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HOUSE BUDGET COMMITTEE PAY-AS-YOU-GO PROPOSAL WOULD EXEMPT ALL TAX CUTS AND MAKE A MOCKERY OF EFFORTS TO RESTORE FISCAL DISCIPLINE

by Joel Friedman and Robert Greenstein

House Budget Committee approved on March 17 legislation introduced by the Committee's Chairman, Rep. Jim Nussle, that would resurrect the "pay-as-you-go" rules, but in a way that undermines their original intent and is likely to fail to achieve meaningful fiscal discipline.

The pay-as-you-go rules that were a centerpiece of the bipartisan 1990 Budget Enforcement Act — and proved highly effective in enforcing fiscal restraint in the 1990s — required the costs of *both* entitlement expansions *and* tax cuts to be offset fully. These rules guarded equally against deficit-increasing actions on both sides of the budget ledger. In contrast, the Nussle proposal adopted by the House Budget Committee would apply the pay-as-you-go rules to entitlement programs only. It would impose no constraints whatsoever on new tax cuts. They would be entirely exempt from the pay-as-you-go discipline.

This unbalanced approach, also proposed by the Bush Administration, is likely to be ineffective in preventing the further growth of deficits. The history of the past few years suggests that the need for restraint is at least as great on the tax side of the budget as on the spending side. The dramatic deterioration in the fiscal situation since 2000 has been far more a function of reductions in revenues than of increases in entitlement spending (see box on page 3).

Without pay-as-you-go restraint on the tax side, the proposal to make the tax cuts enacted in 2001 and 2003 permanent — which is at the heart of the Administration's budget and the budget being proposed by Rep. Nussle — would add more than $1 trillion to deficits over the next ten years by themselves and several trillion dollars in the decade after that.[1] Federal Reserve Chairman Alan Greenspan underscored the inadequacy of an entitlement-only approach to pay-as-you-go in a recent congressional hearing, where he stated that the rules should apply to "both taxes and spending," including extensions of the tax cuts enacted in recent years.[2]

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[1] The Joint Tax Committee on Taxation estimates that the cost of extending the 2001 and 2003 tax cuts and making them permanent would be $1.2 trillion over the next ten years, with the cost reaching $289 billion in 2014 alone. If the costs of these tax cuts remained constant as a share of the economy after 2014 — the standard assumption that CBO and the General Accounting Office use in making long-term forecasts — their cost in the second ten years would be $3.7 trillion.

[2] Alan Greenspan, in response to a question from Senator Jack Reed before the Senate Committee on Banking, Housing and Urban Affairs, Federal News Service Transcript, February 12, 2004.

Restraining Entitlement Expansions But Not Tax Cuts Would Lead To Inequitable Results

The Nussle pay-as-you-go proposal not only represents a flawed approach to restoring budget discipline but also would likely lead to budget outcomes that are highly inequitable. For low- and middle-income families, government benefits and subsidies are provided principally through entitlement programs. For high-income families and corporations, in contrast, government subsidies are provided primarily through various tax breaks. By requiring that increases in entitlement programs be offset while exempting expansions of tax breaks from this discipline, the Nussle proposal has aspects of "Robin Hood in reverse."

- Increases in entitlement programs — including Medicare, Medicaid, food stamps, and veterans' compensation — would have to be offset.

- New proposals to increase refundable tax credits — such as the Earned Income Tax Credit and part of the Child Tax Credit, which are designed to assist low- and moderate-income working families who pay payroll and excise taxes but do not earn enough to owe income taxes — also would have to be offset.[3]

- But the cost of other tax cuts — such as Administration proposals to provide large new tax shelters for saving and investment income, which would disproportionately benefit the wealthiest individuals in the country — would *not* have to be offset.

- Furthermore, the cost of entitlement expansions could be offset only by cuts in other entitlement programs. Thus, a proposal to close abusive corporate tax shelters or other tax-avoidance scams and to use part of the savings to finance improvements in an entitlement benefit — such as in the Medicare drug benefit, a veterans program, or a program to reduce poverty or cover some of the uninsured — would be prohibited.

Incentives for Entitlement Expansions to be Converted into Targeted Tax Breaks

By exempting tax cuts from the pay-as-you-go requirement, the proposal would allow for continued enactment of unlimited, costly tax cuts without any offsets. That would worsen the deficit outlook. Moreover, even the goal of ensuring that the cost of entitlement expansions is offset could be thwarted in cases where a desired entitlement expansion can be converted into a targeted tax break.

The tax code is packed with dozens of tax breaks favoring particular activities, from home ownership to energy production. These tax breaks are referred to as "tax expenditures" by the Joint Committee on Taxation and the Office of Management and Budget, because they essentially represent spending accomplished through the tax code. Indeed, Federal Reserve

[3] Under the Nussle proposal, the extension of the refundable tax credits in the 2001 and 2003 tax-cut packages would not be subject to the pay-as-you-go rules, and thus their costs would not have to be offset. But the cost of any other expansion of refundable tax credits would be subject to the pay-as-you-go rules.

Is the Return of Deficits Primarily Due to Spending Increases?

Some have argued that the return of large deficits over the past few years has been largely a function of action by Congress to increase spending. Analysis by the Congressional Budget Office demonstrates otherwise.

- According to CBO estimates, legislation enacted since the start of 2001 is costing about $500 billion in 2004, which is about the size of the deficit this year. The CBO estimates show that tax cuts account for 58 percent of this cost — or well over half of it.
- Increases in defense and homeland security spending account for another 30 percent of the cost in 2004 of legislation enacted since January 2001.
- By contrast, entitlement increases enacted since the start of 2001 account for only 9 percent of this cost. The cost of the tax cuts this year thus is six times the cost of the entitlement expansions enacted since 2001.
- A similar result holds if one examines the cost of legislation over a ten-year period. Assuming the tax cuts are extended as the Bush Administration proposes, the cost of the tax cuts from 2002 through 2011 will be about four times the cost over this period of the entitlement expansions enacted since 2001, including the prescription drug benefit. (This calculation also assumes, as virtually all observers expect, that relief from the Alternative Minimum Tax will be continued to prevent the AMT from canceling out part or all of the tax cuts for millions of middle-class taxpayers.) The tax cuts thus have played a substantially larger role in the recent swing to deficits from surpluses than entitlement expansions have.

As these data illustrate, there is at least as much reason to be concerned about the impact of tax cuts on the budget as about the impact of entitlement expansions. Both types of measures have the potential to swell the deficit. Proposals that would impose the pay-as-you-go rules only on the entitlement side of the budget fail to address these realities and leave the door open to budget-busting measures that are delivered through the tax code.

Chairman Alan Greenspan has referred to these tax breaks as “tax entitlements.”[4] These measures are costly. OMB estimates that tax expenditures cost many hundreds of billions of dollars a year.[5]

If pay-as-you-go requirements are imposed only on spending entitlements and not on “tax entitlements,” there is little doubt that tax lawyers and lobbyists will be able to redesign various proposed entitlement expansions so they can be delivered through the tax code. Such tax breaks would increase the deficit just as increasing an entitlement on the spending side of the budget would. Moreover, this artificial reliance on the tax code — used as a means to circumvent the pay-as-you-go rules — often would represent a more costly and less efficient approach to achieving the intended policy goals than doing so directly on the expenditure side of the budget.

[4] Alan Greenspan, in response to a question from Rep. Eva Clayton before the Bipartisan Commission on Entitlements and Tax Structure Reform, Federal News Service Transcript, July 15, 1994.

[5] President’s 2005 Budget, Analytical Perspectives. Although OMB estimates the cost of each individual tax expenditure, it does not provide an estimate of the combined cost of all tax expenditures because it does not measure the interaction effects among tax expenditures.

Proposal Would Distort Policy Debates

The proposal also would distort policy debates, pushing policymakers to adopt tax-based approaches to problems rather than programmatic approaches even when the tax-based approaches are costlier and less effective. Consider, for example, proposals to reduce the ranks of the uninsured. Proposals to reduce the numbers of uninsured people by broadening Medicaid coverage or expanding the State Children's Health Insurance Program (SCHIP) would have to be paid for, while proposals to write tax breaks related to health insurance into the tax code would *not* have to be paid for.

A number of health insurance tax breaks that have been proposed in the past few years would most heavily subsidize individuals in the top tax brackets, the vast bulk of whom already have health insurance. Such proposals would be far less effective at reducing the ranks of the uninsured than an SCHIP or Medicaid expansion. The one-sided pay-as-you-go rules that the House Budget Committee has approved thus would force policymakers to debate competing proposals on an unlevel playing field and would confer a large advantage on tax-cut approaches to health insurance over program-based approaches, regardless of their relative merits.

Proposal Lacks "Shared Sacrifice" Needed for Deficit Reduction

The original pay-as-you-go rules played an important role in moving the nation from deficits to surpluses in the 1990s. That approach was successful in large part because it enforced budget discipline on everyone — both those who favored tax cuts and those who advocated entitlement expansions. Each side was willing to accept the imposition of the pay-as-you-go requirement — and thereby to constrain its policy priorities — knowing that the pay-as-you-go rules were being imposed equally on the other side. This balance, or shared sacrifice, was one of the keys to ensuring that the pay-as-you-go rules were successful in promoting fiscal discipline.

If the pay-as-you-go rules are reinstated only on the entitlement side, there will be no shared sacrifice. Only entitlement programs will face the pay-as-you-go constraint; tax breaks will face no similar hurdles. Nor is it credible to think that applying the pay-as-you-go rules solely to entitlement programs would be a first step to restoring the full pay-as-you-go requirement, with the rules being extended to taxes soon thereafter. To the contrary, once the pay-as-you-go rules are imposed only on entitlements, it is likely to become more difficult to extend these requirements to taxes, since those who advocate further tax cuts will no longer have any incentive (in terms of placing further restraint on entitlement spending) to accept pay-as-you-go restraints on taxes. If the pay-as-you-go rules are to apply to both the entitlement and tax sides of the ledger, as they did in the 1990s, the rules need to be extended to both entitlements and taxes *at the same time.*

The sharp reversal in the nation's fiscal outlook over the past few years is stimulating interest in budget process proposals as a way to help restore fiscal discipline. Reinstating the pay-as-you-go rules on both entitlements and taxes would constitute an important step. But imposing these restraints solely on entitlements would not only be of limited effectiveness, but would likely make meaningful budget discipline harder to achieve in the future. It would be more likely to retard the cause of fiscal discipline than to advance it.

ADDENDUM

Comparison of the Statutory Pay-As-You-Go Rule in effect from fiscal years 1991 through 2002[6] with the version approved March 17, 2004, by the House Budget Committee

	PAYGO statute, 1991-2002	PAYGO as approved by the House Budget Committee
Tax cuts	The costs of tax cuts must be offset (or "paid for") in the current year, the coming year, and each of the subsequent four years. The costs can be offset either by tax increases (in the same or separate bills) *or* by entitlement cuts (in the same or separate bills)	Tax cuts do not need to be offset.
Entitlement increases	The cost of entitlement increases must be offset in the current year, the coming year, and each of the next four years. The costs can be offset either by entitlement cuts (in the same or separate bills) *or* by tax increases (in the same or separate bills)	Entitlement increases need to be offset by other entitlement cuts (in the same or separate bills). Tax increases can not be used to pay for entitlement increases.
Refundable tax credits	The expenditure portion of refundable tax credits are costs and so need to be offset, as above.	An extension of the 2001/2003 refundable tax credits is treated as a tax cut and so does not need to be offset, but any *other* new or expanded refundable tax credits are treated as an entitlement increase and so do need to be offset by an entitlement cut.
Enforcement	If at the end of any session of Congress OMB finds that, for the fiscal year just started, the costs of tax cuts or entitlement increases enacted since the imposition of the PAYGO rule have *not* been fully offset, the president is required to "sequester" specified entitlements to make up for the costs that are not paid for. (This sequestration is an across-the-board cut in entitlement programs.) A number of entitlements are exempt from sequestration. But Medicare, farm price supports, veterans' education benefits, and social services grants to states (among others) are subject to sequestration.	No change (except that tax cuts are not part of the calculations).

[6]Each year between 1999 and 2002, Congress suspended the "pay-as-you-go" rules to accommodate deficit-increasing measures — such as the 2001 tax-cut package — and avoid a sequester; the "pay-as-you-go" rules expired after 2002.