BY RAISING MEDICARE TAXES, THE SENATE BREAKS THE PROMISE OF THE 1986 TAX REFORM

The Senate Finance Committee last month approved an $11.6 billion tax increase package as part of its strategy to cut the deficit. The central feature of the package is a sharp increase in Medicare payroll taxes. The current Medicare tax is 2.9 percent of wages up to $43,800, and it is split between employee and employer. Under the Finance Committee tax hike, the $43,800 cap would be eliminated. The 2.9 percent tax thus would be levied on all earnings without limit. This would be a harsh and punitive tax increase on millions of families above the current tax cap.

Families at that cap already face a total payroll tax on their employment of $6,260 this year. While employers supposedly pay half this tax, the fact is that the worker bears almost the entire amount. Because employers treat the tax as a payment for labor, they predictably and typically reduce wages to make up for the payroll tax costs of hiring the worker. To the extent that employers bear the tax, it imposes a substantial burden on small and medium size businesses in particular. Increasing the tax would thus reduce the ability of these firms to create new jobs. The increase would also reduce the stock value of many businesses by reducing their profits, which could add further to the stock market decline.

Payroll tax rates are already scheduled to rise next year under current law. With the Finance Committee's tax hike, the total payroll tax for a worker earning $60,000 in pre-tax wages would increase next year by about $900.

Senate Flip-Flops. The Senate Finance Committee proposal flip-flops on last year's tax reform compromise, under which tax rates were to be reduced sharply in return for the elimination of tax shelters and preferences. The chief focus of tax reform was to bring down the top marginal tax rate in return for fewer deductions. At that time, the payroll tax did not add to the top marginal rate because it applied only to wages up to a maximum cap. By eliminating this cap for the Medicare portion of the payroll tax, the Finance Committee bill raises the top marginal federal tax rate by 2.9 percentage points, from 28 percent to 30.9 percent. This violates the bargain that was the essence of last year's tax reform package.

To make matters worse, the Finance Committee Medicare payroll tax is highly inequitable. Under Medicare, after all, workers all receive the same coverage and benefits. But with a 2.9 percent tax rate applied to all pre-tax wages, some workers would pay much more for the same benefits than others. For one worker, the total Medicare payroll tax could be $2,900 per year, while for another the total tax could be just $290. When the government is providing a direct service to individuals such as health insurance, the most equitable financing is to charge all the same amount for the same service, just as private life insurance or private health insurance premiums are the same regardless of income. Such financing is not a "regressive tax" but a proper, fair, and equal charge for equal service. Under the current payroll tax system, there is a degree of subsidy to those with lower incomes, but the subsidy from higher income workers is limited by the tax cap. The Finance Committee's action would change this principle, treating higher income Americans merely as a "deep pocket."

Penalizing a Minority. The Finance Committee bill thus would make Medicare extremely unfair for those with wages above the current taxable income cap. They would be charged much more for the same service than the others would be. Some proponents of the charge argue that the Medicare tax increase would apply only to about 10 percent of workers. But this seems to suggest nothing more than a political calculation that Congress should penalize this group simply because it represents a minority of Americans.

The Finance Committee bill would impose a harsh new payroll tax that would mean hundreds of dollars per year in new taxes for millions of American families. It would make Medicare into a new tool to soak better-off Americans instead of a self-financed health program, and it would be a dramatic betrayal of the most basic principles of the 1986 tax reform legislation.

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For further information:

Peter J. Ferrara, "Upcoming Social Security Tax Hikes Can Threaten Retirement Benefits," Heritage Foundation *Backgrounder No. 597, August 5, 1987.*

Peter J. Ferrara, "Averting the Medicare Crisis: Health IRAs," *Cato Policy Analysis* No. 62, October 31, 1985.