Statement before the House Committee on Ways and Means
Subcommittee on Select Revenue Measures

Hearing on Framework for Evaluating Tax Extenders

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June 8, 2012

Chairman Tiberi, Ranking Member Neal, and members of the subcommittee, my name is Alex Brill, and I am a research fellow at the American Enterprise Institute. Thank you for the opportunity to appear before you this morning to discuss the regularly expiring tax provisions commonly known as "tax extenders."

As you carefully define in the document setting forth this hearing, "tax extenders" are a subset of the tax provisions extended by Title VII of the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (Public Law No. 111-312), as well as a number of other tax provisions that have expired or will expire this year. Before elaborating on my views, let me lead with my conclusion:

- Each tax extender provision must be considered individually, on its own merits, and against clearly defined objectives. Each and every tax extender must be shown to be appropriate against one or more of these objectives. Later in my testimony I suggest two criteria that could guide this decision-making process.

- No tax policy should be intentionally temporary. Any tax extenders deemed appropriate should be made permanent and the rest should be allowed to expire.

- A successful evaluation of tax extenders—keeping the good and eliminating the bad—may set a useful precedent for the bigger challenges of tackling other tax expenditures.

In this testimony, I first present a brief background on recent trends in tax extenders and then discuss how to evaluate which tax extenders should be made permanent and which should be allowed to expire. I then highlight four harmful effects of intentionally preserving a set of temporary tax provisions. I conclude with a comment regarding tax reform.

Background: Tax Extenders Are Growing, and Thus Are a Growing Concern

The number and budgetary magnitude of regularly expiring tax provisions have ballooned in recent years. The Joint Committee on Taxation (JCT) releases a report almost every year listing expiring provisions and the date on which they are scheduled to expire. Table 1 reports the number of expiring tax provisions by year for each of the JCT reports on expiring provisions since 1998. The table reveals a rapid increase in the number of expiring tax provisions, particularly provisions that are set to expire within the current year or the following year. In 2001, 13 tax provisions were set to expire that year or in 2002. A decade later, in 2011, 129 tax provisions were set to expire in 2011 or 2012.

Table 1. Number of Expiring Federal Tax Provisions and Year in Which They Expire

	JOINT COMMITTEE ON TAXATION LIST OF EXPIRING FEDERAL TAX PROVISIONS											
Report Issue:	1998	1999	2001	2003	2004	2005	2007	2008	2009	2010	2011	2012
Year of Expiration												
1998	9	4										
1999	4	8										
2000	6	5										
2001	5	3	**10**									
2002	5	5	**3**	**3**								
2003	4	6	12	**24**	**22**							
2004	1	3	5	7	**14**	**2**						
2005	7	8	11	11	13	**42**						
2006	0	0	1	9	9	16	**6**					
2007	9	7	7	7	7	9	**47**	**44**				
2008		1	0	1	3	6	22	**26**	**5**			
2009			8	8	8	14	20	21	**89**	**88**		
2010			1	1	1	3	10	12	42	73	**33**	
2011						0	7	8	11	12	**84**	**73**
2012						0	2	2	8	8	46	**56**
2013						1	1	1	7	7	7	8
2014						1	9	9	7	7	7	7
2015							1	1	0	0	0	0
2016 & beyond							1	1	8	9	8	8
Total expiring	**50**	**50**	**58**	**71**	**77**	**94**	**126**	**125**	**177**	**204**	**185**	**152**
1st & 2nd year expiring	**13**	**12**	**13**	**27**	**36**	**44**	**53**	**70**	**94**	**161**	**117**	**129**

Source: Joint Committee on Taxation, various reports.

The great majority of tax extenders are credits, deductions, and exclusions that can be viewed as tax expenditures. Therefore, the increase in the number of tax extenders contributes to the increase in tax expenditures. The JCT tracks the number of tax expenditures over time and recently noted the rise in the number of tax expenditures from 100 in 1981 to 150 in 2003, and then to 250 in 2009.[1]

The budgetary consequence of tax extenders has also increased significantly over time. For example, in September 2004, Congress enacted H.R. 1308, the "Working Families Tax Relief Act," which contained a one-year extension of 23 tax extenders, ranging from the research and experimentation (R&E) tax credit to the above-the-line deduction for teacher classroom expenses, with a net revenue loss of $13 billion

[1] Joint Committee on Taxation (JCT), "Testimony of the Staff of the Joint Committee on Taxation before the Joint Select Committee on Deficit Reduction" (JCX-49-11), September 22, 2011, available through www.jct.gov/publications.html?func=startdown&id=4363.

over the budget window.[2] In 2010, a two-year extension of tax extenders cost $55 billion.[3] If Congress were to extend the set of tax provisions for an additional year, the cost would be even higher.

How to Evaluate Tax Extenders

As I said at the outset, each tax extender should either be made permanent or allowed to expire. To guide this determination, I advocate assessing each tax extender's appropriateness and effectiveness. Policymakers should ask two questions about each tax extender.

1. Does the Intent of the Provision Reflect Sound Tax Policy?

First, policymakers should consider the intent of each provision individually and evaluate whether those intentions improve economic efficiency, increase growth, promote fairness, or achieve some other desirable policy goal.

For example, the R&E tax credit is intended to increase the aggregate level of R&D in the United States because of the "positive externality" R&D generates (i.e., benefits to society beyond those realized by the firm conducting the R&D). This tax credit is intended to promote innovation and foster productivity growth. In my view, these are sound policy objectives, and I support making the credit permanent, in the context of the current tax code.

The deduction for state and local general sales tax, another tax extender, does not seek to promote economic growth, but rather to provide parity between resident of states with state income taxes and residents of states with only sales taxes. In my view, a more appropriate means to achieve parity would be to repeal the deduction for state and local income taxes.[4]

With regard to a tax extender that is intended to subsidize a given activity, special care must be taken to properly evaluate its net economic benefit. Most tax subsidies will increase the subsidized activity or product, but that need not mean that it will produce a net positive economic benefit or improve economic efficiency. In the absence of externalities, a tax credit or other subsidy for a given activity will generally lead to a misallocation of resources in the economy—more of the subsidized activity, but less of everything else. A provision that simply leads to more of a particular activity does not necessarily promote overall economic growth.

This first question has examined each tax extenders' appropriateness based on its intent.

[2] JCT, *Estimated Revenue Effects of the Conference Agreement for H.R. 1308, the "Working Families Tax Relief Act of 2004"* (JCX-60-04), September 23, 2004, available at www.jct.gov/x-60-04.pdf.
[3] JCT, *Estimated Budget Effects of the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," Scheduled for Consideration by the United States Senate* (JCX-54-10), December 10, 2010, available through www.jct.gov/publications.html?func=showdown&id=3715.
[4] See Alex Brill, "A Pro-Growth, Progressive, and Practical Proposal to Cut Business Tax Rates," AEI *Tax Policy Outlook*, no. 1 (January 2012), available at www.aei.org/outlook/economics/fiscal-policy/taxes/a-pro-growth-progressive-and-practical-proposal-to-cut-business-tax-rates.

2. Would the Policy Be Effective If It Were Permanent?

Second, policymakers should evaluate the likely effectiveness of the policy if it were made permanent, a more complicated question than its effectiveness in its current temporary form. For example, numerous analysts have noted that the temporary structure of the R&E tax credit inhibits its effectiveness.[5] As the Technology Policy Institute's Scott Wallsten has testified:

> Because firms tend to smooth their R&D spending over time, their responses to temporary policies are likely to be muted. A temporary tax credit will, therefore, have limited effectiveness. That is, if firms do not have confidence that the credit will remain in effect, they will probably not increase their R&D spending by as much as they would if the credit were permanent. A permanent R&D tax credit would be more consistent with the way companies make decisions regard R&D spending and is more likely to have the intended positive effect on private spending.[6]

Some tax extenders may be ineffective due to their temporary nature, but would be effective if made permanent. Other extenders may be ineffective, distortionary, or undesirable regardless of whether they are temporary or permanent.

Additional Concerns Raised by Tax Extenders

To explain why I advocate either eliminating tax extenders or making them permanent, I now highlight four harmful consequences that the constant expiration and reinstatement of tax extenders have for businesses, the economy, and policymakers.

1. Tax extenders distort the fiscal budget baseline, thereby complicating revenue and deficit forecasts. The fiscal outlook for the U.S. economy is severely troubling, to say the least. Not only have annual deficits exceeded $1 trillion for a number of consecutive years, but spending on health care and Social Security is projected to increase by more than 5 percent of GDP in the next twenty-five years.[7] However, forecasting the budget outlook has become increasingly complicated as the number of tax extenders and the associated revenue loss have increased. While the majority of the revenue uncertainty is attributable to the expiration of tax policies originally enacted in 2001 and 2003, the portion attributable to tax extenders is significant. Making all of the extenders permanent would reduce revenue by approximately $400 billion

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[5] For more on the importance to society of R&D, see Bronwyn H. Hall, Jacques Mairesse, and Pierre Mohnen, "Measuring the Returns to R&D," National Bureau of Economic Research, Working Paper 15622, December 2009.
[6] Scott Wallsten, "The Role of Government in Promoting R&D," testimony before the Senate Finance Committee, September 20, 2011, available at www.techpolicyinstitute.org/files/wallsten_senate_finance_rd_testimony.pdf.
[7] Congressional Budget Office (CBO), *The 2012 Long-Term Budget Outlook*, June 2012, available at www.cbo.gov/sites/default/files/cbofiles/attachments/06-05-Long-Term_Budget_Outlook.pdf.

over the next ten years.[8] Budget forecasts made by the Congressional Budget Office therefore present both a "current law" and a "current policy" baseline, which illustrates the uncertainty of expected future tax receipts given the expiration of "tax extenders" and other temporary policies. The gap between these two scenarios is widening, making plausible budget forecasts more difficult.

Furthermore, new tax extenders are often created as a result of budget scoring maneuvers to mask the long-term budgetary consequences of a new provision. For example, the American Opportunity Tax Credit enacted in 2009 for calendar years 2009 and 2010 at an estimated cost of $10.2 billion[9] was extended in 2010 for two years at a cost of $17.6 billion.[10]

2. Tax extenders create financial reporting problems for publicly traded companies. When tax extenders expire and are retroactively reinstated, this introduces unavoidable discrepancies in public companies' quarterly reports, as they report information based on a policy's having expired, only to then have to account for the policy's subsequent reinstatement.[11]

3. Tax extenders exacerbate the uncertainty facing businesses. While all tax policy is temporary in some sense, because Congress has the authority to change any provision it chooses, the uncertainty of policies *scheduled* to expire but likely to be extended (or reinstated) is an unnecessary burden on an already burdened private sector. This burden worsens the economic environment for firms by increasing uncertainty. For a visual representation of how this uncertainty has increased over time, see Figure 1, drawn from a paper authored by Scott Baker and Nicholas Bloom, both of Stanford University, and Steven Davis of the University of Chicago. This index is, in effect, a discounted summation of the data that I presented in Table 1. Their research, which examines policy uncertainties beyond just tax policy uncertainty, concludes that an increase in fiscal policy uncertainty similar to what was experienced from 2006 to 2011 would have had a very significant impact on U.S. employment and economic production.

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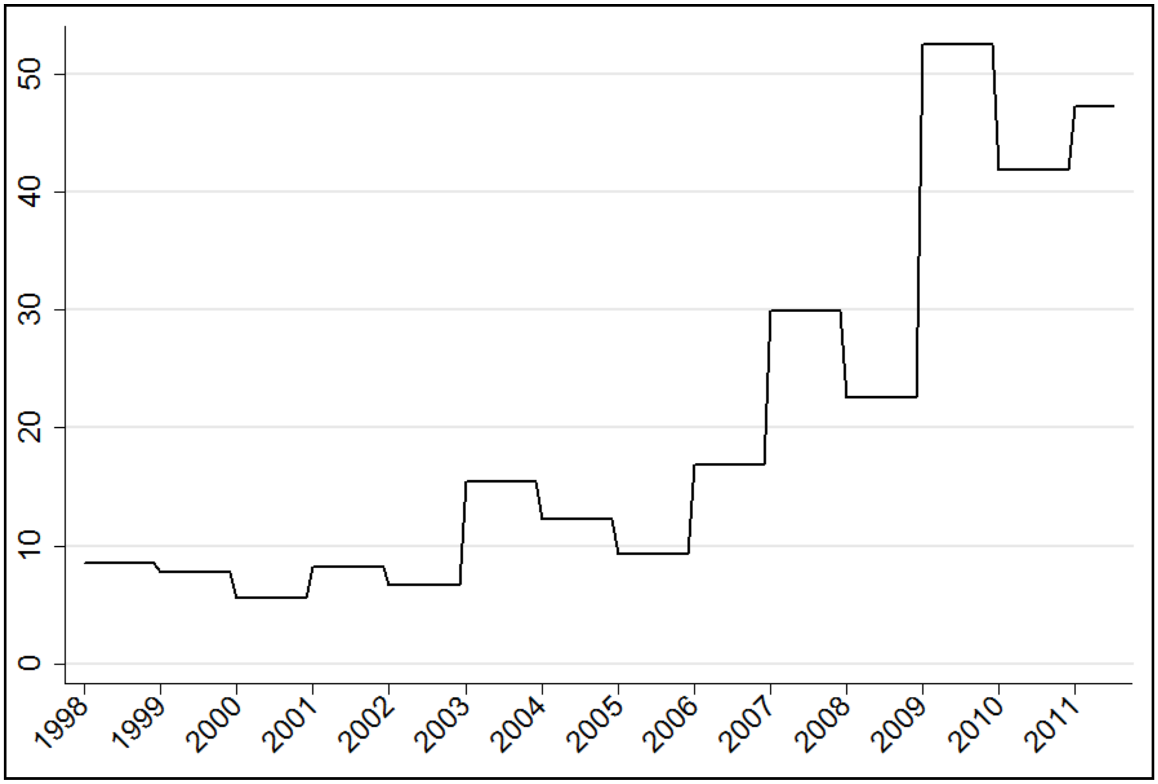
[8] CBO, "Expiring Tax Provisions—January 2012 Baseline," January 31, 2012, available through www.cbo.gov/publication/42910.

[9] JCT, *Estimated Budget Effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1, the "American Recovery and Reinvestment Tax Act of 2009"* (JCX-19-09), February 12, 2009, available through www.jct.gov/publications.html?func=startdown&id=1172.

[10] JCT, *Estimated Budget Effects of the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," Scheduled for Consideration by the United States Senate*.

[11] According to the Chamber of Commerce, "[T]he uncertainty of expired deductions and credits can have a material impact on a business' bottom line in certain cases, requiring certain disclosures such as in financial statements filings, which can adversely affect the business more broadly." (Chamber of Commerce, testimony before the Senate Finance Committee, January 31, 2012, available at www.finance.senate.gov/imo/media/doc/Harris%20Testimony%20SFC%20Tax%20Extenders1.pdf.)

Figure 1. Tax Legislation Expiration Index



Source: Scott R. Baker, Nicholas Bloom, and Steven J. Davis, "Measuring Economic Policy Uncertainty," October 10, 2011, available at http://faculty.chicagobooth.edu/steven.davis/pdf/PolicyUncertainty.pdf.
Notes: Utilizes List of Tax Expirations from the Joint Committee on Taxation. Each year's forecast is a 10-year horizon of expiring tax laws. Future months expirations are weighted by 0.5^((T+1)/12) where T is the number of months in the future the tax is expiring.

4. Tax extenders are intended to ensure oversight, but they are generally extended without much consideration. In theory, forcing periodic reconsideration of tax policy may facilitate congressional oversight of various provisions. Numerous spending policies require periodic reauthorization, which permits reforms and policy adaptations. Obviously, today's hearing and this Committee's previous hearing on this issue could be considered elements of such an oversight effort. However, I would humbly suggest that given the budgetary magnitude of the extenders, such oversight has been woefully inadequate. My view is that much more oversight regarding the effectiveness of these policies (and other tax expenditures) should occur. However, that oversight should not be driven by scheduled tax policy expirations, but rather by the constant pursuit of tax reform. While various spending policies that are scheduled for periodic reauthorization have spurred ample research in these areas,[12] tax extenders have not

[12] See, for example, AEI's research on the Farm Bill reauthorization, available through www.aei.org/topic/farm-bill; and No Child Left Behind, available through www.aei.org/topic/no-child-left-behind.

served to create a framework for research around the provisions, with the exception of the R&E credit[13] and occasional reports on a few other provisions.

Conclusion: The Rise of Tax Extenders Is Evidence of the Need for Tax Reform

The expansion in the number and fiscal impact of tax extenders serves as strong evidence that the quality and efficiency of the tax system has further eroded. Given the budgetary outlook and need for a more rational, pro-growth tax system, lawmakers must seriously evaluate each and every tax extender provision. Even extenders with relatively small budgetary impact deserve scrutiny, as their economic burden or benefit could be much larger.

As I outlined above, the first question is whether the extender is intended to serve a valid policy goal, such as promoting economic growth or tax fairness. The second question is whether the extender would be effective at achieving its intended goal if it were permanent. Extenders that meet these criteria should be made permanent and the others should expire.

No revenue should be forgone for policies that do not serve an appropriate purpose or are limited in their effectiveness. The tax extender "momentum" that has existed over the last decade, whereby new tax extenders are added while few terminate, is not sustainable.

As this Committee knows well, the tax base has eroded significantly over the last twenty-five years. A proliferation of tax credits, deductions, and exclusions has left a tax system with a myriad of provisions that misallocate resources, create complexity, and introduce compliance problems. The discussion of tax extenders offers a modest opportunity to reduce complexity and uncertainty within the tax code. I hope that a successful effort to curtail ineffective or inappropriate tax extenders will set a positive precedent for the greater challenge this Committee will face if it embarks on broader tax reform.

[13] See, for example, Bronwyn H. Hall, "The Private and Social Returns to Research and Development," in *Technology, R&D, and the Economy*, ed. Bruce L. R. Smith and Claude E. Barfield (Washington, DC: The Brookings Institution and the American Enterprise Institute, 1996). For a discussion of possible reforms to the R&E credit, see Alan D. Viard, "Tax Policy and Growth," in *Rules for Growth: Promoting Innovation and Growth through Legal Reform* (Kansas City, MO: Ewing Marion Kauffman Foundation, 2011), available at www.aei.org/files/2011/02/08/Tax-Policy-and-Growth.pdf.