Economic Policy Institute

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INVESTING IN AMERICA'S ECONOMY

A budget blueprint for economic recovery

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Executive summary of the Economic Policy Institute's proposed federal budget prepared for the Peter G. Peterson Foundation's Solutions Initiative

I. Introduction

The American economy continues to struggle in the wake of the Great Recession. The economic downturn has already cost the nation an estimated $3 trillion in foregone income and is projected to cost another $3 trillion absent a sharp policy shift toward prioritizing job creation. If the U.S. economy continues to grow at the same rate it has over the last 18 months, it would take another decade for the labor market to fully recover.

In recent years, pundits and policymakers have obsessed over budget deficits, and, practically if not rhetorically, job creation has taken a back seat to cutting federal spending. However, warnings of a new recession following the "fiscal cliff" (a host of expiring tax provisions and spending cuts scheduled to go into effect in 2013) have served to reemphasize the destructive impact that premature fiscal contraction can have on the economy and affirm that economic recovery should be the first priority of fiscal policy.

Our proposed federal budget is driven by three fundamental truths. First, the near-term budget deficit is largely a symptom of the poor economy, and therefore any fiscal proposal must include a plan to get the economy back on track. Second, tax and budget policy should share the same goal as broader economic policy: providing rising living standards and greater economic opportunity and security for all Americans. Third, a truly sustainable budget provides future generations not only with manageable debt levels but also the building blocks of a prosperous economy: increased investments in infrastructure, education, and R&D, and a strong safety net to ensure that future generations have *at least* the same baseline levels of economic security on which millions of households currently rely.

Too many plans treat budgeting as little more than an accounting exercise, in which the goal is simply to make the spending and revenue lines cross. While this budget plan achieves a sustainable debt path, it was crafted with a broader goal in mind: to create a better economy and society.

II. Principles

1) Create jobs now

The jobs crisis isn't just a short-term problem of unemployment and poverty—it can also permanently scar the economy by depleting the nation's productive capital stock as educational attainment is deferred or forgone, poverty and malnutrition rise, human capital atrophies, businesses refrain from investing, and the physical capital stock depreciates from disuse. This makes long-run fiscal sustainability more difficult to achieve.

The main obstacle to economic growth continues to be a huge shortfall in aggregate demand. This is driven by insufficient spending by households and businesses—spending which pulled back in the aftermath of a housing bubble that wiped out trillions of dollars in household wealth and froze residential and commercial construction. Therefore, boosting aggregate demand with deficit-financed fiscal stimulus remains the most effective policy lever for addressing the jobs crisis.

The first priority for job creation is to successfully navigate the "fiscal obstacle course" (a more useful metaphor than "fiscal cliff") by mitigating the biggest threats to demand in the near term: the expiration of ad hoc stimulus measures (such as the payroll tax cut) and the implementation of spending cuts scheduled under the discretionary spending caps and sequestration mechanism in the Budget Control Act (BCA). Our plan repeals the BCA and finances a package of temporary, cost-effective fiscal stimulus measures that would reorient fiscal policy: increased infrastructure spending, state budget relief, a temporary extension of the Making Work Pay (MWP) tax credit, and emergency unemployment compensation. These measures would also more than offset the negligible effects of raising taxes on upper-income households by letting the Bush tax cuts expire.

2) Let the Bush tax cuts expire

The Bush tax cuts have already added more than $3 trillion to the national debt—roughly half of the total debt added since 2001—and they will add another $4.3 trillion over the next decade if extended. Prior to the Great Recession, these tax cuts were the signature policy presiding over the worst postwar economic expansion on record, in which real median income stagnated and income inequality grew. The Bush tax cuts are simply too expensive and ineffectual to continue.

Our plan allows the Bush tax cuts to fully expire on schedule, and alleviates the minimal impact of their expiration on lower- and middle-income households by pairing the expiration with a consolidation and net expansion of refundable tax credits. Largely based on past proposals from EPI (see Robert Cherry and Max Sawicky's 2000 report, *Giving Tax Credit Where Credit Is Due*) and the Bipartisan Policy Center (see Debt Reduction Task Force co-chairs Pete Domenici and Alice Rivlin's 2010 report, *Restoring America's Future*), our proposal would replace the personal exemption, standard deduction, Earned Income Tax Credit, and Child Tax Credit with a work credit and a family tax credit. This swap would increase progressivity and simplify the tax code relative to current policies.

3) Preserve and strengthen the social safety net

Millions of Americans rely on the economic security afforded by Social Security, Medicare, Medicaid, and other safety net programs. Our plan proposes no benefit reductions and instead strengthens the safety net by expanding unemployment compensation, eliminating the payroll tax cap to solidify Social Security's finances for generations, and building on the Affordable Care Act to attain long-run efficiency savings and cost containment in the provision of health care.

4) Return fairness and progressivity to the tax code

Public policy has failed to provide a robust response to the enormous rise in inequality over the last few decades. In fact, the progressivity of the tax code has been weakened over the last half century, exacerbating rather than reducing income inequality. Our plan restores fairness to the tax code by taxing wealth the same as ordinary income, reinstating more progressive estate tax parameters, adding new tax brackets on taxable income over $2 million, and enacting a net wealth tax. Additionally, our plan adopts the Buffett Rule to ensure that high-income households pay at least the same rate as middle-income households.

5) Tax goods and services that have significant social costs

Taxation creates incentives that can have beneficial outcomes for society. Our plan aims to help economic agents internalize the costs that spill over to the rest of society by pricing carbon emissions, taxing financial transactions and leverage, and levying taxes on products that pose public health risks, notably alcohol and sweetened beverages.

III. Spending

Our spending policies are designed to promote immediate job creation, strengthen the middle class, and expand economic mobility and opportunity. Our plan includes proposals in the following categories:

Public investments and domestic spending

A balanced approach to fiscal sustainability requires boosting employment in the near term and investing in long-term growth. An excessive focus on debt ignores ways in which policies can shortchange future generations by leaving them with inadequate roads, bridges, schools, knowledge, health, or environmental quality. The current budget trajectory underinvests in physical, human, and environmental capital. Our budget repeals the entire BCA, which applies disproportionate cuts to the non-security discretionary budget, half of which consists of public investment. Our budget goes further in investing in our nation's infrastructure, education and training, and research and development by financing a permanent increase in public investments of $200 billion in 2013, which is then indexed to nominal GDP growth in subsequent years. We additionally finance $425 billion in state and local fiscal relief through 2017 to protect public investments at the state and local level and boost employment, as well as $250 billion for a public works and direct employment program over 2013–2014.

Defense

Our plan replaces the frontloaded BCA discretionary spending caps and sequester for defense spending with comparable cuts phased in over a decade and in line with the cuts proposed by the bipartisan Sustainable Defense Task Force. This allows for feasible implementation and minimizes the economic drag from government spending cuts in the near term.

Social Security

Social Security has kept more seniors, disabled persons, and children out of poverty than all other social welfare programs combined, and for 75 years it has provided economic support for millions more. As businesses continue to shift risk to individuals by replacing private pensions with tax-preferred personal savings accounts, Social Security is proving an increasingly important pillar of retirement. Our plan recognizes the need to shore up Social Security while protecting benefits, and phases in a five-year elimination of the cap on both employee- and employer-side payroll tax contributions. This will also keep rising inequality from depriving the Social Security system of revenue, as it has for decades.

Medicare, Medicaid, the Affordable Care Act, and other federal health programs

Our plan protects and strengthens the social insurance programs that ensure health coverage for those who are otherwise unable to receive affordable coverage. As the cost of providing health care escalates, however, it is imperative that we slow the rate of rising *national* health care expenditures instead of simply shifting rising costs onto households or state governments. Using government monopsony (single-buyer) power to contain costs, our plan would negotiate lower Medicare Part D drug prices, offer a public insurance option, encourage bundling payments, accelerate generic drug availability, and finance investments in health information technology and comparative effectiveness research. Furthermore, our plan would expand the jurisdiction of the Independent Payment Advisory Board (IPAB) to the private sector. This super-charged IPAB, plus our other health policies, should sufficiently contain nationwide (and thus government) health costs. If they do not, we propose an all-payer IPAB system that caps federal health spending at nominal GDP plus 1 percent beyond 2022. Lastly, our plan repeals the sustainable growth rate formula for Medicare physician payments.

Other mandatory programs

Our plan extends the Emergency Unemployment Compensation program through 2015, restoring the program's provision of up to 99 weeks of unemployment compensation in high-unemployment states. Our plan eliminates commodity payments to large farms, reduces the value of direct payments, and reforms the crop insurance program in line with Obama administration policy. Finally, many of our tax policies have associated mandatory outlay effects; these include the new universal worker and child credits, a refundable rebate from pricing carbon, the temporary reinstatement of the MWP credit, and the conversion of the charitable contribution and home mortgage interest deductions to refundable tax credits.

IV. Revenues

The current tax code fails along many dimensions. First, tax receipts have been deliberately driven down to levels that will produce large future budget deficits even if the economy fully recovers. The Bush tax cuts, for example, are a core reason that sizable structural deficits are projected if fiscal policy remains unchanged. Second, recent changes in tax policy have exacerbated income inequality, and tax progressivity must be restored to address the large rise in inequality of incomes in recent decades. Third, tax code complexity for both individuals and corporations is such that a tax bill can depend as much on the quality of one's accountant as the size of one's income. High-income households and corporations now often pay far less in taxes than what an optimal system would collect from them. Under our proposals, high-income earners and corporations would contribute more, while negative tax rates for low-income households would be expanded.

Individual income taxes

The Bush tax cuts were costly and ineffective, and the evidence of their failure to boost economic growth continues to mount. Our plan allows all of the Bush tax cuts to expire on schedule, to be replaced with more progressive refundable work and child credits targeted toward lower- and middle-income households. The work credit is set at 30 percent on the first $20,300 of income per worker, while the child credit provides a refundable tax credit of $1,600 per dependent child under 18 (limit of three per household).

The tax code taxes income derived from wealth at a lower rate than income from work, which distorts economic behavior, creates opportunities to shelter wealth from taxation, and worsens inequality. Our plan closes the gap between the two rates by taxing dividends as ordinary income, taxing capital gains as ordinary income up to the revenue-maximizing rate of 36 percent, and repealing the step-up basis of capital gains at death. Our plan also adds additional individual income tax brackets to reflect that tax progressivity has fallen most sharply within the top 0.1 percent of households by income; this change would bring the top effective individual tax rate closer to the optimal top tax rate estimated by economists Peter Diamond and Emmanuel Saez in their 2011 paper *The Case for a Progressive Tax*.

Corporate income taxes

The corporate tax code is rife with inefficient and costly special-interest tax breaks. Our plan starts by adopting the administration's proposals to eliminate fossil fuel tax subsidies, which are unnecessary and inhibit the transition to a more sustainable economy; and to reform the international tax system, close the tax gap, and modify the treatment of financial and insurance companies. Our plan also allows for the expiration of some of the more wasteful business tax preferences, such as bonus depreciation, the Subpart F active financing exception, the alcohol fuel tax credit, and the R&E (research and experimentation) credit (which is replaced with more efficient direct R&D investment in the National Labs and National Institutes of Health). Finally, our plan repeals some of the more egregious instances of corporate welfare in the tax code, but dedicates the savings to deficit reduction rather than using them to reward corporations with lower marginal rates.

Tax expenditures

As structured, many individual income tax expenditures are ineffective in promoting their purported goals and are skewed toward higher-income households. Our plan reforms tax expenditures by replacing the mortgage interest and charitable-giving deductions with 15 percent refundable credits (and limiting the value of tax-preferred mortgage debt to $500,000). We also replace the tax exclusion on municipal bonds with a direct subsidy for the issuer, a more effective and progressive policy. We then cap value of remaining itemized deductions and other preferences, gradually reduced from a 28 percent cap in 2014 to 15 percent in 2017.

Our plan shifts the burden of taxation away from work and on to corrective taxes, seeking to minimize socially harmful outcomes and activities that act as “negative externalities” because their full social costs are unpaid. These include pollution, alcohol consumption, the diabetes epidemic and other adverse health effects, concentrated wealth, high degrees of financial leverage, and high-frequency financial trading. To help mitigate pollution and improve health, our plan prices carbon emissions (initially set at $30 per metric ton) and recycles over half of the revenue back to low- and middle-income households through a refundable tax rebate. Our plan also phases in an increase in the motor fuel excise tax, raises alcohol excise taxes, and enacts a new sweetened-beverage tax. To reduce systemic financial risk, we adopt a leverage tax on “too big to fail” banks and a broad-based financial transaction tax. And to reduce the corrosive effects of concentrated wealth, our plan enacts a half-a-percentage-point annual surcharge on net wealth above $10 million and reinstates the estate tax at a lower exemption ($2 million) and higher top rate (50 percent).

V. Conclusion

Our blueprint navigates the impending headwinds by expanding effective job creation measures and reorienting tax policy to help lower- and middle-income families while letting the costly, inefficient, and regressive Bush tax cuts expire. Over the longer term, our plan reverses the decades-long erosion of public investment and declining tax code progressivity by boosting investments in future generations and financing these investments by asking more of those in society who can most afford it. Our plan preserves social insurance benefits and avoids cost-shifting measures that tend to exacerbate rather than address the underlying economic challenges.

Deficit reduction on its own will fail to boost living standards, opportunity, and security for current and future generations. To be successful, it must be paired with policies that push the labor market back to full employment and that lay the foundation for long-run economic growth.

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