IRET Congressional Advisory

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THE EXTENDERS: HOW NOT TO MAKE TAX AND BUDGET POLICY

The bill to provide for an extension of certain expiring tax provisions is squeaking through the Congress just before adjournment. The last minute nature of the exercise has, predictably, produced an inferior product.

> ***Extenders should be funded primarily from projected federal budget surpluses or spending restraint. They should not be used as an excuse to raise other taxes, fees, or fines on businesses or consumers... [Instead,] we are saddled with permanent tax hikes, mostly on businesses, that will result in reduced investment and growth...or be passed on to consumers.***

Extenders

The major extender items are:

- The R&E credit, extended 5 years, through 2004, but credits accrued in 2000 and 2001 could not be claimed until October 1 of the following years, to save the government money;
- Preventing the AMT from limiting individual non-refundable tax credits or the child credit, extended 3 years, through 2001;
- The Work Opportunity Credit and the Welfare to Work Credit, extended 2.5 years, through 2001; and
- Exemption from Subpart F restrictions for active financing income of U.S. subsidiaries abroad, extended 2 years, through 2001.

The bill also extends through December 31, 2001 the deduction for employer-provided undergraduate education, tax-exempt bond financing of qualified zone school buildings, deduction of costs of remediation of qualified brownfield contamination sites, a credit for electricity generated from wind and chicken waste, and several other provisions as well.

The best of these expiring provisions ought to be made permanent.

R&E credit. R&E produces spill-over effects for which the business conducting the research may not be fully compensated by the market. Basic research findings may not be patentable, and may redound to the benefit of competitors and society at large. There are also demonstration effects from successful product development: others gain just from knowing something is possible. Science advances faster when there is a large pool of highly trained researchers in an area, able to move from task to task, and constantly sharing ideas. Insofar as businesses are unable to capture all these benefits of their actions, they may underinvest in R&E. The R&E credit can be thought of as countering these "externalities" to bring about a more optimal level of research activity. Since the externalities are permanent, the current credit should be permanent, at least and until basic tax reform is enacted that could provide even better tax treatment of such activities. A permanent extension would make the credit more certain and make it more effective at encouraging R&E.

Treatment of foreign investment income from the active business of financial institutions as exempt from Subpart F restrictions. Foreign source income of subsidiaries of American companies operating abroad is generally tax deferred until repatriated (at which time the U.S. parent pays U.S. tax, net of foreign tax credits for taxes paid abroad). However, Subpart F restrictions require that so-called passive income from financial investments

and services which are not the main line of work of the business be reported for tax purposes when earned. In the case of banks and insurance companies operating worldwide, though, the foreign financial investments, services, and earnings are the active business, and should not be subject to the Subpart F restrictions. This is a permanent characteristic of these businesses, and their exemption from Subpart F should also be permanent.

Work credits. Credits for hiring unskilled and/or disadvantaged youths or persons leaving welfare can give such workers a boost over the employment barriers erected by the minimum wage. The credits may also help to pay for the added cost of training such workers. Since the minimum wage is likely to be a permanent obstacle to employing the unskilled, the credits should be made permanent too.

Deduction for employer-provided education. In an optimal tax system, all investment, including education outlays for human capital, should be expensed. The extenders should have included graduate level education as well as undergraduate courses and have made this deduction permanent.

Energy credits. Given the plentiful supplies of conventional fuels, these credits are uncalled for.

Funding the tax relief

Extenders should be funded primarily from projected federal budget surpluses or spending restraint. They should not be used as an excuse to raise other taxes, fees, or fines on businesses or consumers.

Unfortunately, Congress hemmed itself in by pledging (not too successfully) to limit spending increases and tax relief to only the amount of the "on-budget" surplus, and to avoid using the Social Security surplus for anything other than debt reduction. Meanwhile, the White House opposed any reduction in outyear revenues, and wanted the entire package to be offset by tax increases.

The official on-budget surpluses were very small in 1999 and 2000 (even before the spending binge in the budget agreement), and larger later, while the extenders have their full budget impact right from the start. The smart approach would have been to use some portion of the average surplus over five years to cover the near-term cost of the tax provisions.

Instead, Congress and the White House agreed on a set of tax-hike offsets to all of the first-year cost and most of the second-year cost of the extenders. Furthermore, because the White House opposed any reduction in outyear revenues, even as the on-budget surpluses grow, many of the extenders were limited to two years, or may be claimed only with a year's delay.

Ratcheting up taxes. Most of the tax increases adopted to pay for the initial stages of the temporary tax extensions are permanent; they will continue even after the on-budget surplus exceeds the tax relief. So, to get a bit of temporary tax relief, we are saddled with permanent tax hikes, mostly on businesses, that will result in reduced investment and growth (hurting tax revenue) or be passed on to consumers. Since the tax hikes will become part of the new budget baseline, Congress will not be able to claim their outyear revenues as an offset to the revenue "loss" from the next round of extenders, two or five years from now. Therefore, the next extenders bill will be the excuse for yet another round of permanent tax increases.

Illusory cost. The notion that the extenders "cost" revenue is misleading to begin with. The "cost" is relative to the revenue increase that would otherwise occur under current law when these provisions expire. Extending the extenders means keeping taxes at current levels. Unfortunately, the impact of tax changes on the Federal Budget is scored relative to current law, not current tax rates.

Illusory saving. Making the extenders temporary to "save money" is an illusion. They will just have to be extended again later, so they will cost as much as if they had been made permanent in

the first place. In fact, making the extenders permanent in the first place would reduce uncertainty and make them more effective in promoting investment and growth, which would result in the recovery of some of the static revenue loss. Permanent extension would avoid wasting Congress's time in the future wrangling over further extensions. Permanent extension would also minimize the scandalous cost to businesses (and consumers) of persuading the Congress to deal with these provisions each year or two. Such useless business outlays detract from investment and growth, and cost the government future tax revenue.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.