

INTRODUCTION

The Center for American Progress is pleased to host a full-day conference with academic and policy experts from around the country who will highlight options for reforming the tax code. Many experts agree that the tax code is in need of repair. Yet it has been 20 years since the landmark 1986 reform. Given the growing complexity of the tax code, increased revenue pressures, and a changing economy; tax reform will likely be a central issue for 2006 and beyond. This conference will provide a forum for sharing proposals—both quick fixes and broad overhaul—and for open and engaged discussion.

The papers included in this packet are the views of the authors and do not necessarily represent the position of the Center for American Progress.

Many of the papers included are preliminary and subject to revision - please contact the author before quoting or citing.

A FAIR AND SIMPLE TAX SYSTEM FOR OUR FUTURE: A PROGRESSIVE APPROACH TO TAX REFORM

Center for American Progress¹

Summary

The current tax code is unfair, unnecessarily complex, and has failed to meet our national priorities. Today, we are faced with a fundamental choice for our tax structure: continue the policies that have failed the vast majority of taxpayers and our country for the benefit of a few, or reform the tax system consistent with progressive principles. It is time for a fairer and simpler tax system that reduces the massive deficits created over the last four years, strengthens the middle class while honoring their work, and creates opportunity for Americans of all income levels to succeed.

Restoring a fair, simple, and pro-opportunity tax system, while generating the resources necessary to meet our looming challenges, requires moving our tax system in an ambitious new direction. The Center for American Progress proposes a comprehensive tax reform plan that rewards hard work and promotes shared prosperity. We propose a plan that would tax each kind of income according to the same rate schedule, whether the income is derived from wages, salaries, capital gains, or dividends. Our plan shifts the share of taxes away from the regressive payroll tax and onto a restructured income tax. It reduces complexity by establishing a simpler, more progressive three-rate structure, and it eliminates the Alternative Minimum Tax, in addition to closing corporate and individual loopholes. Our plan enhances opportunity by reducing the deficit to strengthen the economy, and it promotes retirement savings for millions of Americans who currently receive no savings incentives through the tax code. Furthermore, our plan improves the Earned Income Tax Credit and expands the number of families eligible to receive the federal Child Tax Credit. Ultimately, the Center for American Progress' reform plan increases the take-home pay of low- and middle-income families and generates the funds our country needs to meet its vital domestic and national security commitments.

¹ Adapted from Center for American Progress, "A Fair and Simple Tax System for our Future: A Progressive Approach to Tax Reform" in Progressive Priorities: An Action Agenda for America, January 2005. Some estimates have been updated to reflect new information.

INTRODUCTION

As a nation, we have established certain fundamental priorities: protecting the safety, security, and health of our citizens; ensuring the right to a world-class education; providing vital public services; and preserving the dignity and basic comfort of our elderly and all individuals who take responsibility for their lives. We have realized throughout our country's history that supporting these priorities requires resources that no individual or small group of individuals could ever hope to raise by themselves. The challenge of tax policy is to generate these resources in a way that is consistent with our values as a nation. Those values can be summarized by three basic principles for our tax code: opportunity, fairness, and simplicity.

These fundamental principles have grown out of our nation's experience. From its beginning, the United States has always valued opportunity. Embedded in our vision of America is the belief that government should never put a limit on the success and wealth of the individual. Indeed, the American culture of innovation and limitless opportunity has been a key ingredient in the economic successes that have driven the great American job machine for generations.

We need a tax code that encourages economic and job growth, continues to reward ingenuity and hard work, and expands the American middle class. We also need a tax system that raises revenue efficiently — that creates as few economic distortions as possible, while still meeting our other national priorities. But large deficits are threatening our nation's ability to foster opportunity for all Americans. The last five years has seen record budget surpluses turned into massive budget deficits. This is a trend that must be reversed.

At the same time, our tax system has at its foundation a basic notion of fairness — that the most successful among us should contribute a greater share to support the collective services we all enjoy. With the enactment of the Income Tax Law of 1913, the federal government applied the principle that taxes should be levied based upon ability to pay. This idea of “progressive” taxation grows from the belief that those who achieve the greatest wealth also benefit the most from what our nation provides. Our schools, the stability of our economy, and public investments in research and innovation all contribute to the successes of America. As Andrew Carnegie explained, “[W]here wealth accrues honorably, the people are always silent partners.”

Finally, Americans have always valued a simple, streamlined role for government in their lives. Complexity in the tax code too often breeds waste and abuse, which erode the fairness and efficiency of our tax code.

Unfortunately, while the above principles are fundamental to America, they are far from representative of our current tax code. These principles lead the Center for American Progress to propose a broad package of reforms of the tax system that reduces taxes for millions of middle-class Americans, rewards work, strengthens our economy, and raises the needed revenue to support our vital national priorities. We propose making the system fair by taxing income at the same levels regardless of how that income was generated and by shifting the share of revenue raised away from the regressive payroll tax. We propose simplifying the code by removing loopholes, broadening the corporate tax base, and reducing the number of tax brackets from six to three. By setting our nation on a path of fiscal responsibility, we can ensure ample opportunity for everyone to succeed in a modern economy.

We deserve a better tax system than the one we have now. Fixing our tax code to better reflect our nation's values while meeting our nation's commitments in a fiscally responsible manner will require nothing less than a wholesale redesign of the current system.

A PLAN FOR PROGRESSIVE TAX REFORM

Restoring a fair, simple, and pro-opportunity tax system, while generating the resources necessary to meet our looming challenges, requires moving our tax system in an ambitious new direction. We propose a comprehensive tax reform plan that rewards hard work and promotes shared prosperity.

The comprehensive reform package proposed below restores balance and fairness to our tax code by shifting to a broad-based progressive tax on each source of income — wages, dividends, and capital gains. The payroll tax is cut in half, while the share of revenue raised by the federal income tax is increased. By converting deductions for retirement savings into refundable credits, we create or enhance incentives for millions of Americans to save for retirement.

The plan takes important steps to restore our revenue-generating capacity by reducing the projected 10-year deficit by nearly \$500 billion, while at the same time eliminating the AMT. It calls for the elimination of tax loopholes and effects sensible corporate tax reforms that remove incentives for corporations to shift production overseas and that increase compliance to ensure that corporate America once again pays its fair share.

Overall, the plan will increase the take-home pay of most households earning under \$200,000 a year, providing an average tax cut of over \$600. Most of those making more than \$200,000 a year will likely see increased tax responsibility relative to current tax policy.²

RESTORING FAIRNESS

After five years of policies that have shifted the tax share onto work and the middle class, hardworking families need real reform that improves their after-tax incomes without bankrupting our economy. We propose fundamentally changing the progressivity of our tax structure in three ways. First, for the very wealthy, the same tax schedule would apply to income no matter the source — a dollar of income from investment would be treated no differently than a dollar earned through work. Second, the plan would shift the tax share of individuals away from the regressive payroll tax while still maintaining a full commitment to Social Security's guaranteed benefit structure. Third, the plan would increase revenue from the very top end of the income distribution, while enhancing the take-home pay of the taxpayers who most need help.

Tax Each Source of Income the Same. For those at the top of the income scale, each source of income — whether from dividends, capital gains, wages or salaries — should be taxed according to the same progressive rate structure. This would reverse the radical direction of our current tax system, and it would ensure that a nurse or firefighter who receives their income through hourly work would not face a higher average tax rate than a wealthy investment banker who receives passive income from accumulated or inherited wealth.

It runs contrary to both our values and ability to grow the middle class to favor passive wealth of the wealthy over the wages of average taxpayers. To encourage savings for those who are not at the very top, and who also hold assets for a number of years, we would allow a portion of realized capital gains to be exempt (as described more fully below).

² The revenue and distribution estimation were conducted by the Urban-Brookings Tax Policy Center's microsimulation model. The estimation was done in December 2004. Comparisons are made against a baseline of current law with the 2001 and 2003 tax legislation extended and do not include the additional tax reductions due to the savings incentives outlined below.

Reduce the Dependence on Regressive Payroll Taxes. The payroll tax has played an important role in our tax system by providing revenue to meet our nation's commitment to retirees. Yet, as described above, the payroll tax is also among the most regressive in our overall tax system. We propose removing the employee component of the Social Security payroll tax, immediately reducing by 6.2 percent the tax rate all Americans pay on the first \$94,200 of earnings.^{3,4} At the same time, we propose removing the cap on the employer side of the payroll tax, making income above the current cap subject to the employer-side tax, and thus making the remaining payroll tax less regressive.

To maintain our full commitment to financing Social Security, we would dedicate a portion of general revenues to the Social Security trust fund. By setting aside 2.25 percent of gross domestic product per year, we would solidify the financial status of the Social Security system. The additional revenue raised by our plan would be sufficient to cover these dedicated funds. Our plan protects this dedicated revenue by having Congress pass procedural rules for the annual budget process — such as requiring a three-fifths majority in the Senate to reduce Social Security funding — to ensure that this funding is not cut. This reform would be sufficient to replace current Social Security revenue and keeps our full commitment to financing Social Security's guaranteed benefit structure — but in a fairer, more sustainable manner.

As part of our effort to reduce dependence on the payroll tax, we would also reform the estate tax. The estate tax is the most progressive of federal taxes: It is only paid by multimillionaires. It raises needed revenue, encourages charitable giving, and affects less than one quarter of one percent of the population — and currently the first \$2 million per individual can be passed from one generation to the next tax-free.⁵ We would increase the exemption to \$2.5 million; married couples would thus be able to shelter twice this amount, or \$5 million, from estate taxes. This would ensure that virtually all small business owners, farmers, and ranchers could pass on their assets without being subject to the estate tax.

Increase Opportunity by Enhancing the Take-Home Pay of Lower-Income Taxpayers. We also propose two specific reforms that are needed to raise the take-home pay of the lowest income earners in the country. First, to ensure that single working parents who currently receive the Earned Income Tax Credit (EITC)

³ This payroll threshold is for 2006 and is adjusted annually.

⁴ Economists generally believe that it does not matter who actually writes the check to the IRS in determining who bears the burden of the tax. In theory, the same end-result could be achieved by eliminating the employer-side, or, alternatively by cutting both rates in half.

⁵ United for a Fair Economy, "Share of Estates Taxed Falls to Fraction of One Percent," available at http://ufenet.org/reports/2006/estate_tax_share_falls.pdf (last viewed March 2, 2005).

do not risk losing any benefits if they marry, we propose altering the tax code to eliminate this disincentive to marriage. Second, we would reform the Child Tax Credit to make it more generous and ensure that low-income workers with stagnant wages can continue to access the benefit. Currently, because the income threshold for receiving the Child Tax Credit is set at \$10,000 and indexed to inflation, many working families living at or below the poverty line do not have enough income to qualify for a full or even partial credit. Over half of African-American children and 40 percent of Hispanic children do not receive the full credit under this arrangement. The Center's plan would lower the income threshold for receipt of the Child Tax Credit to \$5,000 and eliminate inflation indexing, which would allow millions of working families to access their full or increased benefit. This change will allow low-income families with stagnant wages — which are often determined by the minimum wage, which is not indexed — to receive a greater benefit from the credit than under current law. In addition, over time this would increase the number of people who would receive the full benefit from the credit.

SIMPLIFYING THE TAX CODE

George Bush's tax scheme has increased the complexity of our system while shifting the tax share to middle-class taxpayers. We would reverse this trend.

Reduce the Number of Income Tax Brackets. In addition to taxing each source of income equally, we would cut the number of income tax brackets in half, establishing a simpler, more progressive three-rate structure with rates at 15 percent, 25 percent, and 39.6 percent. The three tax rates would apply to brackets of taxable income of \$0 to \$25,000; \$25,001 to \$120,000; and \$120,001 and above. These brackets would be indexed for inflation. The standard deduction would be adjusted slightly to \$10,000 for a married couple and also indexed for inflation.

Combined with the shift away from the employee portion of the payroll tax, most people will see a reduction in their overall tax bill. Households earning less than \$200,000 would see, on average, an increase of \$600 in their take-home pay. (See text box "Distributional Implications" for greater detail.)

In addition, we would also include a \$250 exemption for capital income to simplify tax filing and to reduce the tax share for small investors.

Close Corporate and Individual Loopholes. The complexity of the corporate income tax is hurting our competitiveness and encouraging companies to shift production overseas. By broadening the base of the corporate tax structure we can enhance the overall efficiency of the system, keep rates at relatively low levels, and increase revenues.

Eliminating corporate tax loopholes and special giveaways to the wealthy would provide an estimated revenue gain of \$30 billion annually.⁶ For example, the 2004 \$140 billion corporate tax overhaul legislation included a wide range of specialized credits that should be reexamined. In addition, by closing some of the most egregious loopholes, we would ensure that our tax code no longer offers affirmative incentives for wealthy individuals to shelter taxable income or for corporations to shift production outside the United States.

Eliminate the Alternative Minimum Tax. If left in place under the current system, the Alternative Minimum Tax (AMT) will impact 36 million Americans by 2010.⁷ The AMT adds a significant layer of complexity to the tax-filing process, essentially requiring tax filers to compute their taxes twice. By overhauling the entire income tax code and eliminating personal income tax loopholes, we would ideally eliminate the need for an AMT, and thus address, in a fiscally responsible manner, an important tax challenge facing our country over the next decade.⁸

INCREASING OPPORTUNITY AND INCENTIVES FOR SHARED ECONOMIC GROWTH

Finally, our reform plan is designed to encourage the kind of sustained economic growth that we saw in the 1990s and to increase opportunities for more Americans to join the middle class. Unlike the old failed right-wing trickle-down policies, this plan embodies a new progressive growth strategy based on restoring fiscal discipline, investing in our people, and expanding savings and ownership to the broad middle class.

Fiscal Discipline. Restoring confidence and economic growth requires addressing the record deficits generated under the Bush administration, while keeping our country safe and meeting our commitments to our seniors. American Progress⁹

⁶ Senator John McCain, for example, explained in proposing a Corporate Welfare Commission: “There are more than 100 corporate subsidy programs in the federal budget today, requiring the federal government to spend approximately \$65 billion a year. Terminating even some of these programs could save taxpayers tens of billions of dollars each year.” John McCain, Congressional Press Release, Apr. 17, 2002, available at http://mccain.senate.gov/index.cfm?fuseaction=Newscenter.ViewPressRelease&Content_id=378 (last viewed Jan. 6, 2004)

⁷ William G. Gale, *Key Points on the Alternative Minimum Tax*, Urban-Brookings Tax Policy Center, Jan. 21, 2004, available at <http://www.brookings.edu/views/op-ed/gale/20040121amt.htm> (last viewed Jan. 6, 2004).

⁸ The AMT is currently an important part of the code because it raises significant revenue and because it limits the ability of high-income tax payers to avoid paying. When eliminating the AMT it would be important to place limits on some deductions for very high income individuals and to also limit the ability of high-income individuals to shelter unlimited amounts of income from taxation to ensure that high-income taxpayers are not able to avoid paying taxes. These important purposes of the AMT, however, should be fulfilled in the context of the income tax code and not through what has become a parallel tax code.

tax reform plan would put our country back on a path toward closing our fiscal gap, thus increasing confidence in our economic future and allowing for productivity-enhancing investments in education and research that are keys to our nation's economic success. Significantly, the plan outlined here raises an additional \$478 billion in revenue over 10 years compared with the president's FY2005 budget (which assumes the tax changes enacted in the major 2001-2003 tax bills are extended).⁹

Offer Tens of Millions of Americans New Opportunities to Save and Create Wealth. Today, our tax system is upside-down when it comes to offering incentives to save and create wealth for retirement. Because all retirement savings incentives are provided through upfront tax deductions, higher income individuals are given generous benefits to save while lower-income individuals are given little to no benefit. An individual in the 35 percent tax bracket gets a 35 cent tax break today on every dollar saved for retirement and can accumulate interest on that savings tax-free until retirement. Yet someone in the 15 percent bracket gets only a 15 cent incentive to save now and low-income workers who do not make enough money to owe federal income taxes get nothing for saving.

We propose leaving intact our current retirement savings structure, including IRAs and 401(k) contribution limits and non-discrimination rules. However, we propose to do away with the upside-down deduction-based incentive and replace it with an across-the-board 25 percent refundable tax *credit* for retirement savings. Whether you are an investment banker or a secretary, you would receive 25 cents for every dollar you can afford to put away in an IRA or 401(k). Similar to the current system, the money you save would accumulate tax-free until retirement.

For the 33 million Americans who currently have no income tax liability and hence receive no tax incentives to save, this reform would, for the first time, offer a generous incentive to build for retirement. For 30 million more Americans in the 15 percent income bracket under our plan, this reform would nearly double the tax incentive to save. This component of the plan is revenue neutral, shifting the current tax expenditures on deductibility for retirement savings into the refundable credit for all Americans.¹⁰

⁹ The president's budget assumes that the 2001-2003 tax cuts will be extended. If one also includes in the president's budget the AMT reform desired by the administration, the proposal presented here would raise significant additional revenue relative to the administration's policy.

¹⁰ According to microsimulation estimates, the revenue lost from the refundable credit is approximately offset by the revenue gained by replacing the deductibility.

In addition, in order to encourage long-term savings and provide additional incentives for retirement savings, we would allow those with incomes under \$1 million to exempt a portion of their appreciated assets from capital gains taxation. For assets held less than a year, the full amount of the gain would be subject to the regular income tax rates as described above. For assets held for more than a year, an increasing percentage of any capital gains would be exempted — beginning with 10 percent after the first year and reaching a maximum of 50 percent after five years. For these long-term holdings, those earning less than \$1 million — which covers more than 99 percent of the population — the top marginal effective rate on capital gains would be below the rates that were in effect during the terms of, among others, Ronald Reagan, George H.W. Bush, and Bill Clinton.

Finally, a portion of the nearly \$500 billion set aside for deficit could be used to enhance overall retirement security by financing additional savings incentives. In conjunction with shoring up Social Security and reducing the deficit, we maintain our commitment to a sound financial future for all Americans, young and old.

Overall, our fiscally responsible proposal would make the tax system fairer and less complex, would efficiently raise additional revenue, and would provide higher after-tax incomes for millions of taxpayers. Our great nation deserves a sound tax system that enhances economic growth and allows everyone to benefit from the remarkable success of the American economy. We strongly encourage the president and Congress to take up the challenge of progressive tax reform.

DISTRIBUTIONAL IMPLICATIONS

Overall, our tax plan will increase the take-home pay of most households earning under \$200,000 a year, providing an average tax cut of \$620. Most of those making more than \$200,000 a year will likely see a tax increase relative to current policy.

The main source of reduction for most taxpayers comes in the form of eliminating the employee side of the Social Security payroll tax. This means an immediate 6.2 percent reduction for most people.

Because of the change in the tax rates on capital gains and dividends, some people who have significant income from wealth but little income from wages may see an increase in their tax share. When the entire tax reform plan is considered, 68.4 percent of all taxpayers would receive a cut. The table below shows the impact of the plan on various income groups.¹

Table A. Average Tax Change for Income Groups Under Reform Plan

Cash Income Class (thousands of 2003 dollars)	Percent with Tax Cut	Percent with No Change	Average Tax Change (\$)
Less than 10	59.9	29.4	-220
10-20	63.6	19.3	-524
20-30	73.1	6.6	-620
30-40	73.0	3.8	-496
40-50	72.8	2.0	-519
50-75	76.7	0.4	-687
75-100	76.1	0.1	-950
100-200	73.7	0.0	-1,138
200-500	24.1	0.0	12,722
500-1,000	6.8	0.0	64,752
More than 1,000	3.9	0.0	360,646
All	68.4	9.1	793.1

¹ The calculations do not include the distributional impact of the income exclusion for long-term capital gains. The microsimulation model used to generate the distributional implications currently does not have the capacity to simulate the impact of long-term capital gains exclusions of the type described here. As such, the estimates provided above understate the size of the tax cut for those receiving a cut and overstate the tax increase for those who receive an increase in our plan. When the exclusion for long-term capital gains is included, we estimate tax changes relative to current policy for the various income classes to be: (1) less than \$10,000: -224; (2) \$10-20,000: -533; (3) \$20-30,000: -639; (4) \$30-40,000: -523; (5) \$40-50,000: -568; (6) \$50-75,000: -779; (7) \$75-100,000: -1,127; (8) \$100-200,000: -1,598; (9) \$200-500,000: 10,285; (10) \$500,000: 54,684; (11) more than \$1,000,000: 360,646.