



THE FEDERAL BUDGET GIMMICK: WILL CALIFORNIA'S SENATORS AGREE TO INCREASE THE DEFICIT?

Congressional negotiators recently announced agreement on a bill to cut taxes by \$70 billion over five years. The bill relies on a gimmick to circumvent a long-standing budget rule that would otherwise prevent the Senate from passing a tax bill that increases long-term deficits. In addition, the tax cuts in the bill would disproportionately benefit high-income taxpayers. This Budget Brief explains the gimmick and how it would enable Congress to pass capital gains and dividend tax cuts that increase federal deficits.

Senate Rules Prohibit Reconciliation Bills from Increasing Federal Deficits

Congress is using the “reconciliation” process to pass the tax cut measure. Reconciliation bills follow special rules, which include a prohibition of filibusters in the Senate. The Senate only needs 51 votes to pass a reconciliation bill, rather than the 60 votes that would be needed to end debate during a filibuster. In addition, a Senate rule prevents reconciliation bills from increasing the federal deficit after the period covered by the budget resolution. Since the current budget resolution covers federal fiscal years (FFY) 2006 through 2010, the Senate rule would prevent the measure from increasing deficits after FFY 2010.¹

Tax Bill Contains a Budget Gimmick

Negotiators included a provision in the conference agreement that would extend reduced tax rates for capital gains and dividend income. The extension on reduced rates would increase the federal budget deficit after FFY 2010, which would violate the Senate rule on increasing deficits.² In order to comply with the Senate rule, congressional negotiators included in the conference agreement a gimmick to help offset the costs of the capital gains and dividend tax cuts. The gimmick would use an additional tax cut to help offset the cost of capital gains and dividend tax cuts.

The tax cut that would potentially “pay for” the cost of capital gains and dividend tax cuts would temporarily *increase* revenues between FFY 2011 and FFY 2015, but would *reduce* revenues after FFY 2015. The gimmick would raise the income limits on conversions of traditional Individual Retirement Accounts (IRAs) to Roth IRAs, thus disproportionately benefiting wealthy taxpayers.³ This change would accelerate revenue collections between FFY 2011 and FFY 2015, since individuals who take advantage of the change would pay income taxes on traditional IRA funds that are converted to Roth IRAs. However, the gimmick would reduce revenues after FFY 2015, since withdrawals from Roth IRAs are not subject to income tax. This gimmick would work only if evidence of the long-term reduction in revenues were ignored.

Tax Cuts Would Disproportionately Benefit the Wealthy

The tax package, which contains the capital gains and dividend income tax cut, a reduction in the number of households that must pay the Alternative Minimum Tax, and other tax cuts, is clearly tilted in favor of the wealthy. The average tax cut for the top 1 percent of households would be about \$14,000 (Table 1). In addition, the average tax cut for the top 0.1 percent of households would be nearly \$84,000. In contrast, the tax cuts would have little benefit for households at the middle of the income

distribution and no benefit at all for households in the lowest 20 percent.

Table 1: Tax Cuts Would Primarily Benefit Highest Income Taxpayers

	Average Income, 2006	Average Tax Cut When Fully Phased In
Bottom 20 Percent	\$7,923	\$0
Middle 20 Percent	\$35,940	\$20
Top 20 Percent	\$189,863	\$2,119
Top 1 Percent	\$1,159,675	\$14,094
Top 0.1 Percent	\$5,274,153	\$83,966

Note: Average tax cuts are based on income levels in 2006.
Source: Urban-Brookings Tax Policy Center

The Gimmick Would Increase Long-Term Federal Deficits

Four organizations with federal budget expertise have issued a joint statement that the gimmick “would reduce revenues and increase deficits after 2015.”⁴ Individuals would be expected to take advantage of the change in IRA conversion rules, and thus

pay additional income taxes in the short-term, only if their long-term tax liability were decreased. If individuals did not expect to pay lower taxes over the long-term, they would be unlikely to convert a traditional IRA to a Roth IRA. Thus, the net effect of such a change in IRA conversion rules would be to reduce tax revenues and increase deficits, a violation of the Senate reconciliation rule.

What’s Next?

Proponents of this gimmick hope to convince the Senate Parliamentarian to ignore data showing that the gimmick would reduce revenues beyond FFY 2010 and decide that the gimmick does not violate the Senate rule against increasing future deficits. Opponents argue that because this policy would worsen future deficits, it clearly violates the Senate rule.

If the Senate Parliamentarian allows the gimmick to be included in the tax bill, California’s two senators will have to decide whether to endorse the gimmick and its actual long-term deficit increase. Will California’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?

David Carroll prepared this Budget Brief. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP’s website at www.cbp.org.

ENDNOTES

- ¹ The current budget resolution, adopted by the House and Senate last year, is still in effect since a new budget resolution has not been adopted.
- ² Center on Budget and Policy Priorities, *Background on Potential Budget Gimmick in Tax Reconciliation Conference* (March 28, 2006).
- ³ This action would allow individuals with higher incomes to make such conversions. The conference committee is reportedly considering a separate, additional budget gimmick that would change the timing of tax revenues received from small businesses.
- ⁴ Center on Budget and Policy Priorities, The Committee for a Responsible Federal Budget, The Concord Coalition, and Committee for Economic Development, *Joint Statement Opposing Potential Budget Gimmick* (March 28, 2006).