



## The Payroll Tax Increase: A Loophole and Ticking Time Bomb

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After Saturday's procedural vote in the Senate, health care legislation will finally move forward to a full floor debate and transparent amendment process. With that in mind, it is important to analyze some of the most troubling aspects of the Senate health care legislation, particularly the increase in the payroll tax that many are calling the "Medicare AMT (Alternative Minimum Tax)." Putting aside for a moment the other problems with increasing the payroll tax, the current proposal is not indexed for inflation. This means it will hit an increasing number of middle class families each year, just like the Alternative Minimum Tax does today. This is a big deal, but we're getting ahead of ourselves. Let's start at the beginning.

In an effort to raise money to finance \$841 billion in new health care subsidies, Senate Democrats propose increasing Medicare's Hospital Insurance (HI) payroll tax. This tax increase is billed by supporters as something that "will not only help fund health care reform, but will also extend the solvency of the Medicare Trust Fund." With this one sentence, Senate Democrats not only perfectly capture the absurdity of current "trust fund" accounting conventions, but also signal a total lack of seriousness when it comes to offsetting the new costs associated with health "reform."

The HI tax was originally set at 0.35% when it was established in 1966 as a new payroll tax to fund Medicare. Since then, the tax has increased more than eight times over to the current combined rate of 2.9%. As fast as the tax rate has risen, its growth has been unable to keep up with the increase in

the wage base to which the tax is applied. In 1966, the HI tax applied only to the first \$6,600 of wages. In 1991, the HI taxable maximum earnings base was raised to \$125,000, and in 1994 the cap was eliminated entirely.

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Revenues from the HI tax are "deposited" in the Medicare Part A Trust Fund, which is running a \$20.5 billion deficit (p. 56 of pdf) in 2009. The Trust Fund is expected to continue to hemorrhage money for the next seven years until 2017 when it is expected to be bankrupt. Should Congress elect to keep the program running beyond this date (a safe assumption), the cost to the rest of the budget is estimated to be over \$13 trillion in present value. This is the money Congress would need to invest today to keep Medicare Part A solvent over the 75 year window. And this figure does not include the additional funds that would be necessary to close the even more gaping holes in the other parts of Medicare, principally Part B (doctors' visits) and Part D (prescription drug coverage), which are actually several times larger than the Part A deficit.

Senate Democrats propose raising the HI tax rate by 0.5% to 3.4% on wages in excess of \$200,000 (\$250,000 for joint filers) beginning in 2013. The Joint Committee on Taxation estimates this tax increase will raise \$54 billion over ten years. Given



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the scale of the Medicare funding deficit, some might argue that these additional HI revenues are necessary. But this is not what Democrats propose; this \$54 billion would be used to finance entirely new health insurance subsidies for non-Medicare beneficiaries. The money just gets counted as though it's deposited in the Medicare Trust Fund because the tax is deducted as part of the FICA line item on a worker's paycheck.

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While the person who devised this scheme has no doubt received hearty congratulations from the rest of the Senate Democratic caucus, the cynicism embedded in this strategy is breathtaking. Each dollar raised from the tax increase gets counted by the Joint Committee on Taxation as offsetting new health spending at the same time that very same dollar is treated by the Medicare Actuaries as being deposited in the Medicare Trust Fund. But if this sort of double counting is such a good idea, why stop at \$54 billion? Why not pay for the entire health care reform bill through HI tax increases that also extend the solvency of the HI trust fund?

Astonishingly, this may not even be the most cynical element of this tax increase strategy. The proposed HI tax increase is not indexed for inflation. This means that as inflation pushes up household income, more and more families will be subjected to the tax even though their standard of living remains the same. If you don't think this is a problem, consider the lengths Congress must go each year to extend the so-called “patch” that ensures more households are not subjected to the Alternative Minimum Tax (AMT).

Originally designed for the same households now targeted by the Democrats' HI tax increase, the AMT was never indexed to inflation because the costs of doing so were too high given all of the revenue it was expected to generate from “bracket creep.” As a result, exemption levels that once seemed sufficiently high to exclude all but the richest households would now ensnare over 21 million middle class households absent the annual inflation patch. The same would be true of the new HI tax increase, as families living in high-cost states, struggling to pay their bills, suddenly find themselves subjected to another tax ostensibly designed for someone in a far different circumstance. And, once enacted, repealing the tax would be “too expensive” given that it would be expected to apply to most of the population over the long-run projection window.

Health care reform is a serious topic that deserves serious attention. Yet, when the time came to rise to this occasion, Senate Democrats respond with a bill that exploits a trust fund accounting loophole and creates a “new AMT” imbroglio that future Congresses will have to sort out. Needless to say, this is an inauspicious start to the formal consideration of such a monumental piece of legislation.