WebMemo
Published by The Heritage Foundation

No. 2722
December 8, 2009

Tax Hikes Unnecessary for Extension of Current Policy

Curtis S. Dubay

Congress will soon debate extending certain tax provisions that will expire at the end of the year. Even though continuing these provisions prevents a tax hike, some in Congress still feel it necessary to pay for them by increasing other taxes. Congress should not use the need to extend current policy as an excuse to raise taxes, because preventing a tax hike is not a tax cut.

Not a Tax Cut. Each year a group of about 45 tax provisions, collectively known as the "tax extenders," expire. These tax provisions, which apply to both individuals and businesses, include popular measures such as the research-and-development credit for businesses and the low-income housing credit for individuals. Each year Congress must extend these tax laws; otherwise a steep tax increase on certain groups of taxpayers would result.

Congress retains the tax extenders annually—but not before much hand-wringing about their supposed cost and even more haggling about paying for them with increases in other taxes. As the debate on the tax extenders begins again, Congress should remember that continuing the tax extenders for another year is not a tax cut and that there is no need to pay for them with tax hikes.[1]

Congress should extend all the expiring provisions it deems good tax policy and let the ones it does not expire. Since allowing these provisions to lapse is a tax hike, Congress should cut other taxes to make sure that there is not a net tax increase. Lowering marginal income tax rates would be the best response, since that would help spur the still-struggling economy.[2]

Broken Baseline. The yearly dance Congress goes through in regard to paying for the tax extenders is the result of a faulty revenue baseline constructed by the Congressional Budget Office (CBO). Congress relies on this baseline to judge whether tax provisions are tax hikes or tax cuts and whether overall tax bills are compliant with Pay-as-You-Go (PAYGO) budgeting rules. PAYGO requires that certain tax cuts or spending increases be "paid for" with subsequent tax increases or spending cuts.

Under current methodology, CBO creates its baseline for future government spending on *current policy.* For instance, spending on things like the highway program, the State Children's Health Insurance Program, and most appropriations expire. Since these programs constitute current policy, the CBO then assumes that Congress will extend these spending programs and the spending will continue.

To construct its revenue baseline, however, the CBO takes a decidedly different approach by assuming *current law.* This means that CBO incorporates any impending expiring tax reductions into the baseline as a jump in revenue.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Taxes/wm2722.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

In effect, when spending expires, the CBO assumes Congress really intends for it to continue, but when tax provisions expire, the CBO assumes Congress really intends for them to expire. For example, the 2011 expiration of the 2001 and 2003 tax cuts causes an enormous revenue jump in the CBO's revenue baseline in 2011 and beyond. The same applies for the tax extenders each year.[3]

The Joint Tax Committee (JTC) constructs its revenue estimates off of whatever baseline the CBO provides. Thus, when Congress extends current policies, like the tax extenders, the JTC estimates this as a revenue decline the same as it would a tax cut. Under PAYGO budget rules, Congress must offset the resulting revenue decline to prevent the deficit from increasing.

This flaw creates a bias for tax hikes since there is no appetite for spending cuts in Congress. Since Congress must continue the tax extenders each year, the flawed CBO revenue baseline provides cover for Congress to increase taxes year after year under the guise of faux fiscal discipline.

Fix Revenue Baseline. The CBO should apply the same current policy standard it uses for its spending baseline to fix the flawed revenue baseline. An improved revenue baseline would remove the bias that encourages Congress to increases taxes. Congress would then have consistent revenue and spending baselines to use for budgeting purposes, and the yearly charade of paying for tax provisions that are already in place would mercifully end.

Repairing the baseline would also make permanently fixing the alternative minimum tax (AMT) easier. Just like with the extenders, each year the faulty baseline causes Congress to wrestle with paying for an extension of the AMT patch. The patch prevents the AMT from hitting middle-income taxpayers and drastically raising their taxes. To lower the deceptive long-term cost, Congress only extends the patch for a year or two at a time.

Congress will not permanently fix the AMT until the CBO repairs its baseline and the JCT does not wrongly score patching the AMT as a revenue loss.[4]

Estate Tax Effect. The problematic CBO revenue baseline also impacts the ongoing congressional debate about the estate tax (also known as the death tax).

Under current, long-standing policy, the death tax expires on January 1, 2010. Many in Congress do not want the death tax to expire, and they use CBO's revenue baseline to argue that repealing it would cost too much. Under current law, the death tax comes back to life in full force in 2011. Therefore, the revenue baseline shows a steep increase in revenue from the death tax that year and beyond—even though current policy from 2010 onward is for the death tax to expire.

Under PAYGO rules, simply allowing current policy to take effect would require a large tax increase to offset the illusory revenue loss from the ending of the death tax. Even modest reductions from the original 55 percent rate—to 45 percent rate passed by the U.S. House of Representatives, or 35 percent as called for in the Senate—score as a significant revenue loss under these backward rules.

The broken revenue baseline should not constrain Congress from doing the right thing and killing the death tax once and for all. It is a drag to economic growth, a tremendous burden on family-owned businesses, and theoretically and morally indefensible.[5] Repealing it would not require raising other taxes since it would be continuing current policy and there would be no actual revenue loss.

Rules Matter. The rules governing budget policy play a central role in the outcome of Congress's

1. J. D. Foster and Stephen A. Keen, "Senate Tax Extenders: Another Sneaky Tax Hike," Heritage Foundation *WebMemo* No. 2006, July 30, 2008, at *http://www.heritage.org/Research/Taxes/wm2006.cfm.*
2. J. D. Foster and William W. Beach, "Economic Recovery: How Best to End the Recession," Heritage Foundation *WebMemo* No. 2191, January 7, 2009, at *http://www.heritage.org/Research/Economy/wm2191.cfm.*
3. J. D. Foster, "Obama to CBO Revenue Baseline: Nuts—and He's Right!," Heritage Foundation *WebMemo* No. 2019, August 11, 2008, at *http://www.heritage.org/Research/Budget/wm2019.cfm.*
4. J. D. Foster, "Making Good Policy Out of a Bad AMT," Heritage Foundation *Backgrounder* No. 2082, October 31, 2007, at *http://www.heritage.org/Research/Taxes/bg2082.cfm.*

spending and taxing decisions. The CBO's flawed revenue baseline creates a bias toward higher taxes when used by the JCT to construct revenue estimates.

Congress should correct this flaw and require the CBO to apply the current policy standard to its revenue baseline consistent with its treatment of expiring spending programs. That way it will not wrongly seek to raise taxes to continue current tax policies like the tax extenders, the AMT, the estate tax, and others.

—*Curtis S. Dubay is a Senior Analyst in Tax Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*

5. See Curtis S. Dubay, "Estate Tax a Killer for Family-Owned Businesses and Their Workers," Heritage Foundation *WebMemo* No. 2703, November 19, 2009, at *http://www.heritage.org/Research/Taxes/wm2703.cfm*; William W. Beach, "Seven Reasons Why Congress Should Repeal, Not Fix, the Death Tax," Heritage Foundation *WebMemo* No. 2688, November 9, 2009, at *http://www.heritage.org/Research/Taxes/wm2688.cfm*.