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Issue Brief
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The Budget Deficit Gimmick
Will Oregon's Senators agree to increase the deficit?

Congress will soon consider a tax reconciliation package that includes extending two investment tax cuts that are due to expire in 2008, along with what has become an annual adjustment to the Alternative Minimum Tax (AMT). The investment tax cuts – extension of capital gains and dividends tax reductions – overwhelmingly benefit wealthy households.[1] Unless the costs of the extended cuts are offset with other policy changes, we will see a deepening of the nation's already troubling budget deficit.

Some lawmakers are proposing to use a gimmick to avoid Senate procedural rules concerning bills that increase the deficit: the reconciliation package would include another tax *cut* for the wealthy that appears to pay for the investment tax cuts in the short term. But over the long term, the new tax cut would further deepen the deficit.

Senate Rules and the Reconciliation Process

The budget process in Congress includes an option for consideration of tax and entitlement legislation under special rules that provide protection from a filibuster. Called "reconciliation," the process is designed to help Congress make difficult decisions – such as tax increases and program cuts – necessary to reduce the deficit. Only 51 votes are needed in the Senate to pass a reconciliation bill since it cannot be filibustered.

Since 2001, Congress has used the reconciliation process in an unusual way – to pass tax cuts that increase, not decrease, the deficit during the "budget planning period." The budget planning period is five years for the tax reconciliation bill now under consideration.

Although Senate rules do not prohibit a reconciliation bill from increasing the deficit *within* the five year budget planning period, another key Senate rule – the Byrd Rule – has kept the reconciliation process from being used to increase the deficit over the long term. This rule prohibits a reconciliation bill from increasing the deficit in years subsequent to the budget planning period. The Joint Committee on Taxation (JCT) forecasts revenue impacts over 10 years. Under the Byrd Rule, however, any reconciliation bill that reduces taxes or increases entitlement spending in any year outside of the five-year budget planning period – including beyond the 10-year JCT forecast – must also include provisions that would offset the cost of these provisions.

The 2006 Tax Reconciliation Agreement

Tax reconciliation measures have already passed the House and Senate and are now in conference committee. A central feature of the emerging tax reconciliation conference agreement is a two-year extension of the capital gains and dividend tax cuts due to expire in 2008. This proposal violates the reconciliation budget rules because it would reduce revenues by $51 billion over the following ten years, with $30 billion of the revenue loss occurring in 2011–2015 – outside of the five-year reconciliation period.[2]

Determined to extend the expensive and misguided dividend and capital gains tax cuts, Congressional tax negotiators are now considering a gimmick to evade the Byrd Rule by claiming that the costs of the capital gains and dividend cuts are partially offset – not with increased revenues – but, incredibly, with another tax cut for the wealthy.[3]

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The Gimmick – Simply Increasing the Deficit Permanently

The gimmick has two components that work together to bypass Senate budget rules. First, Congress would remove the income limits on who can convert a traditional IRA to a Roth IRA. Second, the change would likely not begin until after 2011 when budget rules require that the costs of the investment tax breaks show offsets.

A conversion to a Roth IRA is a taxable event, because unlike contributions to traditional IRAs, contributions to Roth IRAs are not tax-free. On the other hand, *withdrawals* from a Roth IRA *are* tax-free. Roth IRAs were created as a retirement tool for households who did not need the tax deduction up front, but were seeking tax-free income in retirement. People elect to convert their traditional IRAs to Roth IRAs if it would lower their tax bills in later years. In other words, they elect to pay some amount of taxes now only if they expect to lower their tax bill by a larger amount when they retire in the future.[4]

Under current law, taxpayers with incomes above $100,000 cannot covert traditional IRAs to Roth IRAs. The proposal to lift the income limits on Roth IRAs would spur a large number of high-income households to convert their traditional IRAs to Roth IRAs to take advantage of the long-term tax advantage. This conversion would generate revenue to the US Treasury shortly after it would go into effect in 2011 because people would pay taxes on the amount being converted. Thus, the scheme accelerates into the 2011-2015 period – the budget period when the additional cost of extending the capital gains and dividend tax cuts would appear – revenues that would otherwise have been collected in later years when the traditional IRA income would be withdrawn and taxed.

This maneuver is a gimmick because the proposal does not really raise any new revenue and because it would also *reduce* revenue in the years beyond 2015 (outside the JCT forecast window), when withdrawals in retirement from the new Roth IRAs would be tax-free.

What's Next?

Proponents of this gimmick hope to convince the Senate Parliamentarian that because official JCT estimates of the gimmick cover only the first 10 years of implementation and show no net loss of revenues during this time, no Senate rules are violated. Opponents argue that because this policy would increase deficits in the years beyond the Joint Tax Committee's official 10-year forecast, it still violates the Senate's Byrd Rule against increasing the deficit permanently.

If the Senate Parliamentarian allows the gimmick to be included in the reconciliation conference agreement, Oregon's two Senators will be faced with the choice of whether to endorse the gimmick and its actual long-term deficit increase. Will Oregon's Senators agree to pay for tax breaks for the wealthy at a time of troubling budget deficits with another tax break for the wealthy that further increases the deficit?

Endnotes:

[1] See the Tax Policy Center's distributional analyses at http://taxpolicycenter.org/TaxModel/tmdb/TMTemplate.cfm?Docid=1142&DocTypeID=2 and http://taxpolicycenter.org/TaxModel/tmdb/TMTemplate.cfm?Docid=1141&DocTypeID=1.

[2] Joint Committee on Taxation, JCX-10-06, Comparison Of The Estimated Revenue Effects Of The Tax Provisions Contained In H.R. 4297, The "Tax Relief Extension Reconciliation Act Of 2005," As Passed By The House, And H.R. 4297, The "Tax Relief Act of 2005," As Amended By The Senate, February 9, 2006

[3] See the Tax Policy Center distribution analysis at http://taxpolicycenter.org/TaxModel/tmdb/TMTemplate.cfm?Docid=1140&DocTypeID=2 and http://taxpolicycenter.org/TaxModel/tmdb/TMTemplate.cfm?Docid=1139&DocTypeID=1.

[4] Jane G. Gravelle, "Budgetary Effects of Alternative Individual Retirement Accounts (IRA) Policies," Congressional Research Service memorandum, February 27, 2006.