The "Tax Expirers"

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Chairman Tiberi, Ranking Member Neal, and Members of the Subcommittee, thank you for inviting me to appear today to discuss the perennial challenge of the "tax extenders," which could equally well be called the "tax expirers."

As you know, the United States faces a sharp "fiscal cliff" at year end when numerous tax cuts expire, automatic spending cuts take effect, temporary spending programs expire, and new taxes begin. If all these changes happen, they will reduce the fiscal 2013 deficit by about $450 billion (Congressional Budget Office 2012a). That figure includes $500 billion in direct deficit reduction from the policy changes, offset by $50 billion in deficit increases from the near-term shock to the economy.[1]

Expiring (and expired) tax provisions make up most of the direct deficit reduction:

- $221 billion for the income, estate, and gift tax cuts originally set in motion in 2001 and 2003, plus the expired "patch" to the Alternative Minimum Tax;
- $95 billion for the 2 percentage point cut in employee payroll taxes; and
- $65 billion for the dozens of other temporary provisions that are the focus of today's hearing. (For a list of these items, see CBO 2012b.)

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[1] CBO (2012a) projects that these changes would push the economy into recession in the first half of calendar 2013 unless they are offset by other tax cuts or spending increases.

Like the AMT patch, most of these other temporary provisions expired at the end of 2011, but much of their revenue impact won't occur until fiscal 2013.

In deciding the fate of these "tax expirers," Congress should consider the larger problems facing our tax system. That system is needlessly complex, economically harmful, and widely perceived as unfair. Because of a plethora of temporary tax cuts, it's increasingly unpredictable. And it fails at its most basic task, raising enough money to pay our government's bills.

The "expirers" worsen at least three of those problems. Their temporary nature adds to policy uncertainty, making it harder for businesses and families to plan ahead. Innovative companies can't be sure whether future research expenses will qualify for the research and experimentation (R&E) credit, for example, and families considering adoption don't know whether a federal credit will offset some of their costs. That uncertainty undermines any incentives created by those credits. Temporary provisions also add complexity to compliance and administration, particularly when they are renewed retroactively, a particularly pernicious feature of recent tax policy. And they reduce federal revenues at a time of persistent, large deficits.

The expiring provisions have mixed effects on the fairness of the tax code. Some, such as the one for NASCAR venues, add to the perception that the tax code is riddled with special interest giveaways. Others arguably make the system fairer. The tax break for mass transit benefits, for example, reduces the federal tax disparity that would otherwise exist between people who use mass transit and those who drive.

These provisions similarly have mixed effects on the health of our economy. Several have attempted to provide near-term economic stimulus. Others attempt to encourage clean energy, but fall short of the economic ideal (Marron 2011a). And some worsen existing economic distortions. The deductibility of mortgage insurance premiums, for example, further amplifies the tax code's bias in favor of housing debt over other uses of capital.

Fundamental tax reform would be the best way to address all these concerns. Congress can and should create a tax code that is simpler, fairer, and more conducive to economic prosperity while raising adequate revenue and eliminating pointless expirations of tax provisions that deserve longer lives. Such reform could involve several components, such as greater reliance on consumption and pollution taxes. The most likely path, however, involves broadening the tax base by reducing tax preferences and using the resulting savings to reduce deficits, lower rates, or both. That approach has been endorsed by several reform efforts, including the Bowles-Simpson commission and the Domenici-Rivlin task force (National Commission on Fiscal Responsibility and Reform 2010; Bipartisan Policy Center Debt Reduction Task Force 2010; I was a member of the latter).

Such reform is not likely this year, however, so lawmakers must again grapple with the "expirers." As a first step, they should differentiate among three types of expiring provisions:

- *Tax cuts enacted to address a temporary challenge.* Some temporary tax provisions were enacted because of national or regional emergencies. Partial expensing, for example, was intended to encourage and accelerate investment in a weak economy. Excluding mortgage forgiveness from taxable income was intended to help homeowners and encourage principal reductions in the aftermath of the housing crash. Tax benefits for New York City following 9/11, the Gulf Coast following Hurricane Katrina, and areas damaged by Hurricane Ike and the 2008 Midwestern storms were intended to help those areas recover from disasters.

  Each of these provisions should expire unless the temporary need still exists and the provision's performance justifies extending it.

- *Tax cuts that have reached a sunset review.* Some temporary tax provisions address ongoing policy concerns but have finite lives in order to force periodic congressional review. When Congress first enacted the R&E credit in 1981, for example, it included a sunset to force a review at the end of 1985 (Joint Committee on Taxation 2012). Prolonged economic weakness and the growing tendency for Congress to enact omnibus short-term extensions make it difficult to identify provisions subject to sunset reviews today. However, JCT (2012) does identify a few expiring provisions that were last enacted before the economic downturn. These include the credit for production of Indian coal and the refundability of credits for prior year minimum tax liability.

  These provisions deserve special scrutiny because they have received no review since their original enactment or last sunset review.

- *Tax cuts that expire every year or two to game budget rules*. Many expiring provisions are in this category. Their supporters intend them to be permanent or long-lived, but they haven't been able to find the budgetary resources to extend them for a prolonged period. Examples include numerous energy incentives, the deduction for schoolteacher expenses, the R&E credit, and the subpart F treatment of active financing income.

Some of these provisions are good policy and ought to be renewed for a prolonged period or made permanent. Others should be allowed to expire once and for all.

To determine which policies are which, policymakers should consider several factors:

- *Rationale for government intervention.* Does the provision address a compelling need for government intervention? For example, does it address an important externality from private activity (e.g., by reducing negative spillovers or increasing positive spillovers)? Does it improve the income distribution or otherwise make society more equitable? Does it correct a flaw in the tax code?

- *Efficiency.* Does the provision accomplish its goal effectively and at reasonable cost? Could the government achieve the same result at lower cost through other means?

- *Fairness*. Does the provision make the tax code more or less fair? Does it level the playing field among different activities or tilt the playing field further (an issue of both fairness and efficiency)?

- *Revenue*. Do the potential benefits, if any, justify the loss of revenue at a time of large and persistent deficits? (Equivalently, for members who want to maintain current revenue levels, do the potential benefits of the provision justify levying higher taxes elsewhere in the economy?)

- *Duration*. Does it make sense for the provision to be enacted a year or two at a time? Or does that undermine its potential benefit? Should it be a permanent part of the tax code or, at least, extended for a prolonged period before its next sunset?

In making such evaluations, policymakers should keep in mind that most of the so-called "tax extenders" are effectively spending programs run through the tax code.

Rather than "letting people keep their own money," these provisions give money to people and businesses if they do things the government wants, whether it be investing in wind energy, adopting a child, giving supplies to school children, making certain types of charitable donations, or undertaking new research. Those incentives could, in principle, be structured as spending programs instead. The logistics and political optics would be different—the program would be recorded as spending and different committees would exercise congressional oversight—but the economic, social, and budget consequences would be the same. Lawmakers should thus hold these provisions to the same standards they apply to equivalent spending programs. They should also keep in mind that cutting back on these subsidies, when appropriate, would make the government smaller even though tax revenues, as conventionally measured, would increase.[2]

Lawmakers should also reform the way they review expiring tax provisions. I have three suggestions:

- *Flip the burden of proof.* Today's standing presumption is that most or all of these provisions will ultimately be extended. That's why they are called "the extenders," even after they have expired. That presumption places the burden of proof on those who believe a provision should expire (and stay expired), rather than on its supporters. Lawmakers could reverse that burden by expecting temporary provisions to expire unless supporters can demonstrate sufficient merit. Such provisions would rightly be known as "the expirers."[3]

- *Divide to conquer.* Musk oxen form into a tight circle when wolves appear on the arctic tundra. They know that the key to survival is to stick together. The wolves, meanwhile, try to separate a single one from the herd so they have a chance to feed their pups.

  The same is true with expiring tax provisions. The beneficiaries of each provision have no desire to stand out, lest that draw scrutiny. Their goal is to coalesce as a single herd—"the extenders"—and migrate across the annual legislative tundra with as little attention as possible.

[2] For an extended discussion of these points, see Marron (2011b) and Marron and Toder (2012).

[3] This approach would make particular sense after Congress reviews all the expiring provisions and makes worthy ones permanent or long-lived; the remaining "expirers" would then be either sincerely temporary or subject to a periodic sunset.

For lawmakers to engage in serious oversight, they need to break up the herd. In principle, that would mean reviewing each provision on its merits every time it faces expiration. In practice, though, demanding annual review of dozens of provisions could well deliver careful review of none.

One way to address this challenge is for policymakers to distinguish and review groups of expiring provisions rather than approach them as an undifferentiated mass. Crandall-Hollick (2012) offers one possible taxonomy, categorizing provisions as individual, business, charity, energy, community, and disaster. The provisions could also be further distinguished as intentionally short-lived, subject to periodic sunset review, or pretending to be temporary for budget reasons. Lawmakers could then focus on each of these smaller groups rather than all the provisions together.[4]

Another strategy would be to spread scheduled expirations out over time. If fewer provisions expired each year, Congress would be able to give each one greater attention. To do so, however, would likely require new budget rules.

- *Change budget rules for temporary tax cuts.* Pay-as-you-go budgeting places crucial discipline on new legislation, but it has an unfortunate side effect: long-term tax policies often get chopped up into one-year segments. For example, lawmakers often find it easier to pay for a one-year extension of the R&E credit than a five- or seven-year extension. The short extension reduces the apparent price tag of the provision, even though everyone knows it will need to be extended again the next year. It also allows lawmakers to use 10 years of offsets to pay for a single-year extension, further lowering the apparent price tag. Such short-sighted budgeting is a key reason the number of expiring provisions has blossomed in recent years.

  One potential solution would be to change the budget rules that apply to temporary tax provisions. Congress could require that any temporary tax provision be assumed to last no less than, say, five years in the official budget baseline. Proponents would then have to round up enough budget offsets to pay for five years of the provision. In return, they wouldn't have to come back to legislators for another five years. Over time, this approach would spread

[4] An example is the hearing this Subcommittee held last fall on taxes and energy policy (Marron 2011a).

tax provisions out in time and allow Congress to devote more attention to each when it periodically comes up for review.[5]

Another possibility would be to require that a one-year extension be paid for with offsets in the same year or, more generally, that offsets happen over the same years covered by the extension. That would eliminate situations in which 10 years of offsets pay for a single-year extension.

If Congress enacts such budget process reforms, it may want to allow a safety valve for special cases. One option would be to allow an emergency designation, similar to that for discretionary spending, for tax cuts that should truly last just a year or two or should not be immediately offset (e.g., stimulus). Such emergency measures could then be exempt from either or both of these requirements.

Thank you again for inviting me to appear today. I look forward to your questions.

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[5] Lawmakers could go even further, of course, and require that temporary tax cuts be assumed to persist for the entire ten-year budget window, as currently happens with mandatory spending programs.

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