



THE PRESIDENT'S PLAN TO HELP MIDDLE-CLASS AND WORKING FAMILIES GET AHEAD

Executive Office of the President and
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The President's Plan to Help Middle-Class and Working Families Get Ahead

"Let's close the loopholes that lead to inequality by allowing the top one percent to avoid paying taxes on their accumulated wealth. We can use that money to help more families pay for childcare and send their kids to college. We need a tax code that truly helps working Americans trying to get a leg up in the new economy, and we can achieve that together."

- President Obama, State of the Union, January 20, 2015

Executive Summary

A fair, simple, and pro-growth tax system is an important part of making the economy work for all Americans. Unfortunately, the current tax system is complex, outdated, and full of inefficient loopholes and tax breaks that mostly benefit the wealthy. Tax benefits that help the middle class are too complicated and do too little to address the challenges today's working families face, including paying for child care, sending a child (or a parent) to college, and saving for retirement. Meanwhile, over the last several decades, wages for typical workers have stagnated, while income and wealth inequality have risen to levels not seen since before the Great Depression. Yet over the same period, tax rates fell for the top 1 percent, and taxes are especially low on unearned income and wealth.

Under the President's leadership, we have made substantial progress in overcoming these challenges. During his first term in office, the President cut taxes by \$3,600 for a typical middle-class family, helping families weather the Great Recession and getting the economy back on track. He created the American Opportunity Tax Credit (AOTC), providing college students with up to \$10,000 of assistance over four years, and he strengthened the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC), helping 16 million working families with children make ends meet. Finally, as part of the "fiscal cliff" deal at the end of 2012, the President pushed to end expensive tax cuts for the wealthiest Americans, reducing the deficit by almost \$800 billion over the next 10 years. At the same time, he pushed to continue tax cuts for middle-class families. As a result, middle-class taxes are at historically low levels, with the typical middle-income family paying lower federal income taxes than in almost any other period in the last 60 years.

But much more can be done to help working families get ahead in today's economy. The President is proposing to simplify our complex tax code, make it fairer by eliminating some of the largest tax loopholes, and reinvest the savings in measures that will grow the economy and expand opportunity. The President's plan would make paychecks go further in covering the cost of child care, college, and a secure retirement and would create and improve tax credits that support and reward work. These proposals would be fully paid for, primarily by closing the "stepped-up basis" loophole, increasing the top capital gains and dividend tax rate to 28 percent,

and imposing a fee on large, highly leveraged financial institutions. While not the focus of this report, the President is also proposing to reform our business tax system to help working families get ahead by boosting U.S. job creation and investing in our nation's infrastructure.

By contrast, Congressional Republicans have chosen different priorities. The Republican Budget Resolutions would balance the budgets on the backs of the middle class and those struggling to get into the middle class, while cutting taxes for the wealthy and well-connected. The proposals specified in the House Republican budget would cut taxes for millionaires by an average of more than \$50,000, before even adding the proposed cuts to tax rates. Meanwhile, House Republicans have advanced a bill to repeal the estate tax, adding hundreds of billions of dollars to the deficit in order to cut taxes for the wealthiest top fraction of the top one percent of Americans.

How the President's Proposals Would Benefit Middle-Class Families

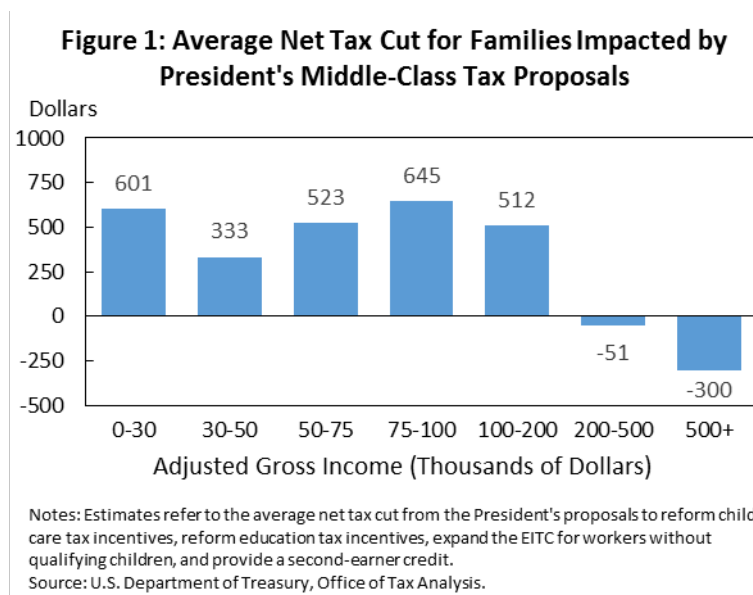
The President's proposals detailed below would provide significant benefits for a wide range of middle-class and working families, from a boost for minimum-wage workers by increasing the EITC to substantial tax cuts for middle-income parents with children in daycare or in college. Examples of the benefits include:

- **A two-earner middle-class family with two young children in child care would get an additional tax cut of more than \$5,000 under the President's proposal from a larger child care tax credit and a new second earner tax credit.** A married couple with two children under age 5, with each parent earning \$50,000 per year and annual child care expenses of \$12,000, would receive a \$500 second earner credit, and be eligible for the new maximum child care tax credit of \$3,000 per child – or \$6,000 in total – compared to the \$1,200 total credit they can claim under current law.
- **A middle-class family with two college-age children could claim an additional tax cut of up to \$5,000 over the course of their children's college education.** Under the President's plan, the AOTC would be available for five calendar years, the norm for students who start a four-year program in the fall semester, rather than four calendar years as under the current AOTC. For example, students who enroll in the fall of 2015 and graduate in the spring of 2019 will have college costs over five calendar years, even though they are graduating on time. The President would therefore increase lifetime AOTC eligibility from \$10,000 per student to \$12,500 per student and ensure that the value of that credit keeps up with inflation – in addition to making the AOTC permanent. If the AOTC is allowed to expire as scheduled after 2017, it will revert to the less generous Hope credit which is only available for two years.
- **30 million workers would gain access to a workplace retirement savings option.** Workers without access to a savings plan at work rarely benefit from the tax incentives for retirement saving. The President's plan makes it easier for firms to provide access to retirement accounts for their workers. The plan especially benefits employees of small

businesses and part-time workers who are disproportionately unlikely to have access to work-based retirement benefits.

- **A 23-year old without custodial children working full time at the minimum wage would become eligible for an EITC of \$560.** Under current law, this worker would be completely ineligible for the EITC, because the EITC for workers without custodial children (including non-parents) is only available to workers 25 and older. Under the President’s proposal, he would be eligible for an EITC of just over \$560.

Combined, the President’s proposed tax cuts would provide over 44 million working families with an average tax cut of nearly \$600. All income groups below \$200,000 would receive net tax cuts from the President’s proposals.



The President’s Middle-Class Tax Plan

The President’s plan makes responsible investments to help the paychecks of middle-class and working families go further, while streamlining and simplifying tax incentives to make it easier for families to access them.

Making Child Care, Education, and Retirement Tax Benefits Work for Middle-Class Families

- **A simplified and dramatically expanded child care tax credit.** For families with children under 5, the President’s plan would triple the maximum Child and Dependent Care Tax Credit, increasing it to \$3,000 per child. It would also make the maximum credit available to families with incomes up to \$120,000, benefiting families with young children as well as those with older children, elderly dependents, and dependents with disabilities; and would eliminate complicated child care flexible spending accounts. The President’s child

care tax reform proposal would give 5.1 million families an average tax cut of \$900, helping them cover child care costs for 6.7 million children. (See state-by-state estimates for child care costs in Appendix 1.) This tax proposal would complement major new investments in child care access and quality for working families, including expanding federal child care subsidies to serve all eligible families with young children, versus the small fraction served today. Together, these proposals would represent an unprecedented federal investment in child care.

- **Education tax reform to simplify duplicative and confusing incentives and improve college affordability.** The President’s plan would consolidate and simplify overlapping education tax provisions. Building on bipartisan reform proposals, his proposal would make the American Opportunity Tax Credit permanent, index the credit for inflation, increase the refundable portion to \$1,500, expand eligibility for part-time students, and allow students to claim the credit for up to five years. The President’s plan would also make it easier for students and families to apply for tax credits and would better target and simplify tax relief for student debt. Overall, the President’s education tax reform proposal would cut taxes by an average of \$750 for 8.5 million families and students and would simplify taxes for the more than 25 million families and students who claim education tax benefits. This tax proposal would complement the President’s plan to partner with states to make community college free for responsible students, as well as other student aid reforms proposed in the President’s Budget – including a proposal to significantly simplify the Free Application for Federal Student Aid (FAFSA).
- **Retirement tax reform that dramatically expands access to employer-based retirement savings options.** The President’s plan would give 30 million more workers access to a workplace savings opportunity through his proposed “auto-IRA” and would create new and expanded incentives for small employers to offer retirement plans and incorporate automatic enrollment into their plans. His plan would also expand access to retirement savings options for part-time workers, simplify certain retirement account withdrawal rules for middle-class savers, and close loopholes that have allowed 300 extraordinarily wealthy individuals to accumulate more than \$25 million each in IRAs. These reforms would complement the President’s actions over the past year to make retirement saving easier, for example by creating the simple, risk-free, and no-fee “myRA” starter retirement savings vehicle.

Reforming the Tax System to Better Support and Reward Work

- **A new “second earner credit” for two-earner families.** Building on bipartisan Congressional proposals, the President’s plan would create a new second earner credit that recognizes the additional costs faced by families when both spouses work. Nearly 24 million couples would benefit from this proposal, which would provide them with a second earner credit of up to \$500. The credit reduces the high marginal tax rates some second earners face on their first \$10,000 of earnings by allowing families to claim a credit equal to 5 percent on a second earner’s first \$10,000 of earnings. The maximum credit

would be available to families with incomes up to \$120,000, with a partial credit available up to \$210,000. (See [state-by-state estimates](#) in Appendix 1.)

- **An expanded childless worker EITC and permanent extension of the EITC and CTC improvements enacted in the Recovery Act.** The President's plan would double the childless worker EITC and expand eligibility, reducing poverty and hardship for 13.2 million low-income workers. Ways and Means Committee Chairman Paul Ryan has endorsed the President's proposed expansion, while other members of Congress have put forward similar proposals. The President's plan would also make permanent EITC and CTC improvements currently set to expire after 2017, preventing a tax increase on 16 million families with children. (See [state-by-state estimates](#) in Appendix 1.)

Eliminating the Biggest Loopholes that Let the Wealthiest Avoid Paying Their Fair Share and Reforming Financial Sector Taxation

All of the above proposals, including the direct investments in community college and child care, would be fully paid for through the reforms below. (For detailed cost estimates, see Appendix 2.)

- **Reforming capital gains taxation by closing the largest capital gains loophole and restoring the 28 percent top rate in place in the Reagan Administration.** Under current law, accrued capital gains on assets held until death are never subject to income taxes, letting the wealthy pass appreciated assets on to their heirs tax free. The President's proposal would close the single largest capital gains tax loophole that allows hundreds of billions in capital gains income to escape taxation each year. It would also increase the top capital gains and dividend rate to 28 percent. 99 percent of the impact of the proposed capital gains reforms would be on the top 1 percent of the income distribution, and more than 80 percent on the top 0.1 percent.
- **Introducing a fee for large, highly-leveraged financial institutions.** The President's plan would make it more costly for the largest financial firms to finance their businesses with excessive borrowing by imposing a 7 basis point fee on covered liabilities for the roughly 100 largest U.S. financial firms (those with assets over \$50 billion).
- **Eliminating a loophole that lets high-paid professionals avoid payroll taxes.** All workers, including those who are self-employed, owe payroll taxes on their earnings to support Social Security and Medicare. The President's plan would close a loophole that lets some high-paid professionals escape this responsibility by reclassifying their earnings as distributions from pass-through businesses – costing the Social Security and Medicare Trust Funds almost \$10 billion per year by the end of the decade.

I. Progress to Date in Reforming the Tax System

Since taking office, the President has worked with Congress to enact tax cuts and reforms that helped end the recession, support working families with children, and bring down the deficit. The result is a tax system that is much more progressive than when the President took office – though with more work to be done to promote opportunity and growth and to raise the revenue needed to achieve fiscal sustainability.

Middle-Class Tax Cuts That Helped End the Recession and Start the Recovery

During his first term in office, the President cut taxes by \$3,600 for a typical middle-class family of four. As part of the Recovery Act, the President and Congress enacted a simple, temporary Making Work Pay credit that provided 95 percent of workers with a tax cut of \$400 (\$800 for couples) in 2009 and 2010. In 2011 and 2012, the Making Work Pay credit was replaced with a payroll tax cut that provided a \$1,000 tax cut for a typical worker making \$50,000 per year.

Along with other measures in the Recovery Act and subsequent legislation, the Making Work Pay credit and the payroll tax cut added significantly to growth. The Council of Economic Advisers estimated that the Recovery Act and other economic stimulus measures increased employment by an average of 2.3 million jobs for 2009-2012, while boosting GDP by an average of 2.4 percent.¹

Tax Credits That Support Work, Strengthen Opportunity, and Reduce Poverty

Also as part of the Recovery Act, the President worked with Congress to enact critical expansions of tax credits for working families that continue to promote work, reduce hardship, and make college more affordable for some 25 million families and students each year.

The Earned Income Tax Credit (EITC) and Child Tax Credit (CTC) are among the nation’s most effective policies for increasing employment and reducing poverty. In 2013, they kept 8.8 million people out of poverty, including 4.7 million children.² The EITC and CTC also increase the returns to work by offsetting payroll taxes and boosting earnings, resulting in higher labor force participation, particularly for single parents. Roughly half a million single mothers entered the labor force in the 1980s and 1990s because of the EITC,³ accounting for more than half of the

¹ Council of Economic Advisers, *Economic Report of the President*. 2014. See Chapter 3, http://www.whitehouse.gov/sites/default/files/docs/erp_2014_chapter_3.pdf

² Calculations from U.S. Census Bureau data. See U.S. Census Bureau, “Press Kit: Supplemental Poverty Measures,” 16 October 2014. http://www.census.gov/newsroom/press-kits/2014/20141016_spm.html.

³ See for example, Jeffrey Grogger, “The Effects of Time Limits, the EITC, and Other Policy Changes on Welfare Use, Work, and Income Among Female-Headed Families,” *Review of Economics and Statistics*. 2003; and Jeffrey Liebman and Nada Eissa, “Labor Supply Responses to the Earned Income Tax Credit.” *Quarterly Journal of Economics*, 1996.

increase in employment among single mothers during this time period.⁴ Today, the EITC likely leads about 1 in 10 parents who otherwise would not be working to enter the labor force.⁵ Research also suggests that the EITC and CTC lead to better health and educational outcomes for children, helping promote economic mobility (see the box on page 9).

The Recovery Act improvements to the EITC and CTC build on this success by strengthening work supports for married couples, larger families, and low-wage workers with children. These improvements include:

- **Making the CTC available to working parents with low earnings.** In the absence of the Recovery Act improvements, working parents with earnings below about \$14,000 would not be eligible for the Child Tax Credit in 2015, and a single parent with two children would need earnings of about \$25,000 to benefit in full (a married couple would need earnings close to \$28,000). The Recovery Act extended eligibility for the Child Tax Credit to working parents with low earnings.
- **Expanding the EITC for families with more than two children and married couples.** Families with more than two children face higher costs and have higher poverty rates than smaller families but until 2009 were not eligible for additional help from the EITC. The Recovery Act increased the maximum EITC for these families, while also expanding EITC eligibility for married couples, reducing EITC marriage penalties.

Together, these improvements benefit 16 million working families each year – including 29 million dependent children – providing these families with an average tax cut of \$900. (See state-by-state estimates in Appendix 1.) These tax credit improvements directly lift 1.4 million Americans out of poverty.

The Recovery Act also significantly improved tax benefits for higher education through the enactment of the American Opportunity Tax Credit (AOTC), which replaced the less generous Hope credit. The enactment of the AOTC increased the maximum tax credit to \$2,500, made the credit available for four years, and made it partially refundable to help low-income families and students who are working their own way through college. Compared to the Hope credit, the

⁴ Bruce D. Meyer and Dan T. Rosenbaum, “Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers,” *Quarterly Journal of Economics* 116(3): 1063-2014.

⁵ See Raj Chetty, John N. Friedman, and Emmanuel Saez (2013) cited in Executive Office of the President and U.S. Treasury Department, “The President’s Proposal to Expand The Earned Income Tax Credit,” March 2014, http://www.whitehouse.gov/sites/default/files/docs/eitc_report.pdf.

AOTC will provide 12 million families in 2015 with an average of more than \$1,100 in additional financial aid for college.

EVIDENCE ON THE EITC AND CHILDREN'S OUTCOMES

Not only do tax credits for working families reward and encourage work, they also help lead to better outcomes for children. The extra support helps working parents better provide for their children, and research suggests that the EITC improves infant health, children's academic achievement, and college attendance. Ultimately, better health and education outcomes improve children's future earnings potential, increasing economic mobility.

- **Infant health.** Researchers have found that each \$1,000 of additional EITC reduces the incidence of low birth weight by 2-3 percent, with part of the mechanism being increased prenatal care.*
- **Academic achievement.** The EITC and refundable Child Tax Credit have been found to improve math and reading test scores, with gains of a third of a standard deviation or more for families eligible for the maximum EITC.** (To put these numbers in context, moving up a third of a standard deviation would be equivalent to moving from the median to about the 63th percentile on a test.)
- **College enrollment.** For older children, researchers have found that the EITC increases college enrollment, with a 2-3 percentage point increase in enrollment per \$1,000 of parents' EITC in the spring of a student's senior year of high school. This is comparable to the impact of state grant programs like the Georgia HOPE Scholarship and implies that the Recovery Act EITC and CTC improvements may have increased enrollment by 2-3 percentage points for affected families.***

* Hilary W. Hoynes, Douglas L. Miller, and David Simon, "Income, the Earned Income Tax Credit, and Infant Health," *American Economic Journal: Economic Policy* 7(1): 172–211, February 2015.

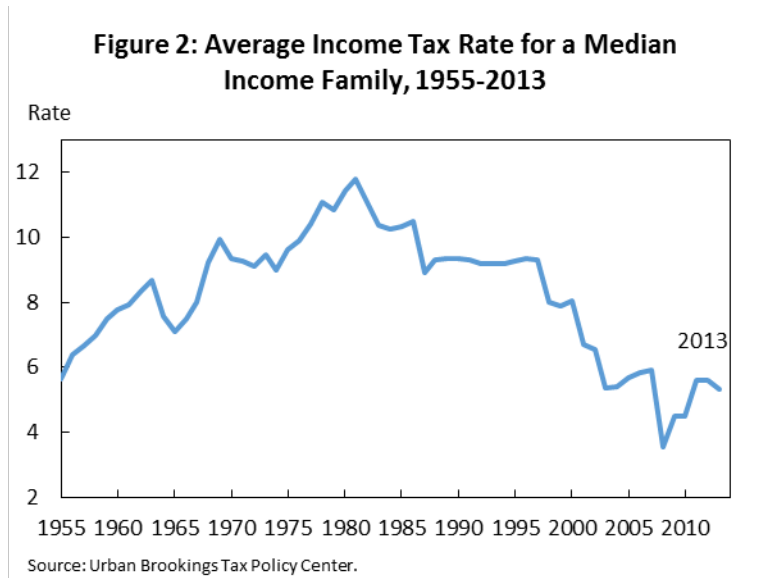
** Raj Chetty, John N. Friedman, and Jonah E. Rockoff, "New Evidence on the Long-Term Impacts of Tax Credits," Internal Revenue Service Statistics of Income Working Paper, November 2011, <http://www.irs.gov/pub/irs-soi/11rpchettyfriedmanrockoff.pdf>; Gordon B. Dahl and Lance Lochner, "The Impact of Family Income on Child Achievement: Evidence from the Earned Income Tax Credit," *American Economic Review*, 2012, <http://dss.ucsd.edu/~gdahl/papers/children-and-EITC.pdf>.

*** Dayanand S. Manoli and Nicholas Turner, "Cash-on-Hand and College Enrollment: Evidence from Population Tax Data and Policy Nonlinearities," National Bureau of Economic Research Working Paper, January 2014, <http://www.nber.org/papers/w19836>.

Reducing the Deficit by Asking High-Income Households to Pay Their Fair Share

The President took office after a decade of large and skewed tax cuts that added more than a trillion dollars to deficits and brought effective tax rates for top income groups to their lowest levels in more than 50 years. As part of the 2012 fiscal cliff debate, the President successfully fought to roll back these tax cuts for the highest-income 2 percent of Americans. These tax increases will reduce the deficit by nearly \$800 billion over the next 10 years, and they helped bring the 2014 deficit down to 2.8 percent of GDP, below the historical average.

The President fought equally hard to prevent middle-class tax cuts from being held hostage to continuing tax cuts for the wealthy. The same legislation that restored Clinton-era tax rates for the top 2 percent also made tax cuts permanent for the other 98 percent of Americans. As a result, middle-class income taxes remain at historically low levels, with the typical middle-income family paying lower federal income taxes than in almost any other period in the last 60 years.⁶



II. Making Child Care, Education, and Retirement Tax Benefits Work for Middle-Class Families

The tax system includes provisions intended to help middle-income families with some of the major economic challenges they face, including paying for child care, sending children to college, and saving for retirement. Unfortunately, these provisions add up to less than the sum of their parts because they are complicated, overlapping, and sometimes poorly designed and targeted. The President’s plan would simplify, expand, and improve tax incentives in these three key areas.

Child Care

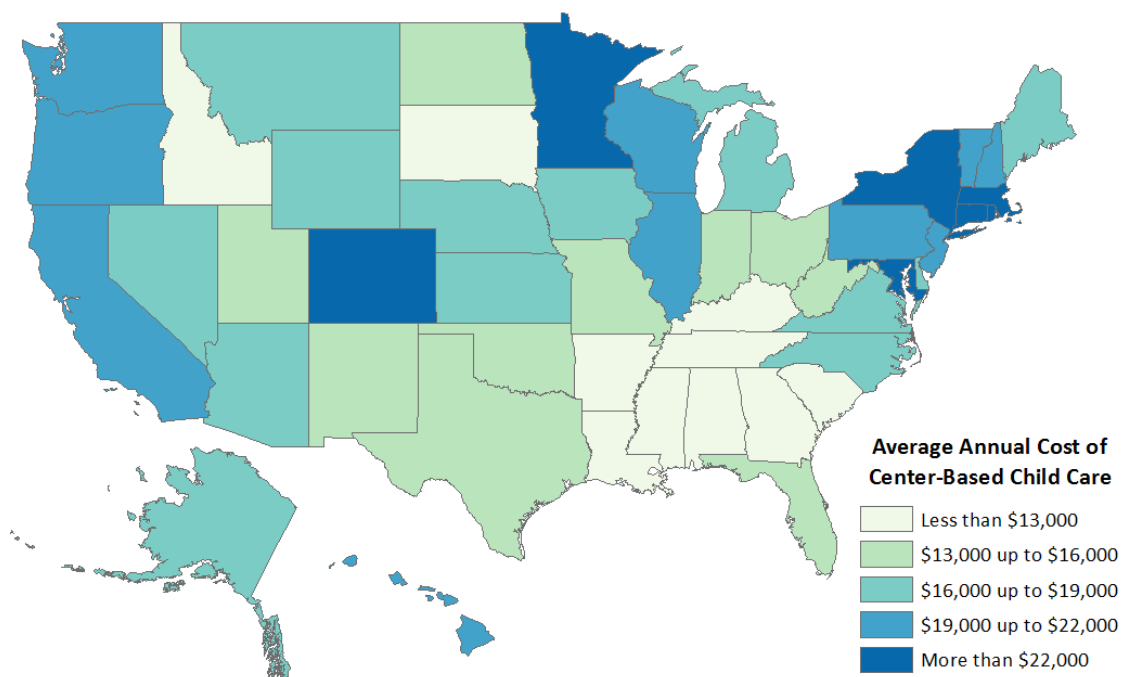
Access to high-quality child care and early education promotes child development and helps support parents who are struggling to balance work and family obligations. Early childhood investments also generate long-term social benefits, since improvements in child development

⁶ Chuck Marr and Nathaniel Frentz, “Federal Income Taxes on Middle-Income Families Remain Near Historic Lows,” Center on Budget and Policy Priorities. Revised April 15, 2014, <http://www.cbpp.org/cms/?fa=view&id=3151>.

lead to higher earnings and employment in adulthood.⁷ Yet despite the high returns to spending on quality childcare, access is too often limited by high and rising costs, particularly in the case of high-quality, center-based care.

Throughout much of the country, child care is the largest single expense families face (this is true for every region except the West, where housing accounts for a larger share of expenses). A year of center-based child care costs more than a year of in-state tuition at public universities in many states, putting a significant strain on parents. In 2013, the average cost of full-time care for an infant at a child care center was about \$10,000 per year – and much higher in some locations – with costs ranging from \$5,496 in Mississippi to \$16,549 in Massachusetts. Families with multiple young children face even higher costs. In 2013, the average annual cost of full-time, center-based child care for an infant and a four-year old exceeded \$10,000 in every state, and exceeded \$20,000 in 18 states plus the District of Columbia (see map and state-by-state estimates in Appendix 1).⁸

Figure 3: Average Annual Cost of Center-Based Child Care for Two Children, 2013



Note: Average annual cost of center-based child care is calculated for a family with an infant and a four-year-old.
Source: Child Care Aware of America.

⁷ Council of Economic Advisers, “The Economics of Early Childhood Investments,” Executive Office of the President. January 2015. http://www.whitehouse.gov/sites/default/files/docs/early_childhood_report_update_final_non-embargo.pdf.

⁸ Child Care Aware, “Parents and the High Cost of Child Care: 2014 Report.” 2014. <http://usa.childcareaware.org/costofcare>.

Access to affordable, quality child care is important for both economic growth and economic mobility – strengthening parents’ ability to go to work, advance their careers, and increase their earning potential, while at the same time helping children prepare for school and succeed later in life.

First, helping families better afford quality child care will help boost parents’ labor force participation by removing disincentives to work. Women with young children are the most likely to leave the workforce, and child care makes it easier for women to choose to stay in the workforce, earning higher wages in the long run. Although estimates vary depending on program specifics, most studies find that reducing the cost of child care increases maternal employment.⁹ For example, the Lanham Act, which provided affordable, universal child care in the U.S. during World War II, increased both labor force participation and the number of hours worked among mothers with young children.¹⁰ Evidence from recent programs similarly show that lower child care costs increase maternal employment: child care subsidies that reduce the cost of care by 10 percent lead to a 0.5 percentage point increase in employment among single mothers.¹¹

Meanwhile, a substantial body of research suggests that high-quality care in early childhood leads to better outcomes and higher wages later in life for children.¹² For example, the high-quality child care offered through the Lanham Act provided children with healthy meals and snacks and focused on educational enrichment activities. At the time of the program, mothers noted improvements in their children’s social behaviors, and the benefits continued long after: children who were eligible to participate in the program were more likely to graduate from high school, earn a college degree, and work full-time as adults. Overall, the program increased participants’ earnings by 1.8 percent a year by the time they reached their 40s to 50s.¹³ Likewise, evidence

⁹ Chris M. Herbst, “The Labor Supply Effects of Child Care Costs and Wages in the Presence of Subsidies and the Earned Income Tax Credit.” 2010. *Review of Economics of the Household*, 8(2): 199-230; Michael Baker, Jonathan Gruber, and Kevin Milligan. “Universal Childcare, Maternal Labor Supply, and Family Well-being.” 2005. Working Paper 11832. Cambridge, Mass.: National Bureau of Economic Research (December). Rachel Connelly and Jean Kimmel. “The Effects of Child Care Costs on the Employment and Welfare Reciprocity of Single Mothers.” 2003. *Southern Economic Journal*, 69(3): 498-519.; Patricia M. Anderson and Philip B. Levine. 2000. “Child Care and Mothers’ Employment Decisions.” In *Finding Jobs: Work and Welfare Reform*, pp. 420-462. Russell Sage Foundation.

¹⁰ Chris M. Herbst, “Universal Child Care, Maternal Employment, and Children's Long-Run Outcomes: Evidence from the U.S. Lanham Act of 1940.” 2014. IZA Discussion Paper No. 7846 (Revised November 2014). http://www.chrisherbst.net/files/Download/C._Herbst_Lanham_Act_Child_Care.pdf.

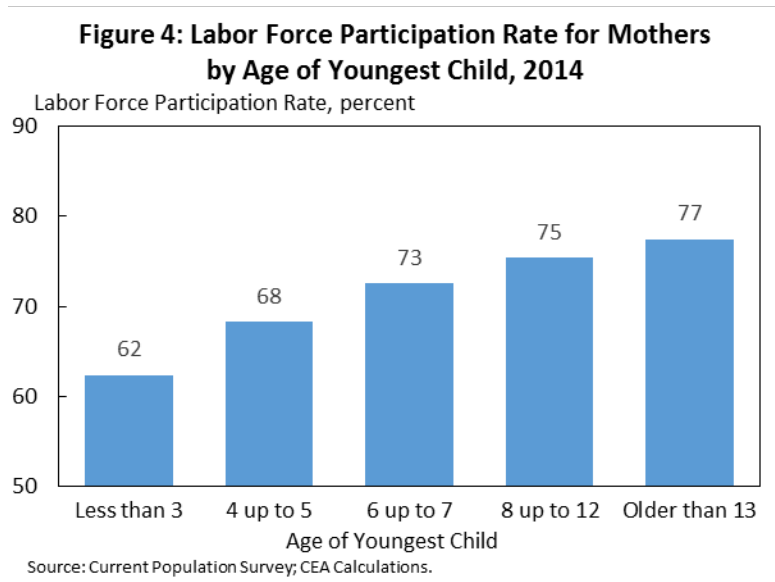
¹¹ Chris M. Herbst, “The Labor Supply Effects of Child Care Costs and Wages in the Presence of Subsidies and the Earned Income Tax Credit.” 2010. *Review of Economics of the Household*, 8(2): 199-230

¹² See for example Leak et al., 2013; Gorey, 2001; Barnett, 2006; Sylva et al., 2004.

¹³ Chris M. Herbst, “Universal Child Care, Maternal Employment, and Children's Long-Run Outcomes: Evidence from the U.S. Lanham Act of 1940.” 2014. IZA Discussion Paper No. 7846 (Revised November 2014). http://www.chrisherbst.net/files/Download/C._Herbst_Lanham_Act_Child_Care.pdf.

from Norway shows that access to high-quality child care can not only improve children’s academic performance when children are in care, but also increase educational attainment, reduce receipt of public assistance, and increase labor force participation in adulthood.¹⁴

Overall, research shows that money spent on young children is a worthwhile investment, yielding immediate benefits for parents and long-term benefits for children and society. For example, the President’s Council of Economic Advisers concluded that investments in high-quality early education can generate economic returns of over \$8 for every \$1 spent.¹⁵



The President’s Plan to Simplify and Expand Child Care Tax Benefits

While the tax code offers benefits for child care expenses, these benefits are typically small compared to the costs faced by middle-class families, especially those with young children. For example, the average Child and Dependent Care Tax Credit (“child care tax credit”) is just \$550 – not enough to put a dent in the cost of infant and toddler care, which runs several thousands of dollars per year. Child care tax benefits are also unnecessarily complex. Families may need to both claim the child care tax credit and use a child care flexible spending account (FSA) to maximize their tax benefits, with the latter requiring additional paperwork, advance planning,

¹⁴ Sandra E. Black, Paul J. Devereux, and Kjell G. Salvanes. "Too Young to Leave the Nest? The Effects of School Starting Age." 2011. *The Review of Economics and Statistics*, 93(2): 455-467.; Havnes, Tarjei, and Magne Mogstad. "No Child Left Behind: Subsidized Child Care and Children's Long-run Outcomes." 2011. *American Economic Journal: Economic Policy*: 97-129

¹⁵ Council of Economic Advisers, “The Economics of Early Childhood Investments,” Executive Office of the President, January 2015.
http://www.whitehouse.gov/sites/default/files/docs/early_childhood_report_update_final_non-embargo.pdf.

and care to avoid losses from the “use-or-lose-it” rules. Moreover, this tax benefit is only available to workers whose employers elect to provide FSAs as part of their benefits package, resulting in unequal access. In fact, only one-third of private-sector employees have access to a child care FSA.¹⁶

As a result of this complexity, determining the tax savings from these benefits and what it means for a family’s ability to afford quality child care can be difficult. Almost no families qualify for the maximum child care tax credit, and middle-income families may have trouble predicting how much tax assistance they will receive.

The President’s child care plan offers every working family meaningful assistance with child care costs for young children, whether through direct subsidies for low-income families (see the box on pages 15-16) or through an expanded and simplified child care tax credit. The President’s tax proposal would streamline child care tax benefits and triple the maximum child care credit for middle-class families with young children, increasing it to \$3,000 per child. The proposal would benefit 5.1 million families, helping them cover child care costs for 6.7 million children (including 3.5 million children under 5), through the following reforms:

- Triple the maximum child care tax credit for families with children under 5, increasing it to \$3,000 per child. Families with young children face the highest child care costs. Under the President’s proposal, they could claim a 50 percent credit for the first \$6,000 of expenses each for up to two children under 5 – covering up to half the cost of child care for preschool-age children.
- Make the full credit available to most middle-class families. Under current law, almost no families qualify for the maximum child care tax credit. The President’s proposal would make the maximum credit available to families with incomes up to \$120,000, meaning that most middle-class families could easily determine how much help they can get. This would benefit families with young children, older children, and elderly or disabled dependents.
- Eliminate complex child care flexible spending accounts and reinvest the savings in the improved child care tax credit. The President’s proposal would replace the current system of complex and duplicative incentives with one generous and simple child care tax benefit.

¹⁶ Eli R. Stoltzfus, “Access to dependent care reimbursement accounts and workplace-funded childcare,” January 2015, *Pay & Benefits*, Vol. 4, No. 1, U.S. Bureau of Labor and Statistics. <http://www.bls.gov/opub/btn/volume-4/access-to-dependent-care-reimbursement-accounts-and-workplace-funded-childcare.htm>.

HELPING ALL WORKING FAMILIES WITH YOUNG CHILDREN AFFORD CHILD CARE

Access to affordable, quality child care is essential for working families. Parents who work in low-wage jobs can face real difficulties affording quality child care; the average cost of full-time care for an infant at a child care center was about \$10,000 in 2013, and can be much higher. Without help, many families may face the untenable choice of not working or leaving their children in unsafe, unstable, or poor quality child care arrangements.

The federal Child Care and Development Fund (CCDF) helps low- and moderate-income families with the cost of child care and increases the availability and quality of that care. States also contribute matching resources for a portion of the CCDF funding they receive. But currently, federal and state funding for child care assistance falls well short of need, and only a small share of young children receive federally-funded child care subsidies. Access to child care subsidies has been declining steadily since 2001 due to funding constraints, resulting in waiting lists in some states.*

Just as important as child care access is quality. Learning begins at birth, and the earliest years of a child's life are among the most critical for building foundational cognitive skills, social and emotional skills, and patterns of engagement in school and learning. Studies show that children who attend high-quality early learning programs – including high-quality child care – are more likely to do well in school, find good jobs, have fewer interactions with the justice system, and have greater earnings as adults than those who don't. The recently reauthorized bipartisan child care legislation includes much-needed reforms that will help raise the bar on child care quality. But high-quality care, especially for young children, is costly, and places additional burdens on families as well as state budgets.

For these reasons, the President is proposing the following historic investments in child care, in addition to his proposed tax reforms:

- **Expand child care assistance to all eligible families with children under age four by the end of ten years.** A significant investment of \$82 billion in new funding over 10 years will ensure that all low- and moderate-income families (those with incomes below 200 percent of the poverty line, or approximately \$40,000 for a family of three) with children age three and under have access to a subsidy to pay for quality child care so they can work, attend school, or participate in training. By 2025, this investment will expand access to high-quality care to more than 1 million additional young children, reaching a total of more than 2.6 million children served monthly through the child care subsidy system. Each state will be required to develop a sound plan for how they will build the supply of quality care for infants and toddlers and ensure that the subsidies they provide (when combined with reasonable copayments families can afford) will cover the cost of quality care. States will also be required to contribute matching funds to receive these federal funds.
- **Improve the quality of child care.** Last year Congress acted on a bipartisan basis to pass child care legislation that includes much-needed reforms to improve the quality and safety in child care settings, including requiring training for providers to prevent sudden infant death syndrome, instituting annual inspections of child care facilities, and comprehensive background checks of all providers. This proposal would provide resources to help states implement those important reforms and support the expansion of access to quality child care

programs staffed by early educators that can provide developmentally appropriate services that promote the healthy development and school readiness of young children.

- **Promote Innovation in the Child Care Subsidy System.** The President will also invest \$100 million in new competitive grants to states, territories, tribes and communities to develop, implement and evaluate models of providing child care to address the unmet needs for families who face unique challenges to securing child care. These pilots could be used to develop promising practices for families in rural communities, families with children with disabilities, parents who work non-traditional hours, and other families that struggle to find and use high-quality child care.

* U.S. Department of Health and Human Services administrative data, FY 1998-2013.

Higher Education

The American Opportunity Tax Credit (AOTC) the President signed into law in 2009 took a major step toward improving education tax benefits for both low- and middle-income students, providing 12 million families with more than \$1,100 in additional tax assistance in 2015, on average. Despite this substantial progress, tax benefits for college expenses remain unnecessarily complex. Families must choose among overlapping benefits, while scholarships and other direct financial aid can interact with college tax benefits in complicated ways – the result being that families often do not claim the education tax benefits they are entitled to. In addition, tax benefits do not provide enough financial aid to the students who need it most.

Under the current tax system, students and families must choose among multiple tax benefits to offset current education expenses: (1) the AOTC, (2) the Lifetime Learning Credit, and (3) the tuition and fees deduction. In 2009, 27 percent of families that claimed the tuition and fees deduction would have gotten a bigger benefit had they claimed a tax credit instead, while 14 percent of apparently eligible filers failed to claim any tax benefit at all.¹⁷

In addition, education tax benefits provide relatively little assistance to the students for whom they could make the most difference in attending college. While the enactment of the AOTC made education tax benefits partially refundable – making them available to many working families for the first time – these students are still eligible only for very limited benefits.

Meanwhile, the current tax break for student loans, a deduction for student loan interest, is poorly targeted to borrowers and working families struggling to afford their student loan debt. The student loan interest deduction is also complicated – so much so that many eligible

¹⁷ Calculated based on U.S. Government Accountability Office, “Higher Education: Improved Tax Information Could Help Families Pay for College,” May 2012. *Report to the Committee on Finance*, U.S. Senate, GAO-12-560.

borrowers fail to claim it – and provides very limited assistance to a broad group of borrowers, rather than targeting more meaningful assistance to those who need it most. The average benefit from the student loan interest deduction is small for all income groups, and especially so for low- and middle-income borrowers. In 2011, the average annual tax cut from the student loan interest deduction was little more than \$100 per borrower.¹⁸ By comparison, the President’s Pay-As-You-Earn (PAYE) income-based repayment plan can provide a meaningful reduction in student loan payments for borrowers who are working but nonetheless struggle with burdensome debt. For example, a college graduate earning about \$39,000 a year as a fourth year teacher, with student loan debt of \$26,500, would see a reduction in annual loan payments of over \$1,500 under PAYE.¹⁹

The President’s Plan for Higher Education Tax Reform

The President’s higher education plan would consolidate a complicated set of credits and deductions into a single, improved AOTC – while making it easier for students to apply for financial aid and claim assistance to which they are entitled. The plan builds on bipartisan Congressional reform proposals, including legislation passed by the House of Representatives in 2014 that, like the President’s plan, would make permanent and expand the AOTC while eliminating duplicative provisions.²⁰ It would simplify and improve higher education tax benefits in the following ways.

Simplify, consolidate, and better target tax benefits through an improved AOTC

- Make permanent and expand the \$2,500 AOTC, while repealing duplicative and less effective provisions. Under current law, the AOTC is scheduled to expire after 2017 and revert to the less generous Hope tax credit. Under the President’s plan, the AOTC would be a permanent feature of the tax code, so that students in school today would not have to worry that these benefits will expire before they graduate; the credit would also grow with inflation. The Lifetime Learning Credit and the tuition and fees deduction would be consolidated into the more generous AOTC.
- Increase the refundable portion of the AOTC to \$1,500. The President’s plan adopts Congressional proposals – from members of both parties – to increase the refundable

¹⁸ Calculated based on Urban-Brookings Tax Policy Center, “Tax Benefits of the Student Loan Interest Deduction, Baseline: Current Law, Distribution of Federal Tax Change by Cash Income Level, 2011,” Table T11-0309, August 2011. Average total benefit among tax units with the benefit is \$118.

¹⁹ The White House, “FACTSHEET: Making Student Loans More Affordable,” 9 June 2014. <http://www.whitehouse.gov/the-press-office/2014/06/09/factsheet-making-student-loans-more-affordable>.

²⁰ Representative Diane Black (R-TN), Press release on H.R. 3393, *The Student and Family Tax Simplification Act*, 24 July 2014. <http://black.house.gov/press-release/house-passes-congressman-black%E2%80%99s-legislation-make-tax-code-simpler-students-and>; and Congressional Budget Office (CBO), “Cost Estimate of H.R. 3393, Student and Family Tax Simplification Act,” 7 July 2014. <http://www.cbo.gov/publication/45506>.

portion of the AOTC so that more working families and students can qualify. Like legislation that passed the House in 2014 and a separate bill recently proposed by Congressional Democrats, the President's plan would increase the refundable portion from a maximum of \$1,000, or 40 percent of the total AOTC benefit, to a maximum of \$1,500. The plan would also remove the 40 percent calculation so that all families that qualify can claim at least the first \$1,500 of their AOTC credit.

- Expand AOTC eligibility for non-traditional students. Currently, students must attend at least half-time to qualify for the AOTC, and families can claim the credit for no more than four years. Under the President's plan, part-time students would be eligible for a \$1,250 AOTC (up to \$750 refundable) and all eligible students would be able to claim the AOTC for up to five years.

Make it easier for students and families to apply for tax credits and financial aid

- Improve information reporting. The proposal would require colleges and universities to provide students with the tuition and fee information they need to claim the AOTC.
- Simplify taxes for approximately 9 million Pell Grant recipients. Currently, eligible families leave tens of millions of dollars on the table every year because the rules related to Pell Grants and the AOTC are so complicated.²¹ Like bipartisan reform proposals, the President's plan would exempt Pell Grants from taxation and the AOTC calculation, making it easier for Pell recipients to claim tax benefits already available to them.
- Remove burdensome and complicated questions from the FAFSA. The President's tax reform plan will complement new proposals in the 2016 Budget to simplify the process of applying for financial aid using the FAFSA by restructuring it to rely on financial information already available from families' tax returns.

Better target and simplify tax relief for student debt

- Eliminate tax on student loan debt forgiveness under Pay-As-You-Earn (PAYE) and other income-based repayment plans. The President has worked hard to make student debt affordable for struggling borrowers by offering PAYE: an income-based repayment plan that lets students limit student loan payments to no more than 10 percent of their discretionary income and qualify for forgiveness after 20 years of repayments. The Department of Education is currently amending its rules to extend this option to all direct student loan borrowers. However, under current law, borrowers who qualify for forgiveness could face a large tax bill – likely a surprise to most borrowers, and for others

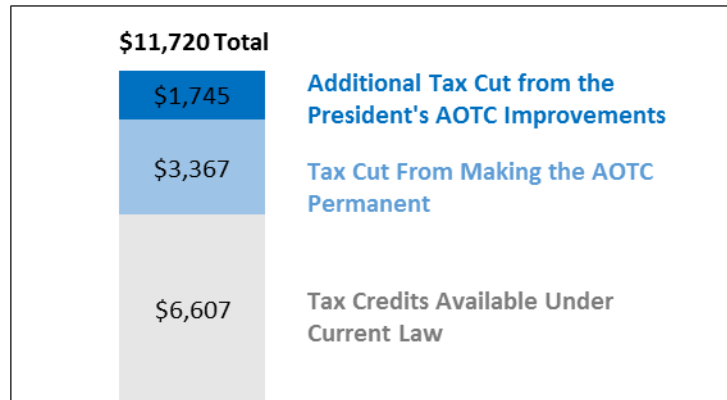
²¹ Adam Looney, "Helping students and families access college tax benefits," 10 June 2014. *Treasury Notes Blog*, U.S. Department of Treasury. <http://www.treasury.gov/connect/blog/Pages/Helping-students-and-families-access-college-tax-benefits.aspx>.

a concern in choosing PAYE. The President's tax reform plan would exempt student loan forgiveness from taxation.

- Repeal the student loan interest deduction for new borrowers. The President's plan would retain the student loan interest deduction for current borrowers. But for new students, his plan would repeal this tax break and instead provide more generous and more targeted tax relief through the improved AOTC while students are in school and through PAYE once they graduate.

The President's education tax reform plan would cut taxes for 8.5 million working families and students by an average of \$750, and simplify taxes for the more than 25 million families and students that claim education tax benefits. These tax credit improvements would be on top of the President's longstanding proposal to make the AOTC permanent to prevent taxes from going up on millions of families.

Figure 5: Total Education Tax Credits for a Typical Student Who Enrolls Fall 2016 and Graduates Spring 2020



Source: U.S. Department of the Treasury, Office of Tax Analysis. Eligible expenses assumed to be median tuition and fees for a four-year non-doctoral institution, from U.S. Department of Education, National Center for Education Statistics and indexed for inflation.

Higher education tax reform will complement the President's other proposals to make college more affordable, including by partnering with states to make a quality community college education free for responsible students. See the box on page 20.

AMERICA'S COLLEGE PROMISE PROPOSAL: TUITION-FREE COMMUNITY COLLEGE FOR RESPONSIBLE STUDENTS

Nearly a century ago, a movement that made high school widely available helped lead to rapid growth in the education and skills training of Americans, driving decades of economic growth and prosperity. Last month, the President unveiled his America's College Promise proposal to make two years of community college free for responsible students to earn the first half of a bachelor's degree or to learn valuable skills needed in the workforce at no cost. The program would be a "first dollar" funding source – allowing students to use Pell grants and other financial aid to pay for books, supplies, transportation, and living expenses. These costs average about \$13,000 for full-time students. The program would be undertaken in partnership with states and is inspired by new programs in Tennessee and Chicago. If all states participate, an estimated 9 million students could benefit. For students that transfer to a four-year institution to complete their bachelor's degree, their final two years would be even more affordable with the help of the higher education tax reforms described in this report. The President's plan would:

- **Enhance student responsibility and cut the cost of college for all Americans:** Students who attend at least half-time, maintain a 2.5 GPA while in college, and make steady progress toward completing their program will have their tuition eliminated. These students will be able to earn half of the academic credit they need for a four-year degree or earn a certificate or two-year degree to prepare them for a good, well-paying job.
- **Build high-quality community colleges:** Community colleges will be expected to offer programs that either (1) are academic programs that fully transfer to local public four-year colleges and universities, giving students a chance to earn half of the credit they need for a four-year degree, or (2) are occupational training programs with high graduation rates and that lead to degrees and certificates that are in demand among employers. Other types of programs will not be eligible for free tuition. Colleges must also adopt promising and evidence-based institutional reforms to improve student outcomes, such as the effective Accelerated Study in Associate Programs (ASAP) programs at the City University of New York, which waive tuition, help students pay for books and transit costs, and provide academic advising and supportive scheduling programs to better meet the needs of participating students, resulting in greater gains in college persistence and degree completion.
- **Ensure shared responsibility with states:** Federal funding will cover three-quarters of the average cost of community college. States that choose to participate will be expected to contribute the remaining funds necessary to eliminate community college tuition for eligible students. States that already invest more and charge students less can make smaller contributions, though all participating states will be required to put up some matching funds. States must also commit to continue existing investments in higher education; coordinate high schools, community colleges, and four-year institutions to reduce the need for remediation and repeated courses; and allocate a significant portion of funding based on performance, not enrollment alone. States will have flexibility to use some resources to expand quality community college offerings, improve affordability at four-year public universities, and improve college readiness, through outreach and early intervention.

Retirement Saving

While Social Security continues to provide a solid foundation for Americans' retirement, the employer-based pension system has changed dramatically over the last 40 years. The number of traditional defined benefit pension plans in the private sector has fallen from 103,000 in 1975 to 44,000 in 2012, and the number of active participants in such plans has fallen from 27 million to 16 million – even as the workforce has grown by 50 million people.²² Employers are increasingly providing defined contribution plans instead. Defined contribution plans and individual retirement accounts (IRAs) now account for nearly \$14 trillion in retirement savings – more than half of Americans' total retirement wealth.²³

Shortcomings in the employer-based system, however, mean that many Americans are being left behind. As many as 78 million working Americans – about half the workforce – do not have a retirement plan at work, largely because they do not have access to an employer-based savings option. Part-time workers and employees of small businesses are particularly unlikely to have access to retirement benefits.²⁴ Many Americans with access to a plan do not participate and, even if they do participate, many lack the time and information necessary to make the complex financial decisions necessary to maximize the impact of their contributions. While workers without access to a workplace plan can save on their own using an IRA, only a tiny fraction of Americans do so.²⁵

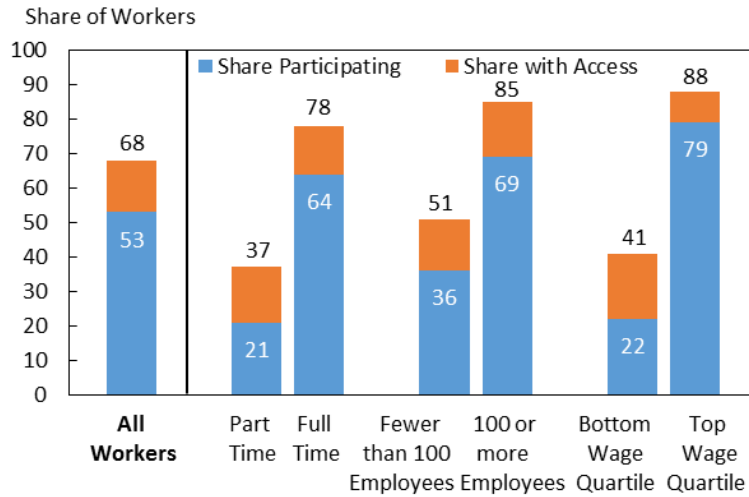
²² Department of Labor, "Private Pension Plan Bulletin Historical Tables and Graphs." December 2014. Employee Benefits Security Administration, Table E1: "Number of Pension Plans" and Table E8: "Number of Active Participants in Pension Plans." <http://www.dol.gov/ebsa/pdf/historicaltables.pdf>; St. Louis Fed. "All Employees: Total Private." Updated 6 March 2015. FRED Economic Data. <http://research.stlouisfed.org/fred2/series/CEU050000001>

²³ Quarterly Retirement Market Data for Third Quarter 2014, updated 17 December 2014. Investment Company Institute (ICI). <http://www.ici.org/research/stats/retirement>

²⁴ Bureau of Labor Statistics (BLS). "Table 2: Retirement benefits: Access, participation, and take-up rates, civilian workers." March 2014. *National Compensation Survey*. <http://www.bls.gov/ncs/ebs/benefits/2014/ownership/civilian/table02a.pdf>

²⁵ Internal Revenue Service. "Accumulation and Distribution of Individual Retirement Arrangements, 2010." Fall 2013. *Statistics of Income Bulletin*, Washington, DC. <http://www.irs.gov/pub/irs-soi/13inirafallbul.pdf>

Figure 6: Retirement Benefit Access and Participation, 2014



Source: Bureau of Labor Statistics.

Meanwhile, the current tax rules around retirement savings can unnecessarily burden middle-class families. For example, minimum distribution rules are important to limit the inappropriate use of tax-preferred retirement accounts for tax planning rather than retirement saving, but they apply to all Americans, even those with modest balances for whom abuse is not a concern. Americans with the misfortune to lose their jobs and become unemployed for long periods may not be able to access an important source of savings without paying significant costs, making it difficult to keep up with fixed costs such as mortgage payments.

Yet even as the system leaves many working Americans behind, loopholes allow high-income Americans to shelter incredibly large sums inside tax-preferred retirement accounts. A recent GAO report estimated that more than 1,000 taxpayers have IRAs worth more than \$10 million each, including 300 with IRAs worth more than \$25 million each.²⁶ The GAO concluded that taxpayers likely accumulate these large balances by investing in assets unavailable to most investors, such as stock in start-up companies that is not publicly traded and available only to certain insiders.

The President’s Retirement Tax Proposals

The President’s retirement tax proposals simultaneously improve the retirement savings system for working Americans and implement reforms that close loopholes and ensure that retirement tax benefits achieve their intended purpose of promoting retirement security. Specifically, the President proposes to:

²⁶ U.S. Government Accountability Office (GAO). “Individual Retirement Accounts: IRS Could Bolster Enforcement on Multimillion Dollar Accounts, but More Direction from Congress is Needed.” October 2014. *Report to the Chairman, Committee on Finance, US Senate*. <http://www.gao.gov/assets/670/666595.pdf>

- Automatically enroll Americans without access to a workplace retirement plan in an IRA. Under the proposal, every employer with more than 10 employees that does not currently offer a retirement plan would be required to automatically enroll their workers in an IRA. Auto-IRAs would let workers opt out of saving if they choose, but would also let them start saving without sorting through a host of complex options. Auto-IRA proposals have been endorsed by independent scholars across the ideological spectrum, including affiliates of both the Brookings Institution and the Heritage Foundation.²⁷
- Provide tax cuts for auto-IRA adoption, as well as for businesses that choose to offer full employer plans or switch to auto-enrollment. To minimize the burden on small businesses, the President’s auto-IRA proposal would provide employers with 100 or fewer employees that offer an auto-IRA a tax credit of up to \$4,500 (up to \$1,000 per year for three years plus \$25 per enrolled employee up to \$250 for six years), which would cover the entire cost of setting up and maintaining an auto-IRA. The President also proposes to triple the existing “start up” credit, so small employers who newly offer a retirement plan would receive a \$4,500 tax credit (\$1,500 per year for three years)– more than enough to offset administrative expenses. And because auto-enrollment is the most effective way to ensure workers with access to a plan participate, small employers who already offer a plan and add auto-enrollment would get an additional \$1,500 tax credit (\$500 per year for three years).
- Ensure long-term, part-time workers can contribute to their employer’s retirement plan. Only 37 percent of part-time workers have access to a workplace retirement plan.²⁸ That’s partly because employers offering retirement plans are allowed to exclude employees who work less than 1,000 hours per year, no matter how long they’ve worked for the employer. The President proposes to expand access for part-time workers by requiring employers who offer plans to permit employees who have worked for the employer for at least 500 hours per year for 3 years or more to make voluntary contributions to the plan.
- Expand penalty-free withdrawals for the long-term unemployed. IRA account holders who have been unemployed for 3 months can withdraw funds without penalty to pay for health insurance, but not for other expenses. The President proposes to expand the

²⁷ J. Mark Iwry and David C. John, “Pursuing Universal Retirement Security Through Automatic IRAs,” 2009. *The Retirement Security Project*. <http://www.brookings.edu/research/papers/2009/07/automatic-ira-iwry>. See also David C. John, “Pursuing Universal Retirement Security Through Automatic IRAs and Account Simplification,” April 12, 2012. Testimony before the Committee on Ways and Means, U.S. House of Representatives. <http://www.heritage.org/research/testimony/2012/04/pursuing-universal-retirement-security-through-automatic-iras-and-account-simplification>

²⁸ Bureau of Labor Statistics (BLS). “Table 2: Retirement benefits: Access, participation, and take-up rates, civilian workers.” March 2014. *National Compensation Survey*. <http://www.bls.gov/ncs/ebs/benefits/2014/ownership/civilian/table02a.pdf>

exception to allow individuals unemployed for at least 27 weeks to make penalty-free withdrawals of up to \$50,000 for two years for any use and from either an IRA or plan.

- Simplify minimum required distribution rules. Individuals with aggregate IRA and tax-favored retirement plan assets of less than \$100,000 at the beginning of the year in which they turn 70 ½ would be exempt from the minimum required distribution rules. The rules for minimum required distributions would be harmonized for Roth IRAs and other tax-favored accounts, with Roth IRAs generally treated in the same manner as all other tax-favored accounts.
- Prevent wealthy individuals from using loopholes to accumulate huge amounts of tax-favored retirement benefits. Tax-preferred retirement plans are intended to help working families save for retirement. But loopholes in the tax system have let some wealthy individuals convert tax-preferred retirement accounts into tax shelters. The President proposes to prohibit contributions to and accruals of additional benefits in tax-preferred retirement plans and IRAs once balances are sufficient to provide an annual income of \$210,000 in retirement for the lifetime of the saver and a spouse, about \$3.4 million at age 62.

Under the President’s plan, restoring tax-preferred retirement accounts to their intended purpose by limiting the accrual of tax-favored retirement benefits and closing other loopholes funds a more robust system for middle-class workers. Under current law, low- and middle-income Americans (defined as those in the 80th percentile and below), collectively receive less than one-third of retirement tax benefits.²⁹

The President’s plan would provide 30 million additional American workers with access to easy, payroll-based retirement savings, helping to spread retirement tax benefits more widely and better achieve their intended purpose: improving retirement security for those for whom it is at risk.

III. Encouraging and Supporting Work

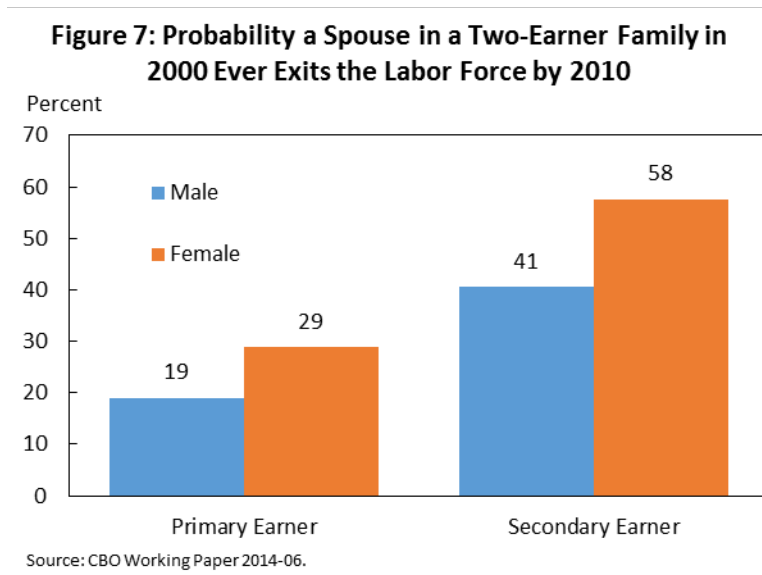
The tax system already includes powerful tools for supporting and rewarding work. As discussed above, the EITC has a strong track record of encouraging hundreds of thousands of low-income parents to enter the workforce, and supporting and rewarding work for millions more. But it can and should be strengthened, and the tax code should also do more to support and reward work for two-earner couples.

²⁹ Calculation based on U.S. Department of Treasury, “Distribution of Selected Tax Expenditures; Selected Retirement Savings,” <http://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Analysis-and-Research.aspx>. See also Tax Policy Center, “Tax Benefit of Certain Retirement Savings Incentives (Present value Approach),” Table T13-0265, December 2013.

Second Earner Credit

Two-earner couples face unique challenges in the workforce. When both spouses work, the family incurs additional costs: commuting, professional expenses, child care, and, increasingly, elder care. When layered on top of other costs, including federal and state taxes, these work-related costs can contribute to a sense that it isn't worth it for both spouses to work.

While women, including married women, are increasingly family breadwinners, the fact remains that women are still much more likely to be the ones who withdraw from the labor force in these circumstances. Among couples where both spouses worked in 2000, female primary earners were 10 percentage points more likely than male primary earners to have left the workforce for at least one year by the end of the decade. Among secondary earners, women were 17 percentage points more likely to have left the workforce compared to men.³⁰ Interruptions in work participation can take a toll on future job options and earnings, a toll currently borne disproportionately by women.



In recognition of the unique challenges faced by two-earner families and as part of a broader focus on female labor force participation (see the box on page 30), the President proposes the creation of a new second earner credit. The credit would provide families with a nonrefundable tax credit equal to 5 percent of the first \$10,000 of earnings for the lower-earning spouse in a married couple and would be available in full to all families making less than \$120,000. The credit would benefit nearly 24 million families each year, providing them with an average tax cut of

³⁰ Robert McClelland, Shannon Mok, and Kevin Pierce, "Labor Force Participation Elasticities of Women and Secondary Earners within Married Couples," September 2014. Working Paper 2014-06, Congressional Budget Office, <http://www.cbo.gov/publication/49433>

almost \$400. More than 60 percent of working-age married couples where both spouses are between 25 and 64 have two earners, and 80 percent of these families would benefit from the new credit. (See Appendix 1 for state-by-state estimates.)

This President's second earner credit builds on similar proposals advanced by independent organizations and both Democrats and Republicans in Congress. For example, Democratic Senator Patty Murray proposed a second earner deduction that would allow married couples with children under 12 to deduct 20 percent the earnings of the lower-earning spouse up to a maximum deduction of \$12,000, and recently proposed a second earner credit for families with children under 12.³¹ Republican Congresswoman Cathy McMorris Rodgers proposed a second earner deduction that would be available to married couples regardless of whether they had children in the home.³²

Expanding the EITC for Workers Without Children and Non-Custodial Parents

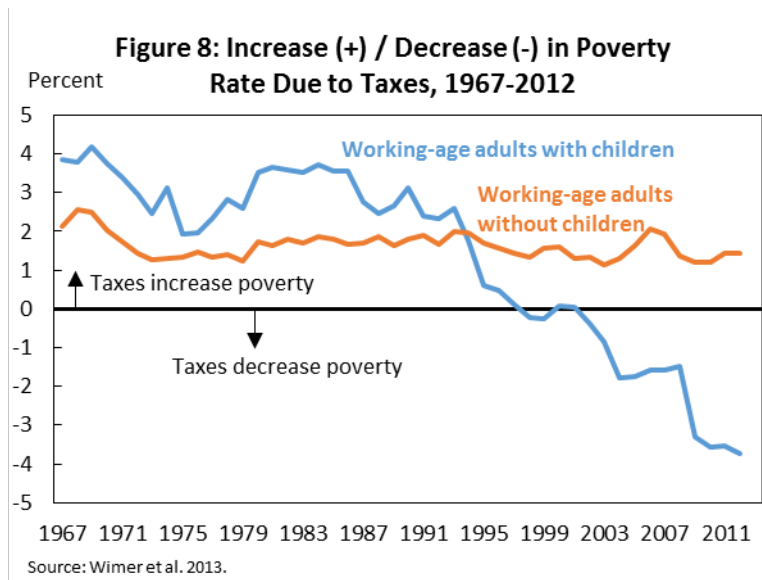
While tax credits like the EITC and CTC help reduce taxes for working families and increase labor force participation, the tax system could do more to build on their success.

Instead, we are in danger of moving backward. The improvements to the EITC and CTC discussed above are currently scheduled to expire after 2017, raising taxes on 16 million families and increasing poverty. For example, if these improvements are allowed to expire, a full-time minimum wage worker with two children would see a tax increase of about \$1,700. The President's plan would make these improvements permanent, locking in the gains they have helped achieve in decreasing poverty, promoting work, and improving economic mobility.

Meanwhile, workers without qualifying children largely miss out on the anti-poverty and employment effects of the EITC. The EITC available to workers without children and non-custodial parents (the "childless worker EITC") is small and phases out at very low incomes. As such, it provides little assistance to childless individuals at or near the poverty line and little incentive to enter the workforce. While the tax system has reversed its role from increasing poverty to decreasing poverty among families with children through improvements to the EITC and CTC, childless workers remain the only group taxed deeper into poverty by federal income and payroll taxes.

³¹ Senator Patty Murray (D-WA), "21st Century Worker Tax Cut Act," 26 March 2014. Press release. <http://www.murray.senate.gov/public/index.cfm/2014/3/senator-patty-murray-introduces-the-21st-century-worker-tax-cut-act>; Senator Patty Murray (D-WA), "Middle Class Tax Cuts: Murray Introduces Bills to Put More Money in Pockets of Working Families, Reduce Costs of College, Child Care," 4 March 2015. Press release. <http://www.murray.senate.gov/public/index.cfm/newsreleases?ID=5b56ec34-14d6-49bf-b6ca-ff4b2eb430c8>

³² House Republicans, "Empowering Americans to Work" Act, 7 August 2014. Press release. <http://www.gop.gov/you-cant-legislate-more-hours-in-the-day-but-heres-something-we-can-do/>



Moreover, the current age restrictions prevent workers younger than 25 from claiming the childless worker EITC, excluding young workers living independently from their parents from its pro-work effects. For individuals at this formative stage of life, encouraging employment and on-the-job experience could help establish patterns of labor force attachment that would persist throughout their working lives.

Last year, the President proposed to address these problems by doubling the EITC for workers without qualifying children, increasing the income level at which the credit is fully phased out, and making it available to workers ages 21 to 66. Specifically, his proposal would double the maximum childless EITC to about \$1,000 and increase the income level at which the credit is fully phased out to about \$18,000 (roughly 150 percent of the Federal poverty line for a single adult). The proposal would also make the credit available to young adult workers age 21 and older and would raise the EITC's upper age limit from 64 to 66, harmonizing it with the recent and scheduled increases in the Social Security full retirement age.

In July 2014, Ways and Means Committee Chairman (then Budget Committee Chairman) Paul Ryan endorsed the President's proposed EITC expansion as part of his poverty plan.³³ In February 2015, Chairman Ryan noted his endorsement of the President's childless EITC expansion, stating "I actually endorsed the idea of EITC reform... I think that's something that actually pulls people into the workforce... And so that is something that I think we should work together on."³⁴ Other members of Congress have put forward similar proposals, while outside

³³ Chairman Paul Ryan, House Budget Committee Majority Staff, "Expanding Opportunity in America: A Discussion Draft from the House Budget Committee," 24 July 2014.

http://budget.house.gov/uploadedfiles/expanding_opportunity_in_america.pdf.

³⁴ NBC News, "Meet the Press Transcript – February 1, 2015." <http://www.nbcnews.com/meet-the-press/meet-press-transcript-february-1-2015-n302111>.

experts from across the political spectrum have endorsed expanding the childless worker EITC as a way to encourage labor force participation.

The President's proposal to expand the childless worker EITC would directly reduce poverty and hardship for 13.2 million low-income workers. Among the groups that would benefit most from the EITC expansion are a number of groups with low or declining labor force participation rates or for whom there are other compelling reasons to strongly subsidize work. These groups include men without a college education, especially minority men; women working at low-wage jobs; young adults not enrolled in school; workers with disabilities; and older workers.³⁵

BIPARTISAN SUPPORT FOR PROPOSALS IN THE PRESIDENT'S BUDGET

As discussed throughout this report, many of the proposals in the President's tax plan build on bipartisan ideas or have bipartisan support. For example:

Simplifying and Improving Student Aid

The President's proposal to streamline and improve education tax credits builds on a proposal that passed the Republican-led House in July 2014. Like the President's plan, the House-passed bill would make the AOTC permanent, increase AOTC refundability, and consolidate overlapping education credits into an improved AOTC.¹ In March 2015, Congressional Democrats also put forth a proposal to expand the AOTC and increase the refundable portion to \$1,500.² Likewise, the President has called for legislation to significantly simplify the Free Application for Federal Student Aid (FAFSA), while Senators Lamar Alexander (R-TN) and Michael Bennet (D-CO) have introduced legislation to reduce the number of questions on the form.³

Retirement

The President's retirement plan to give 30 million more workers an easy way to save through their employer is based on a proposal that was co-authored by scholars at the Heritage Foundation and the Brookings Institution.⁴

Provide a Tax Cut for Two-Earner Families

A total of 24 million couples would benefit from the President's proposal for a new second earner tax credit that recognizes the additional costs faced by families in which both spouses work. Member of both parties have proposed a second earner tax benefit, including Senator Patty Murray (D-WA) and Rep. Cathy McMorris Rodgers (R-WA).

³⁵ Executive Office of the President and U.S. Department of Treasury, "The President's Proposal to Expand the Earned Income Tax Credit," March 2014. http://www.whitehouse.gov/sites/default/files/docs/eitc_report_0.pdf.

Expanding the EITC for Workers without Custodial Children

The President's proposals for pro-work tax credits also reflect proposals that have had bipartisan support. Chairman Paul Ryan (R-WI) has endorsed the President's proposed EITC expansion by including a nearly identical proposal in his poverty plan from July 2014. Shortly after the President's 2015 State of the Union, Chairman Ryan stated, "I actually endorsed the idea of EITC reform... I think that's something that actually pulls people into the workforce... And so that is something that I think we should work together on."

Financial Fee

Both the President's Budget and former Chairman Dave Camp's (R-MI) tax reform plan would impose a fee on the largest financial firms to discourage excessive leverage.

¹ Representative Diane Black (R-TN), Press release on H.R. 3393, *The Student and Family Tax Simplification Act*, 24 July 2014. <http://black.house.gov/press-release/house-passes-congressman-black%E2%80%99s-legislation-make-tax-code-simpler-students-and>; and Congressional Budget Office (CBO), "Cost Estimate of H.R. 3393, Student and Family Tax Simplification Act," 7 July 2014. <http://www.cbo.gov/publication/45506>.

² S. 699, Senator Charles Schumer (D-NY). "With college costs soaring, Schumer launches push to increase & expand college tuition tax credit that provides much-needed relief for upstate NY middle class families – new bill would make more families eligible to receive tax credit & grow savings to up to \$3k per year," 25 February 2015. Press Release. <http://www.schumer.senate.gov/newsroom/press-releases/with-college-costs-soaring-schumer-launches-push-to-increase-and-expand-college-tuition-tax-credit-that-provides-much-needed-relief-for-upstate-ny-middle-class-families-new-bill-would-make-more-families-eligible-to-receive-tax-credit-grow-savings-to-up-to-3k-per-year>. See also H.R. 1260, Rep. Lloyd Doggett (D-TX).

³ US Senate Committee on Health, Education, Labor, and Pensions. "Senators Alexander, Bennet Would Cut 100-Question Student Aid Form to 2 Questions." 19 June 2014. Press release on "FAST Act." <http://www.help.senate.gov/newsroom/press/release/?id=0b173481-41c0-4d78-ab29-76b7dfed071>.

⁴ J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs," *The Retirement Security Project*, 2009, <http://www.brookings.edu/research/papers/2009/07/automatic-ira-iwry>. See also David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs and Account Simplification," Testimony before the Committee on Ways and Means, U.S. House of Representatives, April 12, 2012, <http://www.heritage.org/research/testimony/2012/04/pursuing-universal-retirement-security-through-automatic-iras-and-account-simplification>.

⁵ Chairman Paul Ryan, House Budget Committee Majority Staff, "Expanding Opportunity in America: A Discussion Draft from the House Budget Committee," 24 July 2014, http://budget.house.gov/uploadedfiles/expanding_opportunity_in_america.pdf.

⁶ NBC News, "Meet the Press Transcript – February 1, 2015," <http://www.nbcnews.com/meet-the-press/meet-press-transcript-february-1-2015-n302111>.

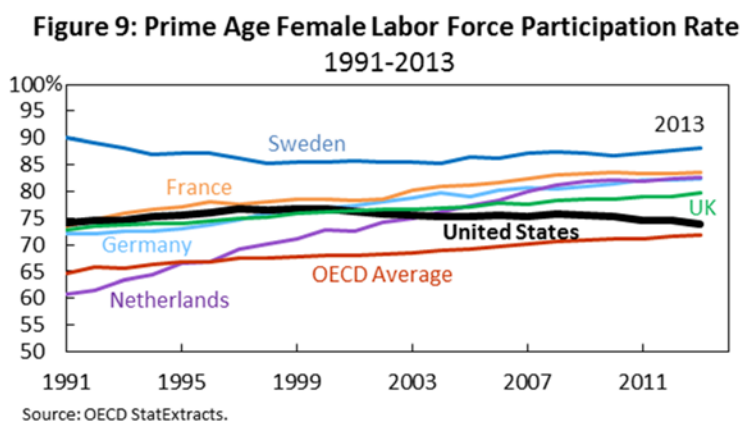
⁷ See Press Release for "Tax Reform Act of 2014," <http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=370987>.

WOMEN'S LABOR FORCE PARTICIPATION

Over the past half century, women have significantly increased their participation in the formal labor force, fundamentally changing our workforce and families. In 1970, only 31 percent of mothers with children under age 5 participated in the labor force. Today, the share has swelled to 63 percent.*

These gains in women's labor force participation, as well as their increased educational attainment and subsequent attachment to the labor force, have translated into large income gains for American families and the economy overall. Women's earnings have accounted for essentially all of the income gains for American families since 1970 because during the period of rapid wage gains for women, wage growth for men has been flat. For example, median family income in 2013 was nearly \$11,000 higher than it was in 1970. If women today still had the same labor force participation and working hours as they did in 1970, median family income would be roughly \$9,000 lower.**

Historically, the United States showed leadership in bringing women into the workforce. In 1990, the United States ranked 7th out of 24 OECD countries in its prime age female labor force participation, slightly higher than the United Kingdom, and about 8 percentage points higher than the OECD average. But since the mid-1990s, women's labor force participation in the United States plateaued and even started to drift down while continuing to rise in other high-income countries, as shown in Figure 9. As a result, in 2013 the United States ranked 19th out of those same 24 countries, falling 6 percentage points behind the United Kingdom and 3 percentage points below the average in these countries.



The reforms to child care tax benefits and the new second earner credit discussed in this report are key components of the President's agenda to remove barriers to women's participation in the economy. These tax reforms complement other pieces of that agenda including the expansion of child care subsidies, the President's Preschool for All proposal, and proposals to support States in expanding paid leave.

* Council of Economic Advisers. "The Economics of Family-Friendly Workplace Policies," Economic Report of the President, 2015, p. 157, http://www.whitehouse.gov/sites/default/files/docs/2015_erp_chapter_4.pdf.

** Council of Economic Advisers. "The Economics of Family-Friendly Workplace Policies," Economic Report of the President, 2015, pp. 157-158, http://www.whitehouse.gov/sites/default/files/docs/2015_erp_chapter_4.pdf.

IV. Paying for Pro-Middle Class and Pro-Work Reforms by Making Sure the Wealthy Pay Their Fair Share

The President proposes to pay for the middle-class and pro-work reforms discussed above by making sure the wealthy pay their fair share. The President's plan would reform the taxation of income from wealth, help address excessive risk taking in the financial sector, and close a loophole by which some high-paid professionals avoid Social Security and Medicare taxes.

Rising Income and Wealth Inequality

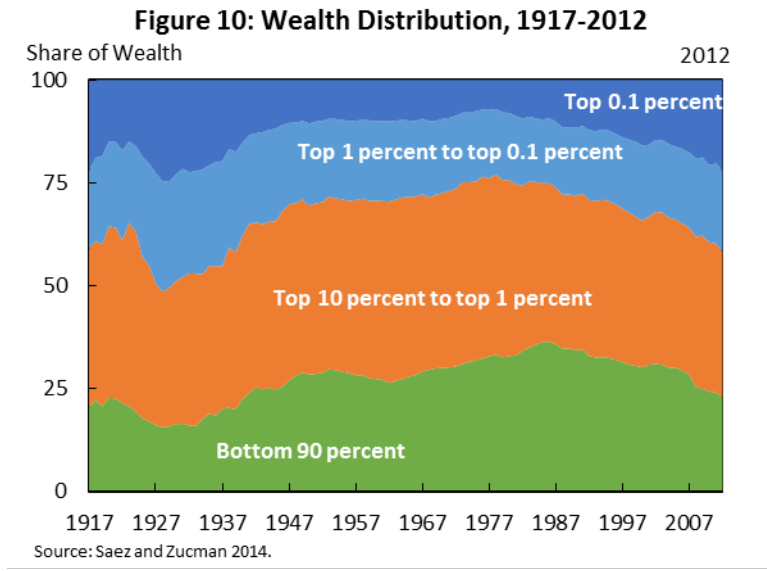
Since the 1970s, income concentration in the United States has surged, the result of rapid income growth at the top coupled with weak income growth for typical families. Between 1973 and 2013, median household income rose only 5 percent, after adjusting for inflation. Over the same period, the average income of the top 1 percent of households rose by about 150 percent, and the average income of the top 0.1 percent rose nearly 300 percent. The result is that the average income of households in the top 1 percent is now more than 20 times median household income, versus 9 times median income in 1973.³⁶

The initial increase in income concentration was driven mostly by changes in the distribution of labor income, including rising returns to education, skyrocketing CEO pay, a falling real value of the minimum wage, and other factors. But more recently, increased concentration of wealth and capital income (capital gains, dividends, interest, and other returns on wealth) has played a larger role in driving increases in income inequality. Rising capital income inequality accounts for more than half of the increase in inequality at the very top of the income distribution over the past 40 years, and is an even more important factor in the past 20 years.³⁷ Today, the top 1 percent holds more than 40 percent of the nation's wealth, and the top 0.1 percent holds more than 20 percent – levels not seen since the 1930s. Meanwhile, the bottom 90 percent has lost ground, with its share of wealth falling since the mid-1980s, and its average wealth falling sharply in the last decade.³⁸

³⁶ Calculations based on U.S. Census Bureau, "Income, Poverty, and Health Insurance Coverage: 2013," September 2014, http://www.census.gov/content/dam/Census/newsroom/press-kits/2014/20140916_ip_slides_plot_points.pdf and Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," 2003. Quarterly Journal of Economics, 118(1), 1-39, updated figures accessible at <http://eml.berkeley.edu/~saez/>.

³⁷ Jason Furman, "Inclusive Growth: For Once, Some Good News," Fourth Quarter 2014, The Milken Institute Review. <http://assets1b.milkeninstitute.org/assets/Publication/MIRReview/PDF/16-29-MR64.pdf>.

³⁸ Emmanuel Saez and Gabriel Zucman, "Wealth Inequality in the United States Since 1913: Evidence from Capitalized Income Tax Data," October 2014. National Bureau of Economic Research, Working Paper 20625.



The sharp increase in wealth inequality also suggests that income inequality is becoming increasingly entrenched in the United States. Starting in the 1980s, increases in labor income inequality began to translate into sharp increases in wealth and capital income inequality, as high-income households maintained their savings rates while increasingly strapped middle-class households reduced their savings to close to zero. High-income households may also obtain higher rates of return on their savings. Since higher wealth results in higher capital income, which results in higher annual savings, the result is a self-perpetuating increase in income and wealth gaps and a reduction in economic mobility. Indeed, top income groups have become strikingly more stable in recent decades, with the probability that a given earner remains in the top 0.1 percent from one year to the next rising from about 45 percent in the 1980s and 1990s to about 60 percent today.³⁹ Inequality also perpetuates itself across generations, contributing to growing gaps in economic opportunity.

Capital Gains Tax Reform

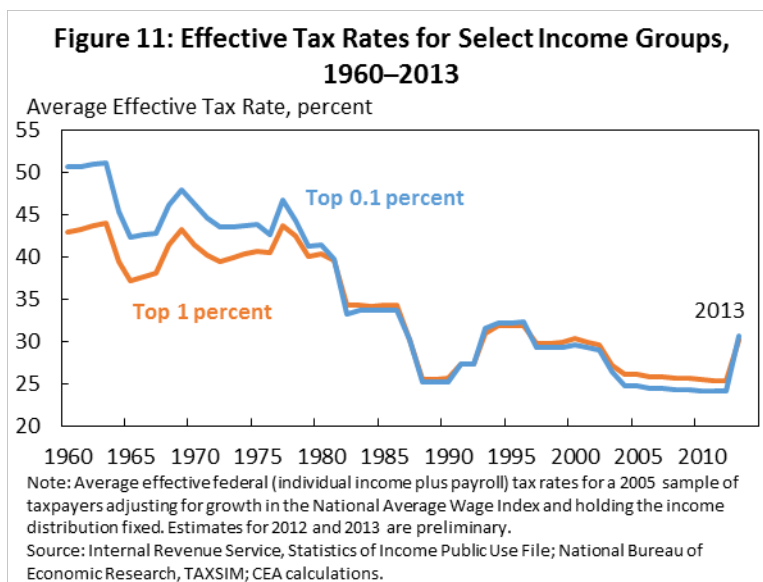
The Need for Reform

Rather than make it easier for middle-class families to make ends meet, our tax system has changed over time in ways that make it easier for the wealthy to avoid paying their fair share. Since the 1970s, effective tax rates (the rates households actually pay) have fallen substantially for high-income households.⁴⁰ For example, Congressional Budget Office data show that while

³⁹ Fatih Guvenen, Greg Kaplan, and Jae Song. "The Glass Ceiling and the Paper Floor: Gender Differences among Top Earners, 1981-2012," October 2014. National Bureau of Economic Research, Working Paper 20560. <http://www.nber.org/papers/w20560>

⁴⁰ CEA calculations based on data from the Internal Revenue Service, Statistics of Income Public Use File; National Bureau of Economic Research, TAXSIM.

average pre-tax income for the top 1 percent of households grew by 275 percent between 1979 and 2007, adjusted for inflation, average after-tax income rose by an even larger percentage, 314 percent. Put differently, if effective tax rates had remained the same over this period, average income within the top 1 percent would have risen by about \$950,000 in real terms. Instead, it rose by nearly \$1.1 million.⁴¹



Capital income tax rates in particular have fallen over time; they are also much lower than tax rates on income from work. The top statutory capital gains rate is below its 28 percent average in the four decades from 1960 to 2000; the top dividend tax rate is lower than in any year since at least the 1930s, except 2003–2012.⁴² Over the same period, effective tax rates on capital income have also fallen due to falling effective tax rates on corporate income and a shrinking estate tax. Overall, the average marginal tax rate on capital income is 18 percent compared with a 30 percent rate on labor income, according to Congressional Budget Office (CBO) estimates.⁴³ Low tax rates on capital income explain how the highest-income 400 taxpayers

⁴¹ Congressional Budget Office, “The Distribution of Household Income and Federal Taxes, 2011.” 12 November 2014. <https://www.cbo.gov/publication/49440>

⁴² Tax Policy Center, “Tax Facts: Historical Capital Gains and Taxes,” 20 November 2012. Tables from Department of the Treasury, Office of Tax Analysis. <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=161> and “Tax Facts: Historical Individual Income Tax Parameters,” 18 September 2015. <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=543>. Currently, the total top statutory capital gains and dividend tax rate is 23.8 percent (20 percent plus a 3.8 percent net investment income surcharge).

⁴³ Congressional Budget Office, “The Economic Effects of the President’s 2015 Budget,” July 2014. https://www.cbo.gov/sites/default/files/45540-Economic_APB.pdf.

in 2012 – who obtained 68 percent of their income from capital gains – paid income tax at an effective rate of 17 percent, even though the top marginal income tax rate was 35 percent.⁴⁴

The problem is that the U.S. capital income tax system is too broken to reverse these trends just by raising tax rates. Loopholes in the individual income tax code let substantial capital income, especially capital gains income, escape tax altogether. Raising the capital gains tax rate without addressing these loopholes would raise relatively little revenue, in part because it would encourage wealthy individuals to take further advantage of the opportunities the current system provides to defer and avoid tax.

The Largest Capital Gains Loophole: Stepped-up Basis

The largest capital gains loophole – perhaps the largest single loophole in the entire individual income tax code – is a provision known as stepped-up basis. Stepped-up basis refers to the fact that capital gains on assets held until death are never subject to income taxes. Not only do bequests to heirs go untaxed, but the “tax basis” of inherited assets is immediately increased (“stepped-up”) to the value at the date of death – making the capital gain disappear forever for income tax purposes. For example, suppose an individual bequeaths stock worth \$50 million to an heir, who immediately sells it. When purchased, the stock was worth \$10 million, so the capital gain is \$40 million. However, the heir’s basis in the stock is “stepped up” to the \$50 million when he inherited it – so no tax is due on the sale. And no tax is ever due on the \$40 million of gain.

Each year, hundreds of billions in capital gains escape income tax as a result of the non-taxation of gains on bequests and gifts.⁴⁵

The President’s Proposal

The President’s proposal would both increase the tax rate on capital gains and dividend income and close the stepped-up basis loophole. Under the President’s proposal, the total top capital gains and dividend tax rate would increase to 28 percent, the rate at which capital gains were taxed under President Reagan.⁴⁶ The rate increase would apply to couples with incomes over about \$500,000. In addition, capital gains taxes would be due on bequests and gifts (other than to charitable organizations), just like in other cases where assets change hands. There would be a \$200,000 per-couple exemption for bequests, as well as other protections to ensure that the

⁴⁴ Internal Revenue Service, “Data on the 400 Individual Income Tax Returns Reporting the Largest Adjusted Gross Incomes,” 2012 Update. January 2015. <http://www.irs.gov/uac/SOI-Tax-Stats-Top-400-Individual-Income-Tax>Returns-with-the-Largest-Adjusted-Gross-Incomes>

⁴⁵ These gains also largely escape estate taxation because of the \$10 million per-couple estate tax exemption and estate tax avoidance.

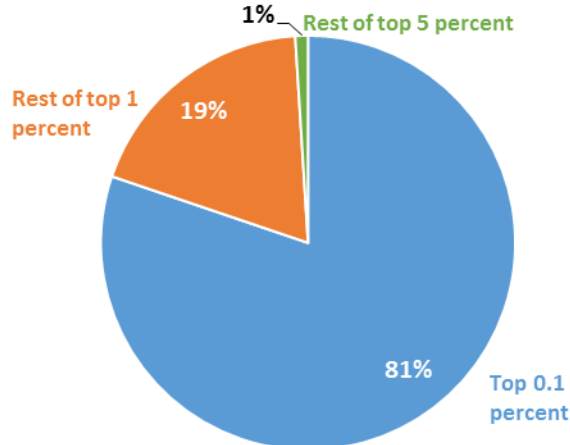
⁴⁶ The rate would be 24.2 percent not counting the Medicare net investment income surcharge of 3.8 percent.

proposal imposes neither tax nor compliance burdens on middle-class families. (See the box on page 37.)

The proposed capital gains reforms would:

- **Almost exclusively impact the top 1 percent.** 99 percent of the impact of the President’s capital gains reform proposal (including eliminating stepped-up basis and raising the capital gains rate) would be on the highest-income 1 percent, and more than 80 percent on the top 0.1 percent (those with incomes over \$2 million).⁴⁷ Under this reform, wealthy people would still get a preferential rate on their income from investments, but they would no longer be able to accumulate extra wealth by paying no capital gains tax whatsoever.

Figure 12: Distribution of Increased Revenue from Reforming Capital Gains Taxation



Source: U.S. Department of the Treasury, Office of Tax Analysis.

- **Address a basic unfairness in the tax system.** Middle-class retirees almost always have to spend down their assets during retirement, which means they owe income taxes on

⁴⁷ U.S. Department of Treasury, Office of Tax Analysis, 2015. These figures provide the most accurate and consistent estimates of the likely impact of the reforms on households at different levels of income and well-being. These estimates reflect a variety of data sources unavailable outside of the Treasury, which facilitate more accurate estimation of income and capital gains than is possible from the small samples available in public survey data. These data, which include return information from 2010 estate returns, when estate tax policy led many wealthy individuals to report unrealized capital gains, suggest both that public survey data (including the Survey of Consumer Finances) underreport capital gains for very wealthy individuals and underreport capital income for high-wealth households with otherwise moderate-incomes. Better data and more rigorous statistical methods substantially improve upon estimates drawn directly from survey data. Furthermore, Treasury’s analysis follows the widely-adopted convention of including capital gains in income upon realization rather than on accrual. In addition to providing consistent and comparable treatment between the effects of this proposal and other capital gains tax proposals (especially within the same distributional analysis), this method is a closer approximation of the income and economic status of households than if this income were ignored.

whatever capital gains they have accrued. But the wealthy can often afford to hold onto assets until death – which is what lets them use the stepped-up basis loophole to avoid ever paying tax.

- **Raise \$210 billion in revenue over 10 years, and more over the long run.** The proposal covers the bulk of the cost of the President’s pro-middle-class, pro-work tax reform proposals in the first decade. Over the long run, it would raise significantly more revenue and begin to contribute to deficit reduction just as the full retirement of the baby boom generation makes the nation’s budget challenges most acute.⁴⁸
- **Unlock capital for productive investment.** By letting very wealthy investors make their capital gains disappear at death, stepped-up basis creates strong “lock-in” incentives to hold on to assets, even when economic factors dictate that resources could be reinvested more productively elsewhere. The economy benefits when investment resources are allocated based on expected economic returns, not tax benefits. The proposal would sharply reduce inefficient lock-in incentives, making it an efficient way to raise revenue.

⁴⁸ The proposal raises less revenue in the first decade than over the long run primarily because couples would not owe taxes on capital gains until the second spouse died.

PROTECTIONS FOR MIDDLE-CLASS FAMILIES AND SMALL BUSINESSES

As discussed in the main text, eliminating stepped-up basis almost exclusively impacts the wealthiest households, simply because these households account for almost all unrealized capital gains. But to ensure that eliminating stepped-up basis would impose neither tax nor compliance burdens on middle-class families, the President's proposal includes the following protections:

- For couples, no tax would be due until the death of the second spouse.
- Capital gains of up to \$200,000 per couple (\$100,000 per individual) could still be bequeathed free of tax. Note that, since capital gains generally represent only a fraction of an asset's value, this exemption would allow couples to bequeath more than \$200,000 without owing taxes. The exemption would be automatically portable between spouses.
- In addition to the basic exemption, couples would have an additional \$500,000 exemption for personal residences (\$250,000 per individual). This exemption would also be automatically portable between spouses.
- Tangible personal property (e.g. bequests or gifts of clothing, furniture, or small family heirlooms) would be tax-exempt. In addition to avoiding any tax burden on these small transfers, this exclusion would prevent families from having to value and report them.

With these measures taken into account, 99 percent of the impact of the proposed capital gains reforms would be on the top 1 percent of households, and 81 percent would be on the top 0.1 percent.

Likewise, very few small businesses would be affected by repeal of stepped-up basis, since the overwhelming majority of small businesses have capital gain less than the \$200,000 per-couple exemption. However, the President's plan includes extra protections that ensure that no small family-owned business would ever have to be sold for tax reasons:

- No tax would be due on the gains on inherited small, family-owned and operated businesses unless and until they were sold.
- Any closely-held business would have the option to pay tax on gains over 15 years.

Financial Sector Tax Reform

Since the late 1970s, the financial sector has grown substantially as a share of the economy. Services provided by banks and other financial firms make it possible for ordinary Americans to take out a mortgage to buy a house and for small and large businesses to access the resources they need to grow. While these services are valuable, excessive risk-taking in the financial services sector can impose huge costs on the broader economy, as vividly illustrated by the 2008-2009 financial crisis.

Since the crisis, the Administration and Congress have taken major steps to make the financial system safer and the broader economy more resilient, including enacting legislation that ensures taxpayers will never be on the hook to bail out a failing financial firm. Recognizing that excessive leverage undertaken by major financial firms was a major cause of the crisis, post-crisis reforms include significantly reducing the amount of debt, or leverage, banks are permitted to use in funding their activities. However, it remains the case that financial firms have incentives to maximize their own expected profits by maximizing the amount of leverage they employ, without taking into account the potential costs to the economy as a whole. Increased leverage creates risk to the broader economy by making it more likely that leveraged firms themselves will fail, and by reducing the cushion of loss-absorbing equity at other firms and therefore increasing the risk that one firm's failure could ripple through the financial system. To the extent that financial firms do not take these broader risks into account when taking on additional leverage, the implication is that those risks are "underpriced" relative to their true social cost.

The President's plan would remedy this dynamic by attaching explicit costs to leverage for large financial firms, further discouraging excessive risk-taking through the use of leverage. In the context of business tax reform, this proposal is part of a broad effort to address a range of economic distortions, including by reducing the tax preference for debt financing, regardless of the form of that debt financing. The financial fee would benefit middle-class Americans by discouraging the largest financial firms from taking excessive risks, and would raise \$110 billion over 10 years to help pay for his proposed investments in the middle class.

Specifically, the President's plan would impose a fee on the covered liabilities of large U.S. financial firms with assets over \$50 billion. The fee rate would be seven basis points, meaning a 0.07 percent additional cost on leverage. Because the vast majority of financial firms have assets less than \$50 billion, the fee would apply to roughly 100 large firms, including the major financial actors – both banks and non-banks – whose actions drove the financial crisis.

This approach is broadly consistent with a proposal from former Ways and Means Chairman Dave Camp's tax reform plan that would have imposed an excise tax on large financial firms.⁴⁹

Closing a Loophole That Takes Billions Away from the Social Security and Medicare Trust Funds

All workers, including those who are self-employed, owe payroll taxes on their earnings to support Social Security and Medicare. But some high-income professionals can escape this responsibility by reclassifying much of their earnings as distributions from certain pass-through entities, without changing anything about the nature of their work. (This loophole has sometimes

⁴⁹ House Committee on Ways and Means. "Tax Reform Act of 2014," 26 February 2014. Press release. <http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=370987>

been referred to as the “Gingrich loophole.”) In total, this tax avoidance is projected to take almost \$10 billion per year from the Social Security and Medicare Trust Funds by the end of the decade.

The President is proposing to end the loophole by extending the payroll tax to cover distributions from certain pass-through entities engaged in a professional service business such as law, consulting, or lobbying, raising \$75 billion over 10 years.

V. Republicans’ Approach: Tax Cuts for the Wealthy at the Expense of the Middle Class

In his fiscal year 2016 budget, the President proposes to simplify our tax code, make it fairer by eliminating some of the largest tax loopholes, and reinvest the savings in measures that will grow the economy and expand opportunity. The Congressional Republican Budgets take a very different approach – one that promises large tax cuts to millionaires, fails to invest in middle-class families, and does nothing to prevent a tax increase on millions of working families and students. Most important, Congressional Republicans are unwilling to close a single tax loophole to help reduce the deficit. As a result, the entire burden of deficit reduction under their budgets falls on the middle class, seniors, low-income children and families, and national security, with the consequences for growth, opportunity, health, and safety.

President’s Budget	Congressional Republican Budgets
Cuts taxes for middle-class families paying for child care, putting kids through college, and saving for retirement	Specified tax policies (House) are targeted toward the wealthy and corporations and provide millionaires with tax cuts averaging \$50,000
Strengthens EITC and continues EITC and Child Tax Credit (CTC) improvements vital to working families	Do nothing to prevent tax increase averaging \$900 on 16 million families from expiration of EITC and CTC improvements
Expands and makes permanent the American Opportunity Tax Credit (AOTC) to help families and students afford college	Do nothing to prevent the AOTC from expiring, letting 12 million families paying for college lose tax credits worth \$1,100 on average
Fiscally responsible, balanced approach that closes loopholes and asks the wealthy to pay their fair share	Do not identify a single tax loophole to close or ask the wealthy to contribute a dollar to deficit reduction, putting full burden on the middle class, seniors, low-income families, and national security

Large Tax Cuts for High-Income Households and Corporations

In a budget that claims to be fiscally responsible, House Republicans start by promising large tax cuts for the wealthy and big corporations. Among the few specific tax proposals in the House Republican budget is a promise to spend hundreds of billions on high-income and business tax

cuts.⁵⁰ The proposals they specify would cut the tax bill of the average millionaire by more than \$50,000, before even adding the proposed cuts to tax rates.

Besides these tax cuts in the House budget, the Republican budgets provide few specifics on tax issues. This year's House budget calls for cutting individual and corporate rates but does not say what rates should be or give any detail as to how the Budget would make up the revenue. However, in recent years, Congressional Republicans have made clear that their top priority in tax reform is to cut the tax rates for the highest-income individuals. Recent House Republican budgets, for example, proposed lowering the highest individual rate by more than one-third, to the lowest level since the presidency of Herbert Hoover. Coupled with other tax policies, these top-bracket tax cuts were estimated to be so costly that meeting the GOP's proposed fiscal targets would require an average tax increase of \$2,000 to \$3,000 or more on families with children making less than \$200,000.⁵¹

Congressional Republicans have also voted for *additional* tax cuts for the wealthy, beyond what they called for in their budget resolutions. In March, House Republicans voted to repeal the estate tax – increasing the deficit by \$270 billion over the next decade in order to give a tax cut to the wealthiest top fraction of the top one percent of Americans.⁵² To put that number into context, just 4,415 estates owed any estate tax in 2011.⁵³ If the estate tax were repealed for 2016, the wealthiest estates would receive tax cuts averaging more than \$3 million per estate (see state-by-state estimates in Appendix 1).

⁵⁰ The only specified tax policies in the House GOP budget are (1) repealing the Affordable Care Act in its entirety, including the Net Investment Income Tax on high-income individuals and the 0.9% additional Medicare tax on high-income individuals, and (2) repealing the Alternative Minimum Tax, which is predominantly paid by upper-income individuals. Previous analyses by the Tax Policy Center suggest that repealing these provisions would cut taxes by about \$50,000 for those with incomes over \$1 million. Taxpayers earning between \$50,000 and \$75,000 would save an average of less than \$10; those earning less than \$50,000 would save essentially nothing. See Tax Policy center tables T14-0087 and T12-0108 and <http://www.offthechartsblog.org/house-budget-chairs-priority-tax-cuts-for-well-to-do/>.

⁵¹ The nonpartisan Tax Policy Center analyzed a similar plan in 2012 – which cut the top individual rates to 28 percent, while the House GOP budget proposed to cut them to 25 percent – and found that even with generous assumptions, it would necessitate raising taxes on families with children and incomes under \$200,000 by more than \$2,000. Since the House Republican budget proposed deeper cuts, others estimated that it would necessitate raising taxes on middle-class families by even more – at least \$3,000. See <http://www.taxpolicycenter.org/publications/url.cfm?ID=1001628>; <http://www.cbpp.org/cms/?fa=view&id=3926>.

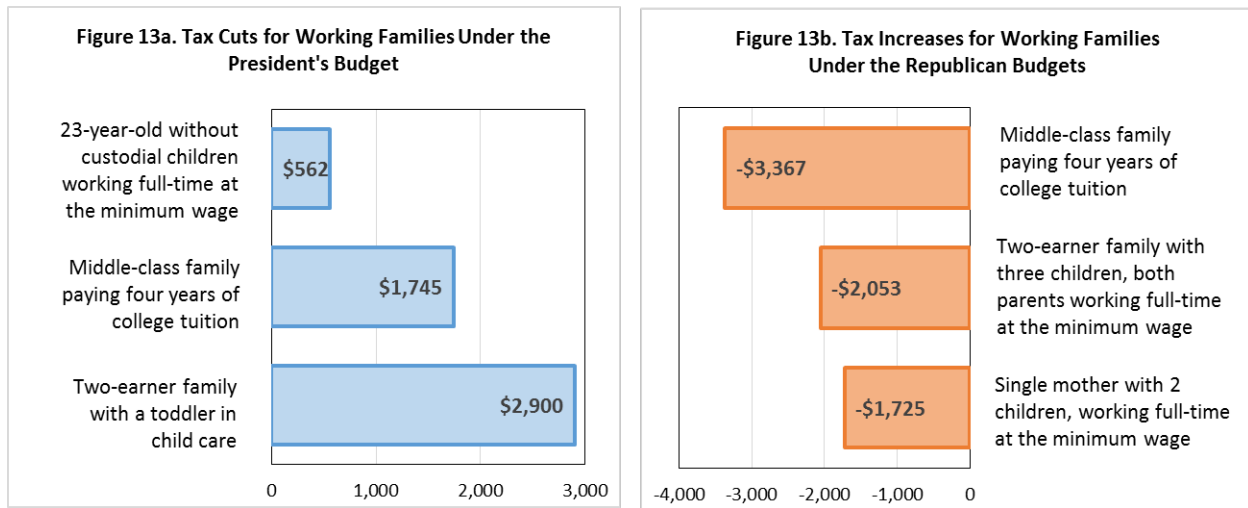
⁵² The Tax Policy Center estimates that only 0.1 percent of estates will owe estate tax in 2015, while recent data from the Joint Committee on Taxation show that only 0.2 percent of estates owed estates tax in 2013. Both analyses show that only the wealthiest 1 or 2 estates out of every 1,000 will owe estate tax under current law. See Tax Policy Center Table T13-0019, January 9, 2013 and Joint Committee on Taxation, "History, Present Law, And Analysis Of The Federal Wealth Transfer Tax System," JCX-52-15, March 16, 2015.

⁵³ Internal Revenue Service, Statistics of Income, Table 6. Estate Tax Returns Filed for 2011 Decedents, by State of Residence.

Letting Taxes Rise for Some 25 Million Working Families and Students

Meanwhile, the House and Senate Republican budget do nothing to prevent a tax increase on some 25 million working families and students. At the end of 2017, unless Congress acts, several significant tax credit improvements signed into law by President Obama and extended twice on a bipartisan basis will expire. These expiring provisions include improvements to the Earned Income Tax Credit (EITC) that benefit families with three or more children and reduce the EITC's so-called "marriage penalty" (when married couples receive smaller tax credits than they would if they were not married and filed taxes as single individuals). They also include improvements to the Child Tax Credit that allow low-wage workers to count more of their earnings toward the credit's refundable portion. The American Opportunity Tax Credit that helps families afford the costs of higher education also expires after 2017.

As illustrated in Figures 13a and 13b, while the President's Budget invests in the middle class, the House and Senate Republican budgets do the opposite.



Source: Calculations based on U.S. Department of Treasury, U.S. Department of Education National Center for Education Statistics, and Center on Budget and Policy Priorities data.

Notes: Tax changes are calculated for illustrative families and are relative to current policy. Changes in education tax credits include the cumulative change over four academic years (tax years 2016-20), and assume the family pays median tuition and fees at a four-year public, non-doctoral university. All other tax changes under the President's Budget are for tax year 2016, and all other tax changes under the Republican Budgets are for tax year 2018. (Tax cuts under the President's Budget include the impact of proposed improvements to the childless EITC, AOTC, child and dependent care tax credit, and new second earner credit. Tax increases under the Republican budgets result from allowing the AOTC and improvements to the EITC and Child Tax Credit to expire after 2017.)

Both the House and Senate Republican budget fail to provide for extending these tax credits (and both assume the revenue from their expiration). If the EITC and CTC improvements are allowed to expire:

- 16 million working families would lose tax credits and effectively get a \$900 pay cut, on average. (*See state-by-state estimates in Appendix 1.*)
- 16 million people would be pushed into poverty or deeper into poverty, including almost 8 million children.
- A full-time, minimum wage worker with two children would lose her entire Child Tax Credit of more than \$1,700.

If the AOTC is allowed to expire:

- 12 million families and students paying for college would see their tuition tax credits reduced by an average of \$1,100.
- The AOTC would revert to the less generous Hope credit, which would be available for only two years of higher education, compared to four years today and five years under the President's Budget.

In sum, allowing these tax cuts to expire would raise taxes on some 25 million families by an average of about \$1,000 each.⁵⁴

Does Not Ask the Wealthy or Corporations to Contribute a Dollar to Deficit Reduction

Finally, while the House Republican budget specifies tax policies that would give millionaires an average tax cut of \$50,000, both it and the Senate Republican budget fail to identify a single tax loophole to close. Moreover, the Republican budgets are clear that if they did find any loopholes to close, the revenue would go toward reducing marginal tax rates or other new tax cuts – not reducing the deficit. Revenues would be kept at current baseline levels – necessarily putting the entire burden of deficit reduction on the middleclass, seniors, and low-income children and families.

⁵⁴ The 25 million families include some who would be affected by the expiration of the American Opportunity Tax Credit as well as the expiration of the EITC or CTC improvements.

Appendix 1: State-by-State Estimates

Table 1. Benefits of EITC and CTC Recovery Act Expansions in 2015					
State	Families	Total Dollar Benefit	State	Families	Total Dollar Benefit
United States	16 million	\$14.2 billion			
Alabama	304,000	\$274 million	Nebraska	81,000	\$73 million
Alaska	27,000	\$24 million	Nevada	146,000	\$136 million
Arizona	359,000	\$345 million	New Hampshire	40,000	\$33 million
Arkansas	179,000	\$161 million	New Jersey	333,000	\$296 million
California	1,966,000	\$1.8 billion	New Mexico	126,000	\$118 million
Colorado	223,000	\$200 million	New York	893,000	\$802 million
Connecticut	113,000	\$98 million	North Carolina	552,000	\$498 million
Delaware	39,000	\$35 million	North Dakota	24,000	\$20 million
Florida	1,080,000	\$965 million	Ohio	546,000	\$490 million
Georgia	642,000	\$601 million	Oklahoma	212,000	\$193 million
Hawaii	57,000	\$50 million	Oregon	173,000	\$156 million
Idaho	88,000	\$80 million	Pennsylvania	486,000	\$423 million
Illinois	629,000	\$577 million	Rhode Island	42,000	\$37 million
Indiana	327,000	\$300 million	South Carolina	279,000	\$253 million
Iowa	120,000	\$105 million	South Dakota	36,000	\$31 million
Kansas	134,000	\$121 million	Tennessee	383,000	\$341 million
Kentucky	234,000	\$205 million	Texas	1,588,000	\$1.5 billion
Louisiana	279,000	\$257 million	Utah	147,000	\$140 million
Maine	53,000	\$43 million	Vermont	23,000	\$19 million
Maryland	212,000	\$192 million	Virginia	329,000	\$288 million
Massachusetts	195,000	\$166 million	Washington	275,000	\$240 million
Michigan	472,000	\$429 million	West Virginia	91,000	\$76 million
Minnesota	191,000	\$169 million	Wisconsin	225,000	\$202 million
Mississippi	217,000	\$202 million	Wyoming	22,000	\$20 million
Missouri	296,000	\$265 million	DC	24,000	\$23 million
Montana	47,000	\$40 million	Other Areas	78,000	\$62 million

Source: U.S. Department of Treasury, Office of Tax Analysis

Table 2. Workers Benefiting from President's Childless EITC Expansion in 2016

State	Families	State	Families
United States	13.2 million		
Alabama	196,000	Nebraska	76,000
Alaska	38,000	Nevada	108,000
Arizona	233,000	New Hampshire	58,000
Arkansas	120,000	New Jersey	344,000
California	1,512,000	New Mexico	91,000
Colorado	203,000	New York	878,000
Connecticut	140,000	North Carolina	374,000
Delaware	35,000	North Dakota	30,000
Florida	1,004,000	Ohio	507,000
Georgia	473,000	Oklahoma	147,000
Hawaii	59,000	Oregon	161,000
Idaho	65,000	Pennsylvania	558,000
Illinois	529,000	Rhode Island	46,000
Indiana	277,000	South Carolina	199,000
Iowa	120,000	South Dakota	37,000
Kansas	115,000	Tennessee	291,000
Kentucky	184,000	Texas	1,007,000
Louisiana	187,000	Utah	100,000
Maine	63,000	Vermont	32,000
Maryland	207,000	Virginia	306,000
Massachusetts	267,000	Washington	256,000
Michigan	463,000	West Virginia	82,000
Minnesota	221,000	Wisconsin	248,000
Mississippi	126,000	Wyoming	24,000
Missouri	255,000	DC	24,000
Montana	51,000	Other Areas	117,000

Source: US Department of Treasury, Office of Tax Analysis

Table 3. Families Benefiting from President's Second Earner Tax Credit in 2016

State	Families	State	Families
United States	24 million		
Alabama	352,000	Nebraska	176,000
Alaska	67,000	Nevada	181,000
Arizona	428,000	New Hampshire	132,000
Arkansas	219,000	New Jersey	659,000
California	2,475,000	New Mexico	137,000
Colorado	442,000	New York	1,201,000
Connecticut	293,000	North Carolina	748,000
Delaware	73,000	North Dakota	67,000
Florida	1,161,000	Ohio	905,000
Georgia	676,000	Oklahoma	297,000
Hawaii	109,000	Oregon	319,000
Idaho	135,000	Pennsylvania	1,104,000
Illinois	994,000	Rhode Island	85,000
Indiana	580,000	South Carolina	340,000
Iowa	306,000	South Dakota	75,000
Kansas	266,000	Tennessee	476,000
Kentucky	361,000	Texas	1,759,000
Louisiana	308,000	Utah	254,000
Maine	120,000	Vermont	58,000
Maryland	449,000	Virginia	688,000
Massachusetts	540,000	Washington	597,000
Michigan	823,000	West Virginia	158,000
Minnesota	526,000	Wisconsin	571,000
Mississippi	186,000	Wyoming	54,000
Missouri	501,000	DC	19,000
Montana	86,000	Other Areas	87,000

Source: US Department of Treasury, Office of Tax Analysis

Table 4. Average Annual Cost of Center-Based Child Care for Two Children, 2013

State	Cost	State	Cost
Alabama	\$11,416	Nebraska	\$16,900
Alaska	\$18,563	Nevada	\$18,303
Arizona	\$16,500	New Hampshire	\$21,524
Arkansas	\$10,877	New Jersey	\$21,080
California	\$19,727	New Mexico	\$14,391
Colorado	\$23,014	New York	\$26,788
Connecticut	\$24,247	North Carolina	\$16,578
Delaware	\$16,266	North Dakota	\$15,018
Florida	\$15,023	Ohio	\$14,258
Georgia	\$12,972	Oklahoma	\$13,502
Hawaii	\$20,565	Oregon	\$19,693
Idaho	\$12,863	Pennsylvania	\$19,196
Illinois	\$21,868	Rhode Island	\$23,062
Indiana	\$14,729	South Carolina	\$11,757
Iowa	\$17,089	South Dakota	\$10,890
Kansas	\$18,402	Tennessee	\$10,372
Kentucky	\$12,165	Texas	\$15,262
Louisiana	\$10,538	Utah	\$14,160
Maine	\$17,680	Vermont	\$20,171
Maryland	\$23,387	Virginia	\$17,724
Massachusetts	\$28,869	Washington	\$21,638
Michigan	\$17,680	West Virginia	\$14,560
Minnesota	\$24,805	Wisconsin	\$20,644
Mississippi	\$10,296	Wyoming	\$17,147
Missouri	\$14,810	DC	\$39,252
Montana	\$16,663		

Source: Child Care Aware. Figures refer to the cost of full-time, center-based care for one infant and one 4-year old.

Table 5. Number and Share of Estates Affected by the Estate Tax in 2016

State	Number	Share	State	Number	Share
United States	5,400	0.2%			
Alabama	50	0.1%	Nebraska	60	0.4%
Alaska	*fewer than 10	0.1%	Nevada	30	0.1%
Arizona	60	0.1%	New Hampshire	20	0.2%
Arkansas	30	0.1%	New Jersey	130	0.2%
California	970	0.4%	New Mexico	30	0.2%
Colorado	100	0.3%	New York	430	0.3%
Connecticut	140	0.5%	North Carolina	120	0.1%
Delaware	10	0.1%	North Dakota	20	0.3%
Florida	660	0.4%	Ohio	100	0.1%
Georgia	100	0.1%	Oklahoma	50	0.1%
Hawaii	30	0.3%	Oregon	50	0.1%
Idaho	20	0.2%	Pennsylvania	160	0.1%
Illinois	220	0.2%	Rhode Island	20	0.2%
Indiana	60	0.1%	South Carolina	60	0.1%
Iowa	60	0.2%	South Dakota	20	0.3%
Kansas	40	0.2%	Tennessee	60	0.1%
Kentucky	40	0.1%	Texas	340	0.2%
Louisiana	80	0.2%	Utah	30	0.2%
Maine	*fewer than 10	0.1%	Vermont	20	0.4%
Maryland	70	0.2%	Virginia	200	0.3%
Massachusetts	140	0.3%	Washington	100	0.2%
Michigan	100	0.1%	West Virginia	10	0.0%
Minnesota	60	0.1%	Wisconsin	70	0.1%
Mississippi	30	0.1%	Wyoming	*fewer than 10	0.1%
Missouri	90	0.2%	DC	40	0.9%
Montana	20	0.2%			

Source: Calculations based on Center on Budget and Policy Priorities; Internal Revenue Service, Statistics of Income; and Centers for Disease Control and Prevention, National Center for Health Statistics.

Appendix 2: Cost Estimates for the President’s Proposals to Help Middle-Class and Working Families

Appendix Table 5: 10-Year Cost (-) and Savings (+)	
Investments to support middle-class and working families	
Reform child care tax incentives	-\$50 billion
Simplify and better target tax benefits for education	-\$47 billion
Provide auto-IRA and reform other retirement tax incentives	-\$20 billion
Expand the EITC for workers without qualifying children	-\$60 billion
Provide a new second earner tax credit	-\$89 billion
Enact other middle-class tax cuts*	-\$13 billion
Expand child care subsidies to all eligible families with young children	-\$78 billion
<u>Partner with States to provide tuition-free community college</u>	<u>-\$60 billion</u>
Subtotal	-\$417 billion
Tax reforms	
Reform capital gains taxation	\$208 billion
Introduce a fee on large, highly leveraged financial institutions	\$112 billion
Close loophole allowing payroll tax avoidance	\$75 billion
<u>Limit retirement account balances</u>	<u>\$26 billion</u>
Subtotal	\$420 billion
TOTAL	\$3 billion
*Other tax cuts in the “Middle-class and pro-work tax reforms” section of the President’s FY 2016 Budget, including simplifying the rules for the EITC for workers without qualifying children and extending the tax exclusion for mortgage debt forgiveness.	