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**TEACHING NOTE:**

**LET'S STOP PROFESSING THAT THE LEGAL INCIDENCE OF THE SOCIAL SECURITY TAX IS IRRELEVANT**

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The division [of the legal incidence of the Social Security tax] has a long history and is a consequence of our lawmakers’ feeling that the payroll tax should be shared equally by employers and employees. It is important to realize that the statutory distinction between workers and bosses is irrelevant. As suggested earlier, the incidence of this labor tax is determined only by the wedge the tax puts between what employers receive and employers pay.

Harvey Rosen (1995, 285; italics in the original)

Whenever Social Security taxes are raised, there is a furor in the legislature about how to divide the legal incidence... [Should the tax] be paid entirely by employees, entirely by firms, divided equally or divided in some other way?... The resolution ultimately makes not one bit of difference to anybody.

Steven E. Landsburg (1995, 26-27)

**INTRODUCTION**

Economists have long argued that a tax’s legal incidence is irrelevant for its economic incidence. Textbook authors frequently use the U.S. Social Security levy to explain this proposition. The frequency probably traces to the “fairness” contested by the levy’s 50/50 split in legal incidence between employers and employees. We economists delight in popping “fairness” balloons!

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The Social Security levy is currently 12.4 percent on a worker's first $72,600 annual income. Suppose Mr. Smith's income exceeds the $72,600 maximum and that he faces the maximum marginal income tax rate (39.6 percent). A move along the legal incidence spectrum from all-employee to all-employer decreases Smith's taxable income by $9,002 (i.e., $72,600 times the 12.4 percent social security tax rate). With Smith's marginal personal income tax rate at 39.6 percent, the shift of legal incidence raises his take-home pay by $3,565.

Dismissing legislative "furor" over the legal incidence of this levy is tantamount to claiming that workers have a "take it or leave it" attitude towards additional annual take-home pay of up to $3,565. At a 4 percent interest rate, this amount when capitalized over fifteen years has a present value of $39,637. Lower marginal income tax rates reduce the potential increases in take-home pay. Nevertheless, employees in all brackets would benefit by shifting legal incidence to their employers.

**FINAL COMMENT**

We see two ways for professors to avoid this difficulty. First, use a tax where the asymmetry is absent. Statelocal income taxes are such a tax because workers can deduct them on their federal returns. Alternatively use a tax where the asymmetry is of little consequence. A federal tax on, say, pension would work because its legal incidence would have inconsequential effects on taxable personal income.

**NOTES**


2. In each of the following assumptions underlying economics' disagnosis: 1) although the social security tax is an ad valorem tax, they treat it as a per unit tax; 2) workers report social security taxes and benefits as independent; 3) the earnings limitation of the social security tax (currently $72,000) is ignored. Our discussion adopts these assumptions. For an analysis that assumes that benefits and tax payments are not independent, see Lee (1998). For an analysis of the earnings limitation, see Maacha and Muflih (1976).

3. To our knowledge, Holmlund (1964) first investigated this asymmetry. However, his technical note fails to make obvious the empirical importance of this asymmetry. Perhaps this explains why, with the exception of a footnote in Stiglitz's (1988) public finance textbook, textbook authors evidence no awareness that the asymmetry undermines their almost rule use of the Social Security levy to illustrate the irrelevance proposition.

4. Including state/local income taxes in the calculations increases the potential variation in take-home pay.

5. The $3,565 figure corresponds to S in Figure 1.
How To Be a Good Graduate Student

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What makes education tricky is that the techniques at each stage change. Woody Allen remarked once that 80 percent of success is showing up on time. I'd say he was right about grade school especially. Such a discipline was perhaps the latest function, as the sociologists put it, of grade schools in the 19th century: get the industrial workers accustomed to showing up on time. In high school you have to move to the next stage, memorization. (Allen would say know your lines.) Then you learn in college to understand, and in graduate school to overstand—at age 20 grasping what it means to say that supply equals demand, then at age 34 grasping why such an equilibrium might or might not describe the world. As a young professional 30-something, you have to learn creativity. As an elder professional 40-something, you have to learn synthesis. As a quito old professional (witness: me) you have to learn judgment. I don't yet know what all the 60-somethings have to learn to do but I bet it's not a technique I learned at an earlier stage. Scary.

Your job in graduate school, anyway, is to overstand; that is, to learn to think critically about pieces of economics. Of course you still have to understand, to memorize, and to show up on time. But the biggest source of failure in graduate school is trying to apply the earlier techniques without the new element of criticism.

Fortunately I'm here to help you. I'm an expert, I assure you. Besides my intrinsic brilliance and perceptiveness, I've been around economics a lot. I've been a student at Harvard (all right, just after the last Ice Age), an academic visitor at London, Australian National, Stanford, Manchester, York, and Erasmus, a tenured faculty member at UIC, Iowa, and Chicago (where I was Director of Graduate Studies for six years during Chicago's most creative decade: Jim Heckman, mark my words, will be the last of the Nobels from Chicago because he's the last of the generation active there in the 1970s, before Chicago became just another math mill). So for God's sake, and your own, believe me.

Other Things Equal, a column by Deirdre N. McCloskey, appears regularly in this Journal.

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