



PAYGO RULE SHOULD NOT BE WAIVED FOR ALTERNATIVE MINIMUM TAX “PATCH”

I. Now comes the hard part.

Earlier this year, Congress took an important step toward restoring fiscal discipline and preventing the daunting long-term outlook from getting any worse by adopting pay-as-you-go budget rules (PAYGO) in the House and Senate. These rules require that any legislation to lower revenues or expand entitlement spending — relative to current law projections (i.e., the “baseline”) — be offset with corresponding revenue increases or spending cuts. In keeping with these rules, congressional committees have struggled hard throughout the year to offset popular initiatives such as expansion of the State Children’s Health Insurance Program (SCHIP) and the Farm Bill. While these efforts have been assisted at times by artificial timing shifts and sunsets, which The Concord Coalition does not condone, neither the House nor the Senate has yet given up the fight and actually waived its PAYGO rule for any legislation.

As Congress enters the final weeks of its current session, the House and Senate face a key test of their commitment to PAYGO when they consider legislation providing a one-year “patch” of relief from the Alternative Minimum Tax (AMT) and extending a number of expiring tax breaks.

With an estimated revenue loss of \$50 billion for the AMT patch alone, strict adherence to PAYGO in this legislation is both necessary as a matter of budgetary discipline and desirable as a means of compelling the types of trade-offs that must be made for a sustainable fiscal future. It presents a choice between paying our own way, which we clearly have the capacity to do, or continuing to run up a legacy of debt for future generations of Americans to pay off. Expressing support for PAYGO in the abstract is relatively easy. Now comes the hard part.

II. The stage is set

This week, the House is expected to take up H.R. 3996, the Temporary Tax Relief Act of 2007. It provides a one-year patch to prevent an additional 19 million taxpayers from being subjected to the AMT and extends several popular tax breaks such as the research and experimentation credit and the deduction for state and local taxes. The total revenue loss from all these provisions is estimated to be \$76 billion. In crafting the bill, however, the House Ways and Means Committee did not flinch when it came to PAYGO. All provisions were offset in a deficit neutral manner over the required budget window.

A broad bipartisan consensus exists to provide another one-year patch for the AMT, as Congress has routinely done since the 2003 tax cuts passed, and to extend the expiring tax breaks in the bill. Unfortunately, there is considerable opposition to fully offsetting the revenue loss. Thus, the

stage is set for the first major showdown over the new PAYGO rules. How it plays out has implications beyond the fate of this one particular bill.

No budget rule will be effective if it is not accompanied by a commitment to enforce it. Thus, it is critical that Congress resist the pressure to weaken PAYGO by exempting a politically popular item such as AMT relief. This will require policymakers to set priorities and make compromises among competing needs. Looking ahead, many tax and spending initiatives will need to be scaled back to fit within the amount of available offsets. If Congress maintains its commitment to PAYGO when the going gets rough, it will send a powerful signal that Washington has found the resolve to take its long-term fiscal problems seriously. By contrast, a decision to waive PAYGO will signal business as usual — casting in doubt the credibility of PAYGO for tough decisions on spending as well as taxes.

III. PAYGO and the AMT Problem

The AMT was originally enacted to prevent high-income taxpayers from escaping income taxes through extensive use of tax preferences. However, it is capturing more and more taxpayers who don't fall into this category. Two factors are responsible for the increase. First, the threshold levels at which the AMT applies are not indexed to inflation. This results in more taxpayers exceeding the threshold every year as incomes grow.

Second, the cuts in regular income tax rates enacted since 2001 subject more taxpayers to the AMT because taxpayers above the threshold pay the higher of their liability under the regular rate or the AMT. Indeed, the 2001-2006 tax cuts more than doubled the projected share of taxpayers who will face the AMT in 2010, from 16.0 percent to 33.6 percent.

Congress and the President have prevented a substantial increase in the number of taxpayers subject to the AMT by enacting a series of temporary patches that increased the threshold levels. The last such patch, for 2006, has expired--meaning that if no new adjustment is made the thresholds will revert to their base levels (\$33,750 for singles and \$45,000 for couples) and the number of AMT filers in 2007 will jump from 4 million to 23 million.

Failure to enact a permanent "fix," which nearly everyone says is the right thing to do, has made the cost of these one-year patches increasingly expensive. While the 2006 patch was estimated to cost \$31 billion, this year's patch will cost \$50 billion. According to the Congressional Budget Office (CBO), extending the AMT relief enacted in 2006 and indexing it for inflation would add \$376 billion to the deficit over the next five years (2008-2012) — \$95 billion in 2012 alone if the tax cuts are extended. A full and permanent fix of the AMT to prevent the alternative tax from negating promised tax cuts and becoming the de-facto tax calculation for the upper-middle class would cost substantially more. AMT relief has thus become a key test of PAYGO.

One of the primary arguments being used to oppose applying PAYGO to the AMT is rooted in the observation that the AMT is now applying to more taxpayers than was ever intended. If the argument goes, Congress did not intend to have the AMT apply to these taxpayers there should be no requirement to offset relief.

While this argument has a surface appeal, it violates both the letter and the basic purpose of PAYGO. There is no “intent” exemption from PAYGO, and for good reason. Congressional actions often have unintended consequences. The point of PAYGO is to prevent damage to the fiscal outlook. It does not matter whether that damage is the result of intended or unintended policy consequences. Moreover, in this case, there is nothing unforeseen in the growing reach of the AMT.

In fact, both the current President’s budget and the Congressional Budget Resolution depend on growing revenues equivalent to the amount that would be gained from an encroaching AMT in order to achieve their balanced budget goals over the next five years. They have similarly depended on those revenues to make their budget deficit projections look smaller in budgets from the past five years.

Allowing the AMT to continue without adjusting its brackets for inflation allowed the costs of the Bush Tax cuts to appear smaller than they actually were when passed in 2001 and 2003. The same thing is happening with regard to the debate about extending the tax cuts.

The President’s budget estimates that extending the 2001 and 2003 tax cuts would cost \$1.7 trillion over the next decade (2008-2017). However, they only include an AMT patch for 2007. Thus, the budget assumes the AMT will begin to ensnare millions more taxpayers and in effect take back part of the tax cuts from those taxpayers. This lowers the estimated revenue loss. Including the costs of AMT relief adds an additional \$1.1 trillion to the price tag. This estimate does not include added interest costs, which the government would be on the hook to pay if AMT relief was not offset, as PAYGO demands, and we had to borrow money to cover the resulting deficits.

The administration’s public position is that a permanent solution to the AMT issue should be enacted as part of revenue neutral tax reform, meaning those revenues would flow to the Treasury without coming from the AMT. However, the President has never proposed permanent AMT reform and given the administration’s repeated objections to any revenue offsets, an expressed commitment to revenue neutrality must be treated with great skepticism.

The broader argument some have been making against applying PAYGO to the AMT patch is that they don’t believe PAYGO should apply to tax cuts in general. This argument was in some sense settled with adoption of the House and Senate rules, which contain no such exemption. However, it is important to go over why such an argument would be fiscal folly.

Budgeting is a process of allocating resources that requires trade-offs, not only among competing spending priorities but also between spending and revenue objectives. Spending and tax decisions both affect overall budget deficits or surpluses. In addition, subjecting tax changes to PAYGO provides balance to budget deliberations by subjecting those who stand to benefit from tax changes to the same level of scrutiny as beneficiaries of entitlement changes.

Exempting tax decisions risks encouraging the expansion of so-called “tax entitlements” (where benefits are funneled through the tax code rather than through direct spending) whose benefits are difficult to target and evaluate in terms of effectiveness and performance.

The way to deprive PAYGO of any real meaning is to begin carving out exemptions. It would send an alarming signal that Congress is not yet taking our nation's deteriorating fiscal outlook seriously. It provides virtually no fiscal discipline. PAYGO can only be effective if it establishes an ongoing standard.

A much more disciplined approach is needed to begin the road back to a balanced budget. Removing tax cuts from PAYGO would do nothing to promote fiscal discipline. It would neither control spending nor shrink the deficit. All it would do is exempt tax cuts from fiscal scrutiny, regardless of the circumstances. Such an enormous and unnecessary loophole would not be wise policy given that deficits are back for as far as the eye can see.

IV. The Long-term Context

PAYGO does not exist in a vacuum. Its importance is best understood in the context of the long-term challenges we face because its basic purpose is to compel trade-offs to ensure that the nation's daunting fiscal outlook does not get any worse.

The most recent analyses of the Congressional Budget Office (CBO), the Government Accountability Office (GAO), the Office of Management and Budget (OMB), and independent fiscal and economic policy experts, including The Concord Coalition, consistently conclude that current budget policies are on an unsustainable path.

Our nation is undergoing an unprecedented demographic transformation to an older society against the backdrop of steadily rising health care costs and steadily falling national savings. It is a dangerous combination for the future health of the economy. Three factors tell the story:

- Social Security, Medicare and Medicaid already comprise 42 percent of the federal budget — before the baby boomers begin to retire.
- Over the next 25 years, the number of Americans aged 65 and up is expected to nearly double, growing from 12 percent of the population to 20 percent. The ratio of workers paying into Social Security and Medicare relative to the number of beneficiaries will fall by roughly one-third.
- For the past 40 years health care spending has consistently grown faster than the economy. If the same growth rate continues over the next 40 years, Medicare and Medicaid will absorb as much of our nation's economy as the entire federal budget does today.

The country has not yet reached a consensus over the question of whether projected spending is too high or projected revenues are too low. But there is no question that the projected gap between revenues and spending, and the resulting debt burden, would put our nation's economic security in serious jeopardy and increase exposure to the uncertainty of global capital markets.

So far, there is little evidence that the bond markets are concerned about the potential borrowing needs of the United States government over the long-term. That has prompted some to believe that the projected fiscal gap does not matter because an ample supply of willing lenders exists to fill the gap. However, recent events should serve as a reminder that domestic credit markets do not always function smoothly and that the United States does not have an inalienable right to cheap and easy credit from the rest of the world.

If the markets begin to focus on the likelihood of serious federal deficits over the long-term and assume that policymakers are unwilling to take action to confront the problem, the market's reaction could be swift and costly. There will be no forbearance as policy makers attempt to remedy the perception. Acting proactively—not waiting for markets to react—would allow a more gradual shift to the policy adjustments that will have to be made.

Whatever the world economy looks like two, three, four decades from now, the United States will have greater room to maneuver if it acts now to limit the growth in future debt levels. Today's relatively benign short-term budget projections should not lull policy makers into believing that conditions cannot change. Hard as it is, adopting a more disciplined stance toward the budget will be easier now than later when the magnitude of required policy adjustment is likely to be greater and far more disruptive to the American people.

V. Conclusion

With a declining short-term budget deficit, it may be tempting for lawmakers to lose sight of the fact that our biggest fiscal challenge is over the long-term. That is why adherence to PAYGO is no mere “green eyeshade” issue. It represents a line in the sand that if crossed contributes even more debt to an already unsustainable burden. Not only does PAYGO help to keep the long-term outlook from getting worse, but it also forces explicit acknowledgement of the obvious—someone sometime will have to pay for deficit financed increases in entitlement spending and tax cuts, if not within the five to 10-year budget window, then sometime in the future through higher taxes or reduced federal programs, benefits and services. There is no free lunch.

It is worth noting in this regard, that the huge \$5.6 trillion surplus projected just six years ago did not simply disappear because of changing economic projections. According to CBO estimates as of January 2007, *legislation and its associated interest costs have consumed more than the entire amount*. While it would not be fair to attribute the breakdown in fiscal discipline entirely to the abandonment of PAYGO in 2002, the absence of this rule certainly played its part. By contrast, PAYGO had a very positive influence in helping to bring about the brief era of budget surpluses that ended in 2002 as the former PAYGO rules were allowed to expire.

The new PAYGO rules are now being tested. Providing AMT relief and extending other popular tax breaks in a deficit neutral manner would send a very positive signal that Congress is finally prepared to take the deficit seriously and make some hard choices among competing priorities. If accomplished with bipartisan support, it would set a good precedent for the kind of cooperation that will be needed to achieve fiscal sustainability.