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COMMENTARY

The $110,000 Question

By MARTIN FELDSTEIN

While the Republican Convention is rightly focusing on what a second Bush term would mean, voters should compare that with the policies of the Democratic candidate. When it comes to taxes, John Kerry says he will raise taxes on taxpayers with incomes over $200,000 but will not increase taxes on the "middle class." Since most Americans regard themselves as middle class, they may feel that they won't be hit by a Kerry tax increase if their income is under $200,000. But while promising not to raise taxes on the middle class, Mr. Kerry is actually considering a big tax increase on families with taxable incomes of $80,000 and even less.

Of course, he doesn't put it quite that way. He speaks instead about raising the maximum amount of income on which the 12.4% Social Security payroll tax would be levied from the current $87,900 to $120,000. For someone with a salary of $110,000, that would mean a combined employee-employer payroll tax increase of $2,740.

That's a big tax increase for such an individual. A $110,000 salary earner with a spouse who looks after two children and with the typical income tax deductions for that income level has taxable income of $79,000 and pays an income tax of $13,400. The $2,740 payroll tax increase would therefore be the same as a 20% increase in that income tax bill.

Mr. Kerry's suggested increase in the payroll tax would do more than just raise the tax burden on millions of families who regard themselves as middle class. For those with wages between $87,900 and $120,000, it would take the marginal payroll tax rate on each extra dollar of earnings from zero to 12.4%. The resulting large increase in the individual's overall marginal tax rate would distort substantially the amount that people work, the effort with which they work, their interest in more training and more responsibility, their willingness to take entrepreneurial risks, etc. The higher marginal tax rate would also encourage substituting lower value fringe benefits for cash compensation.

Here are the specifics. For taxpayers now earning between $87,900 and $120,000, the overall marginal tax rate (including the federal marginal income tax rate of 25%, the Medicare payroll tax and a state income tax) would rise from 33% to about 43%. Experience with past tax changes suggests that raising the marginal tax rate from 33% to 43% would cause individuals to reduce their taxable earnings by about 7% by changing the way that they work and the way that they are compensated. Someone who now earns $110,000 would reduce his taxable income to $102,000. In practice this change wouldn't happen immediately but would mean a smaller increase in taxable income over time than would otherwise have occurred.

This reduction in taxable earnings not only reduces the revenue gain from raising the payroll tax ceiling but also causes an outright loss to the government of personal income tax revenue. For many individuals, the extra payroll tax revenue would be more than offset by the lower personal income tax revenue, causing a net loss of revenue to the government.

Here's why. Since an individual who initially earns $110,000 would react to the higher marginal tax rate by reducing his taxable income to $102,000, the payroll tax revenue that he and his employer pay would only rise by $1,748 rather than the $2,740 that would be collected if there were no change in behavior. Furthermore, income tax revenue would go down by 25% of the $8,000 fall in his taxable earnings or $2,000. In addition, because the increased employer portion of the payroll tax reduces personal taxable income, the income tax collections fall by an additional $218. Finally, the reduction in pretax wages also lowers revenue from the 2.9% Medicare payroll tax by $266. Putting the pieces together shows a payroll tax increase of $1,748 and losses on the income and Medicare taxes of $2,484. For this $110,000 earner, every extra dollar of Social Security tax revenue produced by the Kerry plan would cut other tax revenue by more than a dollar. Raising the taxable income ceiling would actually cause a net fall in total tax revenue for this individual of $736.

The distorting effect of the higher marginal tax rate on the way people work and the form in which they take their compensation creates a waste of real income that economists call the "deadweight loss" of the tax change. This pure waste is over and above the decline in earnings and the loss of tax revenue. For the individual who originally earned $110,000, calculations show that the deadweight loss caused by the higher marginal tax rate is about $3,100 even before taking account of the distorting effects on economic growth.

For individuals with incomes over $120,000, the increase in the payroll tax ceiling would not change the reward for additional work or the relative tax on cash income and fringe benefits. They and their employers pay an additional combined payroll tax of $3,980. The impact on taxable income of the half of this tax that is paid by employers reduces the income tax and Medicare payroll revenue by about $560. The net revenue gain is therefore about $3,420 for each of these individuals.

So the rise in the payroll tax ceiling would mean higher total taxes for some individuals and lower total taxes for others. To calculate the overall national effect of raising the payroll tax ceiling, my colleague Dan Feenberg and I have used a sample of about 100,000 anonymous individual tax returns provided by the Treasury Department. We adjust these data to allow calculations at the 2004 income level. Here's what we found.

The Kerry idea to raise the income ceiling for the Social Security payroll tax to $120,000 would increase the payroll tax revenue by $19 billion if there were no effect on taxpayer behavior. But changes in behavior shrink the additional payroll tax revenue to $16 billion and cause federal and state personal income tax revenue and Medicare payroll revenue to fall by about $11 billion. This means that more than two-thirds of the $16 billion increase in Social Security revenue is just a back door transfer from general revenue and the Medicare trust fund.

The net revenue gain would therefore be only about $5 billion or less than 30% of the $19 billion traditional "static" estimate of the payroll tax gain that ignores the impact of higher tax rates on taxpayer behavior and on the personal income tax liability. Finally, the total deadweight loss -- i.e., the total pure waste caused by the distorting effect of the tax -- would be about $9 billion. The total cost to the private sector of the government's raising the net revenue of $5 billion in this way is therefore $14 billion -- or nearly a $3 cost to taxpayers for every extra dollar of revenue that the government collects.

It's hard to think of a worse tax policy than one that raises very little revenue but causes a very large distortionary deadweight loss. But that's the tax policy that Mr. Kerry says he is considering.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Reagan, is an economics professor at Harvard and a member of the Journal's Board of Contributors.

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