and have the additional effect of reducing poverty and near poverty. Given that the range of alternatives we simulate is relatively narrow (compared to recent historical fluctuations in the share of earnings going to the top earners), it is clear that long-term projections of Social Security benefit distributions and system solvency could differ markedly with relatively modest shifts in assumed wage differentials.

Consistent with the observations of the Technical Panel (2007), we conclude that this question deserves further research along a broader range of assumptions about how precisely skewness in the income distribution is being generated. We have used two very simplistic assumptions that focus on individual-specific aspects of wage growth, but the implications for Social Security and income distribution likely differ in important ways based on the characteristics of the assumed changes to the underlying earnings process (e.g., returns to education as opposed to idiosyncratic or transitory factors).

Government's ability to shape larger trends in the way that the labor market rewards education and talent is likely relatively modest. Government can, however, clearly play a greater role in shaping the distribution of post-tax, post-transfer incomes. Trends in the wage distribution should be factored into policy choices, including Social Security reform proposals. Individuals' abilities to save in order to finance a secure retirement depend to a considerable degree on larger economic trends, like wage polarization, over which they have limited control. If wages at the bottom of the distribution continue to languish, significant fractions of the aged beneficiary population could remain vulnerable to poverty despite increased prosperity for the population as a whole, especially given Social Security's underfunding.

 The research reported herein was performed pursuant to a grant from the U.S. Social Security Administration (SSA) funded as part of the Retirement Research Consortium (RRC).

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