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Tax Legislation

Ike Brannon of Capital Policy Analytics and Gordon Gray of the American Action Forum warn against an attempt in the lame-duck session to revive ''orphan'' tax breaks not made permanent at the end of 2015. The authors write that ''the very presence of a year-end extenders package serves as a de facto substitute for genuine reform, and distracts lawmakers from undertaking a comprehensive tax reform that is long overdue.''

The Annual Renewal of Dubious Tax Provisions Is No Substitute for Real Reform

BY IKE BRANNON AND GORDON GRAY

The U.S. tax code is grievously flawed: For starters, it sacrifices hundreds of billions of dollars to incentivize various behaviors that have no salutary benefit at all and reduce growth, by forcing tax rates to be higher to pay for them. The prospect of Congress debating yet another tax extenders bill during the lame-duck session is both a cause and a symptom of its myriad flaws.

Most of what passes for tax policy the last few years has been wrapped up in the annual tax extenders package, whereby the tax-writing committees put together a list of tax policy changes that get passed in the waning moments of a congressional session. However, in 2015, Congress acted to interrupt this annual tete-a-tete and made many of these annual tax extenders permanent, and did so without paying for these changes. Several extenders that lacked sufficient economic or political justification weren't included in this legislation.

However, Congress may now resurrect these orphan tax breaks in the lame duck. If it does pursue such a path it would be a loss, both because these remaining expiring provisions generally make for bad policy—many are little more than corporate welfare—but also because the very presence of a year-end extenders package serves as a de facto substitute for genuine reform, and distracts lawmakers from undertaking a comprehensive tax reform that is long overdue. The revenue lost from these extenders may be slight but it nevertheless lessens the revenue available to lower rates while strengthening Congress's inclination to micromanage the economy via the tax code.

Ike Brannon is president of Capital Policy Analytics.

Gordon Gray is director of fiscal studies at the American Action Forum.

The goal of Congress should be to produce a tax code that is as neutral as possible across industries and businesses and that seeks to generate as much revenue as possible with as little an impact on the economy as can be accomplished.

Product of Budgeting Rules

The tax-writing committees of the House and Senate have indicated that before the current Congress adjourns it may consider passing a bill that would contain a number of ''temporary'' tax provisions, often referred to as tax ''extenders.'' These provisions are ones that were provisionally inserted in the code a number of years ago and have been repeatedly extended in the ensuing years, usually in the waning moments of the legislative calendar.

This practice is in large part a byproduct of the disparate treatment of tax and spending policies by the rules that govern congressional budgeting. Many tax policies came to be written in law as temporary, often with a one-year duration. Upon expiration, congressional budget agencies assume that revenue will return to its previous level. To renew the policy for an additional year would thus ''cost'' the revenue that would be lost for that one year.

Tax changes that can be viewed as prohibitively expensive in the long run (such as the ''patch'' that rolled back the alternative minimum tax to insulate the middle class from its effects) came to be done annually in order to keep the price tag low. Spending policies are largely treated differently by ‘‘score-keeping’’ rules and thus we don’t tend to see the same passel of temporary spending policies in that realm.

In 2015, Congress enacted the Protecting Americans from Tax Hikes (or PATH) Act, which made a number of these temporary provisions permanent and extended others for a number of years. Despite the high price tag, Congress waived the requirement that an attendant budget reduction be made to ‘‘pay for’’ the $629 billion revenue loss for the total cost of the extenders package, $560 billion of which stems from permanent extensions. For the most part the provisions made permanent had substantial bipartisan support, such as the research and experimentation tax credit and investment incentives for small businesses.

However, several other tax incentives—such as tax credits for electric motorcycles and fuel cell cars, to name but two—weren’t granted permanence or even a longer-term extension.

For the most part, the excluded provisions are either narrowly crafted, cost relatively little in terms of forgone revenue or help a select interest group that happen to have a modicum of political influence. In essence, these tax breaks can be seen as a form of earmarks administered via the tax code instead of the appropriations agenda, and the lack of any economic justification made it difficult for Congress to make them a permanent part of the tax code by including them in the PATH Act, although their supporters certainly tried to do so.

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By not including them in the extenders package, the hope among the tax reformers was that they might die a natural death, but old habits die hard and some members of Congress are showing an interest in a year-end extender package.

The continued exercise of contemplating tax extenders is symptomatic of a deeper problem—the inclination of policy makers to manage the economy via the tax code. Such an approach is manifestly flawed, and the sordid history of tax extenders is Exhibit A for the need of a comprehensive tax reform that results in a tax code designed to generate revenue with as little interference in the economy as possible.

We Shouldn’t Manage The Economy Via the Tax Code

In 1986, President Ronald Reagan signed into law the Tax Reform Act of 1986, making fundamental changes in the tax code that took millions of Americans off the tax rolls, reduced tax rates across the board for both families and businesses, and eliminated the vast majority of credits, exclusions and deductions that made the tax code so complicated and unproductive.

Since then, tax law has changed tremendously: Congress has seen fit to change marginal tax rates on income five times over that span, along with making myriad changes to the tax rates on capital gains, dividends and business income. Congress has also added literally thousands of new deductions, credits or exclusions over that time, wiping away any pretense of the tax code maintaining a degree of neutrality.

Today, the code attempts to encourage or deter a tremendously wide array of activities, from energy production and conservation to home ownership, school supply expenses, retirement savings, restaurant refurbishment, the purchase of life insurance or annuities, parking and the production of tackle boxes, to name but a few.

While each one of these provisions made its way into the code by prevailing on Congress that its benefits outweighed its costs, 30 years after the Tax Reform Act of 1986 the totality of these accumulated tax breaks certainly fail the cost-benefit test. The cost to the Treasury of these provisions has undoubtedly contributed to upward pressure on income tax rates, while concomitantly dampening incentives to work, save and invest. With each new tax break, Congress moves the tax code further away from the hard-won neutrality achieved in the 1986 Act, introducing more distortions and hampering economic efficiency along the way. The cost of these tax breaks is both fiscal and economic, and is significant, manifesting itself in higher tax rates that reduce investment and work as well.

According to the Treasury Department, 167 tax expenditures cost taxpayers $1.4 trillion in fiscal year 2016, and are projected to cost more than $18 trillion over the next 10 years. The cost of these provisions exceeds all discretionary spending and any single major entitlement program. Similar estimates from the Joint Committee on Taxation reflect the same magnitude of the fiscal cost of these tax provisions. The largest are well known and are broadly elected—the exclusion of employer-sponsored health care and tax preferences for home ownership, retirement and charitable deductions—while the balance have far narrower application.

A review of the trend in the cost of these provisions by the Congressional Research Service reveals the backtracking from 1986, where the share of tax expenditures of total revenue collection and gross domestic product plummeted, to gradually rise over time to near pre-1986 levels. Permanently enshrining $560 billion in tax expenditures in the tax code reaffirms this trend, as would making permanent the ‘‘orphaned’’ tax breaks that were merely extended in the PATH Act.

Subsequent to the PATH Act, there remain about 50 temporary tax provisions scheduled to expire over the next decade. Most of these are the narrower tax provisions that didn’t win permanence in the negotiations that produced the PATH Act and are now under consideration for extension at the end of the year. Most of these provisions expire at the end of 2016 or 2019. Some other temporary tax provisions are tied up in broader legislation—such as Highway Trust Fun, Federal Aviation Administration, Black Lung Disability Trust Fund and Oil Spill Liability Trust Fund financing mechanisms.

Making all of these provisions permanent would cost $173 billion over the next 10 years. Divvied up annually—as has been the practice in the past—the apparent price tag of the policies diminishes to a more palatable $17 billion on average.

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While the cost of the surviving tax extenders being considered for annual extension may be relatively minor, at least by Dirksonian standards, they will have an outsized impact on the broader economy. Beyond the mere budgetary cost, the extenders introduce distortions that impede economic efficiency. Capital flows to less productive sectors of the economy more than it otherwise would because of tax subsidies. A review of the economic effects of the 1986 Act found a significant enhancement of capital allocation across the economy—these efficiency gains and thus related growth are harmed as further distortions from the extenders are introduced into the economy.

These anti-growth elements compound the budgetary cost of these policies.[1]

Another extension can also be construed as making these permanent despite the express intent of Congress in 2015 to not do such a thing, which introduces policy uncertainty, specifically tax policy uncertainty, which has been found to harm economic growth.[2] The annual extenders game lessens the pressures to do comprehensive tax reform—by definition one that would be bereft of such incentives—in the future.

The benefit of a comprehensive tax reform is that it would trade off these tax expenditures—most of which do little or nothing to boost the economy—for a lower tax rate on work, saving and investment, which would result in greater economic growth.

Tax Extenders a Poor Substitute For Real Reform

A key achievement of the 1986 Act was to reduce tax-induced distortions in the economy that enhance certain returns relative to other investments. There may well be worthy public policy aims to many such subsidies but for the tax code to impose vastly different effective tax rates across sectors is indefensible, and reduces economic growth in the long run. A Tax Foundation study that examined average tax rates across industries over 2000-2009 found that average effective tax rates can vary from about 14 percent to more than 33 percent.[3]

What is more, the returns to investment vary greatly depending upon how that investment was funded. The Congressional Budget Office found that the code taxes the returns to debt-financed investment at a rate of negative 6 percent, versus 38 percent for equity-financed investment.[4]

To be sure, the 1986 Act didn't move the U.S. to a textbook optimal tax code by any means, but the improvement in capital allocation it accomplished was a meaningful achievement that shouldn't have been surrendered so easily. That this neutrality was ceded incrementally with narrow tax breaks also undermines the political bargain that comprehensive tax reform requires, and underscores the perception that the current tax code is a delivery device for corporate welfare.

The U.S. corporate tax rate has remained virtually untouched since the 1986 Act, which included a significant rate reduction. The only changes since that corporate rate reduction were a 1 percentage point increase in 1994 and an effective 3 percentage point rate reduction for manufacturing firms (and a few non-manufacturers with sufficient clout to gain inclusion) in the late 2000s.

Prior to 1986, the U.S. corporate tax rate was generally higher than that of other Organization for Economic Cooperation and Development nations, and the 1986 Act reduced rates to well below the OECD average. However, since that time the U.S. has increasingly fallen by the global tax wayside as literally every OECD country has reduced its corporate tax rate since then save for one—the U.S.

Today, the U.S. not only imposes the highest corporate tax rate but it also applies its high tax rate to a worldwide tax base that has been largely forgone by other U.S. trading partners. From 2002 to 2013, OECD countries cut corporate taxes by at least 1 percentage point nearly 100 times, with the vast majority of cuts not being accompanied by offsetting spending reductions or tax increases.[5]

We Desperately Need A Comprehensive Tax Reform

The problems with the current tax code go far beyond what could be fixed with a carefully crafted modification or two. Its flaws are almost universally acknowledged—it discourages work and saving while attempting to induce an incredible array of economic activities that the government has no business trying to influence.

The tax code has become the method by which Congress encourages or discourages certain activities, and whether they have a salutary effect on the economy is often beside the point. The cost of the various deductions, credits and exclusions goes beyond the tax revenue sacrificed—by distorting the economy, we also pay via lower economic growth that exceeds the budgetary costs.

The tax code serves the economy and its denizens best when it is as neutral as can be. It should encourage growth, work, investment and saving and little else, ideally, and the sad truth is that we are far away from such a reality.

A fundamental tax reform that shears the code of the vast majority of its deductions, credits, exclusions and other tax expenditures would raise more revenue while doing less to deter economic growth. It would remove the oversized role of the federal government in the day-to-day activities of individuals and businesses and would allow the economy to expand in a way that is simply not the case under the current code.

[1] See Don Fullerton and Yolanda Henderson, ''The Impact of Fundamental Tax Reform on the Allocation of Resources,'' NBER Working Paper 1904, Cambridge, Mass., April 1986; Jason Fichtner and Jacob Feldman, ''When Are Tax Expenditures Really Spending? A Look at Tax Expenditures and Lessons from the Tax Reform Act of 1986,'' Working Paper No. 11-45, Mercatus Center at George Mason University, Arlington, Va., November 2011.

[2] http://digitalcommons.unl.edu/cgi/viewcontent.cgi?article=1088&context=econfacpub.

[3] http://taxfoundation.org/blog/chart-average-effective-corporate-tax-rate-industry-us-average-2000-2009.

[4] https://www.cbo.gov/sites/default/files/113th-congress-2013-2014/reports/49817-Taxing_Capital_Income_0.pdf.

[5] Ike Brannon, ''Cutting the Corporate Tax Rate Means Cutting Corporate Taxes.'' Monograph published by the R Street Institute, 2013.