

The New York Times, November 1, 2009

ECONOMIC VIEW

Supply-Side Ideas, Turned Upside Down

By N. GREGORY MANKIW

BARACK OBAMA is, in many ways, the left's answer to Ronald Reagan.

Both came to office as charismatic and self-confident leaders, elected in times of economic crisis and determined to move the economy in a new direction. What is less obvious, however, is that the signature domestic issue in President Obama's first year in office — health care reform — is shaping up to be the antithesis of President Reagan's supply-side economics.

The starting point for Ronald Reagan was the idea that people respond to incentives. The incentives that he most worried about were those provided by the tax system. According to his budget director, David A. Stockman, Mr. Reagan would regale the staff with stories of how he, as an actor, used to alter his work schedule in response to the tax code.

“You could only make four pictures, and then you were in the top bracket,” Mr. Reagan would say. “So we all quit working after four pictures and went off to the country.”

The key economic concept here is the marginal tax rate, which measures the percentage of a family's incremental income to which the government lays claim. During Mr. Reagan's time in office, the top marginal tax rate on earned income fell to 28 percent from 50 percent.

The verdict on supply-side economics is mixed. The most striking claim associated with the theory — that cuts in marginal rates could generate so much extra work effort that tax revenue would rise — is unlikely to apply except in extreme cases. But substantial evidence supports the more modest proposition that high marginal tax rates discourage people from working to their full potential. Mr. Reagan's behavior as a movie actor is a case in point.

President Obama has said he wants to raise marginal tax rates on high-income taxpayers. Yet under his policies, the largest increases in marginal tax rates may well apply not to the rich but to millions of middle-class families. These increases would not show up explicitly in the tax code but, rather, implicitly as part of health care reform.

The bill that recently came out of the Senate Finance Committee illustrates the problem. Under the proposed legislation, Americans would have the opportunity to buy health insurance through government-run exchanges. Depending on a family's income, premiums and cost-sharing expenses, like co-payments and deductibles, would be subsidized to make health care more affordable.

A family of four with an income, say, of \$54,000 would pay \$9,900 for health care. That covers only about half the actual cost. Uncle Sam would pick up the rest.

Now suppose that the same family earns an additional \$12,000 by, for example, having the primary earner work overtime or sending a secondary worker into the labor force. In that case, the federal subsidy shrinks, so the family's cost of health care rises to \$12,700.

In other words, \$2,800 of the \$12,000 of extra income, or 23 percent, would be effectively taxed away by the government's new health care system.

That implicit marginal tax rate of 23 percent is a significant disincentive. And it comes on top of the explicit marginal tax rate the family already faces from income and payroll taxes. Altogether, many families would face marginal rates at or above the 50 percent level that animated the Reagan supply-side revolution.

One might hope that such a large climb in marginal rates is a bug in the Senate Finance bill, one that could be fixed before the legislation became law. But there is no simple fix. Higher marginal tax rates are an integral part of the Obama health plan.

Here's why:

Health reformers start with the problem that some people are expensive to insure, because of pre-existing health conditions. Their solution is to require insurers to sell insurance to everyone (a policy called guaranteed issue) at the same price (called community rating).

This solution, however, causes another problem. For healthy people, insurance is now a bad bet. A person without significant medical needs has an incentive to wait — to buy insurance later if and when he gets sick, a decision that raises the cost of insurance for everyone else. This problem, according to the reformers, calls for another solution: a mandate requiring people to buy health insurance.

But this mandate leads to yet another problem. Requiring an expensive purchase like health insurance can be onerous for low-income families. So the health reformers offer subsidies.

Which brings us back to marginal tax rates. If large health insurance subsidies were offered to all Americans, regardless of income, the program's cost would be exorbitant, requiring substantial increases in explicit taxes. So, instead, the subsidies are phased out as income rises. As a result, we get implicit marginal rates like those in the Senate Finance bill.

NONE of this necessarily means that health reform is not worth doing. President Obama's push for reform is premised on the belief that access to good health care should be a right of all Americans — a proposition better judged by political philosophers than economists.

But we should not forget the cost of translating that noble aspiration into practical policy. As a matter of economic logic, President Obama's goal of universal health insurance cannot help but undermine former President Reagan's goal of lower marginal tax rates. Future generations of Americans may find health insurance more affordable, but they will also find hard work less financially rewarding.