As journalists like Nicholas Confessore and Jonathan Chait have recounted, conservatives seeking to shift America away from progressive income taxes and toward a wage tax have never pursued their goal directly because of its obvious regressivity. Instead, they have pursued their goals piecemeal. Right-wing lobbyists and strategists came up with a strategy known as “five easy pieces” for tax reform.¹

As this scorecard shows, a sympathetic President and conservative Congress have made substantial progress on that agenda.

The five pieces are 1) flatter marginal tax rates and lower rates for high-income taxpayers, 2) elimination of the tax on income from wealth, 3) elimination of the Alternative Minimum Tax (AMT), 4) allowing unlimited tax-free savings, and 5) allowing full expensing of business investments.² Notably miss-


²Reports have differed on the exact definition of the five pieces, with some excluding AMT elimination and instead including estate tax repeal. In this report, I have included estate tax repeal under item 2.
Table 1: Personal Income Marginal Tax Rates, 2000-2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax Rates (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>15 28 31 36 39.6</td>
</tr>
<tr>
<td>2001</td>
<td>15 27.5 30.5 35.5 39.1</td>
</tr>
<tr>
<td>2002</td>
<td>10 15 27 30 35 38.6</td>
</tr>
<tr>
<td>2003</td>
<td>10 15 25 28 33 35</td>
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<tr>
<td>2004</td>
<td>10 15 25 28 33 35</td>
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<tr>
<td>2005</td>
<td>10 15 25 28 33 35</td>
</tr>
</tbody>
</table>

...ing from the “five easy pieces” strategy is tax simplification and base broadening, two fundamental components of real reform.

There is a better approach. The following report assesses the progress already made on the “five easy pieces” strategy, examines the implications of the changes, looks at the prospects for additional tax changes, and outlines a better approach.

1 Lower and Flatter Marginal Income Tax Rates

Since 2000, the President and Congress have significantly reduced tax rates, especially for those at the top. Table 1 shows the changes made to the code since 2000. While the overall impact of these changes has been a huge reduction for those at the top, it has meant only a small tax reduction for taxpayers in the middle.
Implications

In 2004, the tax cuts enacted by the President, which included the rate changes above, led to an average tax reduction of about $650 for those in the middle 20 percent of the population, while those making more than $1 million a year saw a reduction of over $100,000.\(^3\)

For lower-income Americans, the administration’s focus on the federal income tax (as opposed to on the payroll tax, or providing aid to states to prevent state or local tax increases) meant that nearly 32 million tax filers—including 58 percent of people making under $20,000—did not receive any tax reduction.\(^4\) And since many more people saw increases in state and local taxes, tuition increases, or other service reductions, millions more saw no increase in their take-home pay.

These changes have also led to massive deficits. Over the past five years, the U.S. debt has grown by $2.3 trillion.\(^5\) Federal revenue for 2004 as a share of GDP was the lowest since 1959. Over the next decade, under current law, the government is projected to rack up $2.1 trillion in additional debt, and extending the Bush tax changes and other expiring provisions would add another $1.9 trillion on top of that.\(^6\) Compared to the projections of surpluses that were expected before Bush’s economic policy was enacted, this represents an


unprecedented deterioration in our nation’s finances.

Outlook

From the conservative perspective, there is still more to do. Because of the way the administration forced through the tax changes, additional legislation is required to make the tax cuts permanent. In addition, there are many who would like to continue the trend by replacing the income tax with a flat tax, a value added tax (VAT), or a national retail sales tax. All of these proposals would be another burden to the lower- and middle-income taxpayers and yet another boon to the wealthy.

A Better Approach

The overall structure of the tax code is moving in the wrong direction. Rather than flattening the rate structure in the federal income tax code, we need to provide a reduction to lower- and middle-income taxpayers (who tend to pay more in payroll taxes), while reversing the changes that overwhelmingly benefit those who have the highest earnings.

Rather than continuing the irresponsible policies that have led to massive deficits, our tax code needs to raise adequate revenue with a progressive rate structure that adequately funds vital domestic and international priorities. As a nation, we should not be passing the bill to our kids and future generations. The Center for American Progress has released a comprehensive reform plan that moves our tax code in the right direction.7

7 See Center for American Progress, “A Fair and Simple Tax System for our Future,”
Table 2: Marginal Tax Rates on Capital Gains and Dividends, 2000-2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital gains (%)</th>
<th>Dividends (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>10</td>
<td>20</td>
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<td>2001</td>
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<td>2004</td>
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<tr>
<td>2005</td>
<td>5</td>
<td>15</td>
</tr>
</tbody>
</table>

For tax years 2001-2002, the tax rate on assets held more than five years was reduced by 2 percentage points to 8 and 18 percent. For 2000-2002, dividends were taxed as ordinary income, see Table 1.

2 Eliminate Tax on Income from Wealth

The second goal in the five easy pieces strategy is to eliminate taxes on income from accumulated wealth. Since 2000, we have seen additional preferences for capital gains and dividends. Table 2 shows how capital gains tax rates have been reduced across the board, and how dividend tax rates have been slashed.

In addition to the above reductions, the estate tax, which taxes only very large inherited fortunes at death, is currently being phased out, and will be repealed in 2010.

Implications

Since over half of all capital gains and dividends subject to preferential treatment go to those making more than $1 million per year, the benefits to these tax changes are extremely skewed to a narrow, wealthy segment of the population.

Outlook

Congress intends to continue to push to extend lower capital gains and dividend tax rates through the budget reconciliation process this year, and they will likely be on the agenda next year when Congress again attempts to make permanent this and other tax changes. The first step will likely be to extend cuts past their current expiration date in 2008, with further reductions to come as part of a longer-term agenda.

A Better Approach

In an economy in which advanced skills and education are increasingly important drivers of economic growth, a tax system that rewards physical capital at the expense of “human capital” is counterintuitive and bad for economic growth. A better approach would be to restore the balance between the taxation of capital income and labor income for high-income taxpayers. The American Progress plan taxes capital gains and dividends at the same rate as income from labor for those making more than $1 million per year and for short-held assets. Assets that are retained for longer than five years would receive an exclusion of up to 50 percent for people earning less than $1 million per year. The plan also
retains a reformed estate tax with a $2.5 million exemption per individual.

3 Eliminate the AMT

The Alternative Minimum Tax is effectively a second, parallel tax system that was initially designed to ensure that very high-income tax filers were not able to avoid taxation altogether.

A combination of factors—the failure to index the AMT to inflation, and the decision not to adjust the AMT for recent changes in tax laws—means that the AMT will be a concern to millions more increasingly middle-class taxpayers over the next five years. Unless changes are made, by 2010, 31 million tax filers will owe more due to the AMT.8

Calls to eliminate the AMT have been rightly made on the grounds that the AMT adds additional complexity to the tax code.

Implications

Simply removing the AMT without other reforms would provide a windfall benefit to high-income taxpayers and would allow many to avoid taxation altogether. Already, even with the AMT, 5,650 high-income tax filers were able to avoid paying any federal income tax, according to the IRS.9 This number would likely explode if the AMT were simply removed without making other changes.

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Outlook

Thought the AMT problem has been delayed, it has not been fixed. A permanent solution will cause significant revenue loss, and Congress has simply been pushing the problem down the road one year at a time. Reforming the AMT by indexing the exemption to the higher 2005 level would cost close to $400 billion by itself, or significantly more if the 2001-2004 tax changes are extended.\footnote{Congressional Budget Office, “The Budget and Economic Outlook: An Update,” August 2005, available at http://www.cbo.gov/ftpdocs/66xx/doc6609/08-15-OutlookUpdate.pdf.} The President’s tax reform commission will also propose repealing the AMT as part of a larger, revenue neutral reform package.

A Better Approach

Eliminating the AMT must be done in a fiscally responsible and fair manner. Attention needs to be paid to the massive revenue loss that would be associated with repeal, and these losses need to be offset elsewhere in the tax code. At the same time, closing individual loopholes that allow high-income taxpayers to avoid their tax obligations must be part of the reform as well.

4 Allow Unlimited Tax-Free Savings

Recent tax changes have increased the contribution limits to 401(k)s and IRAs, and have expanded the income limits to contribute to Roth and traditional IRAs. We have also seen the establishment of Health Savings Accounts for those with high-deductible insurance plans.
The Bush administration has proposed expanding tax-free savings accounts for retirement, health, and other expenses. Since upper-income individuals tend to save more (because they have higher incomes and because they can get by while consuming a smaller share of their income,) they would receive the bulk of the benefits from this policy.

**Implications**

For a policy that is meant to encourage savings, we have seen no evidence that national or personal savings has increased. In fact, the long-term trend of declining savings rates has continued and recently hit historic lows. According to income data from the Bureau of Economic Analysis, the personal savings rate hit zero this past summer, and is currently negative.

Also, a mere 5 percent of the population has maxed out their retirement accounts—meaning that increasing those levels will only benefit a small percentage of the population.11

**Outlook**

President Bush’s recently proposed federal budgets have included expansion of tax-preferred savings, including Lifetime Savings Accounts, Retirement Savings Accounts and Health Savings Accounts, and he has repeatedly pushed for Social Security privatization accounts as well. We will likely see continued pushes for additional tax-free savings accounts in the future.

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A Better Approach

A better approach to encouraging savings would be to target incentives to those who need the most help. Those with higher incomes already save a larger fraction of their incomes, and have less need for encouragement. As those at the lower end of the income distribution have less ability to save since a higher percentage of their incomes are devoted to life’s necessities, a generous matching contribution or annual federal contributions would be essential to stimulating savings for low-income Americans.

Also, consolidating the myriad savings plans available through employers and at the individual level would greatly simplify the system for those who currently take advantage of these plans.

5 Allow Full Expensing of Business Investments

On the corporate side, conservatives have been pushing to allow corporations to “expense” investments in new equipment. In theory, this would lower the cost of capital and hopefully expand the capital stock—thus increasing economic output, productivity, wages and living standards.

Section 179, expensing for small businesses, has been expanded, and bonus depreciation provisions that were in effect through 2004 provided significant tax reductions for businesses.
Prospects

The President’s tax reform panel has made expensing part of its reform proposals, and there is strong support for accelerated depreciation provisions on Capital Hill. Expensing will likely remain a top issue in corporate tax reform in the coming months.

A Better Approach

While a growing capital stock should be a high priority, we should also make sure that the tax code encourages the expansion of the stock of “human capital” as well. Businesses should be allowed to expense spending for job training and tuition payments for employees.

Also, expensing should not be blindly enacted without reforming other parts of the corporate tax code—in particular, it is essential to couple this reform with the removal of the deduction for interest expenses for non-financial institutions. And expensing would carry significant revenue costs, so any reform should contain full offsets as well.

Since this change will benefit corporations and businesses already flush with retained earnings, we would only look to implement expensing as part of a broader reform package that simplifies the code for small businesses, and that ensures that large profitable corporations are unable to game the system and are required to pay their fair share of taxes.