Top Ten Tax Policy Developments of the Past Year
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A lot has changed in the tax policy debate over the last year, and at the same time a lot has stayed the same. In this release, we count down the top 10 tax policy developments over the past year.

10. Record Low Revenue and Higher Spending in the Tax Code

In 2010, revenues dipped to 14.9 percent of GDP, a level that ties with 2009 but is otherwise the lowest since the early 1950s. By comparison, historical averages for revenue are slightly above 18 percent of GDP. The main reason for this revenue slump is the weak economy—with lower wages and higher unemployment leading to a reduction in revenue. This is compounded by stimulus measures on the tax side, which have lead to even lower revenue levels.

Also contributing to low revenue levels is the growth of tax expenditures—the exclusions, exemptions, credits, preferences, and deductions that reduce tax liability and, thus, decrease federal revenues. The costs of these tax provisions have increased in recent years, totaling approximately $1.2 trillion on 2010 (including the payroll tax impact) and an estimated $1.3 trillion in 2011. These breaks are not only expensive, but also distort decision-making and lead to higher-than-necessary rates. They have rightfully become a focus of tax reform efforts recently.

9. Senators Wyden, Gregg, and Coats Lead the Charge for Fundamental Tax Reform

The tax code is archaic, inefficient, and complex, and yet there have been no meaningful reforms to the tax code enacted since 1986. Last year Senators Ron Wyden (D-OR) and Judd Gregg (R-NH) attempted to rectify this by proposing a bipartisan, comprehensive tax reform proposal, the Bipartisan Tax Fairness and Simplification Act of 2010.

Their plan sought to simplify the tax code in a revenue-neutral way by consolidating income tax rates from six to three, eliminating the Alternative Minimum Tax, drastically reducing the corporate tax rate, and eliminating many of the tax expenditures in the code. Though it retained many of the most popular tax breaks – for mortgages, charitable giving, state & local taxes, and health care – in many ways it changed the debate in Washington for the better. Since Senator Gregg retired last year, Senator Dan Coats (R-IN) took up the mantel of tax reform by co-sponsoring a similar "Wyden-Coats" bill.

8. The 2010 Tax Deal Where Everyone Got Something (And Charged it to the National Credit Card)

Debate over extending the 2001/2003 tax cuts was a continuing discussion throughout the past year, with a divide over whether to permanently extend all the tax cuts at a cost of about $3.9 trillion, or renew them only for the 95 percent of families earning less than $250,000 at a cost of $3 trillion. The stalemate was resolved in December, not by compromising in the middle or finding ways to offset the costs as we would have liked, but by adding even more to the deficit. Not only were *all* the tax cuts in question extended, but lawmakers went even further by tacking on additional tax cuts – sacrificing fiscal responsibility in the name of political expediency. The final deal included:

- A two-year extension of the 2001/2003 income tax cuts **[$410 billion]**
- The continuation of various refundable tax credits originally passed in the ("temporary") stimulus bill **[$50 billion]**
- A reduction in the estate tax from 2009 levels (which was actually an increase from 2010, where the estate tax disappeared altogether) **[$70 billion]**
- A two-year "patch" of the Alternative Minimum Tax (AMT) **[$140 billion]**
- Corporate investment incentives **[$20 billion]**
- A one-year payroll tax holiday **[$110 billion]**
- A one-year extension of unemployment benefits **[$60 billion]**

Since the deal extended these policies for only two years, the 2001/2003/2010 tax cuts will have to be revisited again before the end of 2012.

7. The Disappearing, Reappearing Estate Tax

The tax deal not only affected income and payroll taxes, it also changed the estate tax. Back in 2000, the estate tax taxed estates worth over $650,000 at a top rate of 55 percent. The 2001 tax cuts gradually phased out the estate tax, increasing the exemption to $3.5 million and reducing the top rate to 45 percent in 2009, then getting rid of the tax altogether in 2010, and returning it to its pre-2001 levels in 2011. But few expected either the disappearance nor the full return of the tax. Even well into 2010, many insisted that policymakers would reinstate the estate tax retroactively. They did not. And when the

estate tax was restored in 2011, it was restored with a lower rate (35 percent) and higher exemption ($5 million) than in 2009. Estate planning is not what it used to be.

6. The VAT Gets Voted Down

A number of tax experts from across the political spectrum have called on the United States to augment (and/or partially replace) its income tax with a consumption tax. Nearly every other developed country has a valued added tax (VAT)—which is essentially a sales tax on all goods and services. Last year, the bipartisan Domenici-Rivlin Debt Reduction Task Force recommended comprehensive tax reform which included the addition of a 6.5 percent VAT (though they called it a "debt reduction sales tax").

Yet it seems that adoption of a VAT is unlikely, at least for now. Many on the left believe it will be too regressive, while those on the right worry that it will become a "money machine" if layered on top of the existing income tax. In a rare sign of near-unity, last April, the Senate voted 85-13 on a "Sense of the Senate" against a VAT. The vote had the support of 39 Republicans and 46 Democrats.

5. Spending Cuts are Labeled Tax Increases

There is no worse way to make sensible policy than to start out with pledges of what not to do. This is especially true of the Americans for Tax Reform (ATR) "tax pledge," which states that no signatory will support any revenue increase for any reason, ever. But it is possible to raise revenue without raising tax rates – by cutting the spending in the tax code (tax expenditures).

In the view of many conservatives like Commission member and Senator Tom Coburn, the ethanol tax credit is one of the most egregious of the tax expenditures. Yet when Senator Coburn proposed eliminating this subsidy earlier this year, ATR president Grover Norquist called it a violation of the tax pledge. "By opposing my amendment, you are defending wasteful spending and a de facto tax increase on every American," Coburn wrote to Norquist. "Continuing to issue blanket defenses of all tax expenditures is a profoundly misguided embrace of activist, progressive government and a strategy for tax complexity, tax deferment, excessive spending, and unsustainable deficits."

4. Non-Story of the Year: Politicians Patched the Alternative Minimum Tax

The Alternative Minimum Tax (AMT) was designed to make sure that the multitude of tax breaks in the code didn't lead to exceedingly low effective tax rates for certain taxpayers. Yet because the AMT is not indexed to inflation and because it was never permanently adjusted to account for the 2001/2003 tax cuts, the AMT is scheduled to hit an increasing number of middle class families that it was never intended to tax, over time. To avoid this, politicians have been "patching" the tax each year, at great cost to

the Treasury. This year, as part of the 2010 tax deal, policymakers extended AMT patches for another two years – adding about $140 billion to the deficit.

3. CUTGO Cuts Out PAYGO

The new rules in the House of Representatives this year included replacing the "pay as you go" (PAYGO) rule with a new "cut as you go" (CUTGO) rule. Whereas PAYGO requires that mandatory spending increases and tax cuts be offset with other spending cuts or tax increases, CUTGO only applies to new spending and can only be offset with spending cuts. CUTGO thus applies no fiscal discipline on tax cuts and leaves a loophole where lawmakers can pass more spending programs through the tax code, so-called tax expenditures, without a requirement to offset the costs.

2. Letting "Make Work Pay" Expire

When the stimulus bill was enacted in 2009, CRFB and others were worried that many of the supposedly-temporary provisions in the legislation would be made permanent. Chief among these was the "Making Work Pay" tax credit, a $400 per person tax credit that President Obama had supported since early in the campaign and continued to through the end of last year. Yet, in a rare occurrence in Washington, the tax credit ended last year. In its place, the 2010 tax deal called for a "holiday" to reduce payroll taxes by 2 percentage points. But because of the nature of the payroll tax holiday, this is far more likely to actually be temporary. And neither an extension of the payroll tax holiday, nor a resurrection of the Making Work Pay tax credit, was included in the President's Budget.

1. The "Zero Plan" Offers a Way Forward

On December 1, 2010, the National Commission on Fiscal Responsibility and Reform (Fiscal Commission) released its debt reduction plan. One of the most notable provisions of the plan from the Fiscal Commission was a sweeping tax reform proposal known as the "Zero Plan". The idea behind the Zero Plan was to wipe out *all* tax expenditures in the code, set aside money for deficit reduction, and then lower tax rates as much as possible. Such a move would significantly improve the simplicity and navigability of the tax code. Tax expenditures could be added back in—but through a "zero-based approach" where they would have to be offset by higher rates. Not only does this framework promote closer scrutiny of tax expenditures, but it offered a win-win for tax reform providing a simpler and more progressive code with dramatically lower rates that raises revenues to help reduced the deficit. The Zero Plan transformed the tax debate and has shown how tax reform can, and must, be an integral part of a comprehensive debt reduction strategy.

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So, what can we expect for tax policy moving forward? In the immediate future the role of revenue in reducing the national debt will be a critical and hotly contested debate. Some will refuse to support any increased revenues to combat the debt, while others will insist only on steep taxes for corporations and high earners. But given how bad the current code is, calls for fundamental tax reform will steadily grow.

We hope that by this time next year, though, we'll only need a "top 1" development—that we reformed the tax code. Only comprehensive reform offers the promise of improving simplicity and fairness, encouraging economic growth, and reducing the deficit. The time for tax reform is now.