Mirage: Social Security Taxes

By ISIDORE PLATKIN

A recent decision of the Supreme Court raises some interesting speculations concerning the effects of "social security" or "payroll" taxes.

The Glenn L. Martin Company had entered into a contract with the War Department, during 1934. The contract provided that if Congress should impose any taxes applicable to the production, manufacture, or sale of supplies, the contractor could add the increased cost to the contract price.

In 1935, while the planes under contract were being manufactured, Congress passed the Social Security Act, which provided for the imposition of payroll taxes. The Martin Company sought to obtain from the government, as additional compensation under its contract, the added cost of manufacturing the airplanes.

The Supreme Court, in ruling against the airplane company, held as follows: "The contract was concerned with Federal taxes 'on' the goods to be provided under it, whatever the occasion for the taxes . . . Since a tax on payrolls, or on the relationship of employment, is not—but in fact is distinct from—the type of tax 'on' articles represented by sales taxes and processing taxes, respondent is not entitled to the additional compensation which it seeks."

Regardless of the legal merits of the Court's opinion, the economic significance of the decision is far-reaching. While the Court held that the increased cost resulting from the type of tax in question did not come under the terms of the contract, the increased cost nevertheless resulted. An employer-employee relationship is always entered into for a single purpose—to engage in production. Hence, any tax on an employer-employee relationship is a tax on production, an additional factor in the cost of production.

Every producer must obtain for his products at least the cost of production plus the prevailing rate of interest on his capital. If his returns fall below this minimum, his operations are not profitable, and he is eliminated from the ranks of the producers. If his costs go up, they must be passed along in the form of increased prices, if his minimum necessary return is to be maintained. And so, despite the legal verdict of the high court, the higher verdict of economic law must rule. The fact that the airplane company was not permitted to recover its additional costs in this case merely means that in its future contracts the payroll taxes will be included in costs, and therefore in price.

The increasing importance of social security taxes, which have become a major source of government revenue, makes necessary at this time a critical examination of their economic effect. In other words, how is industry as a whole affected by those circumstances described above with respect to a single company? Before the answer can be given, it will be desirable to see how these taxes are imposed.

The original Social Security Act became law on August 14, 1935. Since then a number of important changes have been made, most of them being embodied in the Social Security Act Amendments of 1939, which were approved August 10, 1939. The payroll taxes levied under the Social Security Act are of three kinds.

1. Old Age Benefits Tax on Employees. The law imposes a tax upon the income of every individual at the following percentages of their wages: 1 per cent from 1937 to 1942; 2 per cent from 1943 to 1945; 2½ per cent from 1946 to 1948; 3 per cent after 1948.

The law excludes the earnings of agricultural and domestic workers, state and federal employees, and several other minor groups. The law likewise exempts from taxation wages in excess of $3,000 per year.

A consideration of the social security tax on employees reveals several interesting points. The tax, as its wording implies, is simply an income tax; the law itself calls it a tax on "income." Viewed in its true light, that of an income tax, it is seen to violate all the principles upon which our income taxes are supposedly based. It offers no exemption, as does the income tax law, to the man or woman with a small income. It is not based on the principle of ability to pay. That principle, unsound as it is, is here replaced by what is in effect a tax on inability to pay. For if earnings in excess of $3,000 are not taxed, then the man with an income of $6,000 is only taxed on half his income, or, what is equivalent to the same thing, he pays a tax on his entire income at one-half the regular rate; the man with an income of $9,000 per year pays at an equivalent of one-third the regular rate, and so on. As annual income increases the proportion of tax decreases.

That a tax, which upon close examination is seen to be so objectionable, has not met greater opposition on the part of the taxpayer, may be explained by the following three considerations:

First, most of the taxpayers are not aware that they are paying an income tax, as the levy is not imposed by the income tax law, but by the attractively entitled Social Security Act.

Second, the tax extracted from the taxpayers is made less painful because it is deducted from his salary by his employer on pay-day, instead of being paid in a lump sum. The taxpayer does not realize the full extent of his tax and diminution in his purchasing power.

Third, the expectation of benefits which are promised by the Social Security Act, namely an old-age pension. But the proceeds of the tax are not set aside for payment of pensions when they fall due; they are invested in government obligations. This simply means that the tax proceeds are currently spent by the government, which substitutes

for them its "I. O. U's." With our federal deficit mounting, it is obvious that present taxation is not sufficient to meet current expenditures. All indications therefore point to increased taxes. In other words, the money collected today, for which the government promises future benefits, is spent at once, and the taxpayers can look forward to the prospect of additional taxes so that the government may then have funds with which to make good the promise it gives in return for present taxation.

2. Old-Age Benefits Tax on Employers. The tax imposed on employers is at the same rate as that on employees. In other words, the tax at present is one per cent of taxable payrolls (not in excess of $3,000 per employee per year), and will ultimately go up to three per cent. The law calls it an "excise" tax with respect to having individuals in one's employ.

3. Unemployment Insurance Tax on Employers. The federal law levies an "excise" tax on employers at the rate of three per cent of total wages paid. Taxable wages are substantially the same as those subject to the old age benefits tax, but the federal unemployment tax applies only to those employers having eight or more employees. The federal law allows as a credit against this tax the amount of unemployment insurance taxes paid to the various states, provided that this credit may not exceed 90 per cent of the federal tax. All of the states now have unemployment insurance taxes of their own, most of them at 2.7 per cent of the payroll, equivalent to 90 per cent of the federal tax. The effect of this rate is to permit credit against the federal tax for substantially the full amount allowable. The combined result of the state and federal unemployment taxes is for the states to receive 2.7 per cent of taxable payrolls, and the federal government three-tenths of one per cent, or a total of 3 per cent between both.

The federal government does not pay unemployment insurance benefits directly to persons out of work. Its contribution consists of grants to the states for the purpose of covering the cost of their administration expenses in connection with the operation of their unemployment funds.

With the operation of the payroll taxes understood, it becomes possible to consider their effect.

As far as the employee is concerned he pays a tax on the full amount of his wages, up to $3,000 per pear. The rate, now one per cent, will ultimately rise to three per cent. In those states where the employee likewise pays an unemployment insurance tax, his total tax is increased to that extent. The consequence of these taxes is to decrease the employee's net earnings and thus his purchasing power. The result is the same as that of a wage-cut.

The tax on the employer is one per cent for old age benefit purposes, and the rate will go up as high as three per cent. This, combined with the three per cent unemployment insurance tax means a present levy of 4 per cent and an ultimate tax of 6 per cent on his taxable payroll. To this must be added the cost of keeping detailed employment records and the filing of numerous tax returns. The increased costs must be passed along to the consumers in the form of increased prices.

In short, the employee, with a reduced purchasing power, must pay an increased price for the goods and services he buys. Since he no longer can buy as much, some of the workers who previously supplied his demands are thrown out of work. Thus a diminution of the income of some workers results in a diminution, if not an actual cessation, of the income of other producers.

The logic of these considerations is inescapable. And yet, unless the tendency of increased taxes to curtail production is fully understood it is sometimes overlooked because of various other counter-activity tendencies.

It is pointed out, for example, that the price of some products has not been increased since the Social Security Act went into effect. But since prices are closely affected by cost of production, it follows that in such cases prices would have gone down if not for the increased tax cost. Thus, while not as evident in such cases as where there is an absolute increase in price, the tendency to raise prices is just as real if it counteracts what would otherwise be a price reduction.

That the price of some goods has been decreased since the advent of these taxes is undeniable. This tendency may be accounted for by a variety of causes, such as improved methods, introduction of labor-saving devices, or economies resulting from increased production. And yet even in such cases the taxes we are considering exerted their effect by keeping prices at a higher level than that to which they otherwise would have fallen.

Again, the argument is sometimes presented that producers are reluctant to increase prices, as that will curtail their sales; they are content to pay the new taxes out of their profits. Now, producers may be divided into two groups, the few who enjoy special privileges or monopolies, and the vast majority who are subjected to competition. The argument above presented may apply, partly or entirely, to the first group. By virtue of their privileged position, they are already charging as much as the traffic can bear. If they feel that a price increase will be followed by a drastic reduction in sales, they may deem it preferable to absorb the additional cost themselves. While their own return will now be less than it was previously, it will still be greater than the average or normal return on capital.

But by far the greater number of producers are not so favorably situated. They do not enjoy special privileges, and hence competition keeps their profits down to that level below which they will not engage in production. Any added cost forces out the marginal producers, those who formerly were just barely able to keep going. The decrease in the number of producers then has the tendency to raise prices, regardless of any desire on the part of those producers to maintain the old price. That this result must obtain follows from the fact that frequently the payroll taxes are greater than the former profits of the producer.

One further argument must be considered—that which claims that

no purchasing power is destroyed by the taxes because the recipients of social security benefits now have purchasing power which otherwise would not have been available to them. Even a superficial examination of this argument reveals its fallaciousness. In the first place, the purchasing power of those who receive the various benefits is obtained at the expense of the producers. And the diminution in purchasing power of the latter is real. Secondly, even if there were a distribution to beneficiaries of the same amount as the taxes collected, the net purchasing power would still be reduced, because with the increased prices the same amount of money would now buy less than before. And lastly, because without the imposition of additional taxes the full amount collected in social security taxes cannot be distributed to beneficiaries, since a large portion must be deducted for administration expenses.

In the light of this analysis of the social security taxes it is indeed difficult to understand how they ever came to be enacted. No social security program can be successful unless it accomplishes these aims:

1. To increase the real income of all workers and producers, so that they may have the maximum opportunity to satisfy their present needs and desires and also provide for their old age.

2. To facilitate continuous employment.

3. To prevent the occurrence of factors which tend toward artificial price increases, since increased prices lower true income, and low prices increase true income.

The social security taxes fail to accomplish any of these aims. The taxes on employees lower their income. The taxing of employers tends to reduce employment, as does the decreased income of the employees. The tendency for the taxes to increase prices lowers the true income of the community as less goods and services can be obtained for a given equivalent.