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KEY ARGUMENT AGAINST APPLYING PAY-AS-YOU-GO TO TAX CUTS DOES NOT WITHSTAND SCRUTINY

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Summary

In early January the House of Representatives instituted a "pay-as-you-go" rule, under which entitlement expansions and tax cuts — including the extension of expiring provisions of law that expand entitlement programs or cut taxes — must be paid for through offsetting entitlement reductions or tax increases. (PAYGO rules do not apply to annual discretionary appropriations, which are controlled by other means.) The congressional budget plan under consideration by the Senate would institute a PAYGO rule in the Senate, as well.

Bipartisan budget watchdog groups such as the Concord Coalition, the Committee for Economic Development, and the Committee for a Responsible Federal Budget have called for reinstatement of PAYGO, which helped move the budget from deficits to surpluses in the 1990s. So have eminent figures such as former Federal Reserve chair Alan Greenspan and David Walker, head of the Government Accountability Office.

However, the Bush Administration and the Republican leadership of Congress strongly oppose reinstatement of these rules. They justify this opposition, in part, on the claim that applying PAYGO to the extension of expiring tax cuts would be inequitable because the budget baseline rules favor entitlement increases over tax cuts. As Office of Management and Budget Director Rob Portman argued last year, "there is a bias [in the baseline rules], in my view, for spending and a bias against tax relief. Why? Because we assume that programs go out indefinitely on the spending side. . . . Whereas on the tax side, we assume the tax relief would not continue." Backing the baseline rules up with PAYGO would magnify this inequity, PAYGO critics charge.

Examination of the baseline rules makes quite clear, however, that this argument is not valid — that the budget rules do *not* favor entitlement expansions over tax cuts. The general budget rules treat temporary provisions of the tax code *exactly the same* as temporary provisions of entitlement programs. Moreover, a special rule dealing with cases where an entire entitlement program (such as a farm program) expires does not give an advantage to such programs either.

A Brief History of Pay-As-You-Go

The pay-as-you-go rule was first established in the Budget Enforcement Act of 1990 to help ensure that the entitlement cuts and tax increases enacted as a result of the Bipartisan Budget Summit Agreement of 1990 (negotiated by the first President Bush and congressional leaders of both parties) were not reversed by subsequent Congresses. The rule required that if legislation was later enacted that cut taxes or increased entitlement spending, the cost of those changes had to be fully offset by increasing other taxes or cutting other entitlement programs, so that the deficit would not be increased. To enforce this requirement, specified entitlement programs would undergo an automatic, across-the-board reduction if legislation producing the required offsets was not enacted.

The Senate also adopted an additional pay-as-you-go rule, which prohibited consideration of entitlement and tax legislation that would increase the deficit during the first year, the first five years, or the second five years. This constraint could be waived only if at least 60 senators voted to disregard it.

Throughout the 1990s, the pay-as-you-go rules effectively prevented unpaid-for entitlement expansions and tax cuts. In 2001, however, a combination of budget surpluses and pressure from the new Bush Administration led Congress to waive the statutory pay-as-you-go rule in order to enact large tax cuts that were *not* paid for.[1]

Congress then allowed the statutory pay-as-you-go rule and the Senate PAYGO rule to expire at the end of fiscal year 2002. (The Senate reestablished a pay-as-you-go rule in 2003, but the new rule was ineffectual because it allowed deficit-financed tax cuts or entitlement increases, as long as they were assumed in the congressional budget plan.) The expiration of these rules facilitated the enactment of further unpaid-for tax cuts in 2003 and subsequent years.

Despite calls from a wide range of budget experts and watchdog groups (see box above), opposition by the Bush Administration and tax-cut proponents in the Senate has prevented the reinstatement of a pay-as-you-go rule that would apply to both entitlement expansions and tax cuts. In 2006, the Senate came within one vote of restoring a true pay-as-you-go rule that would apply in the Senate, when an amendment to the congressional budget resolution that would have reinstated the rule failed on a 50-50 vote. This issue did not come to a vote in the House until January 2007, as the prior House leadership would not allow a vote on it. Under the new House leadership, a House PAYGO rule was instituted on a vote of 280 to 152.

Budget Baseline Rules Are Not Unfair to Expiring Tax Cuts

Opponents of applying pay-as-you-go to tax cuts as well as entitlement expansions base their argument on what they assert is the unfair treatment of tax cuts under the budget baseline rules. Instead, they support a version of the pay-as-you-go rule that would prohibit increases in entitlement programs unless they are paid for by cuts in other entitlement programs, while allowing unlimited,

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[1] The Senate rule did not apply at that time because surpluses were projected for the coming ten years, even with the tax cuts.

Budget Watchdog Groups Call For Reinstating the Pay-As-You-Go Rule And Applying It to Both Tax Cuts and Entitlement Increases.*

The four organizations joining in this statement … strongly support current efforts to reestablish and comply with pay-as-you-go discipline in the Congressional budget process, which would establish hurdles that make it more difficult to enact fiscally irresponsible policies.

…. While much more needs to be done to improve the long-term fiscal outlook, establishment of a rule making it harder to enact legislation further worsening the situation would represent an important first step in the impending struggle to restore fiscal responsibility.

Some … proposed new initiatives seek to address legitimate, important policy concerns. But there should be no exemptions from the pay-as-you-go rule. If one exemption is granted, advocates of other interests will demand that their priorities be exempted as well. ... In this environment of already excessive red ink, no tax cuts or entitlement increases … should be enacted without offsets ensuring that they do not increase short- or long-term deficits and debt. It is not responsible to continue to promote legislation that is supposed to improve the lot of the American people without considering the corrosive effects that the cumulative deficits and debt added by such legislation would have on current and future citizens.

"….Restoring the pay-as-you-go principle would, at a minimum, force Congress to weigh the short-term political attractions of new proposals against the long-term fiscal consequences. Given where deficits now stand and the known fiscal challenges that lie ahead, it is policymakers' responsibility to do this. They owe future generations no less."

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* Excerpt from *Joint Statement On The Need For Pay-As-You-Go Discipline*, March 21, 2007, Center on Budget and Policy Priorities, The Concord Coalition, The Committee for Economic Development, and The Committee for a Responsible Federal Budget.

deficit-financed tax cuts.[2] As explained below, the claim that the baseline rules unfairly disadvantage expiring tax cuts is simply false; the basic rules apply in the same manner to tax cuts and entitlement increases alike.

Baseline Projections Treat Expiring Tax and Entitlement Provisions the Same

The baseline projections produced by the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) are governed by the Balanced Budget and Emergency Deficit Control Act of 1985, as amended.[3] Subsection 257(a) of that act states the basic rule for projections of revenues and entitlement (or "direct") spending:

> "Laws providing or creating direct spending and receipts are assumed to operate in the manner specified in those laws for each such year…."

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[2] See Chapter 15, "Budget Reform Proposals," in the *Analytical Perspectives* volume of the Presidents *Budget of the United States Government* for Fiscal Year 2007, p. 211.

[3] The current rules were essentially established in the Budget Enforcement Act of 1990, which amended the Balanced Budget Act, and are often called the "BEA" baseline rules.

Thus, when CBO and OMB analysts prepare the ten-year (or in OMB's case, five-year) baseline projections for revenues that they release at the beginning of each session of Congress, they base their revenue projections for each year on the provisions of the tax code that would be effect in that year under current law. For example, in projecting revenue collections, the analysts take into account the fact that the 2001 tax law reduced most income tax rates through 2010, but provided for those rates to return to prior levels after 2010.

In general, the analysts do exactly the same thing when they project expenditures for entitlement programs — they take into account the provisions governing each program that would be in effect each year, under the laws now in place. For instance, since Congress has extended Medicaid's Transitional Medical Assistance (TMA) provisions only through June 30, 2007, the CBO and OMB baseline projections of Medicaid expenditures assume that the TMA provisions will expire on that date.

Thus, the baseline treats the expiring tax cuts the same way it treats the expiring TMA provisions. The baseline treatment of these expiring provisions also is consistent with the "scoring" of the legislation that contained them. The 2001 tax law was charged only with the cost of reducing tax rates through 2010, and the 2006 law that extended TMA was charged only with the cost of extending those provisions through June 2007.

Similarly, the scoring of recently enacted legislation to extend the reduction in the capital gains rate through 2010 is consistent with the scoring of proposals (not yet enacted) to extend TMA beyond June 2007. In both cases, the baseline assumes that these provisions will expire when the provisions themselves say they will.

It is abundantly clear that the neither the baseline nor the scoring rules are biased against tax cuts or in favor of entitlement increases.

Special Baseline Rule for Programs that Expire Gives Them No Advantage

A special baseline rule applies in cases where Congress has decided that an entire mandatory program should be reexamined periodically and, to make sure the reexamination occurs, has provided that the entire program (as opposed to certain provisions of the program) will expire if legislation to extend the program is not enacted.

For instance, the State Children's Health Insurance Program (S-CHIP) is scheduled to expire at the end of 2007, which ensures that Congress will be forced to reevaluate the program. Congress has made a similar decision in the case of a limited number of other mandatory programs. Examples include farm programs funded through the Commodity Credit Corporation and the Food Stamp Program (which together are reauthorized about every five years in the so-called "farm bill"[4]) and the Temporary Assistance for Needy Families (TANF) block grant.

[4] The farm programs represent somewhat of a special case since, if the current laws governing farm support payments were to expire, the permanent price support authority under the Agricultural Adjustment Act of 1939 and the Agricultural Act of 1949 would become effective. Since those laws were based on an agricultural sector that was dramatically different than the one that exists today, it likely would be impossible to produce sensible estimates of what the cost of the farm programs would be under those laws.

Recognizing that Congress intends to use the scheduled expiration of these major programs to trigger a review of how the programs operate, rather than to let them actually expire, the baseline rules adopted as part of the Budget Enforcement Act of 1990 provide that a program with annual outlays of more than $50 million that is scheduled to expire will be assumed to continue in the baseline. The baseline rules were amended in the Balanced Budget Act of 1997, so this special rule applies automatically only to programs enacted prior to the 1997 act. For mandatory programs established after 1997, the House and Senate Budget Committees determine whether the program is assumed to continue in the baseline.[5]

It is important to note that the special rule applies only to entitlement *programs* that are scheduled to expire under current law, not to program *provisions* that are scheduled to expire. As noted above, expiring entitlement *provisions* and expiring tax *provisions* are treated exactly the same under the baseline rules.

The special rule for expiring entitlement programs does not apply to taxes because the tax code is not generally thought of as a collection of separate programs. For instance, it does not make sense to consider the expiration of the temporary reduction in the income tax rate or the capital gains tax rate as the expiration of a tax "program." A temporary change in these tax rates is instead analogous to the temporary extension of Medicaid's TMA provisions, which are assumed to expire in the baseline just as the temporary reduction in the income and capital gains tax rates are. In general, provisions of the tax code are so interconnected that it would be extremely difficult to divide the code into separate "programs" to determine if some subset of the tax code that is scheduled to expire should be accorded the same baseline treatment as an expiring entitlement program.

Most importantly, however, the expiring entitlement programs that are assumed to continue in the baseline receive *no overall advantage* relative to expiring tax provisions. When estimating the costs of legislation that would establish a new entitlement program that will be assumed to continue in the baseline, CBO scores the cost of that legislation for *every year* of the applicable five-year and ten-year budget window. Congress can *not* make the cost of that legislation appear smaller within the "budget window" by scheduling the new program to expire after a few years; *CBO will score the costs in every year regardless.*

For example, if Congress permanently increases the cost of the Food Stamp Program, which is reauthorized periodically but is treated by CBO as permanent under the baseline rules, CBO's cost estimate for the legislation will show increased costs in each of the next ten years, even though the Food Stamp Program is slated to expire in 2007.

This means that while Congress can make *tax cuts* look less costly by sunsetting them after a few years, it *cannot* do the same when it establishes or enlarges an entitlement program that the baseline treats as an ongoing program.

In short, an entitlement program receives no advantage from the fact that the baseline assumes it will continue. It is true that a simple extension of such a program beyond its scheduled expiration date will be scored as having no cost if the reauthorization legislation includes no cost-increasing changes in the program. But the legislation that established or expanded the program in the first

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[5] CBO provides a list of the 11 expiring entitlement programs that are currently assumed to continue under the baseline rules. See CBO's January 2007 report, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017*, pp. 66-67.

Gaming the System in Passing the 2001 and 2003 Tax Cuts

The Administration and congressional tax-cut proponents chose to enact the 2001 and 2003 tax cuts through the budget reconciliation process. Reconciliation bills are not subject to filibuster in the Senate, so they can be passed with 51 votes instead of the 60 votes required to end debate.

Since Senate rules provide that a reconciliation bill cannot increase the deficit outside of the budget window (which in 2001 extended through fiscal year 2011), the Administration and congressional leaders had the tax cuts expire at the end of fiscal year 2011. Then, when it became clear during the House-Senate conference that the tax cuts would cost substantially more than the $1.35 trillion allowed by that year's congressional budget resolution, congressional leaders and the White House decided to have the tax cuts expire nine months earlier, at the end of calendar year 2010 instead of the end of fiscal year 2011. The savings produced by this move allowed additional tax cuts to be packed into the legislation.

Similar considerations governed decisions about the 2003 tax cuts, which included reductions in the tax rates on capital gains and dividends. Congressional leaders designed these tax cuts to expire at the end of 2008 for the same reason — to lower the "scored" cost of these tax cuts so they could pack more tax cuts into that year's legislation.

place will have been scored for the full cost of the legislation *for every year within the budget window*, including the years *after* the program's scheduled expiration.

Assume, for example, that a new entitlement program and a tax provision are enacted at the same time, that each is scheduled to expire after two years, that each is estimated to cost $5 billion over five years if extended ($2 billion in the first two years and $3 billion in the next three years), and that each is then extended for three more years in later legislation.

- If the entitlement program is assumed to continue in the baseline, the original legislation that established the program will have been scored as costing $5 billion over five years, even though the program is slated to expire after two years. The subsequent legislation extending the program will be scored as having no cost.

- The original legislation containing the tax-cut provision will be scored as costing only $2 billion over two years, while the subsequent legislation extending the provision will then be scored as costing $3 billion over three years.

- Thus, the new entitlement program and the tax cut will each be scored as costing $5 billion over five years. The new entitlement program gained no advantage from the baseline assumption that it would be continued.

- If proponents of the tax cut believe that being charged with the cost of the tax cut in two installments is disadvantageous — even though the total cost is no greater than if the tax cuts had been treated as permanent in the baseline and the original legislation had been scored on that basis — they can avoid that outcome by making the tax-cut provision permanent to start with. In recent years, tax-cut proponents often have purposely opted for the installment approach, because they concluded that doing so would be to their advantage. Sunsetting a new tax cut after a few years can make the cost appear lower when the tax cut is first considered, making the tax cut easier to pass. Once the tax has been passed, its proponents then argue that

it must be extended to avoid subjecting the public to a "tax increase" and (they assert) damaging the economy.

Conclusion

There is no inconsistency in the baseline treatment of expiring tax provisions and expiring entitlement program provisions, and the special rule that applies in the case of new entitlement programs that are scheduled to expire provides no advantage to those programs. The claim that tax cuts should be exempt from pay-as-you-go discipline consequently has no merit. Indeed, both tax cuts and entitlement increases *must* be included in pay-as-you-go if Congress is to begin the difficult process of restoring fiscal responsibility.