American Enterprise Institute for Public Policy Research

On the Issues

November 2008

Obama and the Tax Tipping Point

By Adam Lerrick

Today, about 40 percent of Americans pay no federal income taxes. Barack Obama's proposed refundable credit will shift the tax demographics even further, so that half of all voters will receive a cash windfall from Washington and an overwhelming majority will benefit from tax increases and more government programs. This will have profound consequences for those who pay the taxes and for economic growth.

What happens when the voter in the exact middle of the earnings spectrum receives more in benefits from Washington than he pays in taxes? My AEI colleague Allan H. Meltzer and Scott Richard posed this question twenty-seven years ago. We soon enough will know the answer.

Obama is offering voters strong incentives to support higher taxes and bigger government. This could be the magic income redistribution formula Democrats have long sought.

Obama is promising $500 and $1,000 gift-wrapped packets of money in the form of refundable tax credits. These will shift the tax demographics to the tipping point, where half of all voters will receive a cash windfall from Washington and an overwhelming majority will gain from tax hikes and more government spending.

In 2006, the latest year for which we have census data, 220 million Americans were eligible to vote and 89 million—40 percent—paid no income taxes. According to the Tax Policy Center, this will jump to 49 percent when Obama's cash credits remove 18 million more voters from the tax rolls. On top of that, there are an additional 24 million taxpayers (11 percent of the electorate) who will pay a minimal amount of income taxes—less than 5 percent of their income and less than $1,000 annually.

Adam Lerrick is a visiting scholar at AEI. A version of this article appeared in the *Wall Street Journal* on October 22, 2008.

In all, three in five voters will pay little or nothing in income taxes under Obama's plan and will gain when taxes rise on the 40 percent who already pay 95 percent of income tax revenues. The plunder that the Democrats plan to extract from the "very rich"—the 5 percent that earn more than $250,000 and who already pay 60 percent of the federal income tax bill—will never stretch to cover the expansive programs Obama is promising.

What next? A core group of Obama enthusiasts—those educated professionals who applaud the "fairness" of his tax plans—will soon see their $100,000–$150,000 incomes targeted. As entitlements expand and a self-interested majority votes, the higher tax brackets will kick in at lower levels down the ladder, all the way to households with a $75,000 income.

Calculating how far top earners can be pushed before they stop—or cut back on—producing is difficult. But the incentives are easy to see. Voters who benefit from government programs will push for higher tax rates on higher earners—at least until those who power the economy and create jobs and wealth stop working, stop investing, or move out of the country.

Other nations have tried the ideology of fairness in the place of incentives and found that reward without work is a recipe for decline. In the late 1970s and throughout the 1980s, Margaret Thatcher took on the unions and slashed taxes to restore growth and jobs in the United Kingdom. A few years ago, in Germany, Gerhard Schröder defied his party's dogma and loosened labor's grip on the economy to end stagnation. More recently, in France, Nicolas Sarkozy was swept to power on a platform of restoring flexibility to the economy.

> The economic tides will not stand still while Washington experiments with European-type social democracy.

The sequence is always the same: high-tax, big-spending policies force the economy to lose momentum. Then growth in government spending outstrips revenues, causing fiscal and trade deficits to soar. Public debt, excessive taxation, and unemployment follow. The central bank tries to solve the problem by printing money. International competitiveness is lost, the currency depreciates, and the system stagnates. And then a frightened electorate returns conservatives to power.

The economic tides will not stand still while Washington experiments with European-type social democracy, even though the dollar's role as the global reserve currency will buy some time. Our trademark competitive advantage will be lost, and once lost, it will be hard to regain. There are too many emerging economies focused on prosperity and not redistribution of wealth for the United States to easily recapture its role of global economic leader. Tomorrow's children may come to question why their parents sold their birthright for a mess of "fairness"—whatever that will signify when jobs are scarce and American opportunity is no longer the envy of the world.

Related article by Allan D. Viard, Alex Brill, and Arthur C. Brooks:

Article in the *Washington Post*

The Real Problem with Obama's Tax Plan
October 29, 2008

We have heard a lot this month about how Senator Barack Obama's tax plans would affect Joe the Plumber—the Ohio man who recently asked the Democratic nominee whether Obama planned to raise his taxes. Opponents of Obama seized on the incident to argue that his middle-class tax cuts are a scam. Some have even claimed that he has proposed tax increases for people with incomes as low as $32,000. Obama's supporters responded that the tax cuts are real (and noted that Joe is not a licensed plumber). The entire episode has only added to the confusion over what Obama is proposing for middle-class taxes.

How should an honest fiscal conservative see the situation? For those making less than roughly $200,000 ($250,000 for couples), Obama would not only make President Bush's tax cuts permanent but would also offer an array of new tax credits. Nobody should deny this.

To be sure, these "tax cuts" contain some sleight of hand. More than $400 billion of the money over the next ten years would take the form of refundable tax credits paid in cash to people who already pay no federal income tax. It would be more accurate to refer to these cash outlays as cuts in payroll tax or—even more accurately—as transfer payments. Regardless of what the credits are called, though, they would put more money in the pockets of some American families. That sounds great in these tough economic times. Who can be against a boost to spending power and consumption? . . .

Read more at www.aei.org/publication28850/.