214 Massachusetts Avenue, NE • Washington DC 20002 • (202) 546-4400 • heritage.org

CONGRESSIONAL TESTIMONY

"Post Tax Reform Evaluation of Recently Expired Tax Provisions"

Testimony before

The Committee on Ways and Means
Subcommittee on Tax Policy
United States House of Representatives

March 14, 2018

David R. Burton
Senior Fellow in Economic Policy
The Heritage Foundation

My name is David R. Burton. I am Senior Fellow in Economic Policy at The Heritage Foundation. I would like to express my thanks to Tax Policy Subcommittee Chairman Buchanan, Ranking Member Doggett and members of the committee for the opportunity to be here this morning. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Framework for Analysis

The primary objective of sound tax policy is to raise the revenue necessary to fund limited government in the least economically destructive manner.

Taxes have an adverse economic impact. They reduce the output of the economy and therefore incomes. Economists call this the excess burden or deadweight loss of a tax.[1] Taxes distort economic behavior. High marginal tax rates reduce the incentive to work, save and invest. Multiple layers of taxation on capital raise the user cost of capital,[2] reduce investment, hinder productivity growth and harm real wages.

Tax preferences distort the economy by picking winners and losers. They alter the relative return or cost of capital of different investments and induce taxpayers to make suboptimal economic decisions that they would not have made but for the tax preference. They make the economy less efficient so that a given amount of inputs produce less output. In economics terminology, tax preferences reduce the production possibility frontier. In plain terms, they reduce the incomes of the American people.

The optimal tax, public finance and microeconomic literatures lead us to the conclusion that the tax base that has the least adverse economic impact while raising a given amount of revenue is a consumption base or, stated differently, a tax base that taxes all factor incomes once but only once.[3] There is more than one way to get to a consumption tax

[1] What economists called the "deadweight loss" or "excess burden" of a marginal tax rate rise increases with the square of the tax rate increase. The converse is also true: The excess burden of a marginal tax rate decrease declines with the square of the tax rate decrease. See John Creedy, "The Excess Burden of Taxation and Why it (Approximately) Quadruples When the Tax Rate Doubles," New Zealand Treasury Working Paper No. 03/29, December 2003, http://www.treasury.govt.nz/publications/research-policy/wp/2003/03-29/twp03-29.pdf. Also see, for example, N. Gregory Mankiw, *Principles of Economics*, 4th Edition (2006), Chapter 8 (or many other textbooks on price theory, microeconomics, or principles of economics).

[2] For the basic user cost of capital analysis with taxes, see Robert E. Hall and Dale W. Jorgenson, "Tax Policy and Investment Behavior," *American Economic Review*, Vol. 57, No. 3 (June, 1967), pp. 391–414, https://web.stanford.edu/~rehall/Tax-Policy-AER-June-1967.pdf. See also Kevin A. Hassett and Kathryn Newmark, "Taxation and Business Behavior: A Review of the Recent Literature," in John W. Diamond and George R. Zodrow, eds., *Fundamental Tax Reform: Issues, Choices, and Implications* (2008), and Alan J. Auerbach, "Taxation and Capital Spending," University of California, Berkeley, September 2005, http://eml.berkeley.edu//~auerbach/capitalspending.pdf.

[3] A tax system that taxes labor and capital-factor incomes equally, and only once, results in higher output and higher incomes. Usually in the modern public finance literature, this is called a consumption tax or cash-flow tax. See N. Gregory Mankiw, Matthew Charles Weinzierl, and Danny Yagan, "Optimal Taxation in Theory and Practice," *Journal of Economic Perspectives*, Vol. 23, No. 4 (2009), pp. 147–174, http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.23.4.147, and Alan J. Auerbach, "The Choice Between

base.[4] In the context of the current system, that would mean expensing of capital costs,[5] treating all savings in the same fashion as savings in Individual Retirement Accounts (IRAs) or 401(k)s[6] and integrating the corporate and individual tax systems.[7] The essence of good tax policy and sound tax reform is to repeal tax preferences and dedicate the revenue raised to reducing marginal tax rates and reducing the multiple taxation of savings and investment.

The economic advisability of a tax provision should be judged by whether it is a step towards the right tax base. Thus, for example, raising the threshold for section 179 expensing is a step toward a consumption tax. A tax preference for a particular type of energy production is not.[8] Thus, the former warrants support and the latter does not in that the former reduces the excess burden and distortionary impact of the tax system but the latter does not. The formers improves incomes and social welfare, the latter does not.

Expired Provisions

The staff of the Joint Committee on Taxation (JCT) has identified 26 tax provisions that expired in 2017.[9]

Energy Provisions

All 13 of the energy tax provisions are unwarranted tax preferences.

Income and Consumption Taxes: A Primer," NBER Working Paper No. 12307, June 2006, http://www.nber.org/papers/w12307.

[4] For a discussion of the equivalence of various types of consumption taxes, see David R. Burton, "Four Conservative Tax Plans with Equivalent Economic Results, Heritage Foundation Backgrounder No. 2978, December 15, 2014 http://thf_media.s3.amazonaws.com/2014/pdf/BG2978.pdf. The four types of taxes discussed are the (1) Hall-Rabushka "old" flat tax or X tax (the X tax being a graduated rate proposal with the same tax base as the Hall-Rabushka flat tax), (2) a cash-flow tax, consumed income tax, inflow-outflow tax or "new" flat tax, (3) a business transfer tax, business flat tax, business consumption tax or business activity tax and (4) a retail sales tax. A credit-invoice value added taxes (also called a goods and services tax or GST in some countries) is also a consumption tax.

[5] The current tax system is not neutral toward investment. This neutrality criterion is sometimes expressed as ensuring that the private rate of return equals the social rate of return, that the tax system does not raise the user cost of capital, that factor incomes (labor and capital) are taxed once and equally, that the tax system defines income properly, or that the tax is a consumption tax. See, for example, Charles E. Walker and Mark A. Bloomfield, eds., *The Consumption Tax: A Better Alternative?* (Cambridge, MA: Harper and Row, Ballinger, 1987).

[6] For an early discussion of why the income tax should expense capital and treat all savings like IRAs are treated today, see Irving Fisher, "The Double Taxation of Savings," *American Economic Review*, Vol. 29, No. 1 (March, 1939), pp. 16-33.

[7] See David R. Burton, "Tax Reform: Eliminating the Double Taxation of Corporate Income," Heritage Foundation Background No. 3216, May 18, 2017 https://www.heritage.org/sites/default/files/2017-05/BG3216.pdf; For a discussion of tax reform principles generally, see David R. Burton, "A Guide to Tax Reform in the 115th Congress," Heritage Foundation Backgrounder No. 3192, February 10, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3192.pdf.

[8] This would be equally true if the objective were to move towards a comprehensive income tax.

[9] *Federal Tax Provisions Expired in 2017* (JCX-5-18), Joint Committee on Taxation, March 9, 2018. In addition, two others have been rendered irrelevant by the recent tax reform bill.

The only possible economic justification for these provisions is that they are designed to address a negative externality. An externality is (1) a cost that is imposed on (negative externality) or (2) a benefit accorded to (positive externality) someone that is not a party to a transaction or not engaged in an action. There are countless positive and negative externalities all around us. Air pollution is a typical example of a negative externality.

There are many ways to address negative externalities. Improved property rights,[10] tort law,[11] regulation,[12] or a tax equal to the cost involuntarily imposed by the economic actor creating the externality on those "external" to the transaction.[13] A tax subsidy for politically favored interests with strong lobbies would be fairly far down the list of efficacious means of addressing the problem of negative externalities. Moreover, to achieve the desired effect, the policy designed to address the externality must be calibrated to accurately internalize the actual cost of the externality. This would require estimating the costs imposed by the externality and imposing costs in an equal and off-setting amount on the economic actor in question. There is no evidence that policy-makers have done this and there is little reason to believe that this committee has the technical competence at this juncture to do so. Moreover, in the case of the expired provisions being considered by the committee, the subsidy to the various alternative energy sources is only tangentially related to the externalities that may exist. There is little reason to believe that the tax preferences are effectively addressing whatever externality proponents of the tax preferences may use to justify the tax preferences. Detailed scientific, cost and market information must be obtained to get this even close to right.

At roughly $53 billion over ten years,[14] the revenue lost from these provisions is substantial. It would be better used to reduce marginal tax rates or to improve the capital cost recovery provisions for all investment. By way of comparison, the "bonus depreciation" or partial expensing provisions in the 2017 tax bill that applied to most machinery and equipment were scored by JCT as reducing revenues on a static basis by $86.3 billion.[15]

Various True Tax Expenditures

The Indian employment tax credit, the credit for certain expenditures for maintaining railroad tracks, the mine rescue team training credit and the American Samoa economic

[10] In the case of air and water that are usually unowned resources, this is problematic. In other cases, this can be the solution, although transactions costs can impede a private solution. See Ronald H.Coase, "The Problem of Social Cost," *Journal of Law and Economics*, Vol. 3, October, 1960, pp. 1–44.

[11] The common law of nuisance and various more modern environmental torts.

[12] Most notably by the Environmental Protection Agency and state analogs.

[13] This is commonly know as a Pigouvian tax. See Arthur Cecil Pigou, *The Economics of Welfare* (1920 and various later editions); "Pigouvian Taxes," *The Economist*, August 19, 2017 https://www.economist.com/news/economics-brief/21726709-what-do-when-interests-individuals-and-society-do-not-coincide-fourth.

[14] FY 2018-2027. *Federal Tax Provisions Expired in 2017* (JCX-5-18), Joint Committee on Taxation, March 9, 2018 at p. 1 of table.

[15] *Estimated Budget Effects of the Conference Agreement for H.R. 1, The "Tax Cuts and Jobs Act," Fiscal Years 2018 – 2027* (JCX-67-17), Joint Committee on Taxation, December 18, 2017, Item II.D.1, p 3.

development credit are all classic tax expenditures or tax subsidies. To the extent that policy-makers want to fund these subsidies, they should be subject to oversight and the appropriations process. They do not belong in the tax system.

Capital Cost Recovery Provisions

The capital cost recovery provisions before the committee raise different issues. In principle, all capital expenses should be deductible when incurred (i.e. expensed). The various capital cost recovery provisions at issue are highly targeted provisions that shorten recovery periods or provide for expensing. Thus, they move toward the correct policy but only for narrow interests.

In a conventional income tax, property is not expensed but depreciated. The proper class life[16] and rate of depreciation[17] is an empirical question. To accurately measure income, the amount of depreciation should be equal to the annual decline in the present discounted value of the assets' future income stream.[18] This is typically not an observable figure because most assets do not have an active secondary market and because most assets help firms earn income in conjunction with other assets. Thus, determining the proper depreciation or capital cost recovery allowances in a conventional income tax is an intractable and unsolvable problem. The allowances will always be somewhat arbitrary and contentious because, for most assets, all policy-makers can do is make a quasi-educated guess.[19]

There is no particular reason to believe that the class lives in the current Asset Depreciation Range (ADR) system, adopted in 1971, are correct in every respect. ADR serves as the ultimate basis for class lives for both the Modified Accelerated Cost Recovery System (MACRS), its predecessor, the Accelerated Cost Recovery System (ACRS) and for non-MACRS property. On the other hand, those seeking targeted changes to capital cost recovery allowances should be required to provide persuasive evidence that their property is misclassified under current law.

[16] The number of years over which the property is depreciated.

[17] For example, straight line or double declining balance (in accounting) or geometric in many economic models.

[18] This would, in principle, result in a uniform double taxation of capital income and all rates of return on capital income would be reduce by the same proportion. A consumption tax, in contrast, taxes labor and capital incomes once.

[19] Charles Hulten has probably done as much as anyone to try to accurately estimate class lives and depreciation rates going back to at least the early 1980s. See Charles R. Hulten, "Getting Depreciation (Almost) Right," March, 2008 http://econweb.umd.edu/~hulten/WebPageFiles/Getting%20Economic%20Depreciation%20Almost%20Right.pdf and the references to the literature in the paper. See also Barbara M. Fraumeni, "The Measurement of Depreciation in the U.S. National Income and Product Accounts," *Survey of Current Business*, July, 1997, https://www.bea.gov/scb/account_articles/national/0797fr/maintext.htm ; Derek Blades, "Depreciation in the National Accounts," Organization for Economic Cooperation and Development, March 1997 http://www.oecd.org/sdd/na/2666804.pdf.

Discharge of Indebtedness

The provision[20] that excludes gross income arising from the discharge of indebtedness on principal residences is entirely understandable but questionable as a matter of tax policy. When a debt is discharged, the person for whom the debt was forgiven sees their net worth increase by the amount of debt forgiven. It is as if they had income in the amount of the discharged debt and used the income to pay the debt off. In addition, the lender will generally be able to deduct the bad debt. It is for this reason that discharge of indebtedness has historically been treated as income by the tax law. On the other hand, it is understandable why policy-makers may not want the Internal Revenue Service to send a massive tax bill to these already insolvent homeowners. Moreover, the resultant taxes are likely to be discharged in any event if the taxpayer files for bankruptcy.

Tuition Expenses

A tax deduction should be accorded for outlays made for the purpose of earning future income. This is why business expenses are deductible and why capital expenses should be deductible when incurred rather than depreciated or amortized over long periods. In my view, investments in human capital[21] should also be tax deductible. The primary (though by no means exclusive)[22] reason that people pay tuition is to enhance their future earnings capacity. Therefore, Internal Revenue Code section 222, allowing a deduction for qualified tuition expenditures, has a sound policy rationale.

Empowerment Zones and Enterprise Zones

Enterprise zones or empowerment zones were conceived as a means of using the initiative of the private sector to help address poverty. They are meant to draw businesses to economically distressed areas to improve employment prospects for those living in or near the zones and to provide economic services (such as retail) to those same people. Providing work, self-sufficiency and opportunity for lower income people is much better than creating dependency on government programs. Furthermore, creating thriving commerce in an economically depressed area will improve the quality of life of those that live there.

Enterprise zones are, however, inconsistent with sound tax policy principles. They introduce extra complexity to the tax system and create tax preferences that favor one set of taxpayers over another. They can only be justified as an effective anti-poverty initiative. Whether they are effective is the proverbial empirical question.

In the past, I have been supportive of enterprise zones as a reasonable experiment in trying to address the difficult problem of poverty by increasing opportunity in poor

[20] Internal Revenue Code sec. 108(a)(1)(E).
[21] Gary S. Becker, *Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education*, 3rd Edition (1994).
[22] Other reasons may include enjoyment (more in the nature of consumption) or preparation for being an educated, effective citizen.

neighborhoods.[23] The evidence of their effectiveness is mixed, at best. Reasons for this include that the design of existing zones has left a lot to be desired, that the incentives provided have typically been weak and that the complexity of the provisions increase administrative costs and reduce the attractiveness of the zones.

Absent strong evidence that the zones are having positive effects that justify the revenue lost, the administrative costs for businesses and local government and the creation of tax preferences in the tax code, it may be advisable either to reconsider the design of the zones or to simply acknowledge that, while they are an attractive idea in principle, they appear not to be cost-effective in practice. Evidence may exist to the contrary but I am unaware of it. There may also be lessons that can be learned from the experience of other countries that have adopted similar approaches.

Fairness

A well-designed tax system should in general treat similarly situated taxpayers in a similar fashion. Thus, those with the same level of consumption or income should pay roughly the same tax. This concept is sometimes called horizontal equity. Tax preferences or "loopholes" violate this principle and are one of the central reasons that the tax system is viewed as unfair. The committee should keep this principle in mind as it deliberates.

Thank you.

---

[23] David R. Burton, Testimony, House Ways and Means Committee, on "Enterprise Zones," October 17, 1989 http://www.c-span.org/video/?9581-1/enterprise-zones-part-1 and http://www.c-span.org/video/?10969-1/enterprise-zones-part-3.

****

The Heritage Foundation is a public policy, research, and educational organization operating under Section 501(c)(3). It is privately supported and receives no funds from any government at any level, nor does it perform any government or other contract work.

The Heritage Foundation is the most broadly supported think tank in the United States. During 2016, it had hundreds of thousands of individual, foundation, and corporate supporters representing every state in the U.S. Its 2016 income came from the following sources:

Individuals	75%
Foundations	20%
Corporations	2%

The top five corporate givers provided The Heritage Foundation with 1.0% of its 2016 income. The Heritage Foundation's books are audited annually the national accounting firm of RSM US, LLP.

Members of The Heritage Foundation staff testify as individuals discussing their own independent research. The views expressed are their own and do not reflect an institutional position for The Heritage Foundation or its board of trustees.