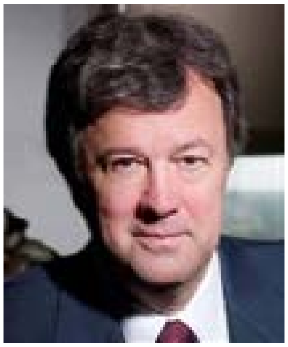
Goodman Institute

Turning Ideas Into Policy

Tax Reform for the Middle Class

Tax reform won't be complete until unfair, anti-work, anti-saving provisions of the tax code are removed - ones that burden the middle class.



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Tax reform championed by Donald Trump and passed by a Republican Congress was a boon for middle-income families. According to a study by the Atlanta Federal Reserve Bank, the average household in America can expect a lifetime gain of about $25,000.

And despite persistent claims that the measure was a giveaway to the rich, the percentage gain was roughly the same for every income class. If anything, the current tax code is more progressive than the one it replaced.

Yet more needs to be done. We need to remove the most unfair, most anti-work, most anti-saving provisions of the tax code – ones that burden the middle-class. What follows are some examples.

Liberate older workers.

Roughly 90 percent of seniors begin collecting Social Security benefits before they reach the full retirement age. Yet if these folks get a new job or a part-time job and earn one dollar more than $17,640, they will lose 50 cents of Social Security benefits because of the earnings penalty – a draconian tax enforced by the IRS. For a $20-an-hour employee, the tax kicks in if you work Monday, Tuesday and half of Wednesday.

Seniors can pay as much as 95 cents in taxes out of each dollar they earn.

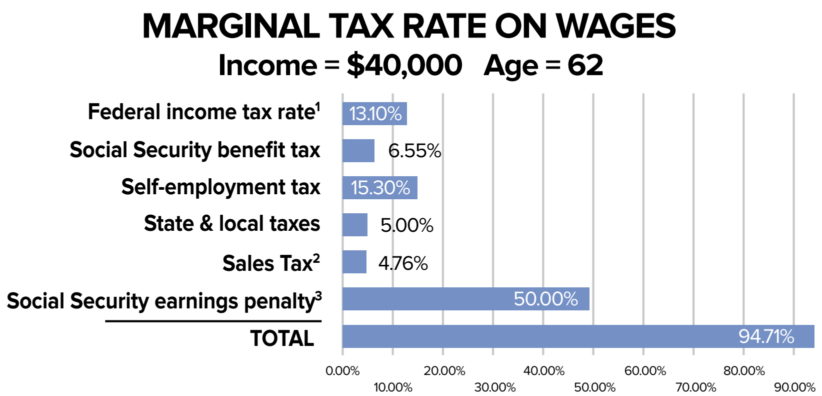
Note: this is a middle-income-earner tax. Low-income seniors who earn less than the earnings limit do not pay the tax because they earn too little. Seniors who earn, say, $50,000 or $60,000 will have completely exhausted their Social Security benefits and thus bear no penalty if they earn a dollar more.

When Social Security's earnings penalty is combined with the Social Security benefits tax and other taxes, middle-income, senior workers can lose as much as 95 cents of every dollar of wages – the highest tax rate in the nation. [See Figure I at the top of page 2.]

Widows with children, trying to get by on Social Security survivors' benefits, also face a 50 percent earnings penalty. Negotiating the tough tradeoff between the demands of parenthood and the demands of work is hard enough in its own right. The earnings penalty doesn't make these choices any easier.

These taxes are unfair. They also make no sense. When seniors reach the full retirement age, the benefits that they have lost are added back into their monthly benefit checks. So, the government takes money away from workers and then turns around and gives it back.

Figure I



1. Nominal bracket of 15% times (1-.0765 - .05) accounts for employer portion of FICA not being taxable and state and local taxes being deductible. 2. Effective rate for a nominal sales tax of 5%. 3. This assumes worker doesn't comprehend Adjustment of the Reduction Factor at Full Retirement Age.

Source: Laurence Kotlikoff, "Some Older Workers Face Astronomical Tax Rates," Goodman Institute Brief Analysis, October 5, 2016.

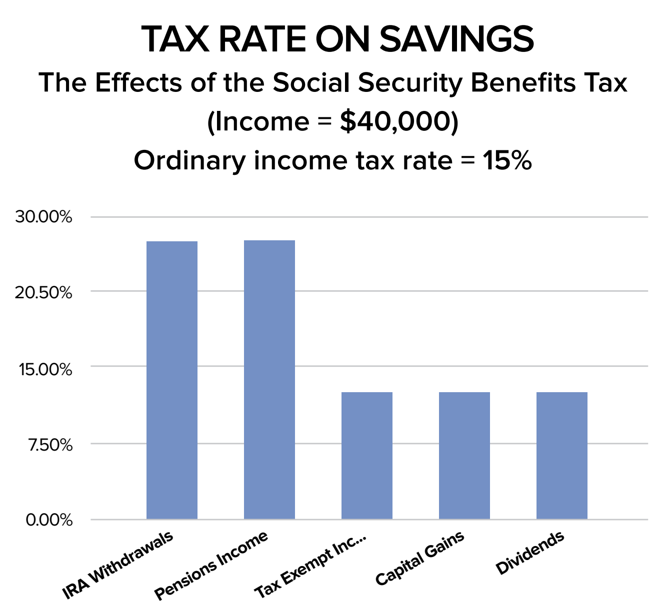
Unfortunately, many seniors do not understand that the loss of benefits is not permanent and economists believe this is why young seniors are not contributing as much as they otherwise would to national output.

A study produced by the Goodman Institute for Public Policy Research estimates we could abolish the earnings penalty tomorrow without any net loss of revenue for the government.

Liberate older savers.

The Social Security benefits tax is misnomer. If a senior has only Social Security income, no tax is owed. The tax kicks in only when there is other income. Because of this tax, seniors can pay almost double the tax everyone else pays on pension income and IRA withdrawals and significantly higher taxes on capital gains and dividend income. They also pay taxes on "tax exempt" securities – taxes that no one else has to pay. [See Figure II.]

Figure II



Source: Laurence Kotlikoff, "Some Older Workers Face Astronomical Tax Rates," Goodman Institute Brief Analysis, October 5, 2016.

Like the earnings penalty, a tax on non-Social Security income does not affect the marginal tax rate of the rich or the poor. It is a middle-income-earner tax.

Another provision that needs to go is the practice forcing seniors to withdraw funds from their savings accounts at age 70½. In future years, mandatory withdrawal will start at age 72. Forced withdrawals also apply to young people who inherit IRA funds; and for future bequests the withdrawal requirements will be even more onerous.

Funds in IRAs, 401(k)s and other tax-sheltered accounts are a source of capital that funds investment, creates jobs and produces higher wages for workers. Why are we forcing people to take this money out of the capital market, give part of it to the federal government, and probably consume whatever is left over?

Liberate the self-employed.

Independent contractors (e.g., Uber drivers) and owners of home-based businesses (most of whom are women) are discriminated against under current tax law. They do not get the same tax relief when they purchase health insurance, save for retirement, pay for day care or pursue other "employee benefits." The goal should be labor market neutrality. People should be treated the same under the tax law – whether they work for themselves or work for someone else.

Social Security beneficiaries are the only people who have to pay taxes on tax exempt income.

Liberate health care consumers.

In many ways, our health care system is shaped and molded by the tax law. Choices that would seem sensible to ordinary mortals often face tax penalties if exercised. For example:

- Prior to January 1, 2020, employers could face large penalties if they gave employees pre-tax dollars to purchase personal and portable health insurance – which is owned by the employees and travels with them from job to job and in and out of the labor market.
- Even after a welcome Trump administration change, the option will still not be open to the 25 million employees who have a Health Savings Account (HSA).
- Although employers can pay for concierge care (direct-pay medicine) with pre-tax dollars and this is a fast-growing employee benefit, they cannot put money into personal accounts and let employees have the doctor of their choice.
- Although the Trump administration has made some administrative improvements, Health Savings Accounts are largely incompatible with direct-pay care and with programs that allow the chronically ill to manage their own health care budgets.

We need to quit using tax law as a tool to micromanage the health care system. Aside from a simple tax credit, we should consider a complete separation of health care and taxes.

Bring Medicare into the 21st century.

Instead of trips to the doctor's office, why can't seniors talk to doctors by phone or email – the way many non-seniors do? Instead of trips to the emergency room at night and on weekends, why can't they have access to Uber-type house calls? Why can't they have a concierge doctor (a service that in some places costs only $100 a month) instead of trying to decipher the complexities of Medicare's complicated fee-for-service system?

One solution is to let Medicare make a deposit to a tax-free Health Savings Account provided the senior is willing to take responsibility, say, for all primary care. Beneficiaries could then take advantage of the best services the market has to offer. Right now, seniors are the only citizens who are not allowed to have an HSA.

Bring laws affecting working families into the 21st century.

If employees have health insurance through a spouse's employer, why can't they trade health insurance for higher pay? Believe it or not, this is another income tax problem. An employer who lets even one employee choose between taxable wages and a nontaxed benefit risks having the IRS declare all the employer's benefits taxable to all the employees. Does anyone think that makes sense?

Why does a housewife who takes a minimum wage job get immediately put into her husband's much higher tax bracket? Why can't husbands and wives get equal credit for their Social Security payroll taxes, the same way they share contributions to other savings plans?

These provisions of our tax system were created years ago when Congress thought husbands would go to work, wives would stay home, and they would never get divorced. It's time to bring the tax law into the modern age.

Another opportunity is to double the child care tax credit. Economist David Henderson has shown that this is a tax relief measure that pays for itself. If working mothers can afford more child care, they will work more hours, earn more money and pay more in taxes to the federal government.

These are just a few of the changes we need to make our tax system work better for seniors, for women and for working families.

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