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REMOVING THE INCOME CAP ON THE PAYROLL TAX: BAD POLICY AND NO SUBSTITUTE FOR REAL REFORM

Senator Edward Kennedy (D-MA) has recently proposed eliminating the cap on income subject to the payroll tax. The cap is $68,400 in 1998 for the portion of the payroll tax used to finance social security retirement and disability benefits (12.4%). The portion of the payroll tax used for hospital insurance under Medicare (2.9%) is already collected on all wages without limit. Senator Kennedy would use the revenue to lower the payroll tax rate. As a result of these changes, the payroll tax would rise for upper-income wage earners as more of their wages became subject to tax, and would fall for lower and middle-income workers as the payroll tax rate was reduced. The "break even" wage would be about $80,800.

[T]he increase in the marginal payroll tax rate ... would cut upper-income workers' after-tax wages, at the margin, by about 20%, a crushing reduction in their incentive to work... Treasury would lose payroll and income taxes on the drop in wages, offsetting about one-quarter of the presumed "static"... tax increase.

[T]n increase in wages subject to the payroll tax entitles workers to additional social security benefits... Ultimately, higher benefits and the revenue losses due to reduced work incentives ... would offset or absorb almost 75% of the revenue gains... [leaving] inadequate net revenue to cover the payroll tax rate reduction.

Simply eliminating the tax cap would lift social security revenue by about 18%, assuming no economic repercussions. That revenue would be enough to trim the retirement and disability portion of the payroll tax by about 1.9 percentage points, from 12.4% to 10.5%. Of course, there would be economic repercussions to consider.

The reduction of the payroll tax rate would lift the after tax marginal wage by about 2.9% for most workers, a small incentive to work harder.[1] However, the increase in the marginal payroll tax rate by 10.5% on wages for upper-income workers would cut upper-income workers' after-tax wages, at the margin, by about 20%, a crushing reduction in their incentive to work.[2] On an income-weighted basis, there would be a net reduction in work incentives economy-wide. Labor costs would have to rise to attract the same total supply of labor, and, in particular, to acquire the same level of talented, trained, and skilled labor.

The tax increase would be enormous for highly-paid entertainers, sports stars, and CEO's of big firms, but they would not be the only ones injured. Millions of owners of moderately successful farms and small businesses, and many self-employed professionals would suffer. Major growth industries relying on highly-trained, highly-talented technicians, such as computer software and hardware, would be hit, and would be inclined to move some of their operations abroad. Another essential growth area, medicine, would feel the pressure of rising costs.[3] The more highly taxed workers would vacation longer, see fewer patients and clients, and sell their businesses and retire earlier than otherwise. People they would otherwise have employed — agricultural, industrial, and service workers

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of all types and wage levels — would have fewer job options and lower incomes.

A 20% reduction in the incentive to work would cut output by the highest productivity, highest wage workers by 5% to 6%, and would adversely affect the employment of their associates as well. Total wage income in the economy might fall by 1.25 to 1.5 percent. After these "dynamic" economic adjustments, the Treasury would lose payroll and income taxes on the drop in wages, offsetting about one-quarter of the presumed "static" payroll tax increase. The Social Security system would come out ahead. The general fund of the Treasury would be a net loser.[4]

If the revenue from eliminating the cap is to be made permanently available for tax rate reduction, the workers subject to the tax increase must be denied the additional benefits they would normally receive... This tax-hike-sans-benefit-increase would make social security an even worse deal for those workers.

Initially, then, only about 75% of the "static" revenue gains from eliminating the cap on income subject to the payroll tax would be available to reduce the payroll tax rate without hurting the finances of the Social Security programs or the rest of the government. This net budget improvement would not last, however.

Normally, an increase in wages subject to the payroll tax entitles workers to additional social security benefits upon retirement. Over time, workers would begin retiring with a history of having paid taxes on these increased amounts of wages. Eventually, the additional social security benefits going to upper-income retirees would build to absorb perhaps 50% or more of the projected static payroll tax revenues from lifting the cap (depending on how fast wages grow). Ultimately, higher benefits and the revenue losses due to reduced work incentives on upper-income workers would offset or absorb almost 75% of the revenue gains anticipated from lifting the tax cap.[5] Longer term, there would be inadequate net revenue to cover the payroll tax rate reduction.

The proposal to eliminate the cap on income subject to the payroll tax is bad economics in and of itself. An even worse consequence of the proposal would be to prolong the agony of the social security system and delay fundamental reform.

If the revenue from eliminating the cap is to be made permanently available for tax rate reduction, the workers subject to the tax increase must be denied the additional benefits they would normally receive from paying taxes on the additional income.[6] Social Security is already a bad deal for upper-income workers. This tax-hike-sans-benefit-increase would make social security an even worse deal for those workers. Proponents of social security have generally resisted such a total divorce of tax payments from benefits for fear of reducing support for the system. Such a move would be a break with tradition, and would further shift the system from a "pension" to a welfare program.

The proposal to eliminate the cap on income subject to the payroll tax is bad economics in and of itself. An even worse consequence of the proposal would be to prolong the agony of the social security system and delay fundamental reform. Social security is an unfunded, pay-as-you-go tax-transfer system that adds nothing to national saving, wealth, and productivity. It should be retired and replaced by a system of private, funded individual saving for retirement. Such a system of real saving would yield far greater retirement incomes, at far lower cost, to future generations. Many proposals to move away from the current system have been introduced in the Congress, or recommended by commissions or policy experts. It is time to stop tinkering with the current system and adopt a fundamental change.

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Endnotes

1. Most workers face a marginal tax rate of about 35%: a 15% marginal income tax rate, a 15.3% payroll tax rate, and some state income tax. They take home about 65 cents on an added dollar of wages. The payroll tax rate cut would boost their take home wage by 1.9 cents out of 65, or about 2.9%.

2. With federal and state income taxes, Medicare taxes, and various phase-outs of deductions and exemptions, most of the affected workers already face combined marginal tax rates of from 40% to 55%. Single workers affected by the elimination of the cap will be mostly in the 31%, 36%, or 39.6% income tax brackets. Some married couples would still be in the 28% bracket, but most would be in the higher brackets. Workers in the 36% to 39.6% marginal income tax brackets actually face marginal tax rates about 1% to 4% higher -- about 37% to 43% -- due to phase-outs of personal exemptions and itemized deductions, depending on family size. The Medicare tax is 2.9%. Marginal state income tax rates may range from 5% to 10%. Consequently, with combined marginal tax rates of 40% to 55%, the affected workers take home only 45 to 60 cents of a dollar of added wages. A 10.5 percentage point hike in the marginal tax rate to between 50% and 65% would cut their take home wage to roughly 35 to 50 cents on the dollar, a drop of about 20% on average.

3. As a consolation, the injured workers might note that other highly-paid professionals affected by the change would include Members of Congress, upper echelons of the Executive Branch, and many successful lawyers.

4. It is possible that the changes in marginal tax rates, and the resulting changes in work incentives and tax revenue, might be moderated slightly by the deductibility for income tax purposes of the employer's half of the payroll tax, if the changes in the business income tax influence wages paid. A 35% corporate income tax rate applied to half of the payroll tax might trim the effective combined marginal rate increases or decreases by about 17.5%. However, the offset would be less if the business is in a lower tax bracket or subject to the lower marginal Alternative Minimum Tax rate, and zero if the business is not profitable or is tax exempt. At most, the increase in work incentives for lower-income workers might be trimmed to 2.4%, and the drop in incentives for upper-income workers might be only 17%. The net reduction in wages might be trimmed to 1% to 1.25%, and the offset to projected revenues might be a bit over one-fifth rather than about one-quarter.

5. After the baby-boom generation retires, there will be 2 workers paying tax for each retiree drawing benefits, later falling to 1.8 workers per retiree. For every 2 upper-income workers paying 10.5% of the additional income subject to tax if the cap were lifted, there would be 1 retired upper-income worker drawing additional benefits that, under the current benefit formula, would equal 15% of the additional income subject to the cap during his working life. Even allowing for the fact of rising wages, which makes the wages of workers in a given year generally higher than the wages earned in the past by the retirees they support, the added benefits, in distant future years, would absorb about 50% of the additional taxes.

6. The current benefit formula would have to be amended to impose a "zero replacement rate bracket" on top of the current 15% replacement bracket that now applies to increases in the average monthly wages on which upper-income retirees paid tax while working.