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A PAY-AS-YOU-GO RULE THAT WOULD EXEMPT ALL TAX CUTS WOULD MAKE A MOCKERY OF EFFORTS TO RESTORE FISCAL DISCIPLINE

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The House of Representatives will apparently consider legislation in coming weeks that would make a number of changes in the federal budget process. It is possible that this legislation will include a provision endorsed by the House Budget Committee in 2004 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 proposal adopted by the House Budget Committee in 2004 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 once again in the President's budget for fiscal year 2007, is likely to have little effect 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 more a function of reductions in revenues than of increases in entitlement spending (see box on page 2).

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 — would add $3.3 trillion to deficits over the next ten years (including interest costs and the cost of extending Alternative Minimum Tax relief) and several trillion dollars in the decade after that.[1] Former Federal Reserve Chairman Alan Greenspan underscored the inadequacy of an entitlement-only approach to pay-as-you-go last year when he reiterated his view that the pay-as-you-go rule should be reinstated in its original form. Despite Greenspan's support for tax cuts, he called for adherence to a pay-as-you-go rule that would cover both entitlement increases and tax cuts, including extensions of the tax cuts enacted in recent years.

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 domestic spending. Analysis of Congressional Budget Office data demonstrates otherwise.

- According to CBO estimates, legislation enacted since the start of 2001 will increase the deficit by $6.2 trillion over the ten-year period, 2002 through 2011. (This assumes that the tax cuts enacted in 2001 and 2003 that are scheduled to expire under current law and Alternative Minimum Tax relief will be extended.) The CBO estimates show that tax cuts account for half of this amount.
- Increases in defense, international, and homeland security spending account for another 33 percent of the cost in 2002 through 2011 of legislation enacted since January 2001 (assuming increases in defense spending proposed by the President and a drawdown of troops in Iraq).
- By contrast, entitlement increases enacted since the start of 2001 account for only 10 percent of the cost of all legislation. The ten-year cost of the tax cuts thus is five times the cost of the entitlement expansions enacted since 2001.

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.

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

A pay-as-you-go rule that applies to legislation affecting entitlement programs but not to legislation cutting taxes 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. Requiring that increases in entitlement programs be offset while exempting expansions of tax breaks from this discipline has aspects of "Robin Hood in reverse."

[1] See Joel Friedman and Aviva Aron-Dine, "Extending Expiring Tax Cuts and AMT Relief Would Cost $3.3 Trillion Through 2016," Center on Budget and Policy Priorities, February 6, 2006.

- 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.[2]

- But the cost of other tax cuts — such as the Administration's proposals to provide 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. (Under the pay-as-you-go rule in effect in the 1990s, improvements in an entitlement program could be paid for either by a reduction in another entitlement *or* an increase in revenues. Similarly, tax cuts could be offset either by revenue-raising measures or entitlement cuts.)

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. As the Joint Committee on Taxation explained in a report issued in January 2005, "special income tax provisions are referred to as tax expenditures because they may be considered analogous to direct outlay programs, and the two can be considered as alternative means of accomplishing similar budget policies. Tax expenditures are similar to those direct spending programs that are available as entitlements to those who meet the statutory criteria established for the programs"[3] Indeed, this equivalence is why former Federal Reserve Chairman Alan Greenspan has referred to these tax breaks as "tax entitlements."

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[2] Under the proposal endorsed by the House Budget Committee in 2004, 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.

[3] Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009," January 12, 2005, p. 2.

Tax expenditures are costly. According to the JCT, the sum of the estimated revenue losses from tax expenditures totaled $914 billion in 2006.[4] The President's budget also contains a list of tax expenditures; the costs listed for these measures total $872 billion in 2007.[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.

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 less effective at reducing the ranks of the uninsured than an SCHIP or Medicaid expansion. For example, a recent study by M.I.T. economist Jonathan Gruber, one of the nation's leading health economists, found that the President's proposals to expand Health Savings Account tax breaks would cost almost $12 billion a year when fully phased in yet would actually cause a net increase in the uninsured population of 600,000 people.[6] The one-sided pay-as-you-go rules that the House Budget Committee has approved 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 Likely to Lack "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

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[4] Ibid.

[5] "Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007," February 2006. Due to interaction effects between various tax expenditure provisions, the precise total cost of all tax expenditures would vary somewhat from these JCT and OMB figures..

[6] Jonathan Gruber, "The Cost and Coverage Impact of the President's Health Insurance Budget Proposals," Center on Budget and Policy Priorities, February 15, 2006.

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, establishing a pay-as-you-go rule on entitlements alone would almost certainly reduce the likelihood of getting agreement in the near future also to apply the pay-as-you-go procedures to tax cuts. Some proponents of tax cuts might be willing to accept a pay-as-you-go constraint on tax cuts if they believe that is the only way to enact a pay-as-you-go rule that applies to entitlements. But if the pay-as-you-go regimen is instituted for entitlements alone, then tax-cut proponents will have no incentive to agree to extend the rule to tax cuts as well, and they almost certainly will work to block enactment of such an extension. 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[7] with the version approved March 17, 2004, by the House Budget Committee.

	PAYGO statute, 1991-2002	PAYGO as approved by the House Budget Committee in 2004
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).

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