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TEMPORARY TAX POLICY IN THE UNITED STATES

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Chairman Thompson, Ranking Member Smith, and Members of the Subcommittee, thank you for inviting me to appear today to discuss issues surrounding temporary tax policy. The views I express in this testimony are my own and should not be attributed to the Tax Policy Center, the Urban Institute, the Brookings Institution, their boards, or their funders.

BACKGROUND

The history of temporary tax policy in the United States is long, going back at least to the 1960s. Just one example can help illustrate this history. In 1962, an investment tax credit was enacted to help spur business investment. The credit rate was 7 percent, and the credit could be claimed on new tangible personal property; generally, this covered machinery and equipment and was intended to exclude buildings. A limited amount of used property ($100,000) also was eligible. The amount of credit claimed was subtracted from the asset basis subject to depreciation, but this provision was dropped in the Revenue Act of 1964. At that point, the credit provided a flat 7 percent tax subsidy for investment in qualified property. But then Congress and the Johnson administration became concerned about inflation and an overheated economy, so the credit was suspended from October 1966 to March 1967, then reinstated. The investment credit was repealed in the Tax Reform Act of 1969 but reinstated in the Revenue Act of 1971. Then the credit rate was temporarily increased to 10 percent in the Tax Reduction Act of 1975 to further stimulate business investment. And in the Tax Reform Act of 1976, Congress extended the 10 percent investment tax credit through 1980. So, Congress saw fit to modify this one provision several times in a decade and a half. And taxpayers had to adjust to these modifications.

During the 1970s, Congress adjusted the standard deduction, personal exemption, and tax brackets to deal with the inflation that had eroded the real value of these tax parameters. That meant Congress temporarily modified provisions that affected large numbers of individual taxpayers.

During the 1980s, several explicitly temporary provisions were introduced into the tax code. These included the Research and Experimentation Tax Credit, the Low-Income Housing Tax Credit, the Targeted Jobs Tax Credit (which became the Work Opportunity Tax Credit), and tax exclusions for employer-provided education assistance and group legal services. The list expanded over time to include mortgage revenue bonds, a deduction for health insurance purchased by self-employed people, the orphan drug credit, tax incentives for ethanol production and for production of nonconventional fuels, and various others.

During the 1980s and 1990s, the list of provisions expiring in any one year grew to 30 items or more. Congress generally extended these provisions, though it allowed some to lapse. And with concerns about the federal budget deficit paramount, Congress began offsetting the revenue cost associated with these extensions. Under the pay-as-you-go budget rules, Members or Committees interested in extending various temporary tax provisions were required to identify offsets to cover the projected forgone revenue caused by the extensions. This set up a healthy tension over the social desirability of these provisions. The political and economic costs of raising taxes on some parties had to be weighed against the political and economic benefits of extending favorable tax treatment to other parties.

In the 2000s, this healthy tension dissipated along with serious concern about budget deficits. Congress enacted two large tax cuts that were scheduled to expire in 2010. And Congress routinely extended the numerous expiring provisions, generally without revenue offsets. The tendency during this period was to enact and extend more and ever-larger temporary tax provisions. The Protecting Americans from Tax Hikes (PATH) Act of 2015 did make some temporary tax provisions permanent, though without offsetting revenue increases. However, it also temporarily extended some other provisions.

The Tax Cuts and Jobs Act, enacted in 2017, continued this trend. Many provisions have scheduled expiration dates: the lower adjusted gross income (AGI) threshold for deductible medical expenses (7.5 percent of AGI instead of 10 percent) expired at the end of 2018, the lower excise taxes on alcoholic beverages expire at the end of 2019, the new tax credit for employers providing paid family and medical leave also expires at the end of 2019, and most new individual income tax provisions and the increased exemption amounts for estate and gift taxes expire at the end of 2025. Other provisions spring up, such as the amortization of research expenditures, which starts in 2022. And some tax rates changes; for instance, the rates for the Global Intangible Low-Taxed Income (GILTI) and the Base Erosion and Anti-Abuse Tax (BEAT) are both scheduled to increase in 2026. So, many new temporary tax provisions were added by the Tax Cuts and Jobs Act.

Another, parallel trend also occurred over recent decades as Congress became more tolerant of failing to extend various temporary tax provisions before the tax year began. Congress even began to accept regular retroactive extensions of some provisions. These delays reduce the effectiveness of the tax incentives contained in the provisions, especially those that affect investment behavior.

A simple illustration may help explain how this works. For a tax incentive to be effective, taxpayers need to incorporate it into their planning for investment or other economic activity. Otherwise, the incentive effect becomes blunted. If the extension is retroactive, the tax incentive becomes, in effect, a financial reward for doing what the taxpayer would have done even in the absence of the incentive. This is essentially the definition of an ineffective subsidy. Now, reality is a bit more complex than that simple illustration because taxpayers operate in a world of uncertainty and so presumably would assign a probability to their ability to claim the tax incentive. But the point is clear: a tax incentive that can be claimed with certainty will have a larger effect on economic behavior than one that only might be available to subsidize the behavior.

I focus on two aspects of desirable tax policy: ensuring adequate revenue to fund the federal government and providing certainty to taxpayers. Recent experience with temporary tax policy indicates that Congress is falling short on both dimensions.

That is not to say that all temporary tax provisions constitute undesirable tax policy. There are certainly pros and cons to enacting tax provisions on a temporary basis. Some arguments in favor of temporarily enacting tax provisions are the following:

- A temporary tax provision can help Congress understand if the provision would be a desirable permanent change to the tax code. For example, whether and how much a tax incentive will increase the level of a targeted activity is usually not precisely known in advance. Key to generating this improved level of understanding is a rigorous evaluation of the tax incentive, ideally performed by an objective evaluation team.

- A temporary tax provision can more easily accommodate fine-tuning or tinkering with the details of the provision. The short-term nature provides natural time points where desirable improvements can be made to the statute.

- A temporary tax provision can allow Congress to see whether the constituency for continuation is broad or narrow. Broader support may indicate more widely perceived social benefit.

There are arguments in the other direction, as well. Some arguments in opposition to temporary tax provisions include the following:

- Temporary tax provisions add uncertainty to the tax code. Taxpayers making important decisions should be able to predict the tax consequences of their actions. This is especially important for investment projects that have long lead times, where the statutory life of a temporary provision may not be long enough to guarantee that a taxpayer will be able to reap the favorable tax consequences (for example, by placing property in service before the scheduled expiration date).

- Routine extensions of temporary tax provisions without a rigorous evaluation of their effectiveness means that these temporary tax provisions may not be effectively promoting the stated desired outcomes.

- Temporary tax provisions with short effective periods put pressure on Congress to legislate regularly (at times annually), and continual demands for legislation is often incompatible with thorough debate over the efficacy of the provisions.

- Short-term extensions of temporary tax provisions create a culture of dependency among specific groups of taxpayers who mobilize regularly to seek legislation that pushes out the expiration date a little further into the future.

- When temporary tax provisions are allowed to lapse, taxpayers are put into an awkward and, at times, untenable position. For instance, taxpayers filing returns this spring have to deal with provisions that lapsed for all of 2018, even if these taxpayers have hopes for a retroactive extension. Such taxpayers need to choose between filing a tax return by the due date or requesting an extension to see if the uncertainly in their 2018 tax situation gets resolved.

Based on the history of temporary tax policy and the recent trends, it appears that Congress is not adhering to all the principles of good tax policy. But Congress can take steps that would be clear moves in the right direction. Three suggestions in this regard are as follows:

1. Enact fewer temporary provisions. And Congress should make legislated provisions temporary as a conscious choice, clearly understanding how and when the decision will be made to make the provision permanent or allow it to expire.
2. Pair each temporary tax provision with a serious evaluation of its effectiveness. Congress can ask the analysts at the Government Accountability Office to undertake this work. Or Congress can appropriate funds to support evaluations by entities such as the National Academies of Sciences.
3. Do not extend temporary tax provisions retroactively. If a provision is important enough to be in the tax code, it should be important enough to have in law so it can be relied upon by taxpayers making investment, spending, and other decisions during the tax year. Providing certainty in this manner will increase the effectiveness of the tax provisions.

These three steps would nudge the tax code in a positive direction, where the tax system can provide appropriate market signals to taxpayers to encourage desirable economic activity. These steps toward creating a tax code that works better for America are modest, but every journey starts with a few steps.