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.

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 four years have 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.

**CURRENT STATE OF PLAY**

Before we can fix the tax code, we must first understand how we arrived at the current state. The Bush tax schemes enacted over the past four years have burdened us with a tax system that has become increasingly unfair, overly complex, and antithetical to opportunity and shared economic growth.
ERODING FAIRNESS
Recent tax policy changes have moved our system away from the basic principle of fairness. This can be most clearly seen in two areas: first, the tax share has shifted away from those who can best afford to pay and onto the middle class; and second, corporations have largely been able to avoid their obligation to pay taxes, often by shifting operations overseas. The result is an increased reliance on a regressive payroll tax, which falls most heavily on lower- and middle-income taxpayers.

Wealth and Work
Recent tax policy has shifted a large share of taxation away from the passive (i.e., unearned) income of the wealthy and onto the work and wages of middle-class workers. President Bush’s effort to eliminate the estate tax, eliminate taxes on capital gains and dividends, and offer new tax-free savings accounts are all intended to eliminate the taxes paid on income from passive wealth. In 2003, billionaire financier Warren Buffett offered a stark example of this effort when he explained that if dividend taxes were eliminated, he would pay a tax rate ten times lower than what his secretary paid.¹

There is little doubt that the benefits of the Bush tax policy were dramatically skewed toward benefiting the wealthy to the detriment of the typical American worker. In 2004, households making more than $1 million received an average federal income tax cut of $123,592, while the average change for those in the middle 20 percent of income was only $647.² At the time the new federal tax laws took effect, many of those in the middle class saw increases in their state and local taxes.³ In addition, from 2000 to 2003, middle-class incomes fell by over twice

Figure 1. Federal Tax Receipts By Source 1954-2004

the amount of the federal tax benefit. Therefore, the overall economic impact of the Bush plan for middle-class Americans was negative.

Equally important, the tax changes shifted the relative share of taxation onto work and onto the middle class. Fiscally irresponsible anti-tax advocates often justify large tax cuts for the wealthiest on the argument that the wealthy are the ones who earn the most income. However, by focusing many of the tax benefits on passive income from investments, President Bush offered individuals in the top 1 percent income bracket a whopping 34 percent of the benefits from the irresponsible tax cuts. As a result, Bush’s tax changes reduced the share of federal taxes paid by the top 1 percent of earners, while increasing the share paid by the middle fifth of workers. These changes thus shifted the tax code to reward wealth at the expense of work.

The focus on tax giveaways to the wealthiest taxpayers has deprived our system of vital income tax revenues that are used to fund our domestic and international priorities. At just 16.2 percent of gross domestic product (GDP), total revenue for fiscal year 2004 was at its lowest level since 1959. Also, as a percent of GDP, revenues from the federal individual income tax fell in 2004 to their lowest level since 1950. In only four years, individual income tax receipts have dropped from 49.9 percent of total tax receipts to only 42.6 percent of receipts (see Figure 1 on page 27).

CORPORATE AVOIDANCE
While the middle class is paying a larger share of federal taxes, major U.S. corporations are paying less and less. Though the corporate income tax rate structure maintains a degree of progressivity, it is riddled with loopholes. A recent study found that 82 of the nation’s largest corporations paid zero taxes in at least one of the last three years, and 28 corporations did not pay taxes in any of the years despite generating pre-tax profits of $44.9 billion over the period. Part of the increase in corporate tax avoidance is explained by an explosion in the shifting of investment and profits overseas. Profits of foreign subsidiaries of U.S. corporations in major tax havens soared from $88 billion in 1999 to $149 billion in 2002. Profits in zero-tax Bermuda tripled over this short period.

Increased avoidance—both overseas and domestically—has sent overall corporate tax revenue to historic lows. In 2003, corporate taxes were only 1.2 percent of GDP—their second lowest level as a share of our economy since 1934 (corporate taxes were 1.1 percent of GDP in 1983). In addition, the role of corporate revenue in meeting our overall revenue needs has fallen in the past four years.

INCREASING RELIANCE ON THE PAYROLL TAX
Our tax system has become increasingly reliant on one of the most regressive components of our tax system: the Social Security payroll tax. Beginning with the Social Security Act of 1935, the federal government has imposed a tax on workers’ wages to help finance Social Security benefits. From its initial rate of 2 percent—collected equally between employee and employer—the payroll tax has increased steadily over time to meet the growing cost of Social Security. Today, all workers pay a flat 6.2 percent tax on their earnings up to $90,000 to help finance Social Security, and their employers pay an additional 6.2 percent on their worker’s behalf as well. Similarly, workers pay a flat 1.45 percent Medicare payroll tax, which is matched by a 1.45 percent tax paid by their employers to help finance Medicare.
The payroll tax is highly regressive, imposing an effective tax rate that is four times larger for middle-income workers than those in the top 1 percent. (See Figure 2, which shows the effective social insurance tax rate—the amount of taxes paid by each group as a percent of total income.) The payroll tax only accounted for 23 percent of federal revenue in 1970 but now makes up an astounding 40 percent. Unless we make structural changes to our tax system, we are poised to enter the baby boom retirement years increasingly reliant on the regressive payroll tax to cover the revenues our nation needs, thus further shifting the tax share onto the middle class.

Increasing Complexity
Our tax code is too complex. Increased complexity can mean a tax system that is overall less fair as well as less efficient—which ultimately takes a toll on our economy. Costs of compliance, recordkeeping, and the time spent filing taxes can quickly add up. The Standard Federal Tax Reporter, the reference point for accountants and other tax professionals, has grown to more than 60,000 pages in length. The process for even paying taxes is so bewildering that H&R Block alone now boasts annual revenues of $3.8 billion.

Yet while everyone seems to decry the complexity of our tax code, there has been far more appetite for tax cuts for the wealthy than for tax simplification. Indeed, one of the least understood results of President Bush’s tax policy is how much complexity it has added to the tax code. After pledging to make things simpler in 2000, President Bush has actually added 10,000 pages to our tax code and related regulations.

Figure 2. Effective Social Insurance Tax Rate

President Bush’s tax policies have increased the number of tax filers subject to the Alternative Minimum Tax (AMT). The AMT was first established in 1969 to ensure that the very wealthiest Americans do not avoid paying their fair share. While the AMT only applied to 9,000 people in 1970, its income limits are not indexed to inflation, so the number of individuals subject to the AMT grew to 1.3 million in 2000.\(^{18}\)

Since then, the number of people affected by the AMT has continued to increase, in part because the Bush tax policies lowered some taxes at the high end, but did not appropriately adjust the AMT. Within the next five years, it is expected that nearly a third of all tax filers will be subject to the AMT.\(^{19}\)

In addition, complexity is adding to the unfairness of our tax code. Tax complexity for both individuals and corporations can create “gray areas” in which some are able to take advantage in ways not foreseen by the code. This favors those wealthier individuals and corporations who can afford tax accountants and professional tax preparers to exploit holes in the system. For lower- and moderate-income families, the cost of a tax preparer can take a big chunk out of their disposable income. This can result in a situation in which two tax filers in similar situations face very different tax payments. In addition, too many end up not collecting the benefits they are afforded through the code due to complexity.

### Undermining Opportunity and Shared Economic Growth

While “unfair” and “complex” are not words one would hope to use to describe a tax system, some measure of either might be acceptable if it contributed to a tax code that encouraged opportunity and helped spur economic growth and job creation. Unfortunately, the same tax policy changes that have made our tax system less fair and more complex have also undermined opportunity and threaten to undermine our economy’s growth potential in the future.

President Bush’s tax policies are largely responsible for turning the record budget surpluses that were achieved in the late 1990s into record budget deficits, generating the sharpest deterioration in fiscal conditions under one president in the nation’s history. The drastic downturn in our fiscal situation comes at just the wrong time. In the next few years, the retirement of the baby boom generation will begin to impose enormous costs on Social Security and Medicare. Those costs will only expand in the coming years as more baby boomers retire. As a result, we are facing a dramatic fiscal gap over coming decades—a structural shortfall between the revenues our system will bring in and the already known national commitments (not to mention the unknown future needs for big ticket items such as homeland security). Moving forward without addressing this long-term fiscal gap—projected to be about 5 percent of the size of our economy—is irresponsible.\(^{20}\) We are driving toward the edge of a cliff, and it is up to us to either take a sharp turn or face the consequences of driving straight off.

Despite recent claims by some that deficits do not matter,\(^{21}\) deficits do matter to the nation’s economic health. Deficits reduce national saving, which reduces the resources available for both public and private investments, thereby driving up interest rates, which directly affects us all.\(^{22}\) Less investment means less productive capacity in the future, which means lower living
standards for American families. Deficits also increase the interest payments that the federal government must pay each year on the national debt, leaving fewer funds for productive public investments such as education, scientific and medical research, and domestic infrastructure.

Deficits also increase the amount of federal debt held outside the United States. At present, 43 percent of the public debt is now held outside the country, almost half of which is held by China and Japan. Specifically, of the $1.85 trillion of our debt held by foreigners, $174 billion is held by China and $720 billion by Japan. This raises the risk that if confidence in the U.S. economy erodes, foreign debt holders will withdraw their investments, causing the value of the dollar to fall and interest rates to rise, perhaps dramatically. The prospects for such a hard landing are real. Former Federal Reserve Chairman Paul Volcker recently said he believes that there is a 75 percent chance of a major financial crisis in the United States over the next five years.

President Bush’s tax changes were premised on old supply-side logic that has found little factual support. The radical right-wing applauded these tax changes and the resulting fiscal deterioration under the theory that it would stimulate investment and savings, and would lead to job growth and long-term advances in productivity. As of July 2005, job growth since the 2001 recession has been substantially below the average of past recoveries. While the average post-WWII recovery has seen employment growth of 2.29 percent at this point following the end of a recession, the most recent recovery has seen meager growth of just 0.60 percent. National savings has deteriorated dramatically in the past four years, leaving the economy in worse shape than before the tax changes.

Additional reductions in the top marginal tax rates are simply not an efficient way to stimulate investments—they provide a windfall to high-income individuals, while providing little incentive for additional savings and investments or job creation. Indeed, when a number of independent organizations looked at the long-term impact of Bush’s tax scheme—taking into account both the impact of the deficit and the potential growth-enhancing features—they found that the overall impact on growth would be negligible. As the nonpartisan Congressional Budget Office (CBO) explained, “[T]he net effect on economic output could be either positive or negative . . . importantly, regardless of its direction, the net effect on output . . . would probably be small.” We have paid trillions in debt to our future for an ideologically driven tax policy that has failed to help our economy grow.

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 plan takes important steps to restore our revenue-generating capacity by reducing the projected ten-year deficit by nearly $500 billion, while at the same time eliminating the need for the AMT. The plan provides bold new incentives for lower-
middle-income families to save and create wealth. And 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.28

We recommend that the Congress pass legislation based on the tax reform components outlined below. In addition, the Bush administration and the Congress should work together to convene tax experts to identify corporate loopholes that should be eliminated.

Restoring Fairness
After four 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, under our plan 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 raise revenue from only 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.** 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 his or her 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 over wages. 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 some of the capital gains to be exempt (as described more fully 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 $90,000 of earnings. At the same time, we propose removing the cap on the payroll taxes paid by employers, making
income above the current cap subject to the employer-side tax, 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. (Details can be found in Addendum I. entitled “Protecting Our Commitment to Retirement Security.”) Our plan protects this revenue by having Congress pass legislation that includes a number of safeguards to prevent Congress from reducing this dedicated stream, including a requirement that any reduction can be made only after a three-fifths majority vote in the Congress, 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 multi-millionaires. It raises needed revenue, encourages charitable giving, and affects less than 2 percent of the population—and currently the first $1.5 million can be passed from one generation to the next tax-free. 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) 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. Because the income threshold for receiving the Child Tax Credit is set at over $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. American Progress’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 raised 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,

**ELIMINATING WASTEFUL CORPORATE TAX LOOPHOLES AND SUBSIDIES**

We believe that by reducing the complexity of the corporate income tax code, we can broaden the base of the corporate tax structure and increase revenue while enhancing the overall efficiency of the system and keeping tax rates relatively low. We would eliminate corporate tax loopholes and special giveaways, which by conservative estimates would provide an estimated revenue gain of $30 billion annually.\(^{32}\)

In particular, we would propose creating a Bipartisan Commission on Corporate Subsidies. Because of the political challenge to eliminating specific corporate subsidies and tax loopholes, the president should initiate a corporate welfare commission modeled on the federal military base-closing process. Such a commission would give a bipartisan group of senior officials the leeway to identify wasteful loopholes and subsidies and develop a comprehensive proposal to be presented to the Congress for an up-or-down vote. For example, many of the perks included in the recent corporate tax bill have little economic justification and should be reexamined.\(^{33}\) Senator John McCain has estimated that such a commission could save taxpayers “tens of billions of dollars each year.”\(^{34}\)

To take just one example of a loophole that could be addressed, Congress should pass an international corporate tax reform bill that removes damaging incentives for companies to shift production abroad. Some of the specific provisions that should be addressed are:

- **Ending deferral.** One of the key provisions that encourages companies to move profits overseas is what is known as “deferral,” which allows U.S. corporations to avoid paying taxes on profits earned abroad as long as those profits are not brought back into the U.S. The Joint Committee on Taxation estimates that ending deferral would raise about $8 billion a year in revenue.

- **Closing the Bermuda tax loophole.** Today, U.S. firms can move their headquarters to foreign tax havens to avoid paying taxes in the United States. Closing this loophole, known as corporate inversion or the “Bermuda loophole,” would raise about $2.6 billion a year in revenue.

- **Clarifying the definition of offshore tax shelters.** Currently there is no single definition of “tax shelter,” which forces the Treasury Department and the IRS to disallow them on a case-by-case basis. Clarifying the definition of tax shelters would reduce waste, make it harder for new variants of shelters to be developed, and raise about $13 billion a year in revenue, according to the Joint Committee on Taxation.

In addition, and just in this past year, there were numerous additional loopholes passed benefiting railroad companies, a few oil companies, and other special interests that need to be addressed.\(^{35}\)
on average, an increase of over $600 in their take-home pay. (See the text box entitled “Distributional Implications” on page 34 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. For example, the recently enacted $140 billion corporate tax overhaul includes a wide range of specialized credits that should be reexamined. (See the text box entitled “Eliminating Wasteful Corporate Tax Loopholes and Subsidies” on page 35 for greater detail.) 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 Need for the Alternative Minimum Tax. If left in place under the current system, the Alternative Minimum Tax (AMT) will impact 36 million Americans by 2010. 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 that are currently limited by the AMT, we would 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.

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 Progress’s 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 the next ten years compared with the president’s FY2005 budget.
While we emphasize the need to restore responsibility by raising additional revenue, our plan does not represent a significant departure from average levels of taxation over the last 25 years. Indeed, as Table 1 on page 38 shows, revenue as a share of GDP over the next five years under the plan would be lower than the average under any of the last four presidents. What is important about this reform is that it reverses the course of the current tax structure and begins to raise additional revenue needed to meet our future challenges.

REVENUE IMPLICATIONS

Record deficits combined with vital domestic and international spending needs necessitate increasing revenue above the current, historically low levels. Our fiscally responsible plan takes important steps to restore our revenue-generating capacity by reducing the projected ten-year deficit by nearly $500 billion relative to current policy.

While we believe it is necessary to raise revenue levels above where they are today, we realize that many “revenue neutral” proposals—that is, proposals that neither raise nor lower revenue—will be presented in the coming months. In order to create an “apples-to-apples” comparison we have analyzed the impact of making our plan revenue neutral. By doing so, we would be able to raise the threshold for the top tax bracket from $120,000 to $170,000, or alternatively we could raise the threshold for the middle tax bracket from $25,000 to $33,000. The table below shows the full impact of the revenue neutral plan on various income groups.

Table B. Average Tax Change for Income Groups: Revenue Neutral Options

<table>
<thead>
<tr>
<th>Cash Income Class (thousands of 2003 dollars)</th>
<th>Revenue Neutral: Top Bracket to $170,000</th>
<th>Revenue Neutral: Middle Bracket to $33,000</th>
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</thead>
<tbody>
<tr>
<td>Percent with Tax Cut</td>
<td>Percent with No Change</td>
<td>Average Tax Change ($)</td>
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<tr>
<td>----------------------</td>
<td>-----------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td>Less than 10</td>
<td>59.9</td>
<td>29.4</td>
</tr>
<tr>
<td>10-20</td>
<td>63.6</td>
<td>19.3</td>
</tr>
<tr>
<td>20-30</td>
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<td>0.1</td>
</tr>
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<td>100-200</td>
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<td>0.0</td>
</tr>
<tr>
<td>200-500</td>
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</tr>
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<td>More than 1,000</td>
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</tr>
<tr>
<td>All</td>
<td>69.7</td>
<td>9.1</td>
</tr>
</tbody>
</table>
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.

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 up-front 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 Individual Retirement Accounts (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.40

| Table 1. Total Revenue as a Percent of Gross Domestic Product |  
|-------------------|---|
| Reagan            | 18.1 |
| Reagan I          | 18.4 |
| Reagan II         | 17.9 |
| Bush I            | 17.9 |
| Clinton           | 19.2 |
| Clinton I         | 18.3 |
| Clinton II        | 20.1 |
| Bush II           | 17.5 |
| Latest year (2004)| 16.2 |
| American Progress Tax Plan 2005-2014 | 17.2 |
| 2005-2009         | 17.1 |
| 2010-2014         | 17.2 |

Source: Historical data from the Congressional Budget Office; calculations based on revenue and GDP projections from the Tax Policy Center.
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 reduction could be used to enhance overall retirement security by financing additional savings incentives. Our vision of what a progressive savings plan should look like is more fully described in Addendum I. “Protecting Our Commitment to Retirement Security.” 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.

Addendum I.

PROTECTING OUR COMMITMENT TO RETIREMENT SECURITY

Social Security
As a nation, we have developed a variety of policies to ensure the health and wellbeing of older Americans. The most important retirement security programs are Social Security, Medicare, and various tax incentives to save for retirement. While each of these programs has served us well, they can and should be improved.

The funding for Social Security currently relies on the regressive payroll tax, and will have to rely on funding from general revenue, starting in 2019, unless benefits are cut or the payroll tax is increased. According to the Congressional Budget Office, in 2025 more than 0.5 percent of gross domestic product (GDP) will have to be shifted from general revenues, and in 2050 over 1 percent of GDP would be required.41

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.
To strengthen the financial foundation of Social Security, we would replace the revenue from the employee portion of the payroll tax, which is currently dedicated to Social Security, by eliminating the income cap on the employer share of the payroll tax and by immediately dedicating from general revenues an amount equal to 2.25 percent of GDP each year. The additional revenue raised by our plan would be sufficient to cover these dedicated funds and is accounted for in our revenue and distributional estimates. This amount would replace the revenues lost from the Social Security payroll tax and would provide $421 billion in additional contributions to the trust fund over the next 10 years (see Table C, above).

In order to protect this dedicated revenue, Congress should pass legislation that commits the equivalent of 2.25 percent of our GDP from our general revenues to funding Social Security. In addition, this legislation should include a number of safeguards to prevent Congress from reducing this dedicated stream, including a requirement that any reduction can be made only after a three-fifths majority vote in the Congress, to ensure that this funding is not cut.

By doing this, we guarantee additional revenue to the Social Security trust fund in the immediate future, and also enhance long-run solvency. Currently, according to various estimates, the Social Security trust fund is projected to run out in 40 to 50 years, and faces a long-run cumulative shortfall over the next 75 years. By dedicating 2.25 percent of GDP to the trust fund annually and eliminating the cap, we are able to cut in half the long-run, 75-year difference between dedicated revenues and outlays.

While other parts of the Social Security system may eventually need to be addressed, our plan enhances our ability to guarantee full benefits to both older and younger Americans. In addition, by reducing the deficit by nearly $500 billion over 10 years, we are also increasing national savings and enhancing our ability to address other longer-term challenges.

## Retirement Savings Incentives

The current structure of tax incentives to save is upside-down. Since most retirement savings incentives are provided through tax deductions, higher-income individuals are given generous

<table>
<thead>
<tr>
<th>Table C. Securing Revenue for Social Security</th>
<th>10-year Revenue Impact ($ billions, 2005-2014)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eliminate Employee Social Security Payroll tax</td>
<td>-3,663</td>
</tr>
<tr>
<td>Remove taxable income cap</td>
<td>686</td>
</tr>
<tr>
<td>Dedicate 2.25 percent of GDP</td>
<td>3,398</td>
</tr>
<tr>
<td>Total Additional Contribution to the Trust Fund</td>
<td>421</td>
</tr>
</tbody>
</table>

benefits to save while lower-income individuals are given little to no benefit. Securing the retirement of all Americans in a fair manner requires changing the current approach.

We propose leaving intact the current structure of retirement plans and replacing the current deductions with a flat 25 percent refundable tax credit for retirement savings. This revenue neutral change would mean an increase in the incentives to save for over 60 million Americans, and would provide—for the first time—an incentive for lower-income families to save for retirement.

In addition, we strengthen our commitment to retirement security by providing an additional benefit to lower- and middle-income savers. By raising enough revenue to reduce the deficit by nearly $500 billion, there would be enough revenue to create additional savings incentives such as providing a matching contribution to retirement savings for low- and middle-income workers. These matching funds and the base contributions would provide an important supplement to Social Security and enhance overall retirement security.

We recommend implementing retirement savings incentives that provide additional matching funds for low-income savers, and then phasing out the match for higher income levels above $100,000. In addition, we would include a modest automatic contribution for low-income families, who often find it difficult to contribute due to a lack of disposable income. The accounts would be managed in a cost-effective manner that limits personal risk. This enhanced savings and retirement wealth would provide an important supplement to Social Security and enhance overall retirement security.

Addendum II.

THE BUDGET AND BUDGET PROCESS

President Bush and the Republican-controlled Congress with which he has worked so closely for the last four years have racked up an unparalleled record of fiscal irresponsibility. Largely through reckless tax cuts, they have turned the record budget surpluses that they inherited in 2001 into massive budget deficits, generating the sharpest deterioration in fiscal conditions under one president in the nation’s history.

Moreover, the president and Republican congressional leaders continue to push for tax and spending policies that, if adopted, would take an increasingly perilous fiscal situation and make it even more dangerous to the nation’s economic future, leading to a weaker economy, continued job loss, a wider gap between the rich and poor, unmet needs in education, health care, and other key priorities, and lower living standards for most Americans. Our budget situation brings to mind the first rule of holes: when you’re in one, stop digging. That is, with our deficit at a historically high level, the last thing we should do is make it worse.

In addition, the annual process by which the federal government sets overall priorities for the budget is in desperate need of an overhaul. The last few years have seen a flood of missed deadlines, continuing resolutions to keep the government operating, and the use of omnibus
legislation to quickly finish remaining appropriations. The result is a loss of transparency in the process, excessive influence by special interests, and the potential for a variety of abuses. For example, a provision that would have allowed members of Congress or their staffs to snoop on private citizens’ tax returns nearly made it into law in the 2004 omnibus passed last December.45

We propose a bold change in budget policy that would again place fiscal discipline at the center of the nation’s budget policy while continuing to invest in vital domestic and international programs.

Our tax plan would reduce the deficit; however, a lower deficit is not the sum total of a responsible budget policy. While reducing the deficit, we must also set priorities so that we can find the resources to invest in programs that will raise the standard of living and quality of life for Americans in the future. That means more investment in education and health care, in environmental protection and law enforcement, and in our transportation and communications networks so that we can take advantage of cutting-edge technology and boost productivity.

In balancing the needs of deficit reduction and investment, the federal government of the 1990s benefited from budget rules that imposed discipline while providing the requisite flexibility through which members of Congress could make choices. Those rules have since expired, and we propose that Congress amend the budget process to restore them, as described below. We also propose other steps that would help Congress make the difficult choices among programs.

Responsible Budgeting
We propose several initiatives that will enable the president and Congress to pursue fiscal discipline as well as to find the resources to invest in high-priority programs.

• *Restore PAYGO rules for new tax cuts or entitlements.* For most of the 1990s, the pay-as-you-go, or PAYGO, rules required that if Congress wanted to cut a tax or create or expand an entitlement program, lawmakers had to offset the costs by raising other taxes or cutting other entitlement programs. The PAYGO rules were widely credited with imposing needed discipline while giving Congress the flexibility to make tax and spending changes that it deemed necessary. The rules expired several years ago. We believe Congress should restore them.

• *Prohibit the use of budget reconciliation measures that increase the budget deficit.* Under the congressional budget process, budget reconciliation has been a key step in ensuring that committees follow through on their obligations to find budget savings. It was never supposed to provide a quick avenue for tax cuts or other measures that would increase the deficit. Congress should specifically prohibit the practice.

• *Avoid block-granting of entitlement programs.* Increasingly, Congress has moved towards placing entitlement spending into block-grants to states. This practice allows federal legislators to avoid the hard decisions required when cutting funding by shifting this responsibility onto states. This process can also leave massive unfunded requirements on the heads of state governments, and often means cuts in services.46
• **End the use of massive omnibus legislation.** By putting together several spending bills into one massive piece of legislation, the process is left open to excessive influence by a small minority of Congress. Spending needs to be open to public scrutiny, especially in times of excessive deficits. Congress should end this practice.

ENDNOTES


3 From 2001 to the beginning of 2004, “about 30 states have expanded their tax bases or increased tax rates to lessen the decline in revenues.” *See* Nicholas Johnson, Jennifer Schiess & Joseph Llobrera, *State Revenues have Fallen Dramatically: Tax Increases Have So Far Failed to Fill the Gap*, November 2003, available at http://www.cbpp.org/10-22-03sf.htm (last viewed Jan. 6, 2005).

4 Average inflation-adjusted incomes for the middle 20 percent of the income scale fell by more than $1,500 over the most recent three years for which we have data. *See* U.S. Census Bureau data available at http://www.census.gov/hhes/income/histinc/h03ar.html (last viewed Jan. 6, 2005).

5 From 2000 to 2003, the average real (inflation-adjusted) pre-tax income for those in the middle 20 percent of the population fell by $1,525.


8 In 2004, individual income tax receipts were estimated at 6.7 percent of GDP. This is the lowest since 1950, when individual income taxes were 5.8 percent of GDP. *See* Office of Management and Budget, *Historical Budget Tables* (2004).


13 There is currently no income cap on the Medicare component of the payroll tax.


For example, former CEA Chairman Glenn Hubbard argued, “[a]s an economist, I don’t buy that there’s a link between swings in the budget deficit of the size we see in the United States and interest rates. There’s just no evidence.” See Richard Stevenson, Bush’s Way is Clear to Press His Agenda for the Economy, New York Times, Nov. 11, 2002, at A12.


The revenue and distribution estimations 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. See text box “Distributional Implications,” and note 38 for details.


The calculations do not include the distributional impact of the income exclusion for long-term capital gains. The microsimulation model described in note 28 that was 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 underestimate 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.

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, 2005).
Among the special interest tax breaks included in the FSC/ETI corporate tax law passed in October 2004 are $44 million in tax breaks for importers of Chinese ceiling fans, a new provision to allow foreign gamblers to exclude their dog-track and horse-track winnings from taxation, tax cuts for fishing tackle box makers, and $339 million in benefits for private debt collectors. These breaks were highlighted in several national newspapers on October 12, 2004. See e.g., Jonathan Weisman, Senate Passes Corporate Tax Bill, Washington Post, Oct. 12, 2004, at A1, available at http://www.washingtonpost.com/ac2/wp-dyn/A25407-2004Oct11 (last viewed Jan. 20, 2005). The FSC/ETI “Jobs” Act was initially designed to avoid European Union tariffs. The EU tariffs were imposed as a response to a World Trade Organization ruling that found the U.S. Foreign Sales Corporation (FSC) and its successor, the Extra-Territorial Income (ETI), to be prohibited export subsidies. However, the revenue that would have been raised by the repeal of the export subsidies and some other revenue provisions were quickly used to finance various additional corporate giveaways.

See note 32.


34 See note 32.

35 See note 32.

36 See note 32.


38 Eliminating the need would be important to place limits on some deductions for very high-income individuals and to limit the ability of high-income individuals to shelter unlimited amounts of income from taxation.

39 If one includes the AMT reform desired by the administration, the proposal would raise additional revenue relative to the administration's policy.

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


43 The Congressional Budget Office estimates that “if annual Social Security revenues were permanently increased, or annual outlays decreased, by 0.5 percent of GDP beginning immediately, trust fund balances would be sufficient to provide spending authority for all of the benefits scheduled to be paid over the next 100 years.” See Congressional Budget Office, The Outlook for Social Security, June 2004, at 6, available at http://www.cbo.gov/ftpdocs/55xx/doc5530/06-14-SocialSecurity.pdf (last viewed Jan. 6, 2005). According to the 2004 trustees' report on Social Security, the 75-year shortfall (the “summarized balance”) is approximately 0.7 percent of GDP. See Social Security Administration, 2004 OASDI Trustees Report, Appendix F, available at http://www.ssa.gov/OACT/TR/TR04/tr04.pdf (last viewed Jan. 6, 2005). The 2.25 percent of GDP that we propose covers the net revenue lost from the reduction in the payroll tax (2.4 percent). The elimination of the income cap would raise an additional 0.45 percent of GDP, which together with the general revenue funding raises the inflow into Social Security by about 0.3 percent of GDP. This amount is sufficient to cover over half of the long-term, 75-year shortfall in Social Security (according to the CBO numbers); and just under half (according to the trustees' report).

44 These ideas are similar to those embodied in the USA Accounts proposals from the 1990s.


46 For an example of the impact in one area, see Sharon Parrot & Jennifer Mezey, Bush Administration Projects That The Number of Children Receiving Child Care Subsidies Will Fall By 200,000 During the Next Five Years, Feb. 5, 2004, available at http://www.cbpp.org/2-5-03tanf.htm (last viewed Jan. 6, 2005).