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Tax Extenders Bill a Good Start—Except for the Tax Increase

J. D. Foster, PhD

The tax extenders bill approved by the Senate Finance Committee on August 2 took important, albeit small, bipartisan baby steps: two forward followed by one big step back. The two steps forward were the committee working toward avoiding a component of Taxmageddon and making the effort to begin sorting through the long list of small, expiring tax provisions and dropping those of inadequate merit. The big step backward is that the bill would raise taxes. The committee approved the bill by a vote of 19–5, which means that five Republican Senators joined with the Democrats to raise taxes.

Finance Committee passage is just the first step, which leaves time for improvement. When the bill is brought to the Senate floor, Members should look to further pare the list of retained provisions. They should then expand one or more of the most meritorious remaining provisions, such as the deduction for higher education expenses, so that the overall product does not raise taxes. The tax extenders bill should be revenue neutral, which would make it an excellent model for tax reform in 2013.

Tax Extenders and Taxmageddon. Taxmageddon is the $500 billion tax hike slated to take effect on January 1, 2013.[1] It has four main components:

1. The expiration of tax relief enacted in 2001 and 2003 and already extended once at the end of 2010. The House of Representatives has already voted to extend these provisions to avoid a tax hike. The Senate passed a bill to extend some provisions but also imposed an economically devastating tax hike on small businesses.

2. A two-percentage-point jump in the payroll tax. Thus far, neither congressional body nor the President has evidenced any interest in preventing this massive middle-class tax hike.

3. Two economically harmful taxes on investment income arising out of Obamacare and effective for the first time in 2013.

4. An array of relatively small tax provisions, historically referred to as "tax extenders," that periodically expire and are then extended by Congress for a brief period. This is the component addressed recently by the Finance Committee.

Tax Extenders. Many of the tax extenders should be extended, including the Research and Experimentation (R&E) tax credit, the deduction for certain higher education expenses, and the ability to make tax-free distributions from an individual retirement plan if the distributions are for charitable purposes. However, many others should have long since expired.

Congress's task should be to extend—or, better, make permanent—the worthwhile provisions and weed out those that lack sufficient merit. In years past, Congress lazily extended these provisions en bloc.

To its credit, the House Committee on Ways and Means has held hearings beginning the weeding process. Senate Finance Committee chairman Max Baucus (D–MT) and ranking member Orrin Hatch

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The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

(R–UT) followed a similar path developing their bill and, in the process, eliminated 21 provisions from the list. More could be done, especially killing off the various alternative energy credits, but both the Finance and Ways and Means Committees have made a good start.

Not the Time to Raise Taxes. The great flaw in the Finance Committee tax extenders bill is that it raises taxes. This is not apparent in the official Joint Committee on Taxation (JCT) scoring, which suggests that the bill actually reduces taxes by some $205 billion over 10 years.[2] The explanation for this, which should surprise no one, is simply that often in Washington, down is up and right is left.

Allowing a tax provision to expire means a change in some taxpayers' burdens. If the provision reduces taxes, then its expiration means that it is a tax hike. If the R&E tax credit expires, for example, then those companies that would otherwise qualify for the credit in 2013 would see their taxes go up. If the deduction for higher education expenses expires, then some families sending their children to college would lose the deduction and thus pay higher taxes.

The confusion traces back to the Congressional Budget Office's (CBO) indefensible practice of constructing the revenue baseline—the JCT's starting point for all revenue analysis—with the assumption that all of the Taxmageddon provisions will go into effect. CBO assumes a massive tax hike as the starting point. Then, when Congress seeks to extend current law and thereby prevent a tax hike, the official scoring shows a tax cut.

The CBO practice is all the more indefensible because it is inconsistent with how it constructs the starting point for spending. When it comes to spending, the CBO generally assumes that current policy will be extended: Spending gets current policy; revenues get current law. This is one time when the Obama Administration gets it right and Congress, through the CBO, gets it wrong.[3] President Obama would allow some expiring provisions to expire, and these expiring provisions are then accurately included in his budget as tax hikes. Other provisions that he would extend, like the tax extenders, are correctly shown as being deficit neutral.

Extending current tax law is not a tax cut. Allowing revenue-reducing tax provisions to expire is a tax hike. The Finance Committee would allow some tax extenders to expire; therefore, members voting in favor of the bill voted to raise taxes. What the committee should have done instead, and what the Senate should do when the bill comes to the floor, is identify those provisions that should expire, tally up the revenues involved, and offset the resulting tax increase by strengthening other provisions, leaving the overall bill revenue neutral.

For example, the Senate could increase the deduction for higher education expenses or increase the rate for the alternative simplified R&E tax credit. Either way, the net result would be to strengthen a good tax provision while eliminating poor provisions—all without raising taxes.

Paving the Way for Tax Reform. The Senate Finance Committee bill is not perfect, but it is a good start. When the bill comes before the full Senate, Members should first carefully consider the remaining list of extenders with a view to culling the herd even more and then strengthen those remaining provisions that are of greatest merit to produce a revenue-neutral bill. The House should soon follow suit with its own revenue-neutral mini-tax reform as a warm-up to greater tax reform efforts in 2013.

—J. D. Foster, PhD, *is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*

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