THIRD WAY

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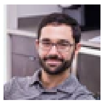
Necessary but Not Sufficient: Why Taxing the Wealthy Can't Fix the Deficit



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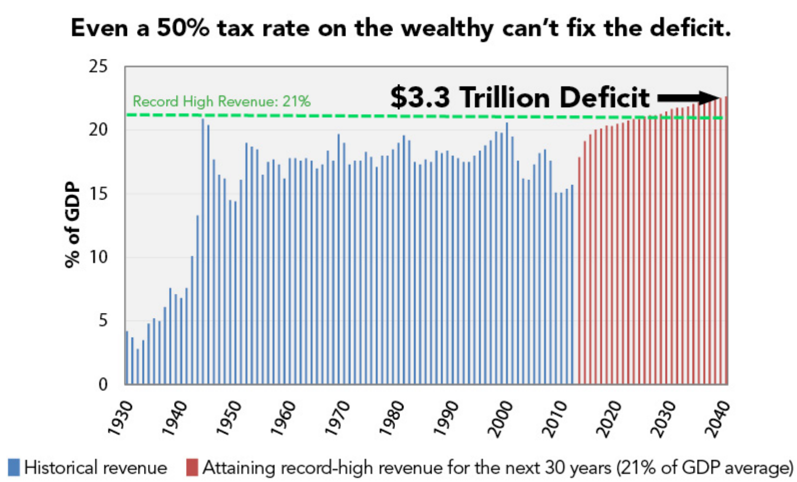
In this paper we shatter the myth that taxes on the wealthy can come close to solving our long-term budget problem. We readily acknowledge that raising taxes on top earners is necessary, but it is not sufficient to solve the looming fiscal crisis. And we make clear that if entitlements are left on autopilot, burdensome middle class tax hikes become inevitable.



This is the first in a pair of papers that demonstrate that purely ideological fixes will not sufficiently address our fiscal issues. Our other report, *Death by a Thousand Cuts: Why Spending Cuts Alone Won't Fix the Deficit,* proves that a cuts-only strategy cannot solve our budget woes without severely compromising our safety, security, and economic growth. Together, these papers make the case that a big and balanced fiscal package is the preferred way to avoid the fiscal cliff, prevent deficits from exploding in the future, and allow our economy to grow.

To stabilize the debt and create a positive economic climate for U.S. growth, most mainstream economists agree that annual deficits must be reduced to 3% of GDP. The question is: how do we get there?

In order to demonstrate that taxes alone cannot solve our budget woes, we explore three budget scenarios, all of which rely solely on revenue and leave entitlements and other spending as is.

- **Scenario I** includes each of the Democrats' key proposals for taxing the wealthy: roll back the Bush tax cuts for those with high incomes, limit their deductions, bump up the estate tax, and pass the Buffett Rule. ***Even if each major Democratic proposal to raise taxes on the wealthy becomes law, the national debt will double as a share of the economy by 2035, and the annual deficit in 2040 will exceed $4 trillion, in inflation-adjusted dollars.***

- **Scenario II** piles on more tax hikes for the rich, enough for the government to reach and surpass its record-high level for revenue as a percentage of GDP (averaging 21% of GDP between 2014 and 2040). In this second scenario we aim all of the tax hikes on the wealthy with only a smattering hitting the near-wealthy. ***Even with tax rates for the wealthy at 50%—higher than any rates under discussion—the national debt will double as a share of the economy by 2040, and the annual deficit that year will exceed $3 trillion, in inflation-adjusted dollars.***

- **Scenario III** shows the volume of tax hikes needed for taxes to single-handedly contain long-term deficits. This scenario keeps the tax hikes on the wealthy from Scenario I, leaves entitlements on autopilot, and pushes deficits to the target level with additional tax increases on everyone. ***Relying on taxes alone to hold long-term deficits at 3% of GDP would require phasing in a 60% tax increase on the median-income family, raising its annual tax burden by $6,200, in 2012 dollars.***

As we have noted previously, entitlements provide critical economic security. But unless taxes rise dramatically, status-quo entitlements will prevent government from doing much else. An all-of-the-above approach on the budget is the only way to preserve entitlements, make room for needed public investments, and spare the middle class from tough tax hikes in the future.

Scenario I

Roll back the Bush tax cuts on the wealthy.

Starting in 2013:

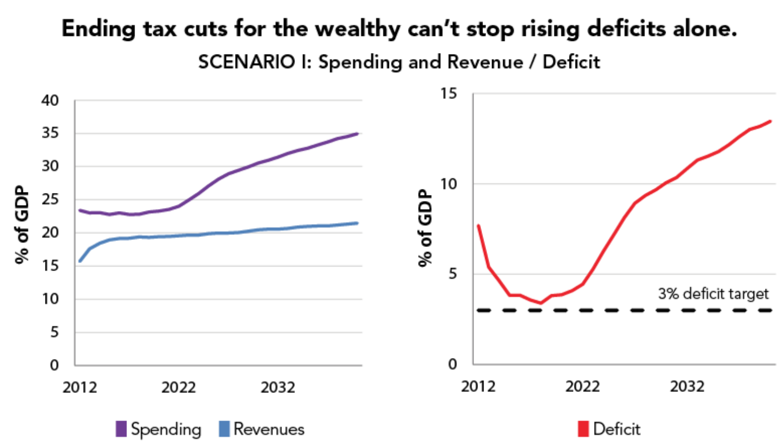
- Raise the top two tax rates, on ordinary income over $250,000 a year for joint filers, to Clinton levels (39.6% and 36%).*
- Raise the top capital gains rate by 5 percentage points (to 23.8%).
- Tax qualified dividends as ordinary income.
- Reduce the value of exemptions and deductions for wealthy taxpayers.
- Restore the estate tax to its 2009 level: a top rate of 45% and exclusion of $3.5 million.
- Impose the Buffett Rule, requiring all earners of over $1 million to pay at least 30% in taxes.

This scenario splits the second-highest bracket, as does the President's 2013 Budget. Income below $247,475 would still be taxed at the 33% level, and income above that threshold would be taxed at 36%.

Scenario I shows the long-term budgetary effects of the revenue increases on high-income earners proposed in the President's 2013 budget. The top two tax rates, on ordinary income over $250,000 for married couples (over $200,000 for individuals), are returned to Clinton-era levels. The estate tax is restored to its 2009 level. Rules limiting the value of personal exemptions and itemized deductions for the wealthy are reinstated. Plus, a cap is imposed on the value of tax preferences claimed by the wealthy. And to make sure millionaires pay at least a 30% effective tax rate, the Buffett Rule kicks in. These proposals protect the middle class from tax hikes entirely and would increase revenue by roughly $1.6 trillion over ten years.

This revenue would temporarily drop annual deficits close to the 3% target that economists deem preferable. But in the next decade:

- Entitlement costs skyrocket and revenue can’t keep up.
- Federal borrowing is so prolific that interest payments consume an unprecedented share of the economy.
- Annual deficits will be $800 billion in 2020, $2.5 trillion 2030, and $4.2 trillion in 2040—all in today’s dollars.
- ***Even if each major Democratic proposal to raise taxes on the wealthy becomes law, the national debt will double as a share of the economy by 2035.***



The end of Bush tax cuts for the wealthy should be part of a deficit grand bargain but cannot be its mainstay. With deficit growth similar to that under Scenario I, a U.S. fiscal crisis would be increasingly likely. Investors would eventually demand higher interest rates for U.S. Treasuries, driving up the cost of government borrowing. As Europe has recently shown, that sequence can unfold rapidly, forcing spending cuts and tax increases much more drastic than if they had come sooner.

Scenario II

Soak the rich.

Starting in 2013:

- All Scenario I tax increases, plus...*
- Raise the top ordinary income rate, on income over $388,350 for joint filers, by 10 additional percentage points (from 39.6% to 49.6%).
- Raise the second and third-highest ordinary income rates, on income between $217,450 and $388,350, by 5 additional percentage points (from 33% and 36% to 38% and 41%).
- Raise the rates on capital gains by 15 percentage points each (from 10% and 23.8% to 25% and 38.8%).
- Increase the cap for the Social Security payroll tax, from $107,000 to $170,000, and adjust for wage growth.
- If ending Bush tax cuts for the wealthy is insufficient, can additional taxes on the wealthy solve long-term deficits?

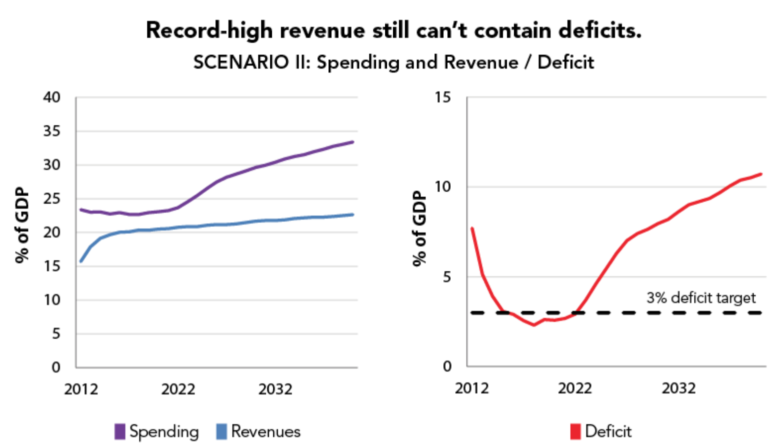
In Scenario II, we assume the Buffett Rule does not generate any extra revenue because ordinary income, dividend, and capital gains rates are all higher than 30%.

Scenario II looks out over 30 years and sets average federal revenue over that period to 21% of GDP—a level achieved only once (during World War II). We add to Scenario I by lifting the top ordinary income rates to levels beyond those under President Clinton or in President Obama's proposals. For joint filers, taxes on income over $388,350 increase from 35% today to 49.6%. Income between $217,450 and $388,350, subject to one 33% rate today, would face two brackets of 38% and 41%. The Social Security payroll tax cap jumps from $107,000 to $170,000 and rises with wage growth. Capital gains rates climb 15 percentage points above Scenario I, reaching 38.8% for wealthy filers and 25% for the rest.

These measures all target the wealthy and near-wealthy and would collect $3.5 trillion over ten years. Revenue as a percentage of GDP would rise from 19.1% in 2014 to 22.7% in 2040, averaging 21% of GDP over that period.

Tax rates this high would achieve healthy deficit levels through the decade but not beyond. This revenue boost still isn't close to matching the entitlement surge coming in the next decade.

- By not controlling entitlement spending, interest payments continue to fuel rising deficits.
- Annual deficits will be $500 billion in 2020, $2.0 trillion 2030, and $3.3 trillion in 2040—all in today's dollars.
- ***Even with tax rates for the wealthy at 50%—higher than any rates under discussion—the national debt will double as a share of the economy by 2040.***



Whether or not this scenario is politically possible (given the high tax rates) the point is clear: very high taxes on the wealthy will only go so far. Deficits would still grow large enough to threaten a fiscal crisis. To achieve long-term budget security and leave entitlements on auto-pilot, a revenue-only approach would require tax increases on the middle class, as is shown in Scenario III.

Scenario III

Without reform—an eventual burdensome middle class tax hike.

- Keep deficits at or below 3% of GDP from 2017 to 2040.
- Maintain current path of entitlement spending.*
- **Starting in 2013:** All Scenario I tax increases.
- **Starting in 2015:** Increase the cap for the Social Security payroll tax, to $170,000 (Scenario II); Increase the payroll tax rate for Medicare by 1 percentage point (to 3.9%).
- **Starting in 2019:** Increase all tax rates on ordinary income 5 additional percentage points, phased in over 10 years. Increase both tax rates on capital gains 10 percentage points (to 20% and 33.8%), phased in over 5 years.
- **Starting in 2023:** Impose a 10% national value-added tax, phased in over 5 years.

As under Scenario II, the Buffett rule is not assumed to generate any revenue.

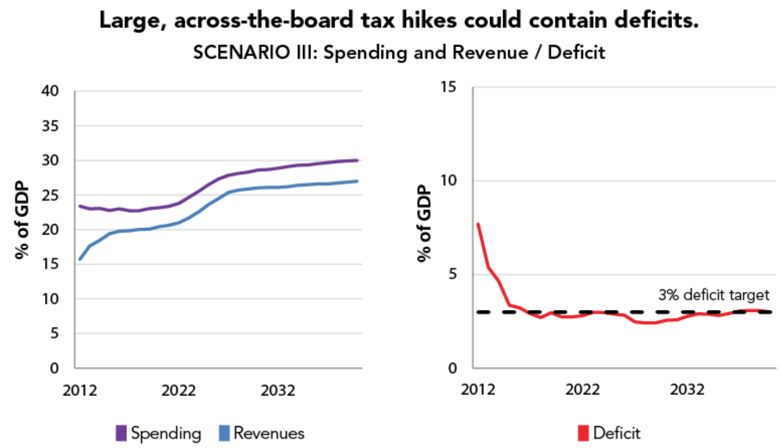
For taxes alone to keep deficits sustainable and leave entitlement spending untouched, revenue in 2040 must reach 27% of GDP, well above the World War II record of 21%. To achieve that, middle class tax hikes are unavoidable.

Scenario III shows the magnitude of tax increases needed if Congress decides to contain deficits by 2017 and ignore entitlement spending. The President's proposed revenue increases, from Scenario I, are enough to push deficits below 4% of GDP by 2015. To push them to 3%, Congress could elect to raise revenue within two programs threatening the deficit, Social Security and Medicare. Raising the cap on the Social Security payroll tax (Scenario I) and raising the Medicare payroll tax 1 percentage point would keep deficits below 3% in 2017 and 2018.

Then, with fast-rising entitlement costs looming, Congress would be forced to raise revenue substantially. Reasonable tax increases on the wealthy alone, already employed through the President's existing proposals, simply can't raise enough money. So in 2019, Congress turns to the most powerful tool at its disposal: rate increases across the board. Each ordinary income rate gradually rises by 5 percentage points, and each capital gains rate gradually rises by 10 percentage points.

The above tax increases contain deficits only through 2022, when entitlement spending is still accelerating. In need of revenue typical of European governments, Congress turns to a European-style tax still unused by the United States. In 2023, Congress begins phasing in a 10-percent national value-added tax (VAT). A popular tax reform idea among economists, the VAT is also regressive, so many existing VAT proposals return significant proceeds to lower and middle-income taxpayers. But in Scenario III, the 10% rate collects just enough revenue to meet the government's obligations; a considerable rebate would require a much higher rate.

Because of its broad sweep, Scenario III delivers enough revenue to stabilize the debt. As federal spending rises, federal revenue keeps pace. Lower interest payments help contain federal spending, and debt—as a share of the economy—begins a slow decline.



But to do this, Scenario III hits middle class families hard—and that is only if taxes on the wealthy reach levels beyond what the President currently proposes. For example, the median income of jointly filing couples is $76,561.* A family of that income level, which has two children and claims the standard deduction, pays a total of $10,406 in federal taxes. ***Relying on taxes alone to hold long-term deficits at 3% of GDP would require phasing in a 60% tax increase on the median-income family, raising its annual tax burden by $6,200, in 2012 dollars.***

Median income statistic is from U.S. Census data (See Appendix III).

Under Scenario III, that tax increase on the median-income family would consist of:

- Higher income tax rates: $2,473
- Higher payroll tax rate: $383
- Burden of national value-added tax (through higher prices): $3,341

Scenario III is our projection of what an all-revenue budget fix would look like, but there are numerous other ways to reach the target through taxes. However, it’s hard to keep the middle class from harm. For example, acclaimed economist Simon Johnson and coauthor James Kwak advocate only minor changes to entitlement programs but call for numerous tax increases, many of which fall directly on the middle class. Their plan increases the rates of the Social Security payroll tax, the Medicare payroll tax, the gas tax, and the capital gains tax. It slashes a big middle class deduction and exemption, for mortgage interest and employer-sponsored health insurance. It also adds a new carbon tax and value-added tax. [1]

Whether you're looking at Scenario III or other serious proposals, one thing is certain: fixing long-term deficits without touching entitlements may be possible in theory, but would punish the middle class with higher taxes.

Conclusion

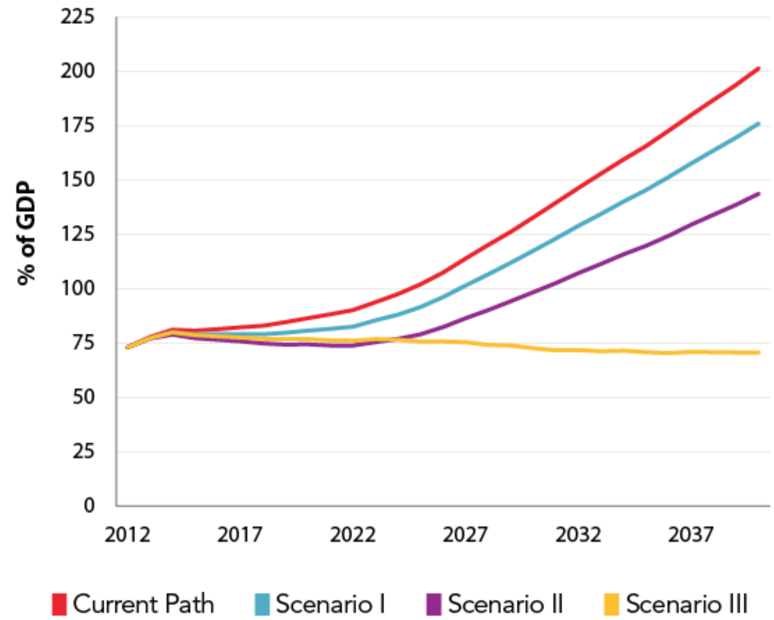
Entitlement programs provide critical economic security to the elderly and the vulnerable. Investments provide opportunities for the economy to grow and for individuals to achieve personal economic success. The tax code must deliver sufficient revenue to support both of these pillars, allowing the government to keep running while allowing people to save, invest, and consume. In today's budget, none of these priorities are where they should be, and in tomorrow's budget the situation only worsens.

Significant revenue must be part of the solution, but fiscal responsibility cannot ignore entitlements. The fastest growing part of our budget is driven by entitlements, and these programs must take their share of reductions in a reasoned way to protect the elderly and the vulnerable.

The fiscal cliff presents a once-in-a-generation moment. Government leaders have an opportunity to create a balanced plan that gives us the economic certainty we need for growth and prosperity for decades to come.

Appendix I

Debt held by the public under each scenario



Appendix II

Baselines and economic assumptions

The baseline for spending is current policy, as defined by the Congressional Budget Office's (CBO) alternative fiscal scenario. [2] Under each scenario, interest payments on the debt are adjusted according to projected deficits each year. To project each year's net interest and change in total debt, we use a model that emulates the projections in the CBO's Extended Baseline Scenario and Alternative Fiscal Scenario. Thus, our assumptions about future interest rates are the same as the CBO's.

Our revenue baseline is also current policy. We assume that all expiring income tax and estate tax provisions are extended and that Alternative Minimum Tax relief is extended. We do not, however, assume the extension of any other temporary tax provisions, such as the current payroll tax cut. This baseline uses the CBO's "Variant 2" assumptions for individual income tax revenue, CBO's Expiring Tax Provisions assumptions for the estate tax, and the Extended Baseline Scenario assumptions for all other revenue sources. [3] GDP growth estimates are those from the CBO's 2012 Long-Term Budget Outlook.

Appendix III

Tax proposals

Tax Proposals by Scenario

		Current Policy	Scenario I	Scenario II	Scenario III
Ordinary Income Marginal Tax Rates (married filing jointly)	$0 - $17,400	10%	10%	10%	15%
	$17,400 - $70,700	15%	15%	15%	20%
	$70,700 - $142,700	25%	25%	25%	30%
	$142,700 - $217,450	28%	28%	28%	33%
	$217,450 - $247,475	33%	33%	38%	38%
	$247,475 - $388,350	33%	36%	41%	41%
	Over $388,350	35%	39.6%	49.6%	44.6%
Taxes on Investment Income	Capital gains (filers in or above current 28% bracket)	18.3%	23.3%	38.8%	33.8%
	Capital gains (all other filers)	10%	10%	25%	20%
	Buffett Rule	No	Yes	Unneeded	Unneeded
	Treatment of qualified dividends	15%	Taxed as ordinary income	Taxed as ordinary income	Taxed as ordinary income
Estate Tax	Rate	35%	45%	45%	45%
	Exemption allowed	$5 million	$3.5 million	$3.5 million	$3.5 million
Other Taxes	Social Security payroll tax cap	$107,000	$107,000	$170,000	$170,000
	Medicare payroll tax rate	2.9%	2.9%	2.9%	3.9%
	Value-added tax	No	No	No	Yes (10%)

The revenue projections for each tax proposal have been scored, over a ten-year period, by the CBO, the Office of Management and Budget (OMB), the Joint Committee on Taxation (JCT) or the Tax Policy Center (TPC).

We adjust the projected revenues from these scores for GDP. For example, the CBO's score of the proposal to raise the cap on the Social Security payroll tax covers the years 2012–2021. Our Scenario III has this proposal beginning in 2015. We adjust projected revenue so that in 2015, revenue from this policy is the same share of GDP as it is in 2012 under CBO's score. For years beyond the ten-year score, we assume that revenue remains the same, as a percentage of GDP, as the last year scored in the proposal.

Following are descriptions of the original revenue proposals used in this report. [4] [5] [6] [7] [8] [9] [10] [11] [12] [13] [14]

Proposal	Source	Description and Notes	Revenue
End Bush tax cuts on ordinary income over $250,000 a year for joint filers	President's 2013 Budget (OMB)[4]	The President's proposal would return the top marginal income rate to 39.6%, from the current 35%. The second highest bracket would split: income below $247,475 would still be taxed at the 33% level, and income above that threshold would be taxed at 36%. The proposal would also reinstate the personal exemption phase-out and the limit on itemized deductions. The president also proposes a 28% cap on the value of exemptions and itemized deductions. Finally, the proposal taxes qualified dividends as ordinary income and increases the top capital gains rate from 15% to 20% (not counting the 3.8% increase from the Affordable Care Act).	$1.4 trillion (2013-2022)
Restore the estate tax to its 2009 level: a top rate of 45% and exclusion of $3.5 million	President's 2013 Budget (OMB)[5]	The President's proposal would "make permanent the estate, generation-skipping transfer, and gift tax parameters as they applied during 2009."[6] The exclusion for gift taxes would be $1 million.	$143 billion (2013-2022)
Impose the Buffett Rule, requiring all earners of over $1 million to pay at least 30% in taxes.	Revenue estimate of "Paying a Fair Share Act of 2012" (JCT)[7]	The Buffett Rule is phased in for jointly filing taxpayers with AGI between $1 million and $2 million. *Note: We exclude the Buffett Rule from Scenarios 2 and 3 because both have top income and capital gains rates rising above 30%, which would presumably make negligible any extra revenue generated by the Buffett Rule.*	$40 billion (2012-2021)
Raise the top ordinary income rate, on joint filers with income over $388,350, 10 more percentage points.	Reducing the Deficit: Spending and Revenue Options (CBO)[8]	With the expiration of tax cuts on top earners, under Scenario I, the top rate rises to 39.6%. This proposal raises it an additional 10 points, to 49.6%. We derive this proposal's revenue effect by taking the CBO's estimate, of raising the top rate one percentage point, and multiplying it by 10. The CBO score incorporates the assumption that taxpayers would respond to higher rates by shifting income from taxable to nontaxable or tax-deferred forms. Our calculation does not reflect the extent to which the magnitude of that behavioral response may vary with a larger rate change.	$84 billion for each percentage point (2012-2021)
Raise the second-highest ordinary income rate, on income between $217,450 and $388,350, 5 more percentage points.	Reducing the Deficit (CBO)[9]	This option is calculated similarly to the one above. With the President's tax increases on top earners, under Scenario I, the second highest rate splits. This proposal raises both of those resulting rates by 5 points, from 33% to 38%, and from 36% to 41%.	$31 billion for each percentage point (2012-2021)

Proposal	Source	Description and Notes	Revenue
Increase the cap for the Social Security payroll tax, from $107,000 to $170,000, and adjust for wage growth	Reducing the Deficit (CBO)[10]	This proposal raises the Social Security payroll tax cap so that 90% of wage earnings are covered by the tax—about the same portion as 1937, when the tax began. The cap then continues to rise with wage growth.	$457 billion (2012-2021)
Raise the rates on capital gains by 15 percentage points each (Scenario II) or 10 percentage points each (Scenario III)	Reducing the Deficit (CBO)[11]	This option is calculated similarly to the individual income rate increases. The CBO option projects revenue collected by increasing each rate 2 percentage points, so we multiply accordingly in each scenario. This option would also repeal the special rates for assets held more than five years and for small-business stock.	$24 billion for each percentage point (2012-2021)
Increase payroll tax for Medicare Hospital Insurance by 1 percentage point	Reducing the Deficit (CBO)[12]	This proposal replaces the Affordable Care Act's 0.9% surtax on high-income taxpayers with a 1.0 percentage point increase in the total hospital insurance tax on all earnings. The rate for both employers and employees would increase by 0.5 percentage points to 1.95%.	$651 billion (2012-2021)
Raise all ordinary income rates and AMT rates 5 percentage points	Reducing the Deficit (CBO)[13]	This option is calculated similarly to the other ordinary income rate increases. This proposal raises the Scenario I rates of 10%, 15%, 25%, 28%, 33%, 36%, and 39.6% to 15%, 20%, 30%, 33%, 38%, 41%, and 44.6%, respectively. We phase in this proposal by half a percentage point per year, for each bracket, over ten years.	$702 billion for each percentage point (2012-2021)
Impose a 10% national value-added tax	Reducing the Deficit (CBO)[14]	This value-added tax would apply to a broad base that would include most goods and services. This proposal is based on CBO's score of a 5% VAT, so we double the expected revenue. Many VAT proposals include rebates for low-income people, to offset the regressive nature of the tax. This proposal does not, in order to maximize revenue.	$5 trillion (2012-2021)

Appendix IV

Scenario III Impact on Median Family

To determine the impact of Scenario III policies, we take the median 2010 income for jointly filing couples, adjusted to 2012 dollars: $76,561.[15] We assume the family earns all its income from wages, has two dependent children, and takes the standard deduction.

To determine the impact of Scenario III, we apply the Scenario III policies, which are phased in fully in 2028, as if implemented in 2012. The effect of a higher Medicare payroll tax rate only includes higher taxes paid by the employee; it does not account for any drop in wages that may result from the higher employer rate. The VAT does not directly tax consumers, but this policy greatly affects consumers through higher prices for goods and services. To assess the VAT's impact on a median family, we use data from a TPC study on the distributional effects of a VAT proposal.[16] We assume that under Scenario III, the VAT reduces the value of after-tax income for the median family in a manner proportional to the drop in after-tax income for a middle-quintile tax unit in the TPC study.

How would Scenario III taxes affect the median-income family today?

	Current tax policy	Scenario III
Income	$76,561	$76,561
Payroll taxes	-$5,857	-$6,240
Net income tax	-$4,549	-$7,022
Value-added tax burden	—	-$3,341
Value of after-tax income	**$66,155**	**$59,958**

Please also see *Death by a Thousand Cuts: Why Spending Cuts Alone Won't Fix the Deficit*, which demonstrates the folly of solving the deficit problem through spending cuts alone.

TOPICS

BUDGET 89 TAXES 78

END NOTES

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