Tax Reform: Where Are We Now?

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The 2012 Republican presidential nomination contest brought taxes front and center. The subject of tax reform -- not just tax rates -- was part of our national political dialogue. Some advocated fundamental reform and even the addition of a consumption tax. Remember Herman Cain's 9-9-9 Plan? Nominees Mitt Romney and Paul Ryan kept the subject alive during the general election, but shifted the conversation about individual income taxes to an equation balancing lower rates with limits on deductions. President Obama narrowed the focus still further, to that of tax rates paid by the wealthy.

As many have said, the appallingly modest legislative package enacted in early January does little to address our nation's long-term fiscal health. Delaying action on significant deficit reduction neither restores confidence in government, nor does much to convince business owners that it is safe to expand payrolls and invest in property and equipment. Unfortunately, recent events also make fundamental tax reform, already a heavy lift, much less likely.

For my money, there are four essential components of good tax policy: permanency, progressivity, simplicity, and sound public policy. Let's look at the deal just struck against these standards and its impact on prospects for future reform.

A terrible feature of our current tax system is the on-again, off-again manner in which provisions are written into law. I can state from experience that by regularly waiting until the last hour before acting, Congress creates formidable challenges for tax administrators. At the Internal Revenue Service, planning for this year's now-delayed filing season has no doubt been a nightmare. While the government, practitioners and taxpayers all suffer from the way Congress conducts its affairs, the real problem arising from a lack of permanency is the reluctance of businesses to invest when they don't have good visibility of the future. This is only compounded by the increasing volatility of our political debates and the well-documented erosion of faith in government.

It is good news that the revenue package made Bush-era tax cuts permanent for the vast majority of Americans, dealt clearly with estate taxes, and made a permanent patch to the Alternative Minimum Tax. That said, business tax provisions didn't get the same treatment. Important incentives like the R&D credit were extended for a period of only two years. In actual fact, the R&D extension is really only one year (through 2013), since Congress had to clean up last year as well! So, while there has been some progress on the permanency front, it is hard to argue that the key engines of our economy -- private sector businesses -- know what the future holds in terms of taxes.

In a period of historically high income inequality, it is curious that Republicans chose the 2012 primary campaign as a moment to debate the merits of a flatter, "fairer" income tax system. The concept that those who earn more should pay relatively more has been a central feature of federal income taxes for a century. Progressivity constitutes a tested, if flexible over time, social contract that has served the nation well. Steve Forbes made an attractive case for a flatter tax system in 1996, but times were better then. Simplifying the issue of progressivity to a question of tax rates paid by the wealthy became the policy focus of the president's re-election campaign. Not surprisingly, it was embraced by the public. The president has claimed his scalp, but it is not clear that he will get all he hoped for. As Senator Mitch McConnell said only days after the package became law, "The tax issue is finished." The president has reinforced progressivity in the Tax Code, but the revenues-only deficit reduction package just enacted makes comprehensive tax reform less likely.

The tax code cries out for simplification. Complexity obscures understanding. Many taxpayers fail to take advantage of benefits to which they are fully entitled because they don't understand the standards. They don't want to claim more than allowed or get crosswise with the IRS. At the same time, too many sophisticated taxpayers use complexity to structure transactions that offer only a measure of technical compliance or, in fact, cross the boundaries of the law.

While our tax system should be simpler and easier to navigate, that doesn't mean Congress should embrace the view that tax policy should avoid picking any "winners and losers." Each time a law is enacted or a government official makes a decision, there is a winner or loser. The goal should be to make sure that sound public policies are the foundation of the Tax Code. In a global, competitive marketplace, it makes sense to support innovation. Small and midsized businesses, which employ two thirds of our nation's private sector workforce, have shouldered the heaviest burden of the downturn and also merit incentives.

As the election season progressed, we moved away from, rather than toward, simplification, a shift now codified by leaving the existing suite of tax expenditures in place and limiting deductions. What Congress has enacted is simply a mutant descendant of the AMT, nothing more than an arithmetic attempt to correct flawed or unsustainable policy choices. And boiling down tax policy largely to a discussion of rates has not increased the prospect that Congress will make tough, needed policy choices anytime soon.

Where we go from here on tax reform is still largely up to the president. Coming after the tortured fiscal cliff negotiations, the upcoming debates on the debt limit, sequestration and government funding promise to be equally tumultuous, if not more so. The president will show his hand in the debt negotiations and when the administration presents its FY2014 budget just a few weeks from now. If the president proposes meaningful entitlement reforms, tax reform may stay on the table. If Washington's slow-moving train wreck continues, a better Tax Code will almost certainly be a casualty.

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