Center for American Progress

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Reforming Our Tax System, Reducing Our Deficit

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Note from the authors: As in any collaborative process, there has been much give and take among the participants in developing this final product. We all subscribe to the analysis and principles articulated here, to the need for revenue levels at the level proposed, and to the need for spending reductions. We also generally agree with the provisions of the plan. There may be specific matters, however, on which some of us have different views.

Contents

Introduction and summary

There are very few things everyone in Washington can agree on these days. But the one notion that will get heads nodding across the political spectrum is that today's fiscal policies simply are not sustainable. If we keep doing what we've been doing, not only will the federal budget stay permanently deep in the red but critical public investments such as education and infrastructure will continue to go underfunded. Key national priorities such as strengthening the middle class, reducing poverty, and building a world-class infrastructure will remain unaddressed. Income inequality will continue to rise, confidence in America's ability to govern its fiscal affairs will continue to fall, and sooner or later we will find ourselves struggling through another economic crisis. Clearly, these are all outcomes that we must avoid. That is why nearly everyone—left, right, and center—agrees that changes in fiscal policy will be necessary.

The nonpartisan Congressional Budget Office estimates that if we do not change course, annual federal budget deficits will never drop below $800 billion. Tax revenues will cover only 80 percent of federal spending, which means we will have to borrow 20 cents for every dollar we spend. As a result, publicly held debt, measured as a share of our national economy, will rise from about 73 percent today to nearly 90 percent by the end of the decade, according to current projections.[1]

That is a budget trajectory fraught with serious risk. No one knows with precision when our debt levels will become so burdensome that they trigger severe economic consequences. But there are few who would disagree that such a level does exist, and that we would do well to avoid finding out exactly what that level is. For that reason, budget experts and economists from all perspectives agree with the goal of preventing such a treacherous rise in the debt-to-GDP ratio.

To do so does not require radically decreasing our deficits immediately as we continue to recover from the Great Recession of 2007–2009. Instead our goal should be to reduce our deficit to stabilize the debt-to-GDP ratio at a responsible level in the medium term. We can achieve this by lowering our annual budget deficits to a level where any new debt incurred in a given year is smaller than overall economic growth that year. Under normal economic conditions, this means deficits of approximately 3 percent of GDP or lower. Though still lower deficits are desirable when the economy is at full employment and operating at potential GDP, getting deficits under 3 percent of GDP would address the most pressing concern in the medium term and put the budget on a sound footing.

Accomplishing that critical goal is going to be difficult. Deficit reduction is always hard—after all, it means cutting back on public services and programs that are important to the nation, and it means raising taxes.

This report offers a plan to achieve meaningful deficit reduction over the next 10 years that rests on two pillars:

- Progressive, revenue-enhancing, efficient, simplifying, and pragmatic tax reform
- Pragmatic spending cuts that do not undermine the middle class, the poor, or seniors

First, we should recognize our revenue problem. Repeated tax cuts played an outsized role in creating the budget deficits of the last decade and they have hurt our country. As Oliver Wendell Holmes said, "Taxes are what we pay for civilized society." They pay for the foundational public investments that are critical to a modern prosperous society, such as infrastructure, education, and basic scientific research. They pay for services that only the government can effectively perform, such as national defense and ensuring clean food, safe consumer products, and clean water. Taxes make it possible for us to meet our societal obligation to care for our veterans, our aged, and our impoverished. And taxation allows us to overcome national challenges and achieve extraordinary feats. Apollo 11, the Hoover Dam, and the Internet were all financed with tax revenues.

Current federal revenue levels are at their lowest levels since the 1950s. And the assumption that all of the tax cuts scheduled to expire at the end of this year will continue is the single-largest reason why budget experts expect federal deficits to remain far too high over the next 10 years.[2] Clearly we have a big revenue problem.

When thinking about where the revenue we need should come from, the starting point should be that our tax system must be progressive. From Adam Smith down to today, it has been a long-recognized principle that those with higher incomes should pay a higher share of their income in taxes because they have the ability to pay and have benefited the most.[3]

After all, no one disagrees that, to take a hypothetical example, a 10 percent tax on a family making $50,000 has a far greater impact on the life of that family than a 10 percent tax on a family making $5 million. And those at the top of the income ladder benefit significantly from our civil society, public investments, the protections taxes pay for, and all our nation provides. It's only fair that the better off be asked to pay a larger share of the bill.

And, in fact, our tax system is progressive. But over the last several decades, the trend has been to ask less and less of those at the top. The very highest-income households have enjoyed substantial tax cuts, even as their incomes have risen: From 1979 to 2007, for example, the pretax incomes of the top 1 percent more than tripled, while their tax rates declined by about one-fifth.[4] And while, on average, higher-income Americans do pay higher federal tax rates than middle-income Americans, there are too many high-income households for whom that general rule does not apply.

Finally, it is important to remember that the federal income tax is only one piece of a larger national tax system. Most of the other pieces—excise taxes, payroll taxes, state and local taxes—ask much less of high-income households than they do of low- and moderate-income households. Taken together, our national tax system is already less progressive than it might appear, which is one reason why it's so important for the federal income tax to be substantially progressive.[5]

In addition to concerning ourselves with progressivity as we address the need to raise more revenue, we should also address the fact that the current tax code is too complex. It contains too many narrowly targeted special interest breaks. In some cases these special preferences create economic inefficiencies that can no longer be justified. They also erode Americans' faith that the tax code is treating everyone fairly.

Our tax reform plan addresses these failings. First and foremost, it would redesign the income tax code so that it will generate adequate levels of revenue to meet our crucial fiscal goals. Over the next 10 years, our tax reform would put us on a stronger fiscal footing by raising $1.8 trillion and, by the end of the decade, matching the overall levels of revenue proposed by fiscal commission co-chairs Alan Simpson and Erskine Bowles as part of their bipartisan deficit reduction plan. Though these proposed revenue levels will likely be insufficient for the country's long-term needs, they are enough to do the job in the medium term. And given their bipartisan pedigree, they provide a realistic target.

The very highest-income households have enjoyed substantial tax cuts, even as their incomes have risen: From 1979 to 2007, for example, the pretax incomes of the top 1 percent more than tripled, while their tax rates declined by about one-fifth.

Our tax plan would raise this revenue in a progressive way, asking those in the top income brackets to pay more. On average, households making less than $100,000 would pay a little less than they do now, those making between $100,000 and $250,000 would see only tiny increases, and the tax hikes up to $500,000 would be small.

Our reform would also simplify the filing process and streamline the code so that everyone could trust that each taxpayer is being treated fairly. It does this by turning certain deductions that currently favor those in the highest tax brackets into credits that will bestow equal benefits. Our plan would tax different sources of income much more equally than the current code does. It would remove the alternative minimum tax, repeal other provisions that add complexity, eliminate unjustified tax loopholes, and reduce the number of taxpayers who would have to itemize.

Of course deficit reduction will not be limited to tax reform. Spending reform will also be necessary. It is important to note that the federal government has already cut spending substantially. In the last two years, President Barack Obama has signed into law $1.5 trillion in spending cuts over the next decade.[6] We propose hundreds of billions of dollars in additional spending savings that can be achieved without reducing retirement or health benefits, without shredding the social safety net, and without further disinvesting in America's future.

The result is a comprehensive deficit reduction plan that will substantially reduce our future deficits, set the budget on a sound course for the coming decade, and bring our debt-to-GDP ratio below 72 percent by 2022.

On the need for more revenue

Our federal tax code is failing at its most important and basic task: raising adequate revenues to fund the services and operations of government. Over the last four years, the effects of repeated tax cuts and a weak economy combined to produce the lowest levels of federal revenue, measured as a share of our national economy, in nearly six decades. If we keep the current tax code the way it is today, federal revenues will stay far below federal spending levels—even with significant spending cuts—for the next decade and beyond, producing unsustainable and eventually dangerous levels of debt. The tax code needs to be reformed so that it generates higher revenues.

According to Congressional Budget Office projections, maintaining today's tax code will result in revenues averaging about 18 percent of gross domestic product over the next decade. From 1998 to 2001—the last years in which we had balanced budgets—revenues averaged about 20 percent of GDP. And in the intervening years, our population has aged, baby boomers have started to retire, health care costs have risen, and our national security needs have changed dramatically.

Of course stabilizing our publicly held debt and setting it on a downward trajectory will certainly require spending reductions in addition to new revenues. But because the revenues generated by our current tax code are so inadequate, to accomplish that goal entirely through spending cuts would require cutbacks of such a magnitude that, because of the economic damage and human suffering they would cause, they would simply be bad policy -- and, for good reason, politically unpopular. "Domestic discretionary" spending—which includes most of what government does outside of the military and the big entitlement programs such as Social Security—is already set to drop to levels lower than at any time since the category was created in 1962.

In fact, nearly all independent experts and bipartisan commissions on deficit reduction have come to the same conclusion. The most well-known of these efforts—the plan that came out of the 2010 bipartisan fiscal commission

(“Simpson-Bowles”)—recommended additional revenue of approximately $2.2 trillion over the next 10 years.[7] Under their plan revenues would reach about 19.6 percent of GDP by 2017 and 20.3 percent of GDP by 2021. Revenues at that level, combined with spending cuts, produce federal budgets that avoid piling on debt at a rate faster than overall economic growth.

While the Simpson-Bowles levels of revenue are certainly higher than the level of revenues we see today and higher than the levels over the past decade, they would still be below those of the late 1990s. And they would not be enough to fully balance the budget, nor to allow the country to boost critical investments.

Nevertheless, just as there are many who would argue these levels are too low, given the needs of the country, the changing demographics, and rising health care costs, there are also those who would argue these levels are too high. The Simpson-Bowles levels are a middle ground between those two camps, as befits a bipartisan compromise. For the plan described below, we adopt as our long-term revenue target the Simpson-Bowles revenue level of 20.3 percent of GDP by 2021—not because we embrace it as ideal but because, as a bipartisan compromise, it is realistic.

Why the additional revenue must come from high-income households

Generating additional revenue is clearly a necessary component of any practical plan to address our medium- and long-term budget challenges. But simply hitting a revenue target isn’t enough. It also matters a great deal how that revenue is raised, and from whom.

Over the last 30 years, income inequality has skyrocketed. From 1979 to 2007 the average household income among the top 1 percent grew by more than 266 percent, adjusted for inflation. Over the same period, the average household in the middle of the income distribution saw its income rise about one-seventh as fast.[8]

Even as those at the top gained, their federal tax rates shrunk. In the middle of the 1990s, a household in the top 1 percent could expect to pay about 35 percent of their income in federal taxes. Over the next decade, that rate fell steadily until, by 2007, their average tax rate was down to just more than 28 percent.[9]

Ideally, no one would have to pay higher taxes, but if we do need to raise new revenue—and we do—then it is reasonable that it first should come from those who can most afford it and who have benefited the most economically. And with growing incomes and falling tax rates, those at the very top of the income ladder can certainly afford to pay a bit more.

Critics will contend that raising taxes on those with high incomes will depress economic growth. Some of the more aggressive proponents of this view will even go so far as to say that raising taxes won't generate even a single new dollar in revenue on net because the economic drag will be so large. This notion—that higher taxes for higher earners are bad for the broader economy—has some understandable basis in theory. After all, it is not hard to see how a 100 percent tax rate on income above a certain threshold would result in dramatically reduced economic activity.

The evidence that this effect extends down to rates much lower than 100 percent, however, is far less persuasive. In fact, the vast preponderance of evidence suggests that tax rates at or near their recent levels are significantly below where they would need to be to have any measurable economic effects.[10]

Indeed, the real-world experience of raising taxes on those with higher incomes in the 1990s and cutting them in the 2000s strongly supports the view that higher taxes for those at the top—in the range seen in the United States in recent decades—don't depress growth, and lower taxes don't spur it. In 1993 when President Bill Clinton raised taxes on the top income earners, his opponents argued loudly that such tax hikes would mean economic decline, with some even promising lower tax revenues as a result. Needless to say, they were proven wrong in spectacular fashion with the longest period of economic growth in U.S. history, increased business investment, 23 million jobs added, and, of course, budget surpluses.[11] Eight years later, President Bush promised that his tax cuts would spark an economic boom. That boom never materialized, but renewed large deficits did. In addition to the clear historical record, study after study has found no relationship between deficit-financed tax cuts and economic growth.[12]

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Raising new revenue is critically important to the fiscal and economic health of the nation. It is equally important to raise new revenue in a fair and efficient way. With income inequality on the rise and a decade-long trend of lower taxes for those with the highest incomes, there can be no doubt that any additional revenue must first come from those at the top of the income ladder.

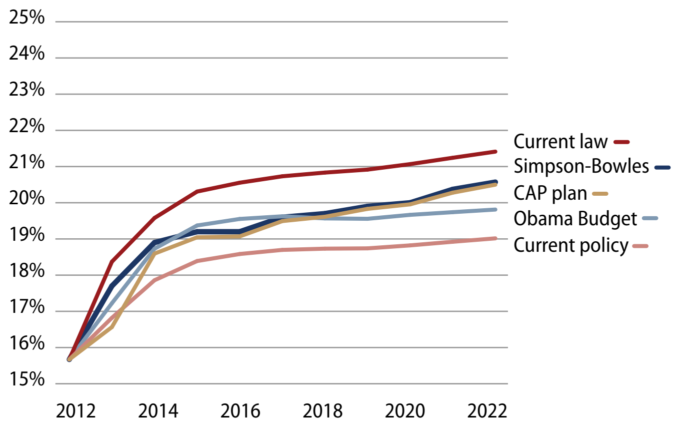
A progressive tax reform

Our plan to reform the federal individual income tax will raise adequate revenues progressively while making the tax system more efficient, simple, fair, and comprehensible. Under our plan, by the middle to the end of this decade, federal revenues will match those revenue levels recommended by the Simpson-Bowles plan. (see Figure 1)

This increase is accomplished while cutting taxes for all income groups with annual incomes less than $500,000, relative to what they would pay under the tax code that becomes law on January 1, 2013—that is, relative to so-called "current law." Relative to the tax code in effect in 2012—"current policy"—there are tax reductions on average for those with incomes less than $100,000 per year, tiny increases on those with incomes from $100,000 to $250,000, and small increases on those with incomes from $250,000 to $500,000. By reforming our tax system in a progressive manner, we raise needed revenue and reduce after-tax income inequality. (see Table 1 on page 11)

FIGURE 1

Revenue, as a share of GDP, 2012-2022



Source: CBO, Moment of Truth Project, Center for American Progress calculations.

The key features of our plan are:

- A top marginal tax rate for the personal income tax of 39.6 percent as it was under President Clinton
- A top marginal tax rate of 28 percent on capital gains as it was under President Ronald Reagan and throughout much of the 1990s
- Converting tax deductions to tax credits
- Closing tax loopholes
- Simplifying the tax system by reducing the number of filers who itemize, repealing the Alternative Minimum Tax, and other reforms

Our proposed tax reform at a glance

Personal exemptions, standard deduction, itemized deductions: Replaced with a "standard credit" ($5,000 for couples and $2,500 for singles) and 18 percent "itemized credits," except charitable contributions would generally receive an itemized credit of up to 28 percent. Taxpayers would have the choice of claiming the standard credit or itemized credits. The impact of the effective reduction of the mortgage interest tax preference for those in higher tax brackets is phased in over time.

Dependent exemption: Replaced with an expanded child tax credit of $1,600. Child credit is refundable under today's rules and the phaseout point is lifted to $200,000. A $600 nonrefundable credit is available for nonchild dependents.

Capital gains and dividends: Tax capital gains at a maximum 28 percent rate (including the Medicare tax that goes into effect in 2013) and dividends as ordinary income.

Health care exclusion: The value of the exclusion is limited for those with earnings in excess of $250,000 per year to 28 percent.

Marginal tax rates:

Couples	Singles
$0–$100,000: 15%	$0–$50,000: 15%
$100,000–$150,000: 21%	$50,000–$75,000: 21%
$150,000–$200,000: 25%	$75,000–$150,000: 25%
$200,000–$422,000: 35%	$150,000–$422,000: 35%
$422,000 and above: 39.6%	$422,000 and above: 39.6%

Earned income tax credit: Recent EITC enhancements are permanently extended.

Personal exemption phaseout, or "PEP," and itemized deduction limitation, or "Pease": Eliminated.

Alternative minimum tax: Eliminated.

Estate tax: Exemption of $2 million per individual—$4 million per couple and 48 percent top rate—indexed for inflation. Close loopholes in the estate and gift tax as proposed by President Obama.

Other elements:

- 50-cent increase in cigarette tax
- Tax on alcoholic beverages at a uniform $16 per proof gallon
- Regulating and imposing small fees on Internet gambling
- Permanent extension of the research and experimentation, or R&E, tax credit and clean energy incentives
- Corporate tax reform that increases corporate tax revenues by 4 percent and results in a lower statutory rate
- $12 billion in savings from reforms to tax-preferred retirement and savings plans.
- Elimination of "carried interest" loophole and "S corporation" Medicare tax loophole

Note: Numbers and amounts are for the 2017 tax year. All parameters would be indexed for inflation according to the chained consumer price index.

TABLE 1

Our plan's distributional effects, tax year 2017

Income group	Average income	Average tax change from current policy		Average tax change from current law	
		$	Percent of pretax income	$	Percent of pretax income
$0-$25,000	$15,800	–131	–0.8%	–450	–2.8%
$25,000-$50,000	$36,500	–279	–0.8%	–1,035	–2.8%
$50,000-$75,000	$61,500	–304	–0.5%	–1,538	–2.5%
$75,000 -$100,000	$86,900	–164	–0.2%	–2,233	–2.6%
$100,000-$250,000	$145,700	+468	+0.3%	–4,287	–2.9%
$250,000-$500,000	$334,400	+5,509	+1.6%	–4,941	–1.5%
$500,000-$1,000,000	$677,000	+18,078	+2.7%	+608	+0.1%
$1,000,000 or more	$3,137,300	+155,700	+5%	+35,658	+1.1%

Notes: Tables reflect plan's income and excise tax changes, fully phased-in, except for retirement savings, carried interest, and Internet gambling proposals. Current policy baseline assumes the extension of the income tax cuts enacted in 2001, 2003, and 2009 and extended through 2012, and an AMT "patch," but does not include the current payroll tax holiday. Current law is the tax law that would take effect in 2013 (with no AMT patch). Source: Institute for Taxation and Economic Policy tax model and CAP calculations (2017 tax year).

Tax rates

Our plan keeps the top individual income tax rate at 39.6 percent—the same as it was under President Clinton—from 1993 through 2000. There has been much talk of late regarding lowering the top marginal income tax rate. Yet the historical record strongly suggests that rates below the 39.6 percent that we propose would have little meaningful positive effect on work incentives or economic growth.[13] Of course 39.6 percent was the top rate during the economic successes of the 1990s, and rates were even higher during many of the other strongest periods of U.S. economic growth.[14] (see Figure 2 on following page)

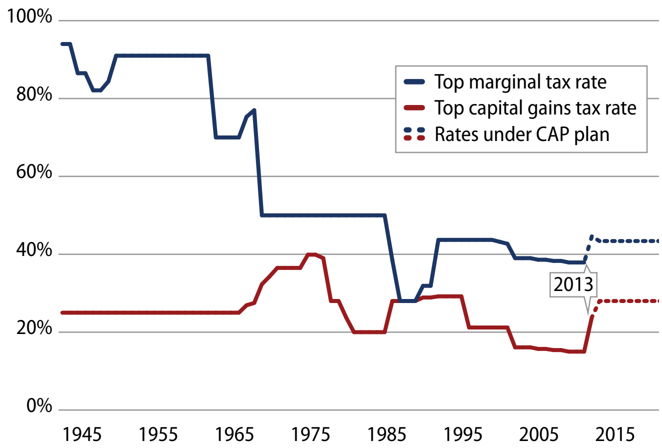
Despite the evidence that lowering the top rate will have little, if any, positive economic effect, the argument persists that we should do so. And while much attention has been paid to the idea of lowering the top rate, very little has been paid to how much tax rates can be lowered while raising adequate revenue and doing so progressively.

Many grand claims have been made claiming that rates can be substantially lowered and the revenue-loss offset by eliminating tax expenditures—those deductions, exemptions, exclusions, credits, and other special provisions that reduce tax liability. But those who make such claims rarely offer specific reforms that make the numbers add up. The few who have done so demonstrate just how difficult and unrealistic it is to make that math work. (see text box)

FIGURE 2

Top marginal federal tax rates since World War II

Combined individual income and payroll taxes on ordinary income and capital gains



Notes: From 1970-1981, the top rate on unearned income other than capital gains (e.g. interest, dividends) was 70 percent. Beginning in 2003, the capital gains rate applied to qualified dividends as well. Top rates includes the effect of the "Pease" limitation on itemized deductions for relevant years and the Medicare tax.

Source: Center for American Progress calculation based on http://www.ctj.org/pdf/regcg.pdf.

This isn't to say, by any means, that tax expenditures couldn't or shouldn't be reined in. In fact, it is by reining in tax expenditures, as described below, that we are able to prevent the tax rate from rising above Clinton levels while generating adequate revenue progressively and simultaneously simplifying the tax system.

The 39.6 percent tax rate is the top rate we propose for ordinary income, but we also address the top rates for dividends and capital gains income that have been cut substantially in recent years. As with the top rate on ordinary income, these lower rates on capital gains and dividend income have not produced their promised economic benefits and have enabled many of the highest-income Americans to pay extremely low overall tax rates—lower than people far below them on the income ladder.[15] Furthermore, these tax breaks for capital income have contributed to the rapid rise in income and wealth inequality. Our plan treats dividends as ordinary income—as they were for 90 years preceding 2003—and restores the top capital gains rate to 28 percent—the same rate that was in effect after President Reagan signed the 1986 Tax Reform Act and throughout much of the 1990s.[16]

Cleaning up the tax code

An important part of the new revenue in our plan comes from reducing the value of various tax expenditures. Under the existing tax system, many of these tax expenditures, such as those for mortgage interest, charitable giving, and retirement savings, are "upside-down"—that is, they provide a bigger benefit to those in higher tax brackets. That is both unfair and inefficient.

Our proposal addresses the upside-down problem while achieving significant, progressive revenue increases by transforming itemized deductions into credits. Most expenses that are currently claimed as itemized deductions would be transformed into nonrefundable tax credits equal to 18 percent of their value. This would provide the same tax benefit to taxpayers in all tax brackets—with middle-income taxpayers benefiting from the change.

Under the current tax code, for example, if two families both deduct $10,000 in mortgage interest paid from their taxable income, their actual tax benefit could vary greatly. For a high-income family in the 35 percent tax bracket, that deduction would lower their tax bill by $3,500. For a middle-income family in the 15 percent bracket, that same $10,000 deduction results in only $1,500 in tax savings. Under our plan, since both families paid the same amount of mortgage interest, they would both receive the same $1,800 tax benefit.

The exception in our plan to the transformation of itemized deductions to an 18 percent credit is for charitable contributions. Those contributions will generally be eligible for up to a 28 percent credit. Thus the subsidy for charitable giving will be decreased for those in higher tax brackets but not decreased by as much as for the other forms of deductions. It should also be noted that at the point when our plan is put into effect, a higher credit than 18 percent will be available for mortgage interest expenses for those taxpayers for whom an 18 percent credit represents a reduction in benefit relative to the current mortgage interest deduction. The mortgage interest credit will be gradually phased down to the 18 percent that is available for other itemized expenses.

Our plan also replaces the standard deduction with a large "standard credit" of $5,000 for couples and $2,500 for singles. The standard credit largely serves the same purpose as the existing standard deduction—relieving most taxpayers of the need to track and itemize their expenses for tax purposes.[17] Currently, only about one-third of taxpayers itemize their expenses. Under our plan, about 80 percent would claim the standard credit and only about one-fifth would itemize.

Other tax expenditures are also streamlined under our plan, including those for retirement savings used by high-income taxpayers. And our plan closes several difficult-to-justify loopholes, including the "carried interest" loophole that allows investment fund managers to convert their income into low-taxed capital gains, and the so-called "S corporation" loophole through which high-income professionals can avoid Medicare taxes.

Why not lower the rates?

Our plan differs from several other plans that propose to reduce deficits while also reducing tax rates—even below the already-low levels in effect today. The Simpson-Bowles plan and the Bipartisan Policy Center plan, for example, would use a large portion of the revenue gains from cutting tax expenditures to reduce income tax rates instead of reducing the deficit. That approach, of course, necessitates much larger cuts in tax expenditures than would otherwise be needed—on the order of $4 trillion or more over 10 years. As a result, these plans hinge on Congress's willingness to agree on tax expenditure reductions that we believe are politically unrealistic, economically and socially undesirable, or both.

To be sure, tax expenditures, which today reduce revenues by a total of more than $1 trillion per year, can and should play a major role in deficit reduction. But in setting the parameters for tax reform, Congress needs to be realistic in how much savings can be achieved from reducing tax expenditures and also needs to be cognizant of the distributional consequences. To their credit, the Simpson-Bowles and Bipartisan Policy Center plans illustrate the kinds of drastic policy changes needed to achieve significant deficit reduction while also lowering tax rates. We simply believe that the benefit from lower income tax rates as part of these deficit reduction proposals is not worth many of the costs and dislocations.

Both the Simpson-Bowles and Bipartisan Policy Center plans, for example, completely repeal the tax exclusion for employer-sponsored health insurance, which benefits 160 million Americans who receive health insurance through their jobs. Although some reasonable level of savings can be achieved in this area, eliminating the health insurance exclusion outright would hit the middle class, potentially disrupt a health care system that is based primarily on employer-provided insurance, and would increase costs for public health care programs.[18]

Both of these plans also eliminate the tax deduction for state and local taxes paid. That deduction has some justification and entirely eliminating it would mean that tax reform would disproportionately burden residents of high-tax states. (Our plan strikes a compromise: transforming it into an 18 percent credit.)

These plans also rely on other tax expenditure reductions that Congress would be extremely unlikely to agree to. The Simpson-Bowles and Bipartisan Policy Center plans, for example, derive hundreds of billions of dollars in savings from assuming that Congress would entirely eliminate a tax expenditure known as "stepup in basis," meaning that all unrealized capital gains—including from businesses or homes that have risen in value—would be taxed upon a person's death. Given the politics of the estate tax and capital gains, that seems extremely unlikely.

The Simpson-Bowles plan would also "broaden the tax base" by taxing veterans benefits, workers' compensation payments, foster care payments, public assistance benefits, and other forms of income that are currently not taxed. We are deeply skeptical that Congress would make these choices deliberately. And that is why we would warn against locking in a tax reform framework with lower tax rates that could necessitate these drastic reductions in tax expenditures. To put this in perspective, a Congressional Research Service report puts the number for realistic tax expenditure reduction, annually, at between $100 billion and $150 billion—on the order of one-quarter or one-third of what the Simpson-Bowles and the Bipartisan Policy Center plans propose.[19]

Furthermore, both of these plans raise taxes on the middle class and low-income Americans.[20] Indeed, the decision to reduce the marginal rates paid by the highest-income Americans all but forces that outcome. There are inevitable distributional tradeoffs between reducing tax rates and reducing tax expenditures. While tax rate reductions disproportionately benefit high-income households, the largest tax expenditures—aside for investment tax breaks—benefit households of all income levels, and deep reductions in those tax expenditures can easily outweigh the benefit that middle-class and low-income households receive from cuts in tax rates.

Finally, it should be noted that there are many other provisions of the tax code to be reviewed and evaluated. Some of these have created openings for creative accounting to avoid the estate tax, ways to make ordinary income look like lower-taxed capital gains, and strategies that allow retirement accounts and life insurance to be used to avoid taxes far beyond what was originally intended. Some of these provisions are well known and have been evaluated, and we know how much they cost in revenue. We have explicitly included addressing some of them in this plan. Others, however, are less well known and have not been fully assessed but should certainly be fully considered as part of tax reform.

Related to the problem of legal tax avoidance is the problem of the "tax gap." The tax gap is the gap between what is actually owed in taxes and what is paid. The gap is a result of both intentional tax evasion and unintentional underpaying. The gap is currently estimated to be at $450 billion.[21] To address both of these compliance problems, the capacity of the IRS should be expanded to ensure the enforcement of our current tax laws and to provide a better understanding of the legal evasion that is taking place and the cost of it. In this way additional revenue could be raised and, if desirable, used to modify some of the provisions of this proposal such as the reduction of the benefit of itemized expenses as we move from a deduction to a credit.

Simplifying filing

Our plan also simplifies the process of tax filing by eliminating several complicating features of today's tax code. For one thing, by cutting back on the tax advantages that the alternative minimum tax is meant to address, that complex part of the tax code is rendered unnecessary. Therefore, our plan entirely eliminates the alternative minimum tax.

We also eliminate personal and dependent exemptions and the standard deduction, and replace them with the larger standard credit and expanded child credit. This reduces the number of steps required for tax filing and consolidates several different calculations into one simpler mechanism. Our plan also renders unnecessary the phase-out of personal exemptions and the "Pease" limit on itemized deductions, which would be restored next year under current law. In our plan about 80 percent of taxpayers will claim the standard credit.

Other taxes

The focus of our plan is reforming the personal income tax. There are, however, several other changes that affect other taxes and generate revenues.

First, our plan includes about $4 billion per year in higher excise taxes on cigarettes, as proposed in CAP's recently released health reform plan, the "Senior Protection Plan."[22] We also raise an additional $6 billion per year in alcohol taxes, reversing decades of erosion in revenue from that source. In addition we raise $4 billion from regulating and imposing small fees on Internet gambling.

Second, we believe the corporate income tax is ripe for reform that broadens the tax base, lowers the statutory rate, and raise additional revenue. Therefore, we assume a reform of the corporate income tax that generates approximately a 4 percent increase in overall corporate income tax revenue.[23] We believe that addressing the use of "transfer pricing"—the valuation of goods, services, and assets in international transactions—is of particular importance in reforming the corporate income tax.

The spending side of the equation

Our tax reform plan would generate approximately $1.8 trillion in additional revenue over the next 10 years. That's above the $1.6 trillion proposal from President Obama but below the overall tax increases proposed by Simpson-Bowles in this 10-year period. Revenues would, however, reach Simpson-Bowles levels toward the end of the period. We believe that this tax reform should be accompanied by spending reductions that are roughly equal in size to the tax increases.

Fortunately, we are already well on our way to that goal. In 2011 President Obama signed into law several pieces of legislation that reduced projected federal spending on discretionary programs—those programs that require an annual appropriation from Congress—by more than $1.5 trillion.[24] These cuts do not include the so-called "sequestration," which is set to begin in January 2013. Rather, these cuts come from the agreed-on caps on both defense and nondefense discretionary spending in place for the remainder of the decade.

Because of those caps—which the president not only signed into law but then also incorporated into his subsequent budget proposals—spending on nondefense discretionary services and programs is set to fall to its lowest levels since this category was created in 1962. Deeper cuts would undermine vital functions of government and sacrifice needed investments. Further cuts to spending must come from other parts of the budget.

The Center for American Progress recently released a plan entitled the "Senior Protection Plan,"[25] which finds $385 billion in additional savings from federal health care programs, mainly from Medicare. These savings do not come from slashing benefits or shifting the cost burden onto senior citizens, families, or states. Rather, our approach is to reduce the overall cost of health care by improving efficiencies, by eliminating wasteful subsidies, and by heightening the incentives for improving the quality of care without increasing costs.

Our plan includes an array of structural reforms to bend the cost curve over the long term:

- **Reforming the way prices are determined for health care products and some services.** Right now, the government sets these prices for the most part. Instead, Medicare and Medicaid should adopt market-based prices, allowing manufacturers and suppliers to compete to offer the best prices.

- **Reforming the way health care is paid for and delivered.** Right now, Medicare and Medicaid pay a fee for each service for the most part. This creates incentives for doctors to order more and more profitable tests and procedures. Instead, these programs should pay a fixed amount for a bundle of services or for all of a patient's care.

- **Encouraging states to become accountable for controlling health care costs.** "Accountable care states" that keep overall health care spending below a global target would be rewarded with bonus payments.

In addition to structural reforms, our plan includes dozens of reforms that would guarantee a "down payment" of savings. These include:

- **Reducing drug costs.** When Medicaid covered drugs for seniors, drug companies provided large discounts, but Medicare does not get the same deal. Medicaid rebates should be extended to brand-name drugs purchased by low-income Medicare beneficiaries.

- **Bringing Medicare payments into line with actual costs.** The independent Medicare Payment Advisory Commission—which advises Congress on Medicare policy—has identified numerous ways that health care providers should be more efficient. Targeting inefficiency is much better than resorting to a series of blunt, across-the-board cuts in provider payment rates. Under our plan, for example, hospitals would fare much better with smaller and better targeted cuts.

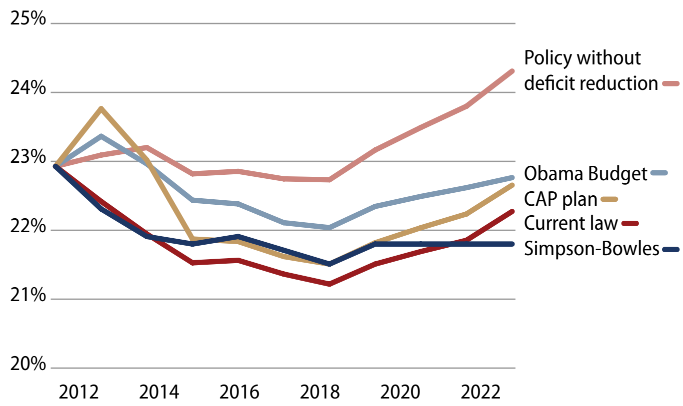
- **Increasing premiums for high-income Medicare beneficiaries.** High-income beneficiaries pay higher premiums under current law. But the share of beneficiaries who pay higher premiums should be expanded and the higher premium amounts should be increased by 15 percent.

In addition to additional savings in health care, we propose $100 billion in savings from other nondiscretionary programs. These are selected from a range of measures previously proposed by the Center for American Progress and found in the president's budget.[26] And while we strongly believe that the sequester must be avoided, the Pentagon should also be asked to streamline, to reduce waste and inefficiency. It is not unreasonable to expect that the Pentagon can contribute about $10 billion a year—less than 2 percent of its currently projected budget—toward deficit reduction.

Finally, spending cuts and tax increases alone cannot solve our budget dilemma. We must also help the economy recover as fast as possible. Elevated unemployment, depressed wages, and increased poverty are all significant contributors to our budget deficits. Any plan to reduce the deficit over the next 10 years must begin with a significant effort to advance job creation today. Our plan includes room for $300 billion in job-creating investments such as infrastructure construction and repair, teacher hiring and training, and home and commercial energy efficiency retrofits. We also make room on the tax side for $100 billion in tax cuts related to employment such as the payroll tax holiday, a return of the Making Work Pay tax credit, or similar measures.[27]

FIGURE 3

Federal spending, as a share of GDP, 2012-2022



Note: "Policy without deficit reduction" is projections of federal spending under current policy prior to discretionary spending cuts enacted since fiscal year 2010.

Source: CBO, Moment of Truth Project, Center for American Progress calculations.

Altogether, and taking into account initial job-creation spending, our plan includes more than $1.8 trillion in programmatic spending cuts. These cuts would reduce federal spending from a projected level of more than 24 percent of GDP in 2022 to about 22.7 percent of GDP. (see Figure 3) When combined with the $1.8 trillion in added revenue, we generate another $500 billion in reduced spending on interest payments on the debt for total deficit reduction over 10 years of $4.1 trillion.

Bottom line

Our plan consists of $1.8 trillion in new revenue from a progressive tax reform, $1.8 trillion in programmatic spending cuts, and another $500 billion in interest savings for a total of $4.1 trillion in deficit reduction. (see Table 2)

If implemented, our plan would reduce budget deficits to less than 3 percent of gross domestic product by 2015 and lower them further, to about 2 percent of GDP, by 2017. Instead of climbing higher and higher, the debt would begin to fall by 2015, dropping to 72 percent of GDP—lower than it is today—by the end of the decade. (see Figure 4)

This is what a balanced and realistic plan for deficit reduction looks like. It asks those who have gained the most over the past decade to give something back. It asks those who can afford it to bear their fair share of the burden. It protects seniors, the middle class, and those striving to get into the middle class. It simplifies the tax code, making it fairer and easier to understand. It finds efficiencies and cuts spending that we cannot afford. And crucially, it stabilizes the debt and sets it on a downward path.

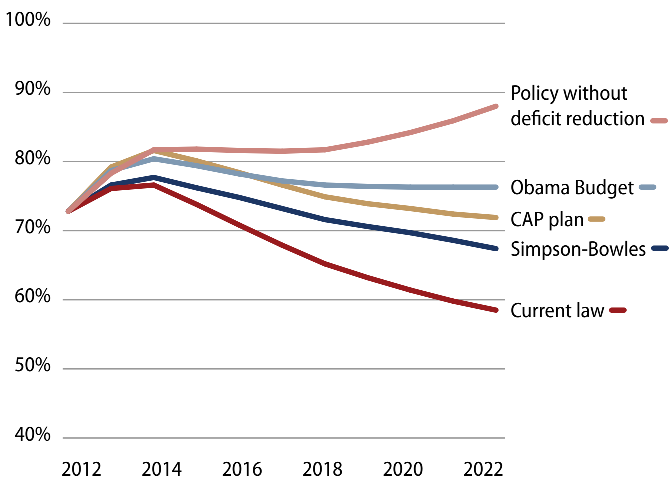
TABLE 2

Elements of CAP deficit plan

Revenue changes	
Tax reform	+ $1.9 trillion
Temporary job creation tax cuts	- $100 billion
Net new revenue	**+$1.8 trillion**
Spending changes	
Disc. spending cuts already enacted	- $1.5 trillion
Additional defense cuts	- $100 billion
Health savings	- $385 billion
Other mandatory cuts	- $100 billion
Job creation	+ $300 billion
Programmatic spending cuts	**- $1.8 trillion**
Interest savings	- $500 billion
Net spending cuts	**- $2.3 trillion**
Total deficit reduction	**$4.1 trillion**

FIGURE 4

Publicly held debt, as a share of GDP, 2012-2022



Note: "Policy without deficit reduction" is projections of federal spending under current policy prior to discretionary spending cuts enacted since fiscal year 2010.

Source: CBO, Moment of Truth Project, Center for American Progress calculations.

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Endnotes

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2 Ibid.

3 In *The Wealth of Nations* (1776), Smith wrote, "It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion."

4 See: Michael Greenstone and others, "A Dozen Economic Facts About Tax Reform" (Washington: Brookings Institution, 2012), available at http://www.brookings.edu/research/papers/2012/05/03-taxes-greenstone-looney-samuels. Incomes of the 1 percent declined sharply in the recession but have bounced back faster than all other groups.

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17 The large standard credit also helps replace personal exemptions under our plan.

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23 While our focus with this tax reform proposal has been the individual income tax, we do think the corporate income tax is ripe for reform as well. As noted, this reform should be revenue positive, though we are not proposing specific mechanisms for doing so. Many reasonable ideas have already been proposed including several proposals in the president's budget request, as well as his outline for more comprehensive reform. See: The White House and the Department of the Treasury, "The President's Framework for Business Tax Reform" (2012). Ideally, such a reform would involve both raising revenue and lowering the top corporate rate.

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