



# Budgeting for Growth and Prosperity

A Long-term Plan to Balance the Budget, Grow the Economy,  
and Strengthen the Middle Class

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Michael Ettlinger, Michael Linden, and Seth Hanlon May 2011



Center for American Progress



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The Peterson Foundation convened organizations with a variety of perspectives to develop plans addressing our nation's fiscal challenges. The American Enterprise Institute, Bipartisan Policy Center, Center for American Progress, Economic Policy Institute, The Heritage Foundation, and Roosevelt Institute Campus Network each received grants. All organizations had discretion and independence to develop their own goals and propose comprehensive solutions. The Peterson Foundation's involvement with this project does not represent endorsement of any plan. The final plans developed by all six organizations were presented as part of the Peterson Foundation's second annual Fiscal Summit in May 2011.



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# Introduction and summary

The purpose of the Center for American Progress plan for long-term deficit reduction is to build a strong American economy that provides the best opportunities for personal success of any country in the world, strengthens and builds a thriving middle class, and secures the position of the United States as the leading nation of the 21st century. To achieve these goals, federal budget deficits must be brought under control to keep credit markets strong and interest payments to foreign creditors low. But a balanced federal budget is far from all that is needed.

America must also invest in its economic future to achieve the economy we envision. Most of America's investments are made by businesses and individuals, but the federal government plays critical roles as a direct investor in areas such as education, basic science, technology, and infrastructure, and as a catalyst for private investment. Without it effectively playing these roles U.S. economic growth will be weak, America will no longer be the global leader it is today, and all Americans will lose.

Central to our strategy is investing in the middle class. The America we know was built by middle-class workers and consumers, innovators, and entrepreneurs. The fortunes of the Forbes 400 have their roots in the opportunities our country has offered those in the middle class. Policies that invest in the middle class are investments in a successful American economy.

The public sector's contribution to the economy we envision, however, goes beyond balanced budgets and investments. An economy must have a basic set of rules and protections that ensure trust and confidence in the marketplace. This role ranges from policing insider trading on Wall Street, to enforcing contracts, to ensuring that our food and medicine are safe. Certainly there is such a thing as too much regulation. But, as the recent financial market disaster painfully reminds us, there is also such thing as too little.

Our economic success also depends on the effective and efficient provision of the public services on which the nation relies. Finally, the tax system’s incentives and disincentives should enhance economic growth and address the growing inequality that undermines our national prosperity.

While the central motivation for the reforms we propose is the long-term success of the American economy, our plan also achieves several objectives motivated by

other values. There are national responsibilities that simply must be honored whatever their economic payoff, among them:

- National security
- Public safety and health
- Preventing destitution
- Honoring valued national commitments, including those to the elderly and disabled

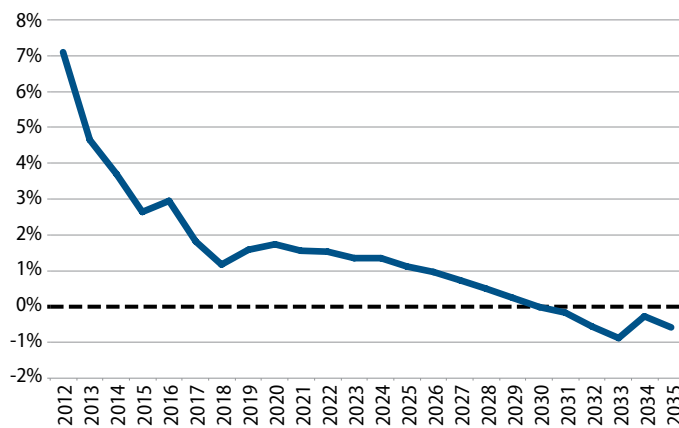
Achieving all of these objectives requires a numerical balancing, but it also requires an extremely challenging political balancing. The *honest* public debate over spending cuts and tax increases is in its infancy, with a long road ahead before there will be sufficient political space for the compromises that must be made in order to achieve a fully balanced federal budget. There is, at this point, no legislative path forward without broader agreement than is now possible. While some deficit reduction plans circulating in Washington appear to reach very low deficit levels quickly, the paths they offer are simply unrealistic. Our plan is designed with an eye on the political journey our nation will have to take and deliberately allows time for the building of a consensus for the major reforms that will be necessary.

We also must allow time for our economy to fully recover before administering the strongest deficit-slashing medicine. Deficit reduction that is too big, too fast would be

FIGURES 1 AND 2

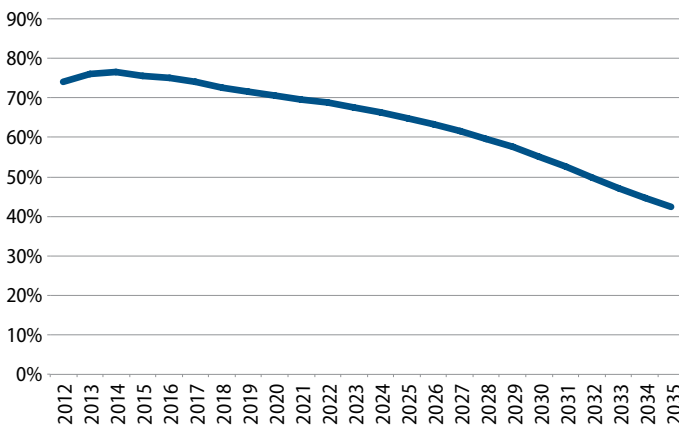
### Our path from deficit to surplus

Federal budget deficit, as percent of gross domestic product, from 2012 to 2035 under the Center for American Progress plan



### Shrinking the debt

Publicly held debt as a share of GDP, from 2012 to 2035, under the Center for American Progress plan



Source: Authors' calculations.



counterproductive—stalling growth and worsening our fiscal problems. Our most important national objective in the near term is to create jobs and get the economy back on track.

For these reasons our plan is implemented in two distinct stages. The first stage hits a meaningful, but achievable, interim budget target of “primary balance” in 2015—with revenues equal to spending except for interest payments on the debt. Starting in 2017 our plan enters a second phase aimed at achieving full balance while making needed investments.

Projections using nonpartisan Congressional Budget Office-based methodologies reviewed by independent analysts show our plan fully balancing the budget by 2030.<sup>1</sup> (see Figures 1 and 2) It is our belief that the economic growth gained in the early years through deficit reduction, investments, and other measures will, in fact, lead to a balanced budget earlier than that year. Outlined below are the spending and revenue policies we use to achieve our objectives.

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## Spending

The federal government makes investments that are important to our economy, provides services to the public, and carries out a variety of activities necessary to a well-functioning society. Our spending plan is designed to do those things well, do them efficiently, and do them at the appropriate level of public expenditure. The CAP spending plan:

- Makes significant new investments in key areas such as education, infrastructure, science, technology, and energy research, as well as areas that strengthen our middle class
- Reduces spending while making it more efficient, maintaining public services that businesses and the public rely on, and ensuring our national defense through a reconfigured national security budget
- Strengthens the social safety net where needed
- Brings under control the most substantial spending challenge facing the country: health care

The plan reduces spending from about 27 percent of gross domestic product in 2030 in the extended Congressional Budget Office baseline—the official, nonpartisan projection of our fiscal future—to under 24 percent of GDP. By 2035 spending is down to about 23 percent of GDP.

## Investing to promote economic growth and a strong middle class

Starting in 2017 the CAP plan makes significant new investments in scientific research, all levels of education, clean energy technologies, and transportation and infrastructure—areas where nations around the world are making substantial commitments. Our plan makes major investments in strengthening the American middle class. All of these investments are necessities if the United States wants to avoid being surpassed as the country with the greatest opportunities, the best jobs, and the most powerful economy. They are essential if we want our nation to continue to be where the great ideas and the most innovation comes from, and remain a nation where entrepreneurs thrive and build successful businesses, large and small.

Investments such as these are the foundation of a strong 21st century economy. The country that leads in basic scientific research obviously has a huge advantage in innovation and technology. The country that can rely on domestically produced renewable energy isn't exposed to the risks associated with relying on imports, keeps funds at home that would otherwise go abroad, and gets a leg up on what will be one of the most important industries of this century. And the country that invests in its middle class produces educated, productive, and creative workers; a strong domestic market; a motivated workforce; and a population from which the greatest innovators and entrepreneurs emerge.

The investments we make include a doubling of spending on science, technology research, and renewable energy; large boosts in K-12 education, pre-K, and Pell grants; and a 20 percent hike in transportation and infrastructure spending.

## Responsibly restraining discretionary spending

The CAP plan includes separate spending limits on a unified security budget and on nonsecurity discretionary spending. Our unified security budget includes the distinct budgets of defense, homeland security, and international affairs—the budget areas that comprise the means by which we implement our national security policy.

Beginning in 2016, we set the limit on the unified security budget at about \$700 billion. This is approximately the same overall level, adjusted for inflation, as it was in 1986 at the height of the Cold War. From there, the cap rises at the rate of inflation plus 1 percentage point.

Our limits on nonsecurity discretionary spending are set at specific levels designed to adequately fund the public services on which the public and businesses rely, assum-

ing they are provided more efficiently than in the past, and to make the investments described above. Overall, discretionary spending will make up about 6 percent of GDP in 2035, compared to 6.2 percent of GDP in the CBO baseline.

### Shifting nonhealth mandatory spending

The CAP plan reduces agricultural subsidies and constrains the growth in many other programs while allowing room for investments and patching holes in the social safety net. The safety-net steps include increasing participation in the Supplemental Nutrition Assistance Program to 85 percent of eligible people, increasing the Supplemental Security Income benefit, increasing housing assistance by 20 percent, and boosting funding for children's programs.

These steps plus our investments in education will reduce the poverty rate to below 7 percent from its current level of over 14 percent. Preventing destitution is a moral obligation but pulling people off the economic sidelines into the mainstream serves national economic goals as well.

CAP has previously released a Social Security plan in our report, "Building It Up, Not Tearing It Down: A Progressive Approach to Strengthening Social Security," which has a number of benefit adjustments that net to a reduction in outlays in 2030 from 6.0 percent of GDP to 5.8 percent.<sup>2</sup>

### Containing health care cost growth

Rising costs and an aging population make health care a major driver of our long-term deficits. Therefore, a key challenge in any deficit reduction plan is to lower these costs without sacrificing care for the millions of Americans who rely on public programs. Any approach that relies solely on savings from Medicare and other public programs without addressing rising health care costs economywide will only shift costs onto individuals and families, hurt the quality of care, or both. Co-pays will go up while providers leave the programs or make up lost revenue by raising private market rates on businesses and families.

To avoid that outcome, our plan brings down the costs of health care for everyone, not just those of the federal government. In this effort the Affordable Care Act, passed last year, is our most valuable tool. The new health care law has dozens of mechanisms, reforms, and pilot programs designed to bring down the costs of care, while

improving the quality. The law also encourages the private sector to follow the public sector's lead, and incentivizes public-private partnerships that bring down costs broadly. Backstopping all of this is the Independent Payment Advisory Board, whose mission it is to ensure that target savings are realized.

In our plan, aggressive implementation of the new health reform law, along with some enhancements to its existing cost-control mechanisms, will result in dramatically lower health expenditures, both for the federal government and overall. But predicting the exact effect of the myriad test programs and reforms in the new health law is fraught with uncertainty. Thus we also include a failsafe mechanism that would ensure significant savings.

Our failsafe would be triggered if, starting in 2020, total economywide health care expenditures grow at a rate faster than the economy. Should that happen then we would empower the Independent Payment Advisory Board to extend successful reforms in Medicare and other public programs to insurance plans offered in the health care exchanges and then potentially to all health care plans, such that the target is met. This will ensure that costs are constrained across the health care sector, preventing cost-shifting and maintaining access for all.

The effect of these reforms, along with our failsafe, will be to hold federal health spending to 7.8 percent of GDP in 2035, compared to 9.8 percent in the CBO baseline. As importantly, they will lower the overall cost of health care thus ensuring that reductions in Medicare do not result in providers leaving the program and costs aren't shifted from the public to the private sector.

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## Revenue

In the spending part of our plan we have constrained the areas of greatest growth, cut unneeded spending, and increased spending that is necessary to the future of our economy. Overall, our plan cuts spending by more than \$13 trillion below current projections over the next 25 years. But even after all our spending cuts, without some revenue enhancement, there would still be more spending than revenue. Compared to the CBO baseline we would still have a average deficit of 3.0 percent of GDP between 2017 and 2030.

When the economy is running well and we are at peace, running deficits unnecessarily weakens our nation. Thus, our plan raises additional revenue to balance the budget. It does so, however, in a way that simplifies a grotesquely complicated tax system. Our plan closes loopholes, eliminates special tax breaks that create unfair disparities among taxpayers, realigns the incentives of the tax system to better serve our econ-

omy and planet, cuts income taxes for middle-income taxpayers, and takes steps to address the inequality that undermines our national prosperity.

## Individual income tax

Our plan makes the individual income tax simpler and fairer. It introduces a flat 15 percent rate for couples with incomes under \$100,000.<sup>3</sup> Many loopholes, deductions, and exemptions are eliminated, but the ones middle-class families most rely on are replaced by better-targeted credits. Thus, while taxpayers will no longer have the option of “deductions” from income such as for mortgage interest and charitable contributions, they will be able to instead receive a direct reduction in their taxes through a credit equal to 15 percent of these costs.

In addition, there will be a large flat “alternative credit” that taxpayers can choose instead of the itemized credits. This alternative credit works similarly to the current standard deduction. For 90 percent of Americans, choosing the alternative credit instead of the itemized credits will both lower their overall tax bill, and make filing simple and easy.

Most middle-class and lower-income taxpayers will pay lower income taxes under our proposal. These tax reductions will, on average, more than offset any higher taxes resulting from our new energy taxes described below. Tax rates are lower at most levels of taxable income. Overall, factoring in all the changes to the personal income tax in our plan, only those in the top 5 percent of the income spectrum will, on average, pay higher taxes. All other income groups, on average, will pay less or the same.

For the wealthy, loopholes are closed and the top tax rate is restored to the level it was at under President Clinton during the 1990s economic expansion. A temporary surtax of 5 percent is added for ordinary income over \$1 million. The surtax expires once the federal budget is balanced. The top rate will still be lower than during most of the postwar period, including the country’s greatest period of economic growth. The top tax rate for capital gains income (income from selling investments) is set at the level signed into law by President Reagan. The reforms make taxes simpler for the rich as well as the middle class by obviating the need for the alternative minimum tax and various high-income phase-outs.

After years of successive tax cuts and rapidly increasing income (even as the income of typical Americans has stagnated or fallen) the wealthiest Americans can afford to pay more. Under our plan, the average *after-tax* income of the richest 1 percent of Americans will *still* be over 40 percent *higher* than it was in 2001. The richest 5 percent will still have over 30 percent higher income.

Finally, once our plan achieves budget surpluses in excess of 1 percent of GDP, the alternative credit is raised substantially to simplify tax filing for still more people and further reduce middle-income taxpayers' tax bills—while maintaining a federal budget in balance or small surplus. This is projected to occur in 2033.

### Reducing greenhouse gas emissions and reliance on foreign oil by pricing carbon pollution and levying an oil-import fee

Our plan addresses the risks and economic damage from our heavy reliance on foreign oil and the dangers of climate change by establishing a price on emissions of carbon dioxide and other greenhouse gases, and introducing an oil-import fee of \$5 per barrel. Under our plan, greenhouse gas emissions will be reduced by 42 percent of 2005 levels by 2030, and 83 percent of 2005 levels by 2050. For low- and middle-income taxpayers, any resulting rises in energy prices are offset by the benefits of reduced income taxes. And, in the case of those who do not owe personal income tax, often the elderly, a rebate program accounted for in our spending proposals provides an offset.

### Financial transactions tax

Our plan imposes a modest fee on financial transactions, including trading in stocks, bonds, and derivatives. The tax is applied at a very low rate—less than two-tenths of a percent on stock trades. We believe the purpose of Wall Street is to raise capital for the productive sectors of the economy and that excessive financial speculation is counterproductive toward this purpose and harmful to stable growth in general. A financial transactions tax discourages unnecessary rapid turnaround speculation and improves incentives for long-term investment while raising revenue. Our proposal is modest compared to financial transactions taxes imposed in other financial centers, including the United Kingdom and Singapore.

### Other revenue reforms

There are a number of other tax changes in the CAP plan. Among them:

- Remove the cap on the employer side of the payroll tax as described in the CAP Social Security plan. Currently the payroll tax to fund Social Security is only applied to earned income up to \$106,800. Our proposal removes that cap but only on the part of the Social Security tax paid by the employer not the part paid by the employee.

- Restore the estate tax to approximately pre-Bush tax-cut levels, but indexed for inflation.
- Adopt several revenue proposals in President Obama’s 2011 and 2012 budgets.
- Eliminate some industry-specific tax expenditures that are effectively government spending administered through the tax system, including those for the oil industry.
- Other revenue measures including an Internet gambling tax and Superfund excise tax.

Overall, our plan raises revenues in 2030 by less than 2 percent of GDP compared to the baseline. Total revenue drops to 23.8 percent of GDP by 2035, just half a percentage point above the baseline.

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## Conclusion

The plan described in this report will boost the economy and meet societal obligations while balancing the budget. It is also a realistic plan. That isn’t to say that it could pass Congress and be signed by a president today. No effective plan for long-term fiscal responsibility could at this point in the debate. That should not give us too much worry. There are many steps we can make now toward a responsible fiscal future with a strong economy and a healthy society. We have offered recommendations for such steps in other reports. Our goal in producing this vision for the long term is to offer a final destination that ensures our nation is as successful as it has ever been while fulfilling all of its responsibilities.

We believe our plan is not only a good one but also one that is not far off from where the country will go. In the end, the country will neither tolerate extreme spending cuts nor the most of dramatic tax increases. In the end, the country will seek a balance—and that is what we offer here—a combination of spending and revenue reforms to see our way to a balanced budget by 2030 and beyond.

In the pages that follow we will present in greater detail the spending and revenue reforms we outlined in this introduction and summary. As we’ll demonstrate, our plan is a fair, effective, and efficient way to restore our federal budget to balance by 2030 while ensuring our nation remains the most competitive, innovative, and prosperous in the world.

# The CAP plan for federal spending, 2012-2035

The plan reduces spending from about 27 percent of gross domestic product in 2030 according to the extended Congressional Budget Office baseline—the official, nonpartisan projection of our fiscal future—to under 24 percent of GDP. By 2035 spending is down to about 23 percent of GDP.



# Spending

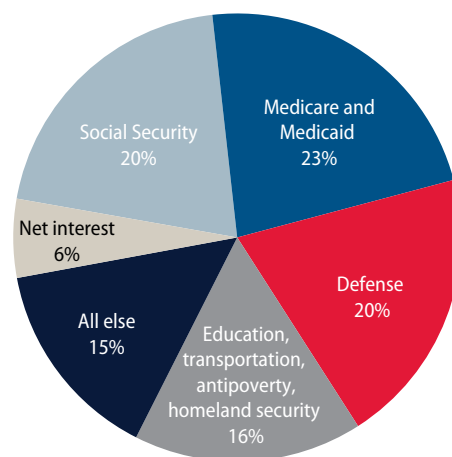
The federal government makes investments that are important to our economy, provides services to the public, and carries out a variety of activities necessary to a well-functioning society. Our plan reduces government spending substantially relative to Congressional Budget Office projections, and puts a balanced budget within reach, but it does so without sacrificing the important role the federal government plays.

There is no simple way to cut spending. Too much of government spending is necessary and, in fact, widely supported by the public. While some claim that the public strongly favors major cuts in spending—using that claim as the basis for taking a meat cleaver to the federal budget—the public’s views on public spending are much more nuanced than acknowledged. The vast majority of government spending is actually extremely popular.

Twenty percent of all federal spending goes to Social Security, a program that enjoys the support of more than 87 percent of the population.<sup>4</sup> Medicare and Medicaid are the next largest programs, together constituting 23 percent of the budget. Seventy-eight percent of Americans oppose cuts to Medicare, and 69 percent oppose cutting Medicaid.<sup>5</sup> Defense spending is next on the list—and 56 percent of Americans said they didn’t want to cut that.<sup>6</sup> That’s nearly two-thirds of the budget already. Add to that education, transportation, homeland security, and antipov-erty efforts, all areas in which a majority of Americans oppose cuts, and there’s simply not much left that the American public doesn’t support.<sup>7</sup> (see Figure 3)

There is no popular mandate for drastic spending cuts, but that does not mean there is widespread satisfaction with the way government uses taxpayer dollars. Getting the most out of our government and spending every dollar of taxpayers’ money

**FIGURE 3**  
**Our federal government’s spending in 2010**



Source: Office of Management and Budget.

efficiently should be the absolute top priority for anyone who believes that government plays an important role in building a better, stronger nation. The truth is the federal government is capable of performing brilliantly, but it is also capable of performing abysmally; it can be guilty of “throwing dollars at problems,” and it can also be thoughtful, efficient, and successful. The government is capable of usurping roles best left to the private sector, but it can also hand off to the private-sector functions that should remain public. Faced with limited resources, it is imperative that government get it right.

In short, there is much that we need for the federal government to do, there is much the public wants government to do, and we cannot shortchange those functions. To be successful, to have the economy and society we want, we need to have a government that chooses its priorities well and makes the best possible use of the resources at its disposal.

In pursuit of this objective the Center for American Progress plan focuses on the following in bringing change to how the federal government spends its resources:

- **Increasing investment that is essential for economic success.** Other countries are ramping up their public investments and gaining on the United States in education, scientific progress, technology, and other critical areas. We must increase our investments to maintain our leadership and sustain strong economic growth.
- **Securing a strong middle class to drive American prosperity.** The America we know was built by middle-class workers, innovators, entrepreneurs, and consumers. Policies that support the middle class support a successful American economy.
- **Bringing overall federal spending to levels consistent with a balanced budget.** Outside of periods of economic weakness or other national emergency the federal government should not run deficits. Areas of unsustainable spending growth, such as health care, must be brought under control.
- **Creating a more efficient federal government.** We must transform government to make more efficient use of the resources it draws from the economy.
- **Meeting public obligations.** There are some national responsibilities that simply must be honored whatever their economic payoff: national security, public safety and health, preventing destitution, and honoring our commitments: including those to the elderly and disabled.

- **Bringing workers into the economic mainstream.** Fighting poverty is good for the economy. Bringing people off the economic sidelines and into the mainstream of American economic life benefits all of us.
- **Creating jobs and strengthening the economic recovery.** Implementing overly aggressive deficit reduction before the economy fully recovers would be counterproductive—stalling growth and worsening our fiscal problems.

Our plan will:

- Invest in education, transportation and infrastructure, science and technology, energy, and foundations for a strong middle class
- Aggressively pursue reforms in health care, both public and private
- Enhance the social safety net
- Establish a unified security budget, better designed to meet our 21st century security needs
- Modernize Social Security, and ensure its long-term solvency
- Seek out efficiencies all across government, cutting and reforming programs that don't work as well as they should

Overall, our plan brings spending, as a share of GDP, down from its current, recession-driven level of about 25 percent to just under 22.5 percent by 2015. From there, spending begins to rise slowly again, as the retiring Baby Boom generation naturally pushes up spending in Social Security and Medicare, and as our plan begins to make new investments in economic development.

But due to cuts we propose in other areas and additional savings in the health care arena, spending rises much more slowly than under current projections. By 2025, spending in our plan peaks at 24.1 percent of GDP, compared to 25.5 percent in the Congressional Budget Office baseline in that year. After 2025, spending begins to drop again, as declining interest payments resulting from earlier deficit reduction begin to have a major effect.

By 2035, federal spending will be 23.2 percent of GDP, a full 5 percentage points below CBO projections. All told, from 2012 to 2035, our plan cuts more than \$13.5 trillion in spending compared to the baseline.

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## Primary budget balance by 2015, major reforms thereafter

The timing of deficit reduction matters. In the short term, our nation's most pressing concern is job creation and continued economic recovery. Therefore deficit reduction must be designed with that in mind. Secondly, achieving a balanced budget is going to require major, comprehensive reforms and it is going to take time before a consensus is reached on those reforms. There is a political journey our nation must travel first.

With these principles in mind, our plan hits an intermediate target of primary balance in 2015, and starts a second phase of deficit reduction in 2017 aimed at achieving a fully balanced federal budget. Thus, our plan doesn't choke off economic recovery, and it allows time to build support for the types of changes that are needed to achieve full balance.

Our 2015 plan includes spending cuts to the Department of Defense and to agriculture subsidies as well as smaller reductions in a number of other mandatory programs and to nondefense discretionary programs, with some adjustments in mandatory health care programs. This plan is detailed in our report "The First Step: A Progressive Plan for Meaningful Deficit Reduction by 2015."<sup>8</sup> In the sections below we describe our spending proposals that carry forward these changes and expand on them, mostly starting in 2017.

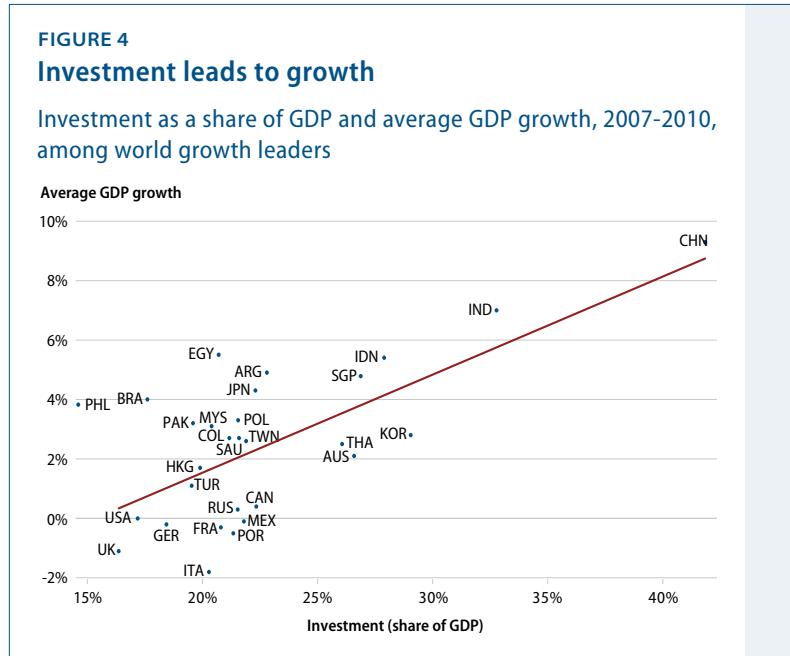
# Investing to promote economic growth

There are many things that can be done to promote economic growth and strengthen the middle class, but among the most important is public investment. There is broad consensus that overall investment levels are a key driver of future economic growth and prosperity. Center for American Progress economists Adam Hersh and Christian Weller, for example, recently demonstrated the “clear causal relationship” between investment and higher productivity.<sup>9</sup> And high productivity growth is essential to higher standards of living.<sup>10</sup>

It’s no wonder then that countries with greater investments in both physical and human capital tend to have higher income levels.<sup>11</sup> (see Figure 4) Unfortunately, overall U.S. net investment is currently at its lowest levels since World War II.<sup>12</sup>

Certainly the lion’s share of investment comes from the private sector, but public investment plays an important role as well.<sup>13</sup> There are some areas where, if left to itself, the private market would vastly underinvest, making us all worse off. Some investments, for example, can be thought of as “public goods” that are important to the economy but from which no profit can be gained because the benefits are such that no one can be excluded from them, and one person enjoying those benefits does not preclude others from doing the same. For instance, national defense, fire departments, flood control, and transportation safety are public goods.

The private market will chronically underinvest in public goods, because there is no easy way to make consumers pay for the benefits they derive. We rely on the government to invest in them because no one else would.



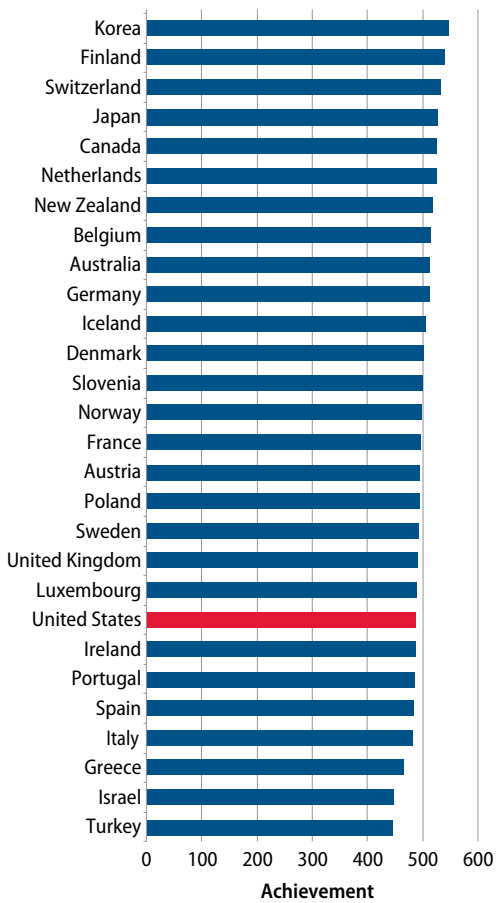
Source: Adam Hersh and Sarah Ayres, “Investment Alternatives: Comparing What Budget Plans Mean for Our Economic Future,” Center for American Progress, February 25, 2011, available at [http://www.americanprogress.org/issues/2011/02/investment\\_alternatives.html](http://www.americanprogress.org/issues/2011/02/investment_alternatives.html)

Public money is also crucial to support investments that create what economists call “positive externalities.” A positive externality results when a particular investment confers benefits on the broader community as well as the person who paid for it. Investment in education is a good example. Getting a quality education is good for the student, of course, but having an educated population is also good for businesses, and for civic society.

In short, the better our school system is, the better off we all are—even if we are no longer in school ourselves. Because of this “positive externality” the private market would undervalue education, and therefore provide less of it than we’d ideally want. That’s where public investment comes in.

**FIGURE 5**  
**Numerically challenged**

Student performance, among 15-year-olds, in mathematics in 2009 compared to other developed nations in the Organisation of Economic Co-operation and Development



Source: Organisation for Economic Co-Operation and Development.

Finally, it’s worth noting that in some areas public investment can actually induce the private sector to increase its own investments. A 2003 study of 17 economically developed countries, for example, found that for every dollar of public investment in research and development, private firms were induced to spend about 70 cents of their own money as the government investments opened up opportunities.<sup>14</sup> Privately funded research, in turn, drives innovation and has spillover benefits throughout the economy.

Basic science and technology research, infrastructure, education, energy—these are the kinds of areas where public investment is absolutely critical and can pay dramatic dividends.

### Science and technology

Public investment in research and development is a key driver in technological innovation and productivity growth. An assessment of the Group of 7 leading developed economies between 1971 and 1990 showed that for every \$1 of R&D investment, GDP increased by \$1.23.<sup>15</sup> Similarly, one study published in the *American Economic Review* in 2002 estimates that nearly 50 percent of U.S. economic growth between 1950 and 1993 could be attributed to the impact of investment in research and development.<sup>16</sup> Clearly, the country that wants to grow will invest heavily in scientific research.

Which is what the United States once did. But U.S. investment in basic science is down across the board. Since the 1960s, federal support for basic science has been shrinking.<sup>17</sup> Corporate investment in this area has been falling, too.<sup>18</sup> At the same time, other countries are increasing their commitments. As a result the United States has fallen to 22nd among the developed country member nations of the Organisation of Economic Co-operation and Development in total investment in nondefense research and development, as a share of the economy.<sup>19</sup>

Under our plan, investment in R&D would no longer take a back seat. We double, in real terms, the federal investment in basic science and technology research.

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## Education

Few would deny the benefits of a highly educated, highly skilled workforce. Both common sense and a deep body of research lead us to the inescapable conclusion that a quality education system yields enormous dividends while weaknesses in our system result in enormous losses. One recent report found that if schools in states with lower-than-average performance were brought up just to the national average, the economy would enjoy a \$700 billion boost.<sup>20</sup>

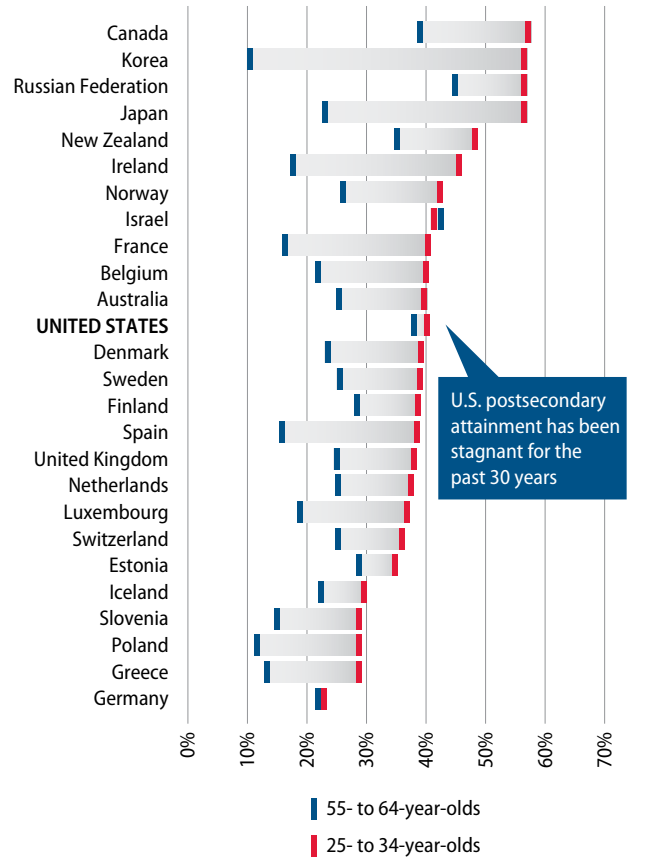
Sadly, we know that America's school system is falling behind. There are any number of statistics one could cite to show how dramatic the needs are. Suffice it to say that one estimate put the economic cost of the gap between U.S. educational achievement and international achievement at anywhere between \$1.3 trillion and \$2.3 trillion a year.<sup>21</sup> Without a quality education system, the United States cannot hope to compete in the 21st century. (see Figure 5)

Our plan addresses this need in three ways. First, we double federal funding for pre-kindergarten. Research consistently shows that investments in early education yield great returns. The HighScope Perry Preschool study documented a return to society of more than \$16 for every tax dollar invested in early childcare and development. At age 40, children who participated in this high-quality preschool program had higher earnings, were more likely to hold a job, had committed fewer crimes, and were more likely to have graduated from high school.<sup>22</sup>

Second, over the span of 20 years, we gradually increase the federal contribution to total K through 12th grade funding from about 6.5 percent in 2007 to about 12 percent by 2035. Overall, our plan would increase total spending on

**FIGURE 6**  
**Postsecondary achievement in the United States is stagnant**

Percentage, by age group, who have attained a postsecondary education among developed countries



Source: Organisation for Economic Co-operation and Development (OECD) Education at a Glance 2009: OECD Indicators, September 2009

education—federal, state, and local—by about 5.5 percent. Though state and local governments are the primary source of funding for K through 12th grade education, the federal government plays an important role in helping to alleviate inequities in the provision of educational resources within districts, between districts, and between states. Despite current federal investment via programs targeted at resolving these inequities, such as Title I of the Elementary and Secondary Education Act, they still persist.

This same K through 12 funding increase also is critical to close achievement gaps between groups of students defined by race and ethnicity and family income. As our population continues to become more diverse and as income inequality continues to increase, the federal government needs to play a larger role in funding schools so that all children have the resources they need to achieve high standards. In addition, federal spending can play a critical role in encouraging local school districts to adopt best practices for improving the quality of education.

Third, we boost federal Pell grants and other higher education grants by about one quarter. Currently, less than 40 percent of American adults have some level of postsecondary education, and yet, by 2018, more than 60 percent of all jobs in the United States will require at least some college education.

Worse, the percentage of American adults with a postsecondary education has been flat while most other developed countries have enjoyed large gains. (see Figure 6) To meet the demands of the labor market and keep America competitive in the global economy, we need to ensure that more people pursue postsecondary education—and that more people finish.

Our increased investment in higher education recognizes that any significant change in postsecondary attainment will require more participation by low-income, first-generation students as well as the development of innovative



approaches to delivering flexible, cost-effective education services. We estimate that our proposed increase will be sufficient to achieve the goal of 60 percent of American adults with some level of postsecondary education.

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## Energy

If the United States is still relying nearly exclusively on fossil fuels by the middle of this century then we will have lost the clean energy race and ceded leadership to other countries. What's worse, if we fail to invest in alternative and renewable energy we will—as the world's second-largest producer of the greenhouses gases that lead to global warming—also be seriously fouling our planet. The good news, however, is that we can avoid that fate by investing now in clean energy. These investments will ensure we are competitive in these technologies and are starting to create new jobs. In fact, dollars invested in energy efficiency and renewable energy technologies result in between two and a half times and four times as many jobs as dollars spent in the oil and gas industry.<sup>23</sup>

Of course, if we want those jobs and if we want to compete with other countries, we have some catching up to do. Right now, the United States ranks 11th among the Group of 20 leading developed and developing countries in “clean energy investment intensity,” measured as clean energy investments per unit of GDP.<sup>24</sup>

Besides the clear economic and environmental benefits, there are several other compelling reasons to invest in clean energy. National security, for one. You would be hard pressed to find anyone who thinks it is a good idea to rely on foreign countries, some of whom are unstable, while others are outright hostile, for our energy needs. And economic security for another. The United States imports huge amounts of foreign oil every year, which greatly contributes to our trade deficit and drains dollars out of the U.S. economy. Becoming a leader in renewable and alternative energy technologies could reverse that flow.

The Center for American Progress plan includes a real doubling of federal investments in clean energy technology research and deployment. These investments will transform America's energy mix, resulting in a clean energy portfolio that will help prevent the most catastrophic impacts of climate change. They will also make the United States a global leader in new, clean energy technologies.

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## Transportation and infrastructure

A robust, efficient, modern transportation network is crucial. Without it the movement of goods and services across the country is significantly harder, raising costs for consumers and cutting into businesses' profit margins. No wonder, then, that the Congressional Budget Office reports that investments in infrastructure are one of the best ways to promote long-term economic and employment growth.<sup>25</sup> But the benefits from investments in transportation and infrastructure go beyond a boost to overall growth—these investments also result in solid, middle-class jobs.<sup>26</sup>

Despite the clear advantages of modern, well-maintained infrastructure, the United States has chronically underinvested in this area for decades. Since the beginning of the Reagan administration, the federal contribution to infrastructure investment as a share of the economy has been declining, and is now close to half what it was in 1980. And the private sector has not filled the gap with overall investment in infrastructure, public and private combined, on the decline.<sup>27</sup> The upshot: The United States in 2009 ranked 23rd in a World

Economic Forum ranking of global infrastructure quality, down from 7th in 1999.<sup>28</sup>

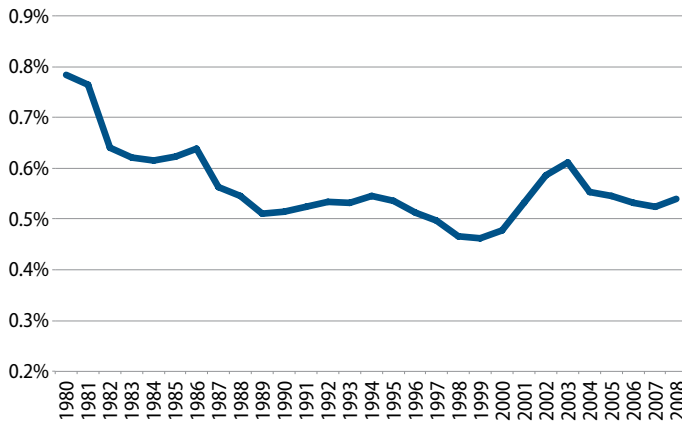
The consequences are readily apparent across our landscape. The Federal Highway Administration reports that approximately 147,000 of the 605,000 bridges in America are failing,<sup>29</sup> and 18 percent of our roadways are deemed in poor condition.<sup>30</sup>

To reverse these trends, our plan includes a 20 percent increase to the level of gross federal investment in transportation and infrastructure, adjusted for inflation, with the objective of fully meeting the projected capacity demands for modern, efficient infrastructure systems.

**FIGURE 7**

### Federal funding for transportation is going downhill

Federal spending on transportation, as a share of GDP, 1980-2008



Source: Office of Management and Budget.

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## Investments in the middle class

Our investment strategy extends to investments in people: the people that comprise the vast American middle class and those who aspire to join it. One of the great advantages our nation has possessed in global economic competition has been the strength of our middle class.

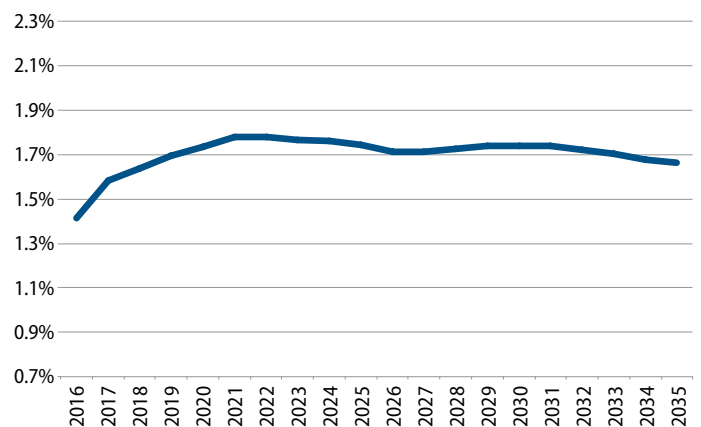
That strength has given a mass of Americans the freedom to become educated workers who have the training to be highly productive and creative. It has meant a body of consumers with the collective buying power to set worldwide trends, benefiting the businesses that best know American tastes and the American market. These consumers have also formed the backbone of sustenance to American industry producing for the American market—a stability in consumption that in turn has prompted massive private investment.

A strong middle class has also meant a group of people with the security to take risks—entrepreneurs and innovators who can risk leaving their jobs to start a company or pursue an invention, having built a modest foundation of middle-class wealth to make the leap of faith that time and again has transformed our economy. The opportunity of succeeding in the middle class—to build a business, to get promoted, to have a better life—has motivated Americans since our founding. Opportunity comes from a strong economy, but a strong economy also comes from motivated workers seeking the bounty that opportunity offers.

Investing in the middle class is important for another reason: The middle class invests in America. Middle-class people don't short-change their children's education. They don't move jobs overseas. And they don't invest the nation's wealth in foolish doomed financial instruments or engage in elaborate tax evasion schemes. What's more, research the world over demonstrates that countries with strong middle classes are countries that make the types of investments we propose in our plan—because people in the middle class know that their fate is tied to the fate of their nation.

**FIGURE 8**  
**Investing in growth and prosperity**

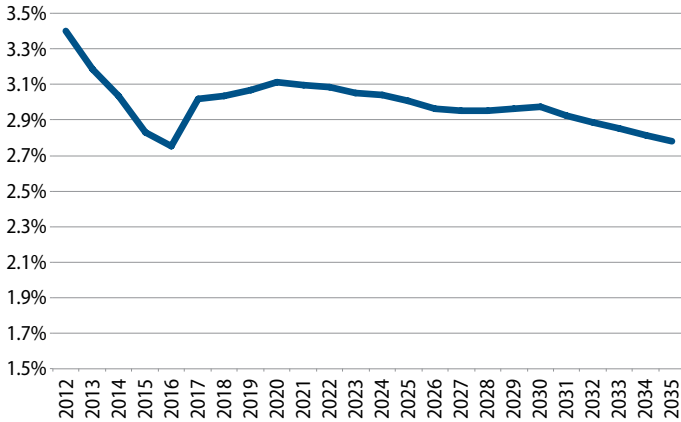
Federal spending on critical investments—education, transportation, energy, science—under CAP plan, as a share of GDP, 2016-2035



Source: Authors' calculations based on CBO methodology.

**FIGURE 9**  
**Controlling nonsecurity discretionary spending**

Total nonsecurity discretionary spending, as a share of GDP, under CAP plan, 2012-2035



Source: Authors' calculations based on CBO methodology.

But, more and more, the deck is being stacked against the middle class and the opportunities to rise into the middle class are becoming fewer. Our plan works to restore the balance. Many of the investments described above will help restore middle-class opportunity. Education is the obvious example, but the middle class also benefits from the jobs and opportunities made available from a variety of investments, and benefits the most from having scientific advancements and innovation happen here in the United States.

Furthermore, Medicare, Social Security, unemployment compensation, and other social insurance, as well as health and public safety programs, are part of a body of public protections that enable middle-class families

to live their lives with an eye on what it will take for them to succeed instead of a constant worry about what dangers lie ahead in their path.

Yet, these are precisely the types of investments and services that have come under assault recently. We believe that, instead, the precise opposite course is best for the country, the economy, and all Americans.

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### The bottom line on investments and nonsecurity discretionary spending

Nearly all of these investments, with the exception of social insurance programs, fall into the category of spending in the federal budget called “nonsecurity discretionary.”<sup>31</sup> In addition to these investments, this category contains almost all the basic domestic functions of the federal government, such as patents, regulatory agencies, and veterans’ services.

All together, nonsecurity discretionary spending in our plan would rise from about 2.8 percent of GDP in 2016—before our major new investments begin—to about 3 percent of GDP in 2017. From there, nonsecurity discretionary spending would peak at 3.1 percent of GDP in 2020, and slowly decline until 2035, at which point it will be down to the same level where it began in 2016. (see Figure 9)

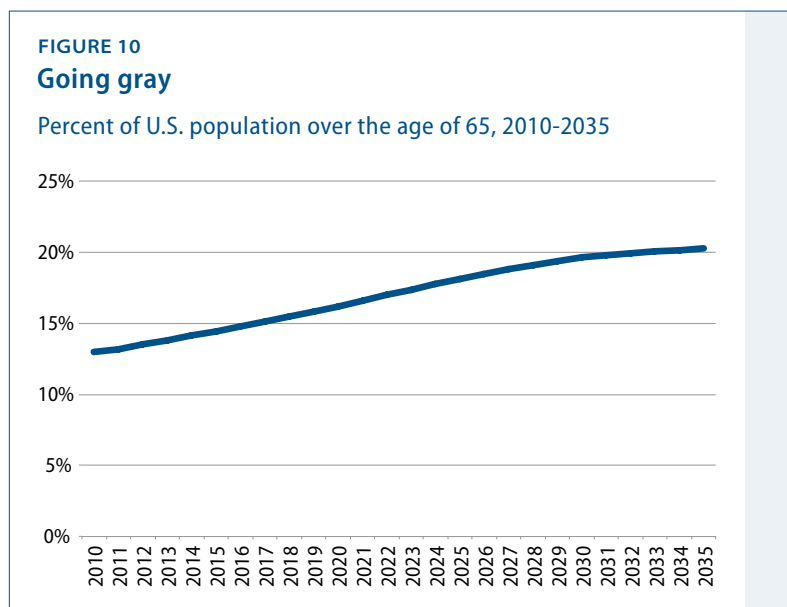
# Containing the growth of health care costs

Federal government spending on health care is a major contributor to our nation's long-term budget deficits. The Congressional Budget Office projects that total federal spending on health care will rise from 5.6 percent of GDP in 2010 to just under 10 percent of GDP by 2035, an increase of nearly 4.5 percentage points. All other federal noninterest spending is actually projected to decline slightly over that same time period. One reason for the projected increase in federal health care spending is simple demographics: Our population is getting older. (see Figure 10)

Blame it on the Baby Boomers. This year about 13 percent of the population is 65 years old or over, but by 2030 that percentage is expected to rise to nearly 20 percent. Of course, the aging of the population puts enormous pressure on programs designed to serve older Americans, such as Medicare and Medicaid.

Medicare, our national health program for senior citizens, is effective, efficient, and popular. Because of Medicare, nearly every single American over the age of 65 is guaranteed health coverage, and public opinion polls consistently show that the American people want to protect it. And despite the fact that the Medicare population, by its nature, costs more to care for than younger, healthier people, cost growth in the public program is nevertheless far lower than in the private sector.<sup>32</sup>

Medicaid, though often thought of as a health program for the poor, will also feel the effects of an aging population. This is because Medicaid is the nation's safety net supporting long-term care. Although older people account for only one-tenth of Medicaid enrollees, they



Source: Social Security Trustees.

account for one-quarter of Medicaid spending. One-third of Medicaid dollars are spent on long-term care for the elderly and disabled. Furthermore, Medicaid pays for about half of all nursing home care. Nearly all nursing home residents are elderly, and many, if not most, of the beneficiaries of this care lived their whole lives in the middle class. Long-term care is, however, expensive, which means many elderly will deplete their own assets and end up relying on Medicaid.

But the aging of our population is only part of the story. In fact, the larger reason for the rising cost of public health programs is that health care costs are on the rise generally—in both the private and public sectors. The United States has the most expensive health care in the world. According to the Kaiser Family Foundation, we spend nearly twice as much on health care, per capita, as the average developed country.<sup>33</sup> (see Figure 11)

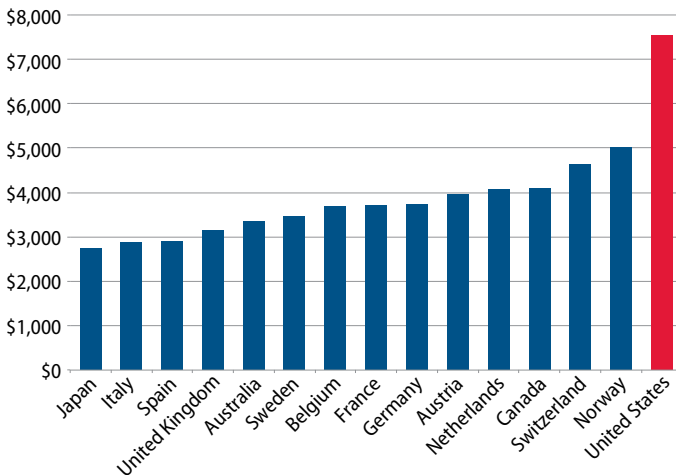
The best of American health care is, arguably, the best in the world, yet spending more than anyone else does not result in overall better health outcomes in the United States. In fact, our national health is no better than many other developed countries, and by some measures is actually worse. Two telling examples: The

United States has below-average life expectancy and above-average infant mortality rates.<sup>34</sup>

Given that health care in the United States is expensive for everyone, it is not surprising that it's expensive for our government, too. This makes addressing government health care costs complicated. This isn't a matter of simply redesigning a federal spending program to be more efficient or stopping out-of-control expansion. Any serious solution has to address the growth of costs in the private sector as well. Otherwise, the consequences for those who rely on public programs would be devastating. Why? Because if spending on those public programs is limited while private-sector costs continue to balloon, some combination of three things will happen:

**FIGURE 11**  
**Big spender**

The United States ranked first among developed nations in combined public and private health care spending, 2008



Source: Kaiser Family Foundation.

1. Out-of-pocket costs for the elderly will grow. That is, the difference between what the public insurance programs pay and what the services cost will widen, leaving the elderly, most of whom are on fixed incomes, facing enormous financial strains.
2. Access to care and the quality of that care will decline. Better doctors and hospitals will cater to the higher-paying private market and avoid treating those who receive their coverage from the public sector—namely the elderly, disabled, and poor.
3. Costs will shift from the public to the private sector. As doctors and hospitals get squeezed by government program cuts they'll raise prices for everyone else.

None of these options is particularly attractive.

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## Our approach—lower costs for everyone, not just in the public programs

To avoid any of these outcomes while simultaneously holding down federal spending on public health programs, our plan is focused on efforts to bring down the costs of health care for everyone, not just those of the federal government. This approach has benefits not just for the federal bottom line but also for the nation's businesses and families who every year bear the burden of rising health costs.

In this effort, the recently passed Affordable Care Act is our most valuable tool. The new health law contains dozens of mechanisms, reforms, and pilot programs designed to bring down the costs of health care while improving the quality of that care. The law also encourages the private sector to follow the public sector's lead, and explicitly encourages public-private partnerships that successfully bring down costs broadly.

Backstopping all of this is the newly created Independent Payment Advisory Board, whose mission is to ensure that target savings are realized. The IPAB will offer binding changes to Medicare if spending, per beneficiary, grows faster than expected. Congress can overrule the IPAB, but if it does nothing the reforms are automatically implemented.

The Congressional Budget Office projects that the Affordable Care Act will reduce the federal budget deficit by \$230 billion over the next 10 years, and we are confident that aggressive implementation of the law can yield even more

savings. But there are some particular enhancements and policy changes that could be made in the near term to both strengthen the new health law and immediately reduce costs further.

First, the Affordable Care Act currently exempts certain health care providers—most significantly hospitals—from any actions taken by the IPAB. Extending the new board’s authority to all health care providers would ensure that all sectors achieve the efficiencies that are at the heart of effective cost containment.

Second, adding a public health insurance option to the new health care exchanges that will be up and running in 2014 would create competition in insurance markets, serve as a model for payment innovation, and put pressure on private plans to bring their costs down. Consumers purchasing health insurance in the health care exchanges could buy into a public option if they choose, or opt for private health insurance plans. Payment rates by the public health insurance plan to health care providers will not be tied to Medicare’s payment rates in our plan, making it a so-called “weak” public option. Instead, the public insurance plan would negotiate with health care providers in the same manner as private-sector plans.

Third, our plan requires that health insurance exchanges act not simply as clearinghouses but as “active purchasers,” a health-policy term for exchanges that set standards. This means they have the power to hold participating insurance plans accountable for keeping premiums down and quality up—through bidding processes, exclusion of poor performers, or other mechanisms. Without being “active purchasers,” the exchanges could end up with an overwhelming number of options for insurance, with no simple way for consumers to distinguish between efficient, low-cost, quality plans and bottom-of-the-barrel plans.

In addition to our enhancements of several elements in the new health law described above, the Center for American Progress plan also would implement some money-saving policies designed to reduce federal health spending by about \$230 billion over the next 10 years. These include:

- A Medicare rebate program, requiring Medicare to negotiate reduced pharmaceutical prices as is already required of Medicaid
- Reduced graduate medical education payments to tie Medicare payments to hospitals with teaching programs more closely aligned to actual training costs
- Enhanced home health savings to accelerate payment reforms already required by the Affordable Care Act
- Additional health care savings identified in President Obama’s 2012 budget<sup>35</sup>



Taken together, these savings are enough to approximately offset the cost of implementing a permanent fix of the sustainable growth rate formula, which, if left unattended, requires automatic massive cuts to Medicare payment rates for doctors, which are unacceptable both politically and substantively.

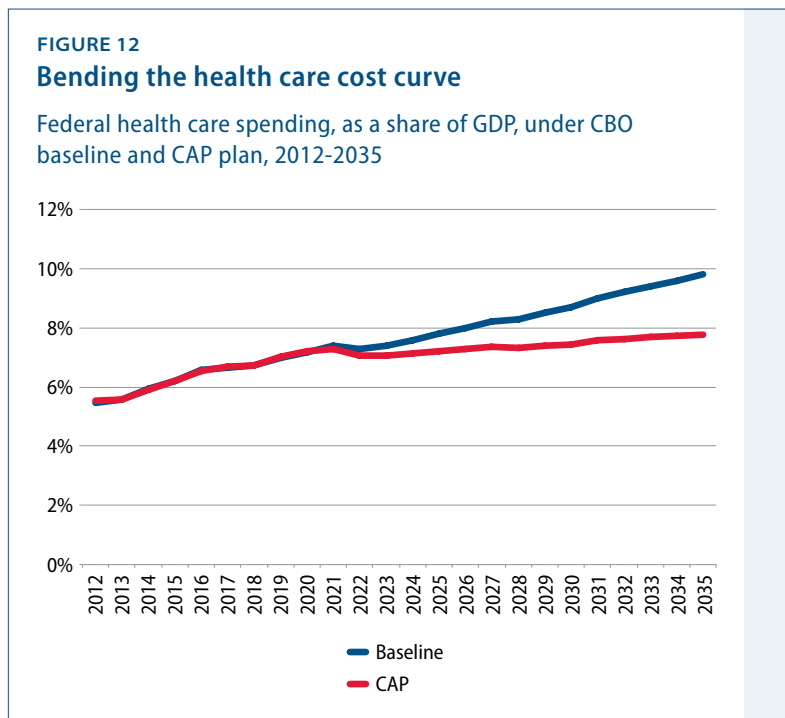
We believe that aggressive implementation of the Affordable Care Act alongside enhancements to its existing cost-control mechanisms will result in dramatically lower health care expenditures, both for the federal government and overall. But we also recognize that predicting the specific effect of the myriad test programs and reforms in the new health law is fraught with uncertainty. That's why our plan also includes a failsafe mechanism that would ensure significant savings throughout the system.

Our failsafe would be triggered if, starting in 2020, total health care expenditures—not just those in the public sector—grow at a rate faster than that of the economy itself. Should that happen, we would empower the Independent Payment Advisory Board—subject to the same congressional review process as exists currently in the health care law—to extend successful reforms in the public sector to all insurance plans offered in the health care exchanges, and then potentially to all health care plans, such that the target is met.

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### The bottom line on health care

The effect of these reforms, along with our failsafe, will be to hold federal health spending to 7.8 percent of GDP in 2035, compared to 9.8 percent in the CBO baseline. As importantly, they will lower the overall cost of health care thus ensuring that reductions in Medicare do not result in providers leaving the program and that costs aren't shifted from the public to the private sector. (see Figure 12)



Source: Congressional Budget Office and authors' calculations based on CBO methodology.

# Lifting millions out of poverty into the middle class

Poverty is a blight and burden, not just for those directly affected but also for society as a whole. Of course, working to lift people out of poverty is a moral obligation, but it is an economic imperative as well. Taking people off the sidelines of the economy and getting them working, producing, and consuming as part of the middle class is an unadulterated good for everyone. Right now, more than 40 million Americans, including nearly 16 million children, live below the federal poverty line—about \$22,000 a year for a family of four. This is remarkably high compared to other economically advanced countries—the United States ranks 24th out of 25 developed countries in terms of overall poverty rates.<sup>36</sup> The societal and economic costs associated with these levels of poverty are simply enormous.

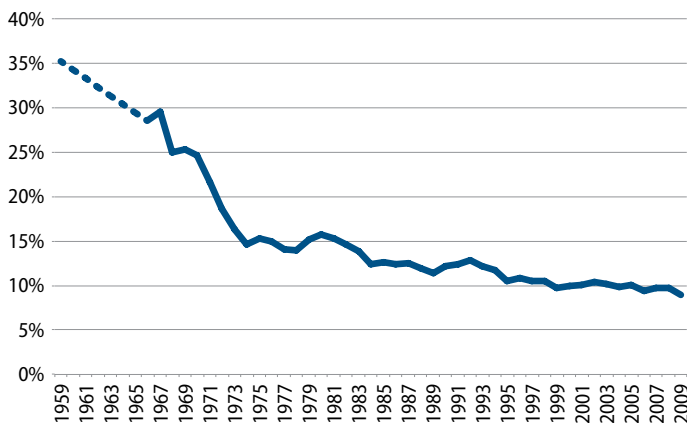
In 2007, a team of economists led by Dr. Harry Holzer of Georgetown University issued a report detailing the economic consequences of child poverty alone. They found that child poverty costs the U.S. economy about 4 percent of GDP per year

in lost adult productivity and wages, increased crime, and higher health expenditures.<sup>37</sup> That would translate into about \$600 billion this year. Holzer's conclusions mesh with a wide array of other academic studies, confirming the Government Accountability Office's conclusion that there is "a negative association between poverty and economic growth consistent with theoretical literature's conclusion that higher rates of poverty can result in lower rates of growth."<sup>38</sup>

Clearly, we would do well to focus our efforts a bit more on cutting down on the numbers of people, especially children, living in poverty. Fortunately, we know from history that with a concerted effort and with appropriate policy changes, we can dramatically lower poverty. In

**FIGURE 13**  
**Antipoverty efforts can succeed**

The falling poverty rate among Americans age 65 and over, 1959-2009



Source: US Census Bureau.

Note: The Census Bureau does not have data for senior citizen poverty between 1960-1966. The dotted line is a simple straight line interpolation between the 1959 level and the 1967 level.

1960, for example, about one in every three senior citizens lived in poverty. Partly in response to that dramatic statistic, the federal government expanded Social Security, and instituted the Medicare and Medicaid programs. Today, poverty among senior citizens is less than 10 percent. (see Figure 13)

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## Our plan to cut poverty in half

In 2007, the Center for American Progress Task Force on Poverty issued recommendations for a comprehensive plan to cut poverty in half by 2030.<sup>39</sup> We largely follow its lead. We target our efforts at people for whom interventions will have the largest effects, especially children and the disabled. Our plan:

- Increases participation in the Supplemental Nutrition Assistance Program to 85 percent of eligible households from about two-thirds currently
- Raises the monthly Supplemental Security Income benefit at least to the poverty level
- Improves child nutrition programs
- Increases federal support for affordable housing by 20 percent
- Maintains the newly enhanced earned income tax credit, and further boosts the child tax credit (see page 43-44 for more information)

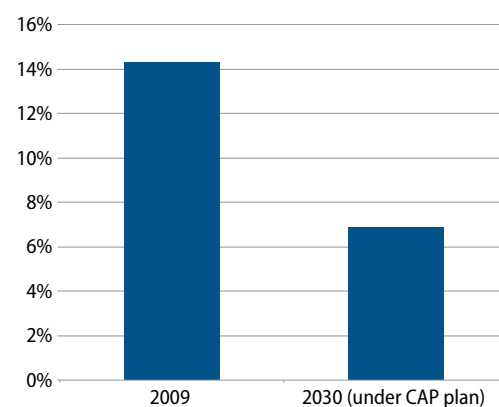
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## The bottom line on antipoverty efforts

These changes, in conjunction with our new investments in education and our proposed changes to Social Security (see page 33) will result in approximately 20 million fewer people in poverty by 2030, dropping the rate down to under 7 percent. These programs are already enormously successful at keeping people out of poverty and putting them on the path to the middle class. A recent report from the National Bureau of Economic Research concludes, “the benefit system in the United States has a major impact on poverty rates.”<sup>40</sup> By improving the system and extending it to more of the population who needs it, we can achieve the goal of cutting poverty in half. (see Figure 14)

**FIGURE 14**  
**Cutting poverty in half**

U.S. poverty rate in 2009 and in 2030 under the CAP plan



Source: US Census Bureau and authors' calculations.

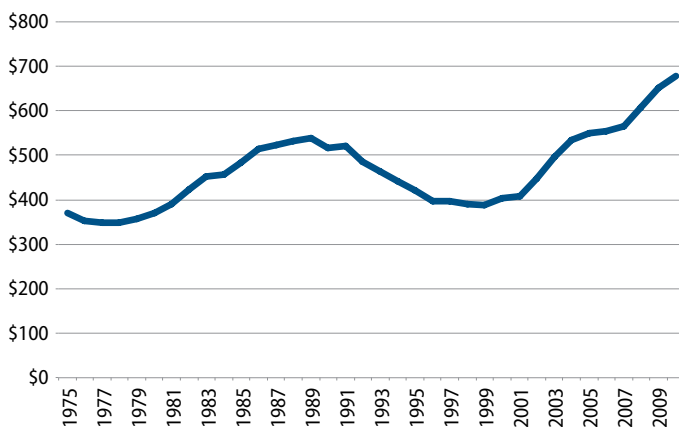
# Budgeting for national security in the 21st century

Budgeting for the security of our country presents two major challenges. First, the traditional way that Congress allocates money to national security agencies is outdated. In 2008, Secretary of Defense Robert Gates remarked, “It has become clear that America’s civilian institutions of diplomacy and development have been chronically undermanned and underfunded for far too long, relative to what we spend on the military.” Just last year, Admiral Mike Mullen, the chairman of the Joint Chiefs of Staff, echoed Secretary Gates’s point:

*It’s time to invest in other departments, such as homeland security, intelligence and the State Department, whose budget pales compared to massive Pentagon funding. My fear, quite frankly, is that we aren’t moving fast enough in this regard. U.S. foreign policy is still too dominated by the military, too dependent upon the generals and admirals who lead our major overseas commands and not enough on the State Department.<sup>41</sup>*

**FIGURE 15**  
**Defense spending at record highs**

U.S. defense spending in billions of constant dollars, 1975-2010



Source: Office of Management and Budget.

A big reason why this imbalance exists between the various elements of our national security strategy—defense, homeland security, and diplomacy—is because these elements are funded in separate categories.<sup>42</sup> Without a unified security budget, policymakers are less able to judge the real trade-offs between the components of a comprehensive security strategy.

The second challenge is dealing with skyrocketing spending in the Pentagon. Of course, the cost of prosecuting the wars in Iraq and Afghanistan are enormous, but even after the expected drawdown in troops in those two conflicts, defense spending is expected to remain higher, in real terms, than at any point since

World War II. In other words, even after the conclusion of the wars, we will still be spending far more on defense than we did at the height of the Cold War buildup. (see Figure 15)

The Center for American Progress plan would address both of these problems by creating a unified security budget while implementing reasonable, achievable cuts to the Pentagon. Our unified security budget incorporates the traditional defense budget, the State Department budget, and the Department of Homeland Security budget.

The cuts we have identified come from a recent Center for American Progress report by Lawrence Korb and Laura Conley entitled, “Strong and Sustainable,” which describes about \$110 billion in cuts to the Defense Department.<sup>43</sup> Our plan adopts these savings. We believe this would bring total security spending to a reasonable and sustainable level, with sufficient resources available to keep the country safe. (see Figure 16)

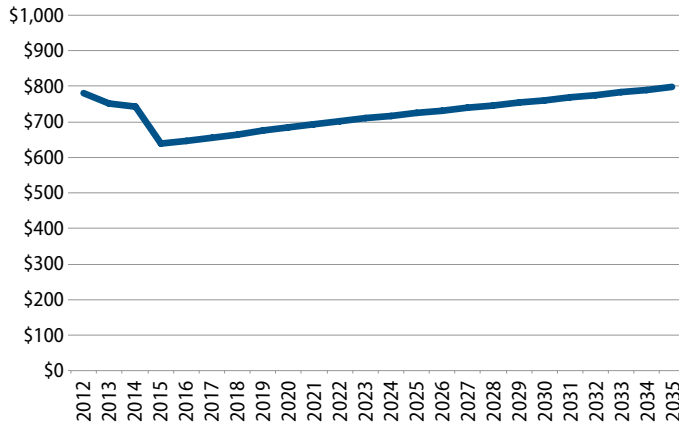
**FIGURE 16**  
**Recommended defense program cuts and estimated savings in FY2015**

Defense programs	“Strong and Sustainable” savings
<b>Total</b>	<b>109.1</b>
Redirect the majority of overhead efficiency savings to reduce the baseline defense budget	25.0
Roll back growth in the Army and Marine Corps	12.1
Permanently reduce the number of non-Iraq/non-Afghanistan overseas personnel	12.0
Reduce nuclear forces	11.4
Adopt across-the-board reduction in research, development, test, and evaluation funding	10.0
Reduce civilian DOD personnel in line with a decrease in military end strength	8.0
Adopt the recommendations of the Task Force on the Future of Military Health Care	6.0
Reform the military pay system in accordance with the Quadrennial Review of Military Compensation	5.5
Reduce Joint Strike Fighter procurement by 50 percent	4.8
Retire two carrier battle groups and associated air wings	3.0
Limit procurement of the Virginia-Class Submarine	2.8
Cancel the V-22 Osprey	1.9
Limit procurement of the DDG-51 Destroyer	1.9
Cancel CVN-80 funding	1.5
Reduce procurement of the Littoral Combat Ship	1.3
Cancel select missile defense programs	1.3
Cancel the Marine Corps’ Expeditionary Fighting Vehicle	0.6

Columns may not sum to totals due to rounding.

**FIGURE 17**  
**Lean and mean**

U.S. security spending in billions of constant 2010 dollars under the CAP plan, 2012-2035



Source: Authors' calculations.

## The bottom line on security

After implementing the cuts, and incorporating the unified security budget, total security spending will be about \$700 billion in 2016. From there, our plan limits the rate of security spending growth to the rate of inflation plus 1 percentage point. Our plan recognizes the need for our total national security spending to post real growth each year given our global obligations and the continuing threats to our homeland. Because of this real growth, by 2030, total security spending will be approximately the same, in inflation adjusted terms, as prereduction-level spending. (see Figure 17) As a share of GDP, however, security spending will be lower than in 2016 thus will contribute to deficit reduction.

# Modernizing Social Security and ensuring its 75-year solvency

Social Security is not a major contributor to the federal budget deficit. Every year up until the onset of the Great Recession in 2007, Social Security revenues were more than enough to cover its costs. But over the next several decades, as the Baby Boom generation retires, a gap is projected to open up between Social Security income and costs. If left unattended, this will cause the Social Security Trust Fund to eventually run out, which would necessitate a large reduction in benefits.

In our report, “Building it Up, Not Tearing it Down,” the Center for American Progress presented a detailed plan to close the shortfall and at the same time modernize the program to address some existing problems. The major elements of the plan:

- Improve benefits for the very old, the very poor, and surviving family members
- Expand spousal benefits to married same-sex couples
- Gradually phase in progressive changes to the benefit formula that would lower benefits at higher incomes
- Remove the Social Security payroll cap on the employer side of the payroll tax
- Invest a portion of the Social Security trust fund in the stock market<sup>44</sup>

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## The bottom line on Social Security

The effect of our reforms is to bring Social Security into 75-year actuarial balance. In terms of spending, these reforms will mean a net reduction in Social Security outlays in 2030 of about 0.2 percent of GDP, compared to the CBO baseline.

## Doing what works

Given the enormous needs of our country—for more investment, for building a strong middle class, for sustainable national security, for honoring our obligations to senior citizens, for reducing poverty—we simply cannot afford to spend money on programs that do not meet those needs, or on those that just don’t work well. “Because that’s the way it’s always been done,” is not a good reason to keep doing something. In an age of tight budgets, we must have a relentless focus on improving government efficiency, calibrating every program so dollars are spent wisely.

Federal agriculture subsidies are an excellent example of a program that is outdated, expensive, and inefficient. A recent report from the Center for American Progress details how these subsidies are both unnecessary and unfair.<sup>45</sup> Most recipients are extremely wealthy farm conglomerates. Nearly two-thirds of all payments go to the largest 12 percent of all farms. It is time to reduce and reform these subsidies, and our plan cuts spending on them in half.

There are also dozens of inefficient or just plain ridiculous spending programs that operate through the individual and corporate income tax codes. These provisions, often called “tax expenditures,” are exactly the same, economically speaking, as traditional spending programs, but they garner far less scrutiny. Many tax expenditures benefit an extremely narrow set of individuals or companies, and very few have undergone rigorous evaluation to determine if they actually achieve their goals (if they even have any goals). Our plan scours the code and eliminates dozens of these kinds of “tax entitlements,” including, for example, special subsidies that go to the oil and gas industry. See Appendix 3 on page 61 for a complete list of tax expenditures that we remove or reform.

Another good example of “business as usual” that calls out for reform is the way in which most government benefit programs are adjusted for inflation. Of course it makes sense to adjust benefit amounts to account for a rise in consumer prices, but right now, the measure the government uses to make these adjustments



overstates the effect of inflation. As a result, these benefits actually increase in real terms each year. Changing to a more accurate measure of inflation, as our plan does across the entire government (including the tax code), would save a significant amount of money compared to continuing to use the existing measure.

These are some specific reforms that our plan explicitly includes, but we also implicitly expect much greater savings deriving from a targeted, committed effort to improve government efficiency across the board. Every year, the government sends out more than \$100 billion in improper payments. Reining in no-bid contracts, promoting competition among contractors, and improving transparency in the contracting system could save \$40 billion a year.<sup>46</sup> Consolidating and modernizing information technology could save another \$16 billion a year.<sup>47</sup>

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### The bottom line on government efficiency

There is no way to calculate the exact magnitude of savings possible from improving the way government does business on a daily basis. Because of that, we do not rely on those kinds of prospective savings—aside from those that derive from specific program changes—to achieve a balanced budget. But we do expect that savings of this nature will allow the effective spending reductions our plan dictates in certain areas to be accomplished without sacrifices in the quality of public services.

# The CAP plan for federal revenue, 2012-2035

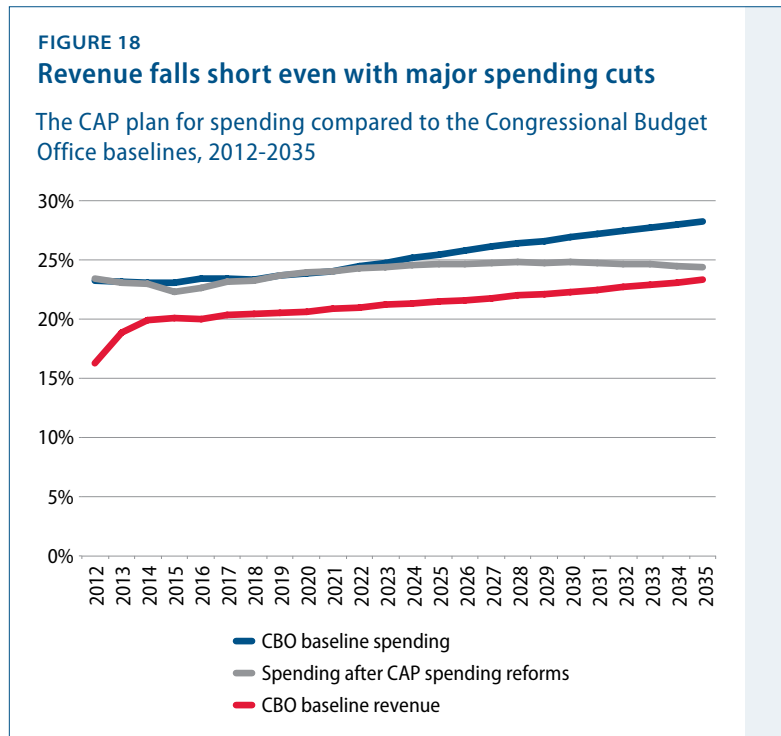
Overall, our plan raises revenues in 2030 by less than 2 percent of GDP compared to the Congressional Budget Office baseline. Total revenue drops to 23.8 percent of GDP by 2035, just half a percentage point above the CBO baseline.

# Revenue

Our revenue plan raises adequate revenue, realigns the incentives of the tax system to better serve our economy, simplifies a grotesquely complicated individual income tax, and takes steps to address the unfairness in the tax system that undermines our national prosperity. In short, our plan raises sufficient revenue more fairly and more efficiently while making tax filing simpler.

There is no responsible way to balance the budget without raising more revenue. In the spending part of our plan we have constrained spending in the areas of greatest growth, cut unneeded spending, and put in place spending increases that are necessary to the future of our economy. Overall, our plan cuts spending to more than \$13 trillion below current projections for the next 25 years.

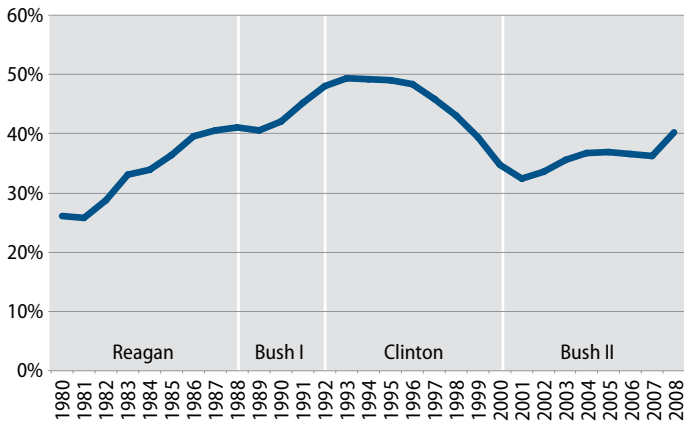
But even with these major spending cuts we are still left with more spending than the revenue projected in the CBO baseline. The deficits under this scenario would be under 3.5 percent of GDP from 2014, which is arguably out of the deficit danger zone that brings the fear of extreme market reaction to the hearts of many economists and investors. But some of the assumptions underpinning the Congressional Budget Office baseline are probably unrealistic. For instance, it assumes none of the Bush tax cuts are extended, and that the alternative minimum tax is allowed to raise more and more revenue from the middle class. This suggests the need for increased revenue, as our plan details. (see Figure 18)



Source: Congressional Budget Office and authors' calculations based on CBO methodology.

**FIGURE 19**  
**Presidential debt**

Publicly held debt, as a share of GDP, 1980-2008



Source: Office of Management and Budget.

Moreover, even if one accepts the CBO baseline estimate as an accurate prediction of future revenues, outside of moments of national crisis or special need there is no reason to be running deficits at any level. During times of strong economic growth even small deficits can have a small negative effect on the economy. Deficits also mean added debt. And added debt means future interest payments that take away from better uses for taxpayer dollars. Added debt also means that a country is not as well positioned going into a period of crisis than it would be otherwise.

Balanced budgets or surpluses during times of peace and economic calm are how we can pay *down* the debt accumulated during times of

special need so that the country is in a stronger position to confront unforeseen challenges. President Clinton recognized these things and the United States ran surpluses from 1998 through 2001—thus paying off significant debt accumulated under Presidents Reagan and George H. W. Bush. President George W. Bush veered off this path. The Bush tax cuts in particular added more to the debt over the last 10 years than any other policy, some \$2.5 trillion, and will likely continue to be the biggest contributor to additional debt over the next 10 years.<sup>48</sup> (see Figure 19) Running largely unnecessary deficits in the 2000s left the country in a fiscally weaker position to deal with the Great Recession that began in the seventh year of the Bush presidency.

The bottom line is that our goal should not simply be getting our deficits out of the danger zone. Our goal should be a balanced budget and to achieve that goal more revenue is needed.

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### Reform the tax system

To gain more revenue will require tax increases, but simply raising existing taxes without reforming the system would be unfair to American taxpayers and bad for the economy. The current system is a mass of loopholes, inequities, unfairness,

and complications. It is needlessly convoluted, favoring some industries over others for reasons having far more to do with lobbying clout than economic objectives. Taxpayers in similar circumstances pay different tax bills, which is unfair and leads to distrust and cynicism.

As income inequality has grown in recent decades, our tax code has become less progressive. The Bush tax cuts for the wealthy failed to generate the promised economic benefits, joining other failed “supply-side” experiments of the past. (see box on page 41) At the same time, effective federal tax rates dropped sharply, sparking the explosive growth of our federal debt. (see Figure 20)

The individual income tax also is incredibly opaque. One can wade through the form instructions, step by step, putting numbers down as directed and have absolutely no idea why one is taking the greater of line 15 and line 17, subtracting from line 12, and then copying to Form Q. The system has had so many loopholes, exceptions to loopholes, political compromises, and random oddities layered on that it simply makes no sense anymore. It needs to be cleaned out.

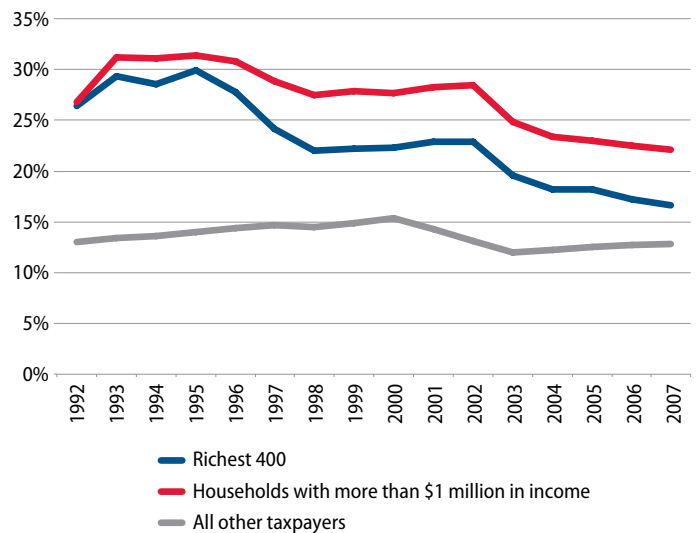
Our current tax system also creates incentives and disincentives that are bad for the economy. We have permanent incentives for oil companies when \$100 per-barrel prices offer ample incentive to drill for more oil, and we need to wean ourselves off fossil fuels, not subsidize their use. Our efforts to do that, however, through federal incentives to boost alternative and renewable energy are seriously undermined because they are tentative and temporary. The tax code is littered with similar provisions that are intended to encourage desired behavior but do so inefficiently, and others that promote behaviors that have minimal or no public benefit.

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### The fix

Our tax plan raises needed revenue, makes the tax system fair and simple, realigns incentives, and eliminates wasteful tax breaks. Specifically, our plan:

**FIGURE 20**  
**Falling tax rates for the wealthy versus the rest of us**  
Effective federal tax rates, 1992-2007



Source: Internal Revenue Service.

- Makes the individual income tax more sensible, simple, and fair
- Lessens our nation's reliance on foreign oil by imposing a per-barrel fee on oil imports and putting a price on greenhouse gas emissions
- Inhibits destructive short-term financial speculation through a new small tax on financial sector transactions in stocks, bonds, and derivatives
- Raises revenue for the Social Security system as described in our previously released Social Security plan<sup>55</sup>
- Eliminates or reforms wasteful and inefficient tax expenditures
- Includes a number of smaller-scale revenue enhancements
- Raises enough revenue to balance the budget in conjunction with our plan's spending cuts

We detail these measures below and in our appendices beginning on page 57. Note that the measures described below comprise our long-term deficit reduction plan. We have not included here measures from our previously released plan to reach primary balance in 2015, discussed above, that are superseded by our long-term, more fundamental reform.<sup>56</sup>

# Supply-side tax cuts favoring the wealthy have failed

Ten years ago, President George W. Bush signed the first of two massive tax cuts weighted heavily toward the wealthy. The Bush administration argued that these cuts would put money in the hands of those people best positioned to make investments and create jobs—with benefits trickling down to the middle class. Supporters also promised that the tax cuts would not lead to deficits. They predicted that even with the Bush tax cuts the United States could pay off its debt by 2010.<sup>49</sup>

What we know all too painfully now is that supply-side tax cut policies were, as they have been in the past, an abject failure.<sup>50</sup> In the 2000s under these policies, even before the Great Recession hit, investment growth, job growth, and income growth were all lower than during any economic expansion in post-World War II U.S. history.<sup>51</sup> The average employment growth over the period between the recessions of 2000-2001 and 2007-2009 was a mere 0.9 percent. This compares poorly to the average for postwar periods of economic expansion of 3 percent. Investment growth was 2.1 percent during the 2000s recovery compared to an average of 6.7 percent during past recoveries. And growth in our gross domestic product was 2.7 percent compared to an historic average of 4.8 percent.<sup>52</sup>

The nation's experience in the 1990s after taxes on the well-off were raised under President Clinton is a telling contrast. The supply-side eras of President's Reagan and Bush that bracketed the more progres-

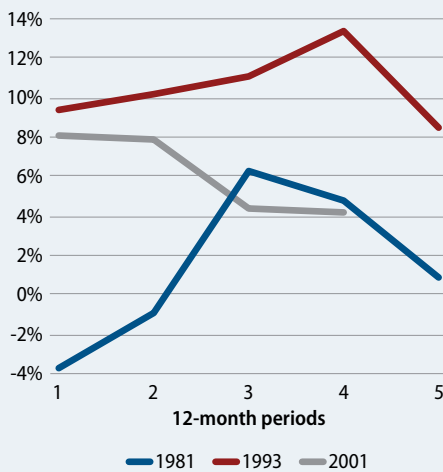
sive tax policies of President Clinton were dismal in terms of economic performance. Real investment, economic growth, median income, wage levels, and employment growth were all better in the Clinton era, and, of course, the budget was in surplus instead of being driven into massive deficit.<sup>53</sup> (see Figure 21)

Supply-side policies are and remain bad news for the middle class. Middle-class incomes essentially made no progress under the Bush tax regime, which is still in place. After accounting for inflation, median family income grew at an average rate of 0.06 percent annually from business cycle peak to peak in the 2000s. Such slow growth may not seem that bad—it's just staying in place after all—but it's important to note that a stagnant median income hides the vast numbers of those whose incomes are going down. When the median income is growing strongly it's a sign that there is a strong economy and most people's incomes are going up even though by varying amounts. When the median is unchanged it means that while some family incomes are going up, about as many are going down.

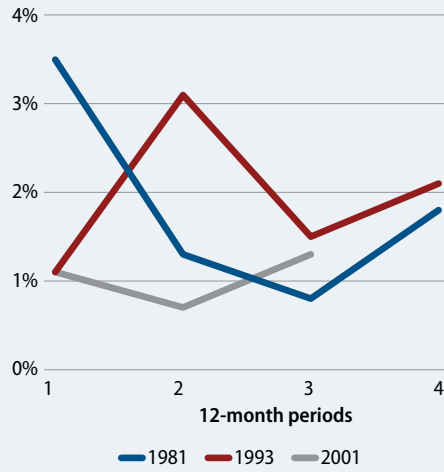
Of course, even the small gains that were achieved during the expansion of the middle 2000s were wiped out by the deep recession that hit in 2007—the worst economic downturn since the Great Depression. There are fewer jobs in the United States today than there were in June 2001, when the major Bush tax policies became law.<sup>54</sup>

**FIGURE 21**  
**The 1990s economy outperformed supply-side eras**

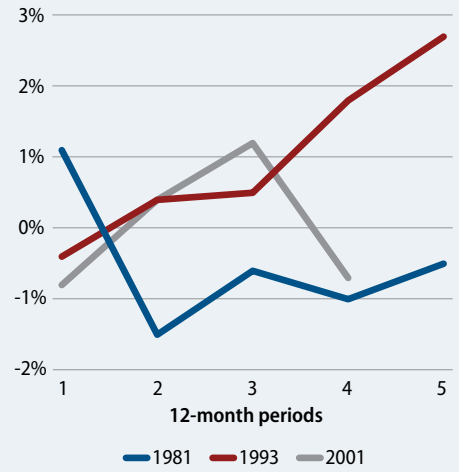
Nonresidential fixed investment grew better in expansion after 1993 tax hike than equivalent supply-side periods



Median household income stronger in non-supply-side business expansion of 1993-1998



Average hourly earnings during parallel periods of economic expansion



Source: Michael Ettlinger and John Irons, "Take a Walk on the Supply Side: Tax Cuts on Profits, Savings, and the Wealthy Fail to Spur Economic Growth," (Washington: Center for American Progress, 2008).

# Individual income tax

CAP offers a far-reaching overhaul of the individual income tax to make it simpler, fairer, and more efficient. Middle-class families are better off under our income tax plan because it treats them fairly, simplifies their taxes, and helps provide adequate revenue for the investments and public services on which the public and businesses rely. Our plan closes loopholes and special tax breaks that create unfair disparities among taxpayers. Top income earners, who have enjoyed the vast majority of income gains in recent decades even as their taxes have been slashed, will be asked to pay more.

Our plan introduces a flat 15 percent rate for couples with incomes under \$100,000.<sup>57</sup> Most taxpayers will pay the same or lower rates than under current law, and the top rates on the wealthy are modest by historic standards. (see Appendix 1 for full rate tables) The plan eliminates many of the features of the tax code that add complexity. Deductions, exemptions, exclusions, and credits are eliminated, reformed, or replaced to make them more fair and simple for taxpayers. Loopholes are closed, eliminating the need for an alternative minimum tax and high-income phase-outs. The marriage penalty is eliminated.

## Our plan and your taxes

### Examples of how sample taxpayers would fare under our individual income tax reform plan

#### **Couple with children earning \$75,000 a year**

- Two dependents
- Currently takes the standard deduction

*They receive a \$1,890 tax cut versus Bush-level taxes*

#### **Single with no dependents earning \$40,000 a year**

- \$10,000 in itemized expenses

*He or she receives a \$620 tax cut versus Bush-level taxes*

#### **Couple with children earning \$100,000 a year**

- Two dependents
- \$20,000 in itemized expenses

*They receive a \$630 tax cut versus Bush-level taxes*

#### **Couple with children earning \$150,000 a year**

- Two dependents
- \$28,000 in itemized expenses

*They receive a \$250 tax cut versus Bush-level taxes*



## Our distributional tables explained

Current individual income tax levels adopted under President Bush in the early 2000s are set to expire after 2012. This means the tax system will largely return to the form it was in before President Bush took office. The Congressional Budget Office baseline used for most comparisons in this report assumes that the Bush tax cuts expire as scheduled. In this section, however, we offer comparisons to both the scenario where they expire, which we label as comparisons to “pre-Bush levels,” and to the scenario where all the Bush tax cuts continue, which we label as “Bush levels.” Elsewhere these scenarios are sometimes referred to, respectively, as “current law” and “current policy.”

So in Figure 22 for the middle 20 percent of income earners, for example, we see that under our plan personal income tax liability goes down by 4.9 percent as a share of their income relative to “pre-Bush levels,” and by 3.7 percent relative to “Bush levels.” This means that if the Bush tax cuts were allowed to expire, and the tax system were

to return to pre-Bush law, then our plan would offer middle-quintile families, on average, a tax cut worth 4.9 percent of their income.

Looked at another way, if the family earned an income of \$50,000, their taxes would go down by 4.9 percent of \$50,000 or \$2,472. If, however, the Bush tax cuts are extended—that is, if the tax system is left the same as it is right now in 2011—then when our proposal goes into effect in 2017, the tax cuts will equal 3.7 percent of middle-quintile families’ income on average, or \$1,862 for a family with income of \$50,000.

We offer the “Bush levels” comparison because the policy currently in place offers an easier reference than policies that were last seen 10 years ago. But since our policies go into effect in 2017 after the Bush tax rules are set to expire, it is useful to see the difference between our proposal and what the tax system is scheduled to be in that year.

Middle- and low-income taxpayers will pay less income tax under our plan on average. High-income taxpayers will pay more but will still enjoy after-tax income at levels dramatically higher than they did only a few years ago. Only the top 5 percent will pay more income tax, on average, relative to the taxes paid under President Bush’s policies. Only the top 1 percent will pay more, on average, than they would under the tax law as it stood prior to President Bush. The bottom 99 percent will, on average, pay less income tax. (see Figure 22 and the accompanying explanatory text box)<sup>58</sup> For middle- and lower-income taxpayers, these tax cuts will, on average, more than offset the energy taxes described below.

### Changing the structure of the individual income tax

Under our proposal, many loopholes, deductions, and exemptions are eliminated. These are listed in detail in Appendix 1 on page 57. The most fundamental change we make that affects the most taxpayers is the replacement of item-

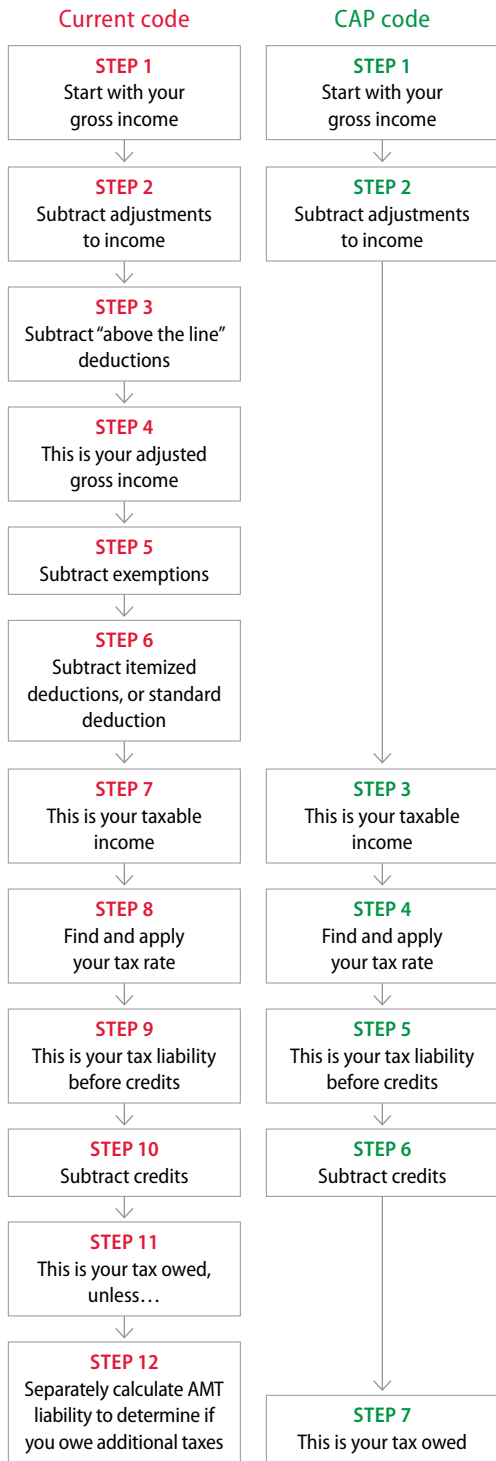
**FIGURE 22**  
**Our plan’s income tax changes**

Tax change as a percent of income, by income group, relative to pre-Bush tax levels and Bush tax levels (see also accompanying explanatory box)

Income group	Relative to:	
	Pre-Bush tax levels	Bush tax levels
Bottom 20%	-2.9%	-2.9%
Second 20%	-5.5%	-4.6%
Middle 20%	-4.9%	-3.7%
Fourth 20%	-2.6%	-1.4%
Next 15%	-1.2%	0.0%
Next 4%	-0.1%	+0.7%
Top 1%	+4.1%	+6.4%

Source: Quantria Strategies, LLC Individual Income Tax Simulation Model.

**FIGURE 23**  
**Calculating your income taxes**



ized deductions, the standard deduction, the personal exemption, and the dependent exemption with a simpler system of credits. In large part this is motivated by the perverse, upside-down way in which the existing system provides greater benefits for deductions, exemptions, and exclusions for higher-income taxpayers than middle-income taxpayers as explained further in the box on page 45.

Under our system, everyone will get the same level of benefits. Instead of “deductions” from income for mortgage interest, charitable contributions, or state and local taxes, taxpayers will instead receive a direct reduction in their taxes through a 15 percent credit for these payments—with the reduction being the same no matter the taxpayer’s income level.

In addition, most taxpayers will find their tax filing greatly simplified by the introduction of a generous flat “alternative credit” that taxpayers can choose to take instead of taking a credit for their itemized expenses. The credit starts at \$6,200 for married couples and \$3,100 for singles, and is indexed for inflation. This alternative credit works similarly to the current standard deduction: Taxpayers will have the choice of claiming the alternative credit or adding up itemized expenses and taking the itemized credit. Most will take the alternative credit instead of the itemized credit because it will offer both lower taxes and simpler filing.

Personal and dependent exemptions are also eliminated. The child credit, however, is broadened to encompass all those who had previously qualified for the dependent exemption, renamed as the “child and dependent credit,” raised from \$1,000 to \$1,250, and indexed to inflation. This credit is made refundable to a greater extent than the existing child credit. The earned income tax credit is preserved and strengthened: Improvements put in place on a temporary basis by the American Recovery and Reinvestment Act of 2009 are made permanent.<sup>59</sup>

Some upper-middle-income taxpayers with incomes that put them above our 15 percent tax bracket will receive less of a benefit under the credit system than they would have if existing exemptions and deductions had been preserved as exemptions and deductions. But because of the other changes we make to the

## The tax code's upside-down subsidies

One of the more offensive characteristics of the current tax system is that a range of subsidies administered through the tax code offer greater support for higher-income taxpayers than lower-income taxpayers. This is because the interaction of deductions, exemptions, and exclusions with graduated income tax rates benefits the former over the latter.

Why? Because the value of such “tax preferences” to a taxpayer is directly related to the taxpayer’s marginal income tax rate. For well-off taxpayers in the 35 percent tax bracket, their taxes are reduced by 35 percent of the deduction, exemption, or exclusion. For middle-class taxpayers in the 15 percent tax bracket, their taxes are reduced by only 15 percent of the deduction, exemption, or exclusion.

This produces outcomes that are indefensible. Imagine anyone openly proposing a subsidy for homeownership that reimburses wealthy taxpayers for 35 percent of the interest they pay on the mortgage but

only 15 percent of what middle-class taxpayers pay. Yet that is precisely the effect of the mortgage interest deduction. And that is why our plan transitions to credits, which are worth the same per dollar of interest expense to all taxpayers regardless of their tax bracket.

Of course, changing the mortgage interest deduction suddenly would not be fair to those who purchased homes prior to the implementation of our plan. So for affected taxpayers, we propose an additional credit for home mortgage interest above the basic 15 percent credit for a 10-year period. This will avoid a disruption of housing markets in higher-income areas where the subsidy level of housing would be implicitly reduced, and will be fair to those who have acted in reliance on a particular level of subsidy. This will allow housing markets to adjust in an orderly way. The impact of our mortgage interest credit proposal, and the impact of going to our itemized credit model, is further explained and discussed in Appendix 4 on page 64.

system, including lower tax rates in that income range, the overall impact on an overwhelming majority of middle-income taxpayers will be lower personal income tax bills, not higher ones.

One outcome of the change in our tax structure described here, and other design improvements in the income tax, is that the need for an alternative minimum tax and high-income phase-outs are eliminated—thus greatly simplifying tax forms and filing. (see Figure 23)

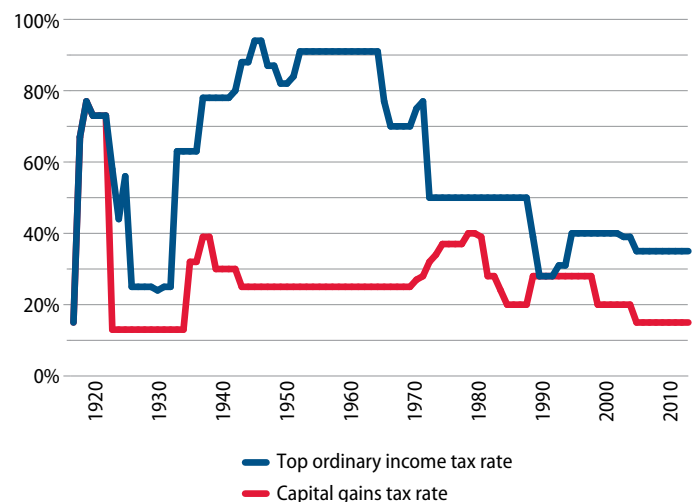
### The individual income tax rates

For nearly all taxpayers with incomes of less than \$1 million, the CAP plan offers lower or equal marginal tax rates at all taxable income levels than existed under President Clinton.

The rates in the plan are generally lower than or equal to the rates under the Bush tax law up to

**FIGURE 24**  
**Marginal federal tax rates over time**

Ordinary income (wages, self-employment, interest, etc.) and capital gains rates



Note: From 1971 to 1982, the top rate on unearned income other than capital gains (e.g. interest, dividends) was taxed at 70 percent. Beginning in 2003, the capital gains rate applied to dividends as well.

Source: Author's calculation based on [Citizens for Tax Justice](#).

## Marginal tax rates

There is often confusion regarding the meaning of tax rates, especially marginal tax rates, which are the rates of tax on one’s *last* dollar of income, not one’s overall tax rate.

Under the CAP plan, married couples pay a 15 percent rate on the first \$100,000 of income less the tax credits we’ve described. Those credits will generally amount to at least the value of our proposed alternative credit and any dependent credits: \$6,200 for a married couple plus \$1,250 per child. Above incomes of \$100,000, the marginal tax rate then goes to 25 percent.

This does not mean that a couple with \$115,000 is paying a 25 percent tax on that \$115,000. This couple would pay the 15 percent rate on the first \$100,000 of their income and then pay 25 percent on the amount of income over \$100,000—in this case 25 percent of \$15,000.

Thus, their pre-credit tax is 15 percent of \$100,000 plus 25 percent of \$15,000, which comes to \$18,750. If they choose to take our proposed alternative credit and have two children, their income tax bill ends up being \$10,050. This means that the actual tax they would pay, their “effective tax rate,” is less than 9 percent of their income.

FIGURE 25

### Our plan’s income tax changes

Tax change as a percent of income, by income group, relative to pre-Bush tax levels and Bush tax levels (see also accompanying explanatory box on page 43)

Income group	Relative to:	
	Pre-Bush tax levels	Bush tax levels
Less than \$50,000	-5.3%	-4.3%
\$50,000 to \$75,000	-3.3%	-2.1%
\$75,000 to \$100,000	-2.3%	-1.1%
\$100,000 to \$200,000	-1.3%	-0.1%
\$200,000 to \$500,000	0.0%	+0.7%
\$500,000 to \$1 million	+1.1%	+3.0%
Over \$1 million (without surtax)	+3.4%	+5.9%
Over \$1 million (with surtax)	+5.4%	+7.8%

Source: Quantria Strategies, LLC Individual Income Tax Simulation Model.

\$400,000 of taxable income.<sup>60</sup> Our rate structure also eliminates the “marriage penalty” so that a couple does not face higher taxes when they get married and file taxes jointly.

For the wealthy, the top tax rate is restored to the level it was at under President Clinton during the 1990s economic expansion: 39.6 percent. A temporary surtax of 5 percent is added for those with incomes of more than \$1 million, which expires once the federal budget is balanced. This is a marginal tax rate, which means that a taxpayer with \$1,200,000 in income would only pay the surtax on the additional \$200,000 of income of more than \$1 million, or a total surtax of \$10,000. (see box above)

The top rate will still be lower than during most of the postwar period, including our country’s greatest period of economic growth. In addition, the top rate for capital gains income from the sale of financial investments, almost three-quarters of which goes to taxpayers with more than \$500,000 in income, is allowed to return to 28 percent, the same 28 percent level signed into law by President Reagan. This rate was in effect for most of the 1990s—a time of strong business investment, rising productivity, and very strong economic growth. Raising the capital gains rate, in addition to raising additional revenue from the sale of investment assets, will help alleviate tax sheltering through accounting gimmicks that turn ordinary income into tax-preferred capital gains. (see Figure 24)

The most notorious current example of this is the “carried interest” loophole, used by managers of hedge funds and private equity funds (some of the wealthiest individuals in the country) to pay much lower tax rates on their compensation income than average workers. Our plan also specifically closes that loophole. (see Appendix 3 on page 61)

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## Who pays?

Most middle-class taxpayers will pay lower income taxes under the system proposed here, which will, on average, more than offset the additional energy taxes described below. All income groups under \$200,000 per year will enjoy income tax cuts, on average. Even the \$200,000 to \$500,000 group on average is held harmless relative to pre-Bush levels and faces an increase of only 0.7 percent of income relative to the Bush tax law—an average increase of \$2,076 for this group.

Overall, relative to the pre-Bush tax law, 65 percent of families and individuals would receive a tax cut under our plan, 10 percent would see a tax increase, and 25 percent would see no change in income tax liability. Relative to the Bush tax law, 61 percent of families and individuals would receive a tax cut under our plan, 15 percent would see a tax increase, and 24 percent would see no change in income tax liability. (see Figure 25)

Or put another way, relative to the pre-Bush tax law, more than 112 million families and individuals would see income tax cuts that would average more than \$2,000. Relative to the Bush tax law, more than 104 million families and individuals would see tax cuts averaging more than \$1,700.

## What about small business?

Any proposal to roll back the tax cuts for the wealthiest Americans is met with claims that it would harm small business. But the vast majority of small businesses are owned and run by middle-class taxpayers, who will on average pay lower taxes under our plan. According to the Tax Policy Center, only 1.9 percent of filers with small-business income are in the top two tax brackets, with the other 98.1 percent earning less than \$212,300 a year.

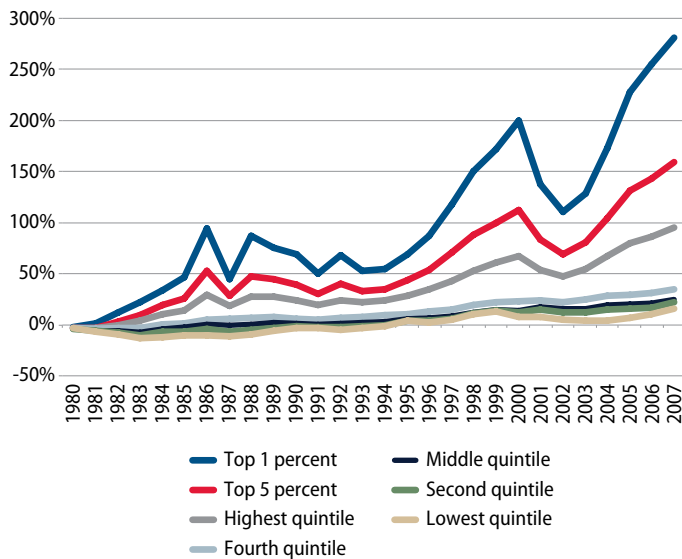
Moreover, even that 1.9 percent includes high-paid lawyers, real estate moguls, owners of large businesses organized as “S corporations,”

and many wealthy passive investors—not the kind of “mom-and-pop” business owners who are misleadingly invoked in defense of massive tax cuts for the rich.<sup>63</sup>

For the vast majority of middle-class Americans and small-business owners, our plan creates a tax system that is much more simple, makes compliance and filing much more straightforward, and lowers their income taxes. Finally, by removing special-interest loopholes that tend to benefit powerful industries, our tax plan allows all businesses, large and small, to compete on a level playing field.

**FIGURE 26**  
**The wealthy will be fine**

Cumulative after-tax income growth, by income group, since 1979, through 2007



Source: Congressional Budget Office.

Our plan raises taxes on the wealthy although not to an extent that will cause any hardship. These tax increases on the highest-income taxpayers would be coming on the heels of substantial tax cuts for the wealthy in recent years. The Bush tax cuts gave millionaires in the top 1 percent a tax break 73 times that of middle-income families.<sup>61</sup> Continuing the Bush bonus tax cuts for the wealthy beyond their 2012 expiration would cost upwards of \$800 billion in the next decade alone.<sup>62</sup> Given the nation's fiscal situation, it is imperative that the wealthy be asked to chip in more to the national purse.

Our wealthiest citizens can certainly afford what we propose. In most years since 1979, the wealthiest 1 percent have, in a single year, seen their income jump by more than enough to pay for the cost of the tax increase we propose for them. (see Figure 26)

## Reforming retirement savings

Our tax code's system of retirement-savings incentives is another example of "upside-down" subsidies. Eighty percent of the benefits of retirement tax breaks go to the top 20 percent of income earners.<sup>64</sup> The bottom three-fifths of Americans get only 7 percent of the benefit. As the Brookings Institution explains: "These existing tax rules not only provide less benefit to those from low- and middle-income households, but are also relatively ineffective at inducing new saving rather than simply shifting other saving into tax-preferred accounts."<sup>65</sup>

The result is that we spend billions of dollars through the tax code every year to incentivize savings but we get little return on that investment in the form of increased savings rates or retirement security for most families.<sup>66</sup>

Our plan, which draws upon an earlier proposal by former CAP Senior Fellow Gene Sperling (now director of President Obama's National Economic Council),<sup>67</sup> ameliorates the upside-down problem with retirement tax incentives by providing refundable tax credits for all

savers regardless of their income level or tax bracket. The current system of deductions and exclusions for new savings in so-called defined-contribution plans (such as 401(k) retirement plans and individual retirement accounts) is transformed into a system that provides refundable tax credits, equal to 33 percent of employer or employee contributions, deposited directly into savings accounts. This provides the same savings incentive for all taxpayers—and a significantly larger incentive, compared to now, for low- and middle-income families, who most often find themselves with adequate savings as they face retirement.

The primary tax benefit of 401(k)s and IRAs, the tax-deferred accumulation of income, will be maintained for all account holders, keeping them as attractive, tax-favored savings vehicles for everyone. Withdrawals from the accounts will be treated the same as they are now. Our plan better targets retirement tax incentives at new savings by low- and middle-income families, strengthening retirement security of those who need it the most.

When put in the context of the amount of income growth they've enjoyed over the years, the proposed tax increase is trivial, but in terms of helping our nation with its fiscal situation, our proposal is decidedly nontrivial. From 1979 to 2007, the earliest and latest years for which reliable official data are available, the pretax income of the richest 1 percent has grown by 281 percent, nearly quadrupling over that time. Over this same 28-year period, the income of the middle 20 percent of Americans grew by only 25 percent.

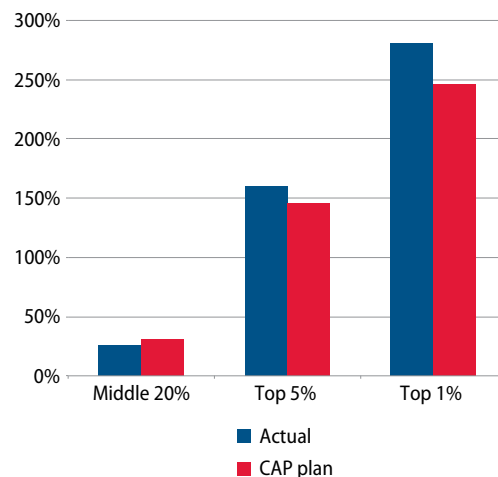
Against that backdrop, our proposal is to raise the income taxes of the top 1 percent by 6.4 percent of their before-tax income. To put what we are asking of the very wealthy in perspective, if our plan had been in place over this period of time, with the temporary millionaire's surtax in effect, the wealthiest 1 percent would still have more than tripled their after-tax income with an increase of 246 percent since 1979. (see Figure 27)

The same story applies in a shorter time horizon. The after-tax income of the richest 1 percent has risen 60 percent since the Bush tax cuts first passed in 2001. If our plan were to go into effect, their incomes would have gone up by "only" 46 percent—while middle-income families' incomes were stagnant.

In the context of changes in after-tax income, our proposal makes very little difference to the wealthy compared to all they've gained. Our tax proposal is hardly burdensome on the wealthy and, in the end, they and all Americans will be better off for it as we reduce the deficit and make the national investments we need. And once the budget is balanced, the surtax on millionaires will be removed.

**FIGURE 27**  
**Not a great burden**

After-tax income growth by income group, 1979–2007, actual and under CAP plan



Source: Congressional Budget Office and authors' calculations.



## Other revenue measures

Our tax reform plan also includes other revenue measures designed to make our tax system more effective and efficient so the system contributes to broad-based economic prosperity. Specifically, we propose:

- Reducing greenhouse gas emissions and our reliance on foreign oil by putting a price on carbon and levying an oil-import fee
- Enacting a financial-transactions tax to improve the functioning of our financial markets
- Enacting business tax reform to rationalize our corporate tax structure
- Applying other tax reforms to bolster Social Security, restore the estate tax to pre-Bush-era levels, and eliminate wasteful tax expenditures for special interests

Many of the details about these reforms are found in the appendices beginning on page 57 but let's briefly review each of them here.

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### Reducing greenhouse gas emissions and our reliance on foreign oil by putting a price on carbon and levying an oil-import fee

Our plan addresses the risks and economic damage of our heavy reliance on foreign oil and the dangers of climate change by establishing a price on emissions of carbon dioxide and other greenhouse gases alongside an oil-import fee of \$5 per barrel. The price on carbon will reduce emissions and at the same time raise revenue to pay for needed investments in a clean energy future.

Under our plan, greenhouse gas emissions will be reduced by 42 percent of 2005 levels by 2030, and 83 percent of 2005 levels by 2050. Such substantial reductions in emissions will combat the harmful effects of climate change on our economy and security. Coupled with our investments in energy efficiency and renewable energy, a price on carbon will also lead to the creation of new jobs in these fields and strengthen U.S. leadership in the growing clean energy economy.



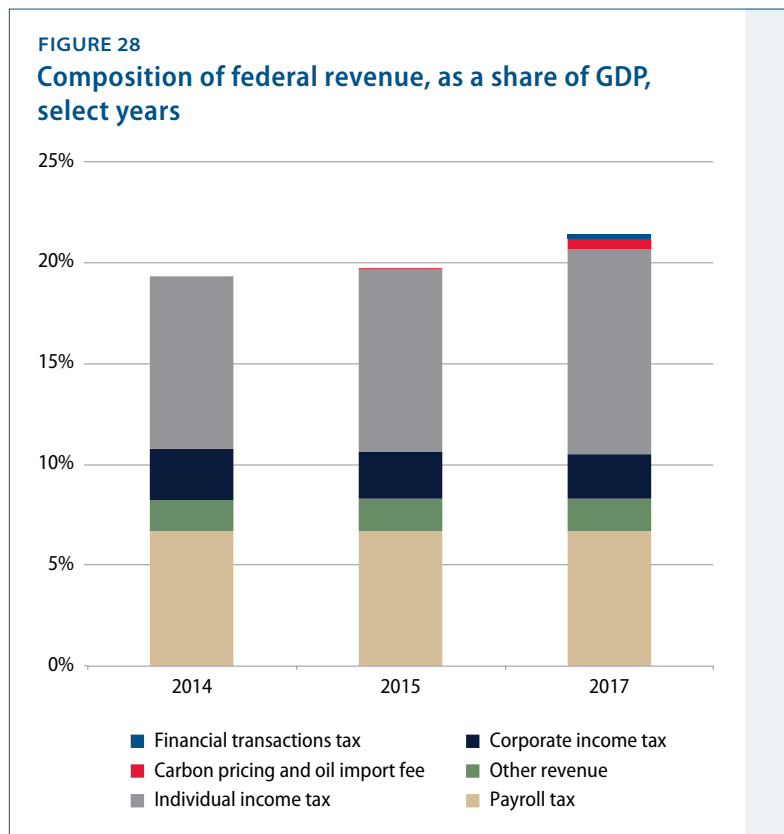
Any resulting rises in energy prices are, on average, more than offset for low- and middle-income taxpayers by the benefits of reduced income taxes and, in the case of those who do not owe income tax, by an energy rebate program accounted for in our spending proposals.

## Financial transactions tax

Our plan imposes a small fee on financial transactions, including trading in stocks, bonds, and derivatives. In addition to raising revenue from a sector of our economy that rebounded quickly from the Great Recession, due in no small way to taxpayer support during the financial crisis, a financial transactions tax would boost the long-term efficiency of financial markets, improve financial market stability, and help direct the allocation of private capital toward critical medium- and long-term investments.

Because it is based on the volume of trading, this tax creates a disincentive for high-speed trading and very short-term speculation and, correspondingly, an incentive for long-term investment. By reducing financial-market volatility, a financial-transactions tax will help reduce the asset price risk and improve the accuracy of expectations on returns in ways that are conducive to greater investment for the real economy. After all, the purpose of our financial sector is not to generate profits from speculation or high-volume trading but to raise capital for the productive sectors of the economy.

Our proposal levies very modest taxes on each kind of financial market transaction. The rates vary across different financial instruments and are set with the goal of preserving the relative costs of transaction across different financial asset markets.<sup>68</sup> We propose a 0.117 percent tax on stocks and stock options trading, a 0.002 percent tax for bonds, a 0.002 percent tax for foreign exchange trading, and a 0.005 percent tax for futures and swaps trading.



Source: Authors' calculations based on CBO methodology.

By tailoring tax rates to transaction costs, our proposal raises revenue from those financial institutions that specialize in short-term speculation—often at the expense of patient investors. And enabling financial regulators to turn on or off the financial transaction tax in extraordinary market circumstances addresses concerns over the potential impact on market liquidity and trading volumes.

One potential concern raised about a U.S. financial transactions tax is that it would drive trading to overseas financial markets. But this kind of tax is common among the United States’s economic rivals. Many countries have had or currently level a financial transactions tax, including 14 of 19 among Group of 20 developed and developing countries, and many countries with large financial centers.<sup>69</sup>

Our proposed financial transaction tax is modest when compared to those currently imposed in other financial centers, including the United Kingdom and Singapore. The U.K. “stamp” tax is 0.5 percent on every stock trade and yet London has one of the top stock markets in the world. And Singapore levies a 0.2 percent tax on each stock trade. Both international experience and theory suggest that the risk that the U.S. financial sector will migrate to other countries is small. The less than \$50 billion in transaction tax revenues raised in 2017 is microscopic when compared to the annual financial trading volume in U.S. markets.

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## Business tax reform

A pro-growth tax code is one that raises adequate revenue while letting markets, not tax considerations, drive investment decisions. Unfortunately, our current tax code is replete with loopholes and special subsidies that distort investment and impede economic growth.<sup>70</sup> Many of these loopholes are simply wasteful and ineffective giveaways, among the most egregious being the \$4 billion in annual tax subsidies for oil companies. Many of these tax loopholes are eliminated under our plan, along with many other ineffective or wasteful tax expenditures, including special breaks for corporate meals and entertainment, hedge fund managers, coal, timber, and agribusiness. A complete list of the tax expenditures our plan reforms or eliminates is in Appendix 3 on page 61.

Many companies use a variety of techniques to avoid paying taxes altogether or to pay only nominal rates. Our plan adopts several proposals in President Obama’s budget to broaden the corporate tax base by addressing international tax loopholes. Several of these address corporate tax strategies whereby global companies

minimize taxes by shifting income overseas. While the details of comprehensive business tax reform are beyond the scope of this project, our proposals begin the process of rehabilitating the business tax base while raising a reasonable amount of additional revenue from the corporate income tax.

We believe comprehensive business tax reform should reverse the erosion of the corporate tax base through the increased use of so-called pass-through businesses that pay no corporate income tax but pass through their earnings directly to their owners, and by realigning tax incentives toward domestic job creation. It is also important to address the abuse of overseas tax havens by corporations and income shifting abroad. These reforms would broaden and protect the corporate tax base while potentially allowing for a lower corporate rate.

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## Other tax reforms

There are a number of other important tax changes in this CAP plan that the Center has detailed in previously published reports and which are presented in the appendices beginning on page 57. Among those changes:

- Remove the cap on the employer side of the payroll tax as described in the CAP Social Security plan.<sup>71</sup> Currently, the payroll tax to fund Social Security is only applied to earned income up to \$106,800. Our proposal removes that cap but only on the part of the Social Security tax paid by employers, not the part paid by employees.
- Restore the estate tax to approximately pre-Bush-tax-cut levels, but indexed for inflation.
- Adopt several revenue proposals in President Obama's 2011 and 2012 budgets, among them extending middle-class tax relief while allowing the high-end Bush tax cuts to expire, until our full-blown individual income tax reform goes into effect in 2017.
- Adopt other revenue measures, including an Internet gambling fee and Superfund excise tax.

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## The bottom line on revenue

Overall, our plan raises revenues in 2030 by less than 2 percent of GDP compared to the Congressional Budget Office baseline. From there, revenue drops to 23.8 percent of GDP by 2035, just half a percentage point above the baseline. Most importantly, our plan raises enough revenue to balance the budget without handing the bill to the middle class.



# Conclusion

The concern in Washington about our nation's fiscal situation is sincere. But the barriers to progress are not merely political. The barriers reflect major disagreements about the future of our country. The Center for American Progress view is embodied in the plan presented here.

We believe the debate over whether government is too big or too small is too abstract to be useful. It's not about the size of government; it's about what we, as a society, are better off accomplishing as a people rather than individually. At the most extreme, we could confine the size of government to a short list of activities that existed early in our nation's history. A court system, a military, a common currency, the issuing of patents—these are certainly important functions of the federal government; but today our nation needs a 21st century government, not an 18th century version.

The role of the federal government has grown over our nation's life for good reason. This expansion came in response to the need to address real problems. Whether it's the need of the elderly for Medicare, the importance of educating our children, the desire for airliners to be safe, or the simple public health imperative of safe food and drinking water, the government has assumed a role in these areas in response to legitimate needs. As our country has grown and our lives have become more complicated, the federal government has had to grow as well. Hamstringing government will not make the world less big and complicated—it will just leave everyone on their own to deal with challenges that really can only be dealt with collectively.

That doesn't mean, of course, that every expansion of the role of the federal government has been a good one. Nor does it mean that everything the government does is done well. But focusing on some arbitrary goal for the size of government is the wrong way to address those problems. Instead, we need to be having a serious discussion, subject by subject, about what government should be doing and how. We do not want to spend taxpayer dollars frivolously or spend them inef-

ficiently. And in the end, once we identify the important activities of government, those that are worth their cost in terms of economic growth, meeting our obligations, and improving the well-being of Americans, we should take responsibility for paying for them.

In this report we engage in that discussion. We have prioritized activities that the federal government can engage in to grow our economy, and those activities that private interests, left to their own devices, won't deliver. We protect and enhance public services that, simply put, make people's lives better and safer. And for national challenges that are best addressed collectively, we employ our strongest mechanism for collective action: the federal government.

There are many reasons that America rose to greatness. The individual contributions of millions over the last 235 years built our country. We invented the great inventions, built the great corporations. But even though we may all want to think of ourselves as brave homesteaders out on the range building our lives without any outside help, that's not the only way it happened. Even those homesteaders benefited from the decision to grant the rights to those lands not to the highest bidders, but instead to those who were willing to work the land. It isn't the government's job to build the nation brick by brick, but there are public investments our nation needs, and there is a role in making a country that offers hope, promise, and security, and builds a strong middle class.

Of all the amazing American innovations, surely the greatest is our democracy itself. By giving voice to the many instead of just the few, we have built a country governed by those who are dedicated to and dependent on its future. The vast majority of Americans can't put their children in private schools or individually endow scientific research. And these Americans know that roads and bridges are important to their communities and their future. They know that their fortunes are tied to the fortunes of their country. That is why we believe that our plan is not only best for America but that, in the long run, it is not far from what Washington must do.

## APPENDIX 1

# Individual income tax rate structure in the CAP plan

FIGURE 29

### Comparison of federal income tax brackets, with Bush tax cuts, without Bush tax cuts, and under CAP reform

Couples								
With Bush tax cuts			Without Bush tax cuts			CAP plan		
Marginal rate	Over	But not over	Marginal rate	Over	But not over	Marginal rate	Over	But not over
10%	\$0	\$17,000	15%	\$0	\$69,000	15%	\$0	\$100,000
15%	\$17,000	\$69,000	28%	\$69,000	\$139,350	25%	\$100,000	\$150,000
25%	\$69,000	\$139,350	31%	\$139,350	\$212,300	30%	\$150,000	\$400,000
28%	\$139,350	\$212,300	36%	\$212,300	\$379,150	39.60%	\$400,000	-
33%	\$212,300	\$379,150	39.60%	\$379,150	-			
35%	\$379,150	-						

Singles								
With Bush tax cuts			With 2001-03 tax cuts expired			CAP plan		
Marginal rate	Over	But not over	Marginal rate	Over	But not over	Marginal rate	Over	But not over
10%	\$0	\$8,500	15%	\$0	\$34,500	15%	\$0	\$50,000
15%	\$8,500	\$34,500	28%	\$34,500	\$83,600	25%	\$50,000	\$75,000
25%	\$34,500	\$83,600	31%	\$83,600	\$174,400	30%	\$75,000	\$200,000
28%	\$83,600	\$174,400	36%	\$174,400	\$379,150	39.60%	\$200,000	-
33%	\$174,400	\$379,150	39.60%	\$379,150	-			
35%	\$379,150	-						

Notes: Bracket thresholds for heads of households are halfway between those for joint filers and singles. "With" and "Without Bush Tax Cuts" brackets are 2011 levels unadjusted for projected inflation.

## APPENDIX 2

# Other revenue proposals in the CAP plan

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### Estate tax

As a temporary measure in our plan to reach primary balance in 2015, our plan adopts President Obama’s proposal to return the estate tax to its 2009 parameters starting in 2012.

In 2017, at the same time that our comprehensive income tax reform plan would go into effect, our plan roughly reinstates the estate tax as it existed before the presidency of George W. Bush, but with higher exemption levels. The exemption was \$1.35 million per couple in 2000 and 2001. Under our plan it is indexed for inflation from a baseline of \$2 million in 2001 so that in 2017, the first year our plan takes effect, it will be about \$2.8 million per couple. Thus, under our plan, a married couple would be able to pass on \$2.8 million to their heirs tax free. This would exempt close to 99 percent of all estates from the estate tax altogether.<sup>72</sup>

The small fraction of estates larger than \$2.8 million would pay estate tax on the value of the estate that exceeds that amount according to a progressive rate schedule ranging from 18 percent to 55 percent. The top 55 percent is the same or lower than it was for nearly seven decades from 1934 through 2001.<sup>73</sup> Special provisions that make compliance easier for the very few small businesses and farms that are subject to the tax would be continued. We are not opposed to other responsible changes to the tax that are revenue neutral relative to our proposal.

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### CAP Social Security plan

Our plan relies on two revenue proposals to ensure the 75-year solvency of Social Security. As described in CAP’s report “Building It Up, Not Tearing It Down,” we propose that:



- The cap on the employer side of the payroll tax is removed. Currently, the payroll tax to fund Social Security is only applied to earned income up to \$106,800. Our proposal removes that cap but only on the part of the Social Security tax paid by employers, not the part paid by employees.
- Cafeteria plan benefits are treated as wages, similarly to salary-reduction contributions to 401(k) plans, for purposes of calculating the employer share of the Social Security tax.<sup>74</sup>

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## Revenue proposals in President Obama's fiscal year 2012 budget

As part of the necessary steps toward achieving primary balance in 2015, our plan adopts several of the revenue proposals in President Obama's FY 2012 budget. Some of these are incorporated into our long-term proposal while others are superceded. The proposals include:

- Extending expiring tax cuts, including the 2001-2003 Bush-era tax cuts, for families with incomes of less than \$250,000 (\$200,000 for singles) while allowing the high-end tax cuts to expire on schedule at the end of 2012. This includes extending the current tax brackets for middle-class taxpayers, maintaining the \$1,000 child credit, and maintaining the earned income tax credit enhancements implemented in the American Recovery and Reinvestment Act of 2009. These changes are superceded by comprehensive income tax reform starting in 2017.
- Adopting the international tax reform proposals in the FY 2012 budget. These proposals are incorporated into our long-term revenue projections.
- Repealing tax expenditures—including fossil-fuel subsidies; the carried interest loophole for hedge fund and private equity fund managers; and the so-called last-in-first-out, or LIFO, and lower-cost-or-market, or LCM, inventory methods.
- Limiting itemized deductions to 28 percent. This is superceded by our comprehensive income tax reform in 2017.
- Limiting certain aggressive strategies used to reduce estate and gift taxes.
- Imposing a systemic risk fee of 0.15 percent on liabilities of large financial firms with more than \$50 billion of assets.
- Reinstating Superfund taxes to make polluters pay for environmental cleanup efforts.

- Extending relief from the alternative minimum tax for the middle class by indexing it through 2016. The AMT is eliminated as part of our comprehensive income tax reform in 2017.
- Permanently extending the research tax credit.

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### Millionaire's surtax

As described in our report “The First Step: A Progressive Plan for Meaningful Deficit Reduction by 2015,” we propose a temporary surtax on adjusted gross income of more than \$1 million beginning in 2015. The surtax is 2 percent on income of more than \$1 million and less than \$10 million, and 5 percent on income of more than \$10 million.<sup>75</sup> This surtax is superceded by our broader reform that goes into effect in 2017.

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### Alcohol and tobacco excise taxes

Our proposal raises revenues from activities that lead to poor health and increased health care costs. The plan increases the existing federal excise tax on cigarettes by 50 cents per pack and raises various existing federal excise taxes on alcoholic beverages to a single levy of \$16 per proof gallon for all alcoholic beverages.

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### License fees on Internet gambling

Our proposal imposes a regulatory framework for Internet gambling and collects a license fee from each authorized site equal to 2 percent of deposits into gambling accounts, with unauthorized bets or wagers subject to a 50 percent fee. Required information returns and withholding would enable proper collection of gambling winnings. The proposals mirror those in H.R. 2268 (111th Congress), offered by Rep. McDermott.<sup>76</sup>

## APPENDIX 3

# Tax expenditures reformed or eliminated under the CAP plan

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### Tax expenditures *reformed* under the CAP revenue plan

- *Itemized deductions.* Itemized deductions replaced with 15 percent itemized credits. Mortgage interest credit is limited to \$25,000 in mortgage interest incurred to acquire, build, or improve a primary residence, or to refinance an existing mortgage. Transition credit available for existing homeowners. (see Appendix 4 for more detail)
- *Retirement savings incentives.* Deductions for contributions to defined contribution retirement savings accounts replaced with a 33 percent refundable tax credit deposited directly into the account. Annual per-person contributions limited to \$15,000 or 15 percent of adjusted gross income.
- *Step-up in basis at death.* Currently, gains on assets fully escape income taxation when they are bequeathed to heirs because the heirs’ “basis” in the asset is deemed to be the asset’s fair market value at the time of the decedent’s death. Our proposal replaces the current step-up in basis to 100 percent of the property’s fair market value at death with a step-up in basis to 50 percent of its fair market value, unless the heirs can establish that the decedent’s basis was higher.
- *Exclusion from income of interest on state and local public purpose bonds.* Our plan reduces the cost of this tax expenditure by reinstating Build America Bonds introduced in the American Recovery and Reinvestment Act of 2009, and limiting tax-exempt bonds.<sup>77</sup>
- *Preferential capital gains rates.* Capital gains taxed as ordinary income with 28 percent maximum rate—the level the rate was from 1987–1997.
- *American Opportunity Tax Credit.* Made permanent and converted to an itemized credit.
- *Deferral of income of foreign subsidiaries.* International tax reforms adopted from President Obama’s FY 2012 budget proposals reduce ability of multinational corporations to shift income abroad to defer U.S. taxes.

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## Tax expenditures *eliminated* under the CAP revenue plan

- Fossil-fuel tax expenditures
  - Enhanced oil recovery credit
  - Credit for oil and gas produced from marginal wells
  - Expensing of intangible drilling costs
  - Deduction for tertiary injectants
  - Exception to passive loss limitation for working interests in oil and natural gas properties
  - Percentage depletion for oil and natural gas wells
  - Domestic manufacturing deduction for oil and natural gas companies
  - Geological and geophysical amortization period for independent producers increased to seven years
- Coal tax expenditures
  - Expensing of exploration and development costs
  - Percentage depletion for hard mineral fossil fuels
  - Capital gains treatment for royalties
  - Domestic manufacturing deduction for coal and other hard mineral fossil fuels
- Timber tax expenditures
  - Expensing of multiperiod timber growing costs
  - Capital gains treatment of certain timber income
- Agriculture tax expenditures
  - Capital gains treatment of certain income from agricultural sales
  - Expensing of certain multiperiod agricultural production costs
  - Expensing of certain capital outlays including fertilizer and feed
- Exclusion of “inside buildup” of life insurance
- Carried interest loophole
- Preferential dividend rates: dividends taxed as ordinary income
- Business meals and entertainment deduction
- Foreign earned income exclusion
- Exemption of credit union income
- Exemption of income of certain insurance companies operated by tax-exempt organizations
- Special Blue Cross Blue Shield deduction
- Exception from passive loss rules for \$25,000 in rental loss

- Exclusion of employer-provided parking reimbursements
- Exclusion of interest on private purpose bonds
- Last-in-first-out, or LIFO, and lower-cost-or-market, or LCM, accounting methods
- Health savings accounts and flexible spending accounts
- Itemized deduction for state and local sales taxes
- Ethanol tax credits
- Child and dependent care credit
- Employer subsidies for child and dependent care
- Tax expenditures for higher education other than the American Opportunity Tax Credit

## APPENDIX 4

# Reforming the mortgage interest deduction carefully and equitably

Sustainable homeownership strengthens communities and helps families build financial security. But the mortgage interest deduction in its current form, with a cost of more than \$100 billion per year, is an expensive and badly targeted incentive for homeownership. It provides a much greater subsidy for wealthy homeowners in top tax brackets because of the so-called “upside-down” effect: A \$100 deduction is worth \$35 to a taxpayer in the 35 percent tax bracket and only \$15 to a taxpayer in the 15 percent bracket. (The “upside-down” effect is explained further in the text box on page 45.) This disparity is worsened by the fact that wealthy taxpayers can deduct interest on mortgages up to \$1.1 million in size and mortgages for vacation homes. Wealthy taxpayers receive subsidies from the mortgage interest deduction up to 10 times as large as middle-class families:<sup>78</sup>

At the same time, reforming the mortgage interest deduction is difficult because it is deeply ingrained in our economy. Millions of current homeowners took out mortgages with the expectation of a tax deduction at their marginal tax rates. The value of the existing deduction is factored into the current value of their homes.

We are conscious that now is a precarious moment for the housing sector. Foreclosures have battered communities in all corners of America. House prices

**FIGURE 30**  
**The “upside-down” effect**

Benefits of mortgage interest tax break by income level

Household income	< \$40,000	\$40,000–\$75,000	\$75,000–\$125,000	\$125,000–\$250,000	\$250,000+
Average tax savings from the mortgage interest deduction	\$91	\$523	\$1,264	\$2,703	\$5,459

Source: James Poterba and Todd Sinai, “Tax-Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income,” available at <http://real.wharton.upenn.edu/~sinai/papers/Poterba-Sinai-2008-ASSA-final.pdf>.

have declined significantly, with negative effects throughout the economy. Fully 23 percent of Americans are currently “underwater” on their mortgages—that is, they owe more than their homes are currently worth.

What’s more, there is a significant likelihood for other policy changes over time that could also weaken home values. One almost certain change over time is lower loan limits for loans eligible for purchase and inclusion in Fannie Mae and Freddie Mac mortgage-backed securities and Federal Housing Administration mortgage insurance, which will likely reduce liquidity and raise costs for higher dollar mortgages, thus reducing the availability of credit and the pool of eligible buyers, putting downward pressure on the value of higher-priced homes. And then there are the specific housing markets that have the highest concentrations of high-cost homes, so these policy changes may have a disproportionate impact on families in these communities.

For these reasons, the transition to a more equitable and efficient homeownership incentive must be undertaken with great caution. Given the size of the federal budget deficit, however, we simply cannot afford to leave in place an untargeted and hugely expensive subsidy. So we must target the mortgage interest deduction more carefully to those for whom it is a significant factor in expanding access to homeownership and the benefits it brings to strengthening communities.

Those changes must be accomplished gradually with a clear eye on the impact on middle-class families. Therefore the CAP plan proceeds in increments, with transition relief for affected homeowners. And we offer the reform in the context of a plan that will reduce the average federal income tax burden, on average, for the bottom 95 percent of households. Specifically, in 2015 we adopt President Obama’s proposal to limit the value of all itemized deductions, including mortgage interest, to 28 percent. This proposal would reduce the value of all deductions (including the mortgage interest deduction) only for taxpayers in the 33 percent and 35 percent tax brackets.

Starting in 2017 the mortgage interest deduction is reformed into an itemized credit with important transition rules to protect homeowners. Taxpayers in all brackets may choose to claim a credit worth 15 percent of their qualifying mortgage expense. The maximum amount of mortgage interest that will qualify for the credit is \$25,000. For mortgages originated in 2017 and later, the credit will be limited to interest on debt incurred to acquire, build, or improve a primary residence, or to refinance an existing mortgage.

Thus, the mortgage interest deduction becomes a 15 percent itemized credit. The new credit is much fairer than the existing deduction, providing the same tax benefit per dollar of mortgage interest to taxpayers regardless of their tax bracket, and within a limit of \$25,000 in interest (the amount of interest a homeowner would pay in the first year of a \$500,000 mortgage at 5 percent interest).

Out of fairness to current mortgage holders, and to minimize disruptions in the housing market, transition relief is available to homeowners in tax brackets above 15 percent. In 2017 affected homeowners—those in tax brackets above 15 percent—will be eligible for an additional 10 percent transition credit. Combined with the 15 percent itemized credit for mortgage interest, taxpayers will essentially be able to take a 25 percent credit for mortgage interest expense (equivalent to a deduction capped at 25 percent as under the Obama proposal).

Each year after 2017, the transition credit is reduced by 1 percent, until fully eliminated in 2027. The plan therefore gradually reduces the maximum value of the mortgage interest deduction from the current maximum of 35 percent, to 28 percent in 2015, then essentially to 25 percent in 2017. It is reduced by 1 percentage point every year until 2027, when the mortgage interest deduction has been fully transformed into a flat 15 percent credit.

We believe that such a gradual phase-down of the mortgage interest deduction into a credit over a 16-year timeframe will mitigate the impact on the value of higher-cost homes. Specifically, the gradual phase-in provides sufficient time for house price appreciation to overwhelm any impact on home values. We believe the reform should not cause significant harm to housing markets.

In fact, the United Kingdom fully phased out its mortgage interest subsidy during the 1990s with no negative impact on homeownership rates.<sup>79</sup> And in the years after Britain announced its phase-out of mortgage interest relief, U.K. home prices actually grew faster than U.S. home prices. Our plan is more incremental, as it leaves in place a 15 percent itemized credit for mortgage interest. We believe it represents a careful, fiscally responsible approach to making the mortgage interest tax expenditure more efficient and equitable.



## APPENDIX 5

# Timeline of CAP revenue proposals

- 
- **2012**
    - Revenue proposals in President's budget and CAP Social Security plan implemented
    - Some tax expenditures eliminated
  - **2013**
    - Tax cuts extended for middle class families
    - Bush tax cuts for the wealthy expire
    - Estate tax returned to 2009 parameters
  - **2015**
    - CAP's First Step revenue proposals implemented:
      - 2 percent surtax on income above \$1 million
      - 3 percent additional surtax on income above \$10 million
      - oil import fee
      - tax expenditures eliminated or reduced
    - Revenue from cigarettes, alcohol, internet gambling
  - **2017**
    - Comprehensive income tax reform supercedes earlier changes
    - 5 percent surtax on income above \$1 million
    - Price imposed on carbon
    - Financial transactions tax implemented
    - Estate tax reform
  - **2030**
    - Budget balanced - millionaire surtax expires
  - **2033**
    - Large budget surplus—10 percent reduction in income taxes

## APPENDIX 6

# The federal budget under the CAP plan, 2012-2035

FIGURE 30

Federal spending, revenue, deficits and debt, as a percent of GDP, 2012-2035, under CAP plan

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Social Security	4.9	4.9	4.9	4.9	4.9	4.9	5.0	5.1	5.2	5.2	5.3	5.3	5.4	5.5	5.5	5.6	5.7	5.8	5.8	5.8	5.8	5.8	5.9	5.9
Medicare, Medicaid	5.5	5.6	5.9	6.2	6.6	6.7	6.7	7.0	7.2	7.3	7.1	7.1	7.1	7.2	7.3	7.3	7.3	7.4	7.4	7.6	7.6	7.7	7.7	7.8
Security	5.1	4.7	4.5	3.8	3.7	3.6	3.6	3.6	3.5	3.5	3.5	3.5	3.5	3.5	3.4	3.4	3.4	3.4	3.4	3.3	3.3	3.3	3.2	3.2
All else	6.3	5.9	5.4	4.9	4.8	5.0	4.9	4.9	4.9	4.8	4.8	4.8	4.7	4.7	4.5	4.5	4.4	4.3	4.3	4.3	4.2	4.1	4.0	4.0
Net Interest	1.7	2.0	2.3	2.6	2.8	2.9	3.0	3.0	3.1	3.0	3.3	3.3	3.4	3.3	3.3	3.2	3.2	3.0	3.0	2.8	2.6	2.5	2.4	2.3
<b>Total outlays</b>	<b>23.5</b>	<b>23.1</b>	<b>23.0</b>	<b>22.3</b>	<b>22.7</b>	<b>23.2</b>	<b>23.2</b>	<b>23.6</b>	<b>23.8</b>	<b>23.8</b>	<b>24.0</b>	<b>24.0</b>	<b>24.1</b>	<b>24.1</b>	<b>24.1</b>	<b>24.0</b>	<b>24.0</b>	<b>23.9</b>	<b>23.9</b>	<b>23.8</b>	<b>23.6</b>	<b>23.5</b>	<b>23.3</b>	<b>23.2</b>
Existing revenue sources, as reformed	16.3	18.5	19.3	19.6	19.7	20.6	21.0	21.0	21.1	21.3	21.5	21.7	21.8	22.0	22.1	22.3	22.5	22.7	22.9	22.9	23.1	23.3	22.5	22.7
Oil import fee and price on carbon				0.1	0.1	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Financial Transactions Tax						0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
<b>Total revenue</b>	<b>16.3</b>	<b>18.5</b>	<b>19.3</b>	<b>19.7</b>	<b>19.8</b>	<b>21.4</b>	<b>22.0</b>	<b>22.0</b>	<b>22.1</b>	<b>22.3</b>	<b>22.4</b>	<b>22.6</b>	<b>22.8</b>	<b>23.0</b>	<b>23.1</b>	<b>23.3</b>	<b>23.5</b>	<b>23.7</b>	<b>23.9</b>	<b>23.9</b>	<b>24.1</b>	<b>24.3</b>	<b>23.5</b>	<b>23.8</b>
<b>Deficit</b>	<b>7.1</b>	<b>4.7</b>	<b>3.7</b>	<b>2.6</b>	<b>2.9</b>	<b>1.8</b>	<b>1.2</b>	<b>1.6</b>	<b>1.7</b>	<b>1.6</b>	<b>1.5</b>	<b>1.3</b>	<b>1.3</b>	<b>1.1</b>	<b>1.0</b>	<b>0.7</b>	<b>0.5</b>	<b>0.2</b>	<b>0.0</b>	<b>-0.2</b>	<b>-0.6</b>	<b>-0.9</b>	<b>-0.3</b>	<b>-0.6</b>
<b>Debt</b>	<b>74.1</b>	<b>76.1</b>	<b>76.4</b>	<b>75.6</b>	<b>75.2</b>	<b>74.1</b>	<b>72.5</b>	<b>71.5</b>	<b>70.6</b>	<b>69.7</b>	<b>68.9</b>	<b>67.5</b>	<b>66.5</b>	<b>64.9</b>	<b>63.4</b>	<b>61.6</b>	<b>59.7</b>	<b>57.7</b>	<b>55.2</b>	<b>52.7</b>	<b>50.0</b>	<b>47.1</b>	<b>44.7</b>	<b>42.3</b>

# Endnotes

- 1 As part of the Peterson Foundation's Solutions Initiative, each participating organization was required to submit their proposals to independent scoring. To allow for fair and objective comparisons of the plans, the foundation engaged independent scorekeepers to review the estimates and analyses for each plan. This scorekeeping effort was led by Barry Anderson, former acting director at the Congressional Budget Office and senior career civil servant at the Office of Management and Budget. Eric Toder and Jim Nunns of the Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution, led the review of the plan's revenue proposals. Bill Menth, former OMB senior analyst, tracked each of the plans' specific proposals and performed aggregate comparisons of the plans. The independent scorekeepers reviewed and confirmed the revenue and outlay effects of our proposals.
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- 59 Currently, the child credit is refundable up to 15 percent of earnings of more than \$3,000; under our plan, it is refundable up to 15 percent of all earnings, starting with the first dollar of earnings. Our plan also makes permanent the increased Earned Income Tax benefit for families with three or more children in the higher phase-out range for married filers.
- 60 There are some exceptions to this but the effect of slightly higher rates for small bands of income are offset by the other changes in the tax code so that by overwhelming numbers, middle- and low-income taxpayers are better off. For example, taxpayers currently in the lowest 10 percent bracket, which is condensed into the 15 percent bracket under our plan, benefit much more from the alternative credit.
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