

Elements of Tax Reform

By Mark W. Everson

Any fundamental tax reform requires consideration of four elements: permanency; progressivity; simplification; and sound policy. The trick is to make sure that all are addressed and that any reform outlives the political environment at the date of enactment, no easy task.

Perhaps the worst feature of the current tax code is its on again, off again nature. While the legislation written after the last presidential election did make permanent certain of the Bush tax cuts for individuals, no such advance was realized on the business side. The result is that businesses are once again waiting for Congress to act on an extenders package. Without visibility, business owners are understandably reluctant to make investment and hiring decisions. To this end, the newly launched House effort to write the R & D tax credit and other important business incentives into permanent law is a positive development.

Progressivity—the idea that those who earn more should pay relatively more than others—has been a cornerstone of our system of personal income tax since its inception a century ago. This social contract has served the nation well. Recent decades have seen periodic arguments for a one size fits all tax code. There was not much policy content in the 2012 presidential election, but President Obama was clear that he would seek to raise taxes for the well to do if elected to a second term. And he won. Income taxes at the high end have increased, and would be even higher but for the refusal of democrats to entertain serious entitlement reform. With income inequality at levels not seen since the 1920's, it is hard to imagine any real revisiting of the progressivity construct anytime soon. If anything, the relative burden on the rich will rise.

The tax code cries out for simplification. Simply stated, complexity obscures understanding. Taxpayers who seek to comply have a difficult time doing so. And those who want to pay less than their share can hide in the crevices of the code. But our representative democracy makes it hard to have a clean, simple system. After all, what politician ever ran for reelection on the platform, “I got you the same deal as the folks in Ohio and New York.” No, the point is to help constituents do better than others. This means dueling efforts to build in special provisions. An additional problem of complexity is that all too often similar economic activities are taxed differently based on legal form. As Ways & Means Chairman Dave Camp has recognized, any reform effort needs to be comprehensive lest it results in benefits for large corporations at the expense of smaller businesses.

Many conservatives argue that the best tax policy would be a code with no incentives whatsoever, believing that government should stay clear of picking winners and losers. Given today’s global economy this approach is unrealistic. The Congress should do its job and make the difficult choices required to support economic growth in the 21st century. In particular, we need to encourage innovation, manufacturing and help small and midsized businesses. If the desire is to reduce statutory rates it will be necessary to kill off popular provisions with limited positive economic impact. Simply reducing rates by placing a dollar or percentage cap on deductions is an arithmetic solution to the problem of high rates, but will in fact complicate the code.

Realizing comprehensive tax reform is a tall order. My own guess is that it will only happen when a presidential candidate puts forth a clear program central to his or her candidacy and wins.

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