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On the Issues

Obama Turns FDR Upside Down

By Lawrence B. Lindsey

Two AEI scholars have recently assessed the merits of Senator Barack Obama's approach to fixing the Social Security system's problems. In a March On the Issues*, Andrew G. Biggs argued that the senator's plan would not fix the system's long-term problems and would impose significant costs on the economy as a whole. To read Biggs's article, visit www.aei.org/publication27704/. In June, Lawrence B. Lindsey wrote that requiring higher-end workers to pay additional taxes without getting additional benefits linked to their extra contributions would be "a big step toward turning Social Security from a contributory pension scheme into just another welfare program." Below, Lindsey spells out the details.*

Senator Barack Obama has a bad idea for "extending the life of Social Security." He has proposed applying the Social Security tax to incomes above $250,000 in addition to the current tax on incomes up to $102,000. It is unfair, he explained, for middle-class earners to pay Social Security tax on "every dime they make" while the very rich pay on "only a very small percentage of their income."

Reporters cited the Obama statement without asking for the logic behind having someone making $100,000 pay on every dime and someone making $250,000 pay on just 41 percent of income, while someone making $10 million would pay on 98.5 percent of income. There is no economic principle or theory of tax law that would endorse such a result.

Senator Obama's logic is fairly obvious, although it hardly makes him an exemplar of the "new politics." The $100,000–$250,000 group is a targeted voter demographic, and he really did not want to sock them with a 12.4 percentage point hike in their tax rate. But, as Obama himself noted in his June 13 announcement, just 3 percent of workers make more than a quarter-million.

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Neither Franklin Roosevelt, who started Social Security, nor the intervening three dozen Congresses thought they were imposing an "unfair" system on the middle class. There is a very good and principled reason why Social Security taxes are paid on just $102,000 of income: benefits are calculated based on that same $102,000 of income.

The fundamental principle of linking taxes and benefits was established when Roosevelt designed Social Security. He wanted to make sure that it was not a welfare system, calling Social Security "a base upon which each one of our citizens may build his individual security through his own individual efforts." His instincts have generally proved sound. Had Social Security been considered "welfare" rather than a return on taxes earned, it probably would never have had the popularity or the staying power that it has enjoyed for the last seven decades.

Although the formula connecting benefits to tax payments or "contributions" has evolved slightly over time, it still adheres to this basic message. Today, what Social Security terms a "low-wage" worker will pay (in present value terms) $77,197 over his or her lifetime and get $112,261 in benefits. A median-wage worker earning $42,000 will pay $171,550 and get back

$187,085. A "high-wage" worker making $67,000 will pay $274,480 and get back $245,085.

Under the current formula, lower-wage workers get a slightly better deal than do higher-wage workers, assuming the same life expectancy. But the principle remains that as workers' wages rise, so do the taxes they pay and so do the benefits they will get from the system.

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Senator Obama would do away with this principle by requiring higher-end workers to pay taxes without getting any extra benefits linked to their higher contributions. This would be a big step toward turning Social Security from a contributory pension scheme into just another welfare program.

The economics of what Obama is proposing should be at least as troubling. A high-income entrepreneur would see his or her federal marginal tax rate rise to 53 percent from 37.7 percent under Obama's tax plan. He proposes a 4.6 percentage point hike in the personal income tax rate, a loss of some itemized deductions, and a 12.4 percentage point hike in the Social Security payroll tax. This would take a successful entrepreneur's effective marginal tax rate higher than what it was under Jimmy Carter or Richard Nixon, when the maximum tax on an entrepreneur was 50 percent.

One of the lessons from the disastrous economics of the 1970s and the subsequent Reagan tax cuts is that everyone—particularly entrepreneurs—responds to incentives. If you take away 10 percent of a high earner's after-tax income at the margin, he will cut his taxable income by at least 4 percent. At the margin, this taxpayer now takes home 62.3 percent of his earnings, a figure that will drop to 47 percent under the Obama plan. According to a widely accepted economics rule of thumb, the entrepreneur's taxable profit would drop by 11.2 percent.

Now consider how the Obama plan would affect the taxes paid by such an entrepreneur with a taxable profit from his business of $500,000. Under current law, he would pay $27,148 in Social Security and Medicare taxes, plus $142,969 in personal income taxes, for a total of $170,117. If the taxpayer did not change his behavior at all, under the Obama plan, he would face a $31,000 Social Security tax hike and an $11,494 hike in his personal taxes—or a 25 percent tax hike. But if the taxpayer responds as the economic models predict, his taxable profit would drop to $444,000. His Social Security and Medicare tax bill would still soar to $51,580. But his income taxes, even with a higher tax rate, would drop to $132,882 for a total of $184,462. In other words, Senator Obama is planning on a combined series of tax hikes to produce $42,000 in tax revenue, but consensus economic modeling suggests the government's net take would rise only $14,000.

We should also keep in mind that the economic well-being of the country is not measured by how much taxes the government can collect, or even the size of the deficit. Rather, it is measured by the country's productive capacity. Our theoretical entrepreneur's 11.2 percent decline in taxable income reflects both less effort on his part and a less efficient use of his income in order to avoid confiscatory tax rates. Or, to put it directly, Obama's plan would reduce an entrepreneur's after-tax profits by $70,000—$56,000 in lost profits and $14,000 more in taxes—just to produce a net revenue gain to the government of $14,000.

It is shocking to think that we have a presidential candidate who would make the private sector $5 poorer in order to make the government $1 richer. More likely, given the calculated political design of the proposal, no one in the Obama campaign told the candidate about the economic, ethical, or historical consequences of his suggestion.

This indicates that what is really on offer is not some postpartisan approach to politics, but a Democratic candidate far to the left of Bill Clinton.