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How the $400K Tax Pledge Undermines Policymaking

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INTRODUCTION

Americans have always understood that our nation's prosperity rests on two pillars: A vibrant free-enterprise system that rewards innovation and risk-taking, and a fiscally responsible government that invests in basic public goods and services that cannot be provided by the private sector. But to benefit from these investments, citizens must pay sufficient taxes to finance them — and for more than two decades now, U.S. political leaders have not asked them to do so.

Last year alone, the federal government spent $2 trillion more than it raised in tax revenue.[1] Our country can afford to borrow when addressing temporary emergencies, but it cannot sustain debts growing faster than our economy in perpetuity. Unfortunately, that's the path we're on today, as the costs of health-care and retirement programs such as Medicare and Social Security continue growing faster than the revenues needed to finance them. If this structural mismatch between taxes and spending continues unabated, rapidly rising interest costs will further crowd out critical public investments and smother our economy.

Anti-tax zealots on the right have argued the imbalance can be solved entirely through spending cuts. Yet they have been unable to produce a plausible plan to do so without eviscerating core functions of government, such as food safety and basic scientific research that plants the seeds for innovation. The reality is some higher tax revenue is necessary to finance the needs of our aging population.

President Joe Biden at least partially grasps this reality and has called for raising taxes by almost $5 trillion over the next decade. However, his approach also is marred by political expediency. In Biden's telling, our current spending trajectory can largely be sustained — and even raised — simply by raising taxes on the top 2% of income-earners, without any contribution from the vast majority of Americans. During his 2020 presidential campaign, Biden famously pledged not to raise taxes on households making under $400,000 (hereafter referred to as "the $400K pledge").[2] Since taking office, his administration has reinforced this pledge by saying no household earning under $400,000 will pay a penny more in taxes from his policies *and* proposing to prevent $1.7 trillion of temporary tax cuts that benefit these households from expiring.[3]

Biden is right that the rich need to pay more in taxes but that simply isn't enough. As this report demonstrates, raising taxes only on households with incomes over $400,000 is insufficient to fund current promises, let alone the new initiatives Biden has proposed during his presidency or the wish list of expanded programs sought by progressives. In addition to starving the government of needed revenue, the $400K pledge prevents the adoption of common-sense tax simplification measures and efficient revenue-raisers that most other advanced economies use to fund their welfare states.

But the final problem with the $400K pledge is perhaps the most serious: it destabilizes our democracy. Asking fewer than 3 million households to bear the burden of financing a government meant to serve 330 million people is neither fair nor practical. It removes the incentive for prudent fiscal policy by severing the crucial link between citizens' demands for more government spending and their willingness to pay for it. After all, why should voters care about wasteful or corrupt government spending if "somebody else" is paying for it? Meanwhile, the few households that are footing the bill will likely reduce their output in response to confiscatory levels of taxation. Government programs in a democratic society can only be sustained if most of the citizens who can contribute are willing to do so.

Pragmatic progressives must pressure the Biden administration to soften the president's misguided tax pledge heading into a potential second term. They must start making the case to voters why progressive programs are worth paying for. That means advocating for not only progressive tax increases, but also for broadening the tax base to close inefficient loopholes — even those that benefit the middle class — and adopting new taxes, such as the consumption taxes that fund European welfare states. Beyond that, progressives must propose to modernize rather than expand existing spending programs, because the public's tolerance for taxation only goes so high. Bringing spending into alignment with revenues at a sustainable level voters truly support is essential for Biden to establish a durable legacy.

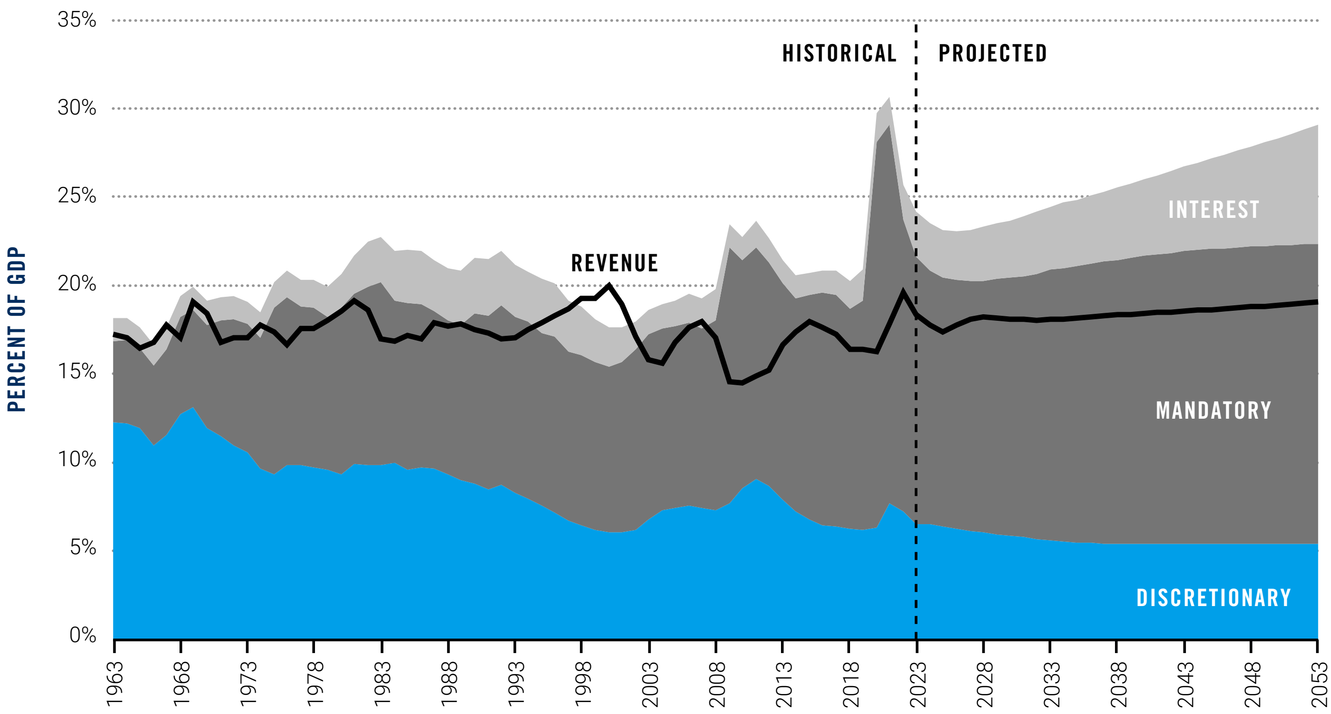
WE DON'T HAVE ENOUGH REVENUE TO FUND EVEN CURRENT PROMISES, LET ALONE THE PROGRESSIVE WISHLIST

The federal government is on an unsustainable fiscal trajectory. Today, the annual federal budget deficit is equal to about 7.5% of gross domestic product.[4] That figure is already more than double the historical average since the end of World War II. Although temporarily elevated deficits can be justified during emergencies or times of economic weakness, today's deficit comes during the longest sustained stretch of low unemployment since the 1960s. Today's deficit is emblematic of a worsening structural mismatch between the taxes our government collects from its citizens and the benefits it promises them.

Spending on health-care and retirement programs is projected to grow from 8.7% of GDP in 2010 to 14.6% of GDP in 2050 thanks to the aging of our population.[5] Whereas there were three workers paying for the benefits of each retiree in 2010, there will be only two in 2050.[6] Lawmakers in both parties have largely opposed taking any action to rein in the growth of these costs, and if they maintain that position, the only option is to finance them with higher revenue.

If we don't pay for these programs, the cost will be enormous. Every dollar the federal government runs in annual deficits is added to the national debt, and our government has to pay interest each year to service that debt. Annual interest costs are already approaching $1 trillion – that's more than the federal government spends on either Medicaid or defense.[7] Under current projections, they will surpass Social Security as the single largest item in the federal budget before 2050.[8] These unsustainable debt-service costs threaten to crowd out other critical public investments as they compete for limited resources.

FIGURE 1: CURRENT REVENUES ARE INSUFFICIENT TO PAY FOR GROWING MANDATORY SPENDING



Note: Projections based on current law, which includes allowing many of the Trump Tax Cuts to expire as scheduled in 2025.

Source: Congressional Budget Office.[9]

Using data from the Congressional Budget Office, PPI estimates that it would take at least $7 trillion of deficit reduction relative to current law over the next decade just to stabilize the national debt as a percentage of GDP. But that figure doesn't include the cost of other policies the Biden administration has pursued. The Build Back Better agenda that collapsed in 2021 amid concerns over its price tag would have cost $4.8 trillion more over 10 years if the policies contained within it were enacted on a permanent basis.[10] Biden has also said he wants to make the Trump tax cuts for households making under $400,000 a year permanent. These budget-busting tax cuts were unaffordable when they were passed and making them permanent as Biden has proposed would add another $1.7 trillion to deficits over a decade, not including interest costs.[11]

Thus, to sustainably finance Biden's proposed policies without enacting any spending cuts, taxes would have to be increased by more than $13 trillion over the next 10 years. And that pales in comparison to the wish list of policies pushed by the far left. In her 2020 presidential campaign, Senator Elizabeth Warren (D-Mass.) proposed $34 trillion of new spending on everything from free college to Medicare for All.[12] Senator Bernie Sanders (I-Vt.) went even further and proposed a whopping $53 trillion of new spending.[13] If this spending were adjusted to account for inflation and real economic growth since 2020, the Warren and Sanders agendas would require $48 trillion and $72 trillion, respectively, to be fiscally sustainable. It is impossible to finance even a fraction of these agendas while maintaining the misguided $400K pledge (though it is worth noting neither Warren nor Sanders could come up with enough tax revenue to fully fund their spending agendas even when unconstrained by Biden's pledge).

PRESIDENT BIDEN'S $400,000 PLEDGE TAKES MOST INCOME OFF THE TABLE

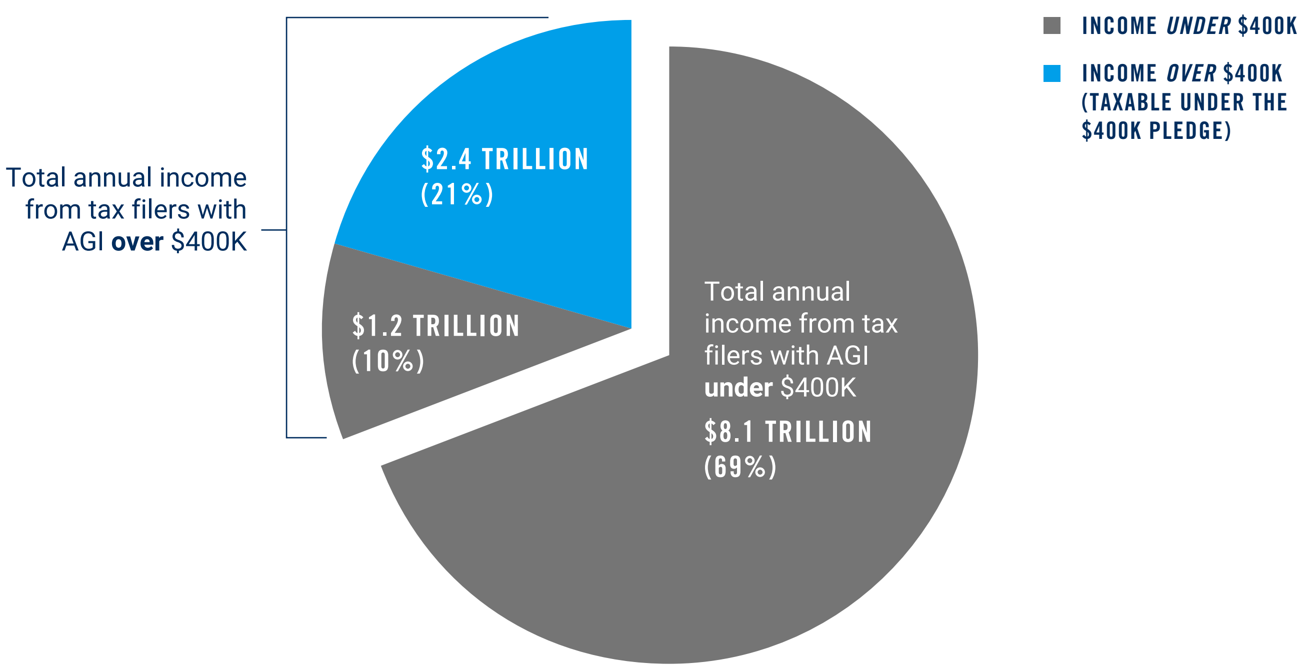
In 2020, households with incomes above $400,000 paid roughly $875 billion in federal income tax and had an average effective federal income tax rate of 24%.[14] Over the next 10 years, PPI estimates they will pay slightly less than $14 trillion in income taxes based on this data. That means just to fund current promises, lawmakers would need to increase the federal income tax burden on households earning more than $400,000 by at least half. And to pay for the Biden agenda, they would have to nearly *double* it. Notably, this would leave households earning over $400,000 paying more than half their total income in federal income taxes even before taking into account other taxes that they pay, such as state income and property taxes. There is no peacetime precedent for such confiscatory taxation aimed at a narrow slice of Americans.

Thus, raising enough revenue to sustainably finance Biden's agenda would be virtually impossible without violating his pledge. Fewer than three million households, or about 2% of taxpayers, reported adjusted gross incomes above $400,000 in 2020 (the most recent year for which we have enough data to construct an estimate).[15] Biden seriously constrains himself by ruling out any tax change that raises a penny of revenue from 98% of the population.

One might reasonably counter that although this group is small, they earn a disproportionate share of national income. That's certainly true, and it absolutely makes sense to ask more from those who are the most well-off in society. But the $400K pledge still insulates the vast majority of national income from tax hikes — including almost one-third of income earned by households earning over $400,000.

Income is taxed via a marginal rate structure, meaning the tax rate is determined by each additional dollar over a certain threshold rather than a percentage of the total. This system makes sense because it ensures nobody owes more in taxes than they earn in additional income as their total income rises. But it also means that much of the income earned by people who are eligible for higher taxation under the $400K pledge can't actually be taxed. If Biden doesn't want to raise marginal rates below $400,000, he can't raise taxes on 80% of the income earned by a household that earns $500,000.

FIGURE 2: THE $400K PLEDGE PREVENTS TAX HIKES ON NEARLY 80% OF INCOME



Note: Figures show total adjusted gross income for 2020, the most-recent year available, and do not reflect revenue already currently claimed through tax collections.

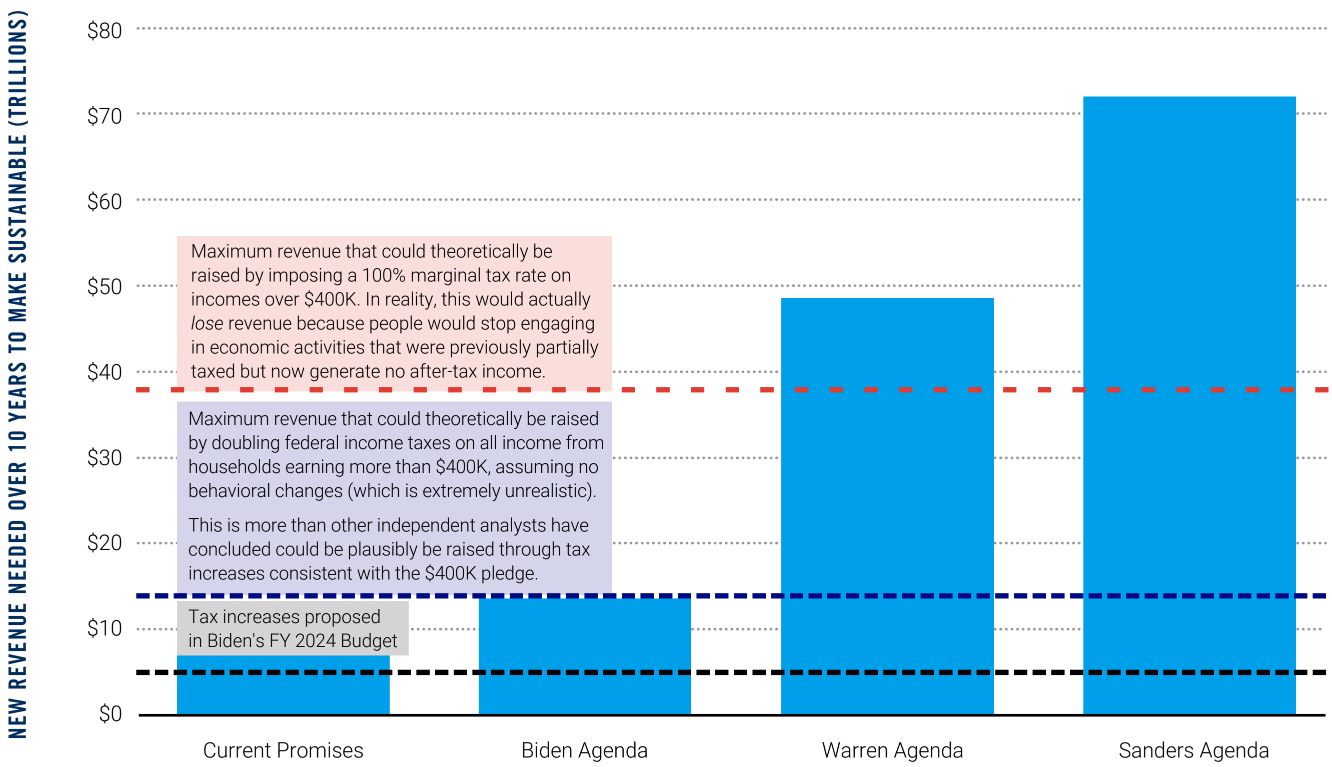
Source: PPI calculations based on IRS data.[16]

Funding the progressive wish list would be mathematically impossible under any tax regime consistent with the $400K pledge. Households with AGI over $400,000 earned $3.6 trillion in 2020 and about one third of that income was part of their first $400,000.[17] In practice, this means roughly $3 trillion of annual income is taxable under the $400K pledge in 2023. Even if the federal government imposed a 100% marginal tax rate on those earnings over $400,000 and doing so had no negative macroeconomic impact, it wouldn't be enough to fund the Warren or Sanders agenda.

But even these figures are far too optimistic. In reality, nobody would earn or report income taxed at or near a 100% rate — estimates of the "revenue-maximizing rate" range from 50% to 70% — and so there are diminishing returns to each marginal increase in the tax rate. Much of the income eligible for tax hikes under the $400K pledge is already collected in taxes, subject to combined marginal tax rates above 50% in states such as California with income taxes of their own.[18] Furthermore, AGI represents income before applying most tax exemptions and deductions, meaning the proportion of total taxable income above $400,000 is smaller than the proportion of total AGI above the threshold.

These factors mean the real potential for raising revenue is much lower than suggested by the figures above. Other analysts who have attempted to estimate the maximum amount of revenue that could plausibly be raised solely by adopting tax increases consistent with the $400K tax pledge have concluded it would be less than $14 trillion over the coming decade.[19,20]

FIGURE 3: ONLY TAXING HIGH-INCOME HOUSEHOLDS WON'T FUND THE PROGRESSIVE WISHLIST



Note: Figures are adjusted for the FY2024-2033 budget window using GDP changes from original scores.

Sources: Congressional Budget Office, Internal Revenue Service, Committee for a Responsible Federal Budget, and past PPI analyses.

One might counter that there are other potential sources of revenue besides personal income that could be subject to additional taxes under the $400K pledge, such as personal wealth or corporate income. However, all these potential tax bases eventually transform into personal income: an individual collects income when they sell a stock they own or when a business distributes profits to shareholders as dividends. Thus, taxes on other entities mostly draw from the same limited pool of resources as taxes on personal income and don't change the conclusions of this analysis.

THE $400K PLEDGE PREVENTS IMPORTANT TAX SIMPLIFICATION MEASURES

Although rate increases are not the only way to raise revenue, the $400K pledge also makes it difficult for policymakers to adopt common-sense changes that close tax loopholes. One of the best ways to raise new revenue, including from affluent taxpayers, is by curtailing carve-outs in the tax code known as "tax expenditures." These tax credits, deductions, and exclusions allow taxpayers to reduce their tax liability for engaging in preferred activities. All else being equal, economists generally believe it is better to have a tax with a broader base and a lower rate. Otherwise, high tax rates will induce people to act in ways that reduce their tax burden rather than increase their economic productivity.

Tax expenditures are also regressive: of the $1.5 trillion that the government foregoes in lost revenue each year due to tax expenditures, half of the benefit of tax expenditures accrues to households in the top quintile of the income distribution compared to just 9% for those at the bottom.[21] Itemized deductions in particular are more beneficial to people in higher tax brackets because they would pay a higher rate on each dollar they deduct from their taxable income (i.e. someone who is taxed at a 37% rate saves 37 cents in taxes for each dollar they deduct from their taxable income, while someone whose top marginal tax rate is 22% bracket only saves 22 cents for each dollar they deduct). Lower- and middle-income taxpayers are also more likely to take the standard deduction than they are to itemize tax deductions, and have fewer resources than the wealthy to seek out and take advantage of all the complicated carve-outs in our tax code.[22]

However, the $400K pledge makes it impossible to repeal even the most indefensible tax expenditures if even one household making under $400,000 benefits one penny from it. The Biden administration has tried to have it both ways by preventing households with incomes over $400,000 from claiming certain tax expenditures while leaving them in place for the other 98% of Americans. But this approach adds a whole new layer of complexity to our tax code for little reason. If policymakers believe a deduction isn't warranted on the merits, it should be repealed. The Biden threshold also would give savvy taxpayers a strong incentive to get their taxable income down to $399,999 to avoid seeing their tax bill rise by more than their income.

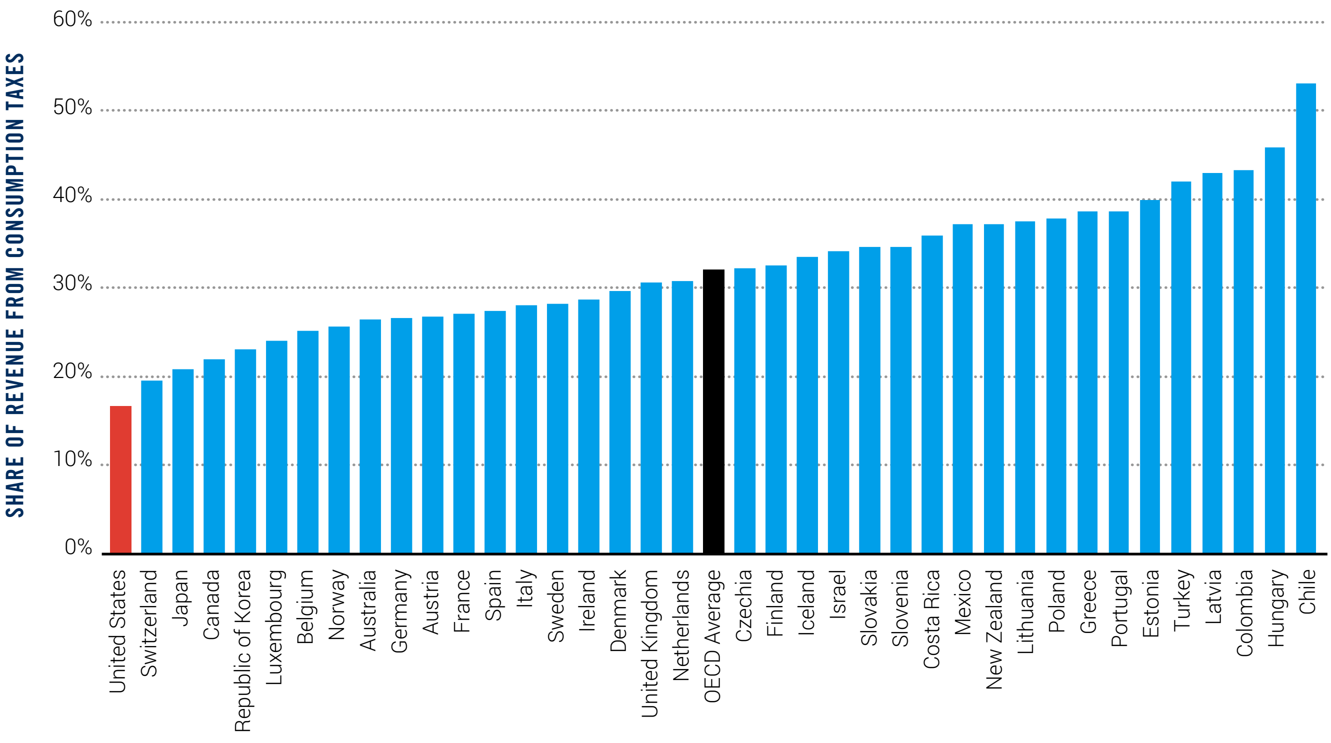
Biden compounds the problem by applying his pledge not just to tax policies, but also to enforcement of those policies. The Inflation Reduction Act included $80 billion in new resources to help the IRS crackdown on tax evasion, which the Congressional Budget Office originally projected would raise $200 billion over the next decade by making tax cheats pay the money they legally owe.[23] After the bill passed, the Biden administration said it would not use these resources to audit households earning under $400,000.[24] The upshot is that wealthy tax cheats can reduce their reported income below $400,000, and even if they do so by illegal means, the government is less likely to catch them because increased enforcement actions are being unnecessarily restricted.

PROGRESSIVE POLICIES REQUIRE BROADENING THE TAX BASE BEYOND HIGH-INCOME HOUSEHOLDS

Broadening the tax base beyond what the pledge allows is both a prerequisite for raising the revenue needed to build a thriving society and an opportunity to collect that revenue in a more pro-growth manner. U.S. progressives often point to European-style welfare states as their aspirational goal and taxes on the rich as their preferred means of financing it. But the United States actually imposes slightly *higher* taxes on the incomes of households in the top 1% of the income distribution than most European countries do — the big difference is in how everyone (and everything) else is taxed.[25]

Most countries with generous social safety nets primarily fund them not with highly progressive taxes on income or wealth, but with broad-based taxes applied to activities such as consumption. Across the OECD, countries collect an average of 32% of their revenue through consumption taxes. By comparison, consumption taxes in the United States account for only 16% of government revenue and most of that is collected at the state and local level in the form of sales taxes.[26]

FIGURE 4: THE UNITED STATES UNDERTAXES CONSUMPTION RELATIVE TO PEERS



Source: Tax Foundation.

The most common form of consumption tax is a value-added tax, which is collected incrementally at each step in a product's supply chain. Under a VAT, businesses pay a tax on the total value of the goods they sell but deduct the tax they paid to purchase inputs. As a result, a business is taxed only on the value it creates for consumers. Economists generally prefer VATs because they discourage consumption and encourage savings on the margins, which can be invested to grow the economy further. VATs are also easier to enforce than income taxes or sales taxes because each business in the supply chain is incentivized to only purchase inputs that have already had their share of the tax paid.

Some critics of consumption taxes contend they are regressive because lower-income people spend a larger share of what they earn on goods and services than high-income people. But this critique highlights another problem with the $400K pledge: income is not the only measure of well-being. A retired CEO who collects $350,000 per year in private pension income and Social Security benefits and lives by himself in a mansion on which he has no mortgage payment (or is using the home mortgage interest deduction to significantly reduce his taxable income) is far better off financially than a four-person family with no assets renting an apartment in San Francisco. Yet the $400K pledge treats them the same.

Income also fluctuates throughout a person's life. When young people are in school learning the skills they need to succeed in the workforce, they often spend more than they earn. In their prime earning years, most workers earn more than they spend and save the difference. Then, when they retire, their income falls and they spend down their savings. A PPI analysis published earlier this year showed that when measured over a lifetime, consumption taxes are roughly distributionally neutral.[27]

Although a tax system should be progressive overall, there is a critical role for taxes other than progressive income taxes to play within that system. Those countries that rely heavily on consumption taxes have less progressive tax codes than the United States, but they use them to finance generous social spending that makes their total tax-and-transfer system more progressive than the United States overall.[28] The United States could use the revenue from broad-based taxes to finance progressive public investment and social spending. Alternatively, the revenue raised by a VAT could be used to reduce the share of existing payroll and income taxes paid by lower-income workers, resulting in a change that is distributionally neutral or progressive relative to the current system but far more efficient and pro-growth.

BROAD-BASED TAXES CAN SERVE IMPORTANT PUBLIC FUNCTIONS BEYOND RAISING REVENUE

There are other reasons to enact broad-based taxes beyond raising revenue. When the price of a good does not reflect the costs it imposes on society, people will produce and consume more of it than is economically desirable. For example, the price of coal doesn't reflect the cost of cleaning up the damage burning coal does to the environment. If such "negative externalities" were incorporated into the price of coal — such as with a tax on carbon emissions — utilities would buy less coal and seek out less carbon-intensive alternatives, and consumers in coal-powered areas would be incentivized to improve energy efficiency. These taxes can even be made progressive with offsets and rebates. But there will inevitably be some middle-income households that have above-average emissions and will have to pay more in tax than the value of offsets. That reality makes it impossible to enact these taxes in a way that is consistent with the $400K pledge.

Another example of a good broad-based tax is the "user fee." Sometimes, public goods are financed with taxes imposed on those who use them. User fees serve to both discourage the overuse of limited resources and guarantee that the revenue available to maintain them rises with demand. One example is the federal highway system, which was designed to be financed by motor fuel taxes. This structure worked for many years, but a combination of increasing fuel efficiency and a refusal by conservatives to index the tax to inflation has led to declining revenues and a chronic shortfall in the highway trust fund.[29]

The bipartisan infrastructure bill passed in 2021 included a promising pilot for a vehicle-miles traveled tax that would tax drivers based on how far they drive rather than how much fuel they use.[30] This innovation has the potential to more accurately capture the true cost of driving and provide a more sustainable source of revenue for road building and repair. Fully implementing it, however, would run afoul of the $400K pledge.

Similarly, Social Security is designed around the principle that the benefits an individual receives should at least somewhat reflect the taxes paid into it. But the program faces a growing shortfall because the payroll taxes that workers pay into the program aren't actually enough to pay for the benefits they are currently scheduled to receive as retirees. In 2018, House Democrats proposed the Social Security 2100 Act to close the gap. The plan wasn't perfect, but it was a serious proposal to close Social Security's funding shortfall for the lifetime of anyone alive today.

However, the plan required big tax increases to make the math work. In addition to raising the cap on income subject to the payroll tax (which is currently set at $168,600 of annual earnings), the original Social Security 2100 required a 4 percentage-point increase in the payroll tax to sustainably finance both currently scheduled benefits and a proposed expansion. Both these provisions violated the $400K pledge, and so when the plan was reintroduced as the Social Security 2100: A Sacred Trust Act in 2018, it had to be financed with budget gimmicks that would actually *worsen* Social Security's financial shortfall.[31]

The final benefit of broad-based taxation is that it strengthens democracy. Elected leaders are more likely to balance trade-offs and responsibly manage public funds when they are accountable to the people paying for it. Voters are also more invested in the success of a government program when they are personally contributing tax dollars to finance it. Conversely, if a majority of voters aren't personally willing to pay anything towards a particular public program, it suggests the government doesn't really have a democratic mandate to administer it. Successful democratic governance requires broad buy-in from the electorate, and that means broad-based taxation is required to fund it.

CONCLUSION

None of the arguments in this paper are intended to suggest that taxes *shouldn't* be raised on high-income households. Funding America's future will require greater contributions from those who have the most means to contribute. It's for this reason that PPI has championed bold progressive tax reforms such as replacing the current estate tax with a progressive inheritance tax that better targets aristocratic generational wealth transfers.[32] Similarly, this paper does not suggest that tax increases alone are the solution to our fiscal challenges. PPI has long argued additional spending restraint is necessary for both economic and political reasons, and we have offered comprehensive proposals to slow its explosive growth alongside our revenue recommendations.[33] But there's also no way around the fact that social insurance programs like Social Security will require a far more radical restructuring and deep benefit cuts in the coming years if policymakers adhere to Biden's $400K tax pledge. It is impossible to maintain broad programs that provide benefits to the vast majority of Americans if the vast majority of Americans don't contribute to them at sustainable levels.

ABOUT THE AUTHOR

Ben Ritz is the Director of PPI's Center for Funding America's Future, which develops fiscally responsible policy proposals to strengthen public investments in the foundation of our economy, modernize health and retirement programs to reflect an aging society, transform our tax code to reward work over wealth, and put the national debt on a downward trajectory.

He previously staffed the Bipartisan Policy Center's Economic Policy Project and served as Legislative Outreach Director for The Concord Coalition. Ben earned his Master's of Public Policy Analysis and a Graduate Certificate of Public Finance from American University, where he also previously completed his undergraduate education.

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