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Dealing with Expiring Provisions in a Fiscally Responsible Manner
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At the end of this month, over 80 tax and spending policies are set to expire. How lawmakers deal with any extensions of these policies has important implications for the federal budget and could represent either a step forward for fiscal sustainability or else a step backward.

The long list of expiring policies includes often renewed policies such as the Alternative Minimum Tax (AMT) patch, so that the AMT does not hit middle-income families; the "doc fix" meant to prevent a 27 percent cut in Medicare physician payments; economic recovery measures such as extended unemployment insurance benefits and a temporary two percent payroll tax cut; as well as a number of so-called "tax extenders" such as the research and experimentation tax credit.

Lawmakers need to address these expiring policies in a fiscally responsible way. Absent offsets, these extensions could add hundreds of billions of dollars to the debt from a one-year extension and trillions over the longer-term.

Ideally, lawmakers would address all of the expiring provisions within the context of a comprehensive fiscal plan that stabilizes and reduces debt relative to the economy this decade. However, since they only have a few weeks to address the expiring provisions, **lawmakers <u>must</u> fully offset the costs of any extensions with real, gimmick-free savings.**

Lawmakers can no longer afford to add to the nation's already dire fiscal outlook, which could deliver a blow both to the future strength of the economy and to the confidence that credit markets have about the United States' commitment to fiscal restraint and ability to finance its debt.

At the same time, lawmakers need to **avoid** steps that move the fiscal debate backward, including:

1. **Deficit-financing the costs of extensions or using gimmicks to artificially inflate the offsets.** Paying for the costs of any new policies should be a minimum requirement, and not achieving real offsets – either through providing no offsets or relying on gimmicks – must be avoided. Ideally, any permanent fixes should occur only if accompanied with a plan to put the debt on a sustainable path.

2. **Dismantling the sequester or otherwise adding to the deficit in exchange for the extensions.** Unable to reach political consensus on offsets, politicians may instead start trading additional deficit-increasing policies, such as extending the 2001/2003/2010 income tax cuts or weakening the sequester now in effect as a result of the Super Committee's failure, so that a package is a short-term win for both parties but a loss for the next generation. This is unacceptable, particularly in the cases mentioned above which represent two of the central motivators for continued negotiations on deficit reduction.

The Costs of Extending Expiring Policies

Between now and the end of the year, over 80 spending and tax provisions are scheduled to expire. In the past, many of these policies have frequently been extended, sometimes with offsets and sometimes not. Taken together, a one-year extension of these policies could cost **over $400 billion** including ten years of interest costs. A permanent extension (other than for economic recovery measures) could add **over $2.3 trillion** to the national debt over ten years if the costs are not offset. While current discussions are focusing more on short-term extensions for many of these policies, their ten-year costs underscore the magnitude of these policies and the importance of offsetting the costs of extending them.

Among the policies expiring at the end of the year, some – such as the Alternative Minimum Tax patch – can be dealt with retroactively. For other policies, such as the doc fix, the end of the year represents a firm deadline by which policymakers will have to make a decision.

The expiring provisions include:

- **Payroll Tax Holiday:** Last year, lawmakers enacted a temporary two percent reduction in the Social Security payroll tax on employees (from 6.2 to 4.2 percent) for calendar year 2011. There have been calls to extend or even expand this holiday for 2012.

- **"Doc Fix:"** The Sustainable Growth Rate (SGR) calls for a 27 percent reduction in Medicare physician payments next year. Since 2003, policymakers have waived these cuts through temporary "doc fixes" and will likely do so again for a one- or two-year period.

- **Unemployment Insurance:** Extended unemployment benefits – which currently allow up to 99 weeks of collection in some states – are scheduled to expire at the end of the year. Proposals exist to extend existing policy, to do so while phasing down the number of weeks and to do so while implementing new programs and reforms to help reduce unemployment.

- **Expiring Medicare Provisions:** Each year, several Medicare payments and provisions are set to expire, including some payments for mental health, rural hospitals, and other services.

- **AMT Patch:** For years, Congress has adjusted the AMT to inflation to prevent the tax from hitting millions of middle-income households. Policymakers will most certainly do so again for 2012, though the change can be made retroactively.

Fig. 1: Costs of Extending Policies Expiring at the End of 2011 (Billions)

Policy	One-Year Extension	Ten-Year Extension
Policies That Must Be Addressed By 12/31/2011		
One-Year Extension of 2% Payroll Tax Holiday	$120	$120
"Doc Fix"*	$20	$290
One-Year Extension of Expanded Unemployment Insurance	$45	$45
Expiring Medicare Provisions	$5	$55
Policies That Expire But Can Be Retroactively Enacted		
Ten-Year Alternative Minimum Tax (AMT) Patch^	$90	$690*
Bonus Expensing Provisions#	$5	$370
"Tax Extenders"	$35	$360
(Subpart F for Active Financing Income)	*($5)*	*($70)*
(R&E Tax Credit)	*($10)*	*($60)*
(Alcohol Fuel Tax Credit)	*($5)*	*($55)*
(Other extenders)	*($20)*	*($170)*
Subtotal, Non-Interest Costs	**$320**	**$1,930**
Interest Costs	$100	$390
Total Costs	**$420**	**$2,320**

Source: CRFB estimates based on Congressional Budget Office and Joint Committee on Taxation data.
Note: Estimates rounded to nearest $5 billion. Numbers may not add due to rounding.
*Estimates reflect the costs of a ten-year freeze in payments against current law projections.
^Excluding costs of any interaction with possible extensions of the 2001/2003/2010 tax cuts.
#Cost of one-year extension reflects costs of continuing 100 percent bonus depreciation rule, while ten-year extension reflects cost of continuing the 50 percent bonus depreciation that is set to expire at the end of 2012.

- **Business Expensing:** A temporary provision to allow 100 percent depreciation deduction on certain business equipment in 2011 will drop to 50 percent next year and disappear thereafter. There have been calls from both sides to extend 100 percent depreciation ("expensing") for another year.

- **"Tax Extenders:"** Also expiring at the end of the year is a package of about 60 small tax provisions known as "extenders," including the research and experimentation tax credit, the alcohol fuels tax credit, the education expenses deduction, the state and local sales tax deduction, and many others. There has been interest in extending most, if not all, of these provisions, though the change can be made retroactively.

Paying for Any Extensions

Lawmakers could deal with expiring policies in many different ways, but it is critical that no matter what they do, they must at the very least fully pay for the costs of any policy extensions.

Ideally, lawmakers would have already addressed expiring provisions in the context of a comprehensive fiscal plan that had savings from each area of the budget, but the timing constraints do not make that likely before the end of 2011. Absent a plan to put the debt on a sustainable path, policymakers should avoid any deficit-financed extension of existing policies and must at least do the minimum by offsetting the full cost of any extension. Such offsets can occur over five to ten years, but must be incorporated into any extenders bill.

In addition, policymakers should consider changes to help ensure that larger reforms do occur. For example, lawmakers could agree to enact, and pay for, only very *short-term* extensions to many of these expiring policies to give them time to reach agreement on an overall fiscal reform package and to maintain the pressure for an agreement. They could also consider extending the fast-track authority of the Super Committee to new proposals which put us on a stable debt path.

Not paying for extensions, or claiming that the costs of extensions have been paid for by relying on budget gimmicks, would represent a step backwards. For example, lawmakers may try to count savings from the war drawdown that is already set to occur as offsets. *The first rule when you're in a hole is to stop digging and making the problem worse. It is also a good idea not to cover the hole with leaves and advertise it as filled.*

Even worse than using gimmicks, though, would be trying to make the deal more palatable by adding *further* to the deficit. For example, some have floated the idea of combining a deficit-financed set of extensions with a dismantling or weakening of the

$1.2 trillion sequester scheduled under current law or extensions of the 2001/2003/2010 income tax cuts. Either would be a mistake.

This sequester, which is the result of the failure of the Super Committee, is one of the few mechanisms that can actually force lawmakers to continue negotiating toward a comprehensive and bipartisan solution for debt reduction. Because of that, it is very important to keep the trigger in place until lawmakers can agree on debt reduction that is at least as large as the savings in the sequester.

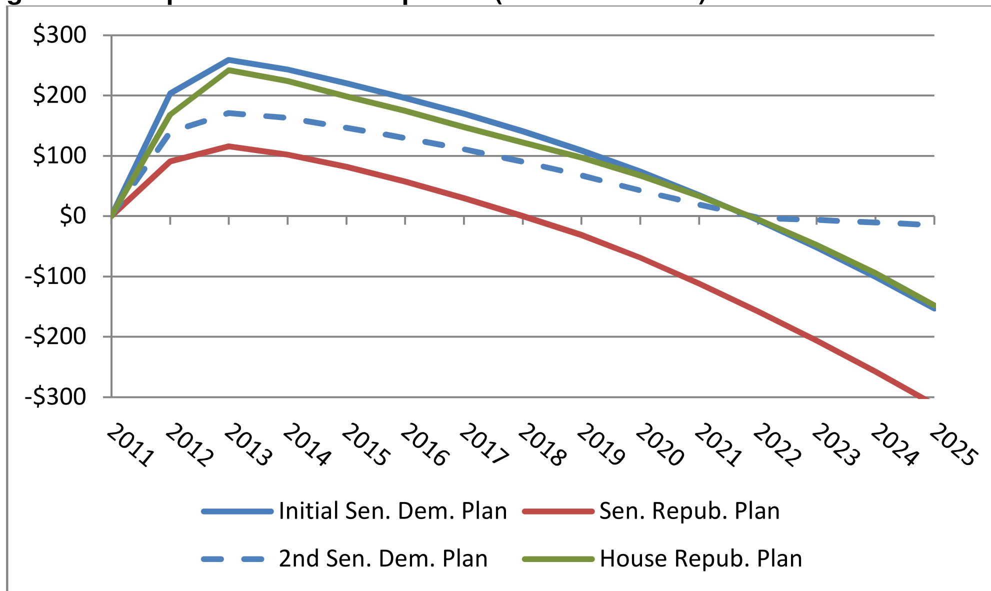
Understanding Current Proposals

To date, public discussions among lawmakers have largely focused on options for extending or expanding the payroll tax holiday, and just recently on extensions for the doc fix and unemployment insurance. Encouragingly, lawmakers have also been proposing specific offsets to pay for extensions of these policies.

These offsets have so far come in three varieties: higher taxes (and/or lower spending) on millionaires, federal workforce changes enforced with lower discretionary caps, and mandatory spending cuts considered in prior bipartisan deficit reduction negotiations.

So far, five packages have been proposed, and those that have been scored would fully pay for the costs of any policy extensions and/or expansions over the next ten years or so.

Fig. 2: Debt Impact of Recent Proposals (Percent of GDP)



Source: CRFB estimates from Congressional Budget Office and Joint Committee on Taxation data.
Note: Estimates include interest costs and savings. Data not available for proposal from Senators Collins and McCaskill.

Fig. 3: Summary of Proposals to Extend Expiring Provisions and Related Offsets

<u>**Senate Democrats' First Proposal (Week of 11/28/2011, Defeated in Senate)**</u>

Proposal: The plan would cut the employee payroll tax in half (from 6.2 to 3.1 percent) and offer employers the same cut on their first $5 million of wages paid. It would also offer a bonus cut to employers who added to their payroll. **(Cost: $265 billion)**

Offsets: The plan would enact a 3.25 percent surtax on income over $1 million. **(Savings: $265 billion)**

<u>**Senate Republicans' Proposal (Week of 11/28/2011, Defeated in Senate)**</u>

Proposal: The proposal would extend the current two percentage point payroll tax holiday for one year. **(Cost: $120 billion)**

Offsets: The plan would lower ten-year discretionary caps from the Budget Control Act by reducing size of the federal workforce and freezing federal salaries for an additional three years on top of the current two-year freeze, and would eliminate millionaires' eligibility for unemployment insurance and food stamps while raising Medicare premiums for higher earners. **(Savings: $230 billion)**

<u>**Senate Democrats' Second Proposal (Week of 12/5/2011, Defeated in Senate)**</u>

Proposal: The plan would cut the employee payroll tax in half (from 6.2 to 3.1 percent). **(Cost: $185 billion)**

Offsets: The plan would enact a temporary 1.9 percent surtax on income over $1 million (to expire after ten years), adopt the Republicans' offer to curtail unemployment benefits and food stamps for millionaires, and increase the fees that Fannie Mae and Freddie Mac charge mortgage lenders to guarantee loans. **(Savings: $190 billion)**

<u>**Senators Collins and McCaskill (Week of 12/5/2011)**</u>

Proposal: The plan would extend the current two percentage point payroll tax holiday for one year and offer a two percent cut to employers as well. It would also extend the R&E credit, 100 percent bonus depreciation, and restaurant and retail depreciation rule, while providing a tax credit for young high-tech small businesses, providing states with $35 billion infrastructure spending, and consolidating and reforming federal job training programs. **(Cost: Unk.)**

Offsets: The plan would enact a two percent surtax on income over $1 million, exempting small businesses, and would repeal tax credits offered to oil companies. **(Savings: Unk.)**

<u>**House Republican Proposal (Week of 12/5/2011)**</u>

Proposal: The plan would extend the current two percentage point payroll tax holiday for one year, enact a two-year doc fix, extend but scale down unemployment insurance, extend 100 percent bonus depreciation, and extend various Medicare provisions. **(Cost: $205 billion)**

Offsets: The plan would lower the discretionary caps by freezing federal salaries for an additional year in 2013, increase fees that Fannie Mae and Freddie Mac charge, reform federal civilian retirement, increase Medicare premiums for high earners, auction spectrum licenses, reform flood insurance, reduce child tax credit fraud, reduce spending from the health care reform law, reduce Social Security overpayments, and include other savings. **(Savings: $205 billion)**

Note: Numbers rounded to the nearest $5 billion.

While it has been very encouraging that proposals so far have fully offset their costs, we continue to worry that if the sides cannot reach agreement they might go forward with deficit-financed extensions or else pay for them using gimmicks. Such behavior would worsen the debt and erode confidence that lawmakers are serious about finding real savings to bring down deficits and debt.

Conclusion

It is reassuring that lawmakers generally appear committed to offsetting not only any new job creation measures, but also policies that have been extended regularly for years. The seriousness of the country's fiscal outlook and recent demonstrations of concern in credit markets about U.S. debt must prompt lawmakers, at the very least, to not add to the debt.

But even fully offsetting the costs of any policy extensions or new measures, Congress and the White House will still have to Go Big in order to enact savings sufficient to stabilize and reduce the debt as a share of the economy while permanently addressing expiring policies. Economically, such a plan would significantly strengthen the economy over the long-term while providing the fiscal space for any additional job creation policies in the near-term. In addition, a Go Big approach would provide market confidence that the U.S. has its debt situation under control, while providing a healthy amount of certainty and predictability currently lacking in the economy.

The expiring provisions, both this year and in future years, offer an opportunity to address the debt under a comprehensive approach. What lawmakers must avoid is using expiring policies to blow another hole in future deficits and debt, like they did last year.