Temporary Policy in the Federal Tax Code

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Chairman Thompson, Ranking Member Smith, and members of the Committee, thank you for the opportunity to speak to you today about temporary tax policy in the Internal Revenue Code.

The Tax Foundation is the nation's oldest organization dedicated to promoting economically sound tax policy at the federal, state, and local levels of government. We are a nonpartisan 501(c)(3) organization.

For more than 80 years, the Tax Foundation's research has been guided by the immutable principles of sound tax policy which say that taxes should be neutral to economic decision-making, and that they should be simple, transparent, and stable.

Today, I want to discuss the important tax policy principle of stability. Taxpayers deserve consistency and predictability in their tax code, and as such, governments should avoid enacting temporary or retroactive tax laws. Stability is also important for the success of any tax policy. A policy that may otherwise produce economic growth or other positive benefits may fail if the policy is temporary or is seen as temporary by taxpayers.

For more than a decade, a collection of temporary, narrowly targeted tax provisions for individuals and businesses have routinely expired and then been temporarily reauthorized, earning the nickname of "tax extenders." Extending these provisions, especially retroactively, would not contribute to economic growth and would simply be a windfall to taxpayers. The best course of action for the majority of these narrow, temporary tax policies would be for Congress to allow them to expire permanently.

Besides extenders, there are major portions of the Internal Revenue Code that are set to change or expire over the next decade. This is due to the temporary nature of much of the Tax Cuts and Jobs Act. These temporary provisions frontload some of the anticipated economic growth, but because they expire, they do not contribute to the long-run economy.

While it was not ideal to make significant portions of the TCJA temporary, there is now an opportunity for lawmakers to evaluate different aspects of the TCJA and

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make those that improve the tax code permanent. Permanently dealing with all provisions of the TCJA will increase taxpayer certainty and can contribute positively to the economy. However, making all or part of the TCJA permanent will require lawmakers to address important trade-offs due to the fiscal costs.

How Tax Policy Affects the Economy

Taxes play a role in the decisions to work, save, and invest by impacting the returns on those activities. Workers decide how many hours to work, and even whether to work based on their after-tax wage. A change in marginal tax rates can impact the incentive to work by changing the after-tax wage earned by a taxpayer. Likewise, businesses make decisions on whether to invest based on the after-tax return on a given investment.

For example, the speed at which companies can deduct investments they make against taxable income is an important determinant of the cost of capital, which affects how much people are willing to invest in new capital. Research by Giorgia Maffini, Jing Xing, and Michael Devereaux found that expensing provisions in the United Kingdom encouraged firms to increase their rate of investment by between 2.1 and 2.6 percent compared to firms that didn't qualify for expensing.[1]

The amount individuals and businesses work, save, and invest has an impact on economic output. If individuals supply more work, or if businesses supply investments in new equipment or factories, this leads to more individuals working more hours and more productive capital in the economy. Higher quantities of capital and labor mean that America earns more income and produces more goods and services. Importantly, capital and labor in the economy are complements. Additional labor increases the returns to capital, leading to additional investment; similarly, additional capital increases the productivity of labor, leading to higher wages for workers.

The decision to work, save, and invest is a forward-looking activity. A business with a potential investment project will look several years into the future at the revenues of the project and any associated expenses, including any taxes assessed on the investment. As a result, tax policies today and those anticipated in the future can impact investment decisions today.

Tax policy doesn't permanently change the rate of growth in the economy, but it does impact the level. When tax policy increases the incentive to work, save, and invest, this results in a new desired level of labor and capital in the economy. The economy may take a few years to get to that new level, which means slightly accelerated growth for a while, but eventually growth will return to its original rate. However, the economy will be at a higher level than it otherwise would have been, assuming tax policy is permanent.

Lastly, tax policy does not necessarily have an immediate effect on output. Changes in tax revenue can impact total economic activity in the short run. However, it can take time for taxpayers to adjust their behavior to new incentives in the tax code. Under a new tax regime, two new factories may be profitable for a company, but it can take years to plan the projects, get the permits to build, and

1 Giorgia Maffini, Jing Xing, and Michael P. Devereux, "The Impact of Investment Incentives: Evidence from UK Corporation Tax Returns," Oxford University Centre for Business Taxation, Working Paper 16/01.

finally get the projects running. It may take an economy several years or even decades to adjust to a new tax code, depending on the magnitude of the change.

Temporary and Retroactive Tax Policy is Ineffective

In general, temporary tax policies should not be expected to have a permanent impact on the economy. Some temporary tax policies may reduce incentives for business to invest. Other policies may simply encourage taxpayers to shift activity from one year to another. Retroactive tax policy, in which a policy increases or decreases tax liability on a past activity, shouldn't have any impact on economic activity. Temporary and retroactive tax policies can cause uncertainty for businesses and individuals, which reduces the effectiveness of such policies to work as incentives.

Compared to permanent changes in tax policy, temporary tax policy has limited economic effects, especially temporary cuts for businesses.[2] This is because investment is a forward-looking behavior. The possibility of a tax increase in the future makes productive activity under a lower rate less enticing, especially for activities where the payoff comes years later.

Take, for example, a temporary cut in the business tax rate. Under this policy, businesses would be reluctant to invest in long-lived assets like structures that generate revenue years or decades after the investment is put in place. If the revenue is not going to come until after the tax cuts expire, the tax cuts are of no use to the investor and do not positively impact the decision to invest.

In 2016, we estimated and compared the economic effects of a permanent and temporary corporate tax cut to 15 percent.[3] Both a permanent and temporary corporate rate cut would result in increased economic growth for a while. However, a temporary corporate tax cut would produce less growth. A permanent reduction would raise growth by 0.39 percentage points in the first year. A temporary corporate tax cut would raise it by 0.28 percentage points.

The economic growth effects of a permanent corporate rate cut would continue through the entire decade. The growth from a temporary tax cut, however, would not. By the middle of the decade, we estimated that growth would start declining and eventually be nearly half a percentage point below what it otherwise would have been if the tax were not cut at all. This is because companies would start to anticipate the expiration of the rate cut and begin cutting back on investment.[4]

Other temporary tax policies may shift the timing of some investments. A good example of this is a one-year policy of expensing. Companies know that they would only be able to qualify for expensing for a single year. As a result, they would have an incentive to shift investments that they may have otherwise put in service the following year into the current year. This makes investment seem higher the year in which expensing is in effect. However, much of that gain is taken back once expensing expires and investment in year two is lower than it otherwise would have been.

2 Alan Cole, "Why Temporary Corporate Income Tax Cuts Won't Generate Much Growth," Tax Foundation, June 12, 2017, https://taxfoundation.org/temporary-tax-cuts-corporate/.

3 Ibid.

4 Ibid

Similarly, retroactive tax policies have little long-run economic benefit. If a retroactive tax cut occurs, businesses cannot go back in time and choose to invest more, nor can individuals go back in time and choose to work more. Instead, retroactive tax cuts result in after-the-fact transfers that do not boost long-run growth nor improve incentives.

Tax Extenders

For more than a decade, a collection of temporary, narrowly targeted tax provisions for individuals and businesses have routinely expired and then been temporarily reauthorized, earning the nickname of "tax extenders."

Many of these provisions were originally designed to phase out, often because they were part of temporary bills like the stimulus package.[5] But rather than letting the provisions phase out as designed, or making them permanent features of the tax code, Congress has instead reauthorized these provisions on a temporary basis, most often at the last minute or retroactively.

Currently, 26 tax breaks that expired at the end of 2017 are under review for retroactive reauthorization. These 26 remaining provisions broadly fall into two categories: those that provide cost recovery benefits for certain investments and those that are tax credits for specific economic activities.[6]

Cost Recovery Extenders

Many extenders improve cost recovery treatment of certain investments. These extenders include accelerated depreciation for racehorses, motorsports entertainment complexes, and mine safety equipment. Generally, these provisions reduce the user cost of capital and move towards proper treatment of investment in the tax code. However, Congress should avoid providing special tax treatment to certain industries, businesses, and business forms.

To the extent that the property covered by these extenders is also covered by 100 percent bonus depreciation from the Tax Cuts and Jobs Act, these extenders are not needed as such property is already eligible for proper cost recovery treatment. However, if the property is considered nonresidential real property, residential real property, water utility property, or railroad grading and tunnel bores (railroad improvements), then it would not qualify for more favorable depreciation schedules under the TCJA.

Tax Credits for Specific Activity

More than half of the remaining provisions are tax credits that subsidize specific economic activities.[7] These extenders include provisions such as tax credits for two-wheeled plug-in electric vehicles, new energy-efficient homes, and qualified fuel cell motor vehicles. These tax preferences reduce the neutrality and efficiency of the tax system by altering relative returns of different investments. This

5 Alan Cole, "Extenders and the Opportunity for Tax Reform," Tax Foundation, Nov. 19, 2014, https://taxfoundation.org/extenders-and-opportunity-tax-reform/.

6 Erica York, "Recommendations to Congress on the 2018 Tax Extenders," Tax Foundation, April 17, 2018. https://taxfoundation.org/2018-tax-extenders/.

7 Ibid.

can lead to otherwise inefficient allocation of resources and favor certain privileged businesses and industries over others.

Most Extenders Should be Left Expired

Most current extenders are not must-pass policies, but rather provide narrowly targeted preferences for specific economic interests, which distorts economic activity and creates uncertainty. The best course of action for the majority of these narrow, temporary tax policies would be for Congress to leave them permanently expired. In addition, most of the cost recovery provisions are duplicative with the 100 percent bonus depreciation provision passed as part of the TCJA.

At this point, these 26 provisions have been expired for well over a year; the tax year that they would be authorized for, tax year 2018, is completely over, and the filing season is well underway. Extending these provisions cannot change the economic activity that occurred in 2018; further, to the extent that tax revenue is a concern, retroactive extension makes little sense as it would constitute a transfer of tax revenue without promoting economic growth.

Leaving aside whether any specific extender is a worthwhile policy, these provisions result in an after-the-fact transfer to narrow groups without incentivizing the intended activity. Businesses and individuals cannot go back in time and make different decisions, and the uncertainty surrounding these incentives renders them ineffective going forward. If lawmakers do think a specific extender is worthwhile, it should be extended permanently.

Temporary Policies in the Tax Cuts and Jobs Act

Another source of temporary policy in the Internal Revenue Code emerges from the passage of the Tax Cuts and Jobs Act, which made some important reforms to the federal tax code. But many business provisions and nearly all the individual provisions are set to either change or expire over the next decade. In fact, by the end of the decade, most of the remaining changes to the tax code will be those made for corporations. Since many parts of the TCJA are temporary, the growth effects of the law will be somewhat muted, especially in the long run.

The TCJA and its Effects

The TCJA reduced statutory tax rates for most taxpayers, reformed family benefits, and broadened the individual income tax base by eliminating and scaling back several itemized deductions.[8] The TCJA also established a 20 percent deduction of qualified business income from certain pass-through businesses. The Alternative Minimum Tax was retained but was scaled back significantly. Lastly, tax parameters will now be adjusted based on chained CPI-U instead of CPI-U. The TCJA also greatly scaled back the estate tax.

8 Huaqun Li and Kyle Pomerleau, "The Distributional Impact of the Tax Cuts and Jobs Act over the Next Decade," Tax Foundation, June 28, 2018, https://taxfoundation.org/the-distributional-impact-of-the-tax-cuts-and-jobs-act-over-the-next-decade/.

The TCJA cut the corporate income tax rate from 35 percent to 21 percent and eliminated the corporate alternative minimum tax. The TCJA also expanded expensing for all businesses (corporations and pass-through businesses) by increasing bonus depreciation from 50 percent to 100 percent for five years. At the same time, the TCJA changed the treatment of the foreign profits of multinational corporations. It also broadened the corporate tax base by limiting the deductibility of net interest expense, eliminating net operating loss carrybacks, and limiting carryforwards to 80 percent of taxable income.

On net, the TCJA is a tax cut over the next decade. Our most recent estimate shows that the TCJA will reduce revenue by $1.8 trillion on a conventional basis between 2018 and 2027.[9] Some $1.1 trillion in the revenue loss would be due to a reduction in individual income taxes, $647 billion from the corporate income tax, and the remaining $72 billion from the estate and gift tax.[10]

The Tax Foundation model also projects that the TCJA would boost the size of the economy over the next decade. In the first few years, the economic impact will be modest as companies begin to invest more, building the capital stock. In 2018, we project the economy to be 0.3 percent over baseline; but by 2020, it will be 1.4 percent over baseline. On average, GDP will be about 2 percent above baseline between 2018 and 2027. By the end of the decade, however, the economy will begin to slow relative to how the economy would have performed without the TCJA.[11]

We estimate that in the long-run, the economy will be about 1.7 percent larger than it otherwise would have been in the absence of the TCJA.[12] This is due almost entirely to the permanent reduction in the corporate income tax rate from 35 percent to 21 percent. Without that provision, the TCJA would likely have produced no long-run benefits for the economy.

We project that the additional economic growth over the next decade would produce about $900 billion in additional federal revenues, mostly through the payroll and individual income tax. As a result, we estimate the net reduction in revenue to be around $900 billion between 2018-2027.

The TCJA will result in a reduction in tax liability for taxpayers in all income groups for most of the decade. However, the distribution of the tax burden would be less progressive than it used to be. The increase in after-tax income is largest in the first few years of the decade. Over time, however, as major provisions of the TCJA begin to phase out and base broadeners begin to phase in, the size of the tax cut will decline, and taxpayers will see smaller increases in after-tax income relative to the baseline. By 2026 and 2027, when the individual provisions have expired, taxpayers in most income groups will see tax increases relative to prior law.

9 This estimate is $300 billion higher than the Tax Foundation's original score of the TCJA. This is due to an update to the CBO baseline, which estimated that pre-TCJA revenues would be higher than previously thought.

10 Ibid.

11 Ibid.

12 Tax Foundation Staff, "Preliminary Details and Analysis of the Tax Cuts and Jobs Act," Tax Foundation, December 18, 2017. https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/

Many Aspects of the TCJA Will Phase Out or Expire over the Next Decade

For lawmakers to satisfy Senate budget rules, while still providing a net tax cut during the decade, major portions of the TCJA were set to phase out or expire.[13] From 2018 until 2021, all business and individual provisions will be in effect. At the end of 2021, two business base broadeners will be phased in. First, businesses will no longer be able to expense research and development costs. Instead, they will need to amortize those costs over five years. Second, the limitation on interest expense will tighten from 30 percent of earnings before interest, tax, depreciation, and amortization (EBITDA) to 30 percent of earnings before interest and tax (EBIT), a narrower definition of corporate income.

At the end of the following year (2022), 100 percent bonus depreciation will begin to phase out, further increasing tax collections from businesses. Its phaseout runs from 2023 to 2027, when the depreciation system will revert to MACRS.

At the end of 2025, a significant number of policy changes are scheduled to occur. All three of the new international provisions (GILTI, FDII, and BEAT)[14] will change. All three are scheduled to change, which will raise the tax burden on U.S. multinational corporations. The estate tax exemption will revert to pre-TCJA levels. Most significantly, however, is that nearly all the individual income tax cuts will expire. The new statutory tax rates and brackets, the standard deduction, the personal exemption, the Child Tax Credit, and the Alternative Minimum Tax will all revert to pre-TCJA rates and levels. The only significant individual income tax change that will remain is the use of chained CPI to adjust tax parameters for inflation.

The Effect of Temporary Policy in the TCJA

While making parts of the TCJA temporary allowed lawmakers to satisfy Senate budget rules, it created uncertainty for taxpayers. The TCJA may have improved the incentive to invest and will boost economic output and income over the next decade, but not as much as it could have if the law were permanent.

One major goal of the TCJA was to boost domestic investment by lowering the cost of capital. This was done in the TCJA chiefly by enacting 100 percent bonus depreciation. The new 100 percent bonus depreciation provision allows businesses to immediately deduct the full cost of eligible investments, as they would with any other business expense, rather than stretching deductions over many years. This removes the tax code's bias against these specific capital investments.

The provision is scheduled to be in effect for five years before it begins gradually phasing out at the end of 2022. Beginning in 2023, the provision would be reduced by 20 percentage points each year, for example, dropping to 80 percent in 2023, 60 percent in 2024, and so on until it expires entirely at the end of 2026.

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13 Huaqun Li and Kyle Pomerleau, "The Distributional Impact of the Tax Cuts and Jobs Act over the Next Decade," Tax Foundation, June 28, 2018, https://taxfoundation.org/the-distributional-impact-of-the-tax-cuts-and-jobs-act-over-the-next-decade/.

14 GILTI: Global Intangible Low-Tax Income; FDII: Foreign Derived Intangible Income; BEAT: Base Erosion and Anti-Abuse Tax.

The temporary nature of the provision will incentivize businesses to make their investments sooner, while they can deduct the full cost, rather than later, when they must take depreciation deductions over longer periods. Thus, the provision will pull some investments forward, leading to faster growth in earlier years that slows back down as the provision expires in later years.

The TCJA also greatly increased the incentive for individuals to work, through reductions in individual income tax rates. However, most of the individual income tax changes are scheduled to expire after 2025. As a result, these incentives will go away. This is a primary reason why we expect the TCJA to produce less economic growth near the end of the decade than the beginning.[15]

There are also businesses that earn their income through the individual tax code. These "pass-through" businesses make up the majority of businesses in the United States and earn about half of all business profits.[16] Since their profits are taxed through the individual income tax, these businesses face a great deal of uncertainty over how investments they are making today will be taxed in the future. This uncertainty will reduce these businesses' willingness to invest.

The effect of the TCJA's temporary policies goes beyond their impact on the incentives to work and invest. The TCJA also enacted policies that were meant to encourage certain behaviors by taxpayers. For example, the new FDII provision, paired with the tax on GILTI, is meant to encourage companies to shift their intellectual property (IP) back to the United States and reduce the incentive to shift profits out of the United States.[17]

However, both of these provisions are scheduled to change after 2025. As a result, the tax benefit on FDII will go down and the tax rate on GILTI will go up. This may change the calculus for these companies thinking about bringing their intellectual property back home. For one company, the current tax rates under FDII and GILTI provide sufficient incentive to bring IP back to the United States. However, the change may reverse that incentive, so companies may opt to not bring their IP back to the U.S. at all.

Making Temporary Policies in the TCJA Permanent

Making portions of the TCJA temporary reduced its effectiveness. Lawmakers could improve the federal tax code's long-run treatment of work, saving, and investment by making major portions of the law permanent. For example, if 100 percent bonus depreciation were permanent, it would have been the most pro-growth provision in the bill. We estimate that making the 100 percent bonus depreciation provision in the TCJA permanent would increase the size of the capital stock by 2.2 percent and long-run GDP by 0.9 percent; the larger economy would result in a 0.8 percent increase in wages and 172,300 full-time equivalent jobs.[18]

15 Ibid.

16 Scott Greenberg, "Pass-Through Businesses: Data and Policy," Tax Foundation, Jan. 17, 2017, https://taxfoundation.org/pass-through-businesses-data-and-policy/.

17 Kyle Pomerleau, "A Hybrid Approach: The Treatment of Foreign Profits under the Tax Cuts and Jobs Act," Tax Foundation, May 3, 2018, https://taxfoundation.org/treatment-foreign-profits-tax-cuts-jobs-act/.

18 Erica York and Alex Muresianu, "The TCJA's Expensing Provision Alleviates the Tax Code's Bias Against Certain Investments," Tax Foundation, Sept. 5, 2018, https://taxfoundation.org/tcja-expensing-provision-benefits/.

The Long-Run Impact of Making the TCJA 100 Percent Bonus Depreciation Provision Permanent

GDP	+0.9%
Wage Rate	+0.8%
Private Business Capital Stock	+2.2%
FTE Jobs	172,300

Source: Taxes and Growth Model, August 2018

Lawmakers may also want to make the individual income tax cut permanent. According to the Tax Foundation Taxes and Growth model, making these provisions permanent would have a small, positive impact on the economy during the 2019 to 2028 budget window. The growth impact of expansion is limited, due to the extension's timing. The provisions are currently in effect through 2025, meaning that only three years of extension are being captured in the budget window.

The economic benefits from making these provisions permanent are found in the long run, as the impacts of tax reform take several years to be fully realized. In the long run, making all individual tax provisions permanent will lead to 2.2 percent higher long-run GDP, 0.9 percent higher wages, and 1.5 million more full-time equivalent jobs.[19]

The Long-Run Impact of Making the Tax Cuts and Jobs Act Individual Provisions Permanent

Long-Run GDP	+2.2%
Wages	+0.9%
Jobs	+1.5 million

Source: Tax Foundation Taxes and Growth Model, April 2018

Making all or part of the TCJA permanent would have a positive impact on the economy, but it would also decrease revenue in both the short term and the long term. Making 100 percent bonus depreciation permanent would reduce federal revenue by $141 billion between 2023 and 2028. Extending all of the individual provisions would increase the budget deficit each year after 2025 by about $200 billion a year.

Given the revenue implications of making all or part of the TCJA permanent, it is important to bear in mind that some provisions are more cost-effective than others, and not all tax policies deserve a permanent place in the tax code.

19 Nicole Kaeding, Kyle Pomerleau, and Alex Muresianu, "Making the Tax Cuts and Jobs Act Individual Income Tax Provisions Permanent," Tax Foundation, July 10, 2018, https://taxfoundation.org/making-the-tax-cuts-and-jobs-act-individual-income-tax-provisions-permanent/.

For example, permanence for 100 percent bonus depreciation as well as the individual provisions would grow the economy, boost wages, and increase jobs. However, making bonus depreciation permanent does so at a lower cost. In the long run, permanent 100 percent bonus depreciation produces about 4.5 times more GDP growth per dollar of forgone revenue than making individual TCJA provisions permanent.[20]

While growth considerations like these are important to factor into permanence discussions, so too are broader tax policy considerations. Often Congress extends most or all policies that are set to change or expire, but it is not advisable to enact blanket extensions, nor permanence, for any policy. Some aspects of the TCJA are important improvements over previous law and should be made permanent. Other aspects of the TCJA should be revisited and improved upon.

Conclusion

Tax policy can increase the size of the economy by having a positive impact on the incentives to work and invest. However, when tax policy is temporary or retroactive, these positive effects are muted, and policies do not effectively incentivize the intended activity.

When considering which policies deserve a permanent place in the tax code, factors such as cost-effectiveness, efficiency, and neutrality should play a central role. Not every tax policy deserves permanence; appropriate care should be taken to ensure that permanence is only given to those policies which are economically efficient and conform to principles of sound tax policy.

20 Erica York, "Permanence for 100 Percent Bonus Depreciation Provides More Cost-Effective Growth than Permanence for Individual Provisions," Tax Foundation, Sept. 5, 2018, https://taxfoundation.org/100-percent-bonus-depreciation-permanence-offers-more-bang-for-the-buck/.