Chairman Baucus, Ranking Member Hatch, and Members of the Committee, it is honor to appear before you today to discuss the very important topic of tax extenders and tax reform.

I am a professor in the economics department of Rutgers University. During various leaves from this position, I have served as Special Advisor to the Joint Committee on Taxation, chief economist for the President’s Advisory Panel on Federal Tax Reform in 2005, and director of the Urban-Brookings Tax Policy Center. In each of these positions, I have advocated the compelling case for tax reform, evaluated the economic consequences of different tax reforms, and studied the implementation issues and transition costs associated with various reforms.

A total of 60 temporary tax provisions expired at the end of 2011. Despite the large number of provisions affecting millions of taxpayers, the expiration of these provisions, which we call “extenders”, was unremarkable. With some exceptions, each was originally enacted with an expiration date and every one of those dates subsequently has been extended. In most cases, these temporary provisions have been extended over and over again for just a couple of short years or less. In fact, the semi-permanent package of tax extenders we are considering today are now referred to as “traditional tax extenders” raising serious questions about their temporary nature and making it hard to argue that they are not fixtures of our tax code. Some of the provisions, like the research and experimentation credit, have been extended so many times they have achieved a state of near immortality.

The vast majority of extenders we are considering today were originally enacted to provide specifically limited incentives for certain activities or investments. Unlike other tax provisions that provide targeted tax benefits, however, extenders have a limited shelf life. Much like the items in the meat section of the grocery store, our tax code is littered with expiration dates. As we will hear today, the past-due inventory is quite large.

I believe these extenders must be considered within the context of fundamental tax reform. In my testimony, I address both the desirability of maintaining a tax code that includes myriad unrelated temporary provisions that are routinely extended (sometimes retroactively) and the need for tax reform. I recommend that instead of arguing about which provisions should be

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1 The staff of the Joint Committee on Taxation publishes an annual report on these provisions that now totals more than 30 pages.

2 For details on the current set of extenders, see “Legislative Background of Expiring Federal Tax Provisions 2011-2022,” Joint Committee on Taxation, January 27, 2012 (JCX-6-12).
included in an extenders package, we should instead devote our energy to building a tax code that will allow us to face the daunting fiscal challenges ahead.

For many taxpayers who are impacted by one of these extenders the frequent ritual of being on tax code death watch only to be saved by last minute clemency --- or, in instances like this year, resurrection --- creates tremendous volatility. This volatility not only creates uncertainty and a perception that our tax code is unfair, it reinforces the view that the current legislative process is dysfunctional and our elected representatives are unwilling or unable to chose among competing priorities.

By making provisions temporary, Congress reduces the benefit of these subsidies relative to their revenue cost. Businesses, for example, are not likely to make long-term investment decisions based on subsidies likely to disappear. Teachers may not buy school supplies using their own money if they do not think they will be allowed a deduction for their expenditures. Temporary provisions by their very nature are more likely to present taxpayers with windfalls for undertaking certain investments providing Congress with little to no economic benefit. As a result, they are likely less effective than they would be if they were permanent.

There are three broad reasons why Congress has enacted so many temporary provisions. First, for better or for worse, tax policy is sometimes used as a stimulus measure in response to an economic downturn or to provide targeted disaster relief. Given their rationale, it makes sense for these provisions to be temporary.3

Second, policymakers may impose expiration dates on provisions so that they can periodically evaluate their effectiveness. In this case an expiration date can be seen as a mechanism to force policymakers to consider the cost and benefits of the special tax treatment and possible changes to increase the effectiveness of the policy. This reasoning is compelling in theory, but has been an absolute failure in practice as no real systematic review ever occurs. Instead of subjecting each provision to careful analysis of whether its benefits outweigh its costs, the extenders are traditionally considered and passed in their entirety as a package of unrelated temporary tax benefits.

Finally, temporary tax legislation may simply (but sadly) be the result of Congress playing a budget game. The Congressional Budget Office (CBO) must project the revenue baseline using current law. This means that the CBO must assume that temporary provisions expire as scheduled.4 If, as past history would strongly suggest, temporary provisions are never allowed to lapse, then they effectively become permanent features of the code that are not accounted for in the revenue baseline. Since almost all extenders involve tax cuts, the assumption that they will be terminated tends to makes the CBO project a healthier revenue baseline than is likely to occur.

3 The temporary nature of a provision increases its strength as stimulus but reduces its long-run impact. Consider the bonus depreciation provision in the American Recovery and Reinvestment Tax Act of 2009. Expiration raises a firm’s net cost of new investment back to its previous level and removes any further incentive to invest now rather than later. In fact, because the provision primarily leads businesses to move their investment up in time and not to increase overall investment, it may lead businesses to reduce investment when the provision expires. If the economy is still in recession at that point, this could be especially undesirable.

4 There is an exception to this rule for temporary taxes whose revenue is deposited in trust funds. CBO considers these provisions to be permanent.
Thus, by making provisions temporary, Congress can effectively pass tax breaks that do not worsen the budget picture.

Thinking about the reasons why we have a slew of temporary provisions should help us decide what to do with the current package of extenders. Stimulus and disaster relief measures should be allowed to expire if they have had their intended effects (or have been found to be ineffective). These provisions, however, represent a small set of the current extenders.

The “traditional extenders” account for the vast majority of items on the current list and have, for the most part, been around for many years through routine extension of their expiration dates. These provisions vary widely in their intent and purpose from special depreciation rules, alternative energy incentives, and investment incentives for developers in tax-favored communities on the business side to education, commuting, charitable contribution and adoption benefits on the individual side.

Based on the three reasons given above, the traditional tax extenders should not be carried forward from year to year as temporary provisions. They are not stimulus or disaster measures. We have not subjected them to systematic review (and it is not at all clear why these special tax incentives should be subject to yearly evaluation and others that happen to be permanent parts of our tax code should not). And hiding the true cost of a provision by giving it an expiration date that is likely to be subsequently extended is not good or responsible budget policy. The traditional extenders should either be permanent features of the tax code or should permanently expire.

In deciding whether to let the traditional extenders expire, I suggest we take the following two steps. First, isolate provisions that are fundamental policies of our current tax system and make them permanent. It does not make sense for provisions that are more properly considered structural features of our tax system, like the active finance exception, to be temporary in nature. If the tax system provides deferral for active business income earned abroad of U.S. corporations in controlled foreign corporations (as it does), it should not single out certain types of active business income and subject it to current taxation. Second, admit that the remaining provisions, however well-intended, should be evaluated along with similar permanent provisions in the context of fundamental tax reform.

In practice, that review should be forthcoming as building the case for tax reform is easy. The current system is riddled with tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers. Whether permanent or temporary, these provisions create complexity, generate enormous compliance costs, breed perceptions of unfairness, create opportunities for manipulation of rules to avoid tax, and lead to an inefficient use of our economic resources. The numerous and frequent changes we have made to the tax code have made the income tax system even more difficult for taxpayers to understand, less stable, and increasingly unpredictable. The state of our current system with its many permanent and temporary special provisions reflects that we have forgotten that the fundamental purpose of our tax system is to raise revenues to fund government.
While there are many fundamental reforms that could be considered, a reform that broadens the base would not only raise revenue but would simplify the system, increase transparency, make it less distortive by both allowing for a lower rate and reducing tax-induced biases towards certain activity, and improve the fairness of the system. Broadening the base involves deciding which special tax provisions to keep in the code and how best to design them. It involves consolidating and simplifying duplicative provisions and eliminating conflicting provisions (for example, energy provisions that both encourage and discourage the use of certain fuels). Tax reform forces policymakers to decide whether to use the tax code to promote widely shared and valued goals such as charitable giving and, if so, how incentives can be optimally designed. On the business side, tax reform involves thinking about how to treat cost recovery for business assets and whether the tax code should be used to encourage research and development and implement energy policy. As such, a base broadening tax reform is the perfect vehicle to consider the traditional tax extenders.

Our current fiscal situation requires that we refrain from our habit of kicking the can down the road on tax reform. Instead of wasting time engaging in a debate over which temporary tax provisions we should save for another year or two and how to manage the revenue impact, we should focus on designing and building support for a reform of the current system that can enhance the growth of the U.S. economy and the well-being of Americans. A reformed tax code would allow special treatment only when it could be demonstrated that the tax code is the best vehicle for delivering the subsidy and that the subsidy is optimally designed. Only tax benefits that provide incentives to change behavior in ways that benefit the economy and society, rather than representing windfalls to targeted groups of taxpayers for activity they would be likely to undertake even without a tax subsidy, should survive.

The process is not easy, but is necessary. A tax reform that broadens the base by eliminating temporary and permanent tax provisions that distort economic activity would leave us with a system that is less costly to our economy and raises more revenue. At the same time the new system would be perceived as being fairer than the current system and would also have the benefits of being considerably less complex and easier to administer.

Thank you. I would be happy to answer any questions you may have.

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5 As Howard Gleckman points out in an Urban-Brookings Tax Policy Center blog entry, the extenders list includes a provision that keeps the cost of fossil fuels low by continuing tax breaks for marginal oil wells along with provisions designed to encourage the use of alternative fuels (http://taxvox.taxpolicycenter.org/2009/12/10/it’s-cold-it’s-icy-it’s-tax-extender-time).