Unhealthy Healthcare Taxes

Hitting the rich on Medicare blurs the case for a major tax reform

An aging population and the Medicare safety net make healthcare costs the biggest single threat to America's fiscal future. To help pay the bill, the Obama Administration is leaning on the rich: two new Medicare taxes, both targeting the well-off, take effect in 2013. Progressives who favor the levies might want to think again. Neither is a great idea, and one of them complicates a reform with far greater potential. Let's look at the new taxes, and see why the negatives could outweigh the revenue they generate.

The first is an extra Medicare payroll tax of 0.9%, on top of the standard 1.45%, on earned income above $200,000 for single filers or $250,000 for joint filers. The second is a Medicare surcharge of 3.8% on the net investment income of persons above the $200,000 and $250,000 thresholds. (Investment income here includes not only capital gains, dividends and interest, it also includes rental income and income from passive investments, i.e., enterprises in which persons invest but play no active role.)

Tapping the wealthy with these two taxes is fine with the economist Paul Krugman: "I'm not a fan of the Tax Foundation's work," Krugman blogged, "but their analysis of the distributional effects of Obamacare looks about right: significant benefits to the bottom half of the income distribution, paid for largely by taxes on the top few percent (the Medicare surcharge and the extra tax on investment income)." These laudable results, however, hold no answer to a larger tax policy question: since when did healthcare costs become the special responsibility of the rich? If the costs are a shared national responsibility, what's up with dedicated healthcare taxes on the affluent?

There's a better way to generate more federal revenue, and to sharply reduce income inequality as well: tax income from wealth and income from work at the same rates, as President Ronald Reagan did with his signature Tax Reform Act of 1986. Today, tax-advantaged income from capital gains and dividends is the biggest single driver of income inequality; analogously, taxing wages and investment income at the same rates is the surest way to shrink that inequality. (Some shrinking, of course, will occur in 2013. Taxes on stock market gains and dividends are rising to 20% from 15%, and will hit 23.8% with the Medicare surcharge included. Earners at the very top will also be hit with the increase in marginal rates.)

The rich couldn't claim they were being singled out if Obama seized the moment to press for the Reagan policy. The President's own Simpson-Bowles deficit commission came down in favor of the idea; so too did a second blue-ribbon deficit reduction blueprint, the Rivlin-Domenici plan issued by the Bipartisan Policy Center in Washington, D.C.

Besides its debatable focus on the rich, the Obama surcharge on investment income has two other disadvantages: 1) Any inflow to the Treasury is inherently subject to the ups and downs of the financial markets, hardly desirable for healthcare funding, 2) It complicates the otherwise clean case for equal taxes on all income. A simple way to overcome these disadvantages is to scrap the surcharge. The scrapping could become a bargaining chip: the surcharge ends when equal taxes begin.

The new Medicare taxes were no doubt well-intended. All the same, dedicated healthcare levies on the rich only muddle the issue of equal taxes on earned and unearned income. (They could set a troubling precedent as well. Should the rich pay a higher dedicated tax for national defense? For environmental protection?)

It’s time to restore Reagan’s equal taxes on wages, capital gains and dividends. If that reform were enacted, and a financial transactions tax along with it, America’s future budget deficits could magically disappear.

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