Center for American Progress

Rebalancing the Tax System

John S. Irons, Ph.D.

Presented at the "Promoting the General Welfare"
Sixth Annual Labor Studies Conference
Omaha, Nebraska

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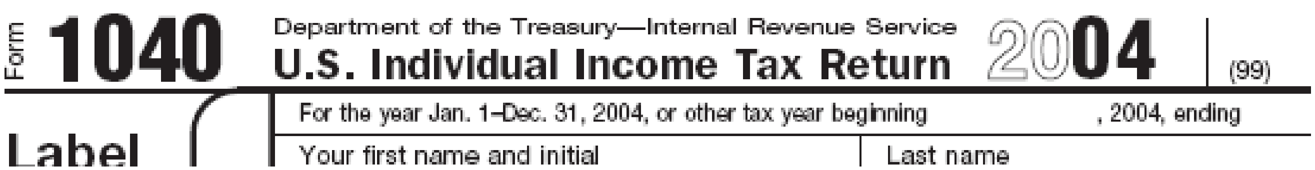
Progressive Ideas for a Strong, Just and Free America

Overview

- **Tax Basics**
- **Current Code**
- **Responsible Reform and Simplification**


Form 1040 Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2004 (99)
Label
For the year Jan. 1–Dec. 31, 2004, or other tax year beginning , 2004, ending
Your first name and initial | Last name

Balance

- Across Income Levels
- Wealth and Work
- Individual and Corporate
- Across governmental levels
  - Federal/State/Local

Tax Concepts: Progressivity

- Regressive vs. Progressive taxation
  - Progressive:
    - Tax owed as a share of income rises with income
    - Bill Gates pays more than you, as a percentage of income
  - Regressive:
    - Tax owed as a share of income falls with income
    - Bill Gates pays a smaller percent than you

Tax Concepts: Progressivity: Examples

- Progressive taxes
  - Income tax (because we have progressive tax brackets)
  - Estate tax (only impacts those with more than $1.5 million in assets)
- Regressive taxes
  - Sales taxes (because lower- and average income taxpayers spend more as a share of their income)
  - Payroll taxes (because taxable wages are capped at $90,000)

Concepts: Marginal and Effective Tax Rates

- Marginal Tax rates
  - The amount of additional tax paid for earning extra money
    - 25% marginal tax rate means $25 in additional tax for each additional $100 earned
- Effective tax rates
  - The total amount of tax paid as a share of total income
- Effective tax rates are lower than marginal tax rates due to exclusions, deductions, etc.

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Concepts: Equity

- Horizontal equity
  - Equal treatment across similarly situated people
- Vertical equity
  - Fairness across income levels
    - Shared Sacrifice
      - Those that can best afford to pay, ought to pay more
      - $1,000 to you means a lot more than $1,000 to Bill Gates
      - 20% of your income means more to you than 20% of Bill Gates' income (He'll still be a billionaire!)

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Concepts: Efficiency

- Need to raise revenue for our nation’s priorities
  - Want to cause as few economic distortions as possible
    - (don’t want to provide harmful incentives)
- Deficits
  - Cause higher interest rates, harms long-run growth
  - Must be paid back…
    - …by future generations
    - …to foreign creditors

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Concepts: Tax Base

- Alternative bases
  - Income…
    - …from work – salaries and wages
    - …from investments and wealth – capital gains and dividends
  - Consumption
    - Sales (sometimes with exemptions, like food)
  - Payroll
  - Wealth
    - Property, Estates
  - Corporate profits
  - Tariffs
- Deductions/Exemption
  - Charitable giving, education, mortgage interest, etc…
- Broaden the base to keep rates low.

Capital Gains:
The increase in the value of stocks or other assets over time. Capital gains are taxed at the time when assets are sold.

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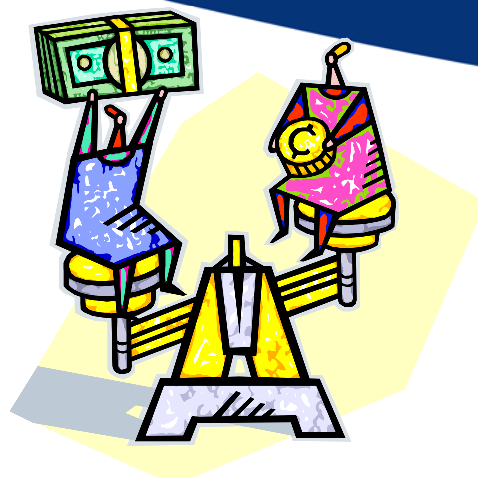
Current Situation

Under **current policy**, the tax system has become:

- **Unfair** – the bulk of the tax changes under the Bush administration benefited only a select few. The tax system has shifted away from the progressive income tax and has become increasing reliant on the payroll tax
- **Complex** – phase-ins and phase-outs, special benefits have made an already complex code worse
- **Irresponsible** – record surpluses have been turned into massive deficits

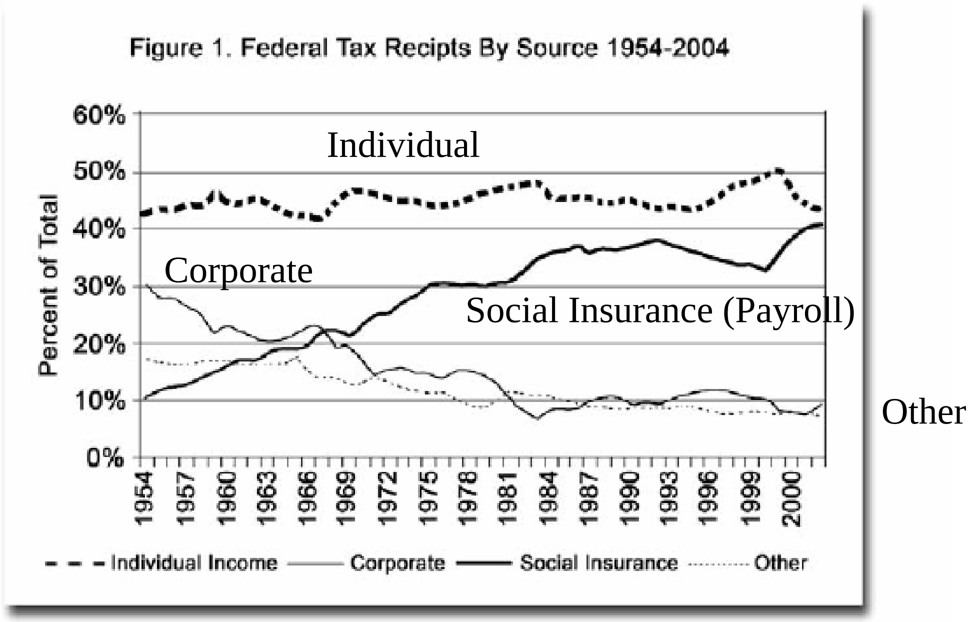
Unfair and Unbalanced



The tax system has shifted:

- Away from highest-income earners, onto the middle class
  - the bulk of the tax changes from 2001-2003 benefited a select few
- Away from the progressive federal income tax, onto the regressive payroll tax
  - Revenue has become increasing reliant on the payroll tax
- Away from wealth, onto work
  - Special treatment for capital gains, dividends
- Away from corporations, onto individuals
  - Corporate tax as a share of the economy at record lows
  - Many corporations pay no tax despite making billions.

Sources of Revenue – 1954-2004

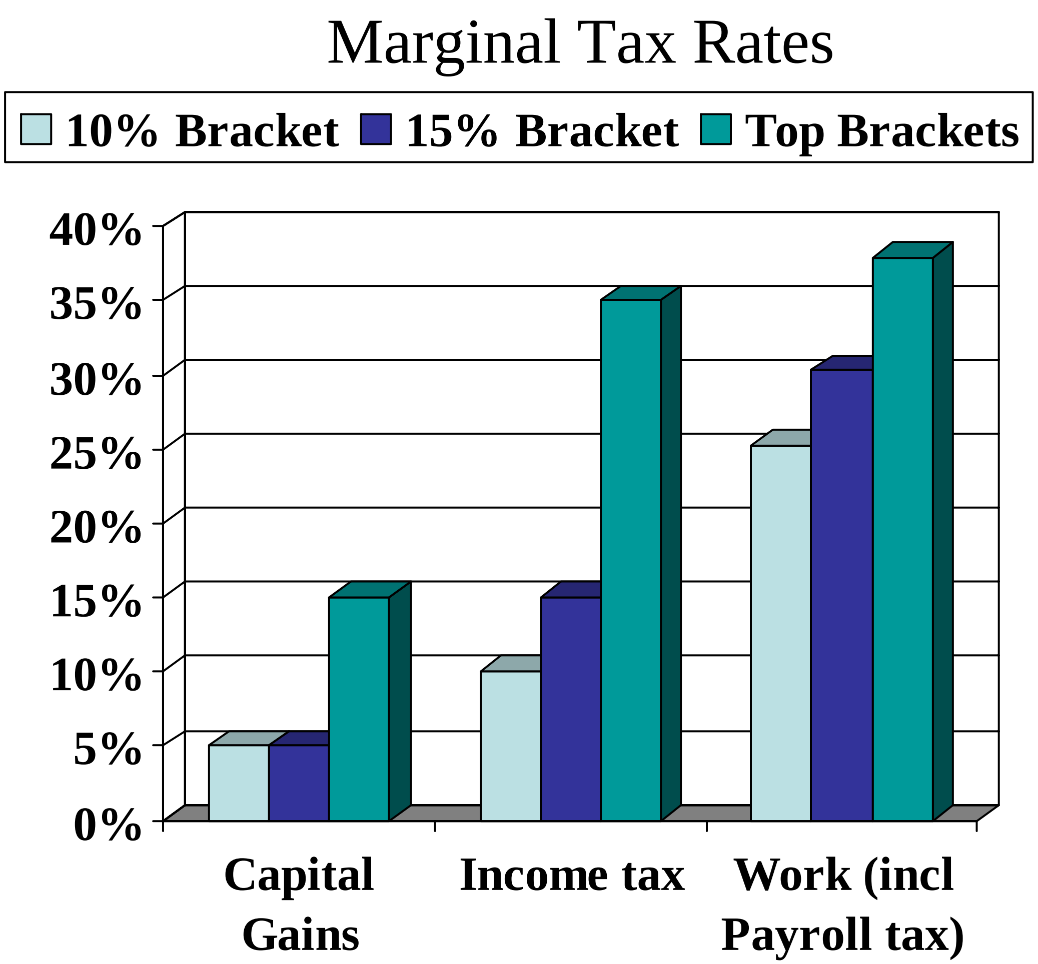


Source data: *Tax Policy Center*, available at http://www.taxpolicycenter.org/TaxFacts/ TFDB/ TFTemplate.cfm?Docid=203. Figures for 2004 are estimates.

- The payroll tax has become increasingly relied upon to finance the federal government
- The more progressive part of the tax code—corporate and individual income taxes—have been declining in importance

Wealth and Work

- Income from wealth is taxed at a lower rate than income from work.
- Over half of capital gains and dividends go to those making more than $1 million per year.



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Share of Federal Tax Liability

- The share of taxes paid by those who can best afford to pay has declined, while the share paid by the middle class has increased.
- In 2004, households making more than $1 million received an average federal income tax cut of $123,592, while the average change for those in the middle 20 percent of income was only $647.
  - For the middle class, much (if not all) of this was offset by higher state and local taxes, higher fees, higher tuition costs, etc.
- Federal deficit is currently more than $1,300 per person per year.

Complex

- President Bush has added 10,000 pages to our tax code and related regulations

- The Alternative Minimum Tax is causing additional complexity for growing numbers of tax filers
- Additional complexity can allow corporations and individuals to avoid tax

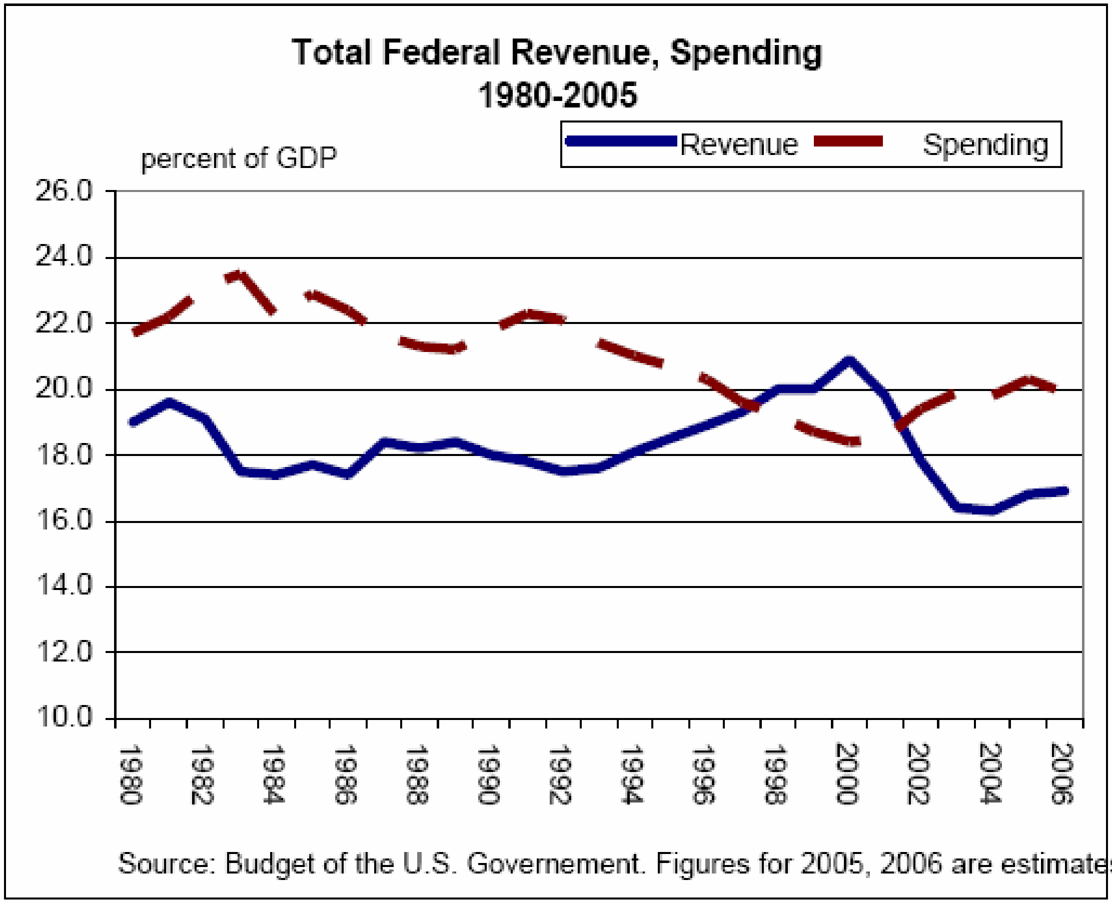
Irresponsible

Record surpluses have turned into massive deficits.

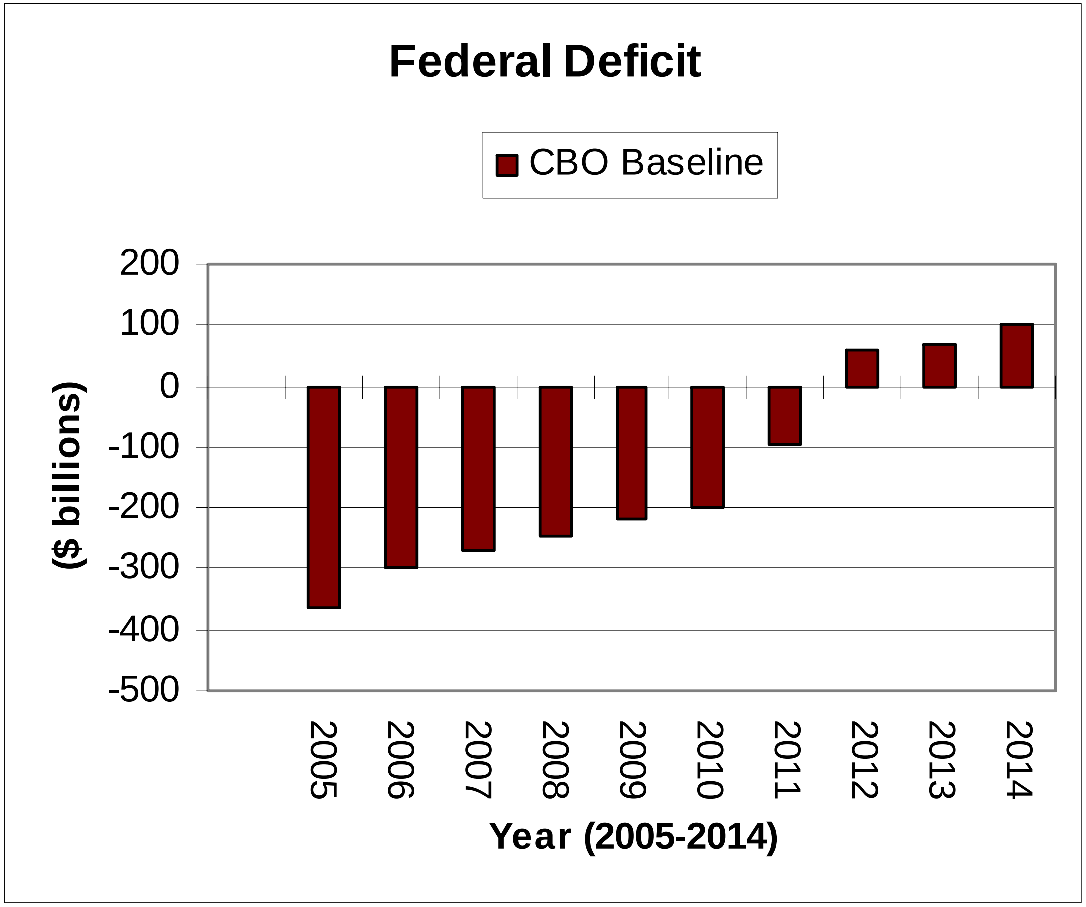
For fiscal year 2004:

- The deficit was over $400 billion
- At just 16.2 percent of gross domestic product, total federal revenue was at its lowest level since 1959
- Individual income tax revenues fell to their lowest level since 1950

Deficits – Revenue in 2004: Lowest level since 1959



Budget Outlook – CBO Baseline (March 2005)



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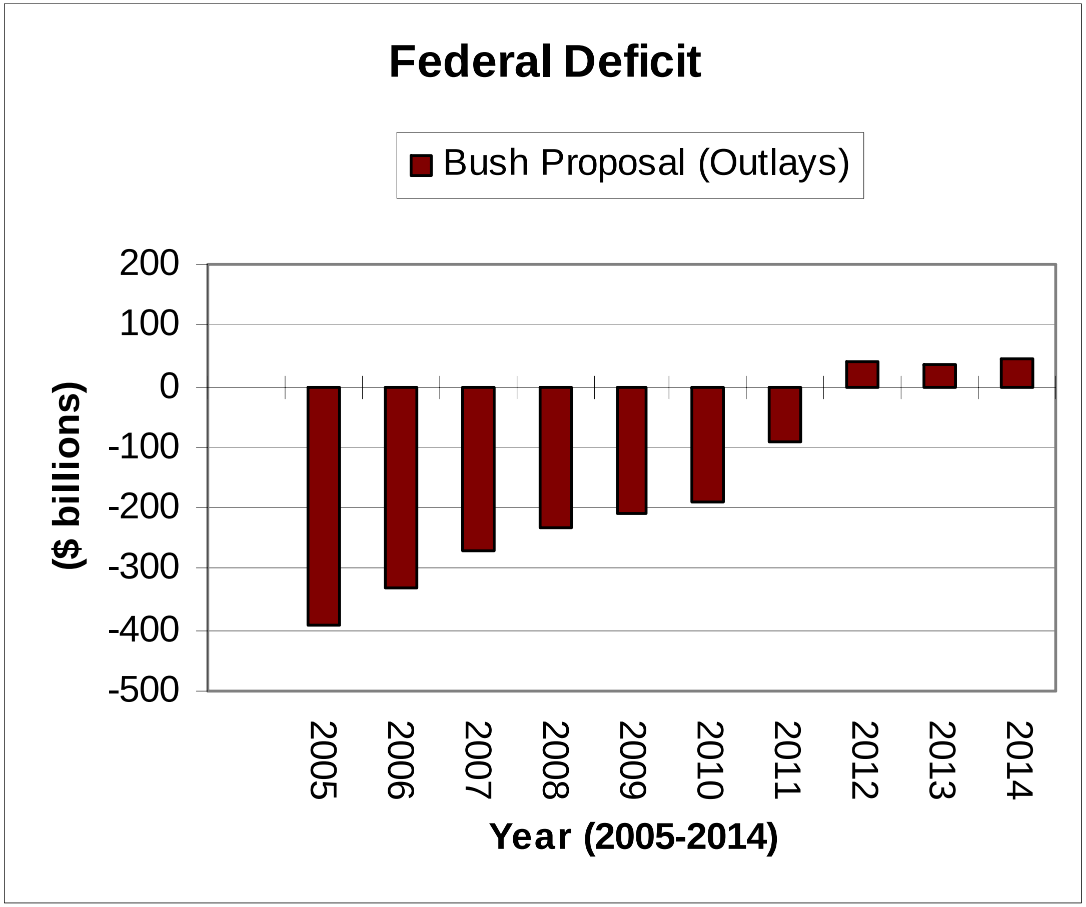
Budget Outlook – Including Bush Spending



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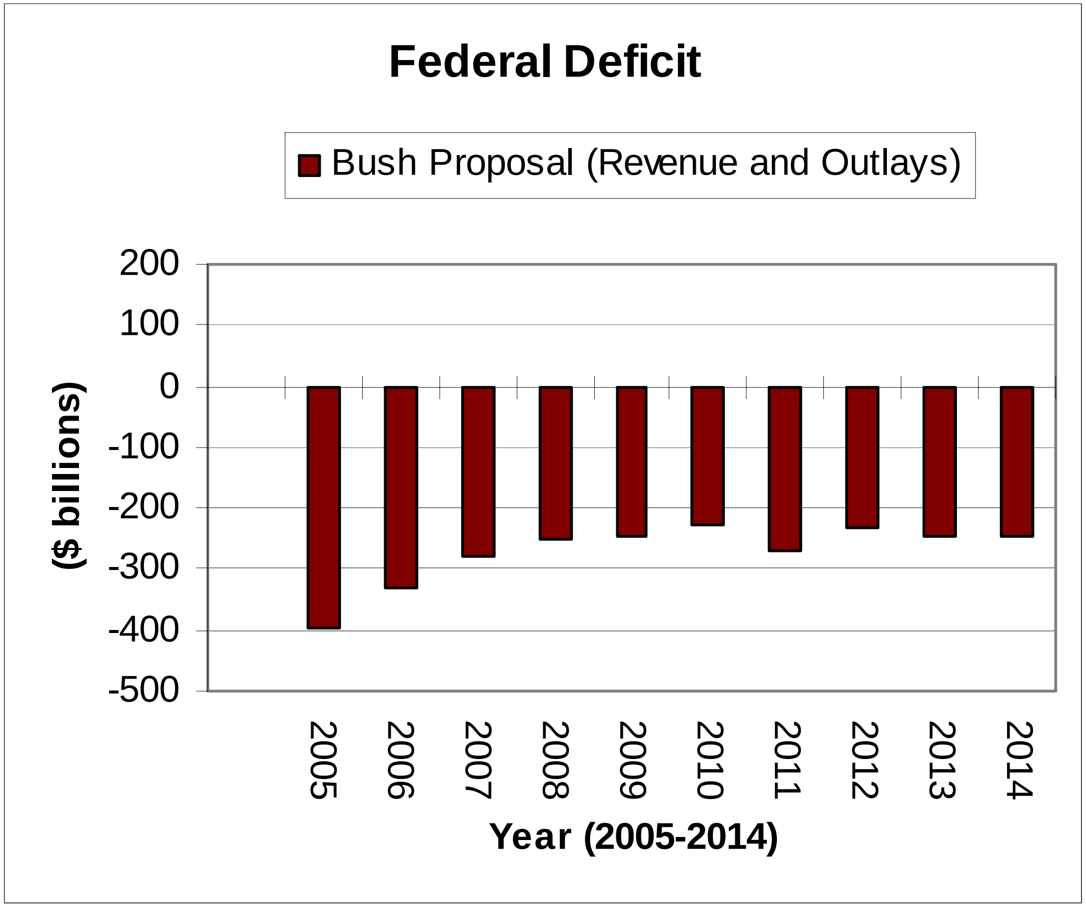
Budget Outlook – Including proposed tax changes



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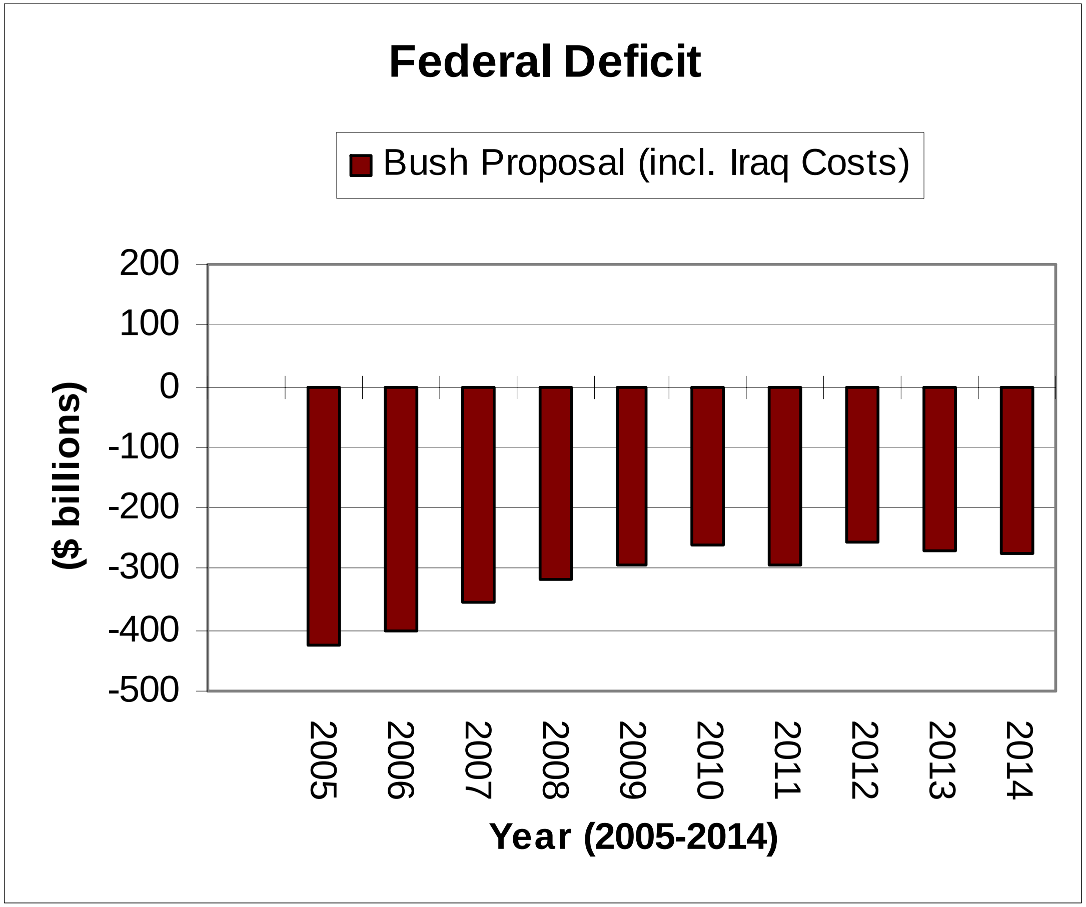
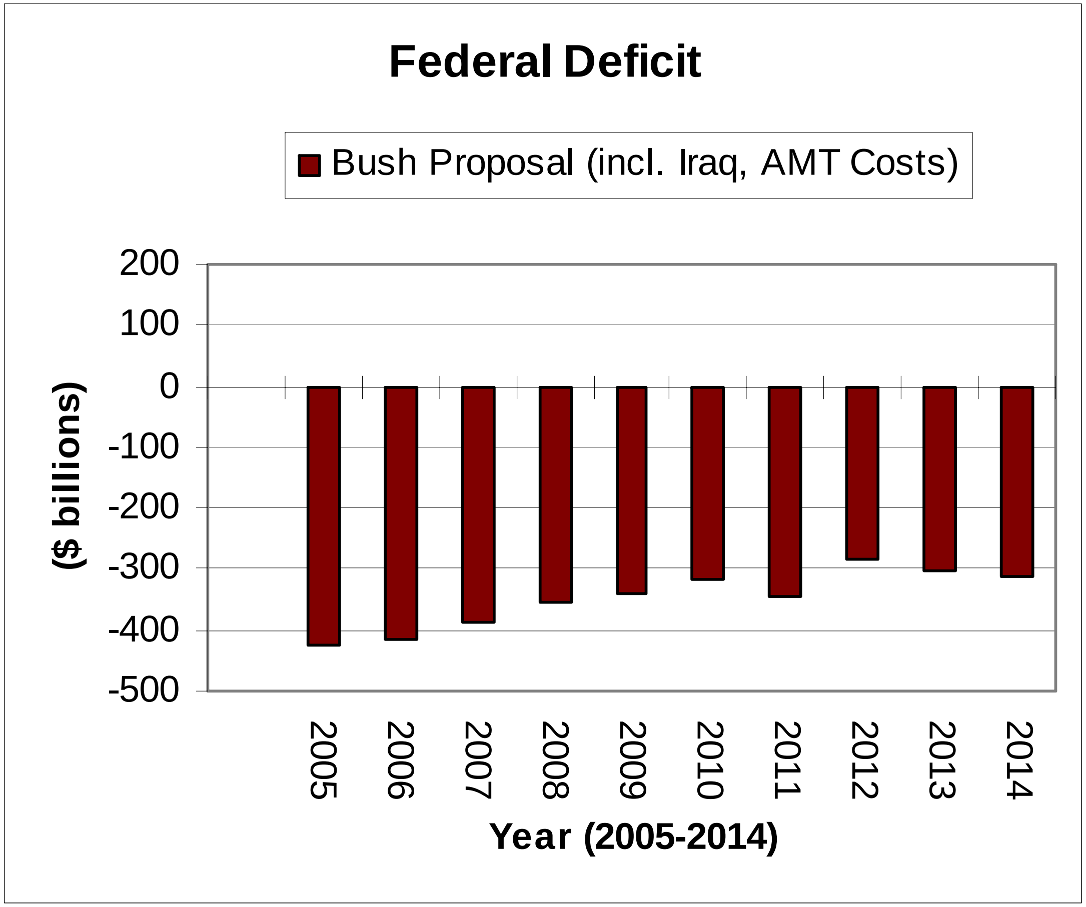
Budget Outlook – Including Iraq



Budget Outlook – Including AMT fix (indexing)



President and Congressional Proposals: Wealth and Work

- Eliminate tax on capital gains and dividends
  - For now, keep rates at low levels by extending capital gains and dividend provisions in 2001-2003 laws
    - Cost: $23 billion over 5 years, more than enough to avoid cuts to Medicaid.
- Eliminate tax on large estates
  - Extend repeal of the estate tax past 2010
  - Only about 1 percent pay the estate tax, and the first $1.5 million (or $3 million per married couple) is tax free!
  - Cost: $290 billion over 10 years!

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President & Congressional Proposals: Income Tax

- Make the Bush Tax changes permanent
  - Even those that benefit only upper-income individuals
    - PEP/PEASE – phase-out of exemptions for upper-income individuals
    - Capital Gains reductions
    - Exempt savings
      - Consumption tax
  - Focus on “federal income tax” – what about other taxes?

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State Impact

- Shifting of program costs onto states
  - Under-funded mandates (like No Child Left Behind)
- Reduction in grant money
  - For example:
    - Medicaid cuts: Nebraska could lose an estimated $60 to $80 billion in funds from the federal government.
- Block grants this year…
  - …cuts next year.
    - For example, proposed cuts to the community development block grant program

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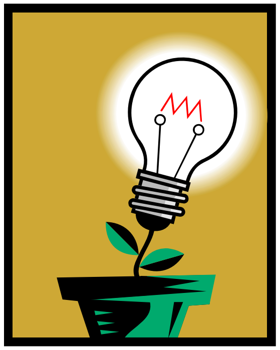
Overview

- **Tax Basics**
- **Current Code**
- **Responsible Reform and Simplification**
  - There is a better way!



The Center for American Progress Plan: Principles

- Fairness
  - Treat income from wealth and work equally
  - We should rely on progressive forms of taxation
- Simplicity
- Opportunity and Economic Growth

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Fairness

- Tax Each Source of Income the Same
  - Income from wealth would be treated the same as income from work
  - The estate tax is retained
- Reduce the Dependence on Regressive Payroll Taxes
  - Shift the employee share of the Social Security payroll tax onto a restructured federal income tax
  - Remove the cap on the employer-side to make the payroll tax more progressive
- Enhance the Take-Home Pay of Lower- and Middle-Income Taxpayers
  - Realign the rate structure to benefit the middle class

Simplicity

- Reduce the Number of Income Tax Brackets
  - At 15%, 25%, and 39.6%,
  - Brackets set at $0, $25,000 and $120,000
- Close Corporate and Individual Loopholes

- Eliminate the Need for an Alternative Minimum Tax by undertaking comprehensive reform

Increasing Economic Opportunity and Growth

- Restore Fiscal Discipline
  - Raise revenue by nearly $500 billion over 10 years
  - Increase national savings to improve economic growth

- Offer Tens of Millions of Americans New Opportunities to Save and Create Wealth for Retirement
  - Replace retirement savings deductibility with 25% refundable matching credit
  - Additional revenue could be used to increase savings incentives for low- and middle-income savers
  - To encourage long-term savings, for those earning less than $1 million annually, assets held at least 1 year would be able to exempt a portion of their capital gains, and for assets held for more than 5 years they would receive a 50% exemption.

- Reduce the Child Tax Credit Threshold
  - Allow those with incomes of $5,000 to receive the credit

Distributional Implications

Cash Income Class (thousands of 2003 dollars)2	Percent with Tax Cut	Percent with No Change	Average Tax Change ($)
Less than 10	59.9	29.4	-220
10-20	63.6	19.3	-524
20-30	73.1	6.6	-620
30-40	73.0	3.8	-496
40-50	72.8	2.0	-519
50-75	76.7	0.4	-687
75-100	76.1	0.1	-950
100-200	73.7	0.0	-1,138
200-500	24.1	0.0	12,722
500-1,000	6.8	0.0	64,752
More than 1,000	3.9	0.0	360,646
All	68.4	9.1	793.1

- Overall, our tax plan will increase the take-home pay of most people earning under $200,000 a year, and will provide an average tax cut of over $600 for this group. Most of those making more than $200,000 a year will likely see a tax increase relative to current policy.

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Enhancing Retirement Security

- New savings incentives for over 30 million Americans
- Enhance our full commitment to financing Social Security
  - Eliminate the cap on the income limit for the employer payroll tax (currently set at $90,000)
  - Dedicate a portion of general revenues—2.25% of GDP—to the Social Security trust fund
    - Enact safeguards to prevent Congress from reducing this dedicated stream. Any reduction can be made only after a three-fifths majority vote in the Congress
  - The additional revenue raised by our plan would be sufficient to cover these dedicated funds
  - This would cut in half the long-run, 75-year difference between dedicated revenues and outlays
- Reduce the deficit – make sure that revenues are available to meet the challenge of an aging population

The Center for American Progress Plan

- There is a stark contrast
  - The administration's fiscally irresponsible policy shifts the tax share away from wealth and a select few at the top, and onto work and the middle class.
  - We would create a fiscally responsible tax code that rewards work, and we would base our policy on a fundamental principle of fairness – that those who can best afford to pay and who have benefited the most from our economy should pay a greater share.

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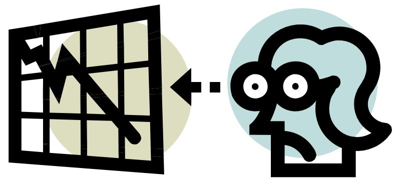
Economic and Budget Policy:

Has the Bush tax policy worked?

Overview

- Current Situation: Failed Economic Policy
- Consequences of a Failed Tax Policy: Wrong Choices on the Budget



The Economy – Middle Class is Struggling

- Median **household income has fallen** by over $1,500 between 2000 and 2003;
- **Wages are stagnating**: in 2004 real hourly wages of production, non-supervisory workers declined for the first time since 1993;
- The **number of uninsured has increased**: in 2003 there were an estimated 45 million people who lacked health insurance;
- At under 2 percent, the **private saving rate is near historic lows**;
- **Bankruptcy has increased**: in 2004 there were over 1.5 million non-business bankruptcy filings, an increase of over 300,000 since 2000, and middle-class Americans, especially the elderly, are increasingly in debt.

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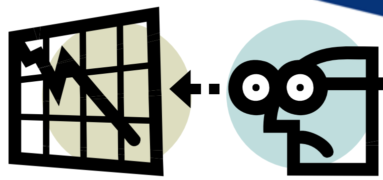


The Economy – Macro

- **Overall growth has been lackluster**: the average rate of growth of real GDP was just 2.5 percent over the last 4 years – which is lower than under the terms of Clinton, Reagan, and even Carter;
- **Job growth has been weak:** over the 4 years of the Bush presidency, the economy added just 119,000 new jobs, well below the level needed to keep up with population growth, and well below that of any other president since Hoover;
- **The dollar is falling**, especially against the euro. In late 2004, the dollar fell to all-time lows relative to the euro;
- **Debt to foreign countries is increasing** – over the first 11 months of 2004, U.S. federal government debt to foreign holders has increased by $362 billion. Nearly half of this increase came from Japan and China;
- **The federal deficit is over $400 billion** for the second year in a row, and shows no real signs of decreasing significantly under Bush’s economic policy;

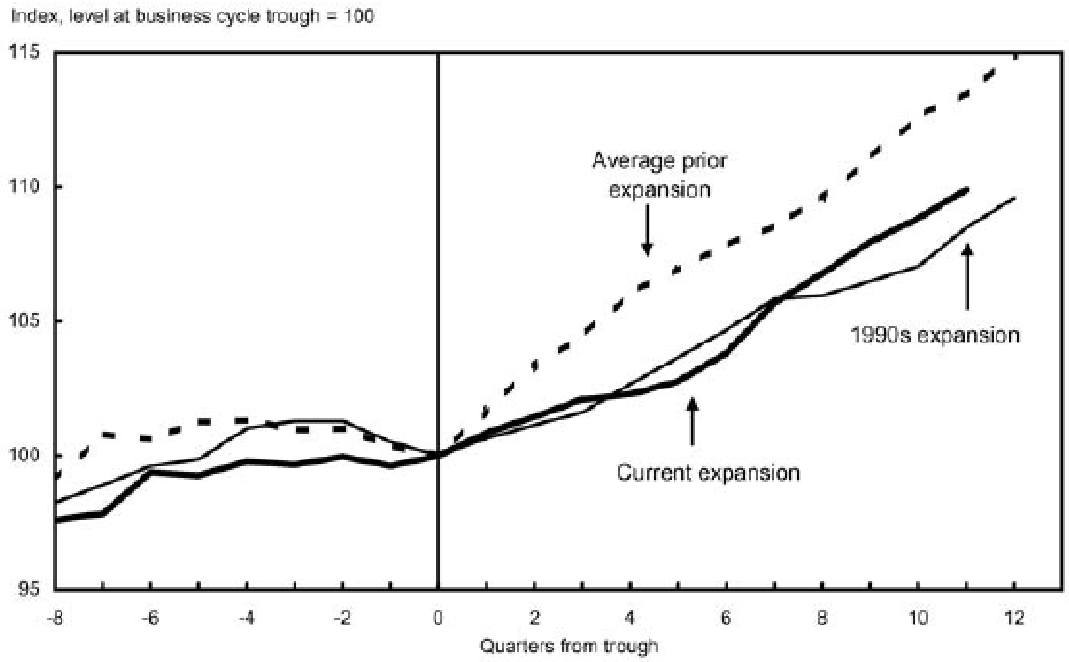
Economy - Poverty

- Poverty is up by 1.2 percentage points from 2000 to 2003.

Comparison with Past Recoveries - GDP

Chart 2-1 **Real Gross Domestic Product**

The last two expansions have had more moderate GDP growth than the prior ones; but the preceding recessions were also more mild, showing smaller drops in GDP from peak to trough.



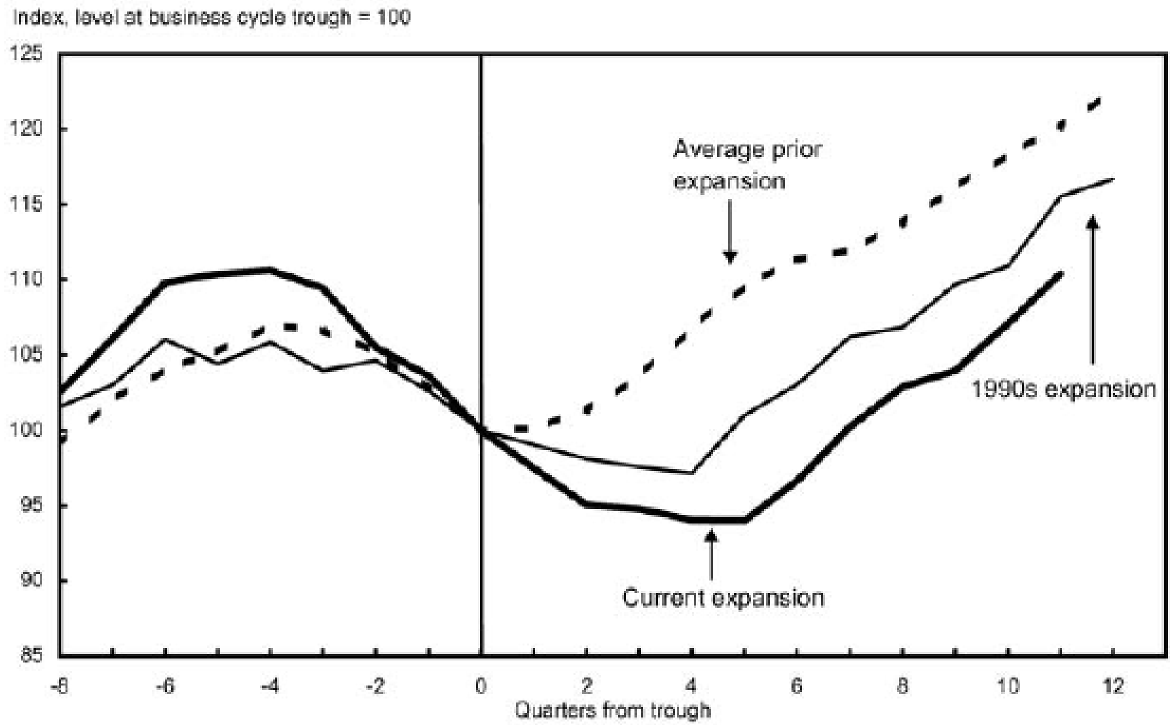
Note: Average based on prior expansions since 1960 excluding 1990s expansion.
Source: Department of Commerce (Bureau of Economic Analysis).

50 | Economic Report of the President

Comparison with Past Recoveries - Investment

Chart 2-3 **Real Nonresidential Investment**

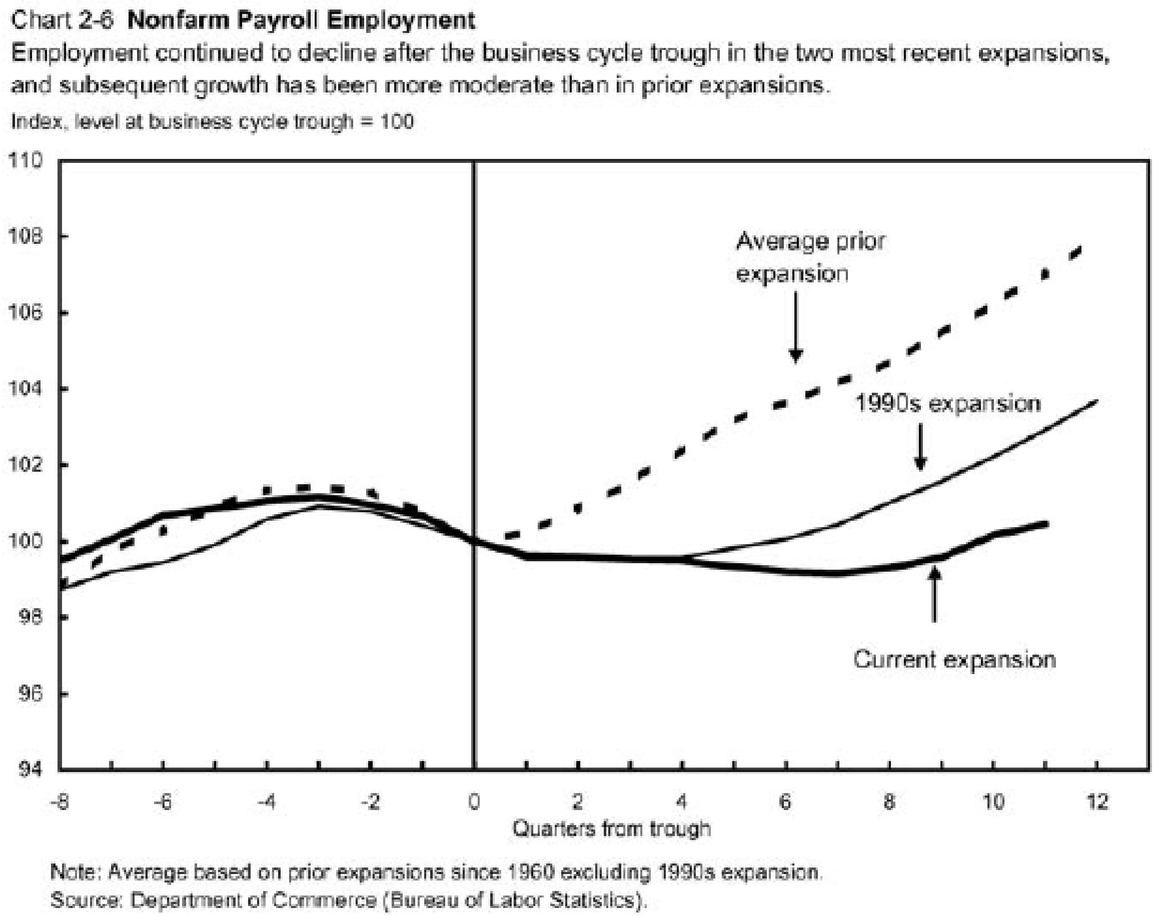
Nonresidential investment continued to fall in the two most recent expansions even after the business cycle trough had been reached.



Note: Average based on prior expansions since 1960 excluding 1990s expansion.

Source: Department of Commerce (Bureau of Economic Analysis).

Comparison with Past Recoveries - Employment



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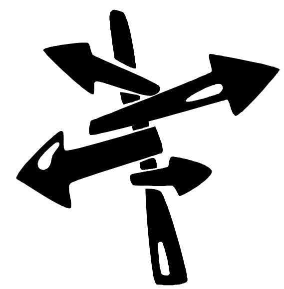
The Budget – Wrong Choices



- The president's 2006 budget, as well as his economic policy more generally, has done nothing to stem these troubling trends. In fact, current policies are exacerbating these problems.

  - Tax policy has overwhelmingly **benefited people with very high incomes and wealth**;
  - The president is proposing **slashing investments and services** that all Americans rely upon;
  - The president's economic proposals **lack compassion**

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Tax Policy

- Those with incomes of $1 million will receive a $150,000+ tax cut;
- Taxes on income from wealth have been reduced, and **the tax system is increasingly relying upon taxes on work**.
    - Over half of capital income subject to preferential treatment goes to those making more than $1 million a year;
- The cost of extending the 2001 and 2003 tax cuts is **$2.1 trillion over 10 years**;
    - only $1.6 trillion of these and other tax costs were included in the president's budget; (e.g. AMT fix not included)
- The cost of eliminating the estate tax is $256 billion over 10 years.
    - Only impacts millionaires and in which the first $1.5 million is tax free. Only 1.25 percent of decedents pay any tax (based on 2003 tax filings.)
    - Cost charities and other nonprofits over $10 billion per year in lost donations.

Slashing Investments and Services

- **Education:**
  - cutting the Department of Education by 1 percent,
  - expanding the unpopular No Child Left Behind requirements to high schools; and
  - proposed increases in Pell Grants that do not keep pace with rising college costs;
- **Environment:**
  - cutting clean water funding by $600 million, and
  - hindering the EPA's ability to enforce environmental laws by cutting the agency's funding by 6 percent;
- **Safety:**
  - The budget slashes aid to state and local law enforcement by 46 percent, from $2.8 billion to $1.5 billion.
  - Entire programs are eliminated or substantially scaled back. The Community Oriented Policing Services (COPS) program, which provides grants for state and local agencies to hire new officers, is cut from $499 million to $22 million.

Budget Lacks Compassion

- **Health care:**
  - Medicaid would be cut by a net $45 billion over 10 years – the lost funding is the equivalent to providing health coverage for 345,000 seniors or 1.8 million children;
- **Low-income assistance:**
  - Housing, food assistance, and low-income heating assistance both face severe cuts under the president's plan.
    - Food stamps would be cut by $1.1 billion over 10 years, and would serve 300,000 fewer people;
    - Cuts the Low Income Home Energy Assistance Program (LIHEAP) by over 8 percent, from $2.2 billion to $2 billion;
- **Veterans:**
  - The co-payment charged of many veterans for prescription drugs would more than double, and veterans would be required to pay a new enrollment fee of $250 a year.

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What’s Missing?

The president’s economic policy and his budget fail to address:

- long-term budget imbalances;
- falling wages;
- falling incomes;
- rising health care costs;
- increasing number of uninsured;
- decreasing international competitiveness in manufacturing;
- growing trade deficits;
- growing imbalance between college costs and student aid;
- growing personal debt levels;
- environmental and resource protection needs;
- adequate job training;
- and many, many other vital domestic and international priorities.

Wrap-up

- Current economic policy is moving our economy in the wrong direction
- Budget is making the wrong choices
  - Cutting investments
  - There are dire consequences for the middle class

A Better Way

- Must reverse the recent tax trends
  - Promote opportunity
  - Create a fair tax code
  - Support vital national priorities

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