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EPI's model federal budget and tax plan

How we can raise the revenues needed to provide universal health care, strengthen safety nets, and shore up public investment

Report • By Hunter Blair • July 18, 2019

On June 11, 2019, the Economic Policy Institute (EPI) presented a model federal budget and tax plan at a "Solutions Initiative" convening organized by the Peter G. Peterson Foundation.[1] While most tax and budget plans proposed in Washington policymaking circles prioritize deficit reduction over almost everything else, our plan's first priorities were to halt decades of rising inequality and to provide an economy that works for the vast majority of Americans, rather than just the wealthy few. Importantly, this includes ensuring that *all* Americans have access to quality health care. It also includes strengthening our safety nets and increasing our public investments in infrastructure, child care, education, and green energy. To achieve these goals, our "Budget for Shared Prosperity" includes large increases in government spending.

These large increases in federal spending require correspondingly large increases in revenue. This report describes our proposals for raising revenue and the reasoning behind them, highlighting in particular policies aimed at raising significant revenue from the richest U.S. households. The report also highlights the often underappreciated potential of raising revenue progressively and efficiently by radically reforming so-called tax expenditures—deductions, exclusions, and exemptions that result in different types of income streams facing different tax rates.

Key principles for tax reform underlying our plan

We believe that current debates about tax reform need to go bigger and broader if we are to create a more just society. Our model budget and tax plan has at its center the following principles for tax reform:

We need higher top tax rates. The highest tax rates on ordinary income proposed under the last two Democratic presidential administrations were below 40 percent—leaving top effective rates far below what research shows would bring in the most revenue.

Capital taxation in America must be dramatically reformed. Incomes of the richest household are dominated by returns from holding wealth, not working. This capital income (e.g., capital gains, dividends, interest) currently faces a lower rate than labor income. This bad tax policy incentivizes tax avoidance as top earners use accounting gimmicks to make their labor income show up as capital income. There is little economic basis for this large preference for capital incomes in the tax code. Our plan taxes labor and capital income at roughly the same rate. It also implements a new wealth tax and expands the estate tax.

In addition to progressive tax reforms that raise top rates and increase taxes on income generated from wealth, we *also* need a broader tax base. Tax reform discussions have often assumed that broad tax bases and higher top marginal tax rates are meaningful substitutes for one another; they are not. A broad tax base and higher rates are complementary tools that must be used in tandem to maximize revenues. In fact, the optimal tax rate goes up as the tax base broadens.

To implement a universal health care plan—which carries high budgetary costs—we will need to raise revenues from a larger share of working families. Health care is an outlier in terms of budgetary cost. Instituting a public Medicare for All plan carries fiscal costs that are almost double the size of all other increases in spending included in the Budget for Shared Prosperity. When creating our budget, we recognized that this was one program that could not be achieved simply through tax policy targeted at the top 1 percent, or even the top 5 or 10 percent. And it is logical that the working families who benefit from the health care program would contribute to it. Therefore, we included in our plan an employer-side health care payroll tax and an income-based health care premium paid by most working families.

Radical reform of tax expenditures should be on the table. In our model budget, we repeal all tax expenditures except for the earned income tax credit (EITC). Tax expenditures are potential revenues that the federal government relinquishes through provisions in the tax code; they include special exemptions, deductions from taxable income (e.g., mortgage interest deduction, charitable deduction), tax credits, and lower tax rates for certain forms of income (e.g., capital income, as discussed above). They are often seen as politically untouchable. But their benefits are regressively distributed—they primarily benefit the top 20 percent of earners—and they are *extraordinarily* costly in fiscal terms. Further, abolishing tax expenditures is economically efficient—it leads to fewer distortions in the tax code and reduces the scope for tax avoidance.

The revenue potential of radical reform of tax expenditures turns out to be immense: Abolishing all tax expenditures except the EITC—especially in the context of significantly higher rates—provides enough revenue to essentially finance a single-payer health plan by itself. (It would fully cover net costs, which take into account projected savings from Medicare and Medicaid cost containment measures.) However, because our budget does more than just provide revenue for a single-payer health system, we will still need some of the revenue raised through our payroll taxes and income-based health premiums to fund our health plan.

Tax policy should ensure that prices reflect the true costs to society. Good tax policy should aim to ensure that the prices consumers face on certain goods reflect the true costs their production and consumption impose on society. The Budget for Shared Prosperity includes numerous taxes on these "economic bads," the largest of which are a Financial Transactions Tax (FTT) and a carbon tax. An FTT would benefit the economy by crowding out wasteful financial transactions, and it has the added benefit of being progressive. And while the direct incidence of carbon taxes is regressive, they remain a useful tool for combating climate change. To ensure their net effect is progressive, we refund on a per-capita basis double the amount raised in revenue.

The spending programs in the Budget for Shared Prosperity would substantially benefit the vast majority of American households

Rising income inequality, anemic wage growth for the vast majority, a dearth of public investments, and an inadequate social safety net all pose significant challenges for the U.S. economy. Facing these challenges most efficiently and equitably will require substantially higher levels of federal spending and, in turn, substantially higher levels of federal revenue. This is just what the Budget for Shared Prosperity calls for. By 2049, our budget raises total noninterest spending by 11.3 percent of GDP on net, or by roughly 50 percent over projected baseline noninterest spending. To support increased spending, we increase federal revenues more than one-for-one.

Safety net spending

About a quarter of this net spending increase, or 2.6 percent of GDP, goes to policies that would strengthen the U.S. social safety net outside of health care. These policies include boosting SNAP (Supplemental Nutrition Assistance Program) benefits, providing additional money for child nutrition, implementing a universal child allowance, strengthening Unemployment Insurance, providing paid family and medical leave, expanding Social Security, implementing the Obama administration's End Family Homelessness initiative, implementing a progressive carbon tax refund to more than offset the regressive impact a new carbon tax would have on low-income households, and expanding the EITC for childless workers. In particular, our universal child allowance—which replaces the current child tax credit with a monthly payment to families of $500 per child under age six and $400 per child age six through 17—would substantially reduce child poverty. Shaefer et al. (2018) find that replacing the child tax credit with monthly payments to families of $300 per child under age six and $250 per child age six through 17 would immediately cut child poverty by about 40 percent and deep child poverty by nearly half.

Infrastructure and public investments

Between one-tenth and one-fifth of spending increases, or 1.7 percent of GDP, goes toward non-health-care-related public investments. We've long argued that the economy could use a substantial uptick in public investment, given slow productivity growth and weak private investment. This investment should be broad, covering not just "core" infrastructure like transportation systems and utilities, but also noncore public investments such as child care, education, renewable energy, and health care (Bivens and Blair 2016b). In keeping with this, we include an ambitious national investment in our nation's children by implementing universal early child care and childhood education, investing in our

nation's educators and schools, and making college more affordable. We provide space for further investments by pushing nondefense discretionary (NDD) spending back up to its historical average of 3.5 percent of GDP, increasing it by roughly 1.5 percent of GDP relative to baseline. Historically, about half of NDD spending is public investment (Bivens 2013). The combination of enhanced NDD spending and the earmarked funds for public investment would provide sufficient money for a major green investment that is worthy of the name "Green New Deal."

Health care reform

The real outlier in terms of budgetary costs is the implementation of a public single-payer Medicare for All program, which we estimate would add 8.2 percent of GDP to public spending by 2049. Even with savings from smart policy that can restrain the growth of Medicare and Medicaid costs, spending on health care in the Budget for Shared Prosperity accounts for almost two-thirds of our increase in overall spending.

How do we pay for these investments?

Making all these socially beneficial investments, while also maintaining a deficit of around 2 percent of GDP,[2] requires a substantial increase in revenues—from the baseline estimate of 19.8 percent of GDP in 2049 to 35.4 percent in 2049. Given the unabated rise of inequality over the past four decades, the first tranche of this revenue should come from those at the top. But increased tax revenue from the top 1 or 5 or even 10 percent will not be sufficient to support the large public spending required to guarantee health care for all Americans through a public single-payer program. A substantial portion of revenue must be raised from a larger share of taxpayers.

Tax policy in the Budget for Shared Prosperity is based on principles of optimal taxation

For decades, much of the discussion in Washington around taxing those at the top has focused largely on increasing top marginal tax rates on labor income within a fairly narrow band of a few percentage points: Top marginal rates were raised to 39.6 percent during both the Clinton and Obama presidencies, and they were reduced to 35 and 37 percent, respectively, during the Bush and Trump presidencies (TPC 2019).

But the history of U.S. taxation makes it clear that the space for increasing top tax rates is far larger than reflected by current rates or by tax policy debates over recent decades. From 1936 to 1980, top rates ranged from 70 percent to over 90 percent (TPC 2019). And contrary to the theory of trickle-down economics that was used to justify the radical tax rate cuts of the 1980s, higher top rates have actually been associated with stronger economic growth, historically: Over the period from 1949 to 1979, the average top marginal

income tax rate was 80.4 percent and the average rate of net productivity growth was 2.4 percent. In contrast, from 1980 to 2018, when top marginal income tax rates were much lower (averaging 39.8 percent), the average growth rate of net productivity was also lower, at 1.3 percent.[3] Higher top rates on labor income have long been under discussion among economists, with Saez (2001) finding optimal top tax rates on labor income to be no lower than 50 percent and possibly as high as 80 percent given the estimates from the empirical literature at the time.

The possibilities for much higher top marginal tax rates seem to have finally pierced Washington policy discussions after Rep. Alexandria Ocasio-Cortez appeared on *60 Minutes* in January 2019 and suggested that a 70 percent top marginal tax rate be applied to earnings over $10 million. Much of the reporting and commentary that followed emphasized the historical precedence and the economic rationale for implementing higher rates (Kessler 2019; Yglesias 2019).

To understand the economic rationale for high top marginal tax rates, we must first look at just what an "optimal" top tax rate is.

An introduction to optimal taxation

At its core, the economics literature on optimal taxation attempts to answer this question: How do you build a tax system that maximizes social welfare subject to a government budget constraint, given that taxes influence individual incentives to work and save? That is, what is the best way to build a tax system given the classic economic tradeoff between equity and efficiency?

Estimating the optimal top tax rate

Deciding what tax policy maximizes social welfare requires making value judgements. One such value judgement flows naturally from a common assumption that economists make about the diminishing marginal utility of income. This assumption of diminishing marginal utility argues that the value to a person of an additional dollar of income falls as their income rises. So, for example, $1,000 to a family making $15,000 really matters; $1,000 to a family making $15 million hardly matters at all. This means that a redistribution of this $1,000 from the richer to the poorer household will increase the latter's happiness far more than it decreases the rich household's happiness. In turn, optimal tax models based on diminishing marginal utility of income put a small value on the consumption of top earners compared with the consumption of an average person; in essence, the parameters of the model assume that society values redistribution.

This means that the *optimal tax* is often simply the one that maximizes revenue from taxpayers in the top bracket. But what rate maximizes revenues depends on how the reported, taxable income of those at the top responds to changes in tax rates—in economics jargon, this is referred to as the elasticity of taxable income to the net-of-tax rate (ETI). Top taxpayers may respond to higher tax rates not just by working less or saving less (which generates some genuine economic losses for society[4]); they may also use

accounting gimmicks to arbitrage across differing tax rates—making sure their income appears (to the IRS) to be whatever type of income will minimize their overall tax rate. They can also adjust the timing of income receipts or find other ways to avoid paying the higher tax rates.

In a broad review of the empirical literature, Saez, Slemrod, and Giertz (2012) find that while there is not yet a truly convincing estimate for ETI in the long run, the best available estimates range from 0.12 to 0.4. Diamond and Saez (2011) show that a midrange empirical estimate for ETI corresponds to an optimal top tax rate of 73 percent. Medium-term estimates following tax code changes in 2013 lend further support for this midrange ETI (Saez 2016).

Broadening the tax base pushes up the optimal top tax rate

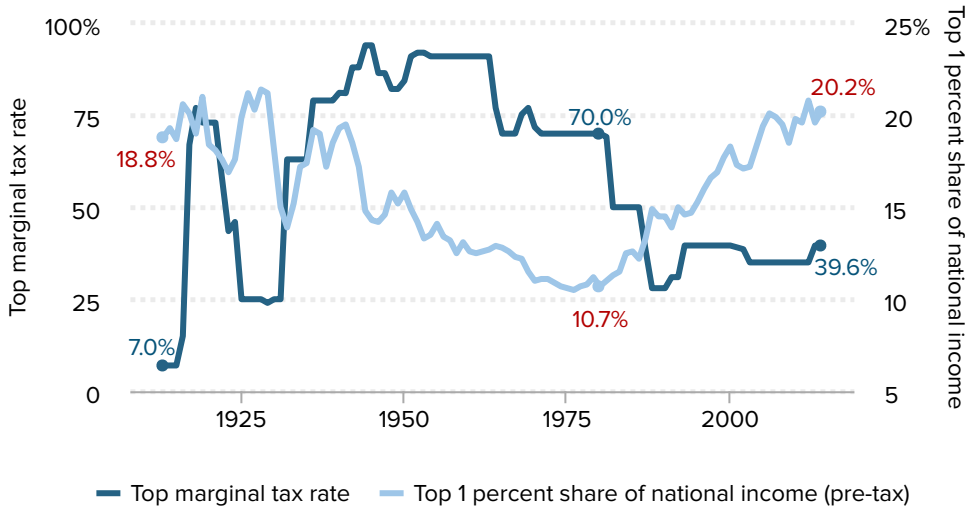
Crucially, ETI is not a fixed parameter; instead, it depends on multiple features of the tax system that policymakers can alter. For example, Slemrod and Kopczuk (2002) and Kopczuk (2005) provide evidence that the ETI depends on the broadness of the tax base.[5] Specifically, they find that a broader tax base reduces the ETI, making it clear that a broader tax base and higher rates effectively complement one another (Fieldhouse 2013). This is because much of the measured behavioral response of top earners to higher tax rates is not real in an economic sense, but is rather attributable to income-shifting by taxpayers aiming to arbitrage between tax rates that differ by type of income. For example, reviewing the literature, McClelland and Mok (2012) find "little compelling evidence that high-income taxpayers have substantially higher elasticities with respect to their labor input than lower-income taxpayers"; instead, they find that "higher estimates of elasticity of broad income among high-income taxpayers appear to reflect their greater ability to time their income rather than great changes in their labor supply." Essentially, rich people don't work or save all that much less when taxes are increased; instead, they just look for ways to shield their income from the now-higher taxes. But a broad tax base, by definition, provides fewer avenues for this type of income-shifting.

The effect that a broad base has on optimal tax rates is considerable. For example, Gruber and Saez (2002) find that ETIs for high-income earners depend on the tax base, with the ETI being nearly three and a half times as high for the current tax base when compared with a tax base with no deductions. Diamond and Saez (2011) show that these estimates of the ETI correspond to optimal top tax rates of 54 percent (current tax base) versus 80 percent (tax base with no deductions). In short, a broader tax base creates a lot more room to raise rates.

Figure A

The share of income going to the top 1 percent has risen dramatically following drastic cuts to top tax rates

Top 1 percent share of pre-tax income and top marginal income tax rates, 1913–2014



Sources: Piketty, Saez, and Zucman 2018; TPC 2019

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Using top rates to address inequality: If the pay of top earners is driven by bargaining power instead of just productivity, top rates should be pushed still higher

If high and rising top incomes are not simply driven by higher productivity, but instead are the result of a shift in economic and bargaining power that makes top income earners' gains come at the zero-sum expense of others—as argued by Bivens and Mishel (2013)—then even the midrange estimate of an optimal top tax rate of 73 percent isn't high enough. As **Figure A** shows, following drastic cuts to top tax rates, the past four decades have seen enormous gains in the share of income going to the top 1 percent. While wages for the vast majority have failed to rise with productivity (Bivens and Mishel 2015), the share of income going to the top 1 percent has surged.

This link between lower top tax rates and rising pre-tax income inequality may not be a coincidence. Piketty, Saez, and Stantcheva (2014) extend the typical optimal tax model to the case where much of the income generated in the economy consists of "rents" that can be bargained over, with the distribution of these rents not affecting decisions regarding labor supply or savings. This means that rising incomes for CEOs and others at the top of the income distribution may stem from increased economic and bargaining power, not because they are adding productivity to the economy. In this case, high marginal tax rates

can reduce the incentive of top-income households to maximize how much income they extract from others in a zero-sum process of wielding greater bargaining power. For example, if you are a CEO when top marginal tax rates are high (say, 90 percent), maybe it isn't worth the hassle and bad publicity ("outrage costs") of bargaining hard against your workers when you'll get to take home only 10 cents of every dollar you wrest away from these workers.

Piketty, Saez, and Stantcheva (2014) present macro and micro evidence that these types of bargaining effects play a large role in the estimate of overall ETI. International evidence in the evolution of top income shares since 1960 suggests an overall long-run ETI for top earners of 0.5. The key addition of Piketty, Saez, and Stantcheva's work is that nested within the overall ETI are not just supply-side and tax-avoidance elasticities, but an elasticity for bargaining as well. In the long run, they find evidence from the U.S. case that tax avoidance can't account for a substantial portion of the long-run surge in top income shares—that is, the extraordinary rise in U.S. top income shares is real, not just an artifact of income-shifting.[6]

However, Piketty, Saez, and Stantcheva also find no evidence of a correlation between growth in real GDP per capita and the drop in marginal rates since 1960, which, consistent with the previous literature we discussed, suggests modest effects of tax rate changes on labor supply or private savings. The modest impact of tax-avoidance effects and supply-side effects suggests that bargaining elasticity plays a significant role in the overall ETI. Microdata on CEO pay provides further evidence that bargaining effects play a critical role in overall elasticity. Including these bargaining effects pushes the optimal top tax rate to 83 percent.

Our plan raises top marginal tax rates closer to their optimal rates while broadening the tax base

After incorporating employer payroll and state income taxes, the effective top marginal labor rate in our model budget is 59.3 percent.[7] Given the findings discussed above, it is clear that this top labor rate is far from being excessive—and not only is it far from being excessive, but it is likely on the *low* end of optimal tax rates in the literature.

While our top rate is on the lower end of the optimal tax range in the literature, it is worth noting that our budget does not undertake a full accounting reform of Social Security. A full accounting reform of Social Security might well result in the full uncapping of the Social Security payroll tax—applying the 12.4 percent tax to all labor earnings, not just those below the current payroll tax cap of $132,900. If the Social Security payroll tax were fully uncapped, then the effective top marginal rate would be pushed to 67 percent[8]—more in line with the literature's optimal tax rates. In essence, we're leaving some tax powder dry to help any potential effort to undertake a comprehensive reform of Social Security.

We also raise the top rate on capital income to be roughly the same as our top labor rate; our capital taxation plan is discussed in more detail in the next section, along with an exploration of capital taxation theory.

Finally, our plan broadens the base of taxes subject to these top rates, e.g., by eliminating all tax expenditures except the EITC and closing loopholes in the tax code. More details on our strategies for broadening the tax base are provided in subsequent sections.

Our plan stops taxing wealth more lightly than work

As we have noted above, it is important to keep rates on different forms of income the same or close to the same; otherwise, top earners will use accounting gimmicks to shift income into the most tax-privileged category. To effectively tax the richest households, we must combine higher top marginal rates with reforms to how income from wealth is taxed.

Capital income tax rates should not be much lower than labor income tax rates

Capital income tax rates must be roughly equivalent to labor income tax rates if we are to meaningfully broaden the tax base. If equity is valuable to society at all, today's large gaps in tax rates facing income generated from wealth versus work are damaging.

The understanding we've built of optimal tax policy can help us see just how far from ideal the U.S. tax treatment of capital income is. Saez and Stantcheva (2018) develop a relatively simple theory of optimal capital taxation that allows the optimal top rate to be calculated from off-the-shelf estimates of elasticities and distributional parameters—much like the derivation of optimal top rates described in the previous section. The broad takeaway is that if equity is a key concern for policymakers, then higher rates on capital incomes are needed. To understand why this is, it is helpful to look at the shares of income coming from capital and business income for various groups. These shares are shown in **Figure B**.

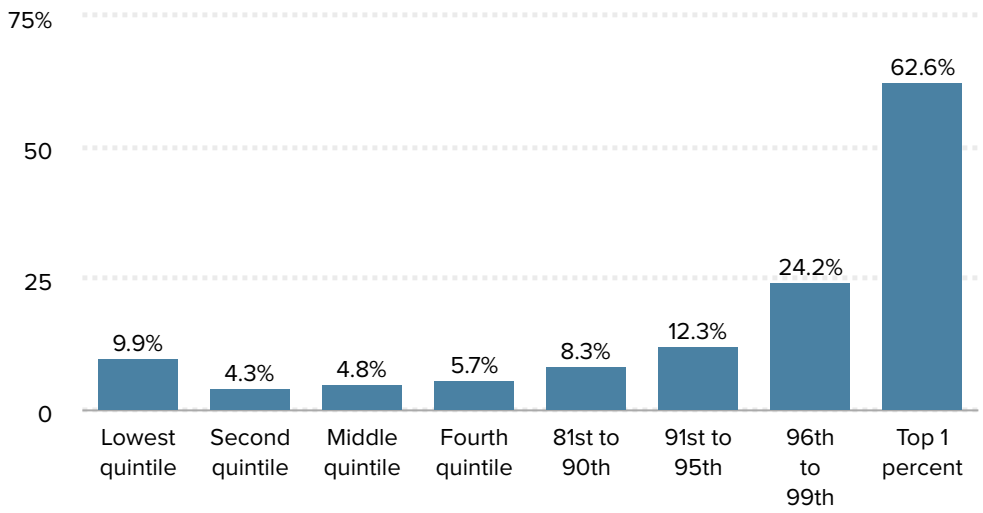
Households at the top of the income distribution largely get their income from capital and business income. So, unsurprisingly, the distribution of capital and business income is more skewed than the distribution of labor income, with the top 1 percent getting 55.9 percent of capital and business income compared with 8.9 percent of earned income (CBO 2018).

If one believes that the utility of income falls as incomes rise, then there is a benefit in redistribution from the top to the middle and bottom, and capital income should be taxed accordingly. Moreover, if the supply-side elasticities are the same, then the extreme concentration of capital income makes the optimal top rate on capital income *higher* than the top rate on labor income. As we discuss above, there is considerable uncertainty around these estimates in the long run, but a recent review of capital gains behavioral response studies suggests elasticities are likely below 0.5 (CRS 2019). Taking the same

Figure B

The bulk of top 1 percent earnings comes from capital and business income

Shares of total income from capital and business income, by percentile group, 2015



Source: EPI analysis of CBO 2018

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previous midrange ETI estimate of 0.25 from Diamond and Saez (2011) would imply top rates on labor income a little under 70 percent and a top rate on capital income of about 75 percent.

In our model budget, the top federal tax rate on capital income is 52.8 percent,[9] slightly lower than our top marginal federal rate of 53.7 percent on labor income. If the cap on Social Security payroll taxes were scrapped, pushing up top labor income tax rates, the gap between labor and capital taxation in our budget would be even wider. Why haven't we erased the labor/capital income tax rate gap completely? Mostly because our budget also includes wealth taxation—which layers on another de facto tax on capital income.

We implement a wealth tax and expand the estate tax to further close the gap between how labor and capital are taxed

Our wealth tax starts at 0.1 percent on net worth over $10 million, which ramps up to 1 percent on net worth over $19 million (affecting roughly the top 0.1 percent of wealth holders [Bricker et al. 2016]). Further, we tax estates at a rate of 45 percent on amounts between $1.5 and $5 million, with a top rate of 55 percent for estates over $5 million; amounts up to $1.5 million are exempt. While a net worth tax is new in the history of U.S. taxation, these levels of estate taxation certainly aren't. Adjusted for inflation, these parameters are roughly in line with estate taxation in the late 1990s and early 2000s

(Jacobson, Raub, and Johnson 2007), when only about the top 1–2 percent of estates were subject to the estate tax (Phillips and Wamhoff 2018).

There are many ways to tax income generated from wealth in the real world. One can levy a net worth tax directly on wealth stocks; one can tax the flow of income generated by wealth (dividends and capital gains, for example); or one can tax bequests when wealth is handed off from one generation to the next. The optimal tax literature does not provide clear guidance about the advantages and disadvantages of choosing one versus another of these ways to tax the income generated by wealth. Instead, this literature tends to examine each type of wealth tax in isolation. A recurring theme in this literature is how one interprets the fact that households see higher rates of return on their net worth the higher this net worth is. A growing body of empirical evidence shows that these differing rates of return are an important factor in wealth inequality (Bach, Calvet, and Sodini 2015; Fagereng et al. 2016).

Piketty and Saez (2012) find that if no other taxes are levied on income generated from wealth, then the optimal tax rate on capitalized *bequests* would be as high as 70 to 80 percent for top wealth holders. Piketty and Saez then note that because capital income taxes and bequest taxes are close substitutes for one another, and because gaps in tax rates between wealth-based and work-based incomes can spur tax avoidance, there is a strong rationale for setting capital income rates closer to labor income rates.

Piketty and Saez also explore different rates of return using a model in which capital taxation can insure individuals against risky returns. But given that returns depend in their model on individual effort, taxing returns may discourage effort and thereby reduce aggregate rates of return. This makes the key elasticity the elasticity of aggregate returns to the net-of-tax rate. Again, there is considerable uncertainty around the true value of this elasticity but Piketty and Saez point to available macro evidence suggesting a low elasticity, in which case the optimal capital income tax is more than double the optimal top rate on labor income. And they suggest this could help explain why countries with high top inheritance taxes often also have high top capital income tax rates.

> Essentially, rich people don't work or save all that much less when taxes are increased; instead, they just look for ways to shield their income from the now-higher taxes.

It is particularly worth highlighting that higher individual effort may largely translate into higher individual returns *at the expense of others*, whereby individual returns vary but the aggregate return is minimally affected. Harkening back to Piketty, Saez, and Stantcheva (2014), it is almost certainly the case that—though they don't explicitly model it in this paper—extending their capital model to include rent-seeking would again imply a still higher top rate on capital income.

We broadly conceive of our plan's wealth tax as shaving off a part of the flow of income for top wealth holders. But as the quantitative importance of differing returns across

households has become more clear in the data, there has been a growing literature exploring the different implications for taxing the stock of capital through a wealth tax vs. the flow of capital through an income tax. Most interestingly, Guvenen et al. (2018) find that in a model where different household returns result from differences in entrepreneurial ability, shifting from capital income taxation to wealth taxation creates efficiency gains economywide by imposing less of the total capital tax burden on productive entrepreneurs relative to unproductive entrepreneurs.

Valuable spending in our plan—particularly for single-payer health care—requires raising revenue from more than just the top 1 percent, or even the top 5 or 10 percent

Between Medicare, Medicaid, the Children's Health Insurance Program (CHIP), and the Affordable Care Act (ACA), the federal government is set to spend 9.2 percent of GDP on health care by 2049. Even with smart savings realized from drug negotiations and other savings within Medicare and Medicaid, our budget would see total federal health expenditures at 6.9 percent of GDP over baseline by 2049.

For context, *all* of the other of the spending we outline in the Budget for Shared Prosperity will cost about 4.3 percent of GDP in 2049. While there are fluctuations in the short run, by 2049 the suite of non-health-care-related spending in our budget is basically paid for by tax proposals that raise the majority of revenue from the top 1 percent (through higher top rates, higher rates on capital, and higher corporate rates).

Shifting private health care spending to a public system is a clear outlier in terms of budgetary cost. To raise enough revenue to pay for health care, we need to tax more households than just those at the very top of the income distribution.

In the long run, the move to a single-payer public health care system would guarantee health care access for all households and would slow the growth of health care costs, which currently put pressure on the growth of living standards. Moreover, a Medicare for All system provides clear benefits to middle-income households, because it is largely about shifting these households' current spending on health care onto the public sector, which has done a much better job historically at containing costs.

This recognition is why we built the Budget for Shared Prosperity around the notion that it's fair to ask middle-income households to pay for programs, like Medicare for All, that provide largely middle-income benefits. And we built our funding sources—an income-based premium contribution and an employer-side payroll tax—to mirror the way most working households currently pay for health care costs (with premium costs generally split between employers and workers). Our plan also aims to cut out-of-pocket health costs in half.

Our plan eliminates regressive tax expenditures, raising enormous revenues—enough to fund universal health care

Tax expenditures are subsidies delivered through the tax system in the form of exemptions, deductions, credits, or privileged tax rates. These tax breaks exist ostensibly to encourage individuals and corporations to perform socially desirable actions, like saving for retirement or investing in plants and equipment. Many tax expenditures—such as the home mortgage deduction—are considered to be politically sacrosanct, because they are seen as broad "middle-class" tax breaks. But this sort of "spending through the tax code" is more opaque than direct government outlays and is in fact often highly regressive. For example, consider the fact that the value of a deduction rises with income—each $1 deduction saves families in the top income bracket $0.37 while saving families in the lowest bracket just $0.10.

In our model, we eliminate all tax expenditures except the EITC. Such a broad repeal of tax expenditures is typically viewed as political fantasy, but the virtues of such a policy are so large they are worth lingering on.

The revenues raised from repealing tax expenditures would be substantial

First, the benefits in terms of revenue raised are substantial. In fact, the revenue gains turned out to be even larger than we had expected when we submitted the budget for scoring.

Figure C shows the size of all tax expenditures (as a share of GDP) relative to other government spending. Tax expenditures accounted for 7.7 percent of GDP in 2017, which is a bit more than half as large as all noninterest mandatory spending, a quarter *larger* than all discretionary spending, and almost half as large as all federal revenues in 2017.

Because of projected changes in taxpayer behavior resulting from the elimination of tax expenditures, we do not get back in revenue the full 7.7 percent of GDP that is currently lost to tax expenditures—but we get close, bringing in 5.9 percent of GDP in 2021. All told, the net effect in our budget of repealing all tax expenditures but the EITC is enormous—it would eventually raise 6.9 percent of GDP by 2049. Coincidentally, the net cost of the Medicare for All plan discussed above is also 6.9 percent of GDP—this means that the revenues from repealing tax expenditures would actually be large enough to entirely pay for our plan's largest expenditure, Medicare for All.

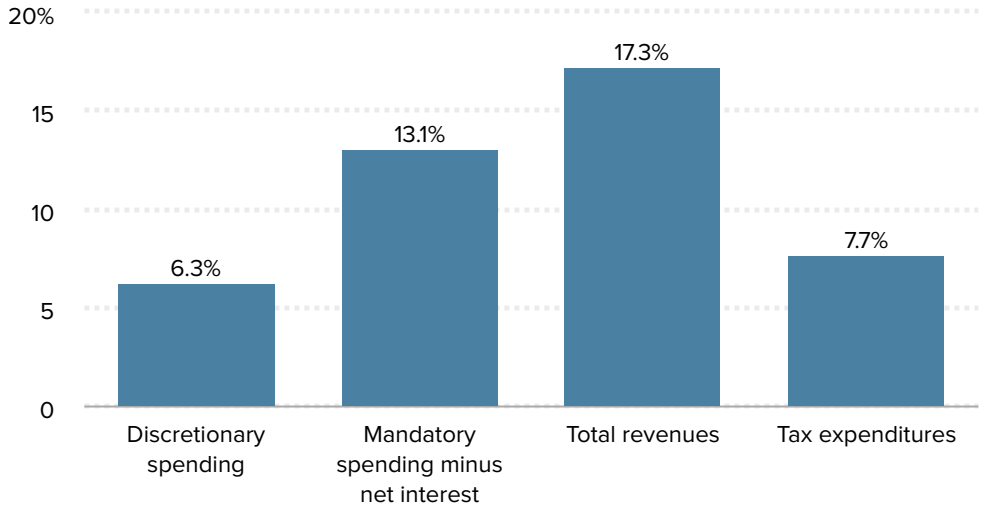
Repeal of tax expenditures is largely progressive

Tax expenditures are largely regressive, so their repeal would be largely progressive. The benefits of tax expenditures largely flow to the top 20 percent—which, according to the Tax Policy Center (TPC), consists of households making over $153,300 in 2018 (TPC 2018).

Figure C

The revenue loss from tax expenditures is enormous

Discretionary spending, noninterest mandatory spending, total revenues, and tax expenditures as a share of GDP, 2017



Source: EPI analysis of data from the Government Accountability Office (GAO 2019) and the Congressional Budget Office (CBO various years)

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According to TPC, the top 20 percent account for 75.2 percent of the benefits of the state and local tax deduction, 79.3 percent of the benefits of the mortgage interest deduction, 90.2 percent of the benefits of the pass-through income deduction, 91.5 percent of the benefits of the charitable deduction, and 93.2 percent of the benefits of the lower rates on capital income. Even these numbers mask some of the skewness, as the top 10 percent alone account for around 60 percent of the benefits of the state and local tax and mortgage interest deductions, around 80 percent of the benefits of the pass-through and charitable deductions, and 90 percent of the benefits of the preferential rates on capital income.

It is worth noting that tax expenditures have become much more regressive in the wake of the Tax Cuts and Jobs Act of 2017 (TCJA). Estimates from TPC show that many tax expenditures are now even more tilted toward the top 1 percent. For example, the share of the home mortgage interest deduction going to the top 1 percent doubled from 8.3 to 16.7 percent after the TCJA. The share of the charitable deduction going to the top 1 percent exploded from an already large 37.9 percent to 56.4 percent.

Additionally, the TCJA opened a brand new loophole for the rich, the deduction for pass-through income: 55.4 percent of the benefits of this deduction goes to the top 1 percent (TPC 2018). The only tax expenditure that the TCJA capped—the deduction for state and local taxes—makes this point in reverse. The share of the state and local deduction going to the top 1 percent fell from 33.6 percent to 12.4 percent after the TCJA. For the most egregious tax expenditure—the previously discussed preferential rates on capital income—TPC estimates that 75 percent of the benefits go to the top 1 percent after the

TCJA.

Repeal of tax expenditures raises revenues from taxpayers beyond just the top 1 percent—but without squeezing those at the bottom

Despite the skewness of tax expenditures toward the very top, these expenditures nevertheless benefit a broader group than just the top 1 percent. As discussed above, they largely accrue to the top 20 percent, or households making over $153,300 in 2018.

Figure D shows the shares of income going to the top 1 percent, the 91st through 99th percentiles, the 81st through 90th percentiles, and the bottom 80 percent from 1979 to 2015. The key takeaway from these data is that while a radical reform of tax expenditures largely affects the top 20 percent of *households,* this reform raises revenue from a base of taxation that accounts for over half of all *income* earned.

This means that by broadly repealing tax expenditures, we can expand the tax base considerably while increasing the progressivity of the tax code to counter growing inequality. Figure D shows that while most of the rise of inequality over the past generation has been accounted for by the top 5 and top 1 percent, even the bottom half of the top 20 percent of households have mostly held their income shares steady in the face of rising inequality.

The share of income going to the bottom 80 percent has fallen by 8.3 percentage points since 1979, while the top 1 percent has seen their income share almost double, from 9.0 percent in 1979 to 16.6 percent in 2015. Within the rest of the top 20 percent there is less movement: Income shares for the 81st to 90th percentiles fell just 0.5 percentage points, while the income share going to the 91st to 99th percentiles increased 2.2 percentage points.

Radical reform of tax expenditures achieves our goal of expanding the share of taxpayers affected by tax reforms beyond just the top 1 percent, in order to raise sufficient revenues to cover big-ticket items like universal health care—but it does so without putting excessive pressure on taxpayers in the bottom 80 percent.

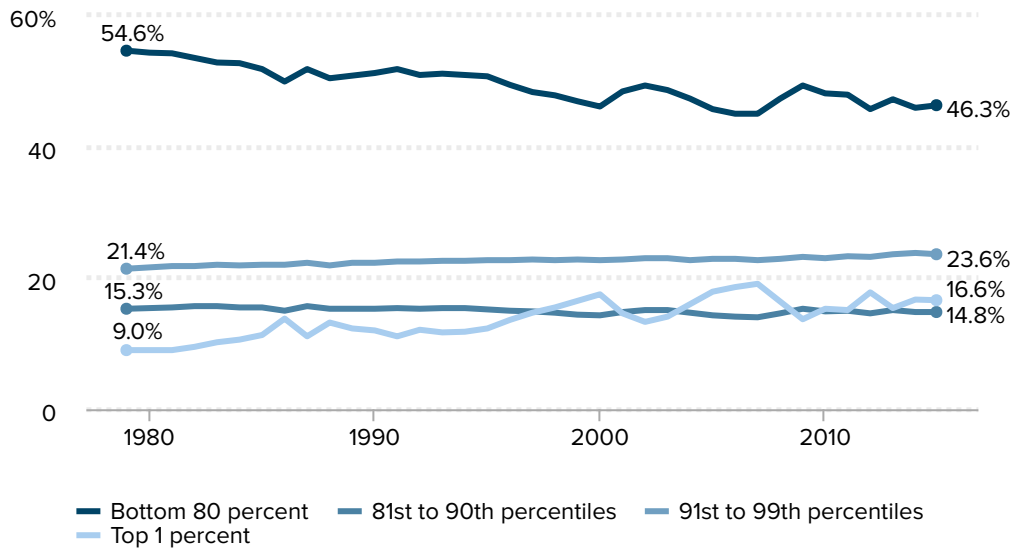
Repeal of tax expenditures further broadens the tax base

The repeal of these tax expenditures would also create further space for raising revenues from the top as it would close off avenues for income-shifting, ensuring those at the top are actually taxed at the new top rates.

Figure D

The top 10 percent have seen their share of income grow since 1979, while the share going to the bottom 90 percent has fallen

Shares of before-tax-and-transfer income, by percentile group, 1979–2015



Source: EPI analysis of CBO 2018

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Revenues from the repeal of tax expenditures can be used to fund direct government spending—which is a more efficient and effective way to provide the benefits associated with tax expenditures

Finally, the social benefits that tax expenditures are *meant* to supply could be provided in a more targeted and efficient manner through direct government spending. For the tax expenditures that aren't ludicrously tilted toward the rich, but may still be nonetheless regressive, the Budget for Shared Prosperity follows the theme of trading them for direct government spending. We institute an ambitious early child care and childhood education initiative instead of the child and dependent care credit. We invest in affordable college education, teachers and schools, and early childhood education in lieu of various education credits and deductions. We reduce child poverty substantially by replacing the child tax credit with a child allowance. We do away with regressive tax benefits for 401(k) retirement plans, but boost spending on Social Security. And we spend a substantial amount guaranteeing health care for all through a public single-payer plan, which makes the exemption of employer-sponsored health insurance unnecessary.

Our plan taxes economic 'bads'

Another tenet of good tax policy is levying Pigovian taxes, which ensure that the prices consumers face on certain goods reflect the true cost their production and consumption imposes on society. We include a whole host of these that have small impacts on revenues, including increasing or instituting taxes on cigarettes, sugar content of beverages, alcohol, and motor fuel. We also impose a tax on "systemically important" (i.e., "too big to fail") financial institutions as a hedge against the costs of government bailouts. But, by far, our Pigovian taxes that are projected to generate the largest revenues are a financial transactions tax (FTT) and a carbon tax.

A little background on the rationale behind an FTT: There is little evidence that the extreme rise in the financial sector's share of the economy has provided economic value-added. Instead, much of the activity undertaken in the finance sector largely constitutes a zero-sum redistribution from households to the financial sector (Bivens and Blair 2016a). This means that an FTT, even if it didn't bring in as much revenue as estimated, would benefit the economy by crowding out wasteful financial transactions.[10]

The social benefits that tax expenditures are *meant* to supply could be provided in a more targeted and efficient manner through direct government spending.

Unlike FTTs, the direct incidence of carbon taxes is regressive. Combating climate change will require a suite of policies—in particular, publicly financed and directed green investments. But we don't think that the regressive nature of a carbon tax should preclude its use to combat climate change—we'll need every tool we can muster. So to ensure that a more efficient price is placed on carbon, while ensuring a progressive net effect, we refund 200 percent of carbon tax revenues on a lump-sum, per-capita basis.[11]

The Budget for Shared Prosperity isn't out of the ordinary on an international scale

The U.S. government taxes and spends substantially less than other OECD countries. U.S. general government revenues (including federal, state, and local government revenues) were 33.3 percent of GDP in 2015, or the fourth-smallest among OECD countries (OECD 2019b). U.S. general government spending of 37.9 percent of GDP in 2015 put the U.S. in the bottom quarter of OECD countries (OECD 2019c). And U.S. spending on family benefits is especially low, at a second-smallest 0.6 percent of GDP compared with an OECD average of 2.0 percent in 2015 (OECD 2019a). While the policies in the Budget for Shared Prosperity are ambitious relative to the current size of U.S. government revenues and

spending, they certainly would not make the U.S. anywhere close to an outlier on an international scale. Boosting government revenues by around 15 percent of GDP and boosting government spending by about 11 percent of GDP would put the U.S. into roughly the top quarter of OECD countries in both categories. The child allowance, paid leave, and early child care and childhood education programs in the Budget for Shared Prosperity would boost spending for family benefits by about 1.8 percent of GDP, for total family benefits spending of 2.4 percent of GDP, putting the U.S. above the OECD average.

Likewise, our budget's support for a universal health care program with a broad tax base also falls in line with the practices of other OECD nations. Unlike the U.S., most OECD countries provide universal health care, with a large majority of the financing coming from public sources. They also typically raise revenues from a broader base of taxes, in particular through value-added taxes (VATs). On average, OECD countries raise about 10.8 percent of GDP from taxes on goods and services, while the U.S. raises just 4.4 percent of GDP from those sources (OECD 2019d). While our budget doesn't include a VAT to cover this spending, we do significantly broaden the tax base with our health care payroll tax, our income-based health insurance premium, and our abolition of non-EITC tax expenditures.

Conclusion

The U.S. economy faces significant challenges going forward, ranging from widening income inequality and stagnant wages for the vast majority to a dearth of public investments and an inadequate social safety net. The Budget for Shared Prosperity meets these challenges head on by considerably increasing the government's fiscal footprint while maintaining good economic and tax policy.

The spending in the Budget for Shared Prosperity includes extensive increases in the size of the social safety net and public investments, along with the spending necessary for a Medicare for All public health care system. This health care spending is an outlier in terms of budgetary costs and therefore requires that we implement a broader base of taxation, beyond just taxes aimed at those at the very top of the income distribution. But a broader base of taxation does not just have to mean additional payroll taxes, health care premiums, or VATs. An enormous amount of revenue can be made available by simply eliminating deductions and closing loopholes in the tax code. When combined with the higher rates on top incomes that maintaining the broadest base of taxation allows for, these policies have the potential to raise very large amounts of revenue.

We call for such bold measures in the Budget for Shared Prosperity in order to highlight how dated and constraining typical discussions of tax policy are among Washington policymakers—and how much revenue we are losing out on as a result. For example, the conventional wisdom that tax reform should "broaden the base to lower the rates" is flat-out wrong. A broader base, created both through the repeal of tax expenditures and by keeping rates on different forms of income similar, should be coupled with *higher* rates, not lower rates. Further, worries about the effects of top marginal tax rates on behavior should include discussions of whether the rates are high enough to blunt the incentives

for top earners to bargain hard over income gains at the expense of everyone else in the economy. Finally, the light taxes we currently levy on capital incomes should be far higher. Setting capital income taxes closer to marginal rates on earned income will make it much more difficult for wealthy taxpayers to avoid paying their full tax bill—they will no longer be able to simply shift income into a different category to get lower rates. The economic literature on this point is clear: If policymakers are concerned about equity, higher rates on capital incomes make sense.

In truth, with a deficit of 1.7 percent of GDP in 2049 and an average deficit of 1.1 percent of GDP over 2040–2049, our plan might raise *more* revenue than is strictly needed even to pay for our ambitious spending plans.[12] If policymakers wanted to use our plan as a model for an actual budget, there would likely be room to pare back some taxes—particularly the new payroll taxes and the income-based health premium. In addition, the falling debt-to-GDP ratio implied by our plan over the next 30 years also provides more than ample room (even in narrow political terms) to take on substantial amounts of debt to aggressively fight any recession that should occur in that time frame. Policymakers often use debt-to-GDP ratios that are high in historic terms as an excuse for inaction in fighting recessions with sufficient vigor. Under our budget, they would no longer have that excuse.

Endnotes

1. See Peter G. Peterson Foundation 2019a, 2019b; Bivens 2019a.

2. For further information on our view of deficits, see our forthcoming report on the topic (Bivens 2019b).

3. Author's analysis of unpublished Total Economy Productivity data from Bureau of Labor Statistics (BLS) Labor Productivity and Costs program, Bureau of Economic Analysis National Income and Product Accounts, and TPC 2019.

4. In theory, less savings can, in the long run, push up economywide interest rates, which can in turn lead to decreases in capital investments that can increase productivity.

5. "Tax base" refers to the total amount of income or assets taxed by the government. When certain income is excluded from taxation—e.g., through itemized deductions—the tax base is narrowed. The tax base is also narrowed when certain types of income are subject to lower taxes. The tax base can be broadened by eliminating tax exemptions and ensuring that different types of income are taxed at similar rates.

6. Saez (2016) provides further evidence that the extraordinary rise in top income shares is real.

7. This top labor tax rate of 59.3 percent includes the proposed top marginal tax of 49 percent, a 7.2 percent payroll tax (composed of the current 2.9 percent Medicare payroll tax, of which half is paid by the employer, plus the current 0.9 percent additional Medicare tax for high-income earners implemented under the Affordable Care Act, plus our plan's 3.0 percent employer health care payroll tax, plus a 0.4 percent paid leave payroll tax, of which half is paid by the employer), and average state income taxes taken from Diamond and Saez (2011). Since employer payroll taxes are deductible for both federal and state income taxes, we calculate the total top tax rate to be (0.49 + 0.029 + 0.009 + 0.03 + 0.004 + 0.0586)/(1.0145 * 1.03 * 1.002) = 0.593.

8. The 6.2 percent employer Social Security tax is deductible for both federal and state income taxes, therefore we calculate the total top tax rate to be (0.49 + 0.029 + 0.009 + 0.03 + 0.004 + 0.0586 + 0.124)/(1.0145 * 1.03 * 1.002 * 1.062) = 0.67.

9. The top tax rate on capital income of 52.8 percent includes the proposed top marginal income tax rate of 49.0 percent plus the 3.8 percent ACA (Affordable Care Act) surtax on investment income.

10. For a more detailed summary of the rationale for and benefits of an FTT, see EPI 2018.

11. For simplicity, we assume that carbon revenue is refunded at double the amount collected the previous year. In practice, households would also need to receive a refund in the first year the carbon tax is imposed so that they won't be harmed economically by the tax. To determine refunds for the first year of implementation, we recommend using an estimate of revenues to be collected that year.

12. For further information, see EPI's forthcoming report on deficits (Bivens 2019b).

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