FISCAL FACT

August 2008
No. 140

Obama’s Income Tax Cliff for Senior Citizens

By Mark Robyn

In recent months the Presidential candidates have been busy crafting and promoting their tax plans. In an effort to reduce the tax burden on America's seniors, Barack Obama has said that he will eliminate all income taxation for senior citizens making less than $50,000 per year. Putting aside the debate on whether this is a good policy, it might be worth exploring how such a policy would be implemented. It sounds simple enough: if you're a senior and your income is less than $50,000, then you don't pay income taxes (note that the threshold is for total income, which is greater than taxable income). But what happens when your income crosses that threshold? Obama's plan does not address this question, and it turns out to be an important question.

Consider an example. A husband and wife are both seniors with a combined income of $49,500. Under Obama's plan they would pay no income taxes. But then they decide to sell their coin collection. They sell the coins for $500 and report the capital gain to the IRS. Since only those making *less than* $50,000 are exempt, they expect they might owe a few cents on the excess $1 of income over $49,999. But when Tax Day rolls around they are hit with a tax liability totaling a whopping $3,585. Now instead of having an income of $49,500 and owing no tax, their income is $50,000 and they owe $3,585, putting their after-tax income at $46,415. They would have been better off not earning the extra money at all.

The reason this happens is that Obama's plan, as stated in his official campaign publications, throws taxpayers directly into the 15% bracket as soon as they cross the $50,000 threshold, making them fully liable for income tax on all of their taxable income (around $29,000 for seniors after the standard deduction and personal exemptions). As seen in the above example, the extra income actually has a negative net effect; the modest $500 gain turns into a net loss of over $3,000. In this way, the policy acts as a "cliff," suddenly slamming the taxpayer with a

substantial tax bill and reducing his after-tax income well below what it would have been if his income had never increased (see Figures 1 and 2).

To better understand the cliff problem it is necessary to clarify two different ways of defining tax rates. A marginal tax rate is the tax rate on the next dollar of income earned. The rates associated with the federal income tax system are marginal tax rates. Only the income that exceeds the bottom of a given tax bracket is taxed at that bracket's marginal rate. The rest is taxed at lower marginal rates.

To gauge the cliff effect, economists use a measure called the effective marginal tax rate (EMTR). The EMTR equals the change in taxes divided by the change in income between any two income levels. The EMTR only becomes distinct from the marginal tax rate when there are abrupt changes in tax liability, as in the case of the elderly couple discussed above. In that case, when their income is $49,999 their taxes equal zero, but when their income is $50,000, their taxes equal $3,585. At $49,999 the marginal tax rate is 0% because the last dollar is not being taxed, and the EMTR is 0% because there is no change in taxes up to that point. The marginal tax rate once they cross the $50,000 threshold is 15%, because the fifty-thousandth dollar by itself is taxed at 15%. However at that same point all the previous dollars become taxable at their respective marginal rates, which results in an immediate and drastic jump in taxes from zero to $3,585. The EMTR at $50,000 is then 358,500% (change in taxes / change in income: [$3,585 - $0] / [$50,000 - $49,999] = $3,585 / $1 = 358,500%). The fifty-thousandth dollar has an effective marginal tax rate of 358,500%, or $3,585. The EMTR quantifies what is intuitively obvious: that a $3,585 increase in taxes associated with a $1 increase in income is excessive and unfair.

But there are ways to avoid the problem of extremely high effective marginal tax rates. Usually any new tax benefit like the one Obama is proposing includes a phase-in. A phase-in would smooth out any jumps in tax liability, and consequently EMTR, by gradually increasing the amount that the taxpayer owes once he crosses the threshold, instead of immediately increasing his liability from zero to $3,585 as in the example above.

There are many ways to structure a phase-in to avoid the cliff effect. One way would be to set the tax owed under the phase-in equal to a percentage of the tax that would be owed without the phase-in, increasing the percentage as income increases. Thus for every $100 that total income exceeds the $50,000 threshold, the applicable percentage could be increased by, say, 1% (so the tax owed would be 1% of the regular tax at $50,100, 2% at $50,200, and so on until the percentage reaches 100%). In a case where total income is $100 over the threshold, the phase-in rate would be 1%. So the taxpayer would owe 1% of $3,600 (the tax that would be owed without a phase-in) for a total of just $36, a much more reasonable increase (see Figures 1 and 2). The EMTR under the phase-in would be just 36% ([$36 - $0] / [$50,100 - $50,000] = $36 / $100 = 36%) rather than the 3,600% that it would be without a phase-in ([$3,600 - $0] / [$50,100 - $50,000] = $3,600 / $100 = 3,600%). Using the 1% per $100 method outlined above, the regular tax would be fully phased in when total income reaches $60,000.

It should be noted that even with the above phase-in structure the EMTR will increase to about 66% before the regular tax is fully phased in. This is because as the phase-in percentage

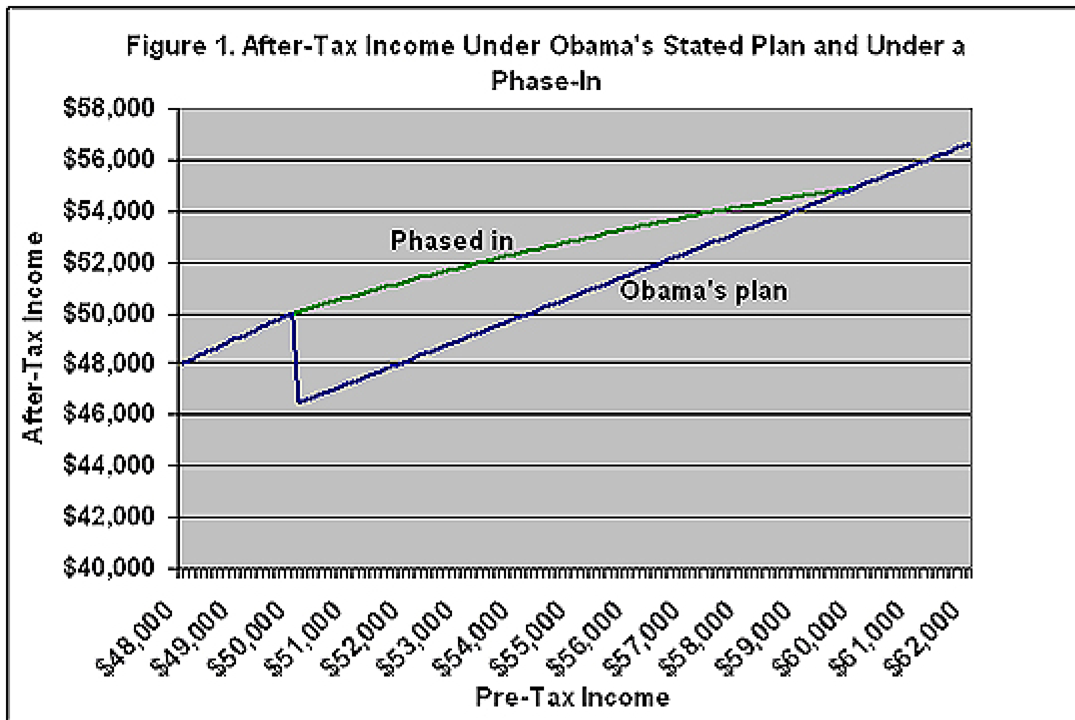
increases, the corresponding regular tax that the phase-in is multiplied with increases as well, accelerating the phase-in until it reaches 100%. This acceleration effect is visible in Figure 2: the phase-in line is not actually a straight line, but in fact curves slightly upward as it increases toward the fully phased-in amount. This effect could be minimized by increasing the income range over which the regular tax is phased in.

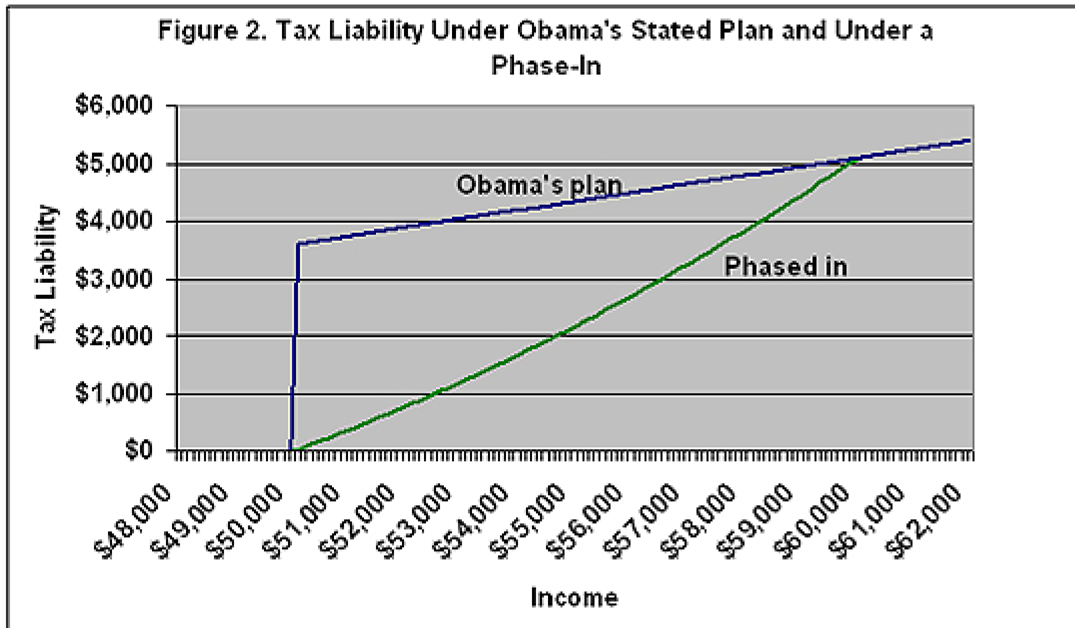
Why Obama does not include a phase-in is not clear. It seems that the Obama campaign has not really thought through this issue since it is almost impossible that a plan like this would ever be implemented in its current form. Of course, a phase-in would increase the cost, since the IRS would be collecting less revenue from taxpayers within the phase-in range, which raises the possibility that the phase-in could have been purposely left out of the plan in order to hide the real cost of the provision.

There are other problems with Obama's senior exemption plan. First, there is no distinction between married and single filers. This means that married filers, who are likely to claim more income on their return than single filers, are more prone to be hit with a sudden tax increase. In addition, the $50,000 threshold is not indexed for inflation, so the value of the exemption will erode over time. These problems, combined with the absence of a phase-in, make the implementation of this provision as it is stated a complete impossibility.

There are other, simpler ways Obama could accomplish his goal of reducing the tax burden of low-income seniors. For example, instead of exempting them from income tax, he could increase the standard deduction for seniors to around $43,000 for couples and $46,500 for singles, which, combined with the $3,500 personal exemption, would keep seniors from being taxed on the first $50,000 of their income. The increased standard deduction would work just like the regular standard deduction, essentially ignoring the first $50,000 of income and only taxing income over that amount. This would be easy to implement because all that would change would be the one line on the 1040 that handles the standard deduction. Also, there would be no need for a complicated phase-in that would probably require a separate calculation and form.

However his goal would be accomplished, it would not be implemented as described by his campaign. The plan he has outlined sounds good politically but is ultimately imprecise and illogical.





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