COMMENTARY

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Compromised

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During the recent off-year elections, the president repeatedly pointed to the booming economy and noted that his tax cuts were responsible. With growth strong and unemployment low despite the ending of the stock-market bubble, terrorist attacks and the war in Iraq, he had every reason to be proud. Moreover, both economic theory and the actual timing of the economic revival support his claims regarding the tax cuts.

That is why it is so odd that rumors swarm around Washington that the president may be willing to raise taxes as part of a "deal" on entitlement reform. In particular, the rumors suggest the president might be willing to get rid of the provision that caps the income level used to compute Social Security taxes and benefits. These rumors aren't without substance; last year the president would not rule out raising the cap when asked.

Doing so would raise the marginal tax rate on the entrepreneurs that Mr. Bush credits for having led the economic recovery by more than 10 percentage points. The new effective rate would be five percentage points above the level when he took office. Moreover, in 2011, the rate would go up a further 4.3 percentage points to an effective 53% marginal rate on entrepreneurial income. The president would thus be not just raising taxes on entrepreneurs to well above the levels that prevailed in the Clinton administration, but to a rate higher than that which prevailed in the Carter administration. Most of the improved incentives for entrepreneurship and work brought about under Reagan would be repealed.

Should the president do this, he doubtless would be thinking that saving Social Security would be worth the price. He would be wrong. In practice this idea would both destroy the basis on which Social Security was started and fail to produce the expected revenue that supposedly would save the system. Social Security was set up as a contributory pension plan, not a welfare scheme. Benefits are linked, by statutory formula, to contributions. Congress and the president could choose to maintain this relationship. Traditional supporters of Social Security like AARP have long insisted on this link and argued against turning the program into another welfare plan by ending the linkage between contributions and benefits.

There are two problems with that approach. First, an increase in the cap on taxes and benefits would produce very little net revenue for the system. Even if one assumed higher taxes did not hurt the economy, the increased benefits would consume much of any increased revenue. Second, the benefits that high income people would get would be politically unsustainable. A retiree who earned a million per year would receive a monthly Social Security benefit of $13,500. This is politically unimaginable. So, expect both the universality of Social Security and the link between taxes and benefits to go, and this most enduring element of the New Deal to become a welfare program.

But it is the damage to the economy and to the fiscal system that is more important. Economists differ on how much such a dramatic increase in tax rates on entrepreneurs would damage the economy. Certainly given the statements of the president earlier this year he believes it would be significant. Consider some figures.

Published IRS data from 2004 show that taxpayers with incomes over $100,000 earned $1.9 trillion in wages, salaries, bonuses and self-employment income. Of that, roughly $800 billion was above the Social Security maximum tax threshold. Levying the 12.4% Social Security tax on that income would produce $99 billion in revenue. Of that, employers and the self-employed would be able to deduct half of that tax from their corporate or personal tax returns. Thus, $17.4 billion of the $99 billion would not be a net gain to the Treasury, but a transfer from the general fund to the Social Security trust fund. So the net gain to the government would have been about $82 billion in 2004.

That assumes that taxpayers would not have changed their behavior when their marginal tax rate rose to 48.6% from 38.4%. No one believes that, although economists do disagree on how much. These are a very sophisticated group of taxpayers with both the knowledge and the means to adjust to taxation by changing the form of business, converting income to capital gains, or other methods. A cautious estimate that enjoys wide acceptance in the tax community says that for every 1% reduction in the share of their income they take home, high income individuals cut their taxable earnings by four-tenths of a percent. My own research from the Reagan tax cuts indicates the response by this group is higher, roughly seven-tenths of 1%.

Although these numbers may seem small, when they are applied to a massive tax rate increase like this, they can have important ramifications. Remember, taxpayers will be seeing the share of income they keep dropping from roughly 61 cents on the dollar to just 51 cents -- and that is before state taxes are figured in. This implies a decline in the tax base of between 7% and 13%.

Under the lower assumption, total federal revenues would only increase by $27 billion, with the behavioral response of taxpayers offsetting 70% of the static revenue increase. True, Social Security tax revenues would still rise by $82 billion, but this would be offset by a net decline in personal income taxes of $55 billion. Under the higher assumption about a behavioral response, total federal revenues would decline. While Social Security taxes would rise by $69 billion, personal income taxes would drop by $95 billion.

Whatever one's assumption, lifting the Social Security tax cap would have to be viewed as an economically and fiscally risky proposition. I seriously doubt that the president would be interested in agreeing to a deal that purports to "save Social Security" when the reality is that it seriously undermines the economic and fiscal basis that underpins the system.

There is another argument that the president will have heard that might persuade him to do what the rumors say he is considering: fairness. It is true that high income earners do not pay Social Security taxes on all of their earnings. As already noted, it is also true that they do not receive benefits on those earnings. So, if you think that Social Security should be a welfare program with benefits unlinked to contributions, then in a sense this may be unfair.

But, consider the total tax system. An urban myth has arisen that the so-called "rich" do not pay their "fair share" of taxes despite the fact that the top 10% of taxpayers pay 68% of federal income taxes in the country. A comparison between a relatively high-income entrepreneur, of which I am one, and a "typical" worker might be illustrative.

Last year an entrepreneur similar to me would have paid federal taxes equal to 33.9% of total income. That is, income before any exemptions, exclusions, adjustments or deductions. By this measure all of the fringe benefits that an entrepreneur provides himself as a self-employed individual are included in income. His federal income taxes and the employer and employee shares of his Social Security taxes are all counted as "taxes."

For comparison, consider a married worker earning a salary of $75,000, who like our entrepreneur, has three children. To compute his total income on the same basis, I gave him the same level of benefits as an average worker and the same level of capital income as others making his income. I also followed convention to impute to him both his own Social Security taxes and all of those paid by his employer. On that basis, his average tax rate was 14.5%.

Based on a 40-hour week, while he finishes paying his Federal taxes on Monday afternoon at 2:48, our entrepreneur will work all day Monday until about the same time on Tuesday until he finishes, another full day. If the plan to eliminate the cap on Social Security earnings is adopted, he will work all day Monday, all day Tuesday, and then Wednesday morning until 10:26 to finish paying his federal taxes. Then he can start paying his state taxes.

That assumes he keeps working as hard as he is and doesn't rearrange his income to take more fringe benefits or shelter it in other ways. This suggests another way to think about just how risky this plan is. Using those 2004 figures cited above, all it would take would be for one of these workers in ten to decide it wasn't worth it to work until 10:30 Wednesday morning just to pay Uncle Sam and this plan the president is reportedly considering would actually cost government tax revenue. Don't make it too tough on him, or Atlas may actually decide to shrug.

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