
December 2, 2011

REPUBLICAN PROPOSAL TO PAY FOR PAYROLL TAX EXTENSION WOULD INCREASE ALREADY SEVERE CUTS IN DISCRETIONARY PROGRAMS

by James R. Horney

The plan of Senate Republican leaders to extend and expand payroll tax relief includes a smaller payroll tax cut and would provide less than half of the economic boost of the Democratic alternative. The plan claims to offset the costs of its payroll tax cut by freezing federal employee pay and cutting federal employment, but that claim is misleading. The plan actually secures these savings by cutting the overall funds available for defense and non-defense discretionary programs for the next ten years. Senate Republican leaders also say their offset reflects a proposal from the “Bowles-Simpson” commission, but their plan would force discretionary cuts of more than *\$500 billion more* than Bowles-Simpson.

The Senate defeated both the Republican leadership and the Democratic plans last night. With President Obama and many lawmakers committed to extending or expanding the payroll tax cut, however, the contents of both plans remain relevant. With the parties now likely to move toward negotiating a final agreement on the payroll tax, participants in those talks may well raise elements of these plans for consideration.

Highlights of the plans include the following:

- The Democratic plan would offset the cost of its payroll tax reduction with a surtax on annual incomes exceeding \$1 million, starting in 2013. The Senate Republican plan claims to pay for itself largely by freezing the pay of federal employees through 2015 and reducing the size of the federal workforce. But, in fact, the savings would come from cuts in the “caps” that limit the amount of funding allowed over the next ten years for discretionary (annually appropriated) programs — defense, veterans’ health care, aid to state and local governments for primary and secondary education, Social Security administration, environmental protection, and an array of other activities. These proposed cuts would come on top of the very large cuts in discretionary programs imposed by the Budget Control Act caps that Congress enacted in August, and by the across-the-board cuts (or “sequestration”) scheduled to start in 2013 because the “Supercommittee” failed to produce \$1.2 trillion in deficit reduction.
- Senate Republican leaders also have said that their offset simply reflects a proposal supported by a bipartisan majority of the President’s Commission on Fiscal Responsibility and Reform

(commonly known as the “Bowles-Simpson” commission). Actually, overall discretionary spending over the next ten years would have to be cut over *\$500 billion more* than the Bowles-Simpson plan proposed.

- Moreover, Bowles and Simpson proposed their discretionary spending cuts *not by themselves*, but as part of a package that also includes \$2.2 trillion in revenue increases and was designed to accomplish all of the deficit reduction needed for the coming decade, so policymakers would not need to return in a few years and enact further deficit reduction. The President and Congress have not enacted such a comprehensive deficit reduction plan but, facing the prospect of growing deficits and the need to stabilize the debt in the years ahead, policymakers will have to do so before long. At that point, discretionary programs will be vulnerable to substantial additional cuts that would come on top of the proposed cuts under the Senate Republican leadership proposal — which, in turn, would add substantial discretionary program cuts to the large cuts already imposed by the Budget Control Act caps and sequestration, as noted above.

The Contours of the Senate Republican and Democratic Plans

The Senate Republican plan (S. 1931, introduced by Senator Dean Heller, R-NV) would extend for one year the two-percentage-point reduction in the payroll tax rate assessed on employees’ wages that is now in effect. The Democratic plan would reduce the employee share of the payroll tax by an additional 1.1 percentage points for the coming year (so that the tax rate would be 3.1 percent in 2012, instead of the normal rate of 6.2 percent) and would also reduce the *employer* share of the payroll tax paid by on the first \$5 million of wages paid by a firm and on up to \$50 million of any *increase* in annual wages paid by a firm. Goldman-Sachs economists estimate that letting the current payroll tax cut expire at the end of this month would reduce economic growth by as much as two-thirds of a percentage point in early 2012. The Senate Republican plan would eliminate that drag on the economy but would not provide the additional boost to the economy that the broader Democratic proposal would.

Senate Republican leaders claim their plan would both offset the \$120 billion cost of extending the payroll tax cut and produce \$111 billion in deficit reduction over ten years because it contains \$231 billion in spending cuts. The Democratic proposal carries a larger price tag of \$265 billion, which would be offset in full by a surtax on incomes of \$1 million or more.

About 4 percent of the savings in the Senate Republican plan — \$9 billion over ten years — would come from proposals affecting entitlement programs.¹ Senate Republican leaders have portrayed these savings as coming from a proposal to make very-high-income Americans pay the full cost of Medicare Part B and Part D insurance (upper-income beneficiaries already pay more than others, but not the full cost of the benefits) and to ensure that millionaires cannot receive food stamps or unemployment insurance benefits. Under current law, millionaires can receive such benefits only in extremely rare circumstances and for short periods of time, such as when a poor individual wins the lottery but briefly continues to collect benefits.

¹ Congressional Budget Office, “Budgetary Effects for a Senate Proposal, the Temporary Tax Holiday and Government Reduction Act,” November 30, 2011, <http://cbo.gov/ftpdocs/125xx/doc12578/s1931.pdf>.

In reality, however, the bulk of the plan’s entitlement savings — roughly \$8 billion of the \$9 billion — would come from a different provision that Senate Republican leaders *haven’t* highlighted, which would increase Medicare premiums in 2020 and 2021 for beneficiaries with incomes that are high but far below \$1 million. This provision affects beneficiaries with incomes starting at \$85,000 for single individuals and \$170,000 for couples.

Why the Plan’s Savings Come Primarily from Broad Cuts in Discretionary Programs Rather than from Federal Workers

The bulk of the savings in the Senate Republican proposal comes from \$222 billion in reduced expenditures over ten years on discretionary (i.e., non-entitlement) programs. Senate Republican leaders have said these savings would come from implementing a Bowles-Simpson proposal to freeze the pay of federal employees through 2015 and reduce the size of the federal civilian workforce by 10 percent — or 200,000 employees — over the coming decade. While the Bowles-Simpson plan does include such a proposal (see the box for a discussion of why this proposal may not be desirable), it is misleading for several reasons for Senate Republican leaders to assert that they are paying for the payroll-tax-cut extension and reducing the deficit by adopting the Bowles-Simpson proposal.

- Freezing federal pay and planning to reduce the size of the federal workforce does not, by itself, produce new budgetary savings. Federal personnel costs are paid out of discretionary (i.e., annually appropriated) funds, which already are subject to the stringent caps under the Budget Control Act that will — taking the automatic sequestration into account — require \$1.6 trillion in discretionary spending cuts over the next ten years. Appropriations for federal personnel costs *are virtually certain to be cut anyway in order to comply with these unprecedented reductions in discretionary funding already in law*. Moreover, savings from cutting the federal workforce by 10 percent almost certainly would be less than 10 percent of federal personnel costs because such reductions generally lead to an increase in the use of federal contractors to carry out necessary functions previously performed by federal employees.
- It’s impossible to know whether total discretionary spending would be lower — and, if so, how much lower — as a result of the Senate Republican plan’s federal pay freeze and workforce reduction language.² Therefore, the Congressional Budget Office (CBO), in its preliminary cost estimate for S. 1931, did not “score” any savings from the pay and workforce proposal. Instead, CBO shows *all \$222 billion* of the proposal’s discretionary program savings coming from another proposal in the legislation — to reduce the Budget Control Act’s caps on discretionary funding in all fiscal years from 2013 through 2021.
- The Bowles-Simpson plan also proposed establishing caps on discretionary appropriations. Its caps would achieve discretionary savings of \$1.3 trillion in 2012 through 2021 (compared to

² Proposed limits on future appropriations are different from changes in laws that govern entitlement programs and taxes; CBO takes the former into account in assessing comprehensive budget plans but not in estimating the deficit effects of specific legislation. As a result, CBO did not include effects of the proposed cap reduction in its estimate of the deficit effect of S. 1931 (it showed those effects as a separate entry in its table). CBO consequently estimates that S. 1931 would *increase* the budget deficit by \$110 billion over ten years. This would run afoul of the Pay-As-You-Go statute, which requires that tax and entitlement legislation not increase the deficit.

CBO's March 2011 baseline projection of discretionary spending, excluding war costs).³ The report issued by Bowles and Simpson listed a number of steps that could be taken to shrink future appropriations to the proposed cap levels, such as the proposal to freeze federal pay and reduce the workforce. In other words, the Bowles-Simpson plan proposed savings from restricting federal pay and personnel *as a way to help meet its tight discretionary caps. It did **not** propose pay and personal savings as a way to extract **additional** savings, beyond those from its caps.*

- The discretionary caps that the Budget Control Act establishes require \$850 billion in discretionary spending cuts in 2012 through 2021 (relative to CBO's March 2011 baseline). The sequestration that the BCA requires (as a result of the supercommittee's failure) will reduce those caps further, requiring an additional \$750 billion cut in discretionary spending. Thus, the total cut in discretionary spending over the next ten years required under current law is \$1.6 trillion — \$300 billion more than the cut that the Bowles-Simpson plan calls for. The current discretionary caps are already substantially lower than those proposed by the Gang of Six, as well.
- The Senate Republican proposal would reduce the caps on discretionary budget authority by an additional \$246 billion (to produce the estimated \$222 billion in outlay savings through 2021). With that reduction, the cuts in discretionary spending required over the next ten years would total \$1.8 trillion. This is *more than \$500 billion — or more than 40 percent — larger than the discretionary spending cuts in the Bowles-Simpson plan.*
- The additional reduction in the discretionary caps required under the Senate Republican plan would cut the amount of funding available for *all* discretionary programs, not just for federal pay and personnel costs. It would affect funding for programs ranging from defense (including procurement and military personnel) and veterans' health care to aid to state and local governments for primary and secondary education, Social Security administration, environmental protection, low-income housing, Head Start, the Federal Bureau of Investigation, the National Park Service, the National Institutes of Health, and a wide array of other activities. The only way to argue that discretionary programs other than pay and personnel costs could *escape* being affected by these additional reductions would be if you assume Congress would have complied with the very tight caps in current law without securing any of the massive savings required to hit those caps from reductions in pay and personnel such as those that Bowles and Simpson proposed. The fact that Bowles and Simpson believed such personnel savings would be necessary to comply with their less draconian caps shows that such an assumption is extremely implausible.

While there are a number of reasons to be skeptical of the claims made on behalf of the Senate Republican proposal, the claim that it would simply carry out a Bowles-Simpson proposal is the most far-fetched. Members of the Bowles-Simpson commission proposed that lawmakers consider freezing federal employee pay and cutting the federal workforce as one of the steps to reduce discretionary spending by \$1.3 trillion over the next ten years. It makes no sense to claim that discretionary spending would be reduced far more than what the Bowles-Simpson plan proposed (as is required under current law) *without touching* federal pay or some of the federal workforce, and thus

³ "Updated Estimates of the Fiscal Commission Proposal," Moment of Truth Project, June 29, 2011, www.momentoftruthproject.org.

that savings in these areas could allow total discretionary spending to be cut even further, by several hundred billion dollars more, without affecting discretionary programs ranging from defense and veterans programs to protecting the food and water, education, infrastructure, and various forms of assistance to the needy, among other program areas. In short, the Senate Republican proposal diverges sharply from, and is inconsistent with, what the Bowles-Simpson plan called for.

It also is important to recognize that the Bowles-Simpson plan to cut discretionary spending by \$1.3 trillion was part of an overall plan that also raised revenues by more than \$2.2 trillion (relative to a baseline that assumes the expiring tax cuts, including the Bush upper-income tax cuts, are extended) and reduced entitlement programs by close to \$800 billion — and was designed to put the budget on a sustainable path for at least the next decade so it wouldn't be necessary to come back in the next few years and find additional budget cuts. The Senate Republican payroll tax plan, in contrast, contains *no* revenue contribution and leaves several trillion dollars of deficit reduction still to do — meaning that even steeper cuts in discretionary programs would likely be made in coming years on top of the \$1.8 trillion in total cuts that would be required if the plan were enacted.

In essence, the Senate Republican payroll-tax plan is consistent not with the Bowles-Simpson plan, but with the position espoused by Grover Norquist — that taxes cannot be increased and deficit reduction must be achieved solely through spending cuts. It would represent another incremental step toward that goal and constitutes another effort to produce budget cut after budget cut while resisting any attempt to raise revenues.

Federal Pay and Workforce Reductions Pose Potential Problems

The proposal to freeze the pay of federal civilian employees through 2015 and reduce the federal workforce by 10 percent, or 200,000 employees, over the next ten years would risk diminishing the ability of federal agencies to provide crucial services and benefits. It might also save less than anticipated due to an increase in the use of federal contractors.

The pay freeze and workforce reduction would — particularly if reductions in federal retirement benefits proposed in the Bowles-Simpson plan (and included in various plans the supercommittee considered) also are enacted — make it more difficult for the federal government to attract and keep qualified workers. They also would make it harder for the remaining workers to manage the operations of the federal government effectively. It is difficult, for example, to justify cutting staffing at the Social Security Administration by 10 percent just as the baby boom generation retires in large numbers and the number of Social Security beneficiaries swells.

As long-time budget expert Stan Collender (now with Qorvis Communications) has explained, the package of federal pay, workforce, and retirement freezes and cuts in the Bowles-Simpson plan would be likely to make the federal government less productive, less efficient, and less competent in performing its work.

The plan calls for a substantial reduction in federal employees. A reduction in employees generally results in the government relying on more outside consultants to get the work done but, in addition to the recommended reductions-in-force, Bowles and Simpson also calls for significant cuts in the use of contractors.

The combination of those two seems to indicate that the now smaller number of federal employees will have to do everything that was done before, that is, that they will have to be much more productive. But Bowles and Simpson also calls for a three-year freeze on federal employee salaries, and that almost inevitably means an increasing number of federal workers will quit. That will reduce rather than increase productivity as new and less experienced workers replace the more senior folks who will have left for greener pastures.

In other words, Bowles and Simpson projects substantial savings based on the expectation that a less experienced and much smaller federal workforce will be more productive and just as effective as the more experienced and larger workforce it replaces. That makes absolutely no sense.

Stan Collender, "The Bowles-Simpson Deficit Reduction Plan Doesn't Add Up," November 11, 2010, <http://capitalgainsandgames.com/blog/stan-collender/2036/bowles-simpson-deficit-reduction-plan-doesnt-add>