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REDUCING THE PAYROLL TAX:
The Moynihan–Kasten and DeLay–Wallop Proposals

Cutting the payroll tax is gathering support on Capitol Hill. The two principal initiatives are the Moynihan–Kasten and the DeLay–Wallop proposals.

Both proposals would reduce the payroll tax rate by roughly two percentage points, but while the DeLay–Wallop plan calls for no revenue-raising offset to the rate cut, the Moynihan–Kasten proposal would raise the maximum wage base subject to the payroll tax.

The DeLay–Wallop proposal is the superior approach.

Under the Moynihan–Kasten bill, the portion of the payroll tax rate that covers Social Security's retirement and disability programs — Old Age and Survivors Insurance and Disability Insurance (OASDI) — would drop from the current level of 6.2% each on the employee and employer to 5.7% in 1992 and to 5.2% in 1994; the combined OASDI employee/employer and the self-employed rate would fall in two steps from 12.4% to 11.4% and 10.4%. (The Medicare portion of the payroll tax, 1.45% each on employee and employer, 2.9% total, would be unaffected.) The OASDI tax rate would be increased in stages as the baby boom retires after 2010. Eventually, the rate would far surpass current levels, reaching 16.2% after the year 2050.

In addition, the bill would increase the maximum income subject to the payroll tax — the wage base cap. Under current law, the wage base cap is increased each year in line with the nationwide increase in average earnings. It is projected to rise from $53,400 in 1991 to $55,800 in 1992 and to $62,400 in 1994. Under the Moynihan–Kasten proposal, the cap would be boosted more rapidly, to $60,600 in 1992 and to $74,100 in 1994, with normal increases thereafter. Since OASDI retirement benefits are tied by formula to a worker's taxable earnings history, this provision would raise retirement benefits in the future for those affected by the base increase.

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The tax rate reductions in the proposals are eminently sensible. Reducing the marginal tax rate on labor services would increase employment and GNP. An across-the-board 2 percentage point OASDI tax rate reduction would raise employment by the equivalent of as many as 700,000 to 1,000,000 additional full-time jobs over the next decade. (Some of the employment gains would be due to added part-time employment, some to new full-time hiring, and some to longer hours worked by current workers.) Moreover, the OASDI system is receiving large near-term surpluses; returning the system to a pay-as-you-go basis does not threaten the trust funds or the payment of future benefits.

Unfortunately, there are two problems with the Moynihan–Kasten bill. The first is the proposal for automatic increases in the tax rate when the baby boom retires, to rates above current levels. These automatic increases are neither necessary nor desirable. At that time, the ratio of retirees to workers will be rising sharply. The last thing one would want to do is tax labor more heavily. This would drive down employment, further worsening the ratio and further increasing the burden on workers of caring for the elderly.

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Far better would be to slow the growth of real retirement benefits beginning ten years down the road to enable OASDI to get by without a future tax rate increase (or at least to avoid the rate's rising back above current levels). This should not be difficult, because real benefits per retiree are projected under present law to rise sharply over the next 75 years, to about 2-1/2 times current levels. Each new wave of retirees will have had higher real wages than the group that preceded it. As a result, real benefits will rise without limit over time. Holding the line on the future tax rate would not require any cuts in future benefits from one group of retirees to the next, merely less of an increase in benefits.

The second problem with the bill, more immediate and more serious, is the proposed increase in the wage base cap. This is not only a terrible precedent, it would reduce employment and output.

Consider the situation in 1994, when the proposed tax rate reduction and base increase would be fully phased in. On income below $62,400, the old wage base cap, the combined employer/employee and the self-employed OASDI tax rate would fall from 12.4% to 10.4%. On income between the old and the new taxable wage base caps, $62,400 to $74,100, the combined OASDI tax rate would jump from zero to 10.4%. On income above $74,100, the marginal rate would remain at zero.

The focus on the marginal tax rate is critical. Average tax rates and total tax liabilities affect a worker's total after-tax income. However, it is the marginal tax rate on incremental earnings that affects incentives to work longer or shorter hours.

Under the Moynihan–Kasten proposal, the roughly 94% of all workers earning less than the current-law taxable wage base cap would experience a reduction of 2 percentage points in both their average and marginal payroll tax rates. Their after-tax incomes and their work incentives would both be improved.

For the roughly 2% of workers earning at or above the new maximum taxable wage, the added tax paid on the added covered earnings would almost exactly offset the taxes saved by the rate reduction on earnings below the old cap. Indeed, the proposed increase in the cap was specifically designed to cancel the tax cut for those above the current cap. These workers would have virtually the same tax liability as before, and still face a zero marginal OASDI tax rate on additional income. Neither their after-tax income nor their work incentives would be affected.

However, the roughly 4% of workers earning between the old wage ceiling and the new wage ceiling would experience a sharp jump, from zero to 10.2 percent, in their OASDI tax rate on additional earnings. The lower tax rate on the portion of the worker's income below the old cap would cut his or her average tax liability, and the worker's after-tax income would rise. Nonetheless, his or her work incentive would fall rather sharply, due to a sharp decrease in the after-tax marginal wage.

For example, under current law, a self-employed single worker just above the current OASDI wage cap would have no OASDI tax on additional earnings, and, after itemizing deductions, might face a roughly 35% marginal income tax rate (a 31% marginal federal income tax rate and, say, a deductible 6% marginal state income tax rate) and the employee-employer Medicare rate of 2.9%, for a total marginal tax rate of nearly 38% on additional earnings. The proposed wage cap increase would raise the worker's marginal OASDI tax rate from zero to 10.4%, and would raise the combined income tax-payroll tax marginal rate to over 48%. The after-tax marginal take-home pay on an added dollar of income would fall from 62 cents to less than 52 cents, a 16% drop in work incentive. A similar increase in the marginal tax rate on those employed by businesses would result in a combination of a lower, after-tax marginal wage, higher labor costs, and reduced employment.

Because workers' contributions to GNP are in proportion to their incomes, the reduction in GNP due to the work disincentives imposed on workers above the current earnings cap would be correspondingly high. The increase in the wage cap would cost nearly 50% of the employment and output gains that the cut in the OASDI tax rate would produce.

The wage cap hike is designed to prevent the rate reduction from giving a tax cut to those with upper middle income or above. On a static basis, in 1994, it would save the Treasury between zero and $1,217 per worker for those with incomes between the old and new wage base caps, and $1,217 for each worker above the new cap, or about $8 billion total. Allowing for lower employment and output due to the higher wage cap, over half of the revenue saving would be eliminated, counting both lost payroll and income taxes.

In addition, the increase in the maximum taxable wage base would increase the future OASDI retirement benefits for those subject to the base increase. The prospect of increased OASDI benefits might reduce, but not eliminate, the adverse work incentive effects described above. Over time, however, these increased OASDI outlays would rise to absorb about 75% of the revenue raised by the wage base increase. Combined with the remaining employment effects, the base increase is certainly a long-term money loser.

The increase in the taxable wage base is purely cosmetic. It would save little revenue in the short run, and would lose money in the long run. The economic damage it would do is considerable.

The authors of the bill need to reexamine their priorities. An immediate and straightforward reduction in the payroll tax rate has the potential to speedily reduce the tax-related portion of labor costs, improve the international competitiveness of the United States as a place to produce goods and services, and raise employment and GNP. If ever there were an anti-recession, pro-growth measure, that would be it. However, the delay in the rate reduction and the increase in the wage base cap, reflecting the injection of income redistribution and budgetary concerns, sharply reduce the proposal's anti-recession and growth benefits. This bill is a marvelous example of how knee-jerk attention to "fairness" can destroy an otherwise highly constructive proposal.

A far better approach would simply cut the payroll tax rate while leaving the maximum taxable wage base unchanged. This approach is part of a comprehensive tax reform proposal for economic growth advanced by Congressman DeLay and Senator Wallop.

The DeLay–Wallop proposal would cut the OASDI tax rate to 10.6% (5.3% each on employee and employer) effective July 1, 1991. The rate reduction is slightly less than in Moynihan–Kasten, reflecting the downward revision of OASDI operating surpluses since the last Trustees Report. The July 1, 1991, effective date makes the proposal more timelythan Moynihan–Kasten for fighting the current recession and bolstering the recovery. It would not raise the wage base cap. It also contains no provision to raise payroll tax rates in the future. Instead, it requires Congress to take action within six months whenever the OASDI Trustees Report projects that the trust fund reserve ratio will decline below 90 percent of a year's benefit outlays within ten years. Whether that action is to raise taxes, adjust the benefit formula, raise the normal retirement age, or find some other source of funding for the system is left for that future Congress, nearer to the situation, to decide.

Concerns over static budget numbers and spurious "fairness" issues are paralyzing fiscal policy. These meaningless concerns should be swept aside, and attention refocused on rising unemployment and falling GNP. A clean, across-the-board payroll tax rate cut would spur employment and economic growth to cut short the recession and promote a sustained recovery. Such a cut should be given the earliest possible consideration.

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