Payroll Taxes Are 'Regressive'? Time to Rethink That Idea; Critics of how Medicare and Social Security are funded don't take into account benefit payouts. Suddenly, the taxes look progressive after all.

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Publication info: Wall Street Journal (Online) [New York, N.Y] 29 Oct 2012: n/a.
ProQuest document link

Full Text: Many of those who assert that the rich don't pay their fair share of the nation's bills often point to how Social Security and Medicare are funded. For example, columnist Paul Krugman wrote on his New York Times blog in 2010 that "the payroll tax is regressive, as are most state and local taxes, which largely offsets the progressivity of the income tax." And President Clinton's secretary of labor, Robert Reich, said in an October 2007 blog post, "payroll taxes take a much bigger portion of the paychecks of lower-income Americans than of higher-income [Americans]. Viewed as a whole, the current tax system is quite regressive." On the contrary, studies show that the Social Security and Medicare programs, viewed as a whole, are anything but regressive. The payroll taxes that fund these programs are collected for the express purpose of providing income supplements and medical care during retirement. In the case of Social Security, earned income is taxed proportionately at 12.4% (split evenly between employee and employer) up to a cap that is currently set at $110,100. Those who assert that the Social Security tax is regressive note that the income cap results in a decline in taxes paid as a percentage of income as income rises above the cap. But this observation omits three critical facts. First, the amount of one's Social Security income at retirement is also capped. Second, higher-income workers receive less of a benefit as a percentage of their contributions than do lower-income workers. The payouts to retirees are, and are intended to be, redistributive. Third, Social Security income is subject to the income tax--and the income tax is progressive. Given the design of Social Security, the only way the program could be regressive is if the mortality rate differences between the group of higher-income and lower-income workers were so large that higher-income people received greater lifetime benefits for each dollar contributed. But this is not the case, according to a 2009 study by the Social Security Administration's Office of Retirement and Disability Policy. Rather, the study concludes that "Social Security is modestly progressive on a lifetime basis; currently, the program lies approximately halfway between paying a benefit directly proportional to lifetime taxable earnings and paying a flat dollar benefit to each retiree." In the case of Medicare, the amount paid into the system--2.9% of income, split evenly between employee and employer--is proportionate to income and has no cap. So a person with a lifetime income of $5 million will pay five times as much into the system as a person with a lifetime income of $1 million. In theory, therefore, the benefits provided by Medicare (paid health care) should be the same for each beneficiary. And like Social Security, lifetime benefits are affected by differences in mortality rates among different income groups (the poor tend to die younger). However, lower-income beneficiaries are more likely to become ill than higher-income beneficiaries and thus consume more benefits. Higher-income beneficiaries are more likely to privately insure or pay out of pocket in old age, thus reducing their demands on the system. So what is the bottom line? Based on the Medicare Current Beneficiary Survey, health economists Jay Bhattacharya of Stanford University and Darius Lakdawalla of USC found that the poorest groups receive the most benefits at any given age, and that this advantage in benefits received significantly outweighs the fact that as a group, they die younger. The authors' 2006 study "Does Medicare Benefit the Poor?" was published in the peer-reviewed Journal of Public Economics. On the whole, the authors conclude that "Medicare is an extraordinarily progressive public program, in dollar terms or welfare terms." The studies suggest that both of the payroll-tax systems are progressive, not regressive. Moreover, according to a July 2012 study by the Congressional Budget Office, entitled "The Distribution of Household Income and

Federal Taxes, 2008 and 2009," the entire U.S. federal tax system (including the earned-income tax, the various capital income taxes, the two types of payroll taxes, the corporate tax, and the excise tax) is also progressive. Those who assert that "the rich" do not pay their "fair share" seem to be ignoring these other facts: A study released in 2008 by the Organization for Economic Cooperation and Development reported the U.S. federal income tax system is the most progressive of any of the 24 countries of its member nations. And an October 2011 report by the Tax Foundation noted that in 2009 the top 1% of U.S. earners--who earned 17% of the income--paid 37% of the taxes. The top 5% earned 32% of the income and paid 59% of the taxes. The bottom 50% paid 2.3% of taxes, and the bottom quintile received money back in the form of refundable tax credits. Those who would increase the marginal rates paid by the top income earners must confront the depressing effect that higher taxes will have on business creation and expansion--and on jobs. Giving a bigger piece of a smaller economic pie to lower-income earners is not likely to be in America's interest. Mr. Hagopian is the chairman of Maxim Integrated Products Inc., a semiconductor company, and was a founding general partner of Brentwood Associates, a venture capital and private-equity firm. Mr. Ohanian is professor of economics at UCLA and a senior fellow at Stanford University's Hoover Institution. Credit: By Kip Hagopian And Lee E. Ohanian

Pages: n/a

Last updated: 2012-10-29

Company/organization: New York Times Co; 511110, 511120, 515112, 515120