WALL STREET JOURNAL

PA ★★★ FRIDAY, DECEMBER 4, 1998 INTERNET ADDRESS: http://wsj.com

Flatten the Payroll Tax, Too

By ALVIN RABUSHKA

The White House is holding a major conference next week on how to save Social Security, and the retirement program is certain to be at the top of the agenda when Congress reconvenes next month. Fundamental tax reform, which had been a high Republican priority, will likely have to wait until another year.

But Social Security and tax reform are inextricably linked, and Congress should deal with them together. By itself, saving Social Security is a sure-fire recipe for higher taxes, either by increasing or eliminating the current cap of $68,400 on which the 12.4% payroll tax is levied. Income-tax reform alone would be hard to sell politically, since the richest Americans, currently in the highest tax brackets, would benefit most from the adoption of a flat tax or a national sales tax.

Yet Another Benefit

A package that eliminated the payroll-tax cap and replaced the income tax with a low flat tax or national sales tax could solve both problems. It would create a tax system in which the rich paid more, but without the high marginal rates that today provide a disincentive to earn more. And it would permit lower- and middle-income households to allocate a portion of their Social Security contributions into a private retirement account.

Today, Social Security is financed by a 12.4% payroll tax, the expense of which is evenly split between employers and employees or paid in full by the self-employed. To maintain the fiction that Social Security is a retirement insurance program in which contributions are linked to benefits, rather than what it is—a transfer of income from workers and self-employed to retired people—income is taxed only up to a maximum of $68,400.

Thus the payroll tax is regressive: Workers making under this amount pay a marginal tax—the levy on each additional dollar of income—of 12.4%; those whose income exceeds the cap pay a marginal rate of zero. The income tax, on the other hand, is progressive; marginal rates go from zero to 39.6%, as income goes up.

The package I propose would change the payroll tax into a flat tax by eliminating the income cap. What might be the effects of such a provision? In 1996 the payroll tax raised roughly $379 billion. If all wage income had been taxed, based on preliminary Internal Revenue Service income data, this figure would rise by $64 billion, to $443 billion. If income from dividends, interest and capital gains were also subject to the Social Security tax, receipts would increase by an additional $68 billion.

> *A reduction in income taxes on the wealthy would be offset by higher Social Security taxes.*

Eliminating the cap—effectively raising taxes on upper-income Americans—would make it possible to reduce the payroll tax rate by nearly 2% without reducing the overall flow of revenue into the system—or cutting anyone's benefits. Two percent is the figure that proponents of partial privatization cite as a starting point for giving low- and middle-income households the chance to build private retirement accounts. Adding capital income to the equation would permit a reduction of 3.3%. All this would be possible without reducing Social Security benefits.

Now let's turn to tax reform—either the flat tax or a national sales tax, with a rate of 20% or less. Critics of such plans say they would give a tax break to the wealthy because the top rate would fall from 39.6% to 20% or less. The current tax system is highly progressive. IRS data show that during the period 1981-96, the share of taxes paid in a given year by the top 1% of individual taxpayers ranged between 20% and 32% of all federal income taxes. The top 5% paid between 35% and 50%. (These numbers give only a rough idea of relative tax burdens, because it's difficult to determine who bears the burden of corporate taxes, which today account for about a fifth of total federal income taxes.)

Critics of tax reform believe—with some justification—that the combination of a regressive payroll tax with a flat-rate income or sales tax would make the overall federal tax code more favorable to the wealthy. But modification of the payroll tax, as I have proposed, in conjunction with replacing the current, multibracket, complicated income tax with a flat tax or a sales tax, would represent a fair solution. A reduction in marginal income tax rates on wealthy households would be offset by higher Social Security taxes on them.

Prosperous Retirement

Taken together the two taxes would be progressive, because a flat income tax would include a large personal allowance that would exempt the first $30,000 or more of income, while a national sales tax would include a credit against the first $30,000 or more of retail purchases. The average household could use a portion of its current Social Security contributions to begin accumulating capital in a private retirement account. Social Security would be saved, the tax system would be flat and fair, and young Americans could look forward to a more prosperous retirement.

Mr. Rabushka is a senior fellow at the Hoover Institution and co-author of "The Flat Tax" (Hoover Press, 1995).