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WILL CONGRESSIONAL TAX-WRITERS EVADE THE BUDGET RESOLUTION LIMIT ON TAX CUTS?

Tax-Writers Could Do So Through Backloading and Other Gimmicks

by Joel Friedman, Richard Kogan, and Robert Greenstein

Summary

Congressional negotiators have agreed to set the overall size of the tax cut at $1.25 trillion over the next ten years (plus an additional $100 billion for economic stimulus, to be split in some proportion between this year and next year). The congressional tax-writing committees must now draft legislation that meets the plan's $1.25 trillion tax-cut target. The issue is how these committees will modify the President's tax-cut package — which costs $1.775 trillion over ten years according to the latest Joint Committee on Taxation estimates — to fit within Congress' somewhat smaller target. These committees will be under pressure not to scale back the President's proposed tax cuts very much, but rather to rely on budget gimmicks to shoehorn in most of his tax cuts and possibly additional tax reduction measures as well (such as pension tax cuts). As House Ways and Means Committee Chairman Bill Thomas said earlier this year, the trick is "to get a pound and a half of sugar in a one-pound bag."

- "Backloading" tax cuts — that is, delaying the date on which they become fully effective — is one gimmick likely to be employed.

- Another gimmick is to rely on the Alternative Minimum Tax to cancel out, on paper, a significant share of the income tax cuts, thereby reducing their cost. This constitutes a gimmick because virtually all observers agree that legislation will be enacted in the next few years to overhaul the AMT so it does not start to affect millions of middle-class taxpayers later in the decade; under that "must pass" legislation, the AMT would *not* have much of an effect in cancelling out the tax cuts, and their cost would rise accordingly.

- Still another gimmick is to defer action on expiring tax credits that do not expire *this year*, while extending the credits that do expire this year for one year only. This maneuver enables lawmakers to avoid counting against the $1.25 trillion limit the cost of extending these tax credits over the next decade — a cost which is virtually certain, as these credits have been routinely extended in the past and are expected to be continued in the future.

If available gimmicks prove inadequate, Congress may go further and engage in a more blatant budget-busting strategy — leaving certain popular tax cuts out of the $1.25 trillion package altogether, with the intention of enacting them later this year as part of a minimum-wage bill or other legislation likely to secure the 60 votes needed in the Senate to breach the budget resolution targets. The budget resolution is supposed to encompass all tax and spending legislation that Congress will consider this year. Senior Senate Republicans and Administration officials, however, have already been quoted as saying they will not be bound by the budget resolution's $1.25 trillion limit and will seek to append additional popular tax cuts to other legislation in the months ahead. If Congress can ignore the budget resolution targets in this manner, the $1.25 trillion tax-cut limit will essentially have become meaningless.

Backloading Already Used Heavily in House-Passed Bills

The House has demonstrated its willingness to engage in budget maneuvers such as these even before facing the new, lower $1.25 trillion target. For example, the tax bills the House has passed in recent weeks rely heavily on backloading.

- The House-passed estate tax bill (H.R. 8) phases in very slowly, repealing the estate tax in 2011. Since it takes a year or two to settle an estate, the full costs of repeal would not appear until after the end of the ten-year period that the budget resolution covers. This enables the cost of H.R. 8 to be held to $186 billion in the first ten years. In the second ten years, its costs skyrocket to approximately $1.1 trillion.

- Similarly, the principal provision in the House-passed H.R. 6 that focuses on married couples — a provision that accounts for 80 percent of the cost of the bill's marriage provisions when the provisions are fully in effect — would not start to phase in until 2004 and not take full effect until 2009. This provision costs $150 billion in the first ten years, but more than $400 billion in the second ten years.

AMT Reforms and Extenders Largely Ignored

Both the House and the Administration have made it clear they plan to defer "must do" tax legislation to a later date to make room for more tax cuts within the targets the budget resolution sets. The most egregious example involves the aforementioned Alternative Minimum Tax. A parallel tax system intended to ensure that high-income taxpayers do not avoid paying income taxes, the AMT will encroach heavily upon the middle class in coming years due to flaws in its design if nothing is done to address this problem. The Joint Tax Committee estimates that the number of taxpayers subject to the AMT will soar by 1,300 percent over the coming decade, rising from 1.5 million taxpayers this year to 21 million in 2011.

Knowledgeable observers agree that Congress and the Administration will not allow this to occur; changes will be made in the AMT to prevent it from hitting millions of middle-class families. The President's budget and the House-passed tax cuts, however, largely ignore this problem and the inevitable cost of addressing it; in fact, they make the problem more severe and raise the costs that ultimately will be incurred when the problem is addressed. Because taxpayers are required to pay the higher of their regular income tax liability or their AMT liability, proposals that substantially reduce regular income taxes *without* addressing the underlying problems in the AMT greatly increase the number of taxpayers who will become subject to the AMT if it is not reformed. The Joint Tax Committee estimates that the income tax rate reductions that are included in the Administration's package and that passed the House will increase the number of taxpayers subject to the AMT by *another 15 million* by 2011.

This aspect of the tax-cut proposals constitutes a budget gimmick for two reasons. First, the failure to include in the tax package the measures needed to address the problems in the AMT results in the cost of these inevitable measures not being counted against the $1.25 trillion budget target. Second, failing to include these measures in the tax bills under consideration substantially lowers the cost of those bills, since the cost estimates for the bills must be based on the dubious assumption that the AMT will remain unchanged, hit 36 million taxpayers by 2011, and thereby cancel out billions of dollars in tax cuts that otherwise would be provided to millions of tax filers. The Joint Tax Committee has estimated that the reductions in income tax rates in H.R. 3 would cost *$292 billion more over ten years* were it not for the effects of the AMT. Thus, when the problems in the AMT are eventually addressed, the cost of H.R. 3 will increase by roughly $300 billion.

Congress also is likely to rely on a similar type of gimmick in dealing with the 20 popular tax credits that expire every couple of years or so and always are renewed. The President's budget proposes a permanent extension of one of these credits, the research and experimentation credit. Since this credit does not expire until 2004, however, Congress may defer action on it, and thereby create more room for other tax cuts in this year's package. For the credits that *do* expire this year, Congress is likely to employ a gimmick the Administration's budget contains and extend the credits for one year only.

Whether tax credits that do not expire this year are extended this year or a few years from now, and whether these tax credits are made permanent or continue to be extended a few years at a time throughout the decade, does not affect their costs over the next ten years. The costs are essentially the same regardless of which course is pursued. The gimmick here, too, is that Congress seems likely to follow a course that enables it to avoid counting billions of dollars in cost that clearly will be incurred against the $1.25 trillion limit.

Gimmicks Swell Costs in Future Decades When Nation's Fiscal Situation Already is Tenuous

These gimmicks — from backloading, to leaving tax cuts out of the pending tax bill and not counting their cost against the $1.25 trillion target, to using the failure to address the problems in the AMT now to shrink artificially the cost assumed for the pending legislation —

all mask the ultimate costs of the tax cuts. In the face of a determined Congressional majority, Congressional budget rules are no obstacle to such gimmicks.

These gimmicks increase the ultimate costs of the tax cuts because they let Congress pack more tax cuts into the current tax-cut legislation than it otherwise could do. Indeed, the Administration's tax cut plan, as embodied in the three tax-cut bills the House has already passed plus the remaining elements of the Bush package and the changes in the AMT that ultimately will be made, would cost nearly $5 trillion in the *second* ten years the legislation would be in effect, from 2012 to 2021.

It is in this second ten-year period, which falls outside the period the budget resolution covers, that the country's fiscal situation becomes tenuous as the baby-boom generation begins to retire in large numbers. In fact, the Comptroller General of the United States (the head of the General Accounting Office) recently testified that "although the 10-year horizon looks better in CBO's January 31 projections than it did in July 2000, *the long-term fiscal outlook looks worse*" (emphasis added).[1] The long-term forecast has deteriorated due to adoption of a higher (and, most analysts believe, a more realistic) estimate of the long-term rate of growth in health care costs. This change for the worse in the long-term projections suggests that the room available for permanent tax cuts or spending increases has gotten smaller, not larger, as compared with previous budget projections. Relying on gimmicks such as backloading to shrink the cost of tax cuts in the first ten years — and thereby making the total tax-cut package larger and ultimately more costly than it otherwise would be — only makes the long-term fiscal situation more troublesome.

Congress Should Adhere to Basic Rules

Because of the long-term fiscal difficulties the nation faces and the high risk that Congress will employ an array of budget gimmicks to evade the tax-cut limits in the budget resolution, we offer three recommendations:

- **All provisions in the tax bill should be fully effective no later than the fifth year, 2006.** It may be noted that every major provision in President Bush's proposed tax package except for estate tax repeal would be fully phased in by 2006. In addition, most of the tax cuts in President Reagan's 1981 package were phased in fully in three years.

- **The tax writers should commit to a "pay-as-you-go" requirement for any tax cuts considered later in the session that would otherwise breach the $1.25 trillion target.** The budget targets are meaningless if Congress applies them only to one bill and breaches them in subsequent legislation.

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[1] *Long-Term Budget Issues: Moving from Balancing the Budget to Balancing Fiscal Risk*, Testimony of Comptroller General David M. Walker before the Senate Budget Committee, February 6, 2001.

- **The tax bill should include provisions that substantially fix the AMT, so the number of taxpayers affected by it stays roughly constant or grows only modestly over the coming decade. The tax bill also should extend throughout the decade those tax credits that ultimately will be extended anyway.**

The remainder of this analysis examines these issues in more detail.

Ten-year Cost Estimates for Tax Bill Likely to Be Misleading

Ten-year figures often say little about the true cost of tax-cut proposals once the proposals are fully in effect. Phasing a tax cut in over a number of years reduces its cost in the first ten years, relative to the cost of making the tax cut fully effective immediately. But such phasing does nothing to reduce the tax cut's ultimate cost — that is, its recurring annual cost in the years after the tax cut is fully in effect. It is a tax cut's recurring annual cost that is crucial for understanding the measure's ultimate fiscal impact.

To illustrate the effects of backloading, the table below presents three scenarios. In these scenarios, a hypothetical tax cut costing $1.25 trillion over the next ten years is assumed to be phased in fully at three different points in time: in 2002, 2006, and 2010.[2] Under each of the three scenarios, the revenue loss from the tax cut is assumed to reach its full cost in the year after the tax cut becomes fully effective. The table shows that while all three scenarios entail a cost of $1.25 trillion over ten years, their costs in the *second* ten years — and in 2011, a year in which the tax cuts would be in full effect under all three scenarios — differ markedly.

Examples Of How Backloading Affects Ultimate Costs

(In billions)

	Annual Cost In:			10-Year Total	*Second* Ten Years
	2003	2007	2011		
#1: Effective in 2002	105	127	155	1,250	2,016
#2: Phased in through 2006	49	153	186	1,250	2,424
#3: Phased in through 2010	35	132	242	1,250	3,154

The first approach — which has no backloading — would cost $155 billion in the tenth year. By contrast, the third example — the most backloaded — would cost $242 billion in that

[2] The tax cuts are assumed to be phased in equal annual increments. For instance, the tax cut that is assumed to be fully in effect after five years, in 2006, is assumed to be phased in at a rate of 20 percent each year.

year, almost 60 percent more. This large differential in the tenth-year cost continues into the future. The third scenario costs more than two-and-a-half times as much in the second ten years — $3.2 trillion — as in the first ten years, and costs $1.1 trillion more in the second ten years than the first scenario does even though the costs of both scenarios are identical over the initial ten-year period. These illustrative examples demonstrate that when a proposal is backloaded the ten-year estimates can be misleading.

Furthermore, backloading can be made more extreme than under any of these illustrative scenarios. The full cost of a tax cut can be pushed off *beyond* the ten-year budget window, by having the tax cut not become fully effective until *after* the end of the initial ten-year period. The House-passed estate-tax repeal bill (H.R. 8) takes such an approach. Under that bill, estate-tax repeal does not occur until 2011. Since the full cost of changes in the estate tax do not show up until a year or two after the effective date for such changes, the full cost of repeal is not captured in any of the first ten years. The Joint Tax Committee estimates that H.R. 8 would cost $186 billion between 2002 and 2011. But during the second ten years, when the full costs of estate-tax repeal would be felt, the bill would cost approximately $1.1 trillion, six times its cost in the first ten years.[3]

To keep the annual, recurring cost of the tax cuts that Congress is planning to adopt from exploding at the time the baby-boom generation starts retiring, the tax-writing committees could require that all provisions of tax-cut legislation be fully effective no later than the fifth year, or 2006. This would still allow substantial phasing in. As noted, the major income tax provisions of President Bush's tax-cut plan (although not the estate repeal provision) would be fully effective by 2006. The 1981 Reagan tax cuts generally phased in over three years.

Deferring AMT Reforms: Two Gimmicks for the Price of One

The authors of the bipartisan Senate floor amendment that reduced the size of the ten-year tax cut in the Senate budget resolution stated that the $1.188 trillion total in the Senate budget plan should accommodate AMT relief. This sensible recommendation may be largely ignored.

Under current law, flaws in the AMT's design are resulting in a growing number of middle-income taxpayers becoming subject to the alternative tax. The Treasury Department estimates that by the end of the decade, more than half of all taxpayers affected by the AMT will

[3] Joel Friedman, "Lower-Cost Estate Tax Repeal Reflects Slow Phase-In: Cost in the Second Ten Years Could Reach $1.3 Trillion," *Center on Budget and Policy Priorities*, April 4, 2001. Based on the recent Joint Tax Committee estimates of President Bush's revised proposal to repeal the estate tax, which now incorporates a carry-over basis provision and provisions to reduce income tax avoidance following repeal of the estate and gift tax, the cost of H.R. 8 in 2012 to 2021could reach $1.1 trillion, somewhat less than originally projected.

have incomes below $100,000, and more than two million will have incomes below $50,000. [4] This growth in the AMT is neither in keeping with its original policy intent nor politically sustainable. As a result, virtually all knowledgeable observers believe Congress will take action to reform the AMT.

AMT reform is expensive. For example, a proposal by Senator Blanche Lincoln that would hold the number of taxpayers affected by the AMT at or just below today's levels would cost $158 billion over ten years under current law and several hundred billion dollars more if the Bush tax cuts are enacted.

This creates an incentive to defer action on AMT relief. The "budget gimmick value" of deferring AMT reforms is great, because an unreformed AMT lowers the official cost estimates for various income tax cuts. The AMT requires a set of calculations that are separate and distinct from regular income tax calculations; taxpayers are required to pay the higher of their regular income tax or their AMT liability. The reductions in income tax rates that the Administration has proposed and the House has passed would lower regular income taxes substantially and thereby greatly increase the number of taxpayers whose AMT liability will be higher than their regular income tax liability if the problems in the AMT are not addressed. The Joint Tax Committee estimates that the reductions in income tax rates included in H.R. 3 would increase the number of taxpayers affected by the AMT by 15 million by 2011, raising the total number of taxpayers subject to the AMT to a startling 35.7 million that year.

In preparing a cost estimate for a tax-cut bill, the Joint Tax Committee is required to assume that the problems in the AMT will

Expiring Tax Credits and "Temporary" Capital Gains Rate Reductions

The Congressional Budget Office estimates that extending the tax credits (other than those related to the AMT) that are due to expire during the coming decade will result in revenue losses of $69 billion over ten years. Nearly every observer believes these tax credits will be extended throughout the decade. Leaving their extension out of the pending tax bill consequently understates the overall cost of tax cuts over the ten-year period. Omitting the all-but-inevitable extension of these tax credits from the current tax-cut bill, and not counting the cost of the extensions against the $1.25 trillion tax-cut ceiling, is a gimmick similar to deferring action on measures that are certain to be enacted to address the problems in the AMT.

In addition, some policymakers have suggested creating new "temporary" tax cuts, such as a temporary reduction in the capital gains tax rate. Such an action would, in effect, create yet another "tax extender" that would likely be renewed every year or two. As a result, inclusion of such temporary measures in tax legislation this year should be regarded as yet another budget gimmick.

[4] Robert Rebelein and Jerry Tempalski, "Who Pays the AMT?," *Office of Tax Analysis, U.S. Treasury Department*, OTA Paper 87, June 2000. The key design flaw is that the AMT exemptions and thresholds are not indexed for inflation. The parameters for the regular income tax, on the other hand, are indexed for inflation. Thus inflation has the effect of increasing AMT liability over time relative to regular income tax liability

not have been addressed unless the bill contains a provision to remedy those problems. Accordingly, in estimating the cost of the rate reductions in H.R. 3, the Joint Committee was compelled to assume that 35.7 million taxpayers would, in fact, be subject to the AMT by 2011 and that this would substantially reduce the cost of the tax-rate reductions by canceling out a significant portion of the tax cuts that the rate reductions otherwise would provide.

The Joint Tax Committee has reported that the large increases in AMT liability it was compelled to assume in preparing the cost estimate for H.R. 3 reduce the cost of H.R. 3 by $292 billion over ten years. The Joint Committee estimates show that the cost of H.R. 3 would be *50 percent higher in 2011* if it were not for these assumed AMT effects. (Note: The House did include some AMT modifications in H.R. 6, primarily to ensure that the AMT does not limit the effect of the increase in the child tax credit. These AMT provisions are modest, however, and do little to counter the massive growth in the number of taxpayers who would be affected by the AMT as a result of the rate reductions in H.R. 3.)

Deferring action on AMT relief is essentially a “two-fer” in the world of budget gimmicks. First, it allows Congress to exclude the cost of needed AMT reforms that virtually all observers are convinced will be enacted in the next few years. Second, omitting the inevitable reforms in the AMT from the tax-cut legislation conveniently shrinks the cost of that legislation.

This strategy substantially increases the long-term costs of the tax cuts. It does so because it makes the cost of the pending tax cuts appear much lower than it really is, since the exclusion of AMT reform from the package artificially reduces the tax-cut package’s cost. That, in turn, enables Congressional tax-writers to include additional, permanent tax cuts — some of them backloaded — in the package, while presenting the package as complying with the $1.25 trillion limit. Accurate accounting of anticipated income tax reductions would require Congress to include fundamental AMT reforms as part of the package. It appears that the Senate Finance Committee may be inclined to provide more AMT relief than the House. But the modest levels of AMT relief being discussed are unlikely to prevent the number of taxpayers affected by the AMT from increasing relative to current law as a result of the tax reductions or protect the middle class from the AMT. Failure to achieve even these goals guarantees that the future costs of reforming the AMT will remain substantial. It also means that the cost of the tax reductions now being considered will continue to be understated.

Busting the Budget Resolution Targets

Gimmicks are intended to create the illusion that budget discipline is being maintained. They make costs “disappear” on paper to create the appearance of compliance with the budget resolution targets. But these costs eventually “reappear.” By its nature, a gimmick does not permanently reduce costs.

Some tax-cut advocates appear to be interested in a more direct approach — directly breaching the budget resolution's $1.25 trillion tax-cut limit. Once a first round of tax cuts totaling $1.25 trillion has been enacted, the plan would be to continue enacting additional tax cuts by packaging them in legislation expected to secure the 60 votes needed in the Senate to waive the budget resolution targets. As Senator Phil Gramm stated: "I'm not bound by the tax number." The strategy appears to be to leave some popular tax cuts out of the current tax-cut legislation and then to package them in a way that makes them politically irresistible.

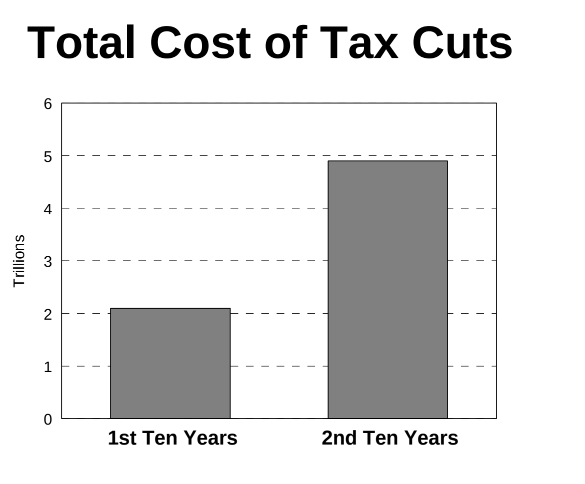
Senate Republican leaders, including Majority Leader Trent Lott has spoken openly about packaging various additional tax cuts into minimum-wage legislation later this year. There also is talk of writing tax cuts into Patients Bill of Right legislation. (In addition, according to media reports, Administration officials have promised conservative House Republicans and corporate lobbyists another substantial tax-cut bill next year.)

Breaching the budget resolution targets in this manner is a more blatant, in-your-face version of a budget gimmick. Like a budget gimmick, it circumvents the commitment to live within certain limits and undermines fiscal discipline. Moreover, such an approach could lead to a "tax-cut binge" that compromises the efforts of the past 15 years to restore fiscal balance and overcome the damaging fiscal effects of the last tax-cut binge in the early 1980s. Rather than repeating these mistakes, Congress should commit to pay-as-you-go rules for any tax cuts considered after the $1.25 trillion target has been reached.

Impact of Gimmicks Would Materialize in the Second Ten Years

Employing gimmicks to hold down the cost of tax cuts over the next ten years creates an illusion of affordability but does not reduce revenue losses over the long term. By masking the ultimate costs of tax cuts, these gimmicks conceal the tax cuts' eventual fiscal impact.

An analysis of the Administration's tax package, as amended by the House, shows how an already-high cost in the first ten years can mushroom into much larger costs in the second ten years. As estimated by the Joint Tax Committee, the total cost of the three House-passed tax bills plus the cost of the remaining components of the Administration's tax-cut plan (such as its health insurance tax credit) equals $1.8 trillion between 2002 and 2011, not counting the increased interest payments on the debt that the tax cuts would necessitate. To this total must be added the cost of



modifying the AMT, a cost that the House and the Administration have purposely left out but that will eventually be incurred. With the AMT reforms, the ten-year cost rises to at least $2.1 trillion, not counting interest payments. But in the second ten-year period, this cost more than doubles, rising to $4.9 trillion.[5]

Conclusion

With the budget resolution about to be approved, Congress will proceed quickly to craft legislation to meet the $1.25 trillion, ten-year tax-cut target. Congress should resist the temptation to rely on backloading and other gimmicks to squeeze 1½ pounds of sugar into a 1-pound bag and to produce tax-cut legislation whose costs explode in the years the baby-boom generation begins to retire in large numbers and the nation's fiscal outlook worsens. Congress should eschew both backloading and gimmicks designed to avoid counting against the $1.25 trillion limit the cost of additional tax cuts that Congress seems determined to pass this year (such as pension tax breaks) or that Congress unquestionably will pass in the near future, such as legislation addressing the problems in the Alternative Minimum Tax and extending the expiring tax credits. Deferring action on these matters and failing to leave room for their cost within the $1.25 trillion ceiling should be regarded as a budget gimmick. These gimmicks not only cloak costs that ultimately will be incurred, but they mislead the American public and weaken the nation's fiscal position over the long term.

[5] If the effects of inflation are removed and the costs are expressed in constant 2001 dollars, the cost still doubles in the second ten years — from $1.8 billion in the first ten years to $3.6 billion in the second ten years. For more details on the methodology behind the estimates, see Richard Kogan, Joel Friedman, and Robert Greenstein, "Cost of the Tax Cut Would More Than Double to $5 Trillion in Second Ten Years," *Center on Budget and Policy Priorities*, April 4, 2001.