Backgrounder

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The 2010 Tax Deal: A Chance for Congress to Lay the Groundwork for Tax Reform

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Abstract: *The 2010 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act—which extended the 2001 and 2003 tax cuts for two years—also extended the lifespan of other policies that will not benefit the economy. The country is in dire need of tax reform, yet confusion reigns about what exactly this reform should entail. Congress now has an opportunity to reverse some of those mistakes and simultaneously lay the groundwork for fundamental tax reform.*

Talking Points

- President Obama and congressional Republicans struck a deal in late 2010 that extended the 2001 and 2003 tax cuts for two years—crucial, but far from perfect.
- A major flaw in the deal is the "tax extenders," a group of tax-reducing provisions. Congress extends them every year, and is long overdue in re-examining these policies, which deter job creation and impede critically needed tax reform.
- The tax-extenders package has 51 provisions. The vast majority are unsound tax policies that are more about rewarding congressionally favored groups than constructing a sound tax code.
- Congress should treat the elimination of unsound policies in the tax extenders as a small-scale tax reform—and reduce other taxes by the amount of revenue that eliminating those unsound policies would raise.
- Congress needs to show Americans that it is serious about improving the economy—small-scale tax reform is the perfect place to start.

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The economy badly needs fundamental tax reform to lessen the damage that the tax code is inflicting on growth and job creation, but there is a great deal of confusion about what tax reform entails. In late 2010, President Barack Obama and Congress struck a deal to extend the 2001 and 2003 tax cuts for two more years, through 2012. This deal—the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act—staved off an economy-killing tax hike for the time being. But the cost of putting off that hike was the extension of other policies that Congress should have eliminated long ago.

Congress now has the opportunity to reverse its error and eliminate those errant policies while laying the groundwork for fundamental—and clear—tax reform by following the guidelines laid out below.

Eliminate "Tax Extenders"

President Obama and congressional Republicans struck a deal at the end of 2010 that prevented the tax rates for all taxpayers from rising back to their pre-

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2001 levels. Preventing a tax hike was crucial, but the deal was far from perfect.

One of the major flaws of the tax deal was the continuation of a group of tax-reducing provisions commonly referred to as the "tax extenders" (the other flaws were the resurrection of the death tax and the 13-month extension of unemployment benefits). This group of narrowly targeted, special-interest tax breaks expires each year. Congress regularly extends them for short periods without much scrutiny. Congress is long overdue in closely examining these policies, which deter job creation and stand in the way of critically needed tax reform.

Examples of special-interest tax breaks in the tax extenders include:

- A tax credit for the production of ethanol, and a host of other energy-related tax breaks;
- Tax breaks for doing business in the District of Columbia, Puerto Rico, and Guam; and
- A tax credit for businesses that hire American Indians.

The tax deal extended these and several other similar special-interest provisions through 2011. Since the tax extenders will yet again expire at the end of this year, the special interests that enjoy the benefits of these provisions are now descending upon Washington to lobby Congress for another extension of their favorite tax perks. They argue that Congress must pass an extension immediately until 2012 and beyond in the name of certainty.

It is true that certainty is crucial for businesses. Business owners do need to know what their cost structure, and therefore tax liability, will be in the future so they can make decisions about hiring and capital expansions today. Therefore Congress should provide the certainty businesses require. But rather than providing an extension, Congress should allow all economically unjustified provisions in the tax extenders to expire permanently, as scheduled at the end of the year. That would give businesses ample time to adjust and fix one of the major flaws of the tax deal.

Small-Scale Tax Reform

There are 51 separate provisions in the tax-extenders package. Some policies, like the Research and Experimentation Credit, deserve full consideration, but the vast majority of these provisions are unsound tax policies that are more about rewarding congressionally favored activities or groups than constructing an economically efficient tax code.

Congress should examine each of the 51 provisions in the tax extenders and decide which are economically unsound, and which are sound policies.

Policies that are among the most egregious and that should be scrapped without hesitation are the:

- Incentives for biodiesel and renewable diesel;
- Credit for construction of new energy-efficient homes;
- Incentives for alternative fuel and alternative fuel mixtures;
- Extension of income tax credits and excise tax credits for ethanol;
- Alternative fuel vehicle refueling property credit (credit for installing alternative fuel mechanisms);
- American Indian employment tax credit;
- New markets tax credit;
- Deduction of income attributable to production activities in Puerto Rico;
- Empowerment zone tax incentives;
- Tax incentives for investment in the District of Columbia;
- Increases in the limit on payments made to Puerto Rico and the Virgin Islands to cover the cost of rum excise taxes;
- Economic development credits for American Somoa; and
- Work Opportunity Tax Credit (WOTC), which reduces the federal tax burden of private, for-profit employers when they hire from any of nine selected groups, such as certain welfare recipients, veterans, or former felons.

It is important to remember that eliminating these policies, however warranted, would constitute a tax *hike*.[1] In fact, if Congress allowed all tax extenders to expire it would result in an approximately $55 billion tax increase over a two-year period. For this reason, Congress should treat the elimination of unsound policies in the tax extenders as a small-scale tax reform and reduce other taxes by the amount of revenue that eliminating those unsound policies would raise.

Fundamental tax reform would likely closely resemble this process. It would likely entail eliminating most credits, deductions, and exemptions from the tax code and instituting lower tax rates in their place. That way the revised tax code would raise the same amount of revenue as the old system. This would also make the tax code more like a flat tax and would be similar to what the President's fiscal commission on the federal debt recommended for the tax code late in 2010—only without the commission's massive unnecessary tax hike.

In this case, since this effort would not represent full-scale tax reform, Congress should take the opportunity to improve a few areas of the tax code that are among the biggest impediments to economic growth and job creation. There is no shortage of options. Congress could:

- Lower marginal income tax rates as an intermediate step to larger tax reform where rates would be reduced further;
- Reform the corporate income tax system by lowering the rate and moving toward a territorial system of taxation, away from the current system which taxes businesses on their worldwide income;
- Abolish the alternative minimum tax (AMT);
- Lower the tax rate on small businesses;
- Allow businesses to expense their purchases of capital expenditures rather than depreciate them over a number of years;[2] or
- Repeal the death tax once and for all.[3]

President Obama and some Members of Congress have recently indicated a desire for fundamental tax reform. This small-scale tax reform could provide a roadmap for how to proceed on that more difficult task. This is important because Congress has not even attempted to fully reform the tax code since 1986 when it last engaged in a complete overhaul. A smaller effort could build momentum toward the greatly needed larger revamp.

A proper roadmap is increasingly necessary since President Obama and some of his allies in Congress envision reform as a way to raise more revenue for Congress to spend. Tax reform is not about raising taxes. The goal of tax reform should be to encourage economic growth by improving the economic efficiency of the tax code and increasing the simplicity of complying with it.

President Obama further muddied the waters in his April 2011 speech on debt reduction, when he reiterated his desire to hike the top two income tax rates back to their pre-2001 levels. He also called on Congress to reform the tax code. Since tax reform would necessarily include lower rates for all taxpayers, these two policies contradict each other.

The small-scale reform would refocus attention on what tax reform should actually accomplish and how to do it.

Economic Benefits

Not all tax cuts are created equal. Tax breaks like those in the tax extenders, which do not lower marginal tax rates and are narrowly targeted to benefit special interests or targeted behaviors, although they reduce total tax collections, actually inhibit economic growth. They do so by locking the inefficient tax code in place and tilting markets in favor of the businesses, industries, and behaviors upon which Congress bestows tax preferences. If

1. J. D. Foster, "A Rose by Any Other Name: Clarity on Tax Hikes," Heritage Foundation *WebMemo* No. 3232, April 25, 2011, at *http://www.heritage.org/Research/Reports/2011/04/Understanding-Tax-Hikes-and-Why-Taxes-Rise*.
2. Curtis S. Dubay, "How to Fix the Tax Code: Five Pro-Growth Policies for Congress," Heritage Foundation *Backgrounder* No. 2502, December 14, 2010, at *http://www.heritage.org/Research/Reports/2010/12/How-to-Fix-the-Tax-Code-Five-Pro-Growth-Policies-for-Congress*.
3. Curtis S. Dubay, "The Economic Case Against the Death Tax," Heritage Foundation *Backgrounder* No. 2440, July 20, 2010, at *http://www.heritage.org/Research/Reports/2010/07/The-Economic-Case-Against-the-Death-Tax*.

Congress enacts the small-scale tax-reform plan laid out above, in addition to allowing the listed pro-growth tax reforms, it would set the economy on better footing to expand and provide a stronger base for job growth by:

- **Increasing the likelihood of fundamental tax reform.** The current tax code is a drag on the economy because it levies progressive and high marginal income tax rates, high tax rates on businesses, and high tax rates on capital. These high rates discourage working, saving, investing, and taking on new risk. Such activities are the building blocks of economic growth, and when the tax code discourages them, the result is fewer jobs and lower wages for all Americans.

  The tax code is littered with many more targeted tax provisions than the 51 in the tax extenders package. Congress must eliminate these special-interest tax breaks to pass fundamental tax reform where it would lower inflated tax rates.

  Each special-interest tax break has a constituency that grows up around it that has a vested interest in seeing that provision remain in the tax code. These constituencies often have powerful sway with Congress through their lobbying activities and are almost always successful at keeping their pet tax breaks in place. As long as the tax code remains cluttered with these inefficient policies, fundamental reform will elude Congress.

  Passing the small-scale tax reform plan will not make the special-interest groups fight less vigorously for their tax breaks if Congress takes up fundamental tax reform. But if Congress passes the small-scale plan, Congress will gain valuable experience taking on special interests, demonstrate that it can curb their influence, and make clear which economic benefits come with doing so. Each part will improve the chances that Congress will succeed in finally reforming the entire tax code.

- **Reducing government influence on markets.** Each special-interest tax break included in the tax extenders, and the tax code at large, tilts markets in favor of the business or industry receiving the tax break. They do so by either lowering the prices of goods or services for consumers, or the production costs for businesses.

  Lower prices entice customers to purchase items they otherwise would not buy. Similarly, lower production costs improve the profitability of businesses. Enhanced profitability makes those businesses more attractive to investors, so they end up with more investments than they would have without the tax assistance.

  Targeted tax breaks direct resources away from businesses that would have won them in a non-biased market. Because those resources are artificially diverted from where the market would dictate they go, their productive efficiency is less than it otherwise would have been.

  The resources are used less efficiently because they are allocated by Congress's political concerns rather than market-based decisions by private individuals, investors, and businesses who have an incentive to put resources to use where they will produce the most output. Congress, on the other hand, puts the resources where they will garner the most votes, with little regard for productive efficiency.

  With less production, economic growth is slower than it could have been. Reduced economic growth means businesses create fewer jobs and wages rise slower.

- **Raising the probability of the next "big thing."** The economy benefits greatly from breakthroughs that both bring new products to the market and increase the productivity of workers.

  New innovative products and services accelerate income creation and job growth as businesses invest in new, must-have items. Similarly, technological improvements that make workers more efficient boost the economy because existing workers can produce more than before.

  Special-interest tax breaks stand in the way of such breakthroughs because they alter the market as described above. Valuable resources are directed away from businesses that could bring the next hot item to the market, or from businesses that could make an important new technological improvement, to businesses that have secured favor from Congress. This makes it less likely that Americans will enjoy the spoils of important new advances from products created by the new Apple, Ford, Pfizer, or Google.

The ethanol credit that is included in the tax extenders is an example of how special-interest tax breaks block necessary progress.[4] Ethanol producers convinced Congress years ago that ethanol was the answer to the country's energy problems. So Congress gave the ethanol industry special tax credits—subsidies—that lower the cost of producing and consuming the fuel. This tilted the market in favor of ethanol to the detriment of other potentially promising new energy sources. Investment that otherwise might have gone to more promising alternatives instead was funneled to ethanol—which has proven far less effective than advertised.

If Congress had left energy markets alone, it is likely that more investment and purchases would have flowed to other alternative energy sources. Some of those likely would have proven more effective and efficient than ethanol. One can only hope that Congress's misguided attempt to manipulate the markets in favor of its preferred alternative energy did not permanently squash better energy options.

Congress Cannot Miss This Opportunity

Congress needs to show the American people that it is serious about improving the economy. The small-scale tax reform plan is the perfect place to start.

In addition to the economic benefits outlined above, the faster economic growth that would result from dropping special-interest tax breaks would increase tax revenues more quickly back to their historical level of around 18 percent of GDP as economic recovery continues from the recession. This would help Congress achieve one of its other major tasks: lowering the deficit.

With all these benefits, and no downside except for the special-interest lobbies, passing the small-scale tax reform is an opportunity Congress should not miss.

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4. Ben Lieberman and Nicholas Loris, "Time to Repeal the Ethanol Mandate," Heritage Foundation *WebMemo* No. 1925, May 15, 2008, at *http://www.heritage.org/Research/Reports/2008/05/Time-to-Repeal-the-Ethanol-Mandate*.