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Reforming Our Tax System, Reducing Our Deficit

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Introduction and summary

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

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

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

To do so does not require radically decreasing our deficits immediately as we continue to recover from the Great Recession of 2007–2009. Instead our goal should be to reduce our deficit to stabilize the debt-to-GDP ratio at a responsible level in the medium term. We can achieve this by lowering our annual budget deficits to a

level where any new debt incurred in a given year is smaller than overall economic growth that year. Under normal economic conditions, this means deficits of approximately 3 percent of GDP or lower. Though still lower deficits are desirable when the economy is at full employment and operating at potential GDP, getting deficits under 3 percent of GDP would address the most pressing concern in the medium term and put the budget on a sound footing.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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