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The President's Advisory Panel on Federal Tax Reform
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comments@taxreformpanel.gov

Dear Advisory Panel,

This letter contains comments per the "Advisory Panel's Request for Comments #2."

As requested, our comments at this time provide our suggestions for reforming the tax code.

Sincerely,

Cassandra Q. Butts
Senior Vice President and Coordinator of Economic Policy

John S. Irons
Director of Tax and Budget Policy

Submitted by the Center for American Progress, Washington, D.C., on March 15, 2005.

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all. We believe Americans are bound together by a common commitment to these values and we aspire to ensure our national policies reflect these values.

American Progress Tax Reform Proposal - Summary

The Center for American Progress Tax Plan is a comprehensive reform of the current tax code. Overall, the reform raises about $500 billion when compared to the president's policy. Under our plan, approximately 70 percent of the population would receive a tax reduction, which would average about $600 for those earning under $200,000. Taxpayers who earn more than this amount would likely see an increase in their tax share.

The Center for American Progress Tax Plan would:

- *Tax Each Source of Income the Same*—tax wealth according to the same rate structure as ordinary income.
- *Reduce the Dependence on Regressive Payroll Taxes*—remove the employee side of the Social Security Payroll Tax, and remove the cap on the employer side.
- *Enhance the Take-Home Pay of Lower-Income Taxpayers*—reduce the marriage disincentive of the EITC, expand eligibility for the child tax credit.
- *Reduce the Number of Income Tax Brackets*—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.
- *Close Corporate and Individual Loopholes*—close existing loopholes that allow corporations and wealthy individuals to avoid paying their fair share of taxes.
- *Eliminate the need for the Alternative Minimum Tax*—overhaul the entire income tax code and eliminate the AMT.
- *Offer Tens of Millions of Americans New Opportunities to Save and Create Wealth for Retirement*—replace the deduction-based retirement savings tax incentive with an across-the-board 25 percent refundable tax credit for retirement savings.

American Progress Tax Reform Proposal

The Center for American Progress has recently released a comprehensive proposal for tax reform that aims to create a fair and simple tax system that encourages economic growth and reduces the fiscal deficit. By addressing the tax system comprehensively, we are able to address long-term challenges such as the growing complexity of the alternative minimum tax while at the same time increasing the progressivity of the tax code and improving the revenue side of the federal budget deficit.

While the panel has been charged with reporting to the Treasury Department revenue neutral options, we believe that the fundamental fiscal imbalances at the federal level demand that more revenue be raised than by the president's budget. The plan contained in this submission raises an additional $500 billion over ten years relative to the president's proposals. While this is our preferred option, we also present two alternatives below that are revenue neutral.

We feel it is essential that impacts of policy proposal are fully examined. The estimates of revenue and distributional impacts were conducted by the joint Urban-Brookings Tax Policy Center micro-simulation model in January 2005.[1] The next several pages outline the major components of the reform plan, and full details are included under separate cover and can also be found online at http://www.americanprogress.org/tax/.

I. Description of the Proposal

The American Progress tax reform plan is based on the three principles of fairness, simplicity, and economic opportunity. The plan has many changes from the current system, with the biggest differences including a change in how capital income is taxed, a shift in the increasing reliance on payroll taxes, and a restructuring of the income tax.

The Center for American Progress plan is fundamentally an income tax system. The plan taxes each kind of income according to the same progressive rate schedule, whether the income is derived from wages, salaries, capital gains, or dividends.

The federal tax system has increasingly relied on the payroll tax to raise federal revenues. Social insurance taxes now make up around 40 percent of all federal tax revenue. While the payroll tax does raise revenue for vital social programs, it does so in a regressive manner by setting a single rate and capping the amount of wages subject to taxation.[2] In order to increase the progressivity of the overall system, our reform calls for the elimination of the employee side of the Social Security payroll tax, and also calls for a removal of the cap (currently set at $90,000) on payroll income subject to taxation on the employer side.

To offset the revenue lost from the payroll tax elimination, we restructure the income tax rates schedule by reducing the number of tax brackets from the current six to just three, with rates and cutoffs as presented in Table 1. Overall, the payroll reductions combined with the rate restructuring and other components of the plan would mean a reduction in the taxes paid for about 70 percent of the population.

Table 1: Proposed Tax Brackets and Rates

Taxable Income ($)	*Tax Rate (%)*
0 to 25,000	15
25,001 to 120,000	25
120,001 and above	39.6

Brackets are for a married couple filing jointly and would be indexed for inflation.

Exemptions, Deductions, Credits and Exclusions

While there is a tradeoff between the tax rates necessary to raise a given amount of revenue and the breadth of the tax base, there are also a number of deductions, exemptions, credits, etc., that are both politically popular and economically or socially desirable. Our plan preserves most of the current system, but makes significant changes to the deductions for retirement savings.

- *Standard Deduction:* The standard deduction would be raised slightly over 2004 levels to $10,000 for a married couple and also indexed for inflation.
- *Refundable Tax Credit for Retirement Savings:* We propose to do away with the upside-down deduction-based incentive to save—where taxpayers in higher tax brackets receive a greater tax incentive to save than those in lower tax brackets—and replace it with an across-the-board 25 percent refundable tax credit for retirement savings. 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 long-term savings for retirement.
- *Capital Income Exemptions:* We would include a $250 exemption for capital income to simplify tax filing and to reduce the tax share for small investors. In addition, to encourage long-term investment for those who hold assets for a number of years, we would allow some of the capital gains to be exempt. We would allow those with incomes under $1 million to exempt a portion of their long-held 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. 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 5 years.

- *Earned Income Tax Credit (EITC):* To ensure that single working parents who currently receive the EITC do not risk losing any benefits if they marry, we propose altering the tax code to eliminate this disincentive to marriage.
- *Child Tax Credit:* 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 currently 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. 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 low-income working families to access their full or increased benefit.
- *Corporate and Individual Loopholes:* A primary goal of the plan is to eliminate corporate and individual loopholes. For example, the recently enacted $140 billion corporate tax overhaul includes a wide range of specialized credits that should be re-examined. Our revenue estimates assume $30 billion per year in savings from these loophole closures.[3] Because of the political challenge to eliminating specific corporate subsidies and tax loopholes, we recommend that an independent panel identify a package of loophole closures that could be taken up together as a

comprehensive whole.[4]

- *Other deductions:* Our plan maintains the current deductibility of charitable giving, home mortgage interest, state tax deductibility, and other deductions. We believe that there is room enough to raise revenue (as assumed above) without eliminating valuable deductions that serve important social interests.

Other Components of the Plan

The Alternative Minimum Tax (AMT)

If left in place under the current system, the AMT will impact 36 million Americans by 2010. Our plan contains an elimination of the AMT. The right way to ensure that very high-income individuals pay their share of the tax is through the regular income tax code. Overhauling the entire income tax code and addressing some of the personal income tax loopholes that are currently limited by the AMT would be an attractive method for eliminating the need for an AMT in a fiscally responsible manner.

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. Currently the first $1.5 million can be passed from one generation to the next tax-free. Our plan increases 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.

II. Impact of Proposal Relative to Current System

Revenue

As mentioned above, over 10 years our proposal raises $500 billion more than the president's current policy extended to 2010 and thereafter.

Distribution of the Tax Burden

Overall, our tax plan will increase the take-home pay of most households earning under $200,000 a year, providing an average tax cute of $620 for that group. 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 in tax payments for most people. When the entire tax reform plan is considered, 68.4 percent of all taxpayers would receive a cut.

Table 2. Distribution of tax changes relative to current tax policy.[5]

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	-510
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

Simplicity

With the elimination of the alternative minimum tax and a consistent income tax on all forms of income according to a three-rate tax rate schedule, our plan would be much simpler for taxpayers to file under than the current system.

Economic Growth and Competitiveness

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. This plan embodies a progressive growth strategy based on restoring fiscal discipline, investing in our nation, 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. Our plan would put the country back on a path toward closing the fiscal gap, allowing for productivity-enhancing investments in education and research that are keys to our nation's economic success. 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 (see Table 2). 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.

Table 2. 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.

- *Offer Tens of Millions of Americans New Opportunities to Save and Create Wealth:* As explained above, we would create a refundable tax credit for retirement savings that would help expand savings and ownership to the broad middle class. This measure will help provide a strong foundation for broad-based economic growth.
- *Reward Work and Skill Accumulation:* In a modern U.S. economy driven increasingly by products and industries developed by human capital (rather than physical capital), we should be encouraging advanced levels of skill accumulation. The current tax system rewards income from wealth and thus shifts the tax share onto income from work—the payroll and the income tax combine to place a much greater marginal tax on payroll income than on tax-preferred income from wealth. This results in a system in which human capital development is taxed more heavily, thus creating a larger disincentive to accumulate human capital. Our plan would

reduce this trend by lowering rates rebalancing the federal tax code.

III. Transition, Tradeoffs and Special Issues

Because the American Progress tax reform plan is fundamentally based on the current tax system, there are very few transition and other major issues that need to be addressed. It represents an improvement of the current system that builds on what has worked and improves or eliminates those components that do not.

Shoring up Social Security

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. Our plan protects this revenue by having Congress pass legislation that includes a number of safeguards to prevent future Congresses from reducing this dedicated stream, including a requirement that any reduction can only be made after a three-fifths majority vote in the Congress, to ensure that this funding is not cut.

By raising more money overall than the current system, our plan fundamentally strengthens the ability of the government to meet future needs.

Revenue Neutral Options

While we argue that the federal government needs to correct fiscal imbalances, we also recognize that tax reform plans must be compared on equal grounds. Our preferred option raises $500 billion in additional revenue over 10 years compared to the president's policy. However, revenue neutral versions of our plan may serve as useful comparisons.

The tax bracket cutoffs are one dimension which could be changed to lower the revenue generating capacity of the plan. Using revenue neutrality as a benchmark, the cutoff for the first tax bracket could be raised from $25,000 to $33,000. Alternatively, the cutoff for the top tax bracket could be raised from $120,000 to $170,000. Obviously, under each of these scenarios, the size of the average tax cut would increase for most of the population, and the size of the tax increase for the wealthiest would decline. Full details can be found at http://www.americanprogress.org/tax/.

Notes

[1] The Tax Policy Center's estimates of revenue and distribution do not include the impacts of the exclusion of capital income as described below. These estimates were done independently of the TPC but are included in the final revenue estimates.
[2] The Social Security payroll tax is currently capped at $90,000.
[3] Senator John McCain has estimated that such a commission could save taxpayers "tens of billions of dollars each year," and also placed the annual savings at $80 billion.
[4] As an 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, closing the Bermuda tax loophole, and clarifying the definition of offshore tax shelters. 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.
[5] These estimates are as reported directly by the Tax Policy Center and do not include the capital gains exclusion, see http://taxpolicycenter.org/TaxModel/TMDB/TMTemplate.cfm?Docid=764. Tax reductions would be greater (and increases smaller) with this provision included. For detailed estimates see http://www.americanprogress.org/tax.