



Payroll Tax Increase Would Make a Bad Health Care Bill Even Worse

Senate Democrats are having a difficult time figuring out how to pay for their trillion dollar health care bill. Although the bill passed by the Senate Finance Committee contains a \$201 billion tax on high-value health insurance plans, recent press reports have suggested that Senator Reid may reduce the so-called “Cadillac plan tax” that is unpopular with labor unions,ⁱ and instead increase and expand the Medicare payroll tax. This is a bad policy for many reasons. First, such an expansion would represent a major break from past practices by using dedicated Medicare taxes to fund non-Medicare programs. Moreover, the rate of the tax will inevitably go up, and the applicable income level will come down, when the current bill turns out not to pay for itself and new revenues are required. And finally, the tax would fund health coverage expansion with revenues outside the health care system in a way that harms job creation and economic growth.

Background on the Medicare payroll tax: Medicare Part A is currently funded by a 2.9 percent payroll tax levied on every dollar earned by employees; half of this tax is paid by the employee and half by the employer, though in reality the burden falls all on the employee because the tax is taken from the employee’s wages. Revenues from this tax go into the Medicare Trust Fund and are generally linked to Medicare benefits the employee will receive in retirement.

Democrats’ New Plan: According to reports, Senate Democrats are considering applying this Medicare tax to capital gains, dividends, interest, royalties, and partnerships for American families earning more than \$250,000. None of this income is currently subject to the Medicare payroll tax. In addition, Democrats are said to be contemplating raising the employee’s share of this tax (currently 1.45 percent of wages) to 1.95 percent of wages on couples earning more than \$250,000; press reports indicate this could raise \$40 to \$50 billion over ten years.

This proposal would make a bad bill even worse.

- **Fundamentally changes the Medicare financing system:** First by applying what has traditionally been a payroll tax to non-payroll income, and second by using this money to pay for a new, non-Medicare entitlement, it breaks the link between the Medicare tax base and Medicare benefits. As the Wall Street Journal pointed out, this new tax would “sever the link between the tax paid over a lifetime and the medical benefits received, officially making Medicare an income redistribution program.”ⁱⁱ
- **Hurts growth:** Additional taxes on saving and investment act as disincentives for these activities, which are the primary drivers of wealth creation in the United States. Multiple studies have shown that increasing taxes on capital gains will reduce the pool of savings available for investment in innovative, job-creating activities, destroy jobs, and lower national income.ⁱⁱⁱ
- **Kills jobs:** Imposing further taxes on higher-income Americans will harm small businesses. Because many small businesses pay taxes at the individual level, imposing higher individual income taxes hurts these engines of job creation. The Joint Committee on Taxation recently estimated that one-third of the income that would be taxed from a similar House proposal comes from small businesses. The Tax Foundation reports that 67 percent of tax filers who earn more than \$200,000 a year report business income^{iv} – raising taxes on this group provides a disincentive to invest in businesses that innovate and create jobs.
- **Does not fully finance health care shortfalls:** According to Bloomberg, House Democrats rejected the proposal now being considered by Senate Democrats “because lawmakers concluded they may need to increase the payroll tax in the future to pay Medicare benefits that are projected to outpace revenue.”^v The *New York Times* pointed out that “the higher payroll tax would not be sufficient in the long run. Payroll tax revenues generally grow with payroll, which is expected to increase more slowly than health costs...”^{vi}

ⁱ The leadership of labor unions, a major Democratic constituency, tend to favor health care benefits in lieu of wage increases for their membership. See for example this article from Washington Post business columnist Steven Pearlstein, “A 9-1-1 for Health-Care Reform: Send Leadership Now,” July 15, 2009, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/07/14/AR2009071403593.html>

ⁱⁱ Wall Street Journal Editorial, “A Tax a Day,” November 16, 2009.

ⁱⁱⁱ See for example the Heritage Foundation, “Economic Effects of Increasing the Tax Rates on Capital Gains and Dividends,” April 2008, and the Treasury Department, “A Dynamic Analysis of Permanent Extension of the President’s Tax Relief,” July 2006.

^{iv} The Tax Foundation, “The Effect of the Presidential Candidates’ Tax Plans on Flow-Through Business,” October, 2008

^v Bloomberg, “Orszag Expects Health Bill to be Completed This Year,” November 12, 2009.

^{vi} *New York Times*, “Reid Mulls Medicare Taxes for High Earners,” November 13, 2009.