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AMT Fix Becomes Massive Tax Hike Via Misleading CBO Baselines

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The central contest over competing visions for federal taxes for the next few years began on October 31. That is when Chairman Rangel (D–NY) of the House Ways and Means Committee shepherded the Temporary Tax Relief Act of 2007 (H.R. 3996) through his committee. Citing analysis by the Joint Committee on Taxation (JCT), Chairman Rangel described the bill as nearly revenue neutral, saying it would raise $484 million over 10 years. Under the approach taken in this bill, however, taxes would rise by nearly a trillion dollars over 10 years. The difference isn't a matter of math or policy, but of baselines.

The Congressional Budget Office (CBO) forecasts future receipts and spending levels, and Congress uses these forecasts to inform their deliberations over fiscal policy. The forecast, or baseline, used for tax legislation is based on "current law" and assumes that expiring tax provisions—like Alternative Minimum Tax (AMT) relief, or the "patch"—will not be renewed. This stands in sharp contrast to the CBO assumption that "current policy" with respect to federal spending will continue even if a spending program is scheduled to expire. For example, the CBO spending baseline assumes the continuation of the State Children's Health Insurance Program (SCHIP) even though that policy expired in 2007.

The result of the CBO receipts baseline assumption is that a tax bill that appears revenue neutral when scored, like Chairman Rangel's, can actually be a tax hike. To eliminate this structural bias favoring higher taxes and to bring greater accuracy and balance to tax policymaking, the CBO should revise its methodology for expiring tax provisions to bring it in line with its practices for spending programs. In the meantime, Congress should extend the patch for 2007. And because extending the patch is not a tax cut but rather the prevention of a tax increase, extension of the patch should not be accompanied by other tax increases.

Revenue Baselines. Where a journey ends often depends on where the journey begins. This year's journey into threatened tax hikes begins with the CBO receipts baseline. The CBO has, for many years, constructed a tax receipts forecast for the federal government based on its forecast for the economy and on current tax law. While the economic forecast occasionally generated controversy, the use of current law led to little.

In part, the assumption of current law for tax policy was non-controversial because current tax law usually extended current policies, without interruption or change, into the future. For example, next year's tax rates are usually the same as current rates. Exceptions, such as the R&D tax credit and related "tax extenders," have been relatively minor in terms

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of overall tax policy. Thus there was no apparent reason to question the current law assumption. Now, however, the current law assumption has become a serious issue, and it is apparent that it has always been the wrong assumption.

AMT and the Baseline. The AMT patch shines a bright spotlight on the CBO's current law assumption in the receipts baseline. The AMT is a parallel income tax; taxpayers pay the larger of the AMT and regular income tax liability. The AMT patch is an increase in the AMT exemption amount. It was first legislated in 2001 to ensure that taxpayers would not be denied their regular income tax relief by falling under the AMT.[1] The AMT patch expired at the end of 2006 and would be extended for 2007 by H.R. 3996.

The AMT patch has, like the R&D tax credit, typically been extended one year at a time. Yet the patch differs in two key respects. First, the AMT patch represents an enormous amount of tax revenue. The JTC scores the 2007 patch at almost $51 billion, whereas a one-year extension of the R&D credit reduces revenues by just under $9 billion.[2] Second, the AMT patch prevents this tax hike from falling on about 18 million individuals and families, rather than a group consisting mostly of large, multinational corporations.

Though the issues the AMT patch raises in terms of the formulation of the CBO baseline are not new, the magnitude of the revenues and the number of taxpayers involved make correcting the CBO baseline most urgent. Formulating the revenue baseline on the basis of current law is neither reasonable nor justifiable for the AMT patch, the R&D tax credit, or any other tax provision.

In 2006, millions of taxpayers were protected from the AMT by the patch. In 2007, absent congressional action and the President's signature, those millions will lose their protection and face an average tax increase of over $2,000; some will face a tax increase of over $5,000. From the perspective of these taxpayers, if the AMT patch is not extended, Congress will have put into effect a tax increase of $51 billion for one year and nearly a trillion dollars over 10 years if this same approach were followed year after year.

Chairman Rangel has repeatedly acknowledged that failure to extend the AMT patch for 2007 would result in an unacceptable tax increase on millions of unsuspecting taxpayers. In this, he is surely correct. His legislation would extend the patch for 2007, thereby preventing a tax hike. But because the CBO baseline reflects current law, the effect of extending the patch for 2007 is not in the baseline, because the patch requires a change in the law. Thus, extending the AMT patch is shown as a tax cut in the official scoring.

For the overall bill to be shown as revenue neutral in the official scoring, the Rangel bill increases taxes by $51 billion on other taxpayers. Chairman Rangel is proposing to raise taxes on other taxpayers to offset a tax cut that is not a tax cut. In short, under this logic, allowing the AMT patch to expire is a tax increase, but extending the AMT patch and raising $51 billion in tax revenue elsewhere is not a tax increase. This is illogical.

Comparing Revenue and Spending Baselines. The flaw in the CBO baseline formulation is further highlighted by contrasting the revenue and spending baselines. Most congressional and administration budget deliberations on the spending side are relative to current policy. The spending baseline[3] shows what spending would look like in future years under current policy, adjusting for inflation, certain legislated and regulatory changes that have not yet taken effect, and changes in the population.

Consider, for example, SCHIP. The SCHIP program expired at the end of September 2007. In

1. For a more complete discussion of the AMT and the AMT patch, see J.D. Foster, "Making Good Policy Out of a Bad AMT," Heritage Foundation *Backgrounder* No. 2082, October 31, 2007, at *www.heritage.org/Research/Taxes/bg2082.cfm*, and Joint Tax Committee, *Present Law and Background Relating to the Individual Alternative Minimum Tax*, staff report, JCX-10-07, March 7, 2007, at *www.house.gov/jct/x-10-07.pdf*.
2. Joint Tax Committee, "Estimated Revenue Effects of the Chairman's Amendment in the Nature of a Substitute to H.R. 3996, 'The Temporary Tax Relief Act of 2007,'" JCX-105-07, at *www.house.gov/jct/x-105-07.pdf*.
3. The current policy baseline is sometimes called the "current services" baseline in budget parlance.

formulating the current policy baseline, the CBO assumed spending would continue in 2008 and beyond at the level set in 2007. Thus, the debate in Congress is about the extent of the change in the program beyond what is provided under current policy.

If the CBO reflected the SCHIP program in the spending baseline the way it treats the AMT patch in the revenue baseline, then SCHIP would be assumed to expire for all time after 2007—that is, the baseline would show no SCHIP funding in 2008 or any year thereafter. This would not be a reasonable budget baseline for SCHIP, and it is not a reasonable way to present the AMT patch.

Faulty Baseline Renders PAYGO Biased. The problem with the CBO revenue baseline is brought into stark relief by Congress's adoption of pay-as-you-go (PAYGO) rules. These are general rules Congress imposes on its own deliberations to constrain legislation from increasing the budget deficit. For example, under the PAYGO rules now in effect, in most cases legislation that changes taxes or non-appropriated spending may not increase the deficit unless Congress votes to waive the rules.

PAYGO rules sum up the effects of changes in receipts and spending relative to a budgetary starting point. That starting point consists of the baseline forecasts for receipts and spending. If those baseline forecasts include systematic biases or errors, then PAYGO rules can fundamentally misinform legislators and the public about the issues under consideration and critically bias the outcome of the debate. This is exactly what is happening with legislation to extend the AMT patch.

If the CBO revenue baseline were formulated correctly, then the revenue score of extending the AMT patch would show it to be revenue neutral, just as legislation to extend the SCHIP program at current levels is budget neutral. Further, legislation such as Chairman Rangel's H.R. 3996 that extends the AMT patch and includes various tax increases as revenue offsets would correctly show a significant tax increase. If there is no tax cut, then a revenue offset is just a tax hike.

What Should Congress Do? The CBO provides Congress with information needed to make decisions. It is an agency of the congressional branch, and its methods, products, and structure all reflect congressional oversight and funding. Congress, therefore, has full latitude to direct the CBO to alter its procedures and methods as needed and appropriate.

The CBO itself may recognize the flaw in its methodology and desire to correct the flaw, but it may feel bound by precedent to continue with past practices until told or at least cleared to do otherwise. In any event, the flaw in the baseline methodology can be corrected by the CBO, and Congress can ensure that the flaw is corrected by clearly instructing the CBO to do so. For example, appropriately worded Sense of the Senate and Sense of the House resolutions should accomplish the task.

These resolutions would state the desire of the Congress that the CBO present unbiased, complete information and that, in so doing, it is important that tax policies and spending policies be treated alike in the budget baselines, using a consistent set of rules based on current policy assumptions. In this way, legislation extending a program without changes would have no budgetary effect for scoring purposes, whereas programmatic changes that increase (or decrease) spending would continue to be clearly scored as such. Similarly, tax provisions that expire would be treated in the receipts baseline as though they were extended indefinitely. Thus, legislation that extends a tax provision would not be scored as changing projected receipts.

Conclusion. Before the year is out, Congress should and likely will extend the AMT patch for 2007, thereby preventing a $51 billion tax hike that would otherwise hit millions of families. Congress should not use this as an excuse to raise taxes by a like amount on some other group of taxpayers.

Some Members' efforts to use the extension of an AMT patch as an opportunity to raise taxes are greatly facilitated by a serious and long-standing flaw in the CBO's methodology for developing its revenue baseline. Unlike its spending baseline, which is formulated based on current policy, the revenue baseline is calculated based on current law. There is no justification for constructing these baselines differently.

The effect of the CBO baseline flaw is that efforts to prevent a tax hike on millions of families are portrayed as a tax cut, rather than preventing a tax increase. And because of Congress's PAYGO rules, which rely on the CBO baseline and JTC scoring relative to that baseline, these efforts to prevent a tax hike must themselves be accompanied by tax hikes or else Congress must waive the rules.

Congress should recognize this serious flaw in the CBO methodology. It should waive the PAYGO rules for purposes of passing an AMT patch extension. It should not use this as an opportunity to raise taxes. And Congress should direct the CBO to remedy the flaw in its methodology and treat both spending and taxes on a current policy basis when developing next year's forecasts.

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