

THE CONCORD COALITION



Issue brief

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The President's Statutory PAYGO Proposal

Introduction

President Obama has proposed a law requiring pay-as-you-go (PAYGO) budgeting for new entitlement spending, including health care reform, and new tax cuts, with the exception of certain existing provisions scheduled to expire. The new PAYGO law would supplement, but not replace, current House and Senate PAYGO rules. It would record the 10-year average costs and savings of new entitlement spending and tax cuts on a 5-year PAYGO ledger for fiscal years 2010-2014. If the net budgetary impact of such legislation would increase the baseline deficit for the coming year (i.e., the "budget year"), the President would be required to issue a sequestration order cutting non-exempt entitlement programs for that year.

The Concord Coalition supports statutory PAYGO as an additional enforcement tool to promote fiscal responsibility. It is important to recognize, however, that simply paying for new initiatives will not be sufficient to remedy the nation's unsustainable fiscal path. For that critical task, policymakers must go beyond PAYGO by reducing projected spending and raising additional revenues.

In assessing the President's proposal, here are five key points to keep in mind:

- PAYGO is a mechanism to encourage hard choices on entitlements and taxes.
- PAYGO is designed to stabilize, not reduce, the deficit.
- PAYGO is not a spending freeze.
- PAYGO is not a substitute for political will.
- PAYGO exemptions are not free and come at a high price.

Background

An assessment of the President's statutory PAYGO proposal must begin with an understanding of PAYGO's value and limitations. History has shown that PAYGO is most effective when used to enforce an agreed upon policy goal and less effective as a goal itself.

PAYGO first appeared in the Budget Enforcement Act of 1990 (BEA), negotiated between Republican President George H. W. Bush and the Democratic leaders of Congress. In its original form, PAYGO was a statutory requirement providing that any legislation to lower revenues or expand entitlement spending be offset with

corresponding revenue increases or entitlement spending cuts. Its basic purpose was not to balance the budget, but to enforce a specific deficit reduction agreement between the President and Congress. As described by former CBO Director Douglas Holtz-Eakin, “Lawmakers set rules that would hold them accountable for changes in the deficit due to new legislation -- but not for the budgetary effects of economic and other factors outside of their immediate control.”¹

The law required that cumulative legislation, tabulated on a “PAYGO scorecard,” be deficit-neutral. Violations of PAYGO were to be enforced by across-the-board cuts in non-exempt entitlement spending, referred to as “sequestration.” During its existence from 1991 through 2002, no sequestrations were implemented. This was due, in part, to PAYGO compliance and, when budget surpluses emerged, to congressional actions overriding sequestration.² PAYGO advocates believe that the very existence of the law, including the threat of sequestration, helped to prevent deficit-increasing legislation — at least until the time when budget surpluses eroded the consensus in favor of such strict fiscal limitations.

PAYGO did not apply to increases in discretionary spending (appropriations), which were controlled by spending caps enforced through a separate sequestration process. The law permitted emergency exemptions from both PAYGO and discretionary spending caps.

PAYGO was extended in the 1993 deficit reduction legislation and again in the 1997 Balanced Budget Act -- when it was extended through 2002. A PAYGO rule was also adopted in the Senate that required deficit neutrality over three time frames: the first year, the first five years, and the subsequent five years. In 2002, statutory PAYGO was allowed to expire as the Bush Administration and many Republicans in Congress worried that the law would be an impediment to permanent extension of the expiring 2001 tax cuts. A new Senate PAYGO rule was approved exempting any policies assumed in the Budget Resolution, including new tax cuts and the Medicare prescription drug benefit which greatly expanded the deficit.

In 2007, the House adopted a PAYGO rule for the first time and the Senate amended its PAYGO rule to eliminate the exemption for policy costs assumed in the Budget Resolution. The House rule requires that individual pieces of legislation must be deficit-neutral over both a six-year and an 11-year window, beginning with the current year. The Senate rule now applies the same time frame but allows legislation enacted during the year reducing the deficit to offset other legislation increasing it. Both rules are somewhat weaker than the original statutory PAYGO because they do not require deficit neutrality in the first year, they are not self-executing (meaning that a point of order must be raised

¹ Statement of Douglas Holtz-Eakin, *Reforming the Federal Budget Process*, House Committee on Rules, Subcommittee on Legislative and Budget Process, March 23, 2004, p.4.

² The largest such action took place following passage of the 2001 tax cuts when Congress enacted legislation directing that no sequestration take place. This had the effect of allowing the tax cuts to take effect without PAYGO offsets.

to invoke the rule), and they do not carry the threat of sequestration which requires a statutory mechanism.

The President’s Proposal

Many features of the President’s statutory PAYGO proposal mirror the original version of statutory PAYGO: the law would apply to new entitlement spending and tax cuts and would be enforced by sequestration in non-exempt entitlement programs.

Each year, the 10-year average annual cost of legislation subject to PAYGO would be estimated by the President’s Office of Management and Budget (OMB) and placed on a PAYGO ledger for the five years covered by the law (FY 2010-2014). This is a change from the prior law, which recorded the projected costs or savings for *each year* on the PAYGO scorecard and required that each year’s cumulative effect not add to the deficit. Averaging permits higher deficits in early years if savings balance them off over the 10-year window. It also permits costs to trend higher than savings at the end of the period — a sign of trouble ahead — if savings outpace costs earlier. On the other hand, policies with backloaded 10-year effects (costs or savings) would have some of those effects moved forward so as to show up on the 5-year PAYGO ledger.

The following table is designed to illustrate how averaging might appear on a hypothetical PAYGO ledger. Obviously, many variations are possible:

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2010-2014	2010-2019
Projected Costs	-25	-25	-30	-50	-60	-70	-80	-90	-95	-105	-190	-630
Projected Savings	5	20	50	60	70	75	80	85	90	95	205	630
Resulting Balance	-20	-5	20	10	10	5	0	-5	-5	-10	15	0
10-yr. average (-)	-63	-63	-63	-63	-63							
10-yr. average (+)	63	63	63	63	63							
Resulting Balance	0	0	0	0	0							

The PAYGO ledger ends in 2014 and only applies to legislation enacted through 2013, meaning that unless the ledger is extended, costs beyond 2014 would not be included except to the extent that they are moved forward through 10-year averaging.

Two provisions of the law address gaming of the system. One of these would apply PAYGO to the outyear costs (beyond the budget year) of new mandatory spending added to an appropriations bill and counted as discretionary spending. The other would ignore timing shifts that artificially move costs outside the 10-year window or move savings forward from outside the window. These provisions are aimed at preventing scoring maneuvers that have been used in the past to evade PAYGO.

If the PAYGO ledger shows an increase in the baseline deficit for the coming (budget) year, the President would be required to issue a sequestration order at the end of the

congressional session eliminating that deficit. The list of programs exempt from sequestration is quite large, as it was in the prior version of statutory PAYGO. It encompasses more than 90 percent of mandatory spending, including Social Security, Medicaid, SCHIP, food stamps, Temporary Assistance to Needy Families (TANF), refundable Earned Income Tax Credits (EITC), most veterans programs, and Supplemental Social Insurance (SSI). Medicare is subjected to sequestration, but as in the former law, a cap of 4 percent is set — meaning that 96 percent of Medicare spending is exempt.

In a major change from the former law and the current House and Senate rules, the President’s proposal would specifically exempt certain policies from PAYGO:

- Extension of the 2001 and 2003 tax cuts
- Maintaining the 2009 estate tax levels
- Relief from the AMT, and
- Avoidance of scheduled cuts in physician payments under Medicare’s sustainable growth rate provision (SGR).

The budgetary impact of extending all these policies over 10 years without offsets is roughly \$3.5 trillion. To be clear, the law does not make these expiring policies permanent. Legislation would still need to be enacted for that purpose. What the law would do is exclude the costs of such legislation from the PAYGO ledger. In other words, for purposes of PAYGO, but not for the deficit, these costs would disappear.

Much of the commentary, pro and con, regarding the President’s proposal misses the mark because it misses the essential purpose of statutory PAYGO. The law would not be as powerful as its advocates sometimes claim, nor as meaningless as its detractors often allege. The following points should be kept in mind when assessing this proposal:

PAYGO is a mechanism to encourage hard choices on entitlements and taxes.

Statutory PAYGO does not prevent Congress from passing tax cuts and entitlement spending increases. Rather, it simply requires that if Congress wants to do these things it must do so in a deficit-neutral way. Given the dire fiscal outlook over the next 10 years, this should not strike anyone as an unreasonable burden. Few contest the fact that current fiscal policies are unsustainable. It is thus a matter of common sense to require those who want to enact new tax cuts or entitlement expansions — which would enlarge the structural deficit — to put forward spending cuts or tax increases necessary to pay for them. In short, PAYGO requires anyone proposing tax cuts or entitlement expansions to answer the question: “How would you pay for it?” Going through this process would force an explicit trade-off between spending, taxes and debt, which is exactly the priority setting exercise that the budget process should facilitate.

Some have argued that PAYGO should only apply to spending increases and not tax cuts. This would be a mistake. Fiscal discipline is a commitment that must apply to the budget as a whole in order to be effective. Any legislation that would increase the deficit should

be part of the enforcement mechanisms. Since spending and tax decisions both affect the bottom line, there is no compelling reason to exempt either from enforcement rules. Moreover, exempting tax cuts from PAYGO would encourage an expansion of so-called “tax expenditures” where benefits are funneled through the tax code rather than by direct spending. Finally, exempting tax cuts from PAYGO would encourage the false notion that debt is a painless alternative to taxes.

A related issue is whether PAYGO is biased in favor of spending provisions which, for the most part, are assumed to continue in the baseline beyond any legislated expiration date whereas tax cuts with a sunset are assumed to expire as scheduled. To a large extent, the President’s proposal concedes this point by exempting expiring tax cuts such as AMT relief and the 2001 and 2003 tax cuts from PAYGO. In the future, it will be important to ensure that both entitlements and tax cuts are fully paid for at the time of enactment. If a policy is assumed to continue in the baseline it should be paid for based on that assumption. Allowing a policy to be scored based on a sunset while assuming ongoing costs in the baseline, without offsets beyond the sunset, would allow those costs to avoid PAYGO. The key point is that the baseline treatment and the PAYGO scoring system should be consistent.

Reinstating statutory PAYGO, and applying it to both entitlement spending and tax cuts, would help to enforce fiscal discipline by giving policy makers an incentive — avoiding sequestration — to ensure that new entitlement and tax policies do not increase the deficit. While budget rules alone will never be able to solve the nation’s fiscal problems, enforcement mechanisms such as statutory PAYGO can bring greater accountability to the budget process and help provide Members of Congress with the political cover to make tough choices.

PAYGO is not a deficit reduction tool.

As noted above, the purpose of PAYGO is to provide an incentive for making hard choices. Its purpose is not to shrink the deficit, but to prevent any given baseline deficit from getting worse through new entitlements or tax cuts. Thus, PAYGO should not be deemed a failure if the baseline deficit does not come down, or even if it goes up for reasons beyond its scope, such as discretionary spending increases or a shrinking economy. Similarly, PAYGO should not be deemed a success simply because the deficit comes down through lower discretionary spending or a strong economy. The test of PAYGO is whether it prevents new entitlements and tax cuts from enlarging the deficit.

Even strict adherence to PAYGO, however, only prevents further damage. It may keep us from digging a deeper fiscal hole, and so constitutes an important first-line firewall. But it won’t help us climb out of the hole we are already in. PAYGO is not, therefore, an excuse for avoiding programmatic reforms. Such reforms could take many shapes. We could begin to control costs by raising eligibility ages, means-testing benefits, or introducing “demographic stabilizers” that index benefits to changes in the ratio of contributors to beneficiaries—as many countries, including Germany, Japan, and Sweden, have recently done. For health benefits, we could begin to control costs by

implementing a global budget for health-care spending, changing payment incentives to reward quality of care rather than volume, and by researching and mandating best-practice standards. We should also reassess tax breaks that funnel benefits through the tax code and look for other ways of raising revenues while promoting economic efficiency.

PAYGO would not make any of these hard choices easier but it would highlight the need to make trade-offs and may thus create an environment where programmatic reforms are more likely to occur.

PAYGO is not a spending freeze.

Critics of PAYGO often point out that it that does not prevent spending from going up. That is true, but irrelevant to PAYGO's essential purpose. PAYGO does not, and never has, applied to discretionary spending (about 32 percent of the budget). Nor does PAYGO apply to automatic increases in current entitlement programs and tax expenditures. That is why PAYGO should not be considered a cure-all for what ails the budget. Additional tools are needed.

In Concord's view, budget enforcement rules should apply to all parts of the budget — taxes, entitlements and discretionary appropriations. Excluding any part of the budget from discipline, including automatic growth in current entitlements and tax expenditures, will inevitably lead to that part of the budget becoming an escape valve from fiscal discipline. That is no reason, however, to reject a rule that would impose discipline where it could do some good. Complaining that PAYGO will not prevent problems in existing entitlement obligations or discretionary spending is like complaining that your blood pressure medicine will not control your cancer and gout. Remedies should be judged by what they are designed to do.

PAYGO is not a substitute for political will.

While PAYGO can provide positive incentives for fiscally responsible action, it is not a substitute for political will. Unfortunately, recent history is replete with examples of PAYGO being waived, ignored, or in the case of sequestration, canceled. No enforcement mechanism will succeed over the long-term if Congress refuses to live by it. On the other hand, no enforcement mechanism will succeed if it is not tried.

Moreover, some of PAYGO's biggest "failures" need to be considered in context. For example, when Congress passed a major tax cut in 2001 and canceled the sequestration that would have occurred otherwise, the budget was projected to have a \$5.6 trillion *surplus* over the coming decade. Today, CBO projects a baseline *deficit* of \$4.4 trillion (over 10 years) even if all expiring provisions, including the policy exemptions contained in the President's proposal, are allowed to expire on schedule. Clearly, the perceived need for strict enforcement of budget rules is stronger now than it was in 2001.

Two other major exemptions took place in recent months when Congress passed the \$700 billion Troubled Asset Relief Program (TARP) and an economic stimulus package of

\$787 billion. The House and Senate PAYGO rules were not applied to either bill because they were declared to be emergencies. However, there was little dispute that an economic emergency really did exist. Speed was imperative and in the case of the economic stimulus bill, the main point was to prop-up lagging demand by increasing government spending and by cutting taxes — in other words, by increasing the deficit.

It is true that the bills could have, and ideally should have, required offsets in the outyears when the economy will presumably have recovered. Yet, the circumstances were hardly normal and do not establish that PAYGO is a meaningless speed bump.

PAYGO exemptions come at a high price.

The most troubling aspect of the President’s proposal is the \$3.5 trillion of exemptions it would provide for existing policies. While it is true that these exemptions recognize political reality, it is also true that extending these policies without offsets will leave the budget in far worse shape than if they were paid for. A recent analysis by Alan Auerbach and William Gale finds that extended Bush Administration policies are responsible for 5 percentage points of the 7-9 percent of GDP long-term “fiscal gap.” About exempting the 2001 and 2003 tax cuts from PAYGO, Gale and Auerbach remark that:

The Administration’s willingness to adopt a baseline that extends the Bush tax cuts is no minor matter and it colors several issues...Now that even the CBO baseline projection is for large deficits throughout the ten-year budget period, it does not seem obvious that the tax cuts should be extended. It certainly is not obvious that the extension should be incorporated into the Administration’s baseline.³

Regardless of political reality, the economic reality remains the same. Persistent deficits of the size now projected under the President’s budget, which assumes these PAYGO exemptions, would harm the economy, increase our reliance on foreign borrowing, crowd out domestic investments, and lead to a spike in interest costs. Thus, if statutory PAYGO is adopted in the form currently proposed, policymakers must acknowledge the economic consequences of its exemptions and be prepared to deal with them. The \$3.5 trillion cost of these policies will not go away simply because they are exempted from PAYGO. If not paid for now, they will be paid for later at a higher cost in interest payments and a less robust economy.

As Gale and Peter Orszag (now OMB Director) wrote in a 2004 Brookings Institution analysis: “Making the tax cuts permanent is likely to reduce, not increase, national income in the long term unless the reduction in revenues is matched by an equal reduction in government consumption. And even in that case, a positive impact on long-

³³ Alan J. Auerbach and William G. Gale, *The Economic Crisis and the Fiscal Crisis: 2009 and Beyond*, June 2009, page 12.

term growth occurs only if the spending cuts occur contemporaneously, which has decidedly not occurred, or if models with implausible features ... are employed.”⁴

Another downside of these PAYGO exemptions is that they would substantially weaken what could be an inducement for broad reforms of the tax code. As explained in an earlier Concord Coalition issue brief:

President Obama and the 111th Congress will face an “action forcing event” regarding tax policy almost immediately: the expiration of the 2001 and 2003 tax cuts on December 31, 2010. The expiration of the tax cuts combined with a recovering economy should force policymakers, faced with the reality of a growing fiscal shortfall, to seek a more sustainable revenue policy going forward. Ideally, they will reform the federal tax system in ways that improve economic efficiency, enhance revenues and achieve the desired degree of progressivity at the same time. Increasing revenues as a share of the economy need not discourage economic growth. To the extent that the tax system can be made more efficient by broadening its base--through closing loopholes, reducing tax entitlements and newly taxing activities that generate social costs--marginal tax rates on productive activities would not have to rise by as much.⁵

A similar argument can be made with regard to the Medicare physician payment system, which is badly in need of reform.

Conclusion

While enacting statutory PAYGO would be a positive development, its effects should not be overestimated. At best, PAYGO is intended to stop the fiscal bleeding and, in this case, the exempted policies allow for a lot of blood loss before the tourniquet is applied. The most immediate benefit of the new law would be to reinforce the President’s commitment to pay for health care reform. This is extremely important and a minimum requirement for fiscal responsibility.

Finding a cure for the nation’s dire fiscal outlook will obviously require a lot more than a new budget rule, but enactment of statutory PAYGO would send a very positive signal that the federal government is beginning to take the problem seriously. This is not a distant future concern. It has immediate consequences for economic recovery efforts, which have greatly expanded our borrowing needs. With financial markets increasingly skeptical about the federal government’s dedication to restoring fiscal discipline once a recovery is underway, we cannot pretend that our ability to borrow cheaply from the rest

⁴ William Gale and Peter Orszag, *Bush Administration Tax Policy: Effects on Long-Term Growth*, (October 18, 2004). The authors note a distinction between the effects of tax cuts on short-term stimulus and long-term growth.

⁵ *Designing a Framework for Economic and Fiscal Sustainability*, January 28, 2009.

<http://www.concordcoalition.org/issue-briefs/2009/0128/designing-framework-economic-recovery-and-fiscal-sustainability>.

of the world to finance our rising debt will persist regardless of our unwillingness to impose long-term fiscal restraint.

Even before the current economic downturn and spike in U.S. debt, the growing awareness that America is living beyond its means, both publicly and privately, had begun to erode confidence in our long-term economic future—and had prompted warnings from international agencies such as the International Monetary Fund about the “irresponsibility” of U.S. fiscal policy that are usually reserved for developing nations. If the administration and Congress do nothing to restore fiscal trust, world markets may lose faith (exactly when cannot be predicted) that U.S. Treasuries are the safe haven they have traditionally been.

But sending signals is not enough. Policymakers must begin forcing the kind of trade-offs that were not made when large deficit-financed tax cuts and entitlement expansions were enacted in the face of alluring, if illusory, budget surpluses, and after the old PAYGO law expired.

The Concord Coalition supports statutory PAYGO and would prefer that the rule not grant a blanket exemption to expiring policies. However, the rule must be assessed for what it is, not for what it isn't. PAYGO is not a deficit reduction tool. It is not a spending freeze. It does not apply to discretionary spending or automatic increases in entitlement programs. Holding PAYGO to a standard that assumes it is intended to do all these things (reduce the deficit, freeze spending, control “pork barrel” appropriations or rein in entitlements) sets up a conclusion that the rule would do no good. That is a false standard. PAYGO's real value comes from its *deterrent effect* on entitlement expansions and tax cuts that would widen our structural deficit. This is certainly worth doing, even if other things are left to be done.