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The Fiscal Policy Agenda of the New Congress: An Early Assessment

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The 110th Congress convened on January 4 with a new Democratic majority and a new policy agenda. That agenda includes tax and fiscal-policy changes, some of which the House of Representatives addressed during its first hundred hours. Congress is adopting a pay-go budget rule and other budget reforms. During 2007, it will almost certainly offer short-term alternative minimum tax (AMT) relief. It will also probably try to raise taxes on domestic oil and gas production and on American firms operating abroad.

The pay-go rule is a welcome, though imperfect, step toward fiscal responsibility. Unfortunately, the tax increases on oil production and American firms abroad are based on populism and economic nationalism rather than sound economics. The choices required by the pay-go rule will probably be manageable this year, but are likely to be more difficult in 2008.

As part of its hundred-hour agenda, the House adopted a pay-go budget rule on January 5. Under this rule, a bill cannot be considered on the House floor if it changes tax and entitlement programs in a manner that increases the deficit. In other words, any tax cut or entitlement spending increase must be offset by either tax increases or entitlement spending cuts of the same or greater magnitude.

The pay-go rule applies only to bills that increase entitlement spending, not those that increase discretionary spending. Entitlement programs do not require annual appropriations from Congress because they are established by law and automatically pay benefits to eligible recipients. Entitlement spending was about $1.418 trillion in fiscal 2006, of which three-quarters went to Social Security, Medicare, and Medicaid. Annually appropriated discretionary spending was about $1.025 trillion, of which half went to national defense.[1] The rule focuses on entitlement spending because it is more difficult to control.

The House's pay-go rule applies to budgetary impacts at both a six-year and an eleven-year horizon. A bill considered this year, for example, cannot increase the cumulative deficit either for fiscal years 2007 through 2012 inclusive or for fiscal 2007 through 2017 inclusive. (Fiscal 2007 began on October 1, 2006, and will end on September 30, 2007). Bills need not be deficit-neutral in any single year.

The pay-go rule is not an absolute constraint. A bill that violates the rule may be considered if the Rules Committee reports a special order that waives the rule and a majority of the House approves that order in a separate vote before the bill is considered.[2]

The Senate leadership has proposed adding a pay-go provision to that chamber's rules. The proposed rule, which could be waived by a three-fifths vote, would apply to different time periods than the House rule: bills considered in 2007 could not increase the deficit in fiscal 2008, fiscal 2008–2012, or fiscal 2008–2017.

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Two Cheers for Pay-Go

The pay-go rule should be viewed against the backdrop of the long-term fiscal imbalance. Current law features a built-in increase in entitlement spending that will outpace the growth of federal revenue and impose massive fiscal burdens on future generations.[3]

To be sure, the rule does not require that legislation be adopted to narrow this existing imbalance. It does, however, prohibit tax and entitlement legislation that would widen the imbalance. While modest, this restriction is essential. When you're in a hole, the first step is to stop digging.

Congressional Democrats are already curtailing two planned entitlement increases to comply with the pay-go rule. The student-loan bill passed by the House on January 17 reduces interest rates on fewer loans and will be phased in more slowly than the House leadership initially desired.[4] And it is becoming clear that the Democratic proposal to reduce patient cost-sharing under the Medicare prescription-drug program will be delayed or scaled back.[5]

Policies that shift burdens to future generations should not continue unchecked while the art of revenue estimation is being perfected.

Some aspects of the pay-go rule are imperfect. The rule relies on estimated budgetary effects that cannot be precisely known. Also, the budgetary effects are estimated only for the first eleven years, which may not always reflect the long-run effects. Furthermore, the estimates do not reflect the revenue and spending feedbacks from changes in macroeconomic variables, such as increases in work and saving resulting from reductions in marginal tax rates, although they do reflect changes in microeconomic behavior, such as increased capital gains realizations caused by reductions in capital gains taxes.

But the perfect should not be the enemy of the good. Policies that shift burdens to future generations should not continue unchecked while the art of revenue estimation is being perfected.

Some critics assert that entitlement spending cuts are politically impossible and complain that the rule will therefore preclude tax cuts, including any extension of the 2001 and 2003 tax reductions that are scheduled to expire at the end of 2010. This objection fails to recognize the economic constraint that taxes and government spending must balance in present value over the long run. The trade-off between entitlements and taxes is not created by the pay-go rule; that tradeoff is already built into the government's long-run budget constraint, although it can be eased or tightened by changes in discretionary spending.

The pay-go rule merely forces the nation to confront that tradeoff today rather than tomorrow. With or without the rule, if entitlement cuts truly are politically impossible, then tax cuts are economically impossible in the long run. Scrapping the pay-go rule would allow tax cuts in the short run, but only at the cost of future tax increases. By removing that short-run option, the pay-go rule highlights the inescapable reality that tax-cut supporters must push for entitlement cuts.

It is an open question whether the Democratic majority will faithfully follow the pay-go rule. Past experience reveals that both Democrats and Republicans are reluctant to adhere to such restrictions when in power.[6] And even if the rule succeeds in blocking legislation that would widen the fiscal imbalance, the task of addressing the existing imbalance will still remain.

On January 5, the House also adopted a rule requiring members who propose earmarks directing funds to specific projects to provide greater disclosure. The Senate adopted a similar restriction on January 18. This highly desirable change will promote better and more transparent budgetary decisions, but will have little effect on total spending.

AMT Relief on the Horizon

In 2007, Congress will probably offer short-term relief from the individual AMT and provide a small amount of business tax relief in conjunction with an increase in the federal minimum wage.

The AMT is an alternative tax system to which each taxpayer is subject if it yields a higher tax liability than the regular tax system. At any given level of taxable income, the AMT imposes a lower tax liability than the regular tax. The AMT rules, however, normally yield a larger taxable income than the regular tax rules. Under the AMT, for example, taxpayers cannot claim the $3,400 per-person exemption or deduct state and local taxes.

According to estimates by the Urban Institute–Brookings Institution Tax Policy Center, the AMT applied to 3.5 million taxpayers in 2006. The number

was held down, however, by the “AMT patch,” which allowed certain tax credits to be claimed under the AMT, and increased the AMT tax-free threshold. Because the patch expired at the end of 2006, a staggering 23 million taxpayers face the AMT this year. Moreover, the number is expected to rise to 32 million by 2010 because the AMT tax-free threshold, unlike most aspects of the regular income tax, is not indexed to inflation. Millions of middle-income taxpayers will move onto the AMT simply because they have large families or live in high-tax states.[7]

To prevent the AMT rolls from expanding in 2007, Congress will probably extend the patch through the end of the year. The extension would reduce revenue by about $40 billion, mostly in fiscal 2008. A long-term solution to the spread of the AMT would trigger a much larger revenue loss and will probably not be adopted this year.

Congress is also likely to provide a small amount of business tax relief as compensation for increasing the minimum wage. On January 17, the Senate Finance Committee approved a bill offering $8 billion of business tax cuts over the next ten years, including temporary extensions of certain depreciation provisions and of a credit for hiring disadvantaged workers. This bill will be attached to the minimum-wage bill that the Senate will consider later this month. Although the minimum-wage bill passed by the House on January 10 does not include tax relief, the two chambers are likely to ultimately agree on a bill that contains such relief, which President George W. Bush is likely to sign.

Congress is likely to pass some tax increases during 2007. In their “Six for ‘06” agenda last year, Democrats pledged to end “tax giveaways to Big Oil companies” and “tax giveaways that reward companies for moving American jobs overseas.”[8] Unfortunately, these proposed tax increases are motivated more by populism and economic nationalism than by sound economics.

Taxing Oil and Gas: A Turn toward Populism

House Democrats began implementing the oil pledge during the first hundred hours. On January 18, the House passed a bill that raises taxes on domestic oil and gas production by $8 billion over the next eleven years. It also obtains $6 billion of budgetary savings by pressuring oil companies to renegotiate certain leases, a provision that lies outside the scope of this article. The bill alters budget rules to facilitate offsetting spending increases for renewable energy and conservation.

Most of the increased taxes would come from denying oil and natural-gas production the tax break for “qualified domestic production activities.” This tax break, which was adopted in October 2004, generally applies to manufacturing, mining, agriculture, construction, and film production—but not to services. While other corporations continue to face a top 35 percent tax rate, those eligible for this break face top rates of 33.95 percent in 2005–06, 32.9 percent in 2007–09, and 31.85 percent thereafter.

This distinction between favored and disfavored activities has no economic justification. It reflects the unfounded notion that the production of goods is inherently better than the provision of services. The purpose of economic activity is to meet human needs and wants, whether through goods or services. Indeed, many products include a mix of both. For example, the provision of restaurant meals, which Congress classified as a disfavored service, involves the preparation of a physical product. The implementation of this distinction has been a thankless task for the IRS.

In any event, if one wanted to distinguish between goods and services, one would undoubtedly put oil and natural-gas production in the goods category, which is what Congress did in 2004. The House bill, however, moves these activities to the disfavored list, while leaving other forms of energy production on the favored list. The only apparent rationale is the populist desire to punish an unpopular industry.

Singling out an industry in this manner is not unprecedented. In 2004, Congress put adult movies, but not other films, on the disfavored list. It is not clear, though, why the production of vital energy resources merits the same treatment as the filming of adult movies. Alcohol distilling, firearms manufacturing, and tobacco farming will remain on the favored list—at least until public opinion shifts against these activities.

The design of this tax break clearly facilitates the punishment or reward of specific industries based on public and Congressional sentiment. This potential for abuse offers yet another reason to scrap this economically irrational distinction and to apply a uniform tax rate to all industries.

Later in the year, Congress may try to curtail various tax preferences for oil and gas production, such as provisions allowing some costs to be written off faster than their useful life warrants. The House bill takes a small, highly selective step in this direction by requiring the five largest producers to write off certain geological and geophysical (G&G) expenditures over seven years rather

than five, while allowing all other oil and gas producers to continue writing off these costs over two years.

In principle, eliminating these incentives could be a move toward a neutral income tax under which firms write off all expenditures over their useful life without special deductions or credits. In a neutral system, the only government intervention would be taxes on any activities that cause harm to other people. For example, if carbon emissions caused harmful global warming, then carbon would be taxed. If rush-hour drivers inflicted traffic congestion on each other, then rush-hour driving tolls would be imposed or, if that was not feasible, gasoline would be taxed. But there would be no special incentives for specific energy sources or conservation methods.[9]

Again, however, the Democratic agenda looks more like targeting an unpopular industry than a move toward neutrality. A neutral approach would eliminate not only the modest tax preferences given to integrated oil producers ("Big Oil"), but also the far more generous preferences given to independent oil producers[10] and the numerous incentives and tax credits for other energy sources, such as coal, solar, and wind.

It is not clear whether any of these tax increases will ever be signed into law. The January 18 House bill may be modified in the Senate. The Bush administration has announced that it opposes the bill's denial of the 2004 tax break to oil and gas production, but supports the slower write-off for G&G costs.

Taxing American Firms Abroad: A Turn toward Nationalism

Congress has not yet moved on the Democratic pledge to tax American firms operating abroad, but is likely to do so later this year.

Under current law, the U.S. corporate income tax applies to the worldwide income of American corporations (those chartered in the United States). American firms operating abroad, however, enjoy two key tax benefits: deferral and the foreign tax credit. Tax on profits earned through foreign subsidiaries is generally deferred until the subsidiary pays dividends to its American parent firm, and foreign income taxes may be credited against the U.S. tax.

Both deferral and the foreign tax credit are subject to complex limitations that cannot be fully described here. For example, tax is not deferred on subsidiaries' income from passive investments, and the foreign tax credit is limited to the U.S. tax on the foreign income. Congress has repeatedly tinkered with these restrictions, sometimes loosening them and sometimes tightening them. Most recently, Congress loosened the rules in October 2004.

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Congressional Democrats may seek to undo some of the 2004 revisions[11] or they may seek broader changes, such as those proposed by Senator John Kerry (D-Mass.) in March 2004. Under Kerry's proposal, an American firm producing in a foreign country would enjoy deferral if it sold its output in that same country, but not if it sold the output in the United States or a third country.

At first glance, such tax changes seem attractive. Why are American firms operating abroad allowed to defer tax when those operating here and creating jobs for American workers are not? Indeed, an old result in public-finance economics is often cited as showing that it is in a country's interest to apply the same tax treatment to all of its firms, regardless of where they operate. Under this view, American firms operating abroad should not enjoy deferral or even the foreign tax credit.[12]

This result depends, though, on a key assumption; when domestic firms invest one dollar less abroad, an additional dollar is invested at home. Quite different results apply under other assumptions. For example, if the taxation of domestic firms' investment abroad does not affect investment at home, then it may be in a nation's best interest not to tax firms operating abroad.[13]

Raising corporate income taxes on investment abroad by American firms would undoubtedly result in less investment abroad by American firms—taxing something is a good way to get less of it. But that does not mean that investment in the United States would increase, at least not to the same extent.

To begin, investment is ultimately done by individuals; firms are just middlemen. Americans seeking to invest their savings abroad can buy shares in any firm that operates abroad, either foreign or American. So, if corporate income taxes were increased for American firms operating abroad, Americans might instead hold shares in foreign firms operating abroad, which are generally not subject to

U.S. corporate income tax. Some American firms operating abroad might even change their charters and become foreign firms. To the extent that these responses occurred, the tax increase would not boost investment in the United States or raise revenue.

Also, foreign as well as American firms invest in the United States. Even if a tax increase on American firms operating abroad prompted some of them to bring their operations home, total investment inside the United States might not rise accordingly. Some of the additional investment by American firms at home would displace investment previously done here by foreign firms. The American jobs created and the U.S. taxes paid by those foreign firms would be lost. There could even be a decline in investment and employment here if American firms passed up profitable business opportunities abroad that would have generated support operations in the United States.

On balance, raising corporate income taxes on American firms operating abroad reflects a misguided appeal to economic nationalism rather than an effective way to protect American jobs or raise revenue. If Congress passes such measures, it is unclear whether President Bush will sign them into law.

By adopting a pay-go budget rule, the new Congress is taking a welcome step toward fiscal responsibility. Unfortunately, planned tax increases on oil production and American firms operating abroad are based on populist appeals rather than on sound economics.

Living under Pay-Go

The pay-go rule will require Congress to make some difficult decisions. The challenge will be greater next year than this year.

The business tax relief linked to the minimum-wage increase can easily be offset by a variety of small revenue-raising measures. The Senate Finance Committee followed that approach in its January 17 bill, offsetting the $8 billion of tax cuts with $8 billion of tax increases. Among other things, the bill tightens rules governing certain tax-shelter transactions and deferred-compensation plans, and prevents firms from deducting punitive damage payments.

Under the House pay-go rule, a one-year AMT patch extension would have to be offset by roughly $40 billion in tax increases or entitlement spending cuts in fiscal 2007–2012. The task would be much harder under the proposed Senate rule, since the bulk of the revenue loss would occur in fiscal 2008 and that rule would require a full offset within that year. But assuming that the Senate ultimately adopts a rule similar to the House rule, the task will probably be manageable.

Although the oil revenue in the January 18 House bill is not set aside to offset tax cuts, subsequent oil tax increases or higher taxes on American firms operating abroad could provide part of the required money. But Congress will have to look elsewhere for the rest.

Some Congressional Democrats hope that "closing the tax gap" will provide easy money. The tax gap is the difference between taxes that are owed on legal activities and those that are paid, the revenue loss due to tax noncompliance. (It does not include unpaid taxes that are owed on drug dealing and other illegal activity.) Hopes of large revenue gains are fueled by the Treasury's February 2006 estimate of a $290 billion tax gap in 2001. The estimate may suggest that $3 trillion of new revenue could be raised over the next ten years, without any tax increase for those who already pay what they owe.

Of course, no such feat is remotely possible. The elimination of tax noncompliance is no more feasible than is the elimination of violent crime. The term "tax gap" is not useful, as there is no way to close this gap. We do not, after all, refer to a "murder gap" equal to the difference between the actual number of murders and the zero number that we desire.

A range of observers agree that improved tax compliance will yield relatively little revenue.[14] A July 2006 General Accounting Office report and a January 2005 Joint Tax Committee report identified many ways to improve compliance, but the estimated revenue gains were only a small fraction of the total tax gap.[15] Some compliance measures—including tax withholding on payments made by federal, state, and local governments to certain contractors—were adopted in May 2006, but they were estimated to raise only about $10 billion over ten years.

Even the revenue raised from improved compliance will not be costless. Steps to improve tax compliance, whether through more reporting or additional IRS enforcement, will impose additional burdens and intrusion, some of which will fall on compliant taxpayers.

Small businesses will bear much of the burden simply because tax noncompliance is greatest in that sector. Nevertheless, some enforcement and compliance measures may help raise the modest revenue needed for 2007. A variety of other revenue-raising proposals included in past bills that did not become law may also be used.[16]

The challenge will be more difficult in 2008. Another year of AMT relief will be required, costing another $40 billion or more. Also, some tax provisions that expire at the end of 2007, such as the sales-tax deduction and the research tax credit, will need to be reinstated and extended.

Congressional Democrats may seek to modify some of the tax cuts adopted in 2001 and 2003. Although some Democratic leaders had stated that they would not address this issue, House Speaker Nancy Pelosi (D-Calif.) stated on January 7 that a rollback of some of the tax cuts for people with incomes above $500,000 per year could not be ruled out. President Bush would surely veto any rollback, however, and Democrats would not be able to override his veto.

It will ultimately be necessary, in 2008 or thereafter, to look elsewhere. An ideal solution would be to reduce entitlement spending, but Congressional Democrats are unlikely to pursue that approach. Significant revenue could be raised by limiting income-tax preferences, perhaps by curtailing the deduction for state and local taxes or the tax break for employer-provided health insurance. Ways and Means Committee chairman Charles Rangel (D-N.Y.) has stated, "If we were able to simplify that tax code, I submit that there's trillions of dollars to be found and saved."[17] Trillions of dollars could indeed be raised over ten years from a sweeping assault on tax preferences, although such moves would go well beyond mere simplification.

Neither Democrats nor Republicans have had the courage to tackle these issues in the past. It remains to be seen whether either or both parties will be willing to do so in the upcoming years.

By adopting a pay-go budget rule, the new Congress is taking a welcome step toward fiscal responsibility. Unfortunately, planned tax increases on oil production and American firms operating abroad are based on populist appeals rather than on sound economics. The ultimate direction of the 110th Congress' fiscal policy agenda may become clearer in 2008, when it will face more difficult choices under the pay-go rule.

AEI research assistant Cindy Soo and AEI editorial associate Nicole Passan worked with Mr. Viard to edit and produce this Tax Policy Outlook.

Notes

1. Fiscal 2006 spending estimates are from Congressional Budget Office (CBO), *The Budget and Economic Outlook: An Update* (Washington, DC: CBO, August 2006), 12–14.

2. Richard Kogan, "The New Pay-As-You-Go Rule in the House of Representatives," Center on Budget and Policy Priorities, January 12, 2007, available at www.cbpp.org/1-12-07bud.htm, provides a detailed description of the rule.

3. The imbalance was documented by Jagadeesh Gokhale and Kent Smetters, *Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities* (Washington, DC: AEI Press, 2003), available at www.aei.org/book426/. Their updated estimates, which reveal an even wider imbalance, are presented in Jagadeesh Gokhale and Kent Smetters, "Fiscal and Generational Imbalances: An Update," *Tax Policy and the Economy* 20, James M. Poterba, ed. (Cambridge, MA: MIT Press, 2006), 193–223.

4. The modifications are described by Diana Jean Schemo, "House Democrats Propose Cuts in Student Loan Rates," *New York Times*, January 13, 2007.

5. Christopher Lee, "Democrats Face Hurdles in Bid to Close Medicare Gap," *Washington Post*, January 7, 2007.

6. Kevin A. Hassett, "Democrats Likely to Lose 'Virtue' on U.S. Budget," Bloomberg.com, January 8, 2007, available at www.aei.org/publication25400/.

7. For the Urban-Brookings estimates, see Greg Leiserson and Jeffrey Rohaly, "The Individual AMT: Historical Data and Updated Projections," *Tax Notes*, December 25, 2006.

8. Democratic Congressional Campaign Committee, "A New Direction for America: Six for '06," available at http://timryan.house.gov/HoR/OH17/Hidden+Content/Six+for+06.htm.

9. See Kevin A. Hassett and Gilbert E. Metcalf, "What Would a Rational Energy Policy Look Like?" special energy issue, *Tax Notes*, November 6, 2006, available at www.aei.org/publication25199.

10. For example, independent producers may claim percentage depletion and immediately expense intangible drilling costs, while integrated producers do not get percentage depletion and may expense only 70 percent of intangible drilling costs.

11. Heidi Glenn, "House Democrats Eyeing Foreign Tax Credit Changes," *Tax Notes*, November 20, 2006, quotes a "senior Democratic aide" to this effect.

12. This result was derived by Peggy Richman (now Musgrave) in *Taxation of Foreign Investment Income: An Economic Analysis* (Baltimore: Johns Hopkins Press, 1963).

13. See Joel Slemrod, Carl Hansen, and Roger Procter, "The Seesaw Principle in International Tax Policy," *Journal of Public Economics* 65, no. 2 (August 1997): 163–76; and Mihir A. Desai and James R. Hines Jr., "Evaluating International Tax Reform," *National Tax Journal* 56, no. 3 (September 2003): 487–502.

14. This view was expressed, with varying degrees of emphasis, by four authors in the January 8, 2007 issue of *Tax Notes*: Christopher Bergin, "Free Tax Advice for Congress: Do Nothing"; Chris Edwards, "Will Democrats Raise Taxes?"; Lawrence B. Gibbs, "Words of Wisdom for the 110th Congress"; and Maya MacGuineas, "Hopes for Tax Reform in 2007."

15. General Accounting Office (GA), *Tax Compliance Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, GAO-06-1000T (Washington, DC: GAO, July 26, 2006), available at www.gao.gov/new.items/d061000t.pdf; and Joint Committee on Taxation (JCT), *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCT-2-05 (Washington, DC: JCT, January 27, 2005), available at www.house.gov/jct/s-2-05.pdf. The latter report included several proposals with large revenue gains, but they pertained to tax expenditures rather than tax compliance.

16. Heidi Glenn, "Democrats Could 'Dust Off' Clinton Revenue Raisers," *Tax Notes*, January 15, 2007. Some of the items listed in that article are included in the January 17 Senate Finance Committee bill.

17. Wesley Elmore, "Tax Simplification Could Lead to 'Trillions' in Savings, Says Rangel," *Tax Notes*, November 27, 2006.