COLORADO CENTER on LAW & POLICY

Justice and Economic Security for *all* Coloradans

Analysis of 2012 Federal Tax Reform, Part Three: The need for balanced budget reform

ISSUE BRIEF
November 14, 2012

Ali Mickelson
Tax Policy Analyst
789 Sherman St.
Suite 300
Denver, CO 80203
www.cclponline.org
303-573-5669 ext. 304
amickelson@cclponline.org

This is the third in a series of issue briefs discussing federal budget changes and their implications for families across America. This brief focuses on the need for a balanced approach to budget reform.

For more information on the lame duck session, please watch for our "Lame Duck Hunt" series that will track and examine the highlights of the lame duck session.

Now that the election has been decided, Congress will convene to discuss federal budget and tax reform. With the expiration of the Bush tax cuts set for January 1, 2013 and the looming "fiscal cliff," Congress is under pressure to make meaningful and lasting changes to the federal budget. However, to date Congress has been unable to come to an agreement on the future of fiscal reform.

Congress needs to take a balanced approach to reform by including new revenues in addition to spending cuts. A one-sided, cuts-focused budget would be devastating to jobs and state budgets, as well as to economic recovery. It is critical that Congressional leaders step up and look at budget reform through a long-term, sustainable and progressive, not regressive, lens. Now is the time for Congress to take a balanced approach to the federal budget.

The lame duck

A lame duck session occurs when Congress convenes after a new Congress has been elected but before the new term officially begins. In practice, this typically occurs between the early November election and the beginning of the following year. For 2012, the lame duck session began November 13.

While traditionally lame duck sessions tend to be uneventful, this year's lame duck session has a lot on the line. Congress will be addressing major issues of federal budget reform, including the pending sequestration cuts and the fiscal cliff, as well as deficit reduction and the Bush tax cuts.

A balanced approach

Policymakers across the spectrum agree that deficit reduction should be the major priority in the 2013 federal budget. Analysis shows that the deficit must be reduced by at least $3 trillion over the next decade in order to ensure that the economy grows faster than federal debt.[1] This amount is in addition to the $1 trillion in cuts that have been implemented by the Budget Control Act of 2011

[1] Leachman, Michael, *DEFICIT REDUCTION PACKAGE THAT LACKS SIGINIFICANT REVENUES WOULD SHITT VERY SUBSTANTIAL COSTS TO STATES AND LOCALITIES: Ryan Budget Cuts to States and Local Services Would be Far Deeper than Cuts Under Sequestration,* Center on Budget and Policy Priorities, August 8, 2012 at http://www.cbpp.org/files/8-8-12sfp.pdf

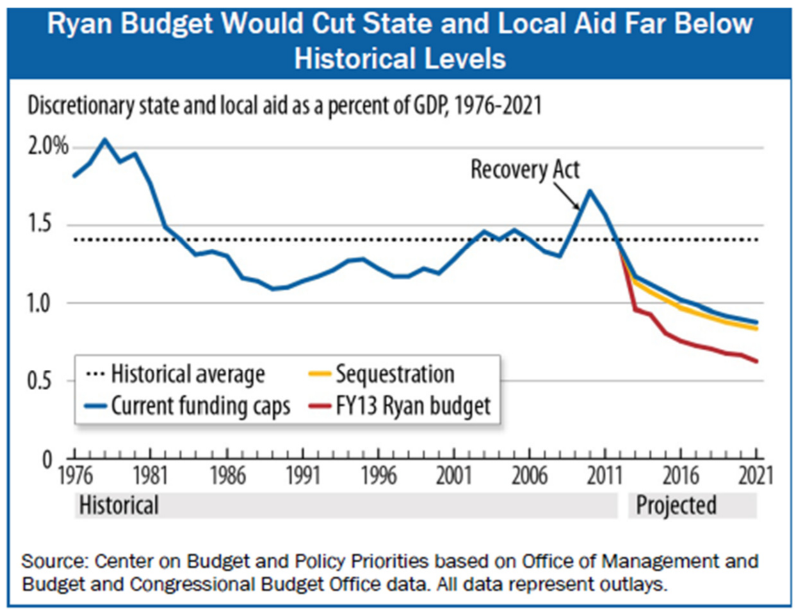
(BCA). However, spending cuts should not be the only focus in deficit reduction. Increases in revenue are a critical part of lasting deficit reform.

All major bipartisan deficit reduction proposals, including Bowles-Simpson, have acknowledged that spending cuts alone will not generate the necessary savings in the budget. The same proposals found that spending cuts alone place a disproportionately higher burden on vulnerable populations, such as low-income families, the disabled and the elderly, and would require detrimental reductions in funding for public education and infrastructure.[2] Spending cuts alone are not an effective way to reduce the federal deficit. Spending cuts *and* significant increases in revenue are the more sustainable and equitable way to reduce federal debt.

Spending cuts

The BCA has already imposed spending cuts that contribute to deficit reduction. The BCA cuts alone will shrink discretionary spending to 5.7 percent of Gross Domestic Product (GDP), compared to the 8.7 percent average of the last 40 years.[3] However, more cuts are needed to achieve significant deficit savings.

Congressional leaders agree that program reductions should not come from Social Security or Medicare benefits for current beneficiaries. Lawmakers are also hesitant to further cut defense spending beyond BCA requirements. That leaves only two major areas in the federal budget for spending cuts: (1) non-defense discretionary programs, and (2) mandatory programs other than Social Security and Medicare.



The House-passed budget authored by Budget Chairman Paul Ryan illustrates this issue. Ryan's plan relies solely on spending cuts to reduce the deficit. His budget would impose $5.3 trillion in spending cuts over the next ten years, primarily from Medicaid and CHIP, changes to Medicare, and a blanket $2.2 billion reduction in other discretionary programs.[4] According to the Center on Budget and Policy Priorities, 62 percent of the spending cuts in Chairman Ryan's plan come from programs that support low-income families. This is neither a progressive nor a sustainable solution to long-term budget reform.

Additionally, if Congressional leaders choose to take the cuts-only approach, states could end up shouldering the cost. According to the Center on Budget and Policy Priorities, if the cuts-only Ryan budget is passed, state services will suffer. By 2021, the Ryan budget would reduce discretionary state and local grant spending to an estimated 0.6 percent of GDP, less than half the average of the last 35 years.[5]

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[2] Marr, Chuck and Huang, Chye-Ching, *HOW TAX REFORM COULD BECOME A TRAP: Tax Reform Holds Promise, But If Not Done Carefully, Could Increase the Deficit and Inequality and Harm the Economy,* Center on Budget and Policy Priorities, June 8, 2012 at http://www.cbpp.org/cms/index.cfm?fa=view&id=3792#_ftn4

[3] Marr, Chuck and Huang, Chye-Ching, *HOW TAX REFORM COULD BECOME A TRAP: Tax Reform Holds Promise, But If Not Done Carefully, Could Increase the Deficit and Inequality and Harm the Economy,* Center on Budget and Policy Priorities, June 8, 2012 at http://www.cbpp.org/cms/index.cfm?fa=view&id=3792#_ftn4

[4] Congressional Budget Office, *The Long-Term Budgetary Impact of Paths for Federal Revenues and Spending Specified by Chairman Ryan,* March 2012 at http://www.cbo.gov/sites/default/files/cbofiles/attachments/03-20-Ryan_Specified_Paths_2.pdf

[5] Leachman, Michael, *DEFICIT REDUCTION PACKAGE THAT LACKS SIGINIFICANT REVENUES WOULD SHITT VERY SUBSTANTIAL COSTS TO STATES AND LOCALITIES: Ryan Budget Cuts to States and Local Services Would be Far Deeper than Cuts Under Sequestration,* Center on Budget and Policy Priorities, August 8, 2012 at http://www.cbpp.org/files/8-8-12sfp.pdf

Impact in Colorado

In Colorado, a budget plan focused exclusively of spending cuts, such as Chairman Ryan's, would have a devastating impact on local jobs and state services. Estimates show that the Ryan budget would cut 22% out of federal discretionary funding for states and localities. In Colorado, this would equate to $366 million in lost state revenue. These reductions would reduce funding for public services, including education, transportation and housing and community development.

The Ryan funding cuts would also be much deeper than the looming sequestration cuts. In 2014, sequestration will result in a 7.3 percent non-discretionary non-defense cut, which includes state and local grant funding. Chairman Ryan's 22% budget cut would be three times larger than the scheduled sequestration cuts.

Colorado Center on Law and Policy economist Chris Stiffler estimates that the Ryan plan would result in the loss of close to 6,000 jobs in Colorado. The cuts in funding would result in the direct loss of roughly 3,800 jobs which will indirectly eliminate another 2,200 jobs as a result of the decline in overall spending in the economy. The majority of these job losses will come from education.

Top 10 industries in Colorado that will face direct job losses under the Ryan plan

Industry sector	**Jobs Lost**
Education	827
Individual and family services	649
Transit and ground passenger transportation	435
Community food, housing, relief services, including rehabilitation services	377
Home health care services	299
Child day care services	279
Scenic and sightseeing transportation and support activities for transportation	257
Nursing and residential care facilities	226
Food services and drinking places	204
Construction of new residential permanent site single- and multi-family structures	173

Furthermore, much of the federal discretionary spending that would be cut by the Ryan plan finances programs that provide assistance to low-income Coloradans. Therefore, eliminating this funding is inherently regressive as it disproportionally burdens the poorest families in Colorado.

Revenue increases

Spending cuts are only one way to achieve deficit reduction. Another more balanced and sustainable approach includes increasing federal revenues in addition to making cuts. There are two main methods Congressional leaders could employ to increase federal revenues: (1) increasing taxes; and (2) cutting tax expenditures.

Increasing taxes

Congress could increase federal revenue by increasing taxes. The two most common ways to increase taxes are by either raising rates on certain types of income, like capital gains, or by raising rates on certain tax brackets, or income groups.

Raising the capital gains rate or eliminating special capital gains treatment all together would be one way to generate increased federal revenues. Capital gains are income derived from the selling of capital assets, such as stocks, bonds, real estate or other investments. Currently, capital gains are taxed at 15 percent, a rate that is often lower than the tax rates on other income, such as wage income. President Obama's 2013 budget would increase the capital gains tax rate to 20 percent. This change would increase revenues by $36 billion between 2013 and 2022.[6] The Ryan budget, on the other hand, would eliminate any tax on capital gains, interest or dividend income, which would further reduce revenues.

Raising the tax rate is another way to increase revenue. In 2012, the tax rates were between 10 percent for the lowest income brackets and 35 percent for the highest income bracket. Those 2012 rates reflected the rate-reductions of the Bush tax cuts. In 2013, if the Bush tax cuts expire as scheduled, the income tax rates will increase and the top two tax brackets will pay 36 percent and 39.6 percent.

President Obama's 2013 federal budget plan would raise the tax rate on the top two wealthiest tax brackets to 36 percent and 39.6 percent by letting the Bush tax cuts expire for those making over $250,000 per year. However, he would extend the reduced Bush tax cut rates for lower-income Americans. This change would raise about $440 billion in tax revenue over the next decade.[7]

The chart to the right shows the different tax rates under three different scenarios. The chart compares the tax rates if the Bush tax cuts were to expire as set in current law, the tax rates under President Obama's budget plan and the tax rates with the extended Bush tax cuts (Chairman Ryan's plan).

2013 Tax Rates Under Three Different Tax Plans (for single filers)

Taxable Income		Current Law	President Obama's Plan	Chairman Ryan's Plan
Over	But not over	Rates		
$ -	$ 8,750	15%	10%	10%
$ 8,750	$ 35,500	15%	15%	15%
$ 35,500	$ 86,000	28%	25%	25%
$ 86,000	$ 179,400	31%	28%	28%
$ 179,400	$ 199,350	36%	33%	33%
$ 1,999,350	$ 390,050	36%	36%	33%
$ 390,050	above	39.6%	39.6%	35%

*Source: Tax Policy Center

While all three plans are generally progressive, President Obama's plan produces the most progressive curve while also providing relief for low-income taxpayers. Additionally, Chairman Ryan's plan is the least sustainable because the reduced rates on the highest-income taxpayers will generate less revenue and hinder deficit reduction. Keeping these rates low and extending the Bush tax cuts would also require more cuts to federal programs as a deficit reduction tool.

Cutting tax expenditures

The second way that Congressional leaders could raise revenue is by eliminating tax expenditures. Tax expenditures (commonly known as tax credits, deductions or exemptions) are a form of federal spending through the tax code that reduces revenue by giving away money to a special interest for a special purpose. In 2012, individual income tax expenditures totaled $942 billion and corporate expenditures totaled $151 billion. Those tax provisions reduce federal revenue by almost $1.1 trillion.[8]

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[6] *Tax Proposals in the 2013 Budget*, Tax Policy Center , Urban Institute and Brookings Institute, at http://www.taxpolicycenter.org/taxtopics/upload/2013-Budget-Analysis-FINAL-3.pdf

[7] *Tax Proposals in the 2013 Budget*, Tax Policy Center , Urban Institute and Brookings Institute, at http://www.taxpolicycenter.org/taxtopics/upload/2013-Budget-Analysis-FINAL-3.pdf

[8] Marron, Donald B., *How Large are Tax Expenditures? A 2012 Update,* Tax Notes, April 9. 2012 at http://taxpolicycenter.org/UploadedPDF/1001602-TN-How-Large-Are-Tax-Expenditures-2012-Update.pdf

Harvard economist and former Reagan economic advisor Martin Feldstein has said the best way to reduce government spending is by curbing tax expenditures.[9] However, tax expenditure reform can be quite difficult. As noted in a recent article from the Congressional Research Service, "there are impediments with eliminating or reducing tax expenditures because they are viewed as serving an important purpose, are important for distributional reasons, are technically difficult to change or are broadly used by the public and quite popular."[10]

Top Ten Largest Individual Tax Expenditures FY2014

Expenditure	Cost (billions)	Share of all tax expenditures
Exclusion of Employer Health Insurance	$ 164.2	13.8%
Excusion of Employer Pensions	$ 162.7	13.7%
Mortgage Interest Deduction	$ 99.8	8.4%
Exclusion of Medicare	$ 76.2	6.4%
Capital Gains Rates	$ 71.4	6.0%
Earned Income Tax Credit	$ 58.4	4.9%
Deduction of Income Taxes	$ 54.0	4.5%
Exclusion of Gains at Death/ Gift Carryover	$ 51.9	4.4%
Deduction of Charitable Contributions	$ 51.6	4.3%
Employer Benefits under Cafeteria Plans	$ 43.8	3.7%

* Source: Gravelle, Jane G. and Hungerford, Thomas L., *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadenin,* at http://assets.opencrs.com/rpts/R42435_20120322.pdf

Tax expenditures have become such a common part of the family budget that many Americans may not even recognize the expenditures that they receive and greatly value every year. The chart to the left shows the top ten most expensive federal tax expenditures, many of which are staples on annual tax returns for both businesses and families.

The President's 2013 budget attempts to curb and eliminate some tax expenditures. For example, the President would reinstate the personal exemption phase-out and limitation on itemized deductions for higher-income taxpayers (those making over $250,000 per year). Taxpayers are permitted to reduce their taxable income through a personal exemption and itemized deductions on their federal tax form. The personal exemption phase-out will reduce the value of the personal exemption for high-income taxpayers over a certain income threshold. Similarly, the itemized deduction limits will reduce the value of itemized deductions over a certain income threshold. These changes are estimated to generate $165 billion in revenue over ten years.[11]

Chairman Ryan's plan also purports to close tax expenditures, largely to pay for his reductions in tax rates and the elimination of the capital gains taxes. However, the specific tax expenditures have not been identified.

Conclusion

This year's lame duck session is shaping up to be anything but lame. With the impending expiration of the Bush tax cuts, looming sequestration and a diverse and expansive array of reform solutions, the future of the federal budget — and all of the programs it supports — remains unclear. In the coming months, Congressional leaders will have the unique opportunity to make lasting and meaningful federal budget and tax reform. Both spending cuts and revenue increases must be on the table. Now is the time for a balanced approach to federal budget reform with a focus on a long-term, sustainable and progressive solution.

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[9] Marr, Chuck and Huang, Chye-Ching, *HOW TAX REFORM COULD BECOME A TRAP: Tax Reform Holds Promise, But If Not Done Carefully, Could Increase the Deficit and Inequality and Harm the Economy,* Center on Budget and Policy Priorities, June 8, 2012 at http://www.cbpp.org/cms/index.cfm?fa=view&id=3792#_ftn4

[10] Gravelle, Jane G and Hungerford, Thomas L., *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening,* Congressional Research Service, March 22, 2012 at http://assets.opencrs.com/rpts/R42435_20120322.pdf

[11] *Tax Proposals in the 2013 Budget*, Tax Policy Center , Urban Institute and Brookings Institute, at http://www.taxpolicycenter.org/taxtopics/upload/2013-Budget-Analysis-FINAL-3.pdf