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MISPLACED PRIORITIES:
THE FLAWED HOUSE AND SENATE CORPORATE TAX BILLS

By Joel Friedman and David Kamin

On June 17, the House passed a corporate tax package that would repeal an export subsidy which the World Trade Organization has ruled to be illegal. In May, the Senate approved its own version of the legislation. Both the House and Senate versions include an extensive array of tax cuts and revenue-raising provisions.

Despite some positive features, these bills are flawed. The most serious problem is they miss an opportunity to use the savings from repealing the export subsidy and closing tax shelters to make progress on pressing national priorities, such as reducing yawning deficits that pose a long-term risk to the economy. All of the savings from these measures would instead be plowed into financing new tax breaks, most of which benefit corporations at a time when corporate tax revenues are already at historically low levels.

Indeed, these bills are likely to *increase* long-term deficits. The Senate bill is estimated to be deficit neutral, while the House measure explicitly increases the deficit by $35 billion through 2014. But numerous tax cuts are written into these bills on a temporary basis, and most are likely to be extended. If these tax cuts ultimately are extended without being paid for, the result will be significant increases in deficits over time.

Moreover, the bills include numerous provisions — from relief for tobacco farmers in the House bill to energy-related tax breaks in the Senate bill — that are unrelated to the WTO dispute, and that have apparently been added primarily to garner more votes for the bills. Even some staunch conservatives who traditionally support extensive tax cuts have sharply criticized these tax bills.[1]

The bills include two positive features.

- **They would repeal the export subsidy that the World Trade Organization has declared illegal.** The WTO authorized sanctions of $4 billion per year, and our European trading partners began phasing in the sanctions on March 1. The sanctions will continue to grow unless the subsidy is repealed.

- **Both the Senate and House measures also attempt to offset the cost of various tax cuts they contain through measures that would raise revenues, including**

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[1] For instance, Robert Novak, "Still No Sign of a Diet," *Washington Post*, June 7, 2004, and Daniel Mitchell, "FSC-ETI: Missed Opportunity?" Heritage Foundation WebMemo #509, May 24, 2004. Also see comments of former Bush Administration officials in Jonathan Weisman, "Opposition Softens on Corporate Tax Bill," *Washington Post*, June 14, 2004.

measures shutting down some tax shelters. This approach is consistent with recent practices in the Senate, but represents a significant change for the House. The Senate has been moving increasingly toward paying for tax cuts, and the Senate recently voted in favor of restoring "pay-as-you-go" rules that would require tax cuts as well as entitlement increases to be paid for. The House, in contrast, has shown little interest in paying for tax cuts and has rejected imposing "pay-as-you-go" requirements on the tax side of the ledger. Although the House corporate tax bill falls well short of the basic goal of being deficit neutral, the revenue-raising provisions in this bill represent a step in the right direction.

These positive features are outweighed, however, by the bills' negative attributes:

- **The House measure explicitly increases the deficit by $35 billion through 2014.** Although the measure includes provisions that would raise $115 billion in revenue, of which $50 billion would come from repeal of the export subsidy, the bill also includes $150 billion in tax cuts over the 11-year period. The Senate-passed measure contains offsets to cover the full cost of its tax cuts, according to the official cost estimate from the Joint Committee on Taxation, which shows the Senate measure raising about $3 billion in revenue over ten years, 2004 through 2013.

- **These official cost estimates, however, are likely to understate the full long-term fiscal impact of these measures.** Both the House and the Senate bills follow recent practices in tax-cut gimmickry by slowly phasing in some of their major tax cuts and scheduling other tax cuts to expire after only a few years, in part to lower their official cost (see box on page 4). Most of the "temporary" tax provisions in these bills are likely to be extended, and their extension will add tens of billions of dollars in cost, unless new offsets are found to cover the cost of these extensions.

  The Joint Tax Committee estimates show that extending the temporary provisions in the House bill would add about $190 billion to the cost of the legislation, raising the total cost of the House bill from $35 billion to $225 billion.[2] Extending the temporary provisions in the Senate bill would be less expensive; there are no estimates available that provide an exact figure. In the absence of a Congressional commitment to impose "pay-as-you-go" requirements on tax cuts in both the House and Senate, one cannot be confident that offsets would be produced to pay for the costly extension of these tax cuts.

- **The House and Senate bills include a grab-bag of corporate and other tax breaks that are notable more for the votes they seek to secure than for their positive effects on the economy or on tax policy.** The House bill includes extraneous provisions ranging from allowing individuals to deduct state and local sales taxes on their federal income tax returns to providing relief to tobacco farmers, while the Senate measure includes large parts of the energy bill that the Senate earlier blocked in the face of widespread criticism of its narrow tax breaks

[2] The Joint Tax Committee estimates that if, in addition to extending the bill's temporary tax cuts, the provisions that the bill slowly phases-in were instead made effective immediately, the bill's total cost would rise to $260 billion through 2014.

for special interests. Many of the revenue-raising provisions in these bills represent positive steps that would broaden the tax base by eliminating inefficient tax shelters. But the bills use much of the revenue from these provisions to pay for more targeted tax preferences, thereby again narrowing the tax base and distorting economic decisions.

Cost of House Corporate Tax Package
(billions of dollars)

	2004-2014
Tax cuts	-150
Repeal export subsidy	50
Other offsets	66
Subtotal, offsets	115
Total net cost	**-35**

Source: Joint Committee on Taxation

Stated another way, the bills include revenue-raising offsets, a precious commodity in these days of high deficits and tight budgets, but use them to pay for a range of narrowly targeted and inefficient tax breaks rather than to reduce the deficit, pay for other tax cuts that Congress is likely to extend without paying for them, or finance more important national priorities.

Reducing the deficit

The long-term budget outlook remains grim. Although the deficit may, over the next few years, recede somewhat from its current high level, it will then swell as the baby boomers retire in large numbers and eventually reach unsustainable levels. One of the most prudent steps that policymakers can take in preparation for these fiscal challenges is to start reducing the deficit.

Many provisions in these bills laudably raise revenues by shutting down tax shelters. By tightening up on shelters that, in many cases, Congress never intended to create in the first place, these provisions raise revenues that policymakers had never planned to forgo. It seems only logical that these funds should be dedicated to deficit reduction.

Moreover, corporate tax revenues are now at historically low levels as a share of the economy. The Congressional Budget Office projected in March that corporate tax revenues will equal 1.4 percent of GDP in 2004 — lower than the average levels seen in each decade from the 1940s on.[3] Furthermore, CBO projects that even after the economy fully recovers, corporate tax receipts will remain at about 1.8 percent of GDP through the end of the decade and beyond. This is lower than the average level of corporate tax receipts in each of these decades except for the 1980s, when corporate receipts plummeted from the effects of tax cuts and economic conditions.[4]

Given the historically low corporate revenues, it does not represent sound policy to use the revenues gained from closing corporate loopholes to fund new targeted corporate tax breaks. The goal should be to restore the corporate revenue base, at least in part, in order to help reduce the deficit, not to fracture the corporate revenue base further.

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[3] A recent CBO report suggests that corporate revenue collections in 2004 have, to date, been "slightly higher" than was expected as of its March 2004 budget projections. But, even with a slight increase above the level CBO projected in March, corporate tax receipts would remain well below historical levels.

[4] See Joel Friedman, "The Decline of Corporate Income Tax Revenues," Center on Budget and Policy Priorities, October 24, 2003.

House Bill Uses Gimmicks to Lower Cost of Tax Package

The House bill would cost $35 billion through 2014, according to the official Joint Committee on Taxation estimate. This cost estimate does not provide a good sense of the bill's true fiscal impact, however, because the bill employs two budget gimmicks, both of which have been widely used since 2001 to hold down artificially the official cost of tax-cut bills. The first gimmick involves phasing in tax cuts slowly over the ten-year period covered by the legislation. "Backloading" tax cuts in this manner shaves tens of billions of dollars off the ten-year cost of the House package. The second gimmick involves having tax cuts expire before the end of the ten-year period, even though the intention is, in many cases, for the tax cuts to be extended and to remain in effect on an ongoing basis.

The budget gimmickry hides the likely long-term cost of the House bill, because the various tax cuts in the bill are never fully in effect at the same time. For instance, the temporary tax cuts in the bill account for about half of the cost of all the tax cuts through 2009. Yet during the second half of the period covered by the bill, 2010 through 2014, these temporary tax cuts add nothing to its cost, because they have all expired. In contrast, the permanent tax cuts more than double in cost between the first half of the period covered by the bill and the second half of the period, reflecting the slow phase-in of many of these provisions. In other words, during the years when the temporary tax cuts are in effect, the permanent tax cuts have yet to phase in fully. By the time the permanent tax cuts are fully phased in, the temporary tax cuts have expired. Most of the bill's offsets, on the other hand, become fully effective immediately and are permanent. This means that when the temporary tax-cut provisions in the bill are extended — as most of them surely will be — the cost of extending these provisions will enlarge long-term deficits unless new offsets to pay for them are found at that time.

The Joint Tax Committee has estimated that making permanent most of the temporary tax cuts in the House bill would add $190 billion to the cost of the bill through 2014.* In 2014, continuing these provisions would raise the bill's net cost from the $2 billion a year as reported in the official cost estimate to $33 billion a year. The latter figure is a better representation of the long-term impact of the bill on the deficit, unless additional offsets are found in the years ahead.

Few of these temporary tax cuts are likely to be allowed to expire. For instance, a significant number of the bill's temporary tax cuts are part of a group of tax cuts that have been regularly extended in the past and are virtually certain to continue being extended in the future. (These tax breaks are sometimes referred to as the "extenders.") Extending these provisions would add $115 billion through 2014 to the cost of the House bill. The other temporary provisions, most of which are new tax cuts, would cost about $75 billion to extend. About 80 percent of this $75 billion cost reflects the cost of extending three provisions — Section 179 expensing for small businesses, the deduction of state and local sales taxes, and an alcohol fuels tax credit — whose supporters will certainly fight hard for their continuation.

The Senate Bill

The Senate bill includes a similar set of measures, relying on slow phase-ins and temporary tax cuts to achieve its "deficit neutral" cost estimate from the Joint Committee on Taxation. To maintain the bill's "deficit-neutral" status, more offsets would have to be found in future years to pay for the cost of extending various temporary provisions in the bill that are likely to be continued. If strong "pay-as-you-go" rules were in place, one might have confidence that such offsets would ultimately be found. In the absence of a "pay-as-you-go" requirement for tax cuts, it is more a matter of faith that the cost of extending these provisions would be offset and that the bill would remain "deficit neutral."

*The Joint Committee on Taxation has not provided estimates for the cost of continuing 5 of the 29 temporary provisions in the bill, including the cost of continuing the $2 billion per year relief for tobacco farmers that is scheduled to expire after 2009 and the one-year reduced tax rate for repatriated foreign earnings.

Paying for "Middle-class" Tax Cuts

If there is not sufficient support for using these revenue-raising provisions to reduce the deficit, then every attempt should be made at least to ensure that fiscal policies do not dig the deficit hole deeper. Congressional leaders have signaled their intent to extend the so-called middle-class tax cuts — the 10 percent bracket, the expansion of the child tax credit, and the relief for married couples — which are scheduled to expire in part at the end of 2004. Just a one-year extension of these provisions costs $26 billion; if these measures are extended through 2010, the cost will be nearly $100 billion. And if these measures are made permanent after 2010 — something that a bi-partisan majority in the House recently approved — the ten-year cost jumps to nearly $440 billion.[5] The extension of relief from the Alternative Minimum Tax, which also is slated to expire at the end of 2004 and is virtually certain to be continued, will cost hundreds of billions of dollars more.

Using the offsets in the House and Senate corporate tax bills to defray a portion of the cost of continuing these popular tax cuts would be a better use of these funds than the course that Congress is likely to follow, which is to extend these popular tax cuts with deficit financing and then to use the savings measures in the House and Senate corporate tax bills to create new and expanded corporate tax breaks.

Addressing National Priorities

With the return of large deficits, the mantra on the spending side of the budget has become that there is no money to address various emerging needs and priorities. Limits on discretionary spending are starting to affect funding for non-defense programs from education and housing to veteran's medical care, environmental protection, and homeland security. Senate Appropriations Committee Chairman Ted Stevens recently told *Congress Daily* "The tension is money. There's not enough money." This situation applies to other priority areas, as well, such as the 44 million Americans without health insurance.

Even without the funds raised by repealing the export subsidy, the revenue-raising provisions in the House and Senate bills would yield between $60 billion and $130 billion over the next ten years. Those funds could be applied in part to address high-priority national needs. In some cases, pressing problems could be addressed with a fraction of the funds being used to pay for the new, narrowly targeted corporate tax breaks that the House and Senate bills contain.

Conclusion

The House and Senate corporate tax bills raise significant revenue by curbing certain tax shelters and other tax breaks. Unfortunately, no consideration is being given to using these savings for deficit reduction, or failing that, to pay for the cost of extending the "middle-class" tax cuts or to finance more pressing priorities. The focus instead is on dubious tax breaks. Moreover, the House and Senate bills are likely to enlarge long-term deficits further, due primarily to the inclusion in these bills of various temporary tax breaks that likely will continually be extended or made permanent, possibly at considerable cost.

[5] The House actually passed an even more costly version of the child tax credit that not only made it permanent, but also expanded it to higher-income families, adding another $69 billion to the ten-year cost of the measure.