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Sorting Tax Extenders a Warm-Up for Fundamental Tax Reform

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The Select Revenues Subcommittee of the House Committee on Ways and Means is scheduled to hold a hearing on June 8 on a "Framework for Evaluating Certain Expiring Provisions." Most hearings on expiring provisions focus on the merits and failings of specific expiring tax provisions. Earlier this year, The Heritage Foundation called on the subcommittee to put the issue into a broader context, much as the June 8 hearing envisions.[1]

This paper builds out further the appropriate framework for considering tax extenders, based on three key points:

1. The legislative process for weeding out ineffective or ill-advised tax provisions from among the tax extenders is a warm-up for fundamental tax reform and thus should follow the same basic guidelines of revenue neutrality, simplification, and tax neutrality.
2. Allowing a tax extender to lapse raises taxes on someone.
3. Treating the exercise as a warm up for fundamental tax reform means Congress should also consider one or more additional changes to ensure revenue neutrality consistent with simplification and tax neutrality.

This paper, in its entirety, can be found at **http://report.heritage.org/ib3633**

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The Regrettable Habit of Making Temporary Tax Policy. In recent years, Congress has acquired the regrettable habit of enacting temporary tax policies. Twenty years ago or so, the list of such temporary policies was fairly short and centered on the Research and Experimentation Tax Credit, the Low-Income Housing Tax Credit, and so forth.

The justification at the time of enactment for making these provisions temporary was often simply that policymakers were unsure if they would work. Proponents typically made strong arguments, but reasonable doubts remained. Few doubt the importance of research and development to increasing productivity, wages, and trade competitiveness, but substantial uncertainty surrounded the efficacy of a credit to encourage such activities, and even more surrounded its ideal design. Enacting the provisions on a temporary and therefore provisional basis then would create a dynamic whereby proponents would be forced to provide real evidence to justify extension or permanence.

However, this dynamic was less than fully successful. Rather than becoming useful experiments in tax policy with unsuccessful provisions allowed to lapse and effective provisions being made permanent and perfected, tax extenders as a group became a lucrative, unseemly log-rolling business for lobbyists and legislators alike. Reminiscent of the famous saying associated with the Three Musketeers, the extenders became an "all for one and one for all" enterprise. And so the extensions have followed, year after year, while political coffers were repeatedly replenished and lobbyists' children had their braces and college tuitions paid for.

More recently, a new, far larger temporary tax exercise came into vogue. In 2001, Congress passed major tax legislation not with one or two temporary provisions but with all changes temporary. Congress has since extended these provisions once, thereby preventing a massive tax hike, yet they are again slated to expire at the end of this year, thus constituting a major component of the pending Taxmageddon. This tax hike should be prevented in toto, with Congress taking action this summer to make all of these tax provisions from the 2001/2003 legislation permanent.

Then, in 2011, Congress again passed a major tax cut—the payroll tax holiday—on a temporary basis. Following some legislative high drama, Congress then extended the reduced payroll tax rate—but only through 2012, adding yet another element to Taxmageddon. Allowing this provision to expire would also result in a huge tax hike on America's workers and should be prevented, sooner rather than later and preferably this summer.

As part of the tax stimulus early in the recession, Congress gave in to bipartisan folly with the temporary cash for clunkers tax credit and first-time homebuyers tax credit. Surprising no one but their sponsors, these policies were utter failures as stimulus. Indeed, the first-time homebuyer's credit almost certainly substantially delayed the recovery in the housing markets by distorting and thereby delaying the price discovery process necessary to healing.

Nevertheless, both temporary stimulus credits did enjoy one redeeming quality in that, perhaps as a precursor to Congress's work today, these provisions showed that a tax provision can be sufficiently useless that it would be allowed to lapse.

A Warm-Up for Tax Reform. The federal income tax code is replete with tax provisions in need of repeal and revision. There is a palpably growing consensus favoring at least some aspects of fundamental tax reform, perhaps starting with the corporate tax. The best way for the committee to frame the discussion surrounding tax extenders is as a warm-up for fundamental tax reform and, in a sense, as a test run for the broader effort.

As such, it is useful to revisit the guidelines appropriate for fundamental tax reform. For example, while tax reform can have many goals, preeminent among these is to draft a tax code that is vastly more conducive to economic growth. This means, for example, that tax reform should focus on lower tax rates *and a better rather than a broader tax base.*

The case for lower tax rates is sufficiently established, at least with respect to corporate tax, that it has achieved the near miraculous—bipartisan consensus as evidenced by the President's Framework for Tax Reform.[2] The area of contention is regarding the deductions, exemptions, and credits to eliminate to finance lower rates. This is where the concept of a correct (or better rather than broader) tax base comes into play.

The defining feature of a better tax base is that it accords with tax neutrality: the simple idea that, to the greatest extent possible, the tax code should leave undisturbed the price signals facing individuals and businesses. Specifically, the tax code should not disturb the relative prices of goods and services or the relative incentives across types of investment and saving.

This distinction between a broader tax base and a better tax base—the latter being an economically neutral tax base—is crucial to tax reform's success. While lower tax rates are vital, some have suggested abandoning any conception of a correct tax base in the pursuit of the broadest possible base and thus the lowest possible tax rates. This approach is errant and counterproductive. For purposes of allowing stronger economic growth, higher productivity, and higher wages through a more economically rational allocation of the nation's resources, what is taxed is as important as the rate at which tax is levied.

Another dimension of tax reform Congress should respect to be successful is that the exercise should also be revenue neutral, at least as revenues are traditionally measured. There are those supporters of a vastly larger government and those who dream of participating in a "grand fiscal bargain" who have evidenced a desire to commingle the issues of tax reform and tax hikes. Tax reform should yield a better tax system altogether separate from the debate about the level of taxation. Attempting to combine the two almost certainly dooms tax reform.

Allowing any of the traditional tax extenders to expire is a tax hike. The official tables from the Joint Committee on Taxation do not describe the budgetary consequences of an expiring tax extender in terms of tax hikes, but that is only because

1. See J. D. Foster, "Tax Extenders Review Needs a Framework" Heritage Foundation *Issue Brief* No. 3586, May 1, 2012, http://www.heritage.org/research/reports/2012/05/tax-extenders-review-needs-a-framework.
2. See U.S. Department of Treasury, "The President's Framework for Business Tax Reform: A Joint Report of the White House and the Treasury Department," February 2012, http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf (accessed June 7, 2012).

the Congressional Budget Office continues to employ the indefensible practice of developing revenue baselines according to current law rather than current policy. The issue is ultimately a simple one: If taxpayers on balance pay more in taxes for doing much the same as they did before, then the change in the tax law has produced a tax hike.

Positive Change, Not Just Eliminating Bad Provisions. Tax reform is not just about eliminating deductions and credits contrary to tax neutrality. It is also about correcting those areas where taxable income is incorrectly defined, resulting in excessive tax being collected, and simplifying those aspects that unnecessarily complicate the tax code.

Seen as a warm-up for fundamental tax reform, the process of allowing certain tax extenders to expire without raising taxes means Congress should also take the opportunity to advance some other goals of tax reform. As the sums involved are too small even to contemplate a material reduction in tax rates, Congress should pair the expiration of tax extenders with revenue-reducing correctives to the tax base.

For example, two goals of tax reform are simplification and reducing the tax bias against saving. Congress could consider a sound, scalable tax relief proposal such as allowing a modest amount of interest income to be tax-exempt. Unlike dividends and long-term capital gains, which are subject to tax at a 15 percent rate, interest income is taxed at ordinary rates. With interest rates at historic lows, seniors who rely on interest income for a significant portion of their taxable income are really struggling. Allowing a modest amount of interest income to be earned tax-free would move the tax system toward tax neutrality, offer significant simplification for many taxpayers, and ease financial pressures especially for low-income seniors.

Allowing an interest exemption is one example, and is offered here only as an example. Other examples include efforts to simplify existing retirement savings provisions or even to adopt the automatic IRA, which enjoys bipartisan support. The Ways and Means Committee has also recently considered improvements to health savings accounts, which could be financed out of the revenues otherwise increased by allowing certain tax extenders to lapse.

Incentivizing Sound Policy

Considering the tax extender exercise as a warm up for tax reform provides a more useful framework than deciding on the extenders one at a time. Even the most dubious of expiring tax provisions has its defenders. If the choice before Congress is simply one of extension yea or nay, then Congress is likely to retain provisions that should lapse. However, if the choice is between extending a dubious provision on the one hand and on the other allowing it to expire and using the revenues for a better purpose consistent with tax neutrality and revenue neutrality, then the incentives are substantially altered in favor of sound policy.

Given a better choice, more of what should disappear will disappear, the committee will avoid raising taxes, and some additional good may come out of the exercise—just as should happen through fundamental tax reform.

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