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THE HOUSE HAS COMPLIED THIS YEAR WITH ITS NEW "PAY-AS-YOU-GO" RULE

But Greater Challenges Lie Ahead

By Richard Kogan and James Horney[1]

In early January, the House of Representatives established a Pay-As-You-Go rule. The rule prohibits the House from considering any tax or entitlement legislation that would increase projected deficits over the coming ten-year period. Proposed entitlement increases must be fully offset, or "paid for," by reductions in existing entitlements or increases in revenues. Likewise, proposed tax cuts must be fully offset by increases in other taxes or reductions in entitlements.[2] We have examined the actions of the current House and the prior three Congresses with regard to the financing of entitlement and tax legislation and present our findings below. We then discuss the importance of continued adherence to the PAYGO rule as well as some reasons that adherence could collapse.

In this analysis we did not examine bills passed by the Senate. Because the Senate allows even non-germane amendments to be added to bills during floor consideration, cost estimates by the Congressional Budget Office

KEY FINDINGS

- **CBO data show that the House has achieved impressive compliance this year with its new PAYGO rule; it has passed entitlement and tax legislation containing several hundred billion dollars in costs (over ten years) — and has fully offset those costs. In fact, the net effect of the tax and entitlement legislation the House has passed would be a slight *reduction* in deficits (about $8 billion over ten years).**
- **Only one extremely small bill appears not to have been paid for. The cost of that bill is a minuscule $150,000.**
- **Compliance has very largely been achieved through real offsets, not gimmicks. And three-fourths of the savings have been entitlement reductions, not tax increases.**
- **This year's record of compliance to date stands in sharp contrast to the record of the last three Congresses, which violated the PAYGO principle by almost *$1.3 trillion* over the 2001-2006 period.**
- **The biggest test for PAYGO lies ahead, as the extension of expiring tax breaks — such as AMT relief — moves to the top of the Congressional schedule. PAYGO compliance is critical to avoiding an explosion of federal debt over the long term.**

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[1] Significant research was contributed by Kris Cox, Andrew Cleland, and Jon Petkun.

[2] See Appendix 2 for a more detailed description of the House PAYGO rule. The Senate PAYGO Rule — re-established by the Congressional budget resolution for FY 2008, agreed to on May 17, 2007 — is almost identical to the House PAYGO Rule.

(CBO) are less likely to be available for Senate-passed bills than for House-passed bills. In addition, the Senate traditionally overlooks, rather than explicitly waives, minor budget violations so we cannot be sure what the non-existence of Senate PAYGO waivers means. For these two reasons, it is easier to be sure the House has complied with PAYGO than the Senate except in the all-important case of legislation that has been sent to the President; this year, such legislation has complied with PAYGO in every case.

Findings

Our examination of CBO cost estimates leads to four conclusions.

- The House of Representatives has complied with its new PAYGO rule to date.
- The record of compliance stands in contrast to $1.3 trillion in cumulative violations of the PAYGO principle (i.e., $1.3 trillion in deficit-financed tax cuts and entitlement increases for the period 2001-2006) enacted by the previous three Congresses.
- Although legitimate questions can be raised about the methods the House has used this year to comply with PAYGO in a few circumstances — such as proposing a "temporary" cost that is offset by permanent savings — House compliance has largely been achieved by finding real offsets, not gimmicks, to pay for entitlement and tax legislation.
- House actions to date cast doubt on the notion that the PAYGO rule is primarily intended to stand in the way of tax cuts or to favor "tax and spend" policies. For example, almost three-fourth of the savings contained in tax and entitlement legislation to date have been entitlement cuts while only one-fourth have been tax increases. (These proportions are based on the Children's Health Insurance — SCHIP — bill as the House originally approved it.)

1. The House has complied with the PAYGO rule so far.

We measured compliance with the House PAYGO rule by examining the 18 bills the House has passed this year that contain the largest gross changes in entitlements or revenues. The results show that the House complied with the PAYGO rule in all of these cases. The tables in this report, such as Table 1 to the right, show the overall costs and savings associated with the 18 bills. We also examined the 23 other House bills that contain very small changes in entitlements or revenues. The House appears also to have complied with PAYGO in all but one of these cases, and the discrepancy in that case is trivial, amounting to $150,000.[3]

Table 1:
House compliance with the PAYGO Rule this Year
Cumulative costs (+) and savings (-), 2007-2017, in billions of dollars

1a: with the *House* SCHIP bill

Gross costs	383.3
Offsetting gross savings	-391.5
Net budget effect	-8.1

1b: with the *Conference* SCHIP bill

Gross costs	187.5
Offsetting gross savings	-196.8
Net budget effect	-9.3

May not add due to rounding.

[3] The one instance in which the House did not comply with the PAYGO rule is an example of the House Rules Committee attempting to remove a trivial cost but, in our judgment, not succeeding. H.R. 865 as reported by the House Committee on Natural Resources would grant an Alaskan electric utility company certain rights of way across Alaskan Native allotments. The reported bill provided that the United States would reimburse the Alaskan Natives from the Treasury's Claims and Judgments account; payments from that account are mandatory, and CBO's cost estimate shows that the total payments

Too Important for PAYGO?

The idea that either a specific tax cut or a specific entitlement increase is "too important" to require adherence with PAYGO is backwards logic. The more important a proposal is — the more the public demands its enactment or the substantive benefit of a proposal justifies its enactment — the simpler it ought to be to justify reducing some existing tax break or entitlement benefit to offset the new cost. It is advocates of *unimportant* or unwarranted entitlement increases or tax cuts who should be unable to find or justify the necessary offsets. One way to explain the PAYGO rule is that it creates a political hurdle that only the most justifiable proposals should be able to overcome.

There is one exception to the notion that the more important a proposal is, the more an offset is justified. A *temporary* fiscal stimulus proposal enacted *during a recession* should not be offset. An example might be a temporary liberalization of unemployment compensation, a one-time fiscal relief payment to states, or a temporary tax cut. In such cases, the PAYGO requirement of offsetting reductions in revenues or increases in other entitlement benefits would reduce aggregate demand and therefore defeat the stimulus value of the proposal. But any tax cut or entitlement increase intended to be permanent should be fully offset; the nation cannot be assumed to suffer from a permanent recession.

For many of the 41 PAYGO bills the House considered, the CBO cost estimates of the reported bills verify compliance. In some other instances, the bills *as reported from the committee of jurisdiction* were not in compliance, but the bills were altered in the House Rules Committee or by their sponsors before coming to the House floor to produce compliance. Because CBO is only required to issue cost estimates for bills when they are reported from the committee of jurisdiction and *not* when they pass on the House or Senate floor, we relied on other methods — as described below — to determine whether bills that did not comply with PAYGO when reported were subsequently amended sufficiently to bring them into compliance.

- In some cases, CBO subsequently provided costs estimates of the bills as they had been amended, and the cost estimates verify that the amended bills comply with PAYGO.

- In other cases, we found that the provision that CBO identified as causing the excess cost was deleted before the House considered the bill, thereby curing the violation.

- In still other instances, provisions offsetting the costs of these bills were either added by the Rules Committee or added by the sponsor before the legislation was placed on the "suspension" calendar of the House (under which legislation must receive a two-thirds vote to pass), and CBO costs estimates are not available for the bill as amended. In these cases, which apply only to bills with very small costs, our examination strongly suggests that the amendments constituted legitimate offsets that eliminated the PAYGO violation. In any case, the total amount at issue in these 23 very small bills is insignificant in the context of the costs and offsets in the 18 largest bills. The 23 small bills not listed in Appendix 1 or included in Tables 1-3 have gross costs totaling at most $144 million through 2017. While we conclude that all this $144

would amount to $150,000. Before the House considered H.R. 865, the Rules Committee apparently cured this tiny PAYGO violation by removing the language directing that payments to Alaskan Natives be made from the Claims and Judgments account. On this basis, the House apparently concluded that the PAYGO violation no longer existed. We believe, however, that the bill would still create mandatory spending; the Alaskan Natives would still have a right to the payments specified by the bill even though the *source* of those payments is no longer specified.

million in costs are offset, even if none were offset, the 41 bills together still would reduce the deficit over the ten-year period by $8 billion, rather than increase it.

The gross costs and offsetting savings contained in each of the largest 18 House-passed bills are shown in Appendix 1. The combined fiscal effect of these 18 bills — a net *reduction* in the deficit of $8 billion or $9 billion — is shown in Table 1. Some 92 percent of the gross costs and savings were provided in just four of these 18 bills: the SCHIP bill, the farm bill, the student loan reform bill enacted through the reconciliation process, and the energy bill.

In Tables 1 and 3, we aggregate the costs and savings of the 18 major House-passed bills in two ways: in the first instance, we use costs and savings contained in the SCHIP legislation as initially approved by the House; under an alternative set of estimates, we use the costs and savings in the version of the SCHIP bill that the House and Senate subsequently agreed to, which was then vetoed by the President.[4] We do this because the two versions of the SCHIP bill, although both fully paid for, had substantially different costs and savings provisions.

As can be seen, the House has approved new gross costs totaling between $188 billion and $383 billion through 2017, depending on which version of the SCHIP bill is considered, and has fully paid for those costs.

2. The previous three Congresses made little pretence of complying with PAYGO

The previous three Congresses — the 107th, 108th, and 109th Congresses, covering the period from January 2001 through December 2006 — enacted many tax or entitlement laws. These three Congresses made no attempt to comply with the PAYGO principle of budget neutrality. During 2001 and 2002, the statutory PAYGO rule, which had been enacted as a result of the Bipartisan Summit Agreement of 1990 and subsequently extended, was still in effect; it expired in September 2002. In direct violation of that rule, very large tax cuts and substantial entitlement increases were enacted. To avoid the "sequestration" (automatic cuts to specified entitlement programs) that the 1990 law required whenever PAYGO was violated, Congress also approved statutes at the end of 2001 and 2002 directing the Office of Management and Budget — which was in charge of PAYGO enforcement — to ignore the PAYGO law. Congress effectively repealed the law rather than comply with it.

In addition to the statutory PAYGO rule, the Senate had its own parliamentary rule throughout this period that was supposed to preclude Senate consideration of legislation that violated PAYGO. But the Senate twice amended its own rule, redefining "PAYGO" so many or most tax cuts and entitlement increases did not, in fact, have to be paid for. Only in May 2007 did the Senate reinstitute a true PAYGO rule.

Table 2:
Current PAYGO compliance contrasts with prior noncompliance
Net costs(+) or savings(-) in billions of dollars, cumulated over specified period

	Cumulative net costs
2001-2006 net costs enacted by the 107th-109th Congresses.	+1,254
2007-2017 net costs approved this session by the House.	-8

[4] The newest version of the SCHIP bill, approved by the House on October 25, has costs that are virtually identical to those in the conference version used in this analysis; the additional constraints on the use of the funds did not alter the amount of funds that the bill would make available.

Table 2 on the previous page shows the cumulative net cost over the 2001-2006 period of all tax and entitlement legislation enacted by the three prior Congresses, using CBO scoring. As can be seen, these net costs cumulate to almost $1.3 trillion. (The net costs are greater if measured over a longer period that extends beyond 2006 or if interest costs are also included.[5]) Of the $1.3 trillion in tax cuts and entitlement increases enacted by the 107th, 108th, and 109th Congresses, almost three-fifths was enacted by the 107th Congress, in violation of the statutory PAYGO requirement, which was still nominally in effect at that time.

Some $271 billion of this $1.3 trillion occurred in 2006 alone. In fact, the budget would have been balanced in 2006, 2007 and a number of subsequent years were it not for the PAYGO violations of the prior three Congresses. In addition, some $209 billion of the $1.3 trillion comes from entitlement increases — $66 billion in 2006 alone. Tax cuts are not the whole story.[6]

In short, the impressive record of PAYGO adherence achieved to date by the *current* Congress stands in stark contrast to the violation of PAYGO principles by the 107th, 108th, and 109th Congresses.

3. Are gimmicks undermining PAYGO compliance?

Some have charged that PAYGO compliance has been achieved this year in part through gimmicks such as timing shifts or the early sunsets of costs.

To a very large extent, this charge is not valid. Overwhelmingly, the offsetting savings in House PAYGO legislation have been real rather than gimmicks. Examples are the increased tobacco taxes and the reduction in Medicare Advantage payments to insurance companies included in the House SCHIP bill, reductions in subsidies to banks and other lenders in the student loan bill, reductions or eliminations of some special tax preferences for oil companies in the energy bill, and reductions in some payments to farmers and to crop insurance companies in the farm bill. In each case, these provisions have excited opposition to the legislation in question, including some veto threats; this opposition comes about precisely because the offsets are real. If the offsets were gimmicks — if the costs in the bills were not actually paid for — powerful special interests would not be objecting.

One should also note that the charge of gimmickry is especially ironic if it comes from those who oppose the existence of the PAYGO rule and supported most or all of the $1.3 trillion in PAYGO violations, such as the 2001-2003 tax cuts, enacted by the prior three Congresses.

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[5] Table 2 shows a $1.3 trillion cumulative cost of PAYGO violations by the prior three congresses. Those tax and entitlement laws also produced costs in 2007 (and subsequent years). If Table 2 had covered the years from 2001 through 2007, it would have shown $1.6 trillion in cumulative unpaid-for costs.

Moreover, because the $1.3 trillion in 2001-2006 costs were not paid for, they increased the debt relative to what it would otherwise have been, thereby increasing the cost of interest on the debt. Including the increased interest payments, the failure of the last three Congresses to adhere to the PAYGO principle has through 2006 made the national debt $1.4 trillion higher than it would otherwise have been. The figure will rise further with each passing year.

[6] The figure of $209 billion in cumulative entitlement increases over the period 2001-2006 significantly understates the degree to which the prior three Congresses increased entitlement costs, because the most important entitlement increase, the new Medicare prescription drug benefit, constitutes only $37 billion of that figure; its costs were just beginning to phase in during this period. CBO projects that the one-year cost of the new drug benefit, less premiums, will grow to about $120 billion in 2017 alone.

Yet there is a bit of legitimacy to one aspect of the charges that have been made. Appendix 2 includes an examination of the use of timing shifts; we find that the fiscal effects of timing shifts used so far this year have been insignificant with one exception — the House-passed farm bill, which uses timing shifts between 2017 (which is inside the PAYGO window) and later years (which are outside the window) to achieve a small amount of its $23.8 billion in total savings.[7] If one ignores timing shifts, the House farm bill would not be viewed as fully complying with PAYGO, and the figure of $8 billion in net savings for all House PAYGO legislation (shown in Table 1) would be somewhere between $4 billion and $8 billion in net savings. Note that the total would *still* be a net savings, not a net cost. (Likewise, the $391 billion in offsets the House has approved, shown in Table 1a, would be reduced by a few billion and the offsets would be 99 percent valid rather than 100 percent valid.)

A different sort of issue, also legitimate, is raised when legislation includes "temporary" costs that are offset by permanent savings, or at least by savings that extend for the entire 10-year PAYGO window. This approach is uncommon, but does exist. The clearest example is the SSI Extension for Elderly and Disabled Refugees Act, in which $157 million in costs over three years are offset by $205 million in savings over ten years. A few small bills such as the extensions of Transitional Medical Assistance pay for one-year costs over a few years.[8]

To understand this issue, consider a hypothetical example. Imagine legislation that increases benefits in entitlement program "A" by $3⅓ billion per year for three years, 2008-2010, for a total cost of $10 billion. Further assume that this $10 billion cost is fully offset by a reduction in benefits in entitlement program "B" by $1 billion per year for all ten years, 2008-2017, for total savings of $10 billion. In this case, there is no PAYGO violation; over the ten-year period, net entitlement spending cumulates to the same total whether or not the legislation is enacted.

But suppose, as is often the case, that the $3⅓ billion annual cost is not designed to meet a purely temporary need (such as providing compensation to the families of 9-11 victims), but rather is for an ongoing program. An observer can reasonably look ahead to 2010, when the $3⅓ billion annual increase in program A is scheduled to expire. Congress will likely want to extend that increase for another three or five or ten years, but where will it find the savings to do so? The cuts in program B already extend through 2017, so Congress will have to find new cuts, or deepen the cuts in program B, if it wishes to extend the increases in program A past 2010.

Taking this approach to paying for increases in spending (or tax cuts) is undesirable because it effectively puts off the question of whether and how a permanent increase will be paid for. But this approach does not constitute a current violation of PAYGO. The real problem occurs if a future Congress decides to extend the temporary provision *without* enacting an offset. (Proponents of the temporary offsets could legitimately be criticized at that future time if they claim then that no offset should be necessary because they "never intended" the increase in spending or tax cut to be temporary.) While it may be difficult to find offsets in the future, it also is possible that offsets that

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[7] According to CBO, the House farm bill shifts $4 billion in costs outside the 2007-2017 PAYGO window. We believe it is best to consider some of this $4 billion as a gimmick and some as actual savings, as is explained in Appendix 3.

[8] The conference version of the SCHIP version has some features analogous to the SSI bill. The SCHIP bill has costs and savings in each of the ten years, and the costs and savings largely match each other both in the first five-year period and in the second five-year period. The SCHIP and Medicaid costs rise over the course of the first five years, in part because of the steadily rising cost of health care and in part because of increases in the number of children covered. But some of the expansions end and funding reverts to a lower level after 2012. Consequently, if Congress desired to extend these costs after 2012, as it likely would, additional offsets would have to be found in 2012 when SCHIP would next be reauthorized.

cannot currently be enacted because of strong opposition from the current President and some Congressional leaders (for instance, reductions in overpayments to Medicare Advantage plans) may be more politically acceptable in the future.

In short, paying for a temporary expansion with a permanent offset is not a problem if Congress continues to adhere to PAYGO; the legislation does not by itself make the long-term budget picture worse and is not the equivalent of paying for a real cost through, say, an accounting gimmick. But this approach will become a problem if the PAYGO rule is abandoned in the next few years, because this approach would then have set the stage for an eventual permanent increase in program A that is larger than the permanent cut in program B.

4. Is PAYGO just an attempt to prevent tax cuts? Is it intended to enshrine a "tax-and-spend" philosophy?

Some critics of the PAYGO rule have charged that it exists primarily to prevent tax cuts and to favor a "tax and spend" philosophy of government. There are three ways in which such charges might have a grain of truth to them.

- The previous three Congresses ignored the PAYGO principle and enacted tax cuts costing $1,045 billion over the 2001-2006 period and entitlement increases costing $209 billion over that period. A simplistic conclusion might be that since Congresses have been more interested in tax cuts than entitlement increases, PAYGO — which arguably makes the enactment of either type of legislation more difficult — is more likely to be an impediment to tax cuts than entitlement increases.

- A number of expensive tax cuts, including those enacted in 2001 and 2003 and recently enacted reductions in tax liability under the Alternative Minimum Tax (AMT), were enacted as temporary provisions of law. Some entitlement increases are also temporary, such as the temporary increases in payments to physicians who treat Medicare patients. However, the dollar amount of scheduled expirations of tax cuts is noticeably larger than the dollar amount of scheduled expirations of entitlement increases. Some claim, then, that "the baseline is biased" against tax cuts, or more precisely against the continuation of temporary tax cuts.

- Some critics of the PAYGO rule may assume that existing entitlement programs such as Medicare are more likely to be maintained than cut, and may contend that PAYGO makes the enactment of net tax cuts less likely because doing so requires enacting offsetting entitlement cuts that are politically very difficult to secure. (Such critics are essentially arguing that in the absence of PAYGO, revenues would be lower — and deficits larger — and that this is preferable to higher revenues and smaller deficits. For example, Grover Norquist, head of the anti-tax Americans for Tax Reform, is reported to have said, "I would rather have a small government with a big deficit than a big government with a balanced budget.")

These arguments against PAYGO are unpersuasive. For example, action to date by the current Congress suggests that increased health care coverage may be as high a priority for it as tax cuts, and PAYGO consequently may be doing as much to restrain health care expansions as tax cuts. And as the cost of health insurance and the number of the uninsured continues to rise, the public demand for federal assistance with health care costs is likely to grow.

More fundamentally, the PAYGO rule is *equally* an impediment to tax cuts and entitlement increases. The essence of the rule is that advocates of both tax cuts and entitlement increases must make trade-offs among competing constituencies. Paying for a tax cut or an entitlement increase by raising taxes or cutting an entitlement immediately excites the opposition of those whose taxes would be raised or whose entitlement benefits would be reduced. The political climate may lean more toward tax cuts in some years and more toward entitlement increases in others, but the PAYGO rule itself is neutral and is an impediment to both.

Moreover, to the extent that expiring tax cuts are more expensive than expiring entitlement increases, this is largely the direct result of actions taken by the previous three Congresses. As noted, those Congresses enacted costly tax cuts (and some major entitlement increases as well) without paying for them. Making the costs of these tax cuts temporary and having the tax cuts expire *before* the end of the applicable five-year or ten-year budget "window" enabled those Congresses to squeeze larger tax cuts within the budget limits they had set for themselves. Had these tax cuts been permanent rather than temporary, the tax cuts would have breached those budget limits. (Another factor was that the previous Congresses elected to use the budget "reconciliation" process — previously used only for deficit *reduction* legislation — to pass three major tax cut bills that were not paid for and that *increased* deficits. Use of the reconciliation process enabled tax-cut proponents to pass these bills with 51 Senate votes rather than 60, but the unpaid-for tax cuts had to be temporary in order to comply with reconciliation rules. In contrast, President Reagan used the *regular* process — rather than reconciliation — to pass the 1981 tax cuts, which were permanent tax reductions.)

Those who argue that the tax cuts slated to expire at the end of 2010 should not have to be offset because they never were really intended to be temporary in the first place are essentially calling for Congress to employ budget evasion and gimmicky on an unprecedented scale. They are saying that the costs that disappeared as a result of having the tax cuts expire should be counted *neither* when the tax cuts were first enacted *nor* when they are extended and made permanent.

One other point is worth mentioning. Our examination of the House's compliance with the PAYGO rule this session and the violations of it in prior sessions suggests that reality is more complex than a simplistic view of American politics in which it is assumed that Republicans care only about tax cuts and Democrats only about entitlement increases. Neither party can be pigeon-holed so easily. It was a Republican Congress that largely designed and enacted the Medicare prescription drug benefit in 2003. And the Democratic chairmen of the Senate Finance Committee and the House Ways and Means Committee, the committees with jurisdiction over tax law, have been speaking for months about providing relief from the Alternative Minimum Tax.

Significantly, Table 3a shows that the House approved legislation with $383 billion in gross costs over the period 2007-2017 and fully paid for those costs — with $285 billion of the offsetting savings, or almost three-fourths of the $383 billion in gross costs, achieved by entitlement cuts rather than tax increases.

To be sure, Table 3b shows that, once the conference version of the SCHIP bill is included in the calculations and the original House-passed version of the SCHIP bill is dropped from the calculations, entitlement cuts offset two-fifths rather than three-fourths of the gross costs. But this fact illustrates another political point. The House SCHIP bill was crafted almost exclusively by House Democrats, while the Senate SCHIP bill — and the SCHIP bill that was agreed to in conference — had major input from key Senate Republicans, including Senators Charles Grassley and Orrin Hatch of the Senate Finance Committee. Largely at their insistence, the Senate SCHIP bill was paid for entirely by an increase in the federal tobacco tax, while the House SCHIP bill contained a smaller increase in the tobacco tax, increased payments to Medicare physicians, and sizeable reductions in payments to "Medicare Advantage" insurance companies. Thus, the influence of Senate Republicans can be observed by comparing Table 3a with Table 3b; the gross tax increases are larger and the gross entitlement cuts much smaller in the bill influenced by Senate Republicans.

Table 3: How costs were paid for

Gross entitlement increases and tax cuts, paid for by gross entitlement cuts and tax increases, cumulated 2007-2017, in billions of dollars.

3a: with *House* SCHIP bill:

Gross entitlement increase	357.9
Gross tax cuts	25.4
Gross costs	383.3
Gross entitlement cuts	-284.6
Gross tax increases	-106.9
Gross savings	-391.5

3b: with *Conference* SCHIP bill:

Gross entitlement increase	162.1
Gross tax cuts	25.4
Gross costs	187.5
Gross entitlement cuts	-75.2
Gross tax increases	-121.6
Gross savings	-196.8

May not add due to rounding.

Similarly, House Republican leaders offered a substitute amendment to the House SCHIP bill during its floor consideration in July. (The substitute was offered in the form of a "motion to recommit.") Like all amendments, that substitute was subject to the House PAYGO rule. Did the substitute reduce or eliminate the tobacco tax increase? No. It left the House tobacco tax intact, eliminated all of the "Medicare Advantage" reduction instead, and scaled back the SCHIP increase. In other words, House Republican leaders sought to provide a smaller SCHIP program and to use the savings (relative to the reported bill) *not* to shrink the size of the tax increase but to shrink the spending cuts instead (the cuts to the Medicare advantage program). Maintaining existing Medicare Advantage entitlement payments proved more important to House Republican leaders than preventing a tax increase.

The Importance of Compliance with PAYGO and Threats to that Compliance

4. The grim long-run budget picture and PAYGO.

PAYGO compliance is critical to avoiding an explosion of federal debt over the long term. Earlier this year, we calculated that if we remain on the current policy course (with current tax cuts extended and no changes in entitlement programs or the health care system), deficits will reach roughly 20 percent of the Gross Domestic Product by mid-century, and the national debt will exceed 200 percent of GDP by that point, a dangerous level unprecedented in our nation's history. We also calculated that if the PAYGO principle is adhered to and no entitlement increases or tax cuts are enacted without being paid for (including the tax reductions that would be provided by extending the Bush tax cuts), then the cumulative "fiscal gap" through 2050 would be cut more than in half.[9] (Stated another way, we found that extending the Bush tax cuts in full *without* paying for them would itself more than double the size of the problem through 2050, relative to a budget path in which PAYGO is scrupulously

[9] See *The Long-Term Fiscal Outlook Is Bleak*, Kogan, Fiedler, Aron-Dine, and Horney, Center on Budget and Policy Priorities, January 29, 2007, at http://www.cbpp.org/1-29-07bud.pdf. The fiscal gap represents the amount by which projected revenues would have to be increased or projected program costs reduced over the a specified time period to insure that the debt, measured as a share of the economy, does not exceed its current level (37 percent of GDP) at the end of that time period. OMB projects a smaller fiscal gap than we do, while some other analysts such as Auerbach, Gale, and Orszag project a larger fiscal gap. (See New Estimates of the Budget Outlook, February 15, 2006, at http://www.econ.berkeley.edu/~auerbach/update1.pdf.)

adhered to.)[10] These projections reinforce the notion that PAYGO should be adhered to — and for as far as the eye can see.

5. The biggest tests of PAYGO compliance lie ahead.

The biggest tests of PAYGO compliance lie ahead, as the extension of expiring tax breaks, such as AMT relief, move to the top of the Congressional schedule. In some cases, the tests will occur shortly. In other cases, the tests will occur in the next few years. Two categories of expiring tax breaks will be addressed by Congress before it adjourns this session.

- **Relief from the Alternative Minimum Tax**, or AMT. Because key AMT tax parameters — in particular, the amount of income that is deducted before taxpayers calculate their AMT tax liability — are not indexed for inflation, more taxpayers become subject to the AMT each year. Since 2001, Congress has acted each year to limit the automatic growth of the AMT by providing tax relief to those who would be subject to it. This tax relief is invariably temporary, however, so the extension of AMT relief — which becomes considerably more costly with each passing year — has become like another "tax extender": it is a tax cut that Congress is simply assumed to enact each year.

- **"Tax extenders."** These are a series of special exemptions, deductions, or preferential rates for certain types of business or personal transactions that are written into the tax code on a temporary basis but are routinely extended. The most well-known of these is the research and experimentation tax credit. Most of these "extenders" were first enacted a decade or more ago. Although these tax breaks are customarily extended for only one or two years at a time, Congress invariably extends them rather than allowing them to expire. This practice has gone on for so long and is so well understood that their scheduled expiration generally does *not* serve as an opportunity for Congress to seriously consider their merits and whether they are effective and still are needed.

Probably the biggest immediate test of PAYGO compliance will occur when Congress extends AMT relief this fall. The Administration and Congressional Republicans are insisting that AMT relief be continued — and that it *not* be paid for.

The periodic extension of temporary tax cuts is matched on the spending side of the budget by the relief that physicians who treat Medicare patients are granted each year. In 1997, the reimbursement rates for Medicare physicians were reduced according to a new schedule of "sustainable growth rates." These reductions proved larger, however, than physicians were willing to accept or policymakers to insist upon, so Congress has habitually granted "temporary" relief from the scheduled payment reductions. The temporary relief measures constitute entitlement increases relative to existing law in exactly the same way that continuation of AMT relief or the "tax extenders" are tax cuts relative to

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[10] Some observers make the mistake of noting the huge growth of Medicare and Medicaid costs when projected forward to 2050 or 2080, and conclude that the Bush tax cuts — at "only" 2 percent of GDP — are insignificant in comparisons. But this is an error. The health programs are projected to *eventually* grow to enormous size, while under PAYGO the Bush tax cuts would need to be fully offset very soon — starting in 2010. The Comptroller General and others have repeatedly pointed out that the sooner Congress acts, the smaller the necessary actions will have to be; this is because actions taken now generate "compound interest" savings over many decades. The Bush tax cuts may seem small compared with the growth of health care costs by 2080, but paying for the Bush tax cuts is required very soon; that is why the Bush tax cuts constitute such a sizable fraction of the entire long-term problem.

The Budgetary Climate May Be Changing

Congressional behavior appears to have changed as a result of the PAYGO rule. While advocates of tax cuts or entitlement increases previously would merely explain how substantively or politically beneficial their proposals would be, now one of the first questions such advocates are asked is, "How will you pay for it?" Less justifiable proposals tend to disappear, and even the more justifiable proposals have to prove their worth by being able to survive with an offset attached — an offset that invariably arouses some opposition.

In contrast, violating the PAYGO rule and simply adding the cost of tax cuts or entitlement increases to projected deficits generally excites no comparable opposition. True, inviolable rules of economics dictate that eventually the extra costs must be paid for (if only because higher interest payments eventually will compel future tax increases or future spending reductions). But an abstract cost that will apply to some future group at some future time does not provoke immediate opposition from the public or powerful interest groups. It takes more political courage to adhere to PAYGO than to violate it.

existing law. As a result, under the PAYGO rule, any such extensions must be paid for. These costs, as well, are likely to be addressed by Congress before it adjourns this session.

Finally, the very large tax cuts enacted in 2001 and 2003, which are scheduled to expire at the end of 2010, will present the biggest challenge to PAYGO. The White House in particular has attempted to foster the notion that all of these tax cuts must be extended beyond their 2010 expiration date, with no questions asked — and without the costs having to be offset.

The question of whether PAYGO will be adhered to in 2010, when the Bush tax cuts are scheduled to expire, is, of course, even more consequential. As noted above, making the Bush tax cuts permanent without paying for them would double the size of the fiscal gap through 2050.

6. Some criticism of imperfect compliance is intended to undermine PAYGO, not to strengthen it.

The House Republican Leadership argues that House compliance with PAYGO has been illusory, citing timing shifts or the fact that some bills contain cost increases that expire before 2017 but are probably not meant to be temporary. We have addressed the substance of these contentions in section 3 above and in appendices to this paper. But one should also be aware of the political context behind these criticisms. The record of the House Republican leaders who contend that the House has not complied with PAYGO is one of staunch opposition to the PAYGO rule, and in particular, to paying for tax cuts. The criticism of House compliance this year appears to be intended to undermine the PAYGO rule rather than to strengthen it and make it still more effective.

Thus, House Republican leaders led the opposition to reestablishing the PAYGO rule in January 2007 and currently oppose paying for the extension of AMT relief. They also recently offered an amendment calling for repeal of the estate tax without offsetting the costs.

7. Keeping PAYGO intact.

As this analysis indicates, the House's record of compliance with PAYGO has been laudable to date. This suggests those who support fiscal discipline should commend the House. If the public does not appreciate the change that has been made, voters may revert to a cynical attitude on this matter as on so many others. And that could have troubling consequences. After all, why should Members of

Congress go through the painful work of finding offsets and choosing not to enact popular but fiscally irresponsible tax cuts and program increases if the media and the public given them no credit for such actions and simply assume they are acting in a fiscally irresponsible, business-as-usual way. Adhering to PAYGO is politically difficult; it involves saying no to powerful constituencies. If Congress concludes it gets no public recognition for taking difficult votes to achieve savings and no credit for abjuring costly, unpaid-for entitlement increases and tax cuts, it will be more likely to abandon fiscal discipline.

If one believes in fiscal discipline, one should commend those with the courage to practice it. Fiscal discipline is a rare commodity that is easily lost. And once lost, history shows that trillions of dollars of extra debt can be enacted in very short periods of time.

Appendix 1:
The 18 largest tax and entitlement bills passed by the House of Representatives as of November 5, 2007 (in millions of dollars)

Positive signs indicate costs (entitlement increases and revenue reductions), while negative signs indicate savings (entitlement reductions and revenue increases)

		Cumulative, 2007-2017
1a. SCHIP bill as originally passed by the House, H.R. 3162	Entitlement increases	+267,300
Children's Health and Medicare Protection Act of 2007 (CHAMP Act)	Entitlement reductions	-209,400
	Revenue increases	-58,100
	Net cost	**-100**
1b. SCHIP conference agreement, H.R. 976 (vetoed)	Entitlement increases	+71,524
Children's Health Insurance Program Reauthorization Act of 2007	Revenue increases	-72,799
	Net cost	**-1,275**
2. Student Loan Reform, HR 2669, P.L. 110-84	Entitlement increases	+39,980
College Cost Reduction and Access Act of 2007	Entitlement reductions	-43,583
	Net cost	**-3,603**
3. Farm bill, H.R. 2419 (passed by House)	Entitlement increases	+23,818
Farm, Nutrition, and Bioenergy Act of 2007	Entitlement reductions[11]	-16,346
	Revenue increases	-7,499
	Net cost	**-27**
4. Energy bill, H.R. 3221	Entitlement increases	+9,508
Renewable Energy and Energy Conservation Tax Act of 2007[12]	Revenue reductions	+13,565
	Entitlement reductions	-7,948
	Revenue increases	-15,285
	Net cost	**-160**
5. *Trade and Globalization Assistance Act of 2007*, HR 3920[13]	Entitlement increases	+9,786
	Revenue reductions	+2,739
	Entitlement reductions	-1,145
	Revenue increases	-12,109
	Net cost	**-729**
6. 2007 Supplemental Appropriations Bill, H.R. 2206, P.L. 110-28[14]	Revenue reductions	+4,853
	Revenue increases	-4,900
	Net cost	**-47**

[11] This figure includes CBO's costs estimate of a provision that saves $222 million though 2017 but was inadvertently omitted from the text of the bill as it passed the House.

[12] CBO has not yet issued a cost estimate for H.R. 3221; these numbers were obtained from the House Budget Committee. Early in the year the House passed H.R. 6, a predecessor to the current energy bill. Because that earlier bill has been superseded by H.R. 3221, it is not included in our calculations. In any case, H.R. 6 more than paid for itself.

[13] This bill was altered by a small amendment for which we do not have a cost estimate, so the figures in this analysis are based on the CBO cost estimate of the reported bill.

[14] The House and Senate PAYGO rules apply only to revenue provisions in appropriations bills. Estimates of revenue reductions and increases provided by this bill were obtained from the House Budget Committee; CBO does not issue standard cost estimates of appropriations bills. Rather, it produces tables showing the amount of funding for each budget account provided in those bills and the estimated outlays for each account. (Note: longstanding Congressional scorekeeping rules, codified in 1990, provide that if appropriations legislation includes provisions changing mandatory programs, those changes count against the spending allocations of the Committees on Appropriations and are therefore classified as discretionary during the session in which they are considered. The Senate has instituted a new rule requiring that any outyear effects of such "changes in mandatory programs" in appropriations bills must net to zero. This is a logical corollary of the PAYGO rule.)

7. *Implementing Recommendations of the 9/11 Commission Act of 2007*, H.R. 1, P.L. 110-53	Entitlement increases	+2,250
	Revenue reductions	+98
	Entitlement reductions	-2,750
	Net cost	**-402**
8. *Federal Housing Finance Reform Act of 2007*, H.R. 1427	Entitlement increases	+3,310
	Revenue increases[15]	-3,310
	Net cost	**0**
9. *Mortgage Forgiveness Debt Relief Act of 2007*, H.R. 3648	Revenue reductions	+1,930
	Revenue increases	-2,005
	Net cost	**-75**
10. *Tax Collection Responsibility Act of 2007*, H.R. 3056	Revenue reductions	+1,136
	Entitlement reductions	-664
	Revenue increases	-1,138
	Net cost	**-666**
11. *Hardrock Mining and Reclamation Act of 2007*, HR 2262	Entitlement reductions	-382
	Revenue increases	-310
	Net cost	**-692**
12. *TMA, Abstinence Education, and QI Programs Extension Act of 2007*, H.R. 3668, P.L. 110-90[16]	Entitlement increases	+667
	Entitlement reductions	-670
	Net cost	**-3**
13. *FAA (Federal Aviation Administration) Reauthorization Act of 2007*, H.R. 2881	Entitlement increases	+302
	Revenue reductions	+315
	Entitlement reductions	-86
	Revenue increases	-2,007
	Net cost	**-1,476**
14. *National Defense Authorization Act for Fiscal Year 2008*, H.R. 1585	Entitlement increases	+583
	Entitlement reductions	-583
	Net cost	**0**
15 *Water Quality Financing Act of 2007,* H.R. 720	Revenue reductions	+541
	Entitlement reductions	-615
	Net cost	**-75**
16. *SSI Extension for Elderly and Disabled Refugees Act*, HR 2608[17]	Entitlement increases	+157
	Entitlement reductions[18]	-205
	Net cost	**-48**
17. *Katrina Housing Tax Relief Act of 2007*, H.R. 1562	Revenue reductions	+237
	Revenue increases	-241
	Net cost	**-4**
18. *Transitional Medical Assistance (TMA) and Abstinence Education Extension*, S. 1701, P.L. 110-48	Entitlement increases	+198
	Entitlement reductions	-199
	Net cost	**-1**

Note: figures may not add due to rounding.

[15] Revenue increases stem from fees collected from government-sponsored enterprises (GSEs), which go to fund the governmental organization that oversees the GSEs operation and financial stability.

[16] This temporary extension of Transitional Medical Assistance (TMA) covers October, November, and December of 2007. The previous temporary extension, shown as item 18, ran through September 2007.

[17] CBO has not yet issued a cost estimate for H.R. 2608; figures were obtained from the House Budget Committee.

[18] This bill includes a reduction in unemployment overpayments, which would result in a similar reduction in revenues as states lower their unemployment tax rate to maintain a steady unemployment trust fund balance. Because the revenue reduction directly stems from the entitlement reduction, we chose to net these two effects and classify them as a net entitlement reduction.

Appendix 2: Additional Features of the House PAYGO Rule

The House PAYGO rule is a bit more complex than we described it in the main body of this report. There are a few minor aspects worth clarifying.

First, the PAYGO rule is called a "ten-year" rule because it encompasses the *budget year* (the fiscal year that starts on October 1 of any session of Congress) plus the next nine years. During this session of Congress, the ten-year period is fiscal year 2008 through fiscal year 2017. Technically, however, the rule also covers the year before the budget year (known as the *current year*), which addresses the possibility that a tax or entitlement bill could be enacted early in a session and have immediate budgetary effects. Thus, the test is really an eleven-year test: this session, House legislation is required to be budget-neutral over the eleven fiscal years from 2007 through 2017.

Second, the PAYGO rule includes a six-year test as well as an eleven-year test: legislation must be budget-neutral over six fiscal years starting with the current year, in addition to being budget-neutral over eleven fiscal years starting with the current year. However, this additional requirement of budget neutrality during the first six years appears to make little or no difference. On some occasions, House committees have prepared bills whose costs are fully paid for over the eleven-year period, but whose costs were not fully covered in the first period while being more than fully covered over the subsequent five years. On those occasions, the legislation has also shifted the scheduled date of some federal payments or receipts between the two periods, thereby satisfying the PAYGO rule. Because such timing shifts are easy to design and implement, in effect the PAYGO rule is simply an eleven-year requirement of budget neutrality.

Table 4:
How much year-by-year variation occurs in achieving overall budget neutrality?
Analysis based on the three largest bills: the House-passed SCHIP bill, the student loan reforms, and the farm bill (in billions of dollars)
All calculations omit timing shifts

Average 2007-2017 ***gross*** costs (omitting savings)	30.1
Average 2007-2017 ***net*** costs or savings (regardless of sign)	2.3
Largest net cost: 2009	5.4
Largest net savings: 2007	-4.9

One can imagine a utopian PAYGO rule that would require tax or entitlement bills to achieve budget neutrality in *each* of the eleven fiscal years and would attempt to ban timing shifts (which would be used to smooth the actual year-to-year patterns to achieve compliance). The actual House rule is more flexible because it only requires budget neutrality over the eleven-year period taken as a whole. We have examined the three largest PAYGO bills to see what difference this flexibility makes. The answer, as shown in Table 4, is that this flexibility does not make a large difference. In these calculations we omit timing shifts because they could be used to smooth the year-to-year path. We find that the average amount by which the net costs or savings in any year deviate from the utopian standard of "perfect budget neutrality in each year" is $2.3 billion. This means that, on average, some years have $2.3 billion in net costs while others have $2.3 billion in net savings, amounting to a net of zero cumulative costs over the eleven-year period.

This $2.3 billion absolute average is a relatively small fraction of the average gross costs of $30.1 billion. In other words, the path of offsets comes relatively close to matching the path of costs. Timing shifts could be used to make the paths appear even smoother, although they would not be smoother in reality. Based on this analysis, we conclude that as long as timing shifts are used only to meet the "six-year" requirement of the PAYGO rule — converting the rule from requiring compliance over both six and eleven years to requiring compliance over eleven years only — they make no important difference to overall PAYGO compliance and should not be a point of criticism.[19]

Finally, budget neutrality is measured relative to the *baseline* as defined in §257 of the Balanced Budget and Deficit Control Act of 1985 as amended. In general, the baseline rules in that Act provide that tax and entitlement law should be assumed to exist in each future year as those tax and entitlement laws currently provide. If a provision of tax or entitlement law is not scheduled to change in the future, then baseline estimates are made under the assumption that the provision does not change. Conversely, if a provision of tax or entitlement law is scheduled to change — e.g., the scheduled expiration of the Transitional Medical Assistance benefit and the Research and Experimentation tax credit, the scheduled reduction in Medicare physician reimbursement rates and the scheduled increase in individual income tax rates after 2010 — then baseline estimates are made under the assumption that those provisions will change as scheduled.

However, there are a few exceptions to a strict "current law" approach to the baseline. Specifically, the benefit levels for compensation payments to disabled veterans are assumed to be indexed even though they are not indexed under current law. In addition, if an *entire* entitlement program (rather than just a provision) is scheduled to be reauthorized periodically — such as the farm price support programs and the Food Stamp Program — then the baseline assumes it will be extended without change. As a result, a reauthorization of such a program without change does not increase deficits projected under the baseline, but any increase in benefits would. Similarly, each excise tax dedicated to a trust fund — for example, the highway gasoline tax — is also assumed to continue at its current rate despite its scheduled expiration; consequently, reauthorization of gasoline taxes does not reduce projected deficits.

For a Question-and-Answer discussion of the House PAYGO rule, see *The New Pay-As-You-Go Rule in the House of Representatives* at http://www.cbpp.org/1-12-07bud.pdf.

[19] A timing shift that moved costs outside the eleven-year window or moved savings into the eleven-year window would, on the other hand, be more of an undesirable gimmick. Proposals to expand back-loaded Roth IRAs, for instance, can increase revenues in the short run in return for permanent revenue losses that show up decades in the future. This type of long-term timing shift should be avoided, and as discussed in section 3, the House appears to have used such gimmicks only to a limited extent, approximately $2.3 billion to date.

Appendix 3: When Is a Timing Shift a Real Savings and When Is It a Gimmick?

The House-passed farm bill, H.R. 2419, contains four provisions, effective in 2012, that permanently delay the date on which certain federal payments are made and one provision that permanently accelerates the date on which federal fees are collected. To what extent are these provisions valid savings and to what extent are they just gimmicks?

To answer that question, we need to understand what constitutes a valid savings. We conclude that a timing shift *can* be considered a valid savings — a real offset — but only if both of two conditions are met.

- First, a *temporary* timing shift is never a real savings. Suppose, for example, that an annual benefit payment is shifted from 2017 to 2018. In that case, the federal government will be making no such payments in 2017 but will have to make double payments in 2018, and so will not be better off over the two years taken together; no savings will be achieved.[20] Yet PAYGO compliance is judged by measuring costs and savings over the period 2007-2017. Thus, the 2017 "savings" from eliminating payments in 2017 will appear in the CBO cost estimates while the 2018 "cost" from having to pay double in that year will not show up. Therefore, *for a timing shift to be real, it must be permanent.*

  Here's a hypothetical example. Social Security retirement benefits are paid monthly. Suppose a new law required that, starting with October 2009 and forever thereafter, each monthly payment would be made 12 months after it had been due, rather than on the day it was due. Thus, the payments that had been scheduled for October 2009 would instead be made in October 2010, the payments scheduled for November 2009 would instead be made in November 2010, and so on forever. From the point of view of the Treasury, no Social Security benefits would be paid during fiscal year 2010. The Treasury would resume making payments in 2011, but would never double up; it would never have to make two years worth of payments in a single year. In a budgetary sense, this is tantamount to skipping one full year of Social Security payments.[21] Although it is only a one-year savings, the savings are real.

- Second, for a timing shift to be entirely real, it must delay a payment (or accelerate a receipt) by a full 12 months. Let's use farm commodity payments as an example. In general, a farmer who receives price supports (based on farm prices, the amount he sells, and so on) is paid once a year, after his crops are harvested and sold.[22] Imagine that a crop is harvested in August and the farmer generally receives the annual payment in September, after the Department of Agriculture has completed its calculations and paperwork. Now suppose a law provides that, starting in 2009 and

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[20] Actually, the federal government would save a small amount of interest, because it would delay the borrowing otherwise needed to finance the 2017 benefit payment. This is the same as saying that if the government delays a payment for a year, it should also pay the recipient interest; and if it does not, that interest avoidance is a real savings. This line of reasoning also suggests that in determining PAYGO compliance, each individual stream of costs or savings in tax and entitlement legislation should be discounted to the present and that the "present-value" (rather than the nominal value) of costs and savings should net to zero. This notion would appeal to economists but is not how any other aspect of multi-year budget enforcement works, either under the Congressional Budget Act or the PAYGO rules.

[21] Recipients would also feel this cut as real. They would have to go for a full year with no Social Security benefits and would only receive their last year's worth of benefits after they had died.

[22] This is a simplification; in reality, many farm price supports are paid in two installments, partly in advance and partly after the crop is harvested.

in each year thereafter, the September payment shall instead be made on October 1. This is a delay of roughly two weeks on average, not at all like the 12-month delay in Social Security payments hypothesized above. Farmers will only be slightly aggrieved, and in any real sense, the Treasury will hardly receive any benefit. Yet because September 2009 is in fiscal year 2009 while October 2009 is in fiscal year *2010*, the federal budget will record (and CBO cost estimates will show) significant savings in 2009. In an accounting sense, the savings will look the same whether the payments are delayed 12 months or two weeks. But in reality, two weeks is a gimmick while 12 months is a real, albeit one-time, savings. Thus, we conclude that a permanent timing shift is a real savings if the shift is for a full 365 days but is a gimmick if the date in question is moved only slightly.

- This leaves the question of how to think about a permanent timing shift of, say, *six months* rather than one day or 12 months. One plausible approach is to pro-rate the timing shift. Instead of thinking of it as entirely real because it is longer than a few days, or entirely a gimmick because it is shorter than 365 days, we might think of a six-month timing shift as 50 percent a gimmick and 50 percent real. From the Treasury's point of view, the enactment of such a proposal would provide a six-month hiatus in which it did not make any payments, and it would never have to double up any payments in a later period.

In the case of the House-passed farm bill, the five timing shifts each extend for various periods. Some delay payments for as much as ten months; others delay payments for shorter periods. According to CBO, the five timing shifts produce scorable savings totaling $4.0 billion within the 2007-2017 PAYGO window. We can examine the length of each of the timing shifts and apply the pro-rating method suggested above. For example, the shift in "direct advance deficiency" price supports moves $1.1 billion in costs outside the window and typically delays such payments by approximately 9½ months. With that length delay, we could use the pro-rating method to treat the payments as 79 percent real, 21 percent gimmick, and consider this particular provision to be about $900 million in real savings.

Using this method, would produce an estimate that of the $4.0 billion in timing shifts CBO has identified, $2.3 billion might be thought of as a gimmick and $1.7 billion as actual savings.