EPI TESTIMONY

TESTIMONY OF

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BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
HEARING ON BENEFITS OF PERMANENT TAX POLICY FOR AMERICA'S JOB CREATORS

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Chairman Camp, Ranking Member Levin, and Members of the Committee: Thank-you for inviting to share my views on the business tax extenders. I am speaking for myself.

Each year dozens of temporary tax provisions expire. And many are regularly extended for another year or two, with little or no scrutiny, in the annual "tax extenders" package. The issue this hearing seeks to address is "the problems caused by tax policies that frequently expire and are extended for short periods of time (and often retroactively)," with particular emphasis on seven expiring business tax provisions.

In summary, here are my main points:

- The tax extenders package is being considered in a challenging long-term fiscal environment—one with budget deficits as far as the eye can see—in which maintaining long-term fiscal discipline is necessary.
- Making some or all of the expiring tax provisions permanent without offsetting the revenue losses will permanently increase budget deficits and accelerate the accumulation of federal debt.
- Running large annual budget deficits when the economy is operating at or near its potential can accelerate inflation, increase interest rates, reduce private sector investment, and reduce economic growth, thus destroying jobs. It is likely that any jobs created by these seven provisions would be entirely offset by jobs lost due to larger budget deficits over the longer-term.
- I think the appropriate question regarding the tax extenders is which ones should remain in the tax code and which ones should be eliminated, rather than asking if they should be permanent or temporary. Some may have outlived their usefulness, others were never effective, and still others achieve important economic goals.

Current Economic Environment

To evaluate tax policy changes, I believe it is important to first look at the economic environment (short-term and long-term) in which the changes are being considered.

The United States faces a long-term fiscal challenge—after 2023 we face the unsustainable growth in federal debt held by the public as projected under the Congressional Budget Office's (CBO) extended baseline.[1] Between now and 2023, federal debt as a percentage of GDP rises from 72 percent to 78 percent.[2] Barring tax and spending changes, however, federal debt as a percentage of GDP is projected to grow to over 100 percent by 2038 (a year near the end of my life), to about 150 percent by 2055 (the year my daughter is first eligible for full Social Security benefits), and to over 200 percent by 2080 (a year near the end of my daughter's life).

I want to emphasize that these are CBO's projections under their extended baseline. This baseline assumes current law does not change. Consequently, it assumes that the seven tax

[1] Congressional Budget Office, *The 2013 Long-term Budget Outlook*, September 2013.
[2] Congressional Budget Office, *The Budget and Economic Outlook: 2014 to 2024*, February 2014.

provisions you are considering today as well as 50 to 60 other expired provisions are not extended for even one day.

Budgetary Implications

Concern over our long-term fiscal challenges appears to have made long-term fiscal discipline the order of the day. For example, Congressional budget proposals, such as the Congressional Progressive Caucus's budget proposal and Mr. Ryan's budget proposal, lay out policies that would reduce budget deficits and federal debt over the 10-year budget window, albeit in very different ways.

Chairman Camp recently unveiled a comprehensive tax reform plan that is revenue-neutral over the 10-year budget window.[3] Revenue losses from tax rate reductions and making certain tax provisions permanent (including most of the provisions under discussion today) are offset with revenue increases from base broadening. Fiscal discipline is maintained over the budget window. This was all noted in the Advisory for this hearing.

The Advisory goes on to note that revenue neutrality "is not consistent with recent practice by Congress in its consideration of tax extenders legislation." One is left to wonder if the commitment to fiscal discipline is to be abandoned for this extenders package. Let's examine the budget implications of the tax extenders under the assumption long-term fiscal discipline is abandoned.

The chart displays projected federal deficits as a percentage of GDP until fiscal year 2023. The dashed line is CBO's baseline deficit projection. It follows a U-shape pattern with the low in 2015 and then gradually rising through to 2023. The thin solid line shows what a 2-year extension of the tax extenders does to projected deficits: a large increase in the next fiscal year, but the same as the baseline by 2023. However, federal debt in 2023 would be larger by almost 0.4 percent of GDP.

Lastly, the solid bold line shows projected deficits if all of the tax extenders were made permanent. Projected deficits would permanently be four-tenths of a percent of GDP higher than in the baseline. Furthermore, federal debt as a percentage of GDP would likely be over 3.5 percentage points higher.

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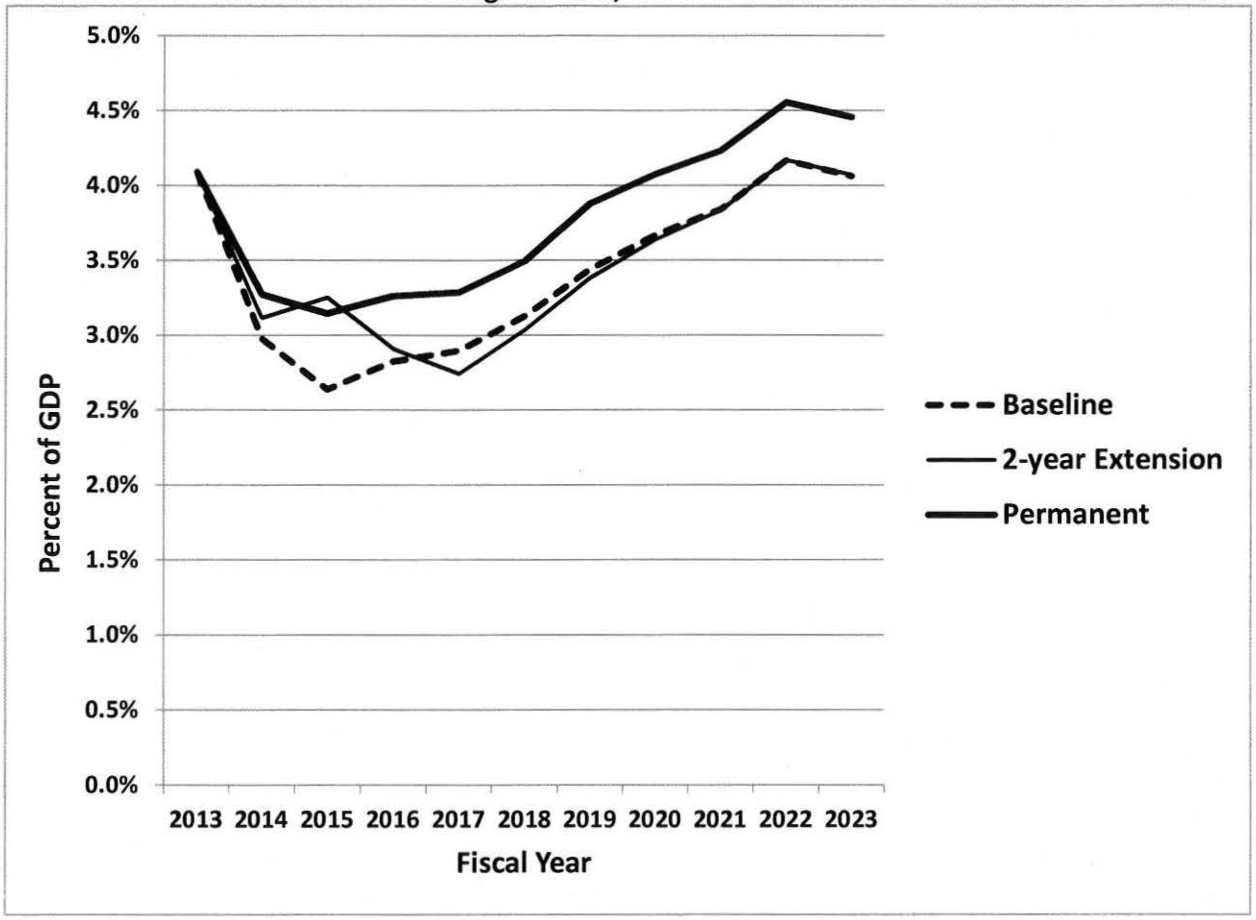
[3] It is unlikely the plan is revenue-neutral after 2024 because tax revenues from the one-time transition tax, changes to depreciate, and retirement savings account changes increase revenue in the first 10 years at the expense of decreasing revenues in the next 10 years.

Chart: Federal Deficits as a Percentage of GDP, 2013 to 2023: Various Tax Extender Scenarios



If the focus is narrowed to just the seven provisions under discussion today, which account for almost half of the revenue loss of all the expiring tax provisions, then the budget implications are not as severe but are still quite significant.[4] Abandoning long-term fiscal discipline by making these seven tax provisions permanent with no offsetting revenue increases could add almost one percentage point of GDP to federal debt by 2023.

The justification for making these seven provisions permanent is they are believed to encourage firms to create more jobs. But if long-term fiscal discipline is abandoned, then we face a future of budget deficits that are larger than expected. Running large annual budget deficits when the economy is operating at or near its potential can accelerate inflation, increase interest rates, reduce private sector investment, and reduce economic growth, thus destroying jobs.[5] CBO projects that the U.S. economy will be back to its potential in 2016. It is likely that

[4] In the Senate Finance Committee 2-year extension bill, extending these seven provisions reduce tax revenue by $40.6 billion over 10 years; this 48 percent of the total revenue loss from all the provisions extended in the bill ($85.3 billion).

[5] See, for example, Congressional Budget Office, *Federal Debt and the Risk of a Fiscal Crisis*, July 2010; William G. Gale and Peter R. Orszag, *Economic Effects of Sustained Budget Deficits*, Brookings Institution, July 2003; Jonathan Huntley, *The Long-Run Effects of Federal Budget Deficits on National Saving and Private Domestic Investment*, CBO

any jobs created by these provisions would be entirely offset by jobs lost due to larger budget deficits over the longer-term.

Other Evaluation Criteria

Ideally, commentators suggest that tax policy should be structured to meet several basic principles or criteria. Most importantly a good tax system must raise adequate revenue to run the government and meet the needs of the governed. Philosopher and economist Adam Smith further argued that a good tax system should meet four criteria: simplicity, convenience, efficiency, and equity.[6]

The tax system is called upon to perform several disparate functions. In addition to raising revenue, tax provisions are designed to provide incentives to encourage taxpayers to do more of a good thing or to discourage doing bad things. Temporary tax decreases are often used to help stimulate the economy during economic downturns—tax policy is one important tool of fiscal policy. (We have also used temporary tax increases to help reduce deficits.)

Without a doubt, tax policy changes can distort market behavior and reduce market efficiency, but they can also be used to correct distortions due to market failures and improve market efficiency. Tax policy changes also affect the complexity of the tax system, which creates compliance issues for taxpayers and enforcement issues for the IRS.

Given these disparate functions, it is no surprise that many tax provisions often conflict with one or more of these tax policy criteria. Any economic evaluation of tax provisions should examine the effects on the tax system with regard to meeting these criteria.

Many of the expired tax provisions are classified by the Joint Committee on Taxation and the Treasury Department as tax expenditures, and as such can be evaluated in the same way.[7] A nonpartisan expert panel, which questioned the extensive use of tax expenditures, recommended that any formal justification for new tax expenditures should answer the following questions:[8]

- Why is a government program necessary at all?
- What objectives is the tax break meant to accomplish, and how will success or failure be measured?
- What evidence can be cited that suggests the tax break will accomplish these objectives at an acceptable cost?

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working paper 2014-02, February 2014; and Marc Labonte, *The Sustainability of the Federal Budget Deficit: Market Confidence and Economic Effects*, CRS report R40770, December 2012.

[6] Adam Smith, *The Wealth of Nations*, Cannan ed. (New York: The Modern Library, 1937), pp. 777-779.

[7] For a detailed discussion, see Thomas L. Hungerford, "Tax Expenditures: Good, Bad, or Ugly?" *Tax Notes*, October 23, 2006, pp. 325-334.

[8] The Century Foundation Working Group on Tax Expenditures, *Bad Breaks All Around* (New York: The Century Foundation Press, 2002), pp. 28-29.

- Why is a tax break better than a direct spending program for accomplishing this purpose?

The expert panel noted that this is similar to the OMB circular A-11 requirements (which were initially considered important but have fallen into disuse over the years). Although the tax extenders are existing tax provisions rather than new provisions, the same questions can and should be asked.

Over the years, a number of analysts, academics, and policy makers have voiced their concern about the growing importance of tax expenditures and their effect on long-term fiscal problems. Some members of the 1994 Bipartisan Commission on Entitlement and Tax Reform thought that tax expenditures should be included as part of reforms to rein in entitlement spending.[9] The Century Foundation Working Group on Tax Expenditures (cited above) recommended that the Administration and the Congress consider scaling back or eliminating many existing tax expenditures and exercising restraint in proposing new ones. And the Government Accountability Office recommended that tax expenditures be subjected to systematic reviews and performance evaluations.[10]

The annual consideration of an extenders package provides an opportunity for a systematic review of many tax provisions, but only to the extent that the relevant Committees choose to do so. Periodic reviews are necessary because new evaluation research has been conducted, business and economic conditions change, and fiscal priorities change. All of this would argue for temporary tax provisions. Balanced against this is the stability that comes with permanence, which is beneficial to taxpayers in making economic decisions and to the government in making budget decisions.

Concluding Remarks

I think the appropriate question regarding the tax extenders is which ones should remain in the tax code and which ones should be eliminated, rather than asking if they should be permanent or temporary. Some may have outlived their usefulness, others were never effective, and still others achieve important economic goals. Congress would be justified in keeping those that (1) correct a market failure, (2) are appropriately targeted, (3) do not unduly compromise the progressivity of the income tax, (4) do not add excessively to the complexity of the income tax, (5) avoid economic disruptions, and (6) are more cost-effective than a direct expenditure program.

Given the long-term fiscal challenge we face, I believe that whatever is decided about the permanence of these provisions, the decision should not increase projected budget deficits—the tax extenders should be paid for by increasing tax revenues.

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[9] Bipartisan Commission on Entitlement and Tax Reform, *Final Report to the President* (Washington, D.C.: Government Printing Office, 1995).

[10] Government Accountability Office, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690, September 2005.