Quick Study
A Policy Report Summary by the Institute for Policy Innovation

A Tax Deduction For Payroll Taxes:
An Analysis of the Ashcroft Proposal

A Summary of IPI Policy Report #142

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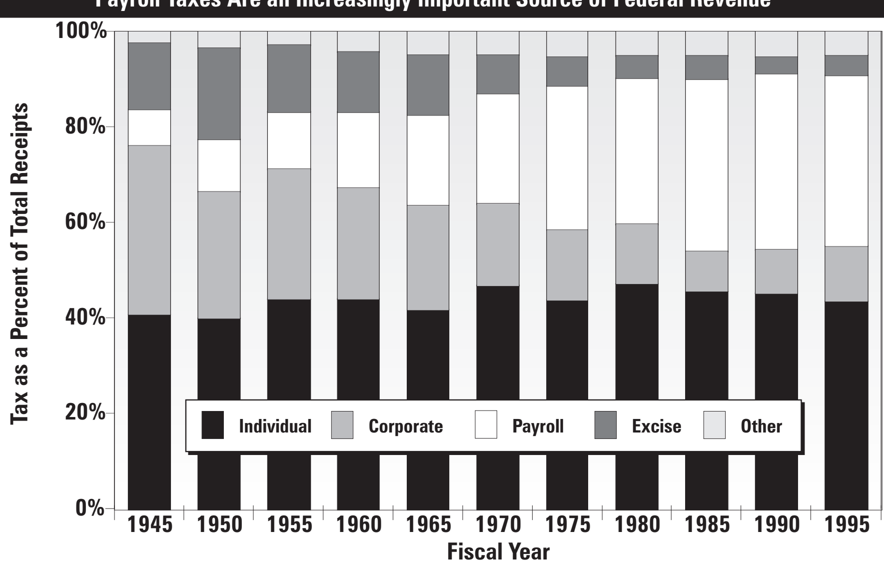
Payroll taxes are not small potatoes: Today, over 90 percent of all workers pay more in payroll taxes than in income taxes.

The report of the Advisory Council on Social Security recommends increasing payroll taxes. The council members split into three camps. Two groups included raising payroll taxes as part of their solution for Social Security's financial problems. The third group also saw a need for more revenue, but favored a broad-based consumption tax over higher payroll taxes.

Senator John Ashcroft (R-MO) believes that the combined federal tax burden is too high for many working Americans. He is offering a bill that would give workers an income tax deduction for the payroll taxes they pay.

Figure 1

Payroll Taxes Are an Increasingly Important Source of Federal Revenue



Payroll Taxes and Federal Revenues

Payroll taxes are the second largest source of federal tax dollars, surpassed only by the individual income tax. [See Figure 1.] There are several types of payroll taxes. The most well known, and largest, are those earmarked for Social Security and Medicare.

Payroll taxes were not always so prominent. In 1937, the Social Security payroll tax rate was 2 percent of the first $3,000 of wages. The next increase did not come until 1950 when the tax rate was raised to 3 percent. But expansion of Social Security retirement and survivor benefits and the addition of new benefits, such as disability and Medicare, resulted in a steady series of increases in both the tax rate and taxable wage base. [See Figure 2.]

Today 12.4 percent of wages up to $65,400 go to support the Old-Age Survivors Insurance and Disability

Insurance programs (OASDI). Another 2.9 percent of wages go to pay for the Hospital Insurance (HI) program, also known as Medicare Part A. The wage base for the Medicare tax was the same as that for Social Security until 1991 when it more than doubled. Since 1994, all wages have been subject to the 2.9 percent HI tax.

Payroll taxes also have become a larger share of the economy. While the federal tax bite has stayed around 18 to 20 percent of GDP, payroll taxes have dramatically increased from 1.6 percent of GDP at the end of World War II to 6.4 percent today. If future payroll taxes were to be increased in an attempt to deal with the burgeoning financial crises looming for Social Security and Medicare, they would take an even greater bite out of the economy.

Payroll Tax Burden on American Workers

Today payroll taxes are a greater burden for most workers than are income taxes. Rising payroll tax rates have more than erased whatever income tax relief the 1980s brought. Moreover, payroll taxes hit the first dollar of wages, while income taxes kick in after exemptions and deductions. *Overall, 40 percent of all workers with income tax returns pay more in payroll taxes than in income taxes considering only the 7.65 percent paid by employees.* That jumps to over 90 percent when the employer's share is added. [See Figure 3.]

Under current law, payroll taxes paid by the employee are subject to the income tax while those attributed to the employer are not. Payroll taxes withheld from workers' paychecks are counted as taxable wages. For example, if a worker earns $30,000 in wages, the employer pays a payroll tax of $2,295, and another $2,295 is withheld from the employee's paychecks. The $2,295 paid by the employer does not appear on the employee's W-2 form and is not included as part of taxable wages. However, the $2,295 that was withheld from the worker's paychecks is counted as a part of the $30,000 of taxable wages, and the worker must pay taxes on the $2,295 withheld. **Many consider the fact that workers must pay income taxes on their payroll taxes a tax on a tax.**

The Ashcroft Proposal: An Income Tax Deduction for Payroll Taxes

A proposal by Senator Ashcroft would eliminate this double taxa-

Figure 2

Social Security & Medicare Tax Rates, 1937 to 1997

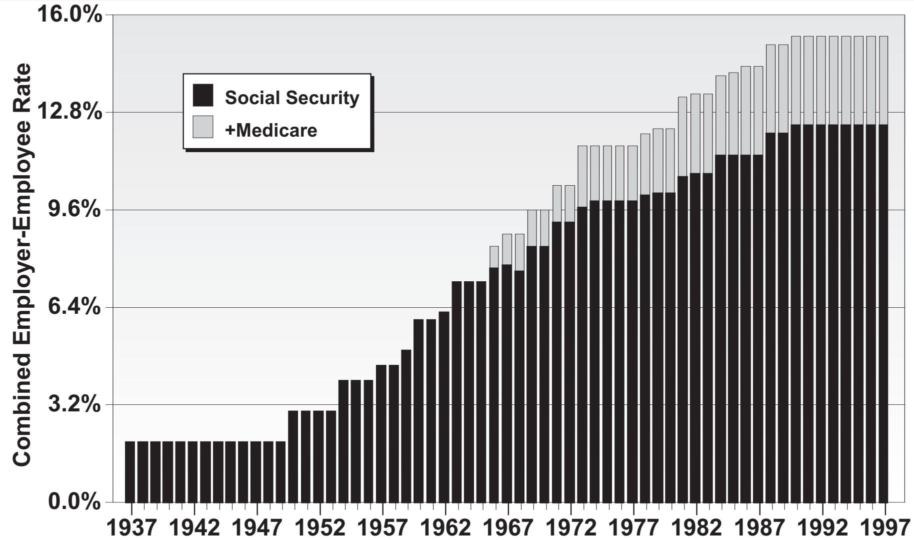
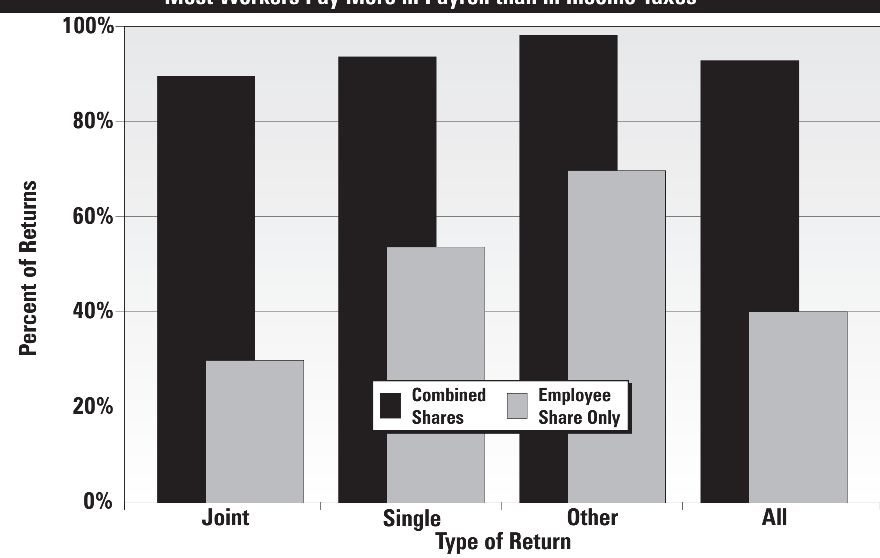


Figure 3

Most Workers Pay More in Payroll than in Income Taxes



tion by allowing workers an income tax deduction for the payroll taxes they pay. Specifically, workers would take an "above-the-line" deduction for their share of payroll taxes that finance Social Security, which amounts to 6.2 percent of wages below the wage base. The 1.45 percent designated as the employee portion of the Medicare tax would not be deductible. Above-the-line means that the deduction would be available to taxpayers whether they itemize or take the standard deduction.

Economic Effects

We used our general equilibrium, neoclassical model of the U.S. economy to assess the economic effects of the proposed income tax deduction for Social Security payroll taxes. The model incorporates taxes through their effects on the returns to labor and capital. An increase in take-home pay caused by a tax cut will increase the amount of labor workers are willing to supply. Similarly, an increase in the aftertax return to capital will result in more saving and investment. Increases in the amount of capital and labor available to the economy will increase output, income, and growth.

Allowing workers to deduct their portion of the Social Security payroll tax would lower the marginal tax rate on labor by 8 percent. In response to the lower tax on labor and resulting increase in take-home pay, workers would supply more labor. After five years, these labor effects would lead to the creation of 917,000 more jobs than otherwise. For the economy as a whole, hourly take-home pay would average 18 cents higher, or an increase of 1.7 percent.

The additional labor would lead to more output and investment. By 2002, annual GDP would be $66.9 billion higher than otherwise, or 0.7 percent. The stock of U.S. capital would be $173.9 billion higher than otherwise, or 0.6 percent.

Revenue Effects

An income tax deduction for payroll taxes would reduce revenues from the individual income tax by about 6.3 percent a year. The Joint Committee on Taxation (JCT) has arrived at a similar estimate. But official scorekeepers like JCT do not account for the likely economic effects of tax changes. If a tax cut leads to an improved economy, the added growth will offset some revenue loss from the cut.

Based on our estimates of the economic effects, the additional growth stimulated by the tax cut on labor would offset one-third of the static revenue loss between 1998 and 2002.

Distributional Effects

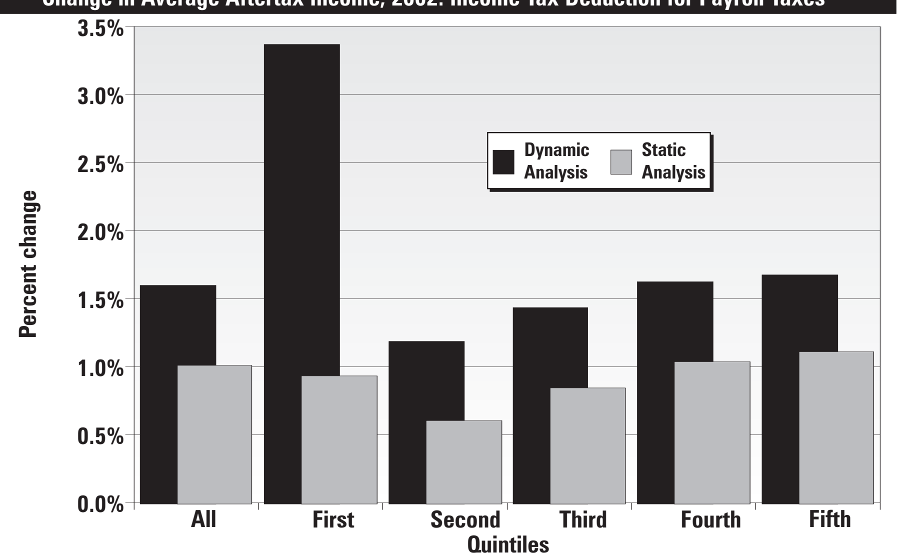
A standard distributional analysis would show that 76 percent of the tax cut from an income tax deduction for payroll taxes would go to taxpayers earning under $100,000. Because these same taxpayers pay 50 percent of federal income taxes, the tax cut package is progressive.

Of greater concern should be the extent to which people are better off after the tax cut, something that static analysis does not measure correctly. That is, what happens to people's incomes after tax?

On average, taxpayers in the middle of the income distribution would experience roughly a 1.5 percent increase in aftertax income from the payroll tax deduction. Those in the top fifth would see their aftertax incomes increase by 1.7 percent. Taxpayers in the bottom fifth would experience the largest increase in aftertax income, 3.4 percent, be-

Figure 4

Change in Average Aftertax Income, 2002: Income Tax Deduction for Payroll Taxes



cause they pay little or no income tax and, therefore, get to keep more of their gains from growth. [See Figure 4.]

Implications for Tax Reform

Because major tax reform remains on the policy agenda, at least for the longer run, tax proposals should be assessed within this context. All the major tax reform efforts underway aim to lower marginal tax rates on work, saving and investing.

The Ashcroft proposal would be a step in this direction. In fact, the Kemp Commission, which was charged with studying how to revamp the current tax system, recommended full deductibility of payroll taxes. Its report states that "making the payroll tax deductible, income taxes would be calculated on the basis of working families' real net incomes."

An income tax deduction for payroll taxes also is a better way to provide relief to lower and middle income Americans than other proposals currently under consideration espousing that same objective. Tax credits for children or college tuition would have few positive economic effects and could be harmful if phased out at certain income levels, thereby raising marginal tax rates. Such targeted tax cuts, which single out some activities for special tax breaks, move away from, not toward, true tax reform.

Conclusions

Payroll taxes are for most Americans more burdensome than income taxes. Allowing workers to deduct the payroll taxes that they pay directly from their wages would offer some relief, particularly for those with lower and middle incomes. A payroll tax deduction also would provide a modest boost to the economy and, unlike the child or tuition tax credits, move in the same direction as broader-based tax reform.

Quick Study

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